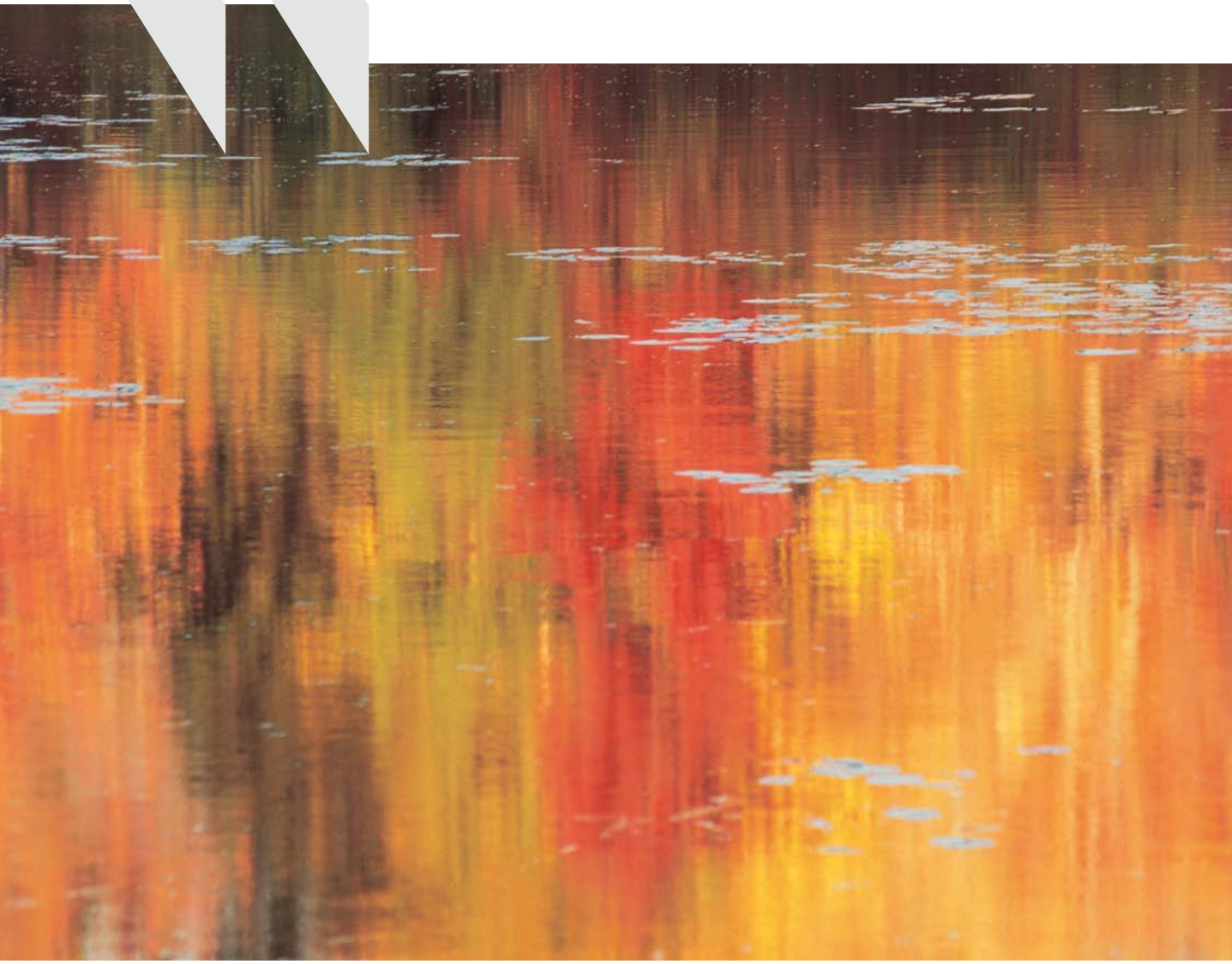
OECD Economic Surveys

TURKEY



Volume 2010/13
September 2010

OECD Economic Surveys: Turkey 2010



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Commission of the European Communities takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

ISBN 978-92-64-08304-2 (print)
ISBN 978-92-64-08305-9 (PDF)

Series: OECD Economic Surveys
ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

OECD Economic Surveys Turkey
ISSN 1995-3429 (print)
ISSN 1999-0480 (online)

Also available in French.

Photo credits: Cover © Comstock/Comstock Images/Getty Images.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Corrigenda to OECD publications may be found on line at: *www.oecd.org/publishing/corrigenda*.

© OECD 2010

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to *rights@oecd.org*. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at *info@copyright.com* or the Centre français d'exploitation du droit de copie (CFC) at *contact@cfcopies.com*.

Table of contents

Executive summary 8

Assessment and recommendations 9

Chapter 1. **After the crisis: ensuring sustained recovery and mitigating future macroeconomic volatility** 19
Turkey was markedly affected by the 2008-09 recession. 20
Recovery is in train and prospects for 2010-11 are brighter 29
Monetary and fiscal policy exit challenges 30
Mitigating risks of macroeconomic instability 35
Policy recommendations 40
Notes 41
Bibliography 42
Annex 1.A1. Explaining recent GDP dynamics 45
Annex 1.A2. Current account deficit and external debt simulations with accelerating domestic demand 47
Annex 1.A3. Empirical determinants of saving 51
Annex 1.A4. Recent trends of public finances 54

Chapter 2. **Fostering sound integration with the global capital market** 59
Turkey's terms of access to international capital markets have improved 60
Capital costs are declining 62
Macroeconomic and institutional credibility accelerates convergence. 64
Credit ratings bear on international capital market standing. 67
Other enhancements in international capital market status would bring additional benefits 77
Fostering sound integration with the global capital market 78
Policy recommendations 88
Notes 90
Bibliography 91
Annex 2.A1. Estimated models for EMBI spreads and credit ratings. 96
Annex 2.A2. Lessons from Turkey's past experience with multi-year fiscal planning 100
Annex 2.A3. Some challenges of comprehensive general government accounting according to recent experience 103
Annex 2.A4. Experience of OECD countries with fiscal policy councils 107

Chapter 3. **Regulatory reforms to unlock long-term growth** 109
Performance has been strong in the 2000s but the income gap remains large 110
Labour market reforms are indispensible 116
Product market regulations hold back productivity 123
Benefits of labour and product market reforms are large 130
Policy recommendations 131
Notes 132
Bibliography 133
Annex 3.A1. The impact of the 2003 labour law change on job creation 135
Annex 3.A2. Progress with structural reform: follow-up to OECD policy recommendations 137
Annex 3.A3. Illustrative long-term growth scenarios 141

Boxes

1.1. Policies to increase saving 38
1.2. Macroeconomic policy recommendations 40
2.1. Impact of integration with the global capital market on catching-up economies 61
2.2. What determines emerging countries' risk premia? 64
2.3. How do rating agencies rank emerging markets and Turkey? 68
2.4. Turkey's perceived strengths and weaknesses 71
2.5. Findings on the determinants of credit ratings 74
2.6. Additional emphasis on fiscal transparency 76
2.7. Upgrading Turkey from "Secondary emerging" to "Advanced emerging" indexes 77
2.8. The new fiscal rule 79
2.9. Lessons for implementing fiscal rules 80
2.10. Ambitions and challenges of high quality general government accounting . . . 83
2.11. Fostering sound integration with the global capital market 89
3.1. Lessons from recent OECD labour market reforms 119
3.2. The political economy of labour market reforms 121
3.3. Real estate planning and construction permits 127
3.4. Handling the labour market impact of privatisation 128
3.5. The Coordination Council for the Improvement of the Investment Environment (YOIKK) 129
3.6. Reforming regulations to unlock long-term growth 131

Tables

1.1. Recent macroeconomic developments and near-term prospects 21
1.2. Fiscal stimulus measures 25
1.3. Fiscal targets of the Medium Term Programme 32
1.A2.1. Assumptions underlying medium-term simulations of the current account balance and external debt 49
1.A3.1. Saving model results 52
2.1. Current credit ratings of emerging markets 70
2.2. Advanced, Advanced emerging, Secondary emerging and Frontier countries in FTSE indexes 78
2.3. Foreign exchange operations by the CBRT (USD million) 88

2.A1.1. Definitions of models' variables 97
2.A1.2. Estimation results for EMBI spreads. 97
2.A1.3. Estimation results for Standard & Poor's credit rating 98
2.A2.1. Variations in tax rates 101
3.A2.1. Follow-up to OECD policy recommendations 137
3.A3.1. Assumptions of GDP growth scenarios 142

Figures

1.1. Synchronisation of the global recession 22
1.2. Key macroeconomic indicators. 23
1.3. General government balance in the crisis. 26
1.4. Comparing Turkish recessions 27
1.5. Risk premia in emerging economies 28
1.6. Monetary policy. 31
1.7. Medium-term fiscal objectives 33
1.8. External imbalances 36
1.A1.1. Conditional in-sample forecasts of real GDP 46
1.A2.1. Differences in current account and foreign debt simulations with accelerating domestic demand 49
1.A4.1. Size and structure of general government 55
1.A4.2. General government spending and revenue. 56
2.1. Gross capital flows to emerging markets and Turkey 60
2.2. Investment-saving gap in selected countries 62
2.3. Lower country risk premia in emerging markets. 63
2.4. Real long-term interest rates in selected countries 63
2.5. Actual and estimated country risk premia 65
2.6. Main determinants of Turkey's and selected countries' risk premia 66
2.7. Moody's scoring map and Turkey's position 69
2.8. Rating upgrades of emerging markets and Turkey in the 2000s 70
2.9. Credit rating and risk premia 73
2.10. Structure of main general government spending and revenue 82
2.A1.1. Actual and estimated credit ratings. 98
2.A1.2. Estimated contributions to credit ratings 99
2.A2.1. Objectives and outcomes: recent experience 102
3.1. Evolution of GDP per capita growth and its components 111
3.2. The income gap remains large 112
3.3. Structural deficiencies in the labour market 113
3.4. The skewed distribution of labour productivity. 115
3.5. Restrictive product market regulations 124
3.6. International comparison of selected electricity and telecommunication prices. 125
3.A1.1. Impact of reform on hiring probability (in percentage points) and weekly hours (in per cent). 136
3.A3.1. Long-term scenarios of potential output growth 142

This Survey *is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

The economic situation and policies of Turkey were reviewed by the Committee on 23 June 2010. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 July 2010.

The Secretariat's draft report was prepared for the Committee by Rauf Gönenç, Łukasz Rawdanowicz, Saygin Şahinöz and S. Özge Tuncel, under the supervision of Andreas Wörgötter. Research assistance was provided by Béatrice Guérard.

The previous Survey of Turkey *was issued in July 2008.*

Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at www.oecd.org/eco/surveys.

This book has...



StatLinks

A service that delivers Excel® files from the printed page!

Look for the *StatLinks* at the bottom right-hand corner of the tables or graphs in this book.
To download the matching Excel® spreadsheet, just type the link into your Internet browser, starting with the ***http://dx.doi.org*** prefix.
If you're reading the PDF e-book edition, and your PC is connected to the Internet, simply click on the link. You'll find *StatLinks* appearing in more OECD books.

BASIC STATISTICS OF TURKEY (2009)

THE LAND

Area (thousand km^2):		Major cities (thousand inhabitants):	
Total	785	Istanbul	12 915
Agricultural area	245	Ankara	4 651
Forests	212	Izmir	3 868

THE PEOPLE

Population (million)	72.6	Civilian labour force (million)	25.2
Inhabitants per km^2	92.4	Civilian employment (million)	21.3
Annual rate of change of population, 1999-2009	1.4	Agriculture, forestry, fishing	5.3
		Industry	4.1
		Construction	1.2
		Services	10.6
		LFS unemployment rate (% of the labour force)	13.7

PRODUCTION

Gross domestic product (TRY billion)	954	Origin of GDP (% of total value added):	
Per head ($ PPP)	13 054	Agriculture, forestry, fishing	9.1
Gross fixed investment (TRY billion)	161	Industry	25.0
Per cent of GDP	16.8	Services	66.0
Per head ($ PPP)	2 198		

THE GOVERNMENT

Public consumption (% of GDP)	14.7	Gross public debt (% of GDP)	48.8
Central government current revenue		Domestic	36.4
(% of GDP)	22.5	Foreign	12.4

FOREIGN TRADE

Exports of goods and services (% of GDP)	23.2	Imports of goods and services (% of GDP)	24.3
Main exports of goods (% of total):		Main imports of goods (% of total):	
Road vehicles	11.6	Petroleum	10.8
Articles of apparel and clothing accessories	11.3	Gas	8.2
Iron and steel	8.9	Road vehicles	6.2
Textile	7.6	Iron and steel	5.4
Other exports	60.6	Other imports	69.4

THE CURRENCY

Monetary unit: Turkish lira		Currency units per $ (period average):	
		Year 2009	1.55
		June 2010	1.57
		Currency units per € (period average):	
		Year 2009	2.15
		June 2010	1.92

Executive summary

Turkey was directly affected by the global crisis, but showed considerable resilience thanks to important reforms implemented after the 2001 crisis. The adverse external shock originating in financial market turmoil and propagated by a sudden collapse of world trade was amplified by domestic confidence effects. With the experiences of the 2001 banking crisis fresh in mind, companies and households cut investment and durable goods consumption. The strong macroeconomic policy framework provided support for the economy. Moreover, confidence building and credibility were considered more important than a possibly short-lived fiscal stimulus. Now, with the recovery under way, a golden opportunity for structural reforms arises from the sharp drop in real interest rates in the wake of the acknowledgement of Turkey's solid fundamentals by international investors. The government should grasp this opportunity and introduce structural reforms which make most out of this positive shock. Further strengthening the macroeconomic policy environment will be necessary to minimise the risk of a boom-bust scenario.

Potential growth in Turkey is held back by high inactivity and not sufficiently broad-based productivity growth, which is also linked to serious skills mismatches. The low capacity to create new jobs is clearly linked to excessive labour market regulation, which provides incentives for informal arrangements, which in turn hinder productivity growth. Informal firms have less access to finance, cannot efficiently participate in innovation networks and invest less in human capital. Their productivity is therefore much lower than in fully formal, rule-abiding firms. Furthermore, product market regulation is not conducive to market entry and network monopolies have too much pricing power. The fiscal policy framework was successful in bringing down public debt after the 2001 crisis, but became pro-cyclical in the run-up to the crisis and fiscal accounts are not yet fully transparent. Monetary policy succeeded in bringing inflation to single-digit levels but still faces challenges in reaching a lower inflation environment on a sustainable basis.

The recent government initiatives to strengthen the macroeconomic policy framework and advance structural reforms are welcome and should be broadened and accelerated in order to meet the challenge of providing Turkey's rapidly growing population with jobs and accelerate catch-up with the OECD average.

The urgent need for labour market reforms is well known. Turkey should therefore move forward and allow more experimentation with new rules on a voluntary basis. Such measures should be closely monitored and the results used to establish nationwide reformed rules, which can be rigorously enforced without hindering job creation. Simultaneously, product market regulations should be aligned with OECD best practice so as to boost productivity growth and competitiveness. Education policy reforms as outlined in previous Economic Surveys *are necessary to remove widespread skills mismatches.*

The new draft law establishing a fiscal rule is very welcome and has the potential of considerably improving fiscal performance over time, as well as removing the current pro-cyclical bias of fiscal policy. Its discussion in Parliament, initially planned for June, was postponed. In order to allow an effective monitoring of compliance with the rule it will be important to pass the draft law on the Court of Accounts. Turkey's position in international ratings does not fully reflect reformed and sound fundamentals. Making more progress with fiscal transparency, strengthening the inflation targeting framework and preserving financial stability will therefore be important.

Assessment and recommendations

From robust post-crisis recovery to sustainable growth

Turkey weathered the crisis remarkably well due to its strong macroeconomic policy framework and important structural reforms implemented after the 2001 crisis and GDP growth in 2010 is expected to be high. The challenge for policymakers now is to ensure that the cyclical recovery be followed by sustained and sustainable growth over the longer run. This will require the following further interrelated steps:

- First, *fiscal policy should be gradually tightened by removing discretionary stimulus and by allowing automatic stabilisers to reduce the deficit as the economy recovers*. Fiscal consolidation will be necessary for stabilising public debt and ensuring fiscal sustainability. Strengthening fiscal institutions to increase fiscal transparency is necessary to fully implement the consolidation plan which was initially included in the 2010-2012 Medium Term Programme (MTP), and is expected to be reiterated in the 2011-2013 MTP, which was to be published during summer 2010. The credibility and transparency of fiscal policy would then mitigate potential negative effects of consolidation on domestic demand via enhanced international and domestic confidence.
- Second, *the Central Bank of the Republic of Turkey (CBRT) should maintain the hard-won credibility of monetary policy by removing the exceptionally large monetary stimulus as it has already foreshadowed*. The normalisation of the monetary stance has to ensure that the gradually declining inflation targets, to 5% at the end of 2012, are met, and thereby to entrench lower and stable inflation expectations. Achieving this goal calls for accompanying fiscal and structural policy measures.
- Third, *the international competitiveness of the business sector needs to be reinforced to avoid an excessive deterioration of the trade balance when growth strengthens*. This notably calls for improving labour and product market regulations to lower labour costs and to support market entry and investment in the higher-productivity, modern sector of the economy.
- Fourth, impediments to higher employment need to be removed to overcome the entrenched dualism between the highly productive and well protected jobs in the formal sector and low-productive and unprotected jobs in the informal sector. It is important to enact the well-identified labour-market reform agenda involving more flexible employment forms, lower minimum wages and lower taxes.

Stronger growth, higher income and saving, as well as social and political stability depend to a large extent on such a broad-based reform push.

The strength of the ongoing recovery gives grounds for well-deserved confidence about medium-term economic prospects, but the persisting structural weaknesses of the

economy threaten the sustainability of strong long-term performance. Risks to the recovery remain predominantly external, not the least originating from the concerns about sovereign debt developments in some European countries.

During the global crisis, Turkey was affected markedly by the foreign demand shock…

During the global crisis, the peak-to-trough decline of Turkey's GDP of nearly 14% was the deepest in the OECD. The massive output contraction is largely explained by the unprecedented foreign demand shock, which prompted a free fall in exports and in turn in industrial output and investment and precipitated a sharp loss in business and consumer confidence, which greatly amplified the initial shock. This episode confirms that worldwide economic developments in general and Turkish export performance in particular are central for cyclical developments in Turkey, despite the rather low share of exports in GDP. Despite the sharp contraction of output, employment held steady, reflecting large-scale labour hoarding facilitated by wage adjustments, including cuts in informal wage payments, and employment support measures. Nevertheless, due to strong working-age population growth and rising labour force participation, the unemployment rate increased by 3 percentage points to 14% in 2009.

… but the rebound has been stronger than expected

After four quarters of sharp contraction in output, GDP rebounded strongly beginning in the second quarter of 2009. The upturn was fuelled by robust export and private consumption growth. The recovery in Turkey was the strongest in the OECD area as measured by the cumulative increase in GDP from the trough until the first quarter of 2010 by over 10%.

A strong macroeconomic policy framework and robust financial supervision yield a dividend on international capital markets

Economic development in Turkey has traditionally been characterised by booms and busts, reflecting tensions arising from competitiveness losses, over-indebtedness and the associated erosion in confidence. The strengthening of its macroeconomic policy framework in the 2000s broke this pattern and was rewarded with a considerable decline in risk premia. Further improvements of the fiscal and monetary policy framework and a continuous adaptation of financial sector supervision are necessary to safeguard this achievement, build on it and embark on a stable and rapid growth path to generate sustainable convergence with the OECD average income level.

Fiscal performance needs to be consolidated given the serious fiscal challenges lying ahead

The budget deficit deteriorated primarily in line with automatic stabilisers. No fiscal cost was incurred on account of financial sector rescues and the public debt/GDP ratio

remained below 50%. Transforming this good fiscal performance into a sustainable fiscal framework conducive to economic growth requires:

i) restoring positive debt dynamics by returning to debt-reducing primary surpluses; any revenue windfalls should be used to accelerate consolidation;

ii) prioritising expenditure to respond to the steadily growing public spending needs in education, health, public infrastructure and other key public services while controlling aggregate spending;

iii) boosting revenue by reducing informality, widening the tax base, and shifting to a growth-friendly tax structure by, gradually alleviating the job-hindering social security taxes paid by the formal sector; and

iv) responding to ageing pressures by putting social security finances on a viable path taking account of the rapidly maturing demography.

The new medium-term fiscal programme and fiscal rule will help

The authorities recently undertook two important fiscal policy initiatives.

- In order to preserve domestic and international confidence in the sustainability of public finances, the government announced in fall 2009 the MTP for the 2010-12 period. The MTP aimed at restoring debt sustainability by setting revenue, expenditure and balance targets for central and general government. The plan was based on a conservative macroeconomic scenario. It envisaged reducing the general government budget deficit (excluding privatisation revenues) from an estimated 7% of GDP in 2009 to 3.4% in 2012, and thus bringing the public debt/GDP ratio, which is expected to peak at around 49% of GDP in 2010, down to 47.8% of GDP in 2012. The new 2011-2013 MTP, which was due for June 2010, is expected to reiterate similar deficit objectives.
- The government submitted a draft fiscal rule law to Parliament in May 2010 and announced preparing the 2011 budget in compliance with it. The rule is to guide budgets based on deviations from the target budget deficit and the cyclical position. Both the MTP and the fiscal rule will provide highly welcome multi-year discipline. The draft was however not legislated in June 2010 as planned, and unfortunately its discussion was postponed. Once adopted, *the government should ensure rapid implementation. If a need arises after initial experience with the implementation of the rule, the authorities should stand ready to phase in a multi-year spending ceiling and a reserve account keeping track of accumulated deviations from deficit ceilings.*

Achieving the intended improvement of general government fiscal transparency is crucial

Securing the transparency of fiscal outcomes and projections at the general government level is a prerequisite for implementing the MTP and the fiscal rule, and for addressing long-term structural fiscal challenges. Turkey has a good legal framework to secure the necessary degree of transparency, thanks to the *Public Financial Management and Control Law* (PFMCL). However, despite major progress in individual areas, the law is not yet completely operational and to date Turkey is still one of the few OECD countries which does not publish consolidated general government accounts according to international standards.

The authorities reiterated that the publication of these accounts was imminent, but as of summer 2010 they were not yet released. However, the authorities already made available important components of the general government statistics. At the same time, quasi-fiscal activities outside the general government sector, after getting smaller in the first half of the 2000s, give signs of resurgence. Hence good complementary information is necessary for fiscal monitoring purposes. Against this background, *all provisions of the PFMCL must be enforced to ensure:*

- complete and consolidated quarterly general government accounts,
- full accounting of quasi-fiscal activities, such as the agriculture purchasing agency and the public housing administration, and
- credible audits, to guarantee the integrity of all accounts.

Producing a comprehensive fiscal transparency report and establishing an administratively independent monitoring agency to start an informed social dialogue on fiscal choices would strengthen the credibility of the fiscal framework.

Inflation expectations should be kept anchored

Following the appropriately swift and large monetary stimulus in response to the crisis, policy interest rates have been left at historically low levels (6.5% for the overnight borrowing rate) since November 2009. In April 2010, the CBRT announced its exit strategy and started to withdraw liquidity measures introduced during the crisis. While the recovery has firmed and inflation peaked at double-digit levels, the monetary policy stance has remained expansionary. This stance has been motivated by CBRT's concerns regarding risks to external demand and the assessment that the increase in headline inflation is temporary. *The process of policy normalisation has already started through withdrawal of liquidity measures and should accelerate with an increase in policy rates before the end of the year.* The pace of removing the stimulus should be fast enough to avoid inflation expectations becoming durably unanchored. The increase in inflation and inflation expectations during the first half of 2010 creates risks, even if the recent inflation surge was driven primarily by one-off effects, and even if labour and output slack remains large. Over the medium term, inflation will crucially depend on the evolution of inflation expectations and all available tools at the disposal of the authorities should be used to avoid their upward drift.

The credibility of the inflation target would gain from a shift to continuous targeting and disinflation needs to be strengthened by structural policies

Until the end of 2012 inflation targets are set in terms of end-year inflation, which was the practice over the past five years. This approach is suitable during disinflation. However, as inflation is targeted to reach a relatively low level at the end of 2012, *shifting to a continuous target (as opposed to end-year targets) could be considered in the following years*. This might help sustain permanently lower inflation, better anchor inflation expectations and facilitate communication and accountability, including concerning the impact of temporary supply side shocks on inflation. As argued in the 2008 *Economic Survey*, disinflation needs to be supported by structural policies that are conducive to lower output and employment costs.

In this regard, *maintaining fiscal discipline would be of key importance. In addition, competition policies should enhance the scope of competition in various service sectors. Authorities should also avoid measures that increase energy and food price volatility. When deciding on official minimum wages the fact that their impact on general wage formation will increase with reduced informality should be taken into account.*

Sustaining the robustness of the banking sector is key to stable growth

The robustness of Turkey's banking sector was a great advantage during the crisis and helped to support the recovery. The efficient functioning of the financial system will be instrumental for future growth by lowering capital costs for all borrowers in the economy, notably the small firms. *Turkey has to continue efforts to implement Basel II regulations and adopt any new amendments that are likely to be introduced following the global crisis.* Moreover, as the experience of many emerging markets demonstrates, shifting to an environment of low inflation and interest rates can lead to excessive credit growth and asset price bubbles. The authorities have already demonstrated their readiness to adjust prudential regulations pre-emptively by preventing households from taking foreign exchange loans. Evolution in the financial markets calls for constant vigilance and, if needed, for taking measures swiftly.

Turkey's international capital market standing is expected to improve further to the benefit of the entire economy

In the wake of its considerably strengthened macroeconomic policy framework and robust financial sector supervision, Turkey has significantly improved its terms of access to international capital markets, as witnessed by the ability to meet its external financing targets during the crisis. The open doors policy of the investors' relations office in the treasury may have helped to serve the information needs of investors during these turbulent times. As a result, during the crisis and in this post-crisis period, Turkey's risk premia evolved very favourably, significantly reducing the borrowing costs of government, banks and non-financial corporations. Turkey's sovereign credit rating was upgraded in recent months, although it has not yet reached "investment grade". Further improving Turkey's international capital market standing is important for lowering long-term capital costs and, thereby, stimulating long-term growth. Thus, *general government fiscal transparency and predictability should continue to be enhanced, external imbalances must be contained, the credibility of monetary policy and financial supervision must be sustained and the quality of public governance and the perceived political stability must be raised to higher levels.* However, in order not to waste the dividend of sound policy, far-reaching reforms to strengthen the supply side of the economy should be implemented.

The recovery has shown that economic and policy fundamentals are strong, but…

The recent crisis differed significantly from the previous recessions, regarding the contribution of macroeconomic fundamentals. Four factors are worth stressing:

- It was an external shock that triggered the recession, and not domestic macroeconomic imbalances as was the case in the past crises. The financial sector, which was re-capitalised and strongly supervised after the 2001 meltdown, proved very robust.
- The improved credibility of macroeconomic policy permitted the authorities to implement a countercyclical response without concerns about sustainability, increasing the impact of policy. Automatic stabilisers operated unconstrained, interest rates were cut to historical lows and liquidity support was provided.
- The strength of international confidence was very supportive: the country's risk premia rapidly reverted to their pre-crisis levels, keeping long-term borrowing costs of the government, banks and enterprises very low.
- Enterprises demonstrated remarkable flexibility and invention in adjusting to the drastically-altered situation in export markets. Given the weakness of the EU markets, they diversified into other markets (Asia, Russia, North Africa and Middle East) and increased their share in the traditional markets by improving the quality of their products and improving delivery terms.

… Turkey's interrelated structural weaknesses persist

Turkey suffers from two structural weaknesses which hinder growth. First, international price competitiveness tends to deteriorate during cyclical upswings, worsening the current account deficit. As growth strengthens, capital inflows gather pace, the exchange rate appreciates, and minimum and average wages in the official sector accelerate. As a consequence trade-exposed activities are squeezed, and so are business and household confidence, employment, income and savings. As a result of this recurrent pattern, the internal and external imbalances of the economy widen. Second, and relatedly, the economy fails to make satisfactory use of its labour resources. Employment in industry and services does not grow strongly enough to absorb the rapidly growing working-age population and the high rate of migration from rural areas. Consequently, the employment rate, at just above 40%, remains the lowest in the OECD area. Migration to cities, combined with complex socio-economic factors, causes many women to withdraw from the labour force, keeping the employment rate for women at just above 20%, which is more than 40 percentage points lower than for men. The labour utilisation challenges are complicated by the recently accelerated shift in the manufacturing sector from low-skill intensive branches towards more capital intensive ones. The twin structural challenges of the economy are therefore related: the difficulty to improve durably the employment rate (the internal balance) goes together with the difficulty of equilibrating the trade and saving-investment balances (the external balance). As a result the economy risks being trapped on a path of low employment, income and savings with periodically large adjustments to restore internal and external equilibrium.

Structural reforms can mitigate external imbalances

To avoid external balances undermining macroeconomic stability and sustainable growth, the authorities could consider measures to mitigate the excessive widening of current account deficits. This would primarily involve improvements in the competitiveness of the trade-exposed sector and increasing saving. In the recent past, high labour costs and real exchange rate appreciation led periodically to the deterioration of price competitiveness, resulting in export market share losses. Non-price competitiveness, *i.e.* the ability to innovate and improve product quality, has improved but is still limited to the small modern sector of the economy. Thus, public policies should boost both sources of competitiveness. This involves helping maintain employment costs in line with productivity, preventing excessive real exchange rate appreciation by keeping fiscal and monetary policy in line with the fundamentals of a rapidly growing catching-up economy, and supporting business development and innovation. Providing more information to social partners about the macroeconomic constraints for wage increases so as to avoid contributing to an accelerating wage-price spiral could help in this respect. Higher domestic saving would also help contain current account deficits. As the effectiveness of direct measures to lift saving, except for increasing budget balances, is limited, the authorities should focus on improving the employment and income generation potential of the economy. In the medium to long term, the current account balance would also benefit from lowering the energy import dependency through an ambitious energy policy to diversify towards renewable and environmentally-sound sources of energy, including nuclear energy. Given Turkey's specific geophysical conditions, particularly high safety standards for nuclear energy should be ensured.

Job creation in the high-productivity, modern sector should be fostered through decisive labour market reforms

As emphasised in past *OECD Economic Surveys*, the growth of the high-productivity and more competitive formal firms and their employment capacities are impaired by an unsupportive legal and regulatory framework. The primary problem pertains to labour market regulations, though there are also some challenges in product market competition. Turkey has one of the OECD's most protective, but also most costly, labour legislation environments. This concerns in particular the severance payment system and employment protection regulations for temporary workers. As a consequence employment creation in the formal sector remains subdued and a large part of business activity takes place in a semi-formal or informal sector. Five barriers to employment stand out, and as long as these obstacles are not tackled, the growth of jobs and incomes in the high-productivity, modern sector would continue to be severely hindered:

- The nation-wide minimum wage, at around 60% of the average wage, remains excessively high, particularly in regions and enterprises where productivity is too low to make them affordable, and where prevailing living costs would justify lower minimum wages.

- Compulsory social security contribution rates remain high, despite their recent reduction, creating a high wedge between gross employment costs and net worker incomes.
- Employment protection for permanent workers in the formal sector is very strict, notably due to one of the most costly severance payment systems in the OECD.
- Temporary work is highly constrained to specific circumstances, making its utilisation practically impossible in the formal sector.
- Despite recent modifications, the employee-related obligations of enterprises rise with the number of employees, discouraging firms from increasing employment beyond certain thresholds.

Semi-formality and informality have exhausted their potential to stimulate the economy, but remain entrenched

Escaping into semi-formality allows companies to achieve employment flexibility and reduce their labour costs, but forces them to operate at the margin of the law and deprives them of full access to financing, high-skilled workers and international co-operation. It therefore lowers their productivity. It has been estimated that labour productivity in the informal sector is 80% below, and in the semi-formal sector 40% below, that in the modern, fully formal sector. The contribution of semi-formality to the development of the Turkish business sector has therefore reached limits. The standard labour market reforms needed to free the development of formal businesses are well known, and acknowledged by the authorities, but political economy factors prevent their implementation. No progress has been achieved in reforming the minimum wage, the large severance payments or the temporary work systems. As in other OECD countries, the divergence of interests between labour market "insiders", who are highly protected by the existing legal framework, and labour market "outsiders", who are employed informally or remain inactive, makes reforms difficult. If this political economy challenge were to be addressed within a broad-based reform initiative, employment and growth-friendly reforms would be easier to implement.

An integrated strategy could help remove the political economy obstacles

In the light of the experiences of other OECD countries, the authorities may need to consider a more integrated approach to reforms. Such an approach would involve a roadmap for indispensible labour market reforms combined with regulatory reforms in the business sector. Together with less distorting and lighter regulation, the ongoing formalisation initiative would receive a welcome boost. In order to overcome the deeply entrenched and multifaceted political economy obstacles, the design, marketing and sequencing of a broad-based reform package should be made a unifying goal of a nationwide consensus-building consultation process. In order to underpin this process with Turkey-specific information and experience, policy measures should be implemented on an experimental basis with transparent monitoring of impacts. Making clear that existing rights are respected should generate confidence in the process. The possibility of

demonstrating how reforms improve performance and building trust with labour unions by improving the enforcement of labour rights and easing restrictions on trade union activity should increase the likelihood of reaching consensus for a broad reform initiative.

The experimental part of this reform package could include the following elements: *i)* introducing more flexible and less costly legal employment forms (with lower minimum wages, lower severance payments and more flexible temporary work provisions) on an initially narrow and experimental basis; *ii)* supporting business enterprises making use of these new forms of employment, also with the help of other structural reforms (see below). Participation in such policy experiments, which are in widespread use in some OECD member countries, should be voluntary and would in principle be limited to new labour contracts. An example could be the possibility for employers to offer labour contracts with flexible working time. Further aspects in an experimental phase would also be most likely of a regional nature, like allowing regions to implement a minimum wage with respect to the average wage of the region as opposed to the nation-wide average. Successful regulatory innovations could then be rolled out more broadly, before being considered for nationwide implementation.

Turkey's welcome *Strategy of Fight against Informality* should thus be enforced together with, and not independently from, such legal and regulatory reforms. Once reforms are implemented, a larger number of enterprises can grow fully within the law, becoming financially fully transparent and technically more productive. Such higher-productivity and more competitive firms can provide their workers with higher wages and better job and income security. These can be negotiated with worker representatives in collective agreements, supported by the ongoing modernisation of Turkey's legislation in this area. Less well-performing enterprises, and the national labour law, can then progressively converge with these higher norms, on the basis of inclusive productivity and income growth in the entire economy. If a common understanding between social partners could be reached on such a path of regulatory reform, formalisation, economic growth and social progress, some of the political economy obstacles to reform could be removed.

Target human capital building and upskilling

The general level of human capital should be considerably increased in Turkey. Ambitious two-pronged policies and reforms are needed: first to improve education standards to equip the future labour force with better skills; and second to improve the skills and employability of the existing large pool of low-skilled workers. On the first challenge, efforts should be intensified to improve education attainment and quality. Recent reforms of curricula in primary, vocational and technical secondary schools are a good start. Given evidence that pre-school education contributes importantly to human capital formation, increasing enrolment rates for pre-school education from their present very low levels could be targeted. The efforts to improve the links between the education system, in particular vocational schools, and the labour market should also be stepped up. On the second issue, ambitious upskilling programmes in close co-operation with employers are the way forward. The challenge of these programmes lies in defining target groups, identifying skill needs and choosing effective and fiscally affordable upskilling instruments. Recent government initiatives in this area have been promising. In this context, Turkey is invited to participate in the recently launched OECD *Programme for the International Assessment of Adult Competencies* (PIAAC). This would help generate new

internationally comparable information on the human capital endowment of working-age population and help the government further its upskilling policies. Many of the recommendations from the in-depth education policy chapter in the 2006 *Economic Survey* are still valid and strengthening education policy measures in the medium-term policy priorities is welcome.

Productivity growth would benefit from freer competition and smart public support

Although remaining barriers in product markets are less binding than in the labour markets, further relaxing anti-competitive product market regulations would stimulate productivity growth and put pressure on labour markets to be more flexible. In the light of OECD's analyses of Turkey's product market regulations, three issues stand out:

- reducing administrative barriers to formal entrepreneurship, in particular by implementing "one-stop shops" and "silence is consent" rules for company registration and some licensing steps;
- reducing government's involvement in business operations by eliminating the remaining price controls and by proceeding with unfinished privatisations in network industries; and
- further easing conditions for foreign direct investment.

In this regard, Development Agencies, which have recently been established in all regions of Turkey, offer an opportunity to improve business environment and to promote entrepreneurship and FDI through local actions. In addition, recent government incentives to enhance technological catching-up by supporting private R&D, technology transfer centres and co-operation between universities and private sector are welcome. Experience with Organised Industrial Zones (OIZs) also deserves special attention. Successful OIZs demonstrate highly positive externalities in terms of technology diffusion, the cost-effective provision of infrastructure and enforcement of regulations (including environmental norms). To ensure their efficiency and effectiveness, these policy measures should be continuously evaluated on the basis of their costs and benefits.

A stronger equilibrium path of growth is within reach, but calls for good policies

Turkey faces a large spectrum of future growth paths. On the higher side of this spectrum is a strong long-term growth path, involving enhanced competitiveness, higher employment, increased income growth, higher savings and lower external imbalances. This scenario is within reach but can by no means be taken for granted. It can only be achieved with good policies, which are also in line with the G-20 framework for strong, sustainable and balanced growth.

Chapter 1

After the crisis: ensuring sustained recovery and mitigating future macroeconomic volatility

Turkey is recovering from its most severe recession in several decades. The massive contraction in GDP is largely explained by the unprecedented collapse in foreign demand, which was aggravated in Turkey by negative confidence effects and structural problems with competitiveness prior to the crisis. In contrast to previous recessions, Turkey could afford counter-cyclical polices and the financial markets proved resilient. During the crisis, the authorities cut interest rates significantly and promptly and implemented fiscal stimulus. This truly novel experience was possible thanks to a better macroeconomic position, a sounder monetary and fiscal policy framework, and better financial market regulations. The immediate policy challenge is to gradually remove policy stimulus and address medium-term stability considerations in a way that does not jeopardise the recovery. Once growth gains full speed, the authorities will likely face the challenge of widening external imbalances and of ensuring a smooth functioning of the financial markets. The former will require improving competitiveness, raising domestic saving, attracting more FDI inflows and reducing energy import dependency. Improvements in many of these areas will require structural reforms in the labour and product markets.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Following the series of boom and busts between the late 1980s and the early 2000s, Turkey enjoyed strong and uninterrupted expansion until 2007. This was possible thanks to important improvements in macroeconomic policy. Budget deficits were significantly reduced and public debt, as a percentage of GDP, declined. The central bank was made independent and an explicit inflation targeting framework was introduced. These reforms were instrumental for successfully starting disinflation. Moreover, the banking sector was restructured and banking supervision enhanced. This, combined with greater political stability, helped reduce risk premia and capital costs and boosted business activities, especially among globally-oriented large and medium-sized companies. In addition, Turkey strengthened its relations with the European Union and started a harmonisation process to fulfil the *acquis,* which had a positive impact on investor confidence.

The 2008-09 recession abruptly interrupted the long expansion and the ensuing catching-up process. In contrast to previous downturns, this crisis was triggered by an unprecedented foreign demand shock, while domestic macroeconomic balances and the financial sector were sound. The recession of 2008-09 led to a massive collapse in exports and subsequently in GDP. However, since the second quarter of 2009, the economy has been quickly rebounding. The recovery poses challenges for fiscal and monetary policy, requiring a careful balance between supporting the recovery and sustaining macroeconomic stability over the longer run.

Against this background, this chapter first analyses the economic performance prior to and in the crisis, focusing on policy responses and differences and similarities with past recessions. Then, it outlines medium-term prospects and related challenges for monetary and fiscal policy. Finally, the chapter investigates the policy agenda for sustaining strong medium-term growth, specifically regarding containing current account deficits and ensuring the smooth functioning of financial markets. These two challenges call for structural reforms in the labour and product markets, which also are crucial for long-term growth. These reforms are discussed in Chapter 3.

Turkey was markedly affected by the 2008-09 recession

Prior to the 2008-09 crisis, Turkey showed some signs of growth moderation. After growing on average at 7.3% between 2002 and 2005, GDP growth gradually decelerated to 4.7% in 2007 (Table 1.1, Figure 1.2). The slowdown was particularly marked in investment, and to a lesser extent in private consumption, and reflected a combination of three factors. First, the ongoing deterioration in the competitiveness of traditional labour-intensive export sectors (notably the clothing industry) *vis-à-vis* other emerging economies (particularly China) together with the adjustment costs accompanying the ongoing changes in the export structure (toward medium-technology activities) were spilling over to the domestic economy via lower employment and profits. This effect was aggravated by some moderation in foreign demand after 2005. Second, monetary policy was tightened in the second half of 2006 (by a total of 425 basis points for the borrowing rate), following the

Table 1.1. **Recent macroeconomic developments and near-term prospects**

	2004 current prices (TRY bn)	2005	2006	2007	2008	2009	2010[1]	2011[1]
		Percentage changes, volume (1998 prices), unless stated otherwise						
Private consumption	398.6	7.9	4.6	5.5	–0.3	–2.3	5.7	5.8
Government consumption	66.8	2.5	8.4	6.5	1.7	7.8	2.1	2.8
Gross fixed capital formation	113.7	17.4	13.3	3.1	–6.2	–19.2	13.2	8.1
Final domestic demand	579.1	9.1	6.8	5.1	–1.3	–4.3	6.4	5.8
Stockbuilding[2]		0.0	–0.1	0.6	0.3	–2.3	2.3	0.0
Total domestic demand	573.8	9.2	6.7	5.7	–1.0	–6.4	8.8	5.9
Exports of goods and services	131.7	7.9	6.6	7.3	2.7	–5.4	8.4	8.8
Imports of goods and services	146.4	12.2	6.9	10.7	–4.1	–14.4	16.8	13.6
Net exports[2]		–1.3	–0.3	–1.3	1.7	2.8	–2.1	–1.6
GDP at market prices	559.0	8.7	6.8	5.0	0.5	–4.9	6.8	4.5
GDP deflator		6.8	9.5	5.9	12.1	5.5	7.1	6.5
Memorandum items								
Consumer price index		8.2	9.6	8.8	10.4	6.3	9.5	6.6
Private consumption deflator		8.3	9.8	6.6	10.8	5.4	8.7	5.7
Unemployment rate		10.4	10.0	10.1	10.7	13.7	14.9	15.9
Current account balance (% of GDP)		–4.6	–6.1	–5.9	–5.6	–2.2	–4.5	–5.9
Nominal GDP (TRY bn)		649	758	843	951	954	1 090	1 213
General government financial balance[3] (% of GDP)		–0.7	–0.2	–1.6	–2.5	–5.8		
Public debt[3] (% of GDP)		52.3	46.1	39.4	39.5	45.4		

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. There are differences between national accounts data published by Turkstat and those used by the OECD, as the OECD calculates annual series from quarterly figures (for all member countries). There are also discrepancies concerning labour market series, which are due to differences in the definition of institutional labour force and of working age. The latter is defined in Turkey as "above 15" while the OECD defines it as "between 15 and 64". See *OECD Economic Outlook* Sources and Methods (*www.oecd.org/eco/sources-and-methods*).

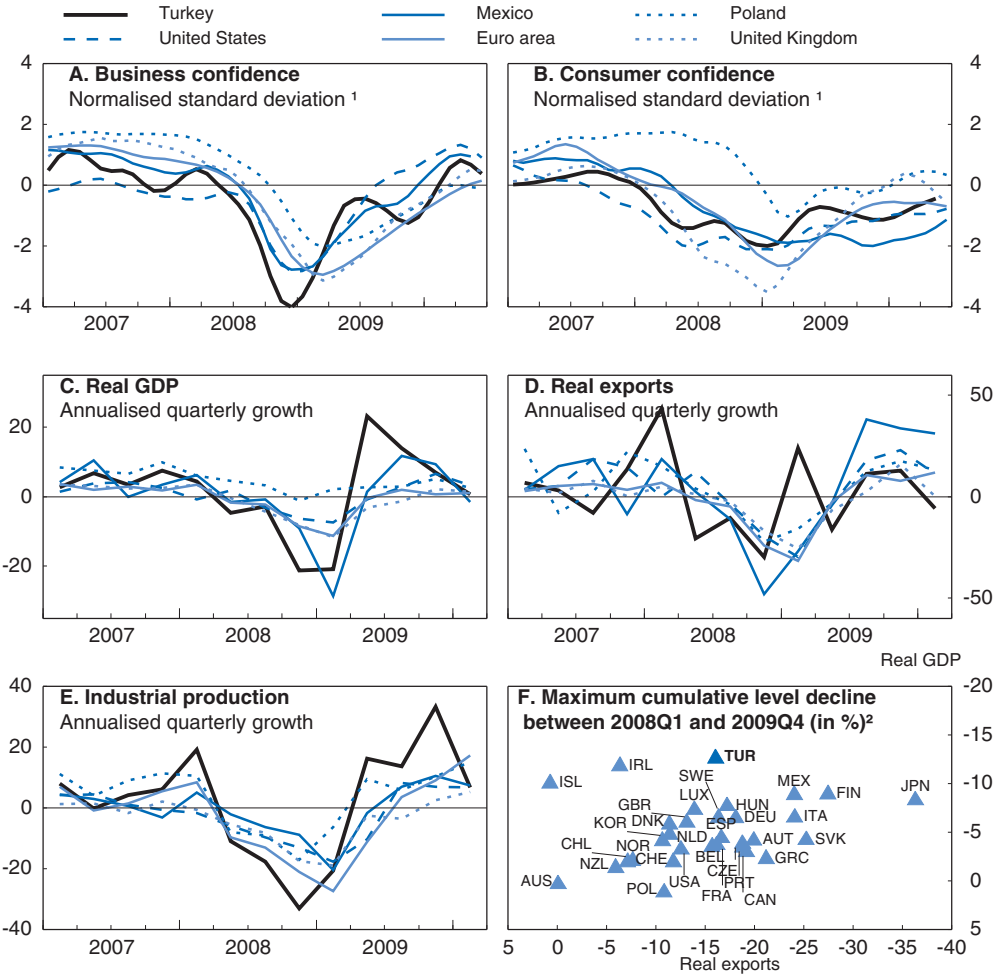
1. OECD Economic Outlook projections, published in June 2010 (based on data available up to May 2010). These projections will be updated in the Autumn 2010 Economic Outlook, based on data available up to October 2010.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
3. Turkish authorities' data.

Source: OECD Economic Outlook 87 Database and SPO (2009a), *Medium Term Programme*.

inflationary shock stemming from exchange rate depreciation and higher food prices. Third, in 2007, Turkey was hit by the oil price shock, which was particularly acute given its relative high energy intensity and a large dependence on imported energy. The econometric evidence presented in Annex 1.A1 suggests that, although developments in export market shares and monetary policy help explain GDP in the run-up to the recession, the main driving forces were foreign demand and oil prices.

In 2008, the global downturn hit Turkey hard in terms of its speed and magnitude (Figure 1.1). It spread via financial markets and trade. As in many other emerging markets, the first channel involved net capital outflows, currency depreciation, a fall in stock prices (by around 60% from the peak of late 2007), rising risk premia and tightening liquidity in the banking sector. Exports slumped, prompting a massive contraction in industrial output and investment. The deterioration in the international environment and large uncertainties, combined with competitiveness losses before the peak of the crisis, led to a sharp loss in business and consumer confidence, amplifying the exceptionally large foreign demand shock. Households cut consumption abruptly, while companies reduced their investment and greatly depleted inventories.

Figure 1.1. **Synchronisation of the global recession**



1. Calculated as deviations from the mean which are expressed in standard deviations.
2. The timing of the trough can differ across countries and between GDP and exports.

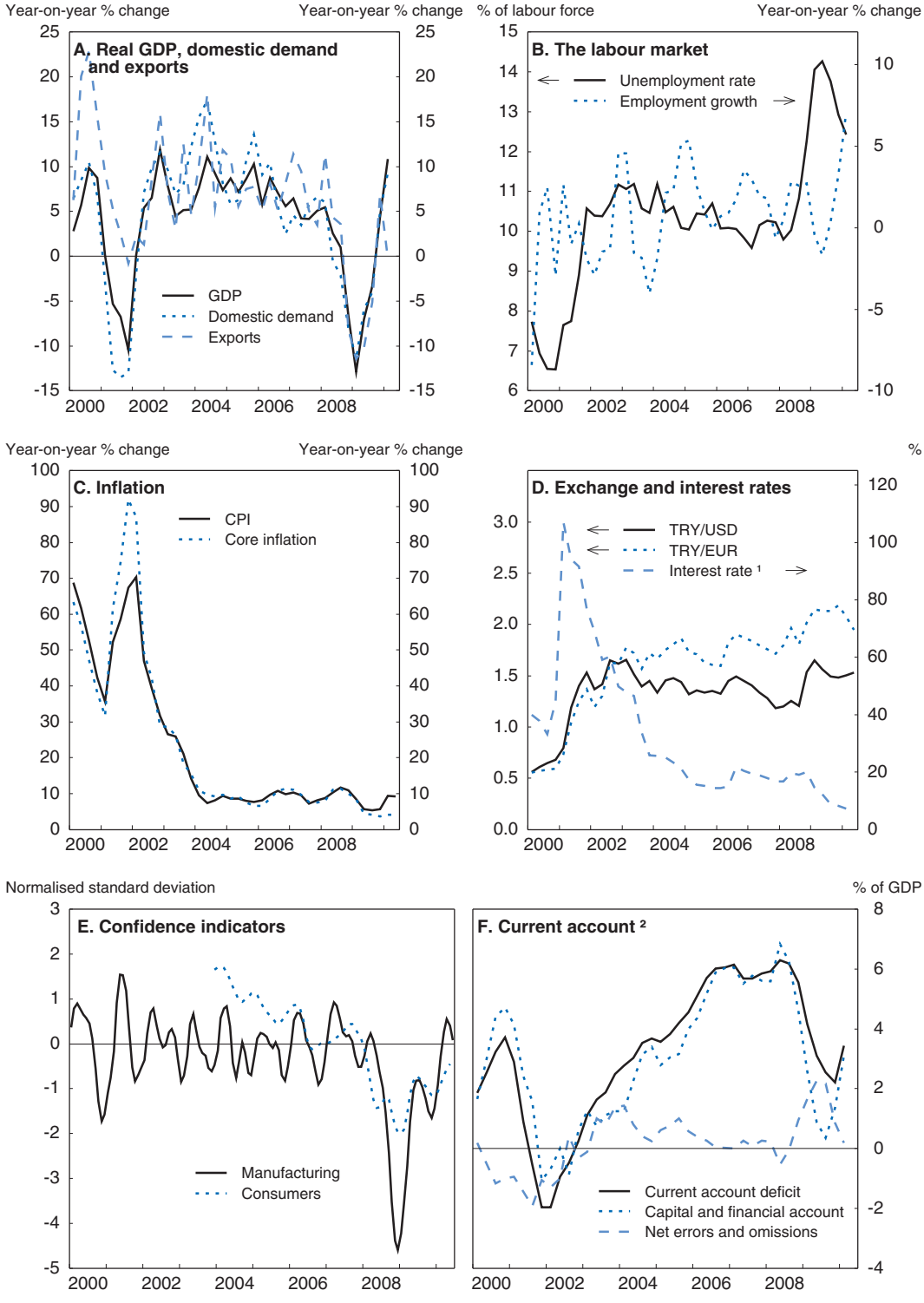
Source: OECD, *Main Economic Indicators* and *OECD Economic Outlook Databases*.

StatLink http://dx.doi.org/10.1787/888932321720

The empirical analysis given in Annex 1.A1 shows that the trade channel can largely explain the massive GDP contraction of close to 14% from peak to trough. This suggests the relatively high importance of foreign demand in explaining domestic developments despite the relatively low share of exports in GDP (around 25% in constant prices). The high sensitivity is evident in international comparison. The initial impact of the crisis on Turkey, as measured by a decline in the GDP level between the beginning of 2008 and mid-2009, was the biggest among the OECD countries, while the export decline was close to the OECD average (Figure 1.1) and Turkey did not experience domestic financial turmoil.

The high sensitivity of output to the foreign demand shock can be partially traced to confidence effects. The collapse of business confidence in Turkey was much larger and more abrupt than in several advanced and emerging OECD economies (Figure 1.1). This, together with the fall in foreign demand, has likely contributed to the significant decline in investment (nearly 30% from peak to trough, which was one of the largest declines in the OECD). Similarly, consumer confidence sapped, causing a very large consumption decline

Figure 1.2. **Key macroeconomic indicators**



1. 3-month money market interest rate.
2. Rolling 4-quarter share in GDP.

Source: OECD, *OECD Economic Outlook* and *Main Economic Indicators Databases*.

StatLink http://dx.doi.org/10.1787/888932321739

as compared to other OECD countries (nearly 10% from peak to trough). The rapid recovery in domestic demand (especially in consumption), which coincided with confidence improvement, seems to support the confidence channel.

On top of the global shock and uncertainties, confidence in Turkey seems to have been undermined by the conjunction of three factors. First, the reaction of companies may have been affected by a combination of uncertainties about rolling over their debts in the face of the global liquidity squeeze, the decline in foreign investors' risk appetite, and the cautious reaction of domestic banks in extending credit. Indeed, the Bank Loans Tendency Survey indicates that debt restructuring was among the key reasons behind the increase in demand for loans by enterprises and that banks tightened significantly credit standards. The foreign debt of the non-financial private sector was rising rapidly prior to the crisis, though from a low level. Its share in GDP almost doubled since 2004, reaching around 16% in 2008 ($ 122.4 billion). Half of this debt was due to mature in 2009 and 2010 (33% and 17% of the total, respectively). The rollover ratios indeed declined steeply, though this was partially affected by statistical effects (CBRT, 2009a).[1] Second, concerns about fiscal policy after the IMF Stand-By Arrangement expired in May 2008 compounded uncertainties. Third, given vivid memories of the past crises, initial worrying economic news could have sparked the wave of over-pessimism among businessmen and consumers.

The depth of the GDP decline could also be linked to smaller automatic stabilisers compared with other OECD countries. The lack of data precludes performing a detailed analysis of automatic stabilisers in Turkey. However, the low share of revenues and expenditures in GDP (which are among the lowest in OECD; Figure 1.A4.1 in Annex 1.A4), suggests that automatic stabilisers cushioned Turkish output to a lesser extent than in other OECD countries. This hypothesis may explain the initial large contraction in private consumption. Moreover, the heavy dependence of service sectors (especially transportation and communication) on export activity may add to high export shock elasticity.

A counter-cyclical policy response was swift

The rapid and sizable deterioration in economic growth triggered a prompt monetary and fiscal policy response. The improved macroeconomic framework and better economic situation prior to the crisis were instrumental in making counter-cyclical policies possible. The swiftness of monetary policy measures was particularly important for calming the markets in the early phase of the crisis and was appreciated by the domestic market participants.

The monetary policy stance was loosened substantially. The Central Bank of the Republic of Turkey (CBRT) cut the main policy interest rate by 1 025 basis points since October 2008, to 6.5% in November 2009. These cuts were the biggest in the OECD and among other emerging markets. Nominal interest rates in Turkey reached record lows and real interest rates approached zero, a level not seen since the beginning of 2002. To further support liquidity and lending, the Turkish lira required reserve ratio was cut from 6% to 5% in October 2009. Such a large monetary policy stimulus was possible without endangering the inflation target in the early phase of the crisis given the opening of a large negative output gap and the decline in energy prices.

In contrast to many other OECD countries, measures to stabilise financial markets were marginal as the financial sector weathered the crisis well (see below). They involved

mainly operations to ensure a smooth functioning of the foreign exchange market and adequate foreign exchange liquidity (CBRT, 2009b). In October 2008, the CBRT resumed its activities as an intermediary in the foreign exchange deposit market, and the limits and maturity of foreign exchange transactions were extended and the interest rates were lowered. Some conditions of these arrangements were subsequently changed in February 2009. Moreover, the foreign exchange buying auctions were suspended between October 2008 and August 2009, additional foreign exchange liquidity was injected via foreign exchange selling auctions (October 2008, March-April 2009), and the required reserve ratios for foreign currency deposits were lowered by 2 percentage points. Certain measures were also taken to mitigate the fallout of the financial turmoil on the corporate sector. In December 2008, the limits of export rediscount credit were extended and their conditions eased. Further easing followed in March and April 2009.

On the fiscal front, the government implemented an anti-crisis package (Table 1.2). It primarily envisaged spending measures (infrastructure investment, reductions in contributions to the pension and health care funds, hike in public servants' salaries, and transfers to sub-national governments), but revenue measures were also taken (temporary cuts in special consumption and value added taxes on selected goods).[2] These direct revenue and expenditure measures are estimated to amount to around 1.8% of GDP for the period 2008-10. In addition, the government offered guarantees and insurance schemes (Credit and Guarantee Fund) for the financial sector to stimulate lending to the private sector, especially to small and medium-size enterprises. The package was to be implemented primarily in 2009 and 2010.

Table 1.2. **Fiscal stimulus measures**

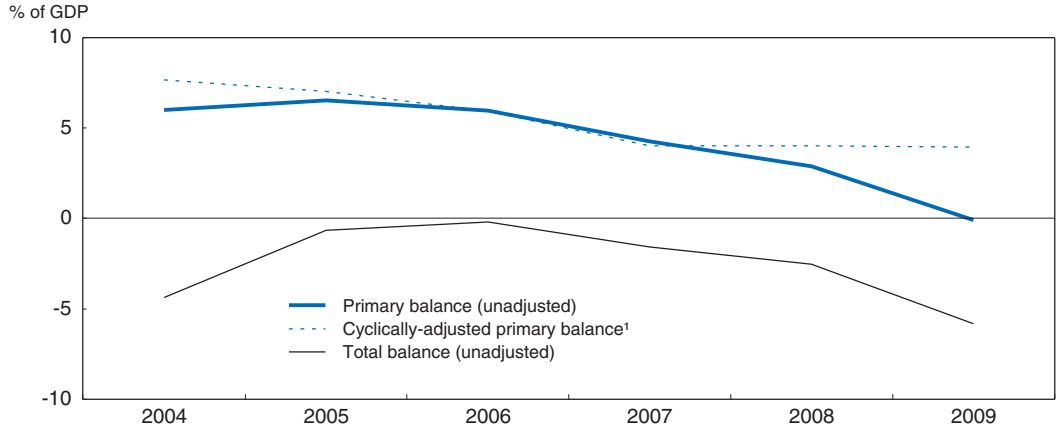
Billion TRY unless stated otherwise	2008	2009	2010	2008-10
Revenue measures	**0.0**	**4.1**	**1.8**	**5.9**
Personal income taxes[1]	0.0	–0.5	–0.7	–1.1
Corporate taxes	0.0	0.7	1.2	1.9
Indirect taxes	0.0	2.6	0.1	2.7
Other	0.0	1.3	1.1	2.4
Expenditure measures	**7.9**	**17.2**	**21.1**	**46.2**
Government investment	5.1	6.4	6.1	17.6
Government consumption	0.9	2.5	5.3	8.7
Contributions to social security funds	0.0	4.6	5.5	10.2
Transfers to households	0.0	0.1	0.1	0.2
Transfers to business	0.0	0.5	0.5	1.0
Transfers to sub-national governments	1.3	2.5	3.1	7.0
Other	0.5	0.5	0.5	1.5
Revenue and expenditure measures	**7.9**	**21.3**	**22.9**	**52.1**
% of GDP in a given year or period	*0.8*	*2.2*	*2.2*	*1.8*
Measures with no direct or immediate impact on finances	1.5	11.3	0.0	12.8
Guarantee and insurance schemes for financial institutions	0.0	6.8	0.0	6.8
Loans to enterprises	1.5	4.5	0.0	6.0
Total	**9.4**	**32.6**	**22.9**	**64.9**
% of GDP in a given year or period	*1.0*	*3.4*	*2.2*	*2.2*

1. Negative figures associated with personal income taxes reflect additional revenues generated by the voluntary disclosure, tax peace and asset repatriation programme.

Source: SPO (2009b), *Pre-Accession Economic Programme 2009*.

Overall, the general government deficit widened by 4.2% of GDP in 2008 and 2009, which is largely explained by the primary balance deterioration (Figure 1.3). This is slightly less than the OECD average increase in budget deficits of around 6.3% over the same period and this reflects three factors. First, Turkey did not have to recapitalise its financial sector, unlike several OECD countries. Second, the government size is smaller (Annex 1.A4), and even with a larger output fall the impact on fiscal balances remains more limited. Third, the amount of fiscal stimulus was effectively limited as the government tried to contain the fiscal costs of the crisis by raising revenue. Notably, in 2009 tobacco and fuel taxes were raised and one-off arrangements to increase tax revenues were implemented. New measures included a voluntary disclosure, tax peace and asset repatriation programme.[3] Thus, the anti-crisis package ultimately involved a re-distribution of tax proceeds rather than their absolute reduction. The last point is corroborated by simplified calculations of the cyclically-adjusted primary balance which suggest that fiscal policy was only marginally expansionary, following the much higher fiscal loosening in 2006 and 2007 (Figure 1.3).[4]

Figure 1.3. **General government balance in the crisis**



1. OECD estimates (see text for further information), % of potential GDP.

Source: OECD; Ministry of Finance; Turkstat; SPO (2009a), *Medium Term Programme 2010-2012*; and OECD, *OECD Economic Outlook Database*.

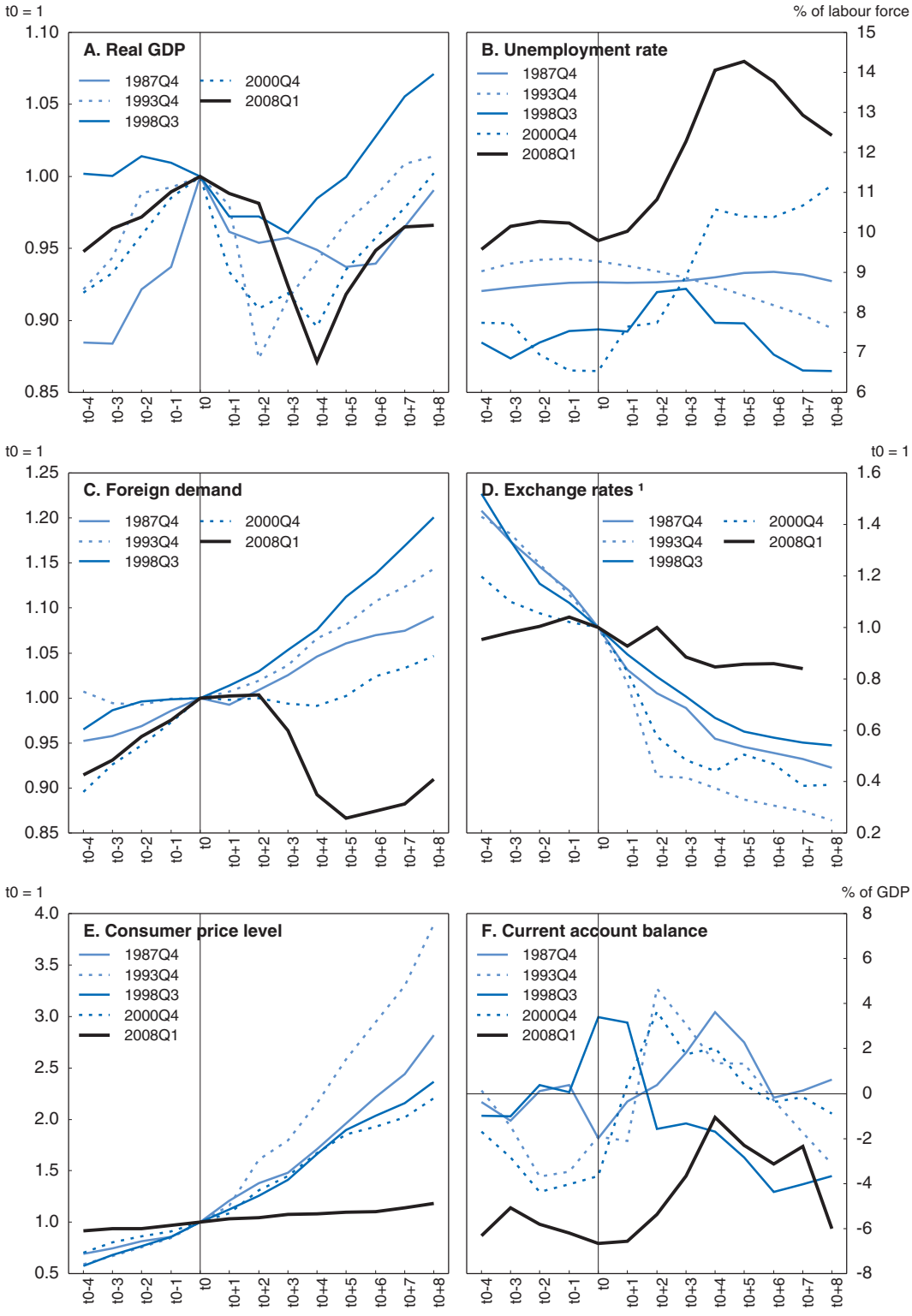
StatLink http://dx.doi.org/10.1787/888932321758

Due to the widening of the general government budget deficit in 2009 to 5.8% of GDP (excluding privatisation revenues) the public debt/GDP ratio (according to the Maastricht definition reported by SPO [2009b]) increased to 45.4% of GDP in 2009 (Table 1.1 and Figure 1.7). Public debt as a share of GDP was still lower than the average of the EU OECD countries and the OECD as a whole.

The last recession was different from previous crises

Over the past two decades, Turkey has experienced five severe GDP contractions (Figure 1.4).[5] In the previous recessions, domestic imbalances and macroeconomic instability prompted the GDP decline, whereas in the 2008-09 recession, the huge negative foreign demand shock was the main trigger. Such a massive and synchronised collapse in world trade and the freeze of capital flows have not been experienced in decades

Figure 1.4. **Comparing Turkish recessions**



1. Nominal effective exchange rate: a decline means effective depreciation of the Turkish lira.

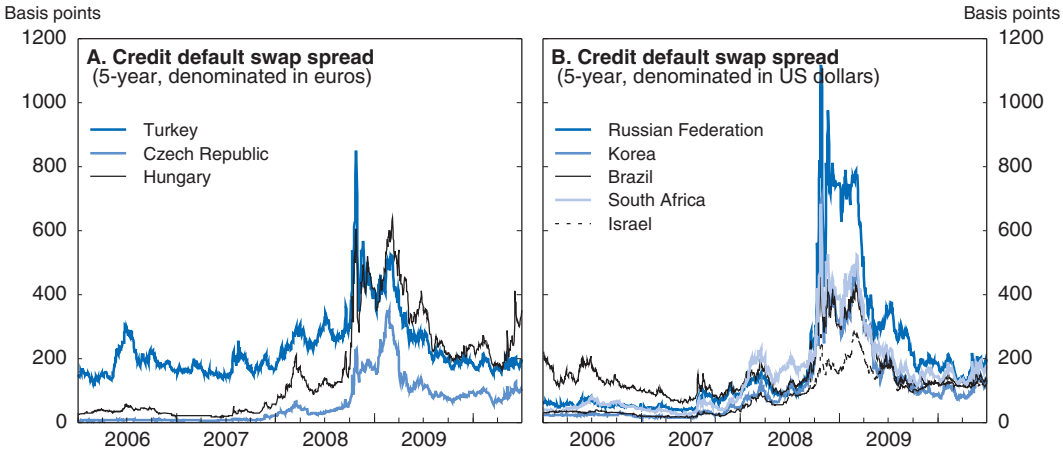
Source: OECD, *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932321777

(Cheung and Guichard, 2009; Freund, 2009). This explains the very deep slump in Turkish exports, reflecting Turkey's increasing exposure to external shocks.

On the other hand, the exchange rate and risk premia fluctuations were far smaller than in the past. In the second half of 2008, the Turkish lira depreciated by around 15% in effective terms, whereas in the past crises depreciation was on average around 35%. In the course of 2009, the lira broadly stabilised against the euro and appreciated somewhat against the US dollar. The volatility of the Turkish lira also declined relative to other emerging markets (CBRT, 2010). Limited nominal exchange rate changes and significantly lower inflation resulted in a much stronger real effective exchange rate compared with the previous recessions. Risk premia in Turkey increased in autumn 2008 as in other emerging markets (Figure 1.5), but since then they have substantially declined to roughly the pre-crisis level (Chapter 2). At the end of 2009, they were relatively low compared with some emerging markets, especially in Central and Eastern Europe (IMF, 2009). The moderate fluctuations in financial indicators, as compared with the previous crises and also relative to other emerging markets, can be explained by two factors. First, the macroeconomic position, including the financial sector and public finances, was sounder and the policy framework was more credible, making a swift implementation of counter-cyclical policies possible. This was a truly novel experience compared with the previous recessions. Second, the 2008-09 downturn affected simultaneously many economies, and Turkey was thus not singled out.

Figure 1.5. **Risk premia in emerging economies**



Source: Datastream.

StatLink http://dx.doi.org/10.1787/888932321796

The resilience of the financial markets is a new feature of the 2008-09 recession. It is attributable to the reforms and consolidation of the banking sector after the 2001 financial crisis (BRSA, 2009; Bredenkamp *et al.*, 2009). These reforms were at the core of the post-2001 stabilisation programme. They involved stronger capital structures, changes in the banking law, and better risk management and supervision. The harmonisation of financial regulations, in line with the EU Directives and best-practice international standards, supported this modernisation. In addition, Turkish banks were not exposed to toxic assets, the share of foreign exchange positions in the banks' balance sheets

decreased before the crisis, and the loan-deposit ratio was well below 100%. The capital adequacy ratio remained well above the required levels (around 20%). Banks enjoyed large capital buffers and sound liquidity due to strong profitability. Their profits declined in 2008, but rebounded in 2009, thanks to net interest income as lower funding costs following monetary easing were only partly passed to offered loans and to a lesser extent due to net trading income (CBRT, 2009a). Even so, the ratio of non-performing loans (NPL) increased, peaking at 5.4% in October 2009 which was higher by 2.2 percentage points than a year before. The largest increase in NPL was observed for consumer loans (especially on credit cards) and for corporate loans for small and medium-size enterprises.

Another remarkable feature of the recent recession is the lack of a strong pick-up in inflation (Figure 1.4). In contrast to past episodes, inflation remained in check, and it even declined in the first phase of the recession. This was possible thanks to the credible monetary policy framework and the relatively small depreciation of the nominal effective exchange rate. The moderation in inflation was in addition supported by indirect tax cuts and lower international commodity prices.

Following the pattern of previous recessions, the current account balance improved. Important reasons for this are the decline in domestic demand and oil prices which offset the effects of the fall in foreign demand and limited exchange rate depreciation. Compared with past downturns, the scale of the current account improvement was one of the largest, even though the process was slightly delayed. The narrowing of the current account deficit and the repatriation of saving from abroad along with channelling cash savings into the system (which is believed to be the explanation of the large net errors and omissions position – Figure 1.8) eased current account deficit financing needs.

Recovery is in train and prospects for 2010-11 are brighter

Following four quarters of recession, GDP growth increased rapidly after the first quarter of 2009 (Figure 1.2). This was initially driven by the recovery in private consumption and exports, and the slowdown of destocking. As the rebound in foreign demand from the European Union – the main export market for Turkey – has been weak, exporters have been shifting to more dynamic markets in Asia, Russia, North Africa and Middle East. The contribution to GDP growth from inventory investment eased towards the end of 2009, but private fixed investment accelerated strongly, helping sustain growth momentum. Government spending increased through 2009 but declined in the first quarter of 2010 (especially sharply in the case of public investment), while imports soared and the net contribution of trade to GDP turned negative. The situation in the labour market remained difficult. Although employment in both rural and urban areas grew in 2009 as a whole, reflecting large-scale labour hoarding facilitated by nominal wage cuts, this was not enough to offset steady inflows of people to the labour market driven by demographic factors and "second earner" effects. Consequently, the unemployment rate initially increased to record levels (above 14%), then declined somewhat but still remained elevated (Figure 1.2). In addition, average hours worked declined. Headline inflation was generally on the rise between mid-2009 and mid-2010 due to sharp increases in energy and food prices and consumption taxes (Figure 1.2). The inflation of unprocessed food was particularly high due to the decline of domestic meat supply. In early 2010, headline inflation exceeded 10% and was well above the end-year inflation target of 6.5%, but decelerated in May and June. In contrast, tax-adjusted core inflation hovered at historically-low levels (around 4%) between mid-2009 and mid-2010.

In the first half of 2010, business confidence reached levels associated with expansion and financing conditions kept improving, especially for large-size borrowers. Credit growth increased strongly given ample liquidity in the banking sector and low interest rates. This, together with the global recovery, should allow for gradual acceleration in exports and, as capacity utilisation begins to rise, in investment. In addition, private consumption is expected to gather momentum, supported by still stimulative polices. The situation in the labour market will remain difficult for some time. If the increase in labour force participation rates continues, the aggregate unemployment rate might increase further.[6] GDP is projected to grow by 6.8% in 2010 and 4.5% in 2011 (Table 1.1). Projection uncertainties are large and risks are tilted to the downside. They relate primarily to the economic situation in Europe. If drastic fiscal consolidation is implemented in Europe, Turkish foreign demand and in turn exports may suffer. On the other hand, if adequate fiscal consolidation is not implemented in Europe, confidence may be undermined and this may affect negatively investment and growth. In this environment, any excessive real exchange rate appreciation in Turkey could hurt exports.

Monetary and fiscal policy exit challenges

The strength and sustainability of the recovery and medium-term growth will crucially depend on domestic policies. As the recovery is now in train, the authorities in Turkey, as in other OECD countries, have to decide on the timing and pace of removing fiscal and monetary stimulus. A too early and too aggressive tightening of policies might jeopardise the recovery, while extending stimulus for too long might undermine medium-term macroeconomic stability. Turkey still has the "emerging market" label and the financial markets may not tolerate risks to medium-term stability to the same extent as for some advanced OECD countries (Chapter 2). This in turn limits the room for extended counter-cyclical policies, and places the focus on the need to safeguard confidence, price stability and balanced public finances.

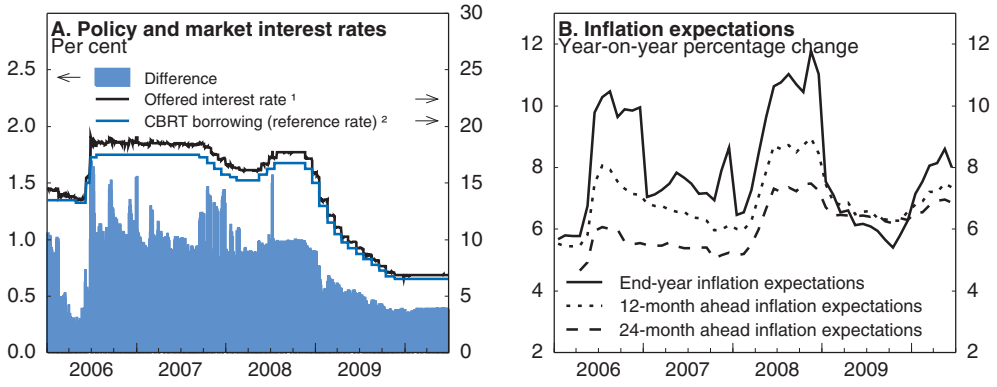
Normalisation of policy interest rates should start before the end of 2010

On the monetary policy side, in April 2010 the CBRT officially outlined its exit strategy, envisaging gradually removing liquidity measures, shifting to a 1-week repo interest rate as the policy rate and the tightening of the monetary policy stance. Even before this announcement, in August 2009, it had resumed foreign exchange auctions to accumulate foreign reserves. Following the strategy's announcement, the amount of liquidity provided through repo auctions was reduced and the reserve requirement on foreign exchange deposits was raised from 9.0% to 9.5%, implying the start of monetary policy tightening. On May 18, the CBRT switched to the 1-week repo auction rate as the policy rate, setting it at 7%. The borrowing rate was the main policy rate before. This technical rate adjustment is meant not to change the monetary policy stance. Thus, the key policy interest rates have been left unchanged at historically low levels since November 2009 (Figure 1.6).

Setting monetary policy in current circumstances is challenging. This owes primarily to uncertainties regarding external demand and the implication of the temporary price shock in the first half of 2010. So far, these two considerations have guided the CBRT into keeping interest rates unchanged. However, as the monetary policy stance is expansionary, the recovery is firming and credit accelerates, the CBRT should start normalising interest rates before the end of 2010, conditional on a favourable economic outlook. Its pace should be fast enough to avoid inflation expectations becoming unanchored. The increase in

inflation and in inflation expectations in early 2010 (Figure 1.6) creates risks, even if it was driven mainly by one-off factors and even if labour and output slack remain large. The latter issue calls for caution as deep recessions tend to lower potential output (OECD, 2009). If this was the case, then the output gap would turn out smaller than expected, resulting in higher inflation pressures. It will be critical to avoid a repetition of the events of 2006-07, when commodity and food price shocks led to the extended overshooting of the inflation target and a subsequent upward revision of the targets. The pace of monetary tightening should also account for delayed interest rate transmission, given the aim to continue disinflation over the next three years when the economic activity and ensuing price pressures are expected to strengthen. In this context, inflation target credibility should be preserved and fostered given that it affects inflation expectations and in turn inflation outcomes; as was discussed in the previous *Economic Survey of Turkey* (OECD, 2008a).

Figure 1.6. **Monetary policy**



1. Turkish interbank overnight offered rate.
2. The reference rate before 18 May 2010.

Source: CBRT and Datastream.

StatLink http://dx.doi.org/10.1787/888932321815

Budget deficits need to be reduced

The recent increase in the budget deficit and public debt requires improving budget balances in the medium term to stabilise debt at a lower level. This should be achieved via automatic stabilisers, a removal of recent discretionary measures and/or some additional tightening measures. The government has already envisaged lowering budget deficits. Following the termination of the IMF Stand-By Arrangement in May 2008, the government announced the Medium Term Programme (MTP) in September 2009 to preserve domestic and international confidence in the sustainability of public finances. This was the major statement on Turkey's post-crisis fiscal strategy. The strategy was to be updated in summer 2010 with a new MTP for the period 2011-13, but its publication was delayed. The initial MTP foresaw a reduction of the budget deficit from estimated 7.0% of GDP in 2009 to 3.4% of GDP in 2012, resulting in a slight decline in the public debt/GDP ratio between 2010 and 2012 (Table 1.3; SPO, 2009a).[7] The improvement was expected to be achieved thanks to a higher primary balance (improving by 2 percentage points to 1.4% of GDP in 2012) and lower interest payments (improving by 1.7 percentage point to 4.8% of GDP in 2012). The primary balance adjustment was expected to be driven mainly by the central government, as balances of other sectors are assumed to remain broadly constant. The new MTP is expected

Table 1.3. **Fiscal targets of the Medium Term Programme**

% of GDP

	2009	2010	2011	2012
A. Central government[1]				
Budget revenues	20.1	21.4	21.4	21.4
Primary expenditures	22.3	22.2	21.6	21.0
Primary balance (non-consolidated)[2]	–2.2	–0.8	–0.2	0.4
B. General government				
Revenues[3]	33.0	34.6	34.5	34.4
Expenditures	40.1	40.3	38.8	37.8
Primary expenditures	33.6	34.3	33.6	33.0
Interest payments	6.4	6.0	5.2	4.8
Balance[3]	–7.0	–5.7	–4.4	–3.4
Primary balance[3]	–0.6	0.3	0.8	1.4
Net primary balances of general government sectors:[4]				
Central government	2.3	2.9	3.2	3.6
Local governments	–0.4	–0.4	–0.3	–0.3
Extra budgetary funds	–0.1	–0.1	–0.1	–0.1
Unemployment Insurance Fund	0.8	0.7	0.8	0.8
Social security institutions and general health insurance	–3.3	–3.1	–3.0	–2.89
Revolving funds	0.2	0.2	0.2	0.2
Memorandum items[5]				
Privatisation revenues	0.5	1.0	0.8	0.7
Public debt stock (EU definition)	(47.3)	49.0	48.8	47.8
Real GDP growth (%)	(–6.0)	3.5	4.0	5.0
Nominal GDP growth (%)	(–0.4)	8.7	8.6	9.7
Consumer inflation (end-year, %)	(5.9)	5.3	4.9	4.8
Nominal GDP (TRY billions)	(947)	1 029	1 118	1 227

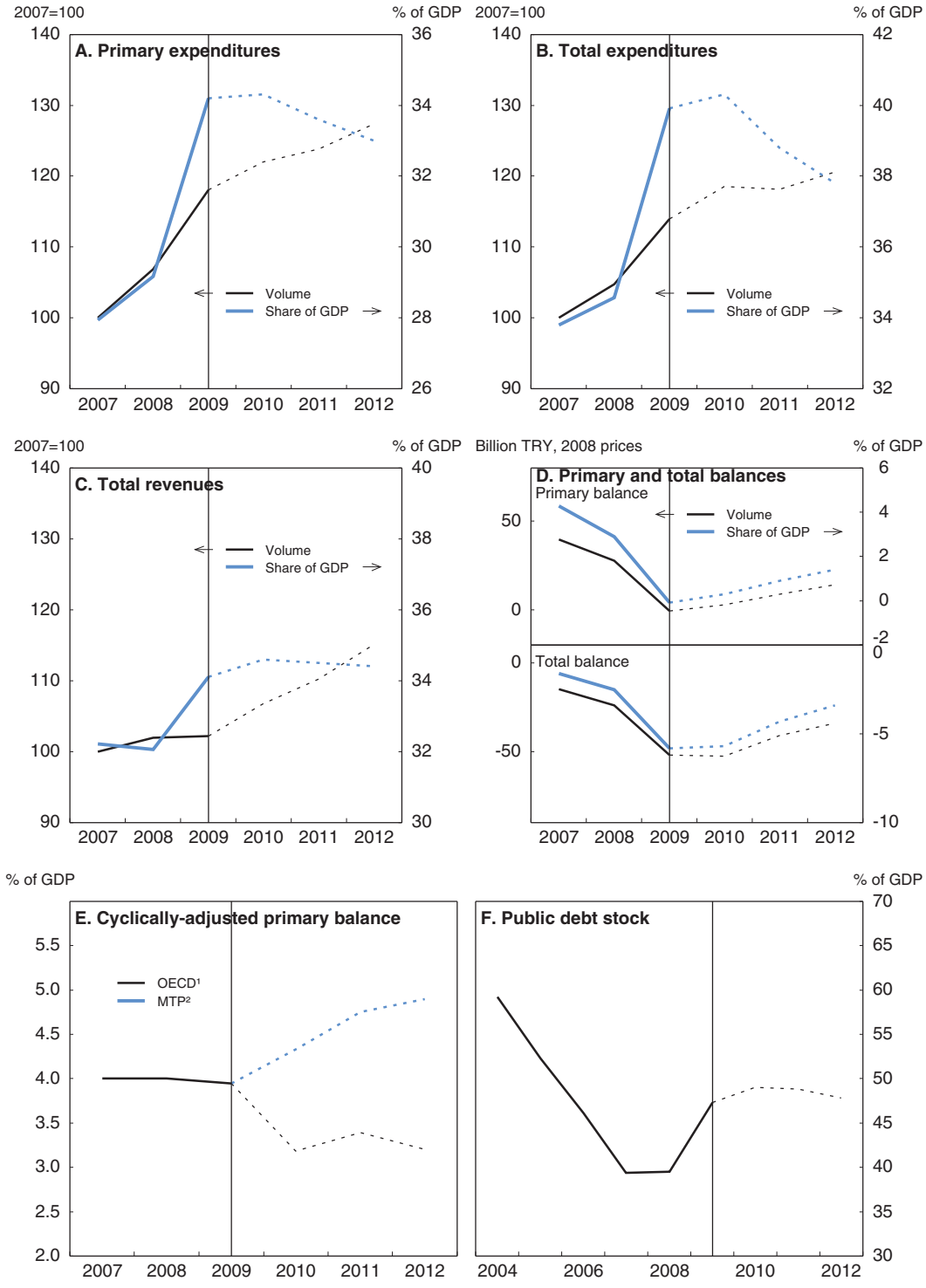
1. All central government figures are set according to the "IMF programme definition".
2. "Non-consolidated balances" includes transfers to/from other general government layers; "net" balances exclude these transfers.
3. Excluding privatisation revenues. Based on the definition of the Pre-Accession Economic Programme submitted to the EU by the State Planning Organization.
4. Excluding interest payments, privatisation revenues and transfers to/from other general government layers.
5. Data for 2009 do not reflect current outcomes but projections published in the MTP done in the second half of 2009.

Source: SPO (2009a), *Medium Term Programme 2010-2012*.

to reiterate similar basic objectives. The emphasis put on central government finances as the main area of adjustment may prove challenging given the fact that the central government only accounts for around half of the general government sector (Annex 1.A4).

The initial MTP targets looked realistic and they were based on a conservative macroeconomic scenario (Table 1.3; Figure 1.7). No excessive improvement was anticipated in revenues. After some increase in 2010 (see below), tax revenues were expected to remain almost constant as a share of GDP. Spending projections were broadly in line with the past trends (Annex 1.A4). One important assumption concerned the planned improvement in social security balances by 0.5% of GDP. Considering the expenditure drifts experienced in the health area in the past three years, this required special measures. Moreover, the increase in public pensions granted in December 2009, which was not appropriated in the 2010 budget, highlighted additional risks to social security balances, especially in the pre-election period. The government argued that the introduction of drastic rationing measures in 2009, including annual budget caps for public and university hospitals, mandatory reductions in pharmaceutical prices, and, user fees would help control health

Figure 1.7. **Medium-term fiscal objectives**



Note: Future fiscal objectives are based on the Medium Term Programme (SPO, 2009a).

1. Based on the GDP projections by the OECD.
2. Based on the GDP projections of the Medium Term Programme.

Source: Ministry of Finance; Turkstat; SPO (2009a), *Medium Term Programme 2010-2012*; and OECD, *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932321834

expenditures, and the increase in premium revenues in the recovery would compensate additional pension expenditures. These measures were expected to prove effective in the short term but called for complementary structural action in the longer term, as discussed in Chapter 2. Also, if the world recovery stays on track, as assumed in the OECD baseline, the 2009 MTP's growth projections may turn out too conservative for the period 2010-12. As implied by the simplified calculations of the cyclically-adjusted primary balance based on OECD projections (Figure 1.7), the initial MTP may then turn out to entail only limited structural tightening.

Regarding 2010 budget, it assumed modest consolidation, from an initially expected 7.0% of GDP in 2009 to just below 6% of GDP (Table 1.3). This was based on a modest increase in spending, 7% in nominal terms over the previous year, and a stronger increase in revenues (projected 10%). The latter would not only reflect stronger GDP growth, but also hikes in indirect taxes. Indeed, at the beginning of 2010, taxes on fuels, tobacco products and alcoholic drinks, road and bridge tolls, stamp duties and fees were increased. Moreover, consumption tax exemptions granted in 2009 were discontinued and the normal collection of VAT on natural gas was resumed (it was suspended due to financial problems in the energy sector). Given the conservative macroeconomic assumptions made in the MTP for 2010-12 (nominal GDP growth in 2010 of 8.7% *versus* 13.9% in OECD projections), it will be desirable to save any windfall revenues instead of increasing spending.

Ensuring successful consolidation and the credibility of future prudent fiscal policy will be important for bolstering confidence and the economic recovery. Gradually limiting budget deficits will minimise crowding-out of private investment in the recovery phase. Fiscal crowding-out posed serious problems in the past (Kaplan *et al*., 2006) and should be avoided in the future. Sound and credible fiscal policy is the prime safeguard against risks of financial market tensions, especially given the expected increase in the risk diversification of foreign investors. It is also essential for lowering the cost of credit for the whole economy (Chapter 2). Moreover, the recent international experience demonstrates that ensuring positive or balanced fiscal positions in good times is essential for having room for discretionary fiscal policies in the face of economic shocks. In the light of these considerations, the costs of any procrastination in consolidation can hardly be exaggerated and should not be downplayed.

Fiscal consolidation would benefit from the improved transparency and predictability of fiscal policy (including the announced fiscal rule), better situation of the social security funds and stronger formalisation of the economy. These issues are discussed at length in Chapter 2.

The right policy mix is important

Before the crisis, the improved headline budget balances turned out to be supportive of the disinflation process, breaking with the past fiscal dominance of monetary policy;[8] such progress should be sustained. Policy mix could also benefit from more stable indirect taxation, which was frequently changed in the recent past (Annex 2.A2 in Chapter 2). Such changes add to inflation volatility and distort price signals, complicating monetary policy. For instance, the tax hikes of January 2010 are estimated to add 1.9 percentage points to 2010 inflation (CBRT, 2010). The impact of the frequent changes in indirect taxes should be seen in a broader context of increased government price controls since 2003 (Wölfl *et al*., 2009; Chapter 3) and the high share of indirect taxes in total tax revenues. This increases the leverage of indirect taxation and price controls and thus makes it more tempting for the government to actually use them. The recourse to these measures should be minimised.

Mitigating risks of macroeconomic instability

Following two decades of a volatile macroeconomic environment, Turkey has experienced the benefits of an improved macroeconomic policy regime in the 2000s. Once the economy fully recovers, consolidating these achievements will be crucial. Thus, Turkey should not only continue to improve the policy framework, as discussed in Chapter 2, but it should also act pre-emptively regarding potential risks to macroeconomic stability stemming from external imbalances and maintain a proper functioning of the financial markets. Progress in these areas will not be possible without structural reforms.

Avoiding external imbalances

The simulations based on an estimated trade model (Annex 1.A2), which takes into account improvements in non-price competitiveness, suggest that, given the current structure of the Turkish economy, strong demand growth is not compatible with low current account deficits and foreign debt. The implied excessive growth in external imbalances would likely spark capital outflows and in turn a correction in the exchange rate and/or domestic demand, which might ultimately threaten macroeconomic and financial stability.[9] The recent financial global crisis demonstrated that capital reversals do not have to be triggered by domestic developments and that emerging markets with high current account deficits and heavy dependence on foreign financing, experienced particularly sharp output contractions (*e.g.* Estonia, Bulgaria, Latvia, Lithuania and Romania). This does not however imply that low and moderate current account deficits are necessarily bad for Turkey, as they may facilitate higher investment and thus stronger future growth.

The authorities could consider policies to rein in an excessive widening of external imbalances. Four areas deserve particular attention: international competitiveness, saving, the structure of capital inflows and energy import dependency. Effective policies in these areas would not only have a positive effect on current account balances but also on long-term growth (Chapter 3). Once such policies are in place, Turkey will be more likely to grow strongly without high current account deficits.

Preserving competitiveness

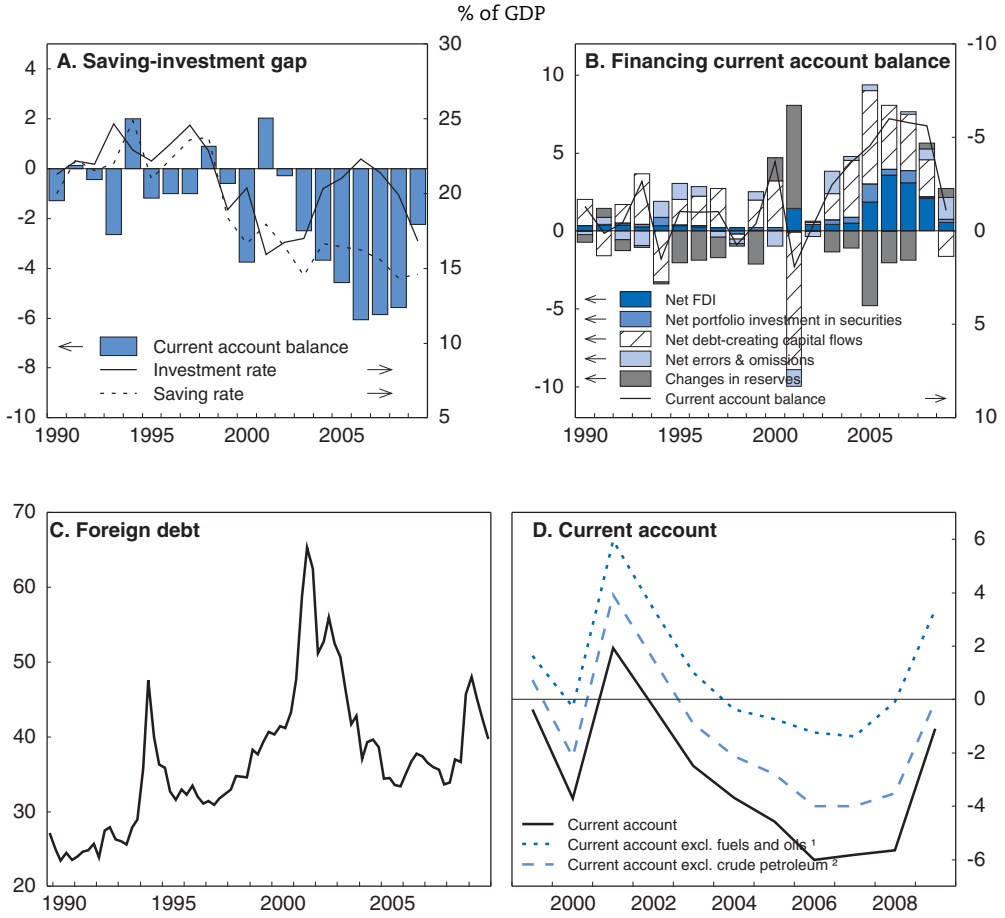
Price and non-price competitiveness are important determinants of current account balances (Annex 1.A2). Non-price competitiveness – understood broadly as factors affecting firms' ability to innovate and improve products' quality – has improved in the 2000s, but there is still much scope for progress (Chapter 3). Regarding price competitiveness, the picture is mixed. Previous OECD surveys documented that the labour intensive sectors of the Turkish economy faced serious competitiveness and employment losses, while medium-technology based activities coped well and continued to grow strongly (OECD, 2006, 2008a). Although, currently there is no strong evidence of exchange rate overvaluation, high labour costs, as demonstrated in Chapter 3, and the loss of export market share prior to the crisis suggest price competition pressures. Looking into the future, the authorities should focus on further enhancing non-price competitiveness and preserving price competitiveness. This primarily requires improving labour and product market regulations to back productivity gains and making wage setting (including minimum wages) more responsive to economic circumstances. Specific policies are discussed in Chapter 3. Moreover, macroeconomic policy should be geared to maintaining the real exchange rate close to its fundamentals. This will be especially important as strong nominal exchange rate appreciation after the crisis is likely to occur. Once the domestic and international

environment improves, Turkey will likely experience increased capital inflows and exchange rate appreciation, as already was the case in the 2000s (OECD, 2008a). Consequently, corporate saving, employment and growth in the tradables sector may be seriously affected (see below and Annex 1.A3).[10] Incipient nominal exchange rate appreciation pressures have already been observed in early 2010. If the authorities would decide to engage in direct measures to prevent excessive nominal exchange rate appreciation (like foreign exchange intervention or capital controls), it should be stressed that such measures cannot be a substitute to structural reforms to improve competiveness and to lower labour costs.

Increasing saving

Increasing domestic saving would help sustain robust economic expansion without fuelling external imbalances and risking turbulent corrections. Turkey will likely need much higher investment than in recent years to sustain GDP expansion in the future. The World Bank (2008) estimates that Turkey would require investment at above 30% of GDP to sustain growth of 6-7%. The ratio was on average around 20% of GDP in the 2003-08 period (Figure 1.8). In the absence of sufficient domestic saving, high investment will have to be

Figure 1.8. **External imbalances**



1. Excluding net exports of processed and unprocessed fuels and oils and gasoline (according to Board Economic Categories).
2. Excluding only imports of crude petroleum.

Source: OECD, *OECD Economic Outlook Database*; IMF, *International Financial Statistics Database* and CBRT.

StatLink http://dx.doi.org/10.1787/888932321853

financed from abroad. However, international experience shows that it is difficult to achieve sustained and strong investment without sufficient domestic saving (Commission on Growth and Development, 2008).

The investment driven widening of the current account balance was already observed in the 2000s (Figure 1.8). The impact on external balances was then exacerbated by a fall in saving. The overall saving rate declined strongly between the late 1990s and the early 2000s and, after a temporary reversal, it continued falling in the following years, but at a lower rate. In the first period, the drop in saving coincided with high budget deficits, whereas in the second phase the reverse was true, implying a fall in private saving.[11]

Saving can be affected by policies to boosting saving, and by changes in macroeconomic fundamentals. Direct policies to increase domestic saving are numerous but their effects are often contested and uncertain (Box 1.1). In the Turkish case, it seems that fiscal discipline may be the best and direct way to raise total domestic saving, adding another argument for fiscal discipline. Implementing tax incentives and altering the tax structure to boost saving are not recommended for Turkey before dealing with pervasive informality and tax evasion.

A more effective way, however, would seem to be to focus on policies affecting key macroeconomic determinants of saving, in particular on employment, real exchange rate and economic growth. Implementing structural reforms to improve productivity and employment and ensuring that macroeconomic policies do not lead to excessive exchange rate overvaluation is expected to boost saving. In recent years, the falling and very low employment rate increased the number of households dependent on the income of only one earner, reducing income per head and in turn making saving difficult. In parallel, real exchange rate appreciation seemed to have reduced the average margins of manufacturing firms (Yilmaz and Gönenç, 2008) and in turn lowered corporate saving.[12] These two factors are indeed found to affect saving negatively in the empirical cross-country analysis presented in Annex 1.A3. Private saving should also rise alongside higher GDP growth (Loayza *et al.*, 2000a, b).

Improving the structure of capital inflows

Increasing the share of foreign direct investment (FDI) and equity portfolio investment (the so-called non-debt creating capital) in overall capital flows would mitigate the risk of an abrupt current account correction and would likely improve the trade balance over time. FDI inflows are more stable than portfolio investment and less sensitive to short-term macroeconomic developments. The non-debt creating capital inflows affect foreign debt dynamics positively, limiting external vulnerabilities (Annex 1.A2). FDI inflows are associated with a transfer of technologies and new investment; when invested in the tradable sector, they are likely to improve productive capacities and thus the trade balance.

In the mid-2000s, domestic market-oriented FDI inflows in service sectors increased considerably (Figure 1.8). This likely reflected a more stable and predictable macroeconomic and political environment as well as the easing product market regulations (Chapters 2 and 3). Nonetheless, many barriers still remain and attracting higher FDI inflows, especially in exporter industries, will be difficult without further improving general conditions for doing business and without further lowering barriers to foreign investment. These issues are discussed in Chapter 3. Attracting FDI could also benefit from higher domestic saving, as such saving is found to be important for FDI co-financing, especially in countries that are far from the technological frontier (Aghion *et al.*, 2006).

Box 1.1. **Policies to increase saving**

Despite voluminous research on policies to increase domestic saving, no consensus has been reached on the best measures and the effectiveness of particular solutions. This box reviews selected policies.

Public saving. Increasing public saving is often claimed to be the most direct and effective, though not always politically feasible, way of boosting private saving (Loayza *et al.*, 2000a). This policy is effective if public saving does not fully crowd out private saving, contrary to the implications of the Ricardian equivalence theory. Available empirical evidence indicates that indeed Ricardian equivalence does not hold in Turkey (Akbostanci and Tunç, 2002; Metin-Ozcan *et al.*, 2003) and in other countries (Lopez *et al.*, 2000). Improved public finances may also have positive indirect long-run effects on private saving: with lower budget deficits more private saving could be channelled to domestic investment, boosting economic growth and in turn private saving (Dayal-Gulati and Thimann, 1997; Loayza *et al.*, 2000a).

Tax incentives. Such measures are controversial (Bernheim, 2002) and are frequently judged as ineffective in raising saving rates (Loayza *et al.*, 2000a). The assessment of tax measures is complicated by difficulties in estimating the elasticity of saving with respect to the rate of net return. There is a theoretical and empirical debate regarding the sign and magnitude of the elasticity, making predictions difficult, especially on a macro scale. Consequently the evidence of positive effects of tax incentives on saving is scarce (Loayza *et al.*, 2000a). Tax incentives may also involve high administration costs and create difficult to predict distortions.

Tax structure. Another way in which tax policy can affect saving relates to the tax structure and its anti-saving distortions. Shifting taxation from income to consumption is believed to boost private saving (Tanzi and Zee, 1998). Taxation in Turkey is already skewed towards consumption taxes. Indirect taxes accounted for around 45% of all tax revenue in 2007. This skew reflects mostly a pervasive evasion of personal income tax, rather than very high indirect tax rates (some exception refer to special consumption and excise taxes) or/and very low personal income tax rates.

Financial sector. Financial sector development and liberalisation have ambiguous effects on saving (Bandiera *et al.*, 2000; Loayza *et al.*, 2000a), though they are likely to be positive in the long run. In the short run, a greater availability of credit and eased liquidity constraints are usually found to reduce private saving (Loayza *et al.*, 2000b). However, some positive short-run effect can also be expected: for instance, wider access to mortgages may stimulate private saving for the down payment. In the long run, a robust and efficient financial sector is likely to bolster investment and economic growth and to provide access to more attractive and diversified saving instruments, stimulating private saving. In this respect, institutional support to stock market development could be considered. The recent global events demonstrated, however, that financial market innovations, if not properly supervised, may lead to bubbles and capital misallocation. Thus, effective financial market supervision must be ensured. This could be accompanied by policies to increase the level of financial education. Explaining the purposes of saving and informing about saving possibilities are believed to affect private saving positively (Bernanke, 2006; OECD, 2008b).

Reducing energy import dependency

Lower energy import dependence and higher energy efficiency would help redress current account imbalances. Energy self-sufficiency in Turkey was around 30% in 2008 (IEA, 2009), implying a heavy reliance on energy imports. Consequently, trade deficits in energy were high (Figure 1.8). This may reflect Turkey's current comparative advantage. This could however change thanks to deliberate policies. The energy import dependence may diminish if government's targets to increase the production of energy from nuclear power and renewable sources of energy are achieved. The government envisages to supply 5% of energy by 2020 from nuclear power plants, and obtaining 30% of electricity generation from renewable sources by 2023 (SPO, 2009b). Given Turkey's specific geophysical conditions, particularly high safety standards for nuclear energy should be ensured. At the same time, the efficiency of the production and consumption of energy should be improved. This requires minimising waste, energy intensity and technical losses during the generation, transmission and distribution of energy. In addition, the effective functioning of the internal energy market should be ensured. The recent decisions to privatise distribution assets and regional distribution facilities and to implement cost-based pricing mechanisms should contribute to achieving this goal.

A successful energy strategy would also support stronger economic growth. Power outages are common in Turkey, adversely affecting economic activity. Turkish businessmen report on average six power outages per month, which are particularly severe for the manufacturing sector (Enterprise Survey, 2009). Electricity failures highlight more generally the challenges for the security of energy provision, which have raised concerns in the past (IMF, 2008). In this respect, appropriate investment in energy infrastructure is needed to ensure sufficient energy supply and its uninterrupted distribution. The security of gas provision is expected to improve upon accomplishing the Nabucco pipeline project. The pipeline will traverse Turkey, connecting the Caspian region, Middle East and Egypt with western European countries, and is estimated to start operating in 2014.

The energy strategy has to be sustainable in terms of its environmental impact. The assessment of Turkey's environmental conditions is mixed. Regarding greenhouse gas emissions, the CO_2 emission per capita is one of the lowest in the OECD but, when measured *per GDP* at market exchange rates, it is among the highest in the OECD. Since 1990, Turkey has doubled its CO_2 emissions. This was among the largest increases observed in the OECD countries (IEA, 2009). Moreover, the CO_2 intensity of electricity and heat production in 2007 was among the highest, even if it declined from 1990. In addition, ambient air pollution by sulphur dioxide (SO_2) and nitrogen monoxide (NO_x) exceeds national air quality standards (OECD, 2008c). Turkey's share of renewables in total primary energy supply was below 10% in 2008, which was higher than the OECD average (IEA, 2009). Given the projected increase in energy consumption, reaching the targets for renewable energy production (see above) would require significant investment. By and large, although the environmental impact of energy production and consumption is not alarming, there is scope for improvement, especially as the continuing rapid economic development is likely to intensify some of the environmental challenges.

Ensuring smooth functioning of the financial sector

A smooth functioning of the financial markets and prudent financial supervision are key to macroeconomic stability. Turkey has painfully learned this lesson in 2001 (BRSA, 2009; Bredenkamp *et al*., 2009), and the OECD countries were reminded about it during the

recent crisis. The current situation in the Turkish financial sector is significantly better than in many OECD countries, but there are still some challenges and scope for improvement. Moreover, fast innovation in the financial markets requires constant vigilance and adapting to an ever changing situation. The efficient functioning of the financial system will be also instrumental for lowering the cost of capital and in turn for boosting economic growth (Chapter 2). The policy challenges to financial stability are discussed in Chapter 2. In the very short term, it is highly welcome that certain measures taken in early 2009 to relax some of the prudential rules applicable to banks in order to ease credit conditions for businesses[13] are kept temporary. Standard prudential rules will be fully applicable again from March 2011.

Even if Turkey fully consolidates its macroeconomic framework and secures external and financial stability, some volatility in output could still be experienced. Domestic and foreign shocks cannot be eliminated,[14] but enhancements in structural policies and the macroeconomic framework would improve resilience to shocks, partially due to active counter-cyclical polices, as was already the case in 2008-09. Consequently, protracted and negative effects on growth and employment could be limited, boosting long-term growth. The improved macroeconomic framework and prudent economic policy prior to and during the crisis were already rewarded by the upgrade of the sovereign credit ratings by all rating agencies and the rapid normalisation of the risk premia in recent months (Chapter 2). Nevertheless, Turkey still has a sub-investment grade rating and there is room for the improvement of Turkey's international capital market status and for lowering capital costs. These topics are analysed in Chapter 2, while Chapter 3 discusses long-term growth prospects in the context of labour and product market regulations and related political economy considerations.

Policy recommendations

Policy recommendations are summarised in Box 1.2.

Box 1.2. **Macroeconomic policy recommendations**

Monetary policy

- The process of normalising interest rates should begin before the end of 2010, conditional on a favourable economic outlook. The pace of monetary tightening should be fast enough to avoid inflation expectations becoming unanchored.

Fiscal policy

- The new fiscal rule should be already implemented for the 2011 Budget. Fiscal policy should be gradually tightened by removing discretionary stimulus and by allowing automatic stabilisers to reduce the deficit as the economy recovers.

Mitigating future disruptive growth volatility

- The likely widening of external balances once economic growth accelerates should be addressed by structural policies to boost productivity and employment (Chapter 3) and in turn to enhance competitiveness, saving and FDI. Moreover, efforts to increase domestic energy production and energy efficiency should be intensified.
- Financial market supervision should ensure a smooth functioning of financial markets (Chapter 2).

Notes

1. Prior to the crises a significant part of long-term foreign borrowing of the non-bank private sector was provided by foreign branches of Turkish banks. After the crisis, some of these loans were transferred from the foreign to domestic branches of Turkish banks. In September 2009, the rollover ratio adjusted for this effect would be around 17 percentage points higher than the actual rollover ratio (CBRT, 2009a).
2. The classification of revenue and expenditure measures follows the one adopted by SPO (2009b). In some instances, an alternative classification could be made. For instance, several measures to reduce contributions to social security institutions could be classified as revenue measures (lost social security revenues) rather than expenditure measures (central government transfers to social security funds offsetting their losses).
3. Previously undeclared income reported for clearance brought TRY 46 billion, nearly 5% of GDP.
4. As time series of general government proxies are short and are only tentatively estimated, computing cyclical adjustments according to standard methods like by Girouard and André (2005) is not possible. Thus, a simplified approach is proposed. It assumes that cyclically adjusted revenues are proportional to the ratio of potential and actual real GDP and total actual revenues (implying unit elasticity in the Girouard and André (2005) methodology). Expenditures are not adjusted for the cycle. The output gap is based on OECD calculations. SPO (2009b) also prepares cyclically-adjusted budget balances in the context of the pre-accession economic programmes submitted to the EU. Cyclically-adjusted balances should be analysed carefully given uncertainties regarding the measures of output gap (the estimates of the OECD differ from the estimates of the Turkish authorities).
5. Including the 2008-09 recession. A recession is defined here when quarterly GDP growth is negative for at least two consecutive quarters. t_0 refers to the quarter preceding the recession (*i.e.* the peak in the GDP level).
6. OECD projections assume that the trend increase in labour force participation will continue, albeit at a slower pace, after the crisis; and that the labour market slack which formed in the crisis will be gradually eliminated through slow employment growth in the recovery.
7. The budget balance excludes the privatisation revenues in contrast to the figures published in SPO (2009a). The general government budget deficit in 2009 actually turned out lower than expected (5.8% of GDP instead of 7.0% of GDP).
8. In particular, a risk premium increase related to the costs of public debt servicing was shown to have adverse effects for monetary policy transmission and inflation in Turkey, leading to higher and not lower prices following the tightening of monetary policy (Aktas *et al*., 2010).
9. The macroeconomic correction due to external imbalances is however neither automatic nor imminent. Usually it is difficult to predict a critical level of the current account deficit/foreign debt, the timing of the correction as well as its mechanism (exchange rate and/or domestic demand). Nevertheless, current account deficits are among the key predictors of financial crises (*e.g.* in Kaminsky *et al*., 1997).
10. Overvalued exchange rates are believed to lower economic growth (Eichengreen, 2008; Rodrik, 2008). In the particular case of Turkey, the real exchange appreciation was found to diminish significantly profit margins in the manufacturing industry, especially in the sectors using low-skilled labour (Yilmaz and Gönenç, 2008).
11. Assessing precisely the contributions of private (household and corporate) and of public saving is complicated by the lack of reliable data. Total saving is calculated as a sum of the current account balance and investment.
12. A similar argument is made by Rodrik (2009b).
13. A decree published on 16 June 2009 gave additional margins to banks to restructure loans for squeezed corporate customers without necessarily re-classifying their loans and undermining their creditworthy borrower status. Certain capital provisioning rules for new credits extended after June 2009 were also temporarily relaxed. These measures will be phased out as of 1 March 2011.
14. Higher output volatility may reflect the production specialisation towards less complex goods which exports are found to be more volatile (Pravin and Levchenko, 2009). Thus, shifting to modern tradables may not only be a way to increase growth, as argued by Rodrik (2009a), but also a mean to reduce output volatility.

Bibliography

Aghion, P., D. Comin and P. Howitt (2006), "When Does Domestic Saving Matter for Economic Growth?", *NBER Working Papers*, No. 12275, National Bureau of Economic Research, Cambridge, MA.

Akbostanci, E. and G.I. Tunç (2002), "Turkish Twin Effects: An Error Correction Model of Trade Balance", *Economic Research Center Working Papers in Economics*, No. 01/06, Middle East Technical University, Ankara.

Aktas, Z., N. Kaya and Ü. Özlale (2010), "Coordination between Monetary Policy and Fiscal Policy for an Inflation Targeting Emerging Market", *Journal of International Money and Finance*, Vol. 29(1), p.123-138.

Armington, P.S. (1969), "A Theory of Demand for Products Distinguished by Place of Production", *IMF Staff Papers*, No. 16, IMF, Washington, DC.

Aslan, M. and K. Aslan (2008), "Turkiyede 1963-2006 Doneminde Kamu ve Ozel Sektor Ucretleri", *Eskişehir Osmangazi Üniversitesi Sosyal Bilimler Dergisi*, Vol. 9(2), Eskisehir.

Bandiera, O., G. Caprio, P. Honohan and F. Schiantarelli (2000), "Does Financial Reform Raise or Reduce Private Savings?", *Review of Economics and Statistics*, Vol. 82(2).

Bernanke, B.S. (2006), "The Coming Demographic Transition: Will We Treat Future Generations Fairley?", *Speech before the Washington Economic Club*, 4 October, Washington, DC.

Bernheim, B.D. (2002), "Taxation and Saving", in: A.J. Auerbach and M. Feldstein (ed.), *Handbook of Public Economics*, Vol. 3, Ch. 18, Elsevier, Amsterdam.

Bredenkamp, H., M. Josefsson and C.J. Lindgren (2009), "Turkey's Renaissance: From Banking Crisis to Economic Revival", in Brau E. and I. McDonald, *Successes of the International Monetary Fund: Untold Stories of Cooperation at Work*, Palgrave Macmillan.

BRSA (2009), "From Crisis to Financial Stability (Turkey Experience)", *BRSA Working Paper*, Banking Regulatory and Supervision Agency, Ankara.

CBRT (2009a), *Financial Stability Report*, Vol. 9, November, Central Bank of the Republic of Turkey, Ankara.

CBRT (2009b), *Monetary and Exchange Rate Policy for 2010*, Central Bank of the Republic of Turkey, 10 December, Ankara.

CBRT (2010), *Inflation Report. 2010-II*, Central Bank of the Republic of Turkey, April, Ankara.

Cheung, C. and S. Guichard (2009), "Understanding the World Trade Collapse", *OECD Economics Department Working Papers*, No. 729, OECD, Paris.

Commission on Growth and Development (2008), *The Growth Report. Strategies for Sustained Growth and Inclusive Development*, International Bank for Reconstruction and Development and World Bank, Washington, DC.

Dayal-Ghulati, A. and C. Thimann (1997), "Saving in Southeast Asia and Latin America Compared: Searching for Policy Lessons", *IMF Working Papers*, No. 97/110, IMF, Washington, DC.

Doan, T., R.B. Litterman and C. Sims (1984), "Forecasting and Conditional Projection Using Realistic Prior Distributions", *Econometric Reviews*, Vol. 3(1), p. 1-100.

Edwards, S. (1995), "Why Are Saving Rates So Different across Countries? An International Comparative Analysis", *NBER Working Papers*, No. 5097, National Bureau of Economic Research, Cambridge, MA.

Eichengreen, B. (2008), "The Real Exchange Rate and Economic Growth", *Commission on Growth and Development Working Papers*, No. 4, Washington, DC.

Enterprise Surveys (2009), "Running a Business in Turkey", *Enterprise Surveys Country Note Series*, No. 1, World Bank Group, Washington, DC.

Ericsson, N.R. and J.G. MacKinnon (2002), "Distributions of Error Correction Tests for Cointegration", *Econometrics Journal*, Vol. 5, p. 285-318.

Freund, C. (2009), "The Trade Response to Global Crises: Historical Evidence", World Bank, Washington, DC.

Gagnon, J.E. (2007), "Productive Capacity, Product Varieties and the Elasticities Approach to the Trade Balance", *Review of International Economics*, Vol. 15, p. 639-659.

Girouard, N. and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for OECD Countries", *Economics Department Working Papers*, No. 434, OECD, Paris.

Hannon, P. (2010), "What Counts Now Is How Governable a Nation Is", *Wall Street Journal*, 5 February.

Hooper, P., K. Johnson and J. Marquez (1998), "Trade Elasticities for G-7 Countries", *International Finance Discussion Papers*, No. 609, Board of Governors of the Federal Reserve System, Washington, DC.

IEA (2009), *IEA Scoreboard 2009. 35 Key Energy Trends over 35 Years*, International Energy Agency, Paris.

IMF (2008), "Turkey: Seventh Review and Inflation Consultation under the Stand-By Arrangement and Request for Wavier of Nonobservance of Performance Criteria", *IMF Country Report, No.* 08/272, August, Washington, DC.

IMF (2009), "Policies in Emerging Economies for Coping with Heightened Risk during Recovery", in *IMF Regional Economic Outlook: Europe. Securing Recovery*, October, Washington, DC.

Jarociński, M. and F.R. Smets (2008), *House Prices and the Stance of Monetary Policy*, *Review*, Federal Reserve Bank of St. Louis, Vol. 90(4).

Kaminsky, G., S. Linzondo and C. Reihart (1997), "Leading Indicators of Currency Crises", *IMF Staff Papers*, Vol. 45(1), Washington, DC.

Kaplan, C., E. Özmen and C. Yalçin (2006), "The Determinants and Implications of Financial Asset Holdings of Non-financial Firms in Turkey: An Empirical Investigation", *Central Bank of the Republic of Turkey Working Paper*, No. 06/06, CBRT, Ankara.

Loayza, N., K. Schmidt-Hebbel and L. Servén (2000a), "Saving in Developing Countries: An Overview", *World Bank Economic Review*, Vol. 14(3), Washington, DC.

Loayza, N., K. Schmidt-Hebbel and L. Servén (2000b), "What Drives Private Saving across the World?", *Review of Economics and Statistics*, Vol. 82(2), p. 165-181.

Lopez, H., K. Schmidt-Hebbel and L. Servén (2000), "How Effective Is Fiscal Policy in Raising National Saving?", *Review of Economics and Statistics*, Vol. 82(2), p. 226-238.

Metin-Ozcan, K., A. Gunay and S. Ertac (2003), "Determinants of Private Savings Behaviour in Turkey", *Applied Economics*, Vol. 35(12).

OECD (2006), *OECD Economic Surveys: Turkey*, Vol. 2006/15, OECD, Paris.

OECD (2008a), *OECD Economic Surveys: Turkey*, Vol. 2008/14, OECD, Paris.

OECD (2008b), *Improving Financial Education and Awareness on Insurance and Private Pensions*, Paris.

OECD (2008c), *OECD Environmental Performance Reviews: Turkey*, OECD, Paris.

OECD (2009), "Beyond the Crisis: Medium-Term Challenges Relating to Potential Output, Unemployment and Fiscal Positions", Chapter 4 in *OECD Economic Outlook*, Vol. 2009, No. 1, June 2009, pp. 204-235, OECD, Paris.

Pain, N., A. Mourougane, F. Sédillot and L. Le Fouler (2005), "The New OECD International Trade Model", *OECD Economics Department Working Papers*, No. ECO/WKP(2005)27, OECD, Paris.

Pravin, K. and A.Al. Levchenko (2009), "Comparative Advantage, Complexity and Volatility", *NBER Working Papers*, No. 14965, National Bureau of Economic Research, Cambridge, MA.

Rodrik, D. (2008), "The Real Exchange Rate and Economic Growth", *Brookings Papers on Economic Activity*, Conference Draft, September.

Rodrik, D. (2009a), "Growth after the Crisis", *CEPR Discussion Paper*, No. 7480, Centre for Economic Policy Research, London.

Rodrik, D. (2009b), "The Turkish Economy after the Crisis", *Turkish Economic Association Discussion Papers*, No. 2009/9.

Rubaszek, M. and Ł. Rawdanowicz (2009), "Economic Convergence and the Fundamental Equilibrium Exchange Rate in Central and Eastern Europe", *International Review of Financial Analysis*, Vol. 18(5), p. 277-284.

Sato, K. (1977), "The Demand Function for Industrial Exports: A Cross-Country Analysis", *Review of Economics and Statistics*, Vol. 65, p. 456-64.

SPO (2009a), *Medium Term Programme 2010-2012*, State Planning Organization, September, Ankara.

SPO (2009b), *Pre-Accession Economic Programme 2009*, State Planning Organization, December 2009, Ankara.

Tanzi, V. and H. Zee (1998), "Taxation and the Household Saving Rate: Evidence from OECD Countries", *IMF Working Papers*, No. 98/36, Washington, DC.

Waggoner, D.F. and T. Zha (1999), "Conditional Forecasts in Dynamic Multivariate Models", *Review of Economics and Statistics*, Vol. 81(4), p. 639-51.

Wölfl, A., I. Wanner, T. Kożluk and G. Nicoletti (2009), "Ten Years of Product Market Reform in OECD Countries: Insights from a Revised PMR Indicator", *OECD Economics Department Working Papers*, No. 695, OECD, Paris.

World Bank (2008), "Turkey Country Economic Memorandum. Sustaining High Growth: Selected Issues", *World Bank Report*, No. 39194-TR, Washington, DC.

Yilmaz, G. and R. Gönenç (2008), "How Did the Turkish Industry Respond to Increased Competitive Pressures, 1998-2007?", *Central Bank of the Republic of Turkey Working Papers*, No. 08/04, CBRT, Ankara.

ANNEX 1.A1

Explaining recent GDP dynamics

In order to investigate the triggers of the growth moderation in 2005-07 and the subsequent deep recession, a series of conditional forecasts based on an estimated Bayesian Vector Autoregression (BVAR) model are conducted. This approach is useful for illustrating stylised facts about the role of different factors in analysing certain economic developments. The methodology follows the approach by Jarociński and Smets (2008).[1] It involves estimating a BVAR in levels with the Minnesota prior, and then conducting experiments with in-sample conditional forecasts, *i.e.* forecasts conditional on the estimated model and on the actual realisation of some of the endogenous variables (Doan *et al.*, 1984; Waggoner and Zha, 1999).

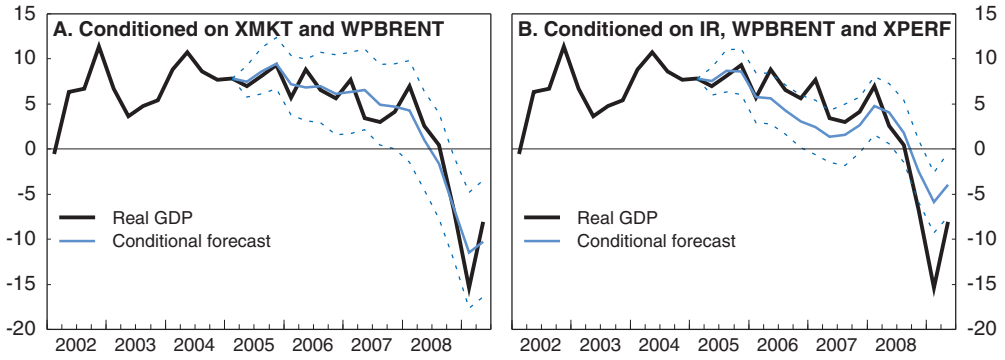
The Turkish BVAR contains seven variables in levels. They include five domestic variables: real GDP (GDPV), GDP deflator (PGDP), nominal effective exchange rate (EXCHE), nominal money market interest rate (IR), business confidence indicator (BSCI) and Turkish market export share (XPERF); and two foreign variables: trade-weighted volume of foreign demand (XMKT) and world oil prices denominated in US dollars (WPBRENT). All variables except the interest rate are in logarithms. The BVAR is estimated over the period 1991-2009Q2, on quarterly data with 5 lags. GDP, GDP deflator and foreign demand are seasonally adjusted.

First, we ask the question if, conditional on the estimated model and observed foreign variables (foreign demand and oil prices), we can forecast real GDP growth over the past five years. Then, we increase the information set by conditioning forecasts in turn on interest rates, business confidence, and the exchange rate and export market shares. This will help us to check if these variables can provide extra information in addition to information already contained in the foreign variables.

The results imply that foreign developments can explain largely both the gradual GDP moderation in 2005-07 and the GDP contraction in 2008-09 (Figure 1.A1.1). They contain sufficient information to obtain reasonable joint projections of GDP volumes and prices, business confidence and exchange and interest rates. Adding separately additional information contained in business confidence, interest and exchange rates does not seem to improve tangibly real GDP projections.[2] This implies that foreign variables are the main triggers of economic developments in Turkey, however, business confidence, interest and exchange rates are still important for modelling GDP dynamics as excluding them from the BVAR model results in worse conditional projections of GDP. Moreover, projecting GDP conditioned on interest rates, oil prices and export market performance – the three main

Figure 1.A1.1. **Conditional in-sample forecasts of real GDP**

Year-on-year % change



Note: Dotted lines indicate 16 and 84 percentile. XMKT is the trade-weighted volume of foreign demand, WPBRENT is the world oil prices denominated in US dollars, IR is the nominal money market interest rate and XPERF is the Turkish market export share.

Source: OECD calculations based on the *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932321872

hypothesised drivers of growth moderation in 2005-07 (see the main text) – gives worse projections than those based only on foreign demand and oil prices (Figure 1.A1.1).

Notes

1. Special thanks to M. Jarociński for providing programmes for estimating BVAR models and conditional forecasting.
2. In fact, the lowest root mean squared error (RMSE) is for the information set including foreign variables and export market performance, the second comes the set containing only foreign variables and the set with foreign variables and business confidence, and the highest RMSE is for the projection conditioned on foreign variables and the exchange rate. The ranking changes if one focus primarily on 2005-07 period.

ANNEX 1.A2

Current account deficit and external debt simulations with accelerating domestic demand

Current account balances and foreign debt are important indicators of macroeconomic stability in emerging markets. High and protracted current account deficits, especially when they raise foreign debt, may lead to a turbulent correction. In order to gain insights about potential external imbalances in the medium term in Turkey, this annex presents two hypothetical current account and foreign debt simulations based on partial equilibrium analysis, using an estimated trade model. The simulations do not assume any feedback from the current account balance and external debt to other macroeconomic variables, such as exchange rate. Thus, they are not meant to be projections. They simply aim to demonstrate that under the current structure of the economy, Turkey is likely to experience growing external imbalances following sustained domestic demand accelerations.

The Turkish trade model consists of four equations for the prices and volume of exports and imports. Export and import prices are assumed to be determined by domestic and foreign prices in line with the standard practice (Pain *et al.*, 2005). In contrast, volume equations depart from the standard approach, which focuses primarily on demand and relative prices (Pain *et al.*, 2005).[1] Following the ideas of Sato (1977) and Gagnon (2007), trade volume equations are augmented with a proxy of productive capacities.[2] This variable aims at capturing non-price competitiveness or other factors explaining international trade (like love for variety, product differentiation, economies of scale, or Rodrik's (2009a) idea about "modern" tradables). The intuition is that fast-growing countries are likely to raise the quality of their products and to encourage innovation, improving *ceteris paribus* their trade balances. Consequently, the catching-up process involving quality and variety improvements may to some extent mitigate the negative impact of concomitant real exchange rate appreciation.

The trade equations are estimated as error-correction models (ECM). The following long-run relations, derived from the ECM, were obtained (standard errors in brackets):[3]

	adj. R^2	sample	
$mgsv = 43.96 + 2.66^{*}gdpv - 0.39^{*}rpm - 1.30^{*}rpc$ (2.96) (0.11) (0.12) (0.25)	0.84	1993-07	(1)
$xgsv = -4.48 + 1.00^{*}xmkt - 2.68^{*}rpx + 1.66^{*}rpc$ (2.30) (1.16) (0.57)	0.29	1980-07	(2)
$(pmgs - pgdp) = -1.18 - 0.65^{*}(pgdp - pmsh) \rightarrow pmgs = 0.35^{*}\, pgdp + 0.65^{*}pmsh$ (0.11) (0.06)	0.82	1990-07	(3)

$$(pxgs - pgdp) = -1.71 - 0.91^{*}(pgdp - pxc) \rightarrow pxgs = 0.09^{*}\ pgdp + 0.91^{*}pxc \qquad 0.72 \qquad 1990\text{-}07 \qquad (4)$$
$$(0.20)\ \ (0.11)$$

where *mgsv* and *xgsv* are import and export volumes (goods and services), *gdpv* is Turkish real GDP, *rpc* is a proxy of relative productivity capacity defined in terms of average labour productivity (the indicator for Turkey divided by weighted indicators for the main Turkish trading partners),[4] *xmkt* is weighted export demand, *pmsh* is the weighted export price of Turkey's trade partners, *pxc* is weighted export prices of Turkey's main competitors in foreign markets, *pgdp*, *pmgs* and *pxgs* are Turkey's GDP, import and export deflators respectively, *rpm* is relative import price (*pmgs* – *pgdp*), and *rpx* is relative export price (*pxgs* – *pxc*).[5] All above-mentioned price indices are denominated in the Turkish lira. Small letters denote variables in logarithms.

The estimated equations have good statistical properties and reasonable economic interpretation in general (in terms of the signs and magnitudes of the long-term elasticities).[6] In particular, the relative productive capacity proxy is statistically significant and has the expected sign. It implies that if the productivity catching-up continues, Turkey will, *ceteris paribus*, import less and export more. Following Pain *et al.* (2005), the demand elasticity in the export equation was restricted to 1, however, in contrast, a similar restriction in import equation was not imposed as it is strongly rejected by the data and it is inconsistent with the fact that since the early 1990s the share of imports in GDP (in real terms) increased from 0.10 to 0.30.[7] The estimated price equations suggest that Turkey is a price taker, *i.e.* import and export prices are determined primarily by foreign prices. This is in line with expectations, though the high elasticities on foreign prices may be affected by the large volatility in nominal exchange rates experienced in Turkey over the estimation period.

Combining equations (1) – (4), the current account identity is given by:

$$CA_t = PXGS_t{}^{*}XGSV_t - PMGS_t{}^{*}MGSV_t + CA_t^{TR} + CA_t^{INC} \qquad (5)$$

where CA_t^{TR} and CA_t^{INC} are transfer and income items of the current account balance.

Given the current account projections, the external debt can be calculated as:

$$ED_t = ED_{t-1} - (CA_t + NDC_t) \qquad (6)$$

where ED_t is external debt, CA_t is the current account balance, and NDC_t is non-debt creating capital inflows (FDI and equity portfolio capital).[8] All the above variables are expressed in Turkish lira.

In order to demonstrate the sensitivity of current account balance, and external debt, to acceleration in domestic demand two hypothetical medium-term simulations are presented. They are derived from the estimated trade model and are based on two alternative demand assumptions (Table 1.A2.1). Simulation 1 assumes constant GDP growth of 4% over a five-year period, whereas Simulation 2 envisages growth of 5%. Higher demand growth in Simulation 2 does not imply higher productivity as the employment growth assumption is also higher in Simulation 2 and the improvement in non-price competitiveness is the same in both simulations. Thus, Simulation 2 implies a demand shock. For the sake of simplicity, all other variables are assumed to be the same in both scenarios and are calibrated to reflect broadly their average past trends.

Table 1.A2.1. **Assumptions underlying medium-term simulations of the current account balance and external debt**[1]

		Simulation 1	Simulation 2	Historic average	
				1998-2007	2003-2007
Domestic variables					
Real GDP	GDPV	4.0	5.0	4.2	6.9
Total employment	ET	1.2	2.2	0.7	1.1
GDP deflator	PGDP	5.0	5.0	33.2	11.8
Nominal exchange rate (USD per TRY)[2]	EXCH	0.0	0.0	–16.1	3.6
Transfer and income accounts (% of GDP)	CA^{TR} + CA^{INC}	–1.0	–1.0	–1.1	–1.1
Non-debt creating capital flows (% of GDP)	NDC	1.9	1.9	1.5	2.5
Foreign variables					
Foreign productive capacity	PCF	1.0	1.0	1.2	1.1
Foreign demand	XMKT	8.0	8.0	7.5	8.9
Foreign import prices in USD	PMSHF	3.5	3.5	3.8	9.9
Turkey's competitors' export prices in USD	PXCF	3.0	3.0	3.0	8.3
Implied variables					
Turkey's productive capacity	PC = GDPV/ET	2.8	2.8	3.5	5.8
Relative productive capacities	RPC = PC/PCF	1.8	1.8	2.3	4.6
Foreign import prices in TRY	PMSH = PMSHF/EXCH	3.5	3.5	31.4	5.8
Turkey's competitors' export prices in TRY	PXC = PXCF/EXCH	3.0	3.0	3.0	8.3
Relative import prices	RPM = PMGS/PMSH	–1.3	–1.3	–0.6	–3.1
Relative export prices	RPX = PXGS/PXC	–0.2	–0.2	–1.4	–2.9

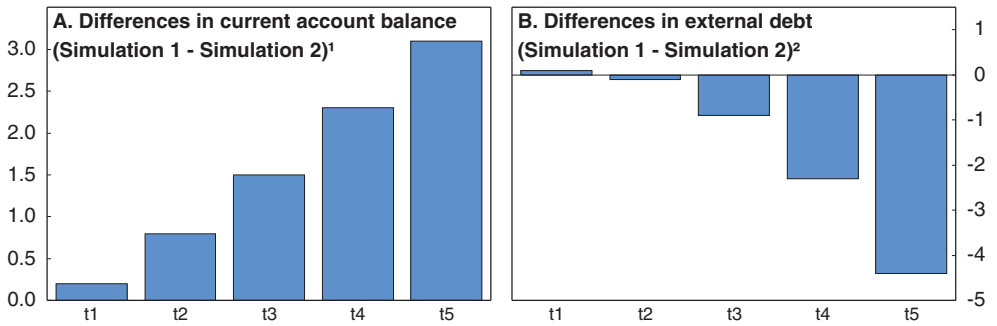
1. Annual average growth rates unless stated otherwise.
2. An increase means an appreciation of the Turkish lira (TRY).

Source: OECD based on the *OECD Economic Outlook Database*.

The hypothetical exercise shows that even small sustained differences in domestic demand growth over the medium term have a tangible impact on the current account deficit and external debt (Figure 1.A2.1). This suggests, given the current structure of the economy and absent real exchange rate adjustments, an incompatibility of strong growth and current account deficit sustainability, despite the ongoing improvements in non-price

Figure 1.A2.1. **Differences in current account and foreign debt simulations with accelerating domestic demand**

Percentage points



1. Positive figures imply that current account deficit, as a percentage of GDP, in Simulation 1 is lower than in Simulation 2.
2. Negative figures imply that external debt, as a percentage of GDP, in Simulation 1 is lower than in Simulation 2.

Note: Time scale refers to years.

Source: OECD calculations based on the *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932321891

competitiveness. The implied pace of external imbalances growth would likely trigger corrections in GDP growth and/or the exchange rate. However, reforms to change the structure of the economy, beyond the direct impact of non-price competitiveness, could reduce the required constraint on growth and the real exchange rate to achieve the needed improvement in the external balance. If successfully implemented, Turkey would be able to enjoy strong GDP growth, even stronger than in Simulation 2, without excessive current account deficits.

Notes

1. The so-called Armington's (1969) specification, which implicitly assumes that countries produce one variety of goods and that consumers perceive different varieties originating from a foreign country as perfect substitutes of domestically produced goods.
2. The same idea was used by Rubaszek and Rawdanowicz (2009) to estimate trade equations for the Czech Republic, Hungary, Poland and the Slovak Republic in the context of investigating fundamental equilibrium exchange rates.
3. The short-term dynamics are not shown here. Sample selection was based on the cointegration tests in the single-equation conditional error correction model based on small-sample critical values from Ericsson and MacKinnon (2002).
4. Other proxies were also tested (relative potential output per capita and per worker), but the resulting statistical properties of the estimated models were inferior. Only main OECD trading partners are included due to data limitations.
5. For detailed definitions of *xmkt*, *pmsh* and *pxc* refer to Pain *et al.* (2005).
6. Export volume equation has exceptionally poor properties. Problems with estimating well-behaving trade equations are however common in the literature (Hooper *et al.*, 1998; Pain *et al.*, 2005). The equations without relative productive capacity proxy performed even worse. Pain *et al.* (2005) attempted to improve the standard trade model specification by adding a deterministic time trend in the long-term equation.
7. The restricted import equation has much worse statistical and economic properties (*i.e.* less explanatory power, unstable signs and insignificant elasticities).
8. This is a simple version of external debt dynamics which presumes that interest payments on foreign debt are included in the current account balance. For the sake of simplicity, these payments are assumed to be independent of the level of foreign debt.

ANNEX 1.A3

Empirical determinants of saving

Empirical determinants of saving have been extensively tested in the economic literature (*e.g.* Edwards, 1995; Loayza *et al.*, 2000a, b). Studies varied with respect to the definition of saving, the use of explanatory variables as well as estimation methods and the country coverage. This annex adds to this literature by testing the role of labour market outcomes and international competitiveness in saving formation – two important factors for Turkey.

Saving determinants are numerous and contested and they vary across institutional sectors. Total saving is often explained by fiscal balances. Most empirical studies find that improved fiscal balances spurs private saving. This is in contrast to the strict version of the Ricardian equivalence theory. The latter predicts that fiscal balances should not have any impact on total domestic saving, as any change in government saving would be offset by an opposite change in private saving. Total saving is also frequently determined by income growth and real interest rates, although the theoretical impact of these two factors is ambiguous (Loayza *et al.*, 2000a; Metin-Ozcan *et al.*, 2003). Regarding household saving, one of the most common determinants is the age structure of the population, relating to the life-cycle hypothesis. According to this hypothesis, people save most in their middle age and dissave when they are young and/or retired.

In the case of Turkey, the profitability of firms related to international competitiveness and the family income distribution reflecting the labour market outcomes seem to affect saving on top of the standard determinants (Chapter 1). These two factors are likely to impact on saving in other countries as well. Against this background, this annex attempts to test if the two hypotheses (international competitiveness and labour market) help explain domestic saving on top of standard determinants. To this end, panel estimations of saving equation for a wide range of countries are undertaken.

Data pose significant challenges. Data on saving for a wide range of countries are scarce. Thus, following usual practice, saving is derived from the saving-investment-current account identity (*i.e.* as a sum of the current account balance and investment). In the estimations, the dependent variable is the ratio of saving to nominal GDP (*SX*). The labour market effect is approximated with the labour force participation rate (*LFPR*), *i.e.* a share of labour force in working age population, since it is more widely available than employment rates. Real effective exchange rate growth is expected to account for international competitiveness (*REER*), where an increase in *REER* implies real exchange rate appreciation. The remaining standard determinants of saving include: the age dependency ratio – the share of population below 20 years and above 64 years in population

between 20 and 64 years (*ADR*), GDP growth (*Y*), fiscal balances as a percentage of nominal GDP (*NGL*) and real interest rates (*RIR*). Data are collected mainly from the World Bank *World Development Indicator*, IMF *International Financial Statistics* and *OECD Economic Outlook Databases*.[1]

Given problems with collecting all variables for a wide range of economies for a sufficient long period, three different country groups are selected. The first contains 46 countries for which all variables are available, the second comprises 64 countries, adding countries for which only fiscal data are not available, and the third includes 88 countries, adding countries for which fiscal balances and real effective exchange rates are not available.[2] For all three country groups, the series span from 1998 to 2007. To eliminate cyclical movements, estimations are run for 5-year and 10-year averages, resulting in 2-period balanced panel and cross-section estimations (Table 1.A3.1).

Table 1.A3.1. **Saving model results**

	[1]	[2]	[3]	[4]	[5]	[6]
Constant	25.19 ***	26.73 **	13.98	11.37 ***	17.99 ***	17.80 ***
	(1.50)	(11.52)	(8.39)	(1.22)	(0.62)	(5.56)
Y	–1.02 ***	–1.15 ***	–0.06	–0.03 ***	0.15 ***	0.07
	(0.25)	(0.42)	(0.47)	(0.00)	(0.02)	(0.49)
ADR	–0.28 ***	–0.34 *	–0.36 ***	–0.31 ***	–0.20 ***	–0.20 ***
	(0.03)	(0.19)	(0.09)	(0.01)	(0.01)	(0.05)
LFPR	0.24 ***	0.28 *	0.46 ***	0.44 ***	0.22 ***	0.22 **
	(0.03)	(0.16)	(0.15)	(0.01)	(0.00)	(0.10)
RIR	–0.27 ***	–0.37 **	–0.60 ***	–0.38 ***	–0.07	–0.10
	(0.07)	(0.18)	(0.21)	(0.11)	(0.05)	(0.10)
REER	–0.43 ***	–0.92	–1.37 ***	–0.49 ***		
	(0.01)	(0.62)	(0.47)	(0.10)		
NLG	0.92 ***	0.86 ***				
	(0.04)	(0.28)				
Adj. R^2	0.45	0.47	0.34	0.29	0.16	0.14
No. of countries	46	46	64	64	88	88
No. of periods	1	2	1	2	1	2
Period unit	10-year ave.	5-year ave.	10-year ave.	5-year ave.	10-year ave.	5vyear ave.

Notes: Saving ratio to GDP (SX) is the dependent variable in all specifications. Equations are estimated using the (pooled) least squares estimator over the 1998-2007 period. Standard errors are provided in brackets (based on White robust covariances). ***, **, * mark significance at a 1%, 5% and 10% level.

The results obtained render support for the labour market and international competitiveness mechanisms (Table 1.A3.1). The coefficient of the labour force participation rate is positive and significant across all specifications. Thus, countries with higher shares of people in the labour force are likely to save more. The real effective exchange rate is negative and significant in most specifications, implying that appreciation lowers domestic saving. These results are robust to including separately the age dependency ratio for young and old cohorts, excluding GDP growth (given possible endogeneity with saving), including the GDP level as a proxy of the income level as well as to including some proxies of institution quality. Regarding the standard determinants of saving, the demographic factor turned significant and in line with expectations. Countries with a higher share of young and old people tend to have lower saving. The fiscal balances also proved significant and positive, implying that an improvement in the budget balance

leads to higher overall saving, rebutting Ricardian equivalence. This particular finding should be interpreted with caution as not for all countries the budget balances refer to general government and comply with the same accounting standards. The real interest rate and real growth seems to have a negative impact on saving, though the effect of growth is not robust across different specifications.

Notes

1. In a few cases the missing data were directly collected from central banks and national statistical offices.
2. The first group includes: Australia, Bolivia, Canada, Chile, Costa Rica, Croatia, Georgia, Iceland, Israel, Japan, Korea, Lesotho, Moldova, New Zealand, Nicaragua, Norway, the Russian Federation, Singapore, South Africa, Switzerland, the United States, Uruguay, and EU27 countries excluding Luxembourg, Malta and Portugal; the second group includes in addition to the first group: Belize, Cameroon, China, Côte d'Ivoire, the Dominican Republic, Ghana, Indonesia, Macedonia (FYR), Malaysia, Mexico, Morocco, Paraguay, Philippines, Saudi Arabia, Trinidad and Tobago, Turkey, Ukraine and Venezuela (RB); the third group includes in addition to the second group: Bangladesh, Belarus, Botswana, Brazil, Cambodia, Cape Verde, Hong Kong, Ethiopia, Guatemala, Honduras, Jordan, Mali, Mauritius, Namibia, Panama, Peru, Rwanda, Senegal, Sri Lanka, Swaziland, Thailand and Viet Nam.

ANNEX 1.A4

Recent trends of public finances

This annex provides a review of public finances in recent years based on approximated general government accounts. Official data consolidated at the general government level according to international standards of national accounts were not available by the time of finalising this survey. For an approximation of the general government fiscal statistics, the OECD Secretariat drew entirely on the "general state sector" information published by SPO and made a small number of adjustments, in consultation with the authorities. Privatisation revenues are taken below the line. Net contributions to general government spending and revenues by individual government layers, previously estimated with the support of SPO, started to be published by SPO from 1 July 2010 and have been utilised in this Survey. All data are converted into 2008 prices and into time-consistent "GDP shares" (adjustments were needed because of the revision of the GDP level in 2008). These adjustments were implemented to make the series closer to the international concept of general government, and more time-consistent.

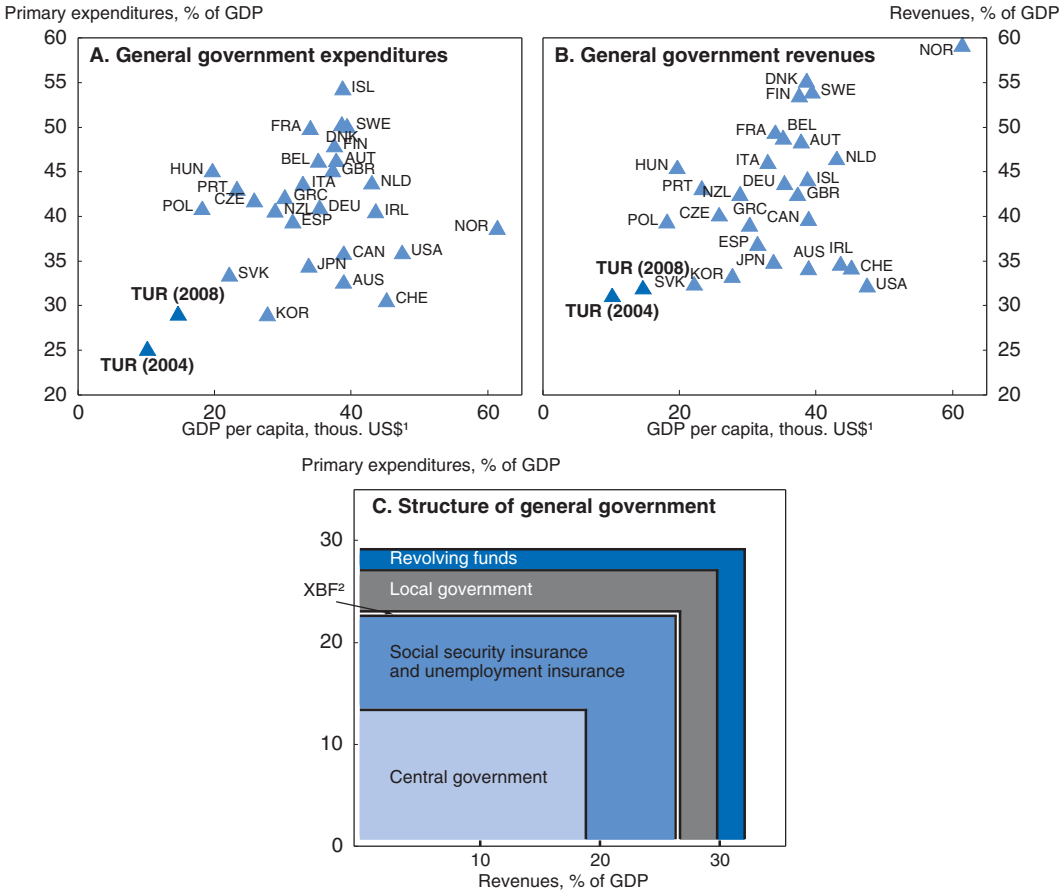
The size and structure of the general government in Turkey

An overview of public spending and revenues on the basis of a general government concept highlights two important facts concerning the scope of government. First, the central government does not dominate the fiscal scene in Turkey, it is compounded by other major general government layers. Second, after accounting for those layers, the total amount of government spending and revenues nonetheless remains smaller than in other OECD countries (Figure 1.A4.1). These facts were not fully visible on the basis of the central government accounts utilised in the 2000s to monitor fiscal policy.

The confined weight of central government points to a challenge for fiscal policy. Public finances are not driven solely by the central government. The latter affects less than 60% of all revenues and spending. Thus, and instruments must be put in place to make sure that fiscal outcomes remain in tune with government policies. Extra-budgetary funds have been reduced and do not raise any risks of fiscal drift, but 3 051 local governments (2 935 municipalities, 35 metropolitan municipalities and utilities, and 81 special provincial administration units) and revolving funds remain centrifugal forces for fiscal policy. Revenue and spending outcomes in the social security system also bear heavily on fiscal results. Turkey could face a challenge with comprehensive social security systems in the future similar to certain Mediterranean countries of the European Union. In the wording of a recent review of Spain's public finances: "The problem [becomes fiscal] governability. Spain's central government – excluding the state's social security administration – directly control less than

Figure 1.A4.1. **Size and structure of general government**

2008



1. At purchasing power parities at current prices.
2. Extra-budgetary funds.

Source: OECD, *OECD Economic Outlook Database*; SPO; Ministry of Finance and Turkstat.

StatLink http://dx.doi.org/10.1787/888932321910

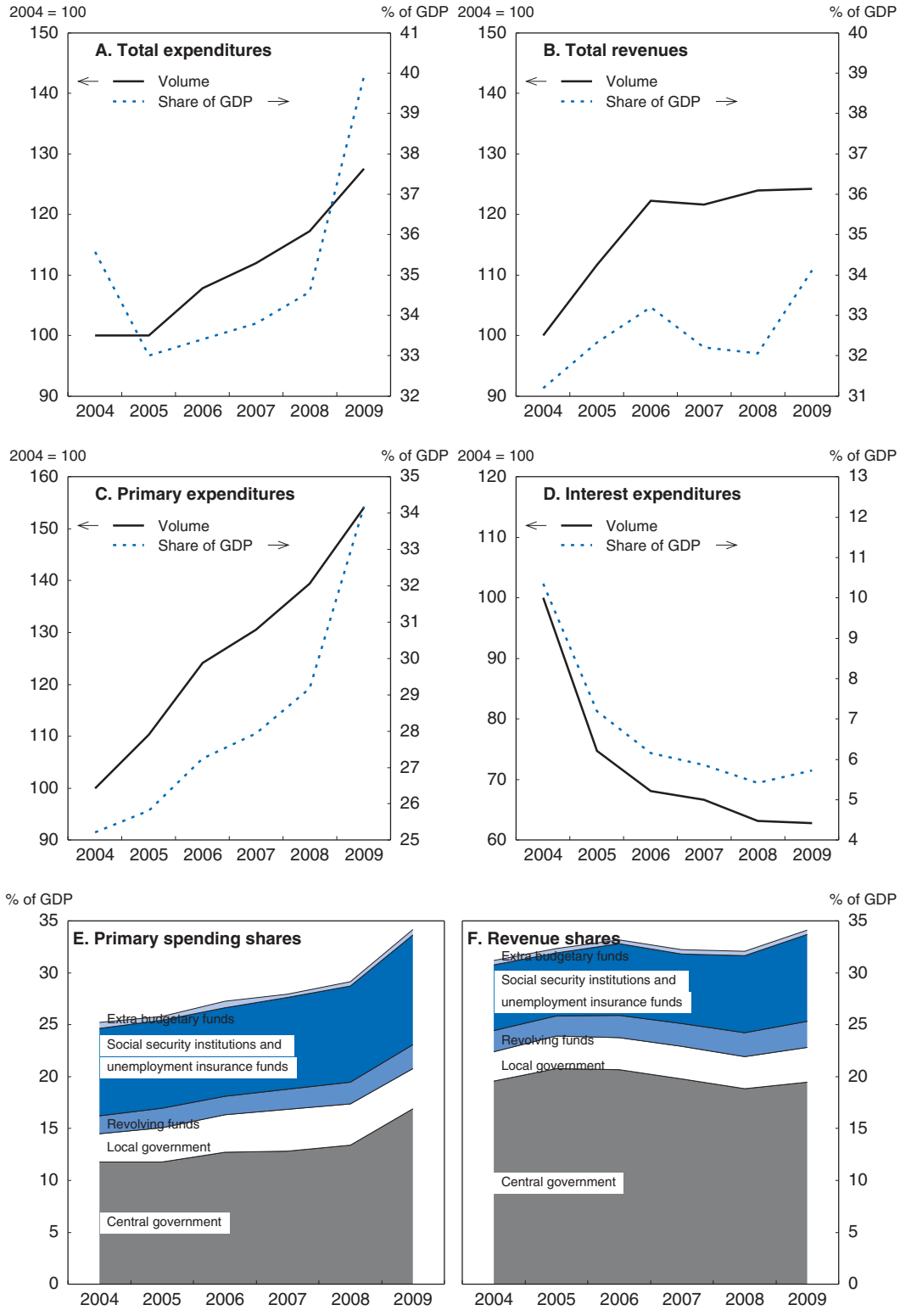
a third of public-sector spending. The government can only set guidelines to control the rest, making it more difficult to implement fiscal policy" (Hannon, 2010).

The relatively modest size of the general government raises, in contrast, some degrees of freedom for future policies. Room could become available in the years ahead to increase revenues and spending as a share of GDP without necessarily putting the sustainability and credibility of public finances at risk. Provided that revenues are raised without undermining incentives for investment and employment, and if supported by robust growth, such space may become significant. Spending in important public infrastructure and services may be increased, and the most distortive taxes may be reduced. However, such developments would need to be envisaged extremely carefully, on the basis of comprehensive cost-benefit and long-term sustainability analyses.

Evolution of fiscal balances in 2004-08

Seen from a general government perspective, primary expenditures grew by as much as 8% in volume per year between 2004 and 2008, suggesting pro-cyclical spending growth (Figure 1.A4.2). Aggregate spending grew, however, below the trend growth rate of the

Figure 1.A4.2. **General government spending and revenue**



Source: SPO, Ministry of Finance and Turkstat.

StatLink http://dx.doi.org/10.1787/888932321929

economy up till the global crisis, thanks to lower interest payments which reflected falling risk premia and interest rates. Consequently, the share of total expenditures in GDP in 2008 was below its level in 2004. The fiscal space created by the reduction of interest expenditures was used only marginally to reduce taxes. A number of tax reductions were implemented, but they concerned items with relatively low yields. The corporate income tax rate was cut from 30% to 20% in 2006 and a personal income tax allowance was granted at low wage levels dependent on the marital status of wage earners in 2007.

Spending increases occurred in two main areas: personnel costs and health spending. Public wages grew as authorities wanted to redress the gap against wages in the private sector (Aslan and Aslan, 2008). Health expenditures also grew strongly after 2004. This was largely explained by the so-called "green card" expenditures benefiting households not covered by the formal social security system and by the increased access of the insured people to health services (including private hospitals) and the introduction of general health insurance in 2008. In this context, as state and university hospitals are the main health-care providers, the revenues and the expenditures of the "revolving funds" affiliated with these hospitals have strongly increased after 2004. Savings generated from the reduced interest costs of public debt were therefore mainly used for such social transfers.

On the basis of existing data, general government revenues grew in less clear-cut directions between 2004 and 2008. Tax revenues soared strongly at the beginning of the period, by as much as 14% per year in volume between 2004 and 2006. This was backed by an increase in government "factor revenues", permitted by price increases in public utilities. This seems to have reflected government attempts to maximise revenue – a dominant fiscal policy objective after the adoption of the Public Financial Management and Control Law (PFMCL). GDP growth remained positive in 2007-08, but proceeds from most taxes contracted or stagnated. Factor incomes also weakened. In contrast, following efforts to fight informality, social security contributions and corporate income taxes collections increased. A possible conjecture for this revenue moderation could be government efforts to support the economy in the face of the early signs of a growth slowdown. For example, value-added taxes were reduced drastically for textile and clothing products.

Chapter 2

Fostering sound integration with the global capital market

Turkey, like other fast-growing emerging countries, has significantly improved its terms of integration with the global capital market before as well as after the international crisis. Emerging markets' risk premia and interest rates are driven primarily by worldwide investment conditions and risk appetite, but steady progress in national economic fundamentals in the 2000s has considerably enhanced Turkey's credibility and reduced capital costs. In comparison to peer countries, Turkey has enjoyed a strong fall in risk premia, an important decline in domestic interest rates, but improvement in credit ratings has been comparatively slower.

Taking place under an entirely liberalised capital account, the improvement of Turkey's access to the global capital market has broad effects on capital supply conditions in the entire economy. Real interest rates have declined, and funds of lengthened maturity are becoming available for a broader range of borrowers and fund users. This supports not only the post-crisis recovery, but also offers a basis for stronger and broader-based long-term growth. Estimates of this survey and academic research confirm that the prime determinants of international risk premia and credit rating include the fiscal situation, price stability, trade and growth performance, governance quality and political stability. Furthering improvements in these areas will help Turkey evolve into a fully normalised and resilient economy and foster its full participation in the global capital market.

Greater recourse by catching-up economies to global savings promotes faster capital formation and growth. As they succeed in achieving credit rating upgrades and are admitted to the upper segments of global investment indexes, fast-growing emerging markets benefit from reductions in market risk premia, declines in equity capital costs and sustained falls in domestic real interest rates. Turkey has made substantial progress in these areas through the 2000s.

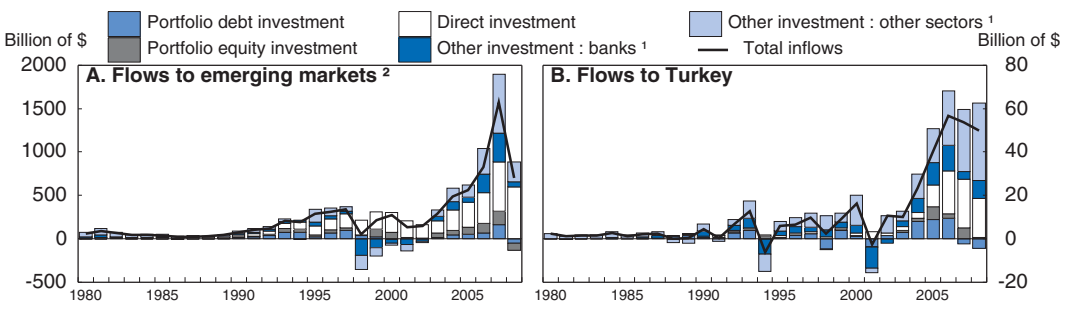
This chapter evaluates Turkey's international capital market credibility and resulting gains in the economy's funding costs. It reviews the key drivers of recent reductions in capital costs, and compares Turkey's progress with achievements in other fast-growing emerging markets. It emphasises three key areas for further consolidating international capital market status: making fiscal policy fully predictable, consolidating the credibility of monetary policy, and further reinforcing the quality of financial supervision.

Turkey's terms of access to international capital markets have improved

Catching-up countries had sharply increased their capital absorption from global markets in the decade preceding the global crisis. Inflows have taken a variety of forms, including foreign direct investment, bank and inter-enterprise loans and cross-border investment in public and private securities. The total volume of these gross capital flows into the fastest growing 23 emerging markets accelerated sharply in the 2000s. Inflows collapsed in the exceptional circumstances of 2008 and 2009 but there are signs that trend growth is now resuming. A recent study based on financial firms' data concluded: "The crisis will cause no more than a pause in the development of emerging market financial systems. Some indicators suggest that emerging markets may already be rebounding. This represents a far stronger comeback than in mature economies and one that reflects stronger GDP growth" (McKinsey Global Institute, 2009). The Bank for International Settlements (BIS) provided also a detailed discussion of the participation of emerging countries in the global capital market (BIS, 2009) (Figure 2.1).

Figure 2.1. **Gross capital flows to emerging markets and Turkey**

1980-2008



1. Includes loans from abroad to respectively banks and non-financial enterprises.
2. Emerging markets cover Argentina, Brazil, Chile, China, Hong Kong (China P.R.), Colombia, the Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russian Federation, Singapore, South Africa, Thailand, Turkey, and Venezuela. Note that coverage may vary over time and indicator depending on data availability.

Source: IMF, *Balance of Payments Database* and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932321948

Turkey is one of the countries where gross foreign capital inflows grew particularly strongly before the crisis. The most dynamic items were inter-enterprise loans and direct investment, but other forms of inflows also grew rapidly. Turkey faced a sharp contraction in these inflows during the crisis but this was partially offset by the repatriation of Turkish funds abroad and no significant gap arose in the funding of the current account deficit (Figure 2.1). Box 2.1 provides a short review of recent insights on the impacts of growing participation in the global capital market on catching-up economies.

Box 2.1. **Impact of integration with the global capital market on catching-up economies**

The impact of foreign capital inflows on emerging economies depends on the recipient country being a net saver or a net dissaver (Feldstein and Horioka, 1980; Johnson, 2009). Net saver countries generate more internal savings than their own investment needs and produce current account surpluses. In these economies, as in many Asian emerging markets in the 2000s* capital inflows contribute mainly to the quality of capital allocation. In contrast, in the net dissaver countries national savings fall short of investment needs and there is a current account deficit. Foreign savings are indispensable to achieve the intended quantity of capital utilisation. Turkey is at present in the latter position together with most Central and Eastern European and South American economies (Figure 2.2).

The use that the Turkish economy has made of foreign savings has evolved over recent years. While until the early 2000s capital inflows had chiefly financed public sector deficits, in the following period they financed mainly a strong acceleration in business sector investment, and, secondarily, household borrowing (Chapter 1). Thanks to improved macroeconomic balances, restrictive fiscal policies and sound financial intermediation Turkey was able to make a productive use of foreign savings during this period.

The benefits and costs of integration with the global capital market for emerging countries is a controversial topic among academics and policymakers. Two recent studies reviewed theoretical arguments and empirical studies on hand (BIS, 2009; Prasad *et al.*, 2006). They confirm that, while one stream of research highlights benefits for business investment, growth and consumption smoothing, a second stream insists on the risks and vulnerabilities raised by high dependence on foreign savings. Detailed analyses may lead to a more consensual view: emerging countries with sound macroeconomic balances, strong productivity growth and sound financial intermediation tend to benefit highly from foreign savings, whereas countries with persisting macroeconomic imbalances, low productivity and poorly regulated financial sectors become vulnerable to boom and bust cycles and face an amplification of their macroeconomic volatility.

Even though reformers in emerging countries may aim at attaining a minimum level of institutional and financial development before liberalising, financial integration itself is a springboard for domestic institutional and financial development. Better understanding how to increase the absorption capacity of foreign savings without undermining financial stability would help emerging countries to draw further on this synergy.

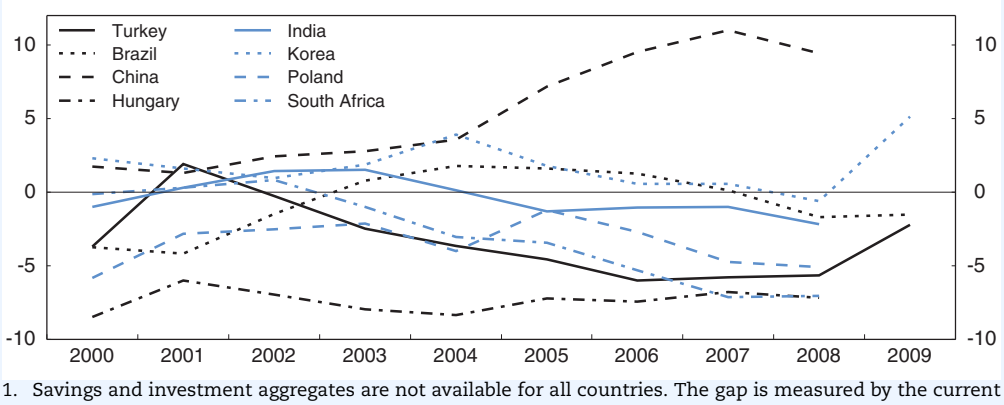
Financial integration creates challenges for monetary policy. Long-term interest rates start to follow global rather than local influences. As monetary policy works via changes in short-term interest rates, short-term capital flows become highly sensitive to domestic short-term rates, increasing the volatility of the exchange rate.

Box 2.1. **Impact of integration with the global capital market on catching-up economies** *(cont.)*

All in all, it is a combination of stable macroeconomic policy, sound domestic financial supervision, and prudent foreign exchange reserve levels which permit emerging countries to reconcile integration with the global capital market and financial stability. The international crisis of 2008-09 reinforced these lessons. It showed that countries with open capital accounts should always be prepared to cope with the volatility of the global environment. Exchange rate flexibility is a good buffer, and together with effective prudential regulation in the financial sector, deters the build-up of imprudent private sector risk exposures. Sufficient foreign exchange reserves are also useful to cushion the shocks entailed by capital movements.

Figure 2.2. **Investment-saving gap in selected countries**[1]

% of GDP



1. Savings and investment aggregates are not available for all countries. The gap is measured by the current account balance for all countries.

Source: IMF, *World Economic Outlook*, April 2010.

StatLink http://dx.doi.org/10.1787/888932321967

* This differs from conditions in the 1990s. Until the 1997 crisis many Asian economies were net dissavers and ran current account deficits.

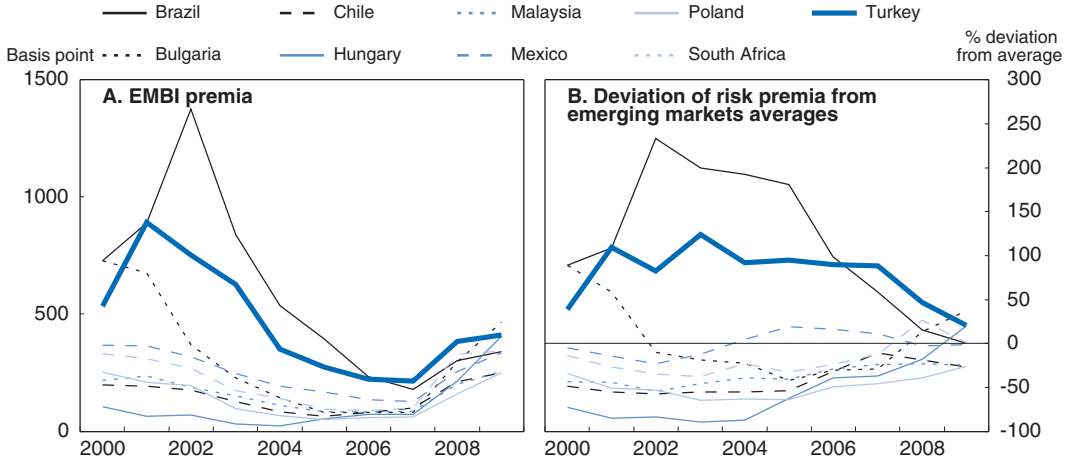
Capital costs are declining

International risk premia

Turkey absorbed foreign savings with diminishing risk premia through the 2000s. This reflected not only the supportive conditions in global capital markets, but also Turkey's success in reducing its perceived country-specific risk. Turkey was not the only country reinforcing its credibility during this period, but was part of a narrow group of reform-driven economies which have been particularly successful in attracting foreign savings at lower costs.

Estimating the average cost of imported capital raises difficulties because certain cost components are not observable. Each type of capital inflows entails different capital cost (such as dividend expectations, capital gain expectations and different forms of interest rates). Capital costs for successful emerging countries declined across the full range of instruments, but are best documented through the most widely available measurement of country risk premia: interest-rate spreads on the long-term foreign currency borrowing of their governments (Figure 2.3).

Figure 2.3. **Lower country risk premia in emerging markets**



Source: Bloomberg.

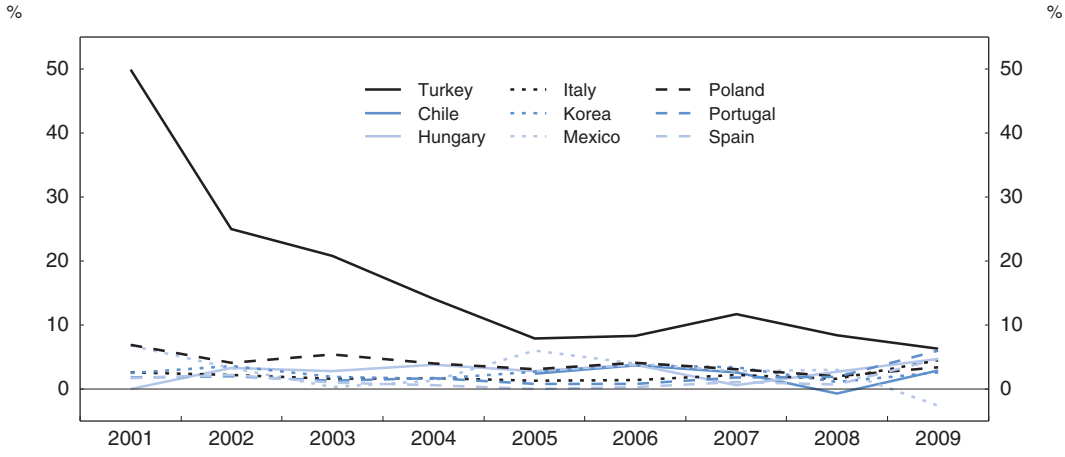
StatLink http://dx.doi.org/10.1787/888932321986

Domestic real interest rates

Increased participation in the global financial market is having deep impacts on the Turkish economy. First of all, it facilitates Turkey's domestic real interest rates beginning their long-awaited convergence with global real interest rates. Such a "conditional convergence" process has permitted the most advanced catching-up economies to align gradually with international interest rates by avoiding excessive risk premia (Arghyrou *et al.*, 2009; Ferreira and Leon-Ledesma, 2007). More supportive funding conditions for financial intermediaries permit them to extend longer-term credits to a larger population of local borrowers. Equity capital also becomes more widely available. The process may now have been set in motion in Turkey (Figure 2.4).

Well before this convergence, Turkey had liberalised its capital account in 1989 and had shifted to fully floating exchange rates in 2001. Yet, the domestic real interest rates had

Figure 2.4. **Real long-term interest rates in selected countries**



Source: OECD, *OECD Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932322005

remained disconnected from global capital costs. The relationship between external and internal capital markets were distorted by highly unstable inflation and exchange rate expectations. The covered interest rate parity principle was in action (as in all economies with an open capital account) but in the presence of severe uncertainties concerning future inflation and exchange rates. As a consequence real interest rates had turned extremely volatile, both *ex ante* and *ex post*. Long-term financial transactions had become entirely dollarised, or foreign currency-indexed. This made long-term funding costly or inaccessible for companies lacking hedges against exchange rate risks, especially for small and medium-sized enterprises. Investment and growth were therefore taxed in large segments of the economy (OECD, 2006). This environment had prevailed before the mid-2000s.

Macroeconomic and institutional credibility accelerates convergence

Turkey's strong and more credible macroeconomic policy framework gave a new impetus to the convergence of real interest rates. The interest rate parity principle started to operate under more stable inflation and exchange rate expectations, generating more moderate risk premia. The process heralds a much more supportive capital cost environment for the entire Turkish economy. Fiscal and monetary predictability, trade and growth performance and progress with political stability are the driving forces of this course (Box 2.2).

Box 2.2. **What determines emerging countries' risk premia?**

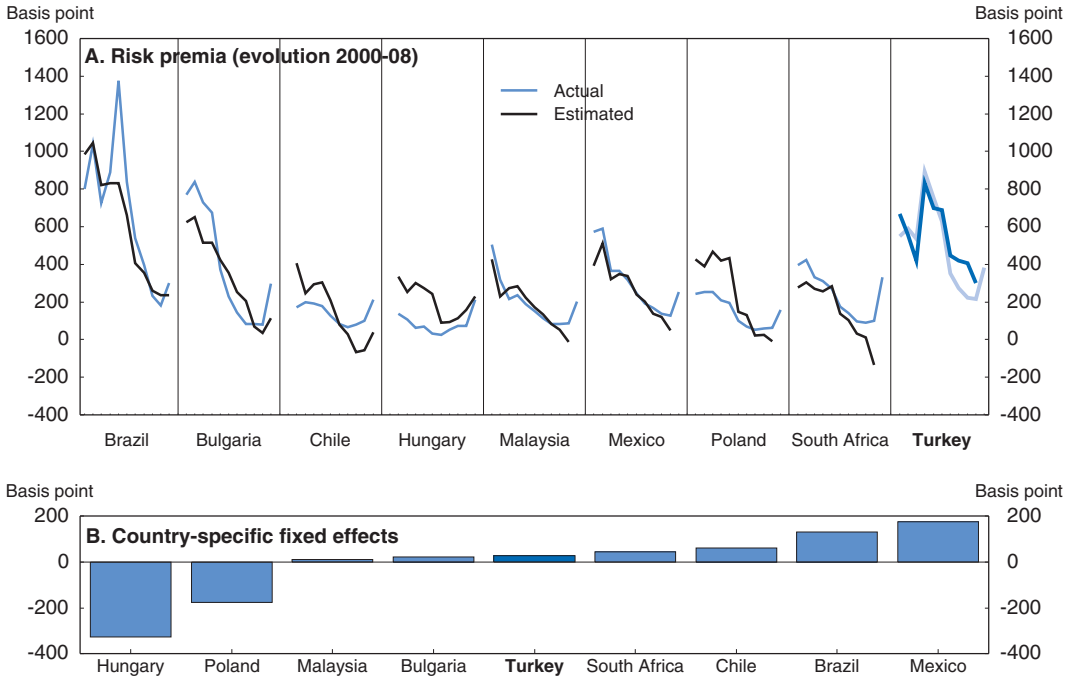
A large empirical literature highlights two main streams of influences on emerging countries' risk premia: *i)* international and regional common factors which depend on global capital market conditions (factors related to global risk appetite); and *ii)* individual country's credibility rooted in its political stability, quality of market institutions and fiscal and monetary framework (country-specific factors). Among country-specific factors, a small number of factors explains the lion's share of variation in risk premia across countries and through time.

Some important research insights are:

- McGuire and Schivers (2003) found that a small set of variables explains up to 80% of the variance of emerging market risk premia. The largest part of the variance is explained by regional and global conditions, whereas country-specific variables account for a smaller part of the explained variance.
- Subsequent studies, including Uribe and Yue (2006), Culha *et al.* (2006) and Maier and Vasishta (2008) confirmed the co-determination of spreads by common global factors and country-specific fundamentals.
- Hilscher and Nosbuch (2007) found that, all other conditions being equal, spreads vary according to geographical location. They are lower in Eastern Europe and Asia than in South America.
- Mati *et al.* (2008) found that the composition of fiscal policy matters for spreads. For instance, spending on public investment rather than on current expenditures lowers spreads, provided that the aggregate fiscal balance is preserved. Moser (2007) confirmed that policy news have a direct impact on spreads when they affect the future course of economic policy.

To assess the degree to which macroeconomic and institutional reforms in the 2000s have affected Turkey's access to the international capital market, a panel model is estimated for Turkey and eight comparable countries (Annex 2.A1). It regresses risk premia on macroeconomic, fiscal, monetary and political stability indicators. The quality of the estimation proved satisfactory (the selected factors explaining about 70% of the variation in risk premia across countries and across time) and confirms that Turkey's reform efforts through the 2000s considerably improved the costs of foreign borrowing. Additional improvements appear nevertheless possible (Figures 2.5 and 2.6).

Figure 2.5. **Actual and estimated country risk premia**[1]



1. EMBI risk premia (for definitions see Annex 2.A1).

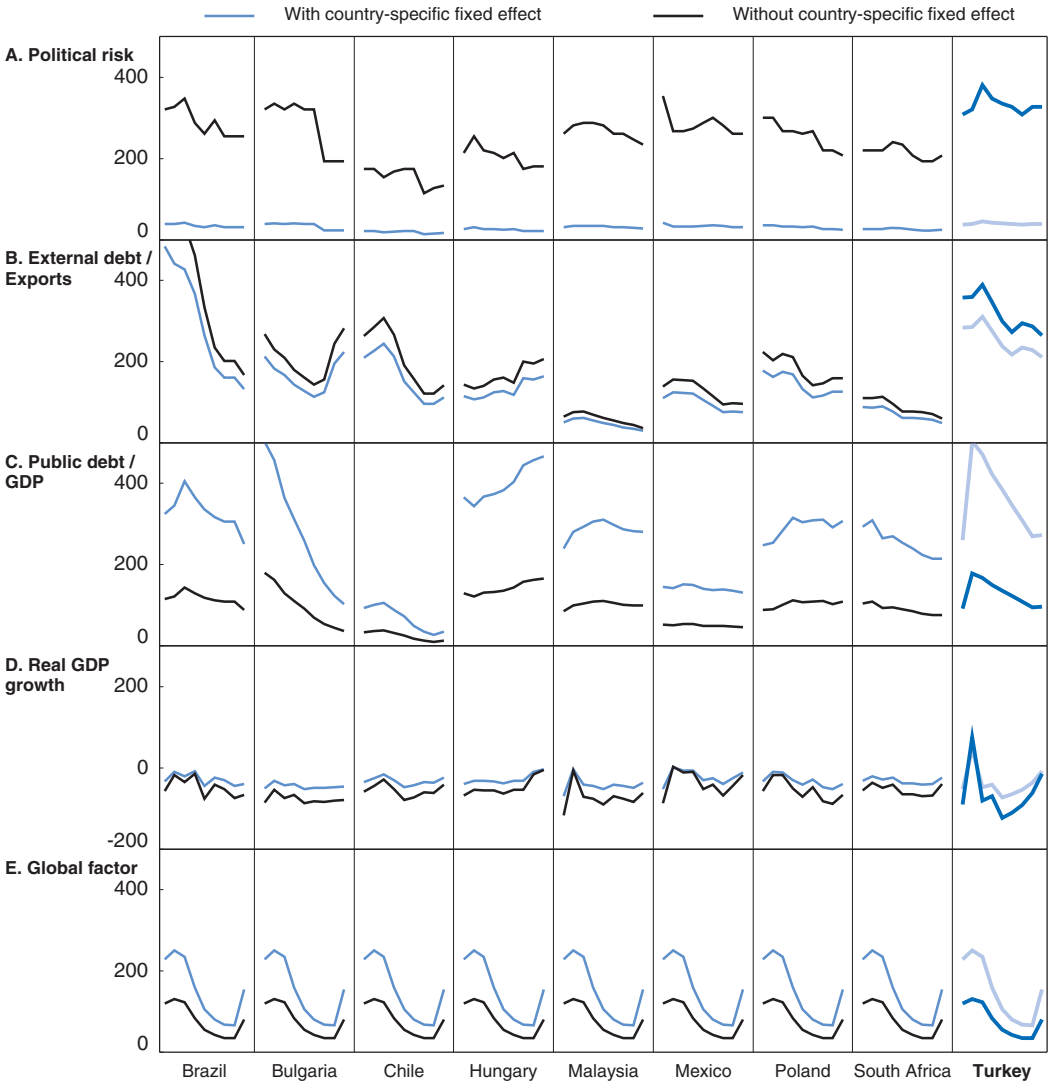
Source: Datastream, Standard & Poor's and CBRT.

StatLink http://dx.doi.org/10.1787/888932322024

Seven findings are worth stressing:

- Political stability has a particularly strong bearing on catching-up countries' risk premia. It is the first factor differentiating their comparative standing in international markets. According to the indicators utilised in the estimation (Annex 2.A1), most of the reviewed countries have enhanced their perceived political stability in the 2000s, but somewhat in contrast, Turkey's perceived political stability has not tangibly improved.
- The second key influence is external exposure. Approximated by the ratio of external debt to exports, it improved in all countries, including Turkey. However, Turkey's balances have remained comparatively more exposed than in the other countries. Despite strong export growth, the current account deficits remained high, not allowing a reduction in foreign debt as much as in the benchmark countries.
- Fiscal performance, approximated by the level of the public debt/GDP ratio, exerts a strong impact. This is the area where Turkey has achieved the fastest progress in

Figure 2.6. **Main determinants of Turkey's and selected countries' risk premia**[1]
Evolution 2000-08



1. Contribution of explanatory variables (in the estimated model).

Source: Datastream, Standard & Poor's and CBRT.

StatLink http://dx.doi.org/10.1787/888932322043

comparison with other countries, with a very significant positive impact on its risk premia.

- GDP growth has also a strong influence as it affects all financial ratios. In this area, while other countries have achieved relatively steady and regular performances, Turkey had a more uneven record: the collapse of GDP growth in 2000-01 was more than offset by following rapid growth (Chapter 1), but fell behind other countries after 2007.
- European Union membership offers a "bonus" for the credibility of fast-growing economies. Turkey has not benefitted from this EU halo effect.
- Comparing each country's actual risk premium to its statistically expected level (the so-called country residual) also provides some lessons. Turkey's risk premia had stayed

above their statistically expected level for the most part of the 2000s, but fell sharply below their expected level at the end of the period. According to the estimated model, Turkey has enjoyed a credibility "bonus" in the most recent period.

- Country-specific influences are also detected through the so-called country-specific fixed effects. Individual countries feature either a genuine "handicap" or a "bonus" against the other common determinants of their position. Viewed from this perspective, and in the period as a whole, Turkey appears to have faced a handicap but this does not capture the recent improvement.

Credit ratings bear on international capital market standing

International capital flows diversify, shifting from large-size bank lending to various forms of security investing and inter-enterprise credits. The number of potential investors increases and as a result their individual market share in the total supply of funds declines. When arms-length investors are less inclined to invest in the proprietary analysis of borrowing countries, this generates demand for third-party information on the economic fundamentals of emerging countries. This demand is behind the role devoted to credit rating agencies. Improving credit rating is becoming an important objective for all emerging borrowers participating in the global capital market.

The nature of the information and analysis provided by rating agencies had been reviewed through the 2000s, and appeared to be initially better understood (Setty and Dodd, 2003; Canuto *et al*., 2004). However, their failure to detect the inherent risks of asset-based securities before the international financial crisis created new controversies and scepticism on the quality of their analyses. Their role remains nonetheless quasi-institutional, as was officialised by the US regulators under the label of *Nationally Recognised Statistical Rating Organisations* (NRSROs).[1] European authorities also envisage providing agencies with an official status, in exchange for compliance with additional quality norms (European Commission, 2008, 2010). Irrespective of policy discussions on possible additional requirements for their certification (Merkel, 2010; Lagarde, 2010), financial regulations in all OECD economies attach more importance to agency ratings in the investment regulations for financial institutions. The position granted by agencies to individual countries in their credit risk class-tables influence the international capital flows also through this channel.[2]

Rating agencies have been disseminating information on emerging markets for more than two decades. It is important to note however that this information does not match the amount of statistical information that they have compiled on private corporations. Information on the payment history of the population of security-issuing firms is indeed their key statistical input, and permits them to select the most relevant statistical indicators for assessing borrower quality. In contrast, the lack of sufficiently long statistical series was recognised as a major factor in the rating failures of the asset-based securities before the 2008-09 crisis. Similar information on emerging markets is only available for smaller populations (a few tens of countries) and shorter periods (two or three decades). The statistical usefulness of this information is also reduced by discontinuities in these countries' growth dynamics, which tend to alter their structural sources of risks.[3] In these circumstances, credit rating agencies try to develop *ad hoc* methods of assessment that they aim at formatting into systematic risk evaluation systems. Box 2.3 summarises the

Box 2.3. **How do rating agencies rank emerging markets and Turkey?**

A set of economic, financial and political information is utilised in the determination of sovereign ratings. The data are processed according to agency-specific procedures and are updated from time to time. The structure of the rating criteria used by Standard & Poor's and Moody's, and Turkey's position in the scoring map of Moody's are summarised below.

Standard & Poor's rating criteria

Standard & Poor's has an analytical framework for sovereign countries including ten key categories (Standard & Poor's, 2010). Each country is ranked on a scale of 1 to 6 for each of these criteria. Variables are interrelated but they do not have constant weights:

- *Political risk:* This category documents issues such as the stability and legitimacy of political institutions, transparency in economic policy decisions and objectives, public security and geopolitical risk.
- *Income and economic structure:* The degree to which the economy is market-oriented, the competitiveness and profitability of the business sector and labour flexibility.
- *Growth prospects:* The rate and pattern of economic growth and the composition of savings and investment.
- *Fiscal flexibility:* Public revenue, expenditure and balance, revenue raising flexibility and expenditure effectiveness.
- *Debt burden:* Gross and net public debt as a share of GDP, the currency composition of debt and the maturity profile of debt.
- *Off-budget liabilities:* The size and health of the non-financial public sector and the robustness of the financial sector.
- *Monetary stability:* Price behaviour in economic cycles, the range and efficiency of monetary policy tools and central bank independence.
- *External liquidity:* The structure of the current account, the composition of capital flows and reserve adequacy.
- *Public external debt:* Gross and net public external debt as a share of current account receipts, the maturity profile and currency composition of public external debt and access to concessional funding.
- Private external debt.

Moody's rating criteria and Turkey's position in its scoring map

Moody's states that a sovereign rating is determined through three steps (Moody's, 2008):

Step 1: *Evaluating economic resiliency*

The shock absorption capacity of a country is assessed based on two factors:

- Factor 1: Economic strength (captured in particular by its GDP per capita level) and the shock-absorption capacity.
- Factor 2: Institutional strength, *i.e.* whether the quality of the institutional framework (including property rights, transparency, predictability of government action, and the degree of consensus on the goals of political action) supports respecting contracts.

Combining these two indicators helps rank each country on a "scale of resiliency" which spans five levels: very high, high, moderate, low or very low (Figure 2.7).

Box 2.3. **How do rating agencies rank emerging markets and Turkey?** *(cont.)*

Step 2: *Evaluating financial robustness*

The second stage focuses on the public debt level and sustainability on the basis of two considerations**:**

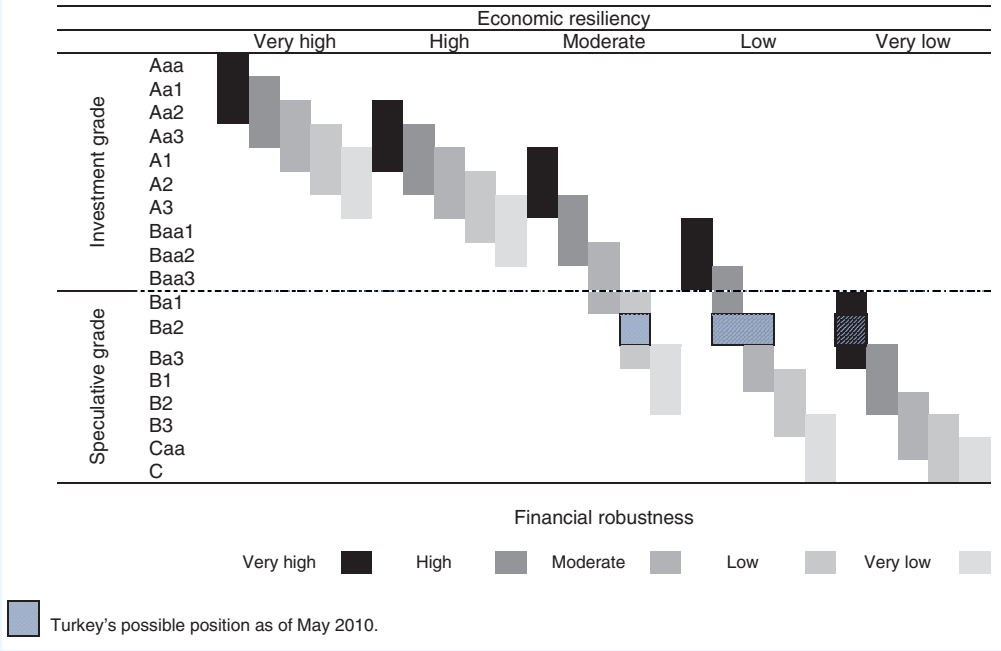
- Factor 3: Financial strength of the government, taking account of the public debt level and of the ability of the government to mobilise resources (raising taxes, cutting spending and selling assets).
- Factor 4: Susceptibility to event risk, *i.e.* the degree to which debt might increase as a result of economic, financial or political events.

By combining these two indicators, each country is placed on the same scale as in Step 1.

Step 3: *Rating decision in the Committee*

A Rating Committee "adjusts" each country's economic resiliency to its degree of financial robustness. The scores are decided by deliberation. The rating decision is reached on the basis of a peer comparison and weighing additional factors that may not have been adequately captured earlier (Figure 2.7).

Figure 2.7. **Moody's scoring map and Turkey's position**[1]



Source: Moody's.

procedures utilised by two main agencies in rating emerging markets and discloses how Turkey is positioned in the scoring map of one of them.

The present rating of different emerging markets by main agencies is summarised in Table 2.1 and Figure 2.8. Turkey has obtained a sub-investment grade by all rating agencies over the past decade, in contrast to some emerging markets which graduated to investment grade (India and Morocco in 2007 and Brazil in 2008). However, an upgrading momentum has started for Turkey. In December 2009, Fitch increased Turkey's rating by

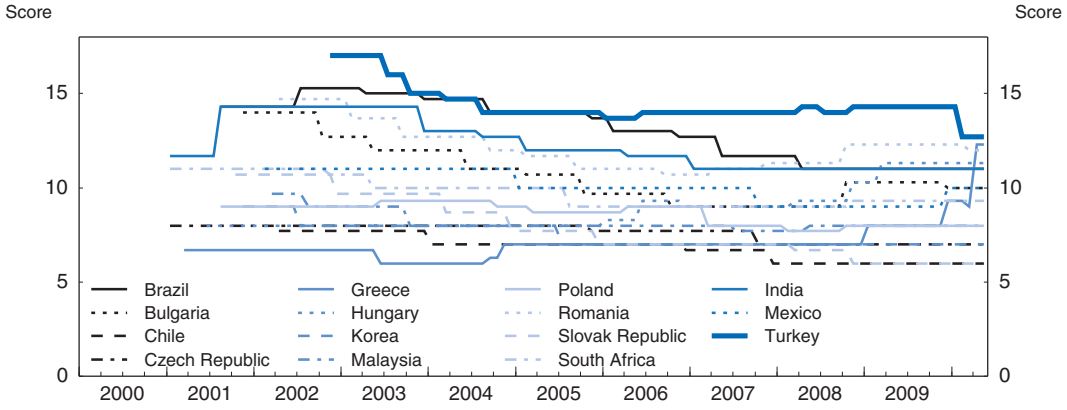
Table 2.1. **Current credit ratings of emerging markets**

As of 21 May 2010

		Moody's		Standard & Poor's		Fitch
Investment grade countries	A2	Bahrain, Poland	A	Bahrain, Czech Republic, Israel, Malta, South Korea	A	Bahrain, Chile, Israel
	A3	Malaysia, South Africa, Greece	A–	Malaysia, Estonia, Poland, Portugal	A–	Malaysia, Poland
	Baa1	Mexico, Montenegro, Lithuania, Russia, Thailand, Hungary	BBB+	South Africa, Thailand	BBB+	Estonia, South Africa
	Baa2	Azerbaijan, Kazakhstan, Tunisia	BBB	Bulgaria, Croatia, Mexico, Russia, Tunisia, Lithuania	BBB	Hungary, Lithuania, Mexico, Russia, Tunisia, Thailand
	Baa3	Armenia, Bulgaria, Croatia, India, Iceland, Latvia, Romania, Brazil, Peru	BBB–	Brazil, Colombia, Iceland, India, Kazakhstan, Macedonia, Morocco, Peru, Hungary	BBB–	Azerbaijan, Brazil, Bulgaria, Croatia, Greece, India, Morocco, Panama, Peru, Kazakhstan
Sub-investment grade countries	Ba1	Albania, Colombia, Costa Rica, Egypt, El Salvador, Morocco, Panama	BB+	Azerbaijan, Egypt, Greece, Panama, Romania	BB+	**Turkey (stable)**, Colombia, Egypt, Guatemala, Latvia, Macedonia, Romania, Iceland
	Ba2	**Turkey (stable)**, Belarus, Guatemala, Jordan, Indonesia, Papua New Guinea, Suriname	BB	**Turkey (positive)**, Cook Islands, Costa Rica, Indonesia, Guatemala, Jordan, Viet Nam, El Salvador, Uruguay, Latvia, Macedonia	BB	Costa Rica, Indonesia, Philippines, El Salvador
	Ba3	Philippines, Uruguay, Viet Nam	BB–	Gabon, Mongolia, Philippines, Serbia, Venezuela	BB–	Gabon, Lesotho, Nigeria, Serbia, Viet Nam, Uruguay, Armenia
	B1	Fiji, Lebanon, Mongolia	B+	Bosnia and Herzegovina, Georgia, Ghana, Mozambique, Nigeria, Suriname	B+	Georgia, Iran, Sri Lanka, Venezuela, Ghana
	B2	Bosnia and Herzegovina, Bolivia, Venezuela, Turkmenistan, Ukraine	B	Belize, Bolivia, Kenya, Paraguay, Sri Lanka, Lebanon, Ukraine	B	Bolivia, Lebanon, Mongolia, Mozambique, Suriname
	B3	Argentina, Belize, Jamaica, Pakistan, Paraguay	B–	Argentina, Fiji, Jamaica, Madagascar, Pakistan	B–	Argentina, Ukraine, Ecuador, Jamaica

Source: Bloomberg.

Figure 2.8. **Rating upgrades of emerging markets and Turkey in the 2000s**



Note: Standard & Poor's ratings of long-term foreign currency liabilities of sovereign governments were used as reference. Alphanumeric ratings were transformed into a numerical scale: AAA rating has the value 1, AAA– has the value 2 and so on.

Source: Datastream and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932322062

two notches, lifting it to the highest position before graduation. Moody's followed in January 2010, providing an upgrade from three to two notches below investment grade. Then in February 2010, Standard & Poor's granted an upgrade to two notches below the investment grade. All three agencies made detailed announcements on their view of Turkey's strengths and weaknesses with respect to their rating criteria (Box 2.4).

Box 2.4. **Turkey's perceived strengths and weaknesses**

Fitch

Fitch upgraded Turkey's Long-Term Foreign Currency Rating by two notches to BB+ in December 2009.* The agency said that "Turkey's resilience in the global crisis revealed that credit fundamentals and debt tolerance were stronger than previously thought".

Turkey's relative strengths

- GDP per capita is the second highest in the "BB" range and above the BBB range.
- The business climate, institutions and governance are relatively strong. There is a customs union with the EU.
- Debt tolerance is enhanced by strong banking sector, relatively deep local markets, strong debt management capacities and good debt service record.
- The banking sector is well capitalised, with a balanced net external and foreign exchange position and a loan/deposit ratio of only 80%. Households have very low foreign debt and are long in foreign exchange.
- The floating exchange rate and inflation targeting regime are strong points. The country has a track record of successful fiscal consolidation in 2001-06.
- Prior to the current downturn, GDP growth averaged 6.9% in the five years to 2007, above the "BB" range median of 5.8%.
- Demographics are favourable for growth and public finances.

Weaknesses

- EU defined general government debt rose to 45.4% of GDP at the end of 2009, above the "BB" range median of 41%. Yet, only about 35% of this debt is in foreign currency, compared with 66% for the "BB" range median.
- Turkey faces large gross external financing requirements, projected at $ 115 billion for 2010 (including $ 48 billion of short-term debt). This amounts to 150% of official foreign exchange reserves for 2009, compared with the "BB" median of 82%.
- The unemployment rate rose to an annual average of 14% in 2009, well above rating peers.
- Fiscal transparency is weak: International-standard general government data are not available, control and reporting of local authority budgets is poor, and the quality of the administrative infrastructure for fiscal policy has weaknesses.
- Political risk weighs on Turkey's rating. The country is ranked in the bottom 21st percentile in the World Bank's political stability index, even below the "B" range (the group which is below Turkey's present grade).

Moody's

When announcing Turkey's rating upgrade to Ba2, Moody's made the following points:

Performance in the crisis

- The upgrading reflects Moody's growing confidence in the government's financial shock-absorption capacity. Although Turkish growth has contracted very sharply – even more sharply than was seen in its 2001 financial crisis – the resilience of the public finances relative to past such crises has been notable.
- The Turkish economy's ability to rebound from shocks, whether external or domestic, is the product of a significant improvement in the policy credibility over the last decade. The recent financial crisis is a kind of "stress test" for these policy reforms.

Box 2.4. **Turkey's perceived strengths and weaknesses** *(cont.)*

- The ability of the government and the country more generally to regroup when faced with a very significant economic and financial challenge indicates that Turkey has reached a higher level of resiliency.

Growth outlook

- The economy is starting to recover and capital inflows have resumed. The government has proven access to foreign capital, as was demonstrated by a recent $ 2 billion 30-year Eurobond issue. This was the largest-ever emerging market sovereign transaction of that maturity.
- The government's fiscal exit strategy has begun with passing the 2010 budget. The budget was in line with the Medium Term Programme, announced in September 2009 and represents a first step towards reining in the budget deficit and returning to a primary surplus position.
- Foundations for long-term growth are robust, even if growth may not achieve the same pace as in the mid-2000s due to both global and domestic factors. The industry used the financial crisis to expand into new export markets and to reduce its dependence on EU markets.
- The population dynamics are favourable.

Vulnerabilities

- Debt affordability metrics are still poor by international standards. The ratio of interest/revenues is estimