TURKEY

Highlights

- **Economic growth moderated to 2.9 per cent in 2014 and remains below its potential in 2015.** Growth in 2014 was driven by net exports, a positive development in view of external current account vulnerabilities, although the contribution of net exports moderated towards the end of 2014 and early 2015 amid continuing weakness in the eurozone, geopolitical tension in the Middle East and the recession in Russia.
- **Structural reforms slowed in the past two election years.** The structural reform priorities include: increasing labour market flexibility; reducing energy dependence; improving regional infrastructure; enhancing private sector competitiveness; deepening local capital markets; and promoting regional, gender and youth inclusion.
- **Reforms to the energy sector progressed moderately over the past year.** Despite some initial delays, electricity distribution grids are now fully privatised, but the public sector's share in electricity generation remains high. The government, with the support of the EBRD, finalised the National Renewable Energy Action Plan in 2014, and is developing a National Energy Efficiency Action Plan.

Key priorities for 2016

- **Reform of the energy sector should be further intensified**. While steps have been taken to move towards a better functioning and more transparent energy market, progress towards liberalising the natural gas market should be accelerated, and support to the renewable energy sector should continue, while avoiding market distortions.
- **Despite some improvements in the business environment, further efforts are needed.** Turkey still scores relatively poorly on business climate indicators compared with its European peers, receiving particularly low scores in starting a business, dealing with construction permits and resolving insolvency procedures. Improvements in justice legislation and practice are needed, while the fight against corruption remains a key challenge.
- **Efforts to encourage efficient intermediation of long-term funds should be escalated.** Attracting domestic long-term funds into financial intermediation and local currency capital markets would ease the dependence on foreign borrowing and make investment decisions less exposed to global liquidity conditions.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	8.8	2.1	4.2	2.9	3.0
Inflation (average)	6.5	8.9	7.5	8.9	7.5
Government balance/GDP	-1.4	-2.0	-1.2	-1.3	-1.1
Current account balance/GDP	-9.7	-6.2	-7.9	-5.7	-4.5
Net FDI/GDP (neg. sign = inflows)	-1.8	-1.2	-1.1	-0.7	-0.9
External debt/GDP	39.2	43.0	47.3	50.4	n.a.
Gross reserves/GDP	11.4	15.1	15.9	15.9	n.a.
Credit to private sector/GDP	53.1	57.9	70.1	74.5	n.a.

CONTINUES

Macroeconomic performance

Turkey's economic growth slowed over the past year. The economy grew by 2.9 per cent in 2014 on the back of net exports. In the second quarter of 2015, domestic demand was the main driver of growth, while net exports remained subdued amid elevating regional political uncertainty and external demand weakness, resulting in a year-on-year GDP growth of 3.8 per cent. Meanwhile, inflation remained high at 7.9 per cent in September 2015 well above the central bank's target of 5 per cent for the fourth consecutive year. Despite the fall in commodity and oil prices, their pass-through to inflation remained limited due to ongoing currency pressures bolstering inflation.

Currency volatility returned at the end of 2014. After a period of some stability in the second half of 2014, the lira weakened against the dollar by a cumulative 35 per cent year-on-year by the end of August 2015. This was due to the expected US monetary tightening and elevated domestic political uncertainty amid the inconclusive June parliamentary elections. Versus the euro, however – the currency of Turkey's major trading partner – the depreciation of the lira was 15.5 per cent in the same period, implying some limited improvement in trade competitiveness. The currency pressure occurred against the background of falling net international reserves and rising net open foreign currency positions of non-financial corporations.

Large external vulnerabilities remained but public finances and banks remained stable. The declining energy import bill, due to lower oil prices, and the boost from the weaker lira to net exports, helped ease the current account deficit to 5.7 per cent of GDP in 2014, from 7.9 per cent in 2013. But the country continues to rely on volatile portfolio inflows to meet its large external financing needs, leaving it exposed to global liquidity conditions, including tightening by the US Federal Reserve. On a positive note, government finances are still under control, with public debt around 33 cent of GDP in 2014, albeit rising in 2015, and the banking sector is broadly healthy, with low non-performing loans (NPLs) and comfortable capitalisation levels, albeit with banks increasingly relying on external foreign-currency funding.

Growth is expected to continue at a similar pace of around 3.0 per cent in 2015 and 2.8 per cent in 2016. As the positive effect of lower oil prices is offset by weaknesses in external demand, Turkey is expected to grow at around 3.0 per cent in 2015 and 2.8 per cent in 2016. Expectations of monetary tightening in the United States, rising geopolitical tensions in the Middle East, elevated domestic political uncertainty following the inconclusive June parliamentary elections, and limited room for interest rate cuts (given Turkey's high dependence on capital inflows) are all likely to keep growth below its long-term potential. To achieve higher growth rates, sophisticated structural changes and institutional improvements, many of them outlined in the development plan, will need to be carried out. However, the pace of structural reform has stalled over the past two years and may not quickly recover, given increased domestic political uncertainty.

Major structural reform developments

Progress on improving the business climate across sectors has been mixed. In the World Bank's *Doing Business 2016* report, Turkey ranked 55th out of 189 countries, with a slight drop from last year's ranking, receiving particularly low scores in starting a business, dealing with construction permits and resolving insolvency procedures.

Reforms in the energy sector have been slow over the past year. The establishment of the Energy Market Operation Joint Stock Company (EPIAS), a big step towards liberalisation of Turkey's wholesale power market, was finalised in March 2015. EPIAS has introduced an intra-day market for power producers, allowing producers more efficient production planning. Despite some initial delays, electricity distribution grids are now fully privatised but the public sector still has a one-third share in electricity generation. Meanwhile, progress towards liberalising the natural gas market, through lowering the monopolistic market share of state-owned Petroleum Pipeline Corporation (BOTAS), has remained slow. While financial incentives and price guarantees have boosted investments in the renewable energy sector, some of these incentives, such as bonus payments for locally sourced content, may be distortive. The government, with the support of the EBRD, finalised the National Renewable Energy Action Plan in 2014, and is developing a National Energy Efficiency Action Plan.

CONTINUES

Measures to liberalise transport and infrastructure have been undertaken. A law was adopted in 2013 to liberalise the rail transport sector, but secondary legislations and by-laws have not yet been prepared. Although some legal arrangements were made in 2013 to privatise highways and bridge crossings, and related communiques have been issued in 2014, the efforts towards privatisation remained limited. Two airports, Bodrum and Dalaman, were privatised via transfer of operating rights in 2014 and financing agreements were signed in late 2014. Large public transport and infrastructure projects continue to be implemented, some under public-private partnership (PPP) structures. In order to support ongoing projects and share the risk with investors, the Turkish Treasury has defined the modalities and standards of providing guarantees to international funding for PPPs.

Private sector involvement in health sector projects has increased. In 2014, an amendment to enhance the bankability of draft PPP project agreements was added to the PPP law that was introduced in 2013. As a result, since December 2014, financial agreements have been signed for six projects. Capacity building efforts to design the methodology for value-for-money assessments for future PPP projects and to establish a PPP contract monitoring unit within the Ministry of Health have also been carried out.

Agribusiness potential remains under-used. The lack of proper irrigation, the relatively small and uneconomic size of individual family-owned farms, under-supply of capital for using modern production inputs, techniques and machinery and lack of long-term financing options, particularly for small and medium-sized enterprises (SMEs), prevent the country from realising its agribusiness potential. The total level of state support in agriculture remains moderate, despite a highly complex support system.

Reforms towards commercialisation and corporatisation of key utilities in mid-sized and smaller municipalities are slow. Regional economic disparities have highlighted the need for more regional investments and fiscal decentralisation. Lending to mid-sized and smaller municipalities remains difficult. Investment planning for local infrastructure remains highly centralised and delivery of capital investments is slow. Reforms to commercialise and corporatise key utilities in smaller municipalities are not fully undertaken, and these municipalities remain dependent on concessional state finance.

Efforts to attract long-term funds into financial intermediation and local currency capital markets should be enhanced. Turkey has a relatively low domestic savings rate which increases its dependence on foreign borrowing, making investment decisions more exposed to capital inflow cycles and external liquidity conditions. Despite reasonably functioning financial markets for short-term lending, there is a lack of efficient intermediation of long-term funds and there is no market-relevant floating rate index. The lira money market lacks a fully liquid benchmark, despite relatively abundant foreign exchange liquidity. The number and size of long-term domestic institutional investors is small and there is limited foreign participation in the corporate bond market, which is still in its early development stage. Some policies in the right direction have been implemented over the past couple of years, such as the new Capital Markets Law, the establishment of Borsa Istanbul, or the new private pension incentive scheme, but further efforts are needed.

Despite reforms to improve regional, gender and youth inclusion, challenges remain. Although several goals to improve labour market conditions were identified in the 2014-18 Strategic Plan of the Ministry of Labour and Social Security, major inefficiencies remain. Opportunities to move into formal salaried jobs remain limited in poorer regions, which already have lower employment rates and productivity levels than the more developed regions. Despite improvement recorded over the past decade, the female labour participation rate still remains one of the lowest in the OECD, below 34 per cent in 2014. Youth access to education, training opportunities and financial services lags behind the more developed economies, and improvements remain a challenge.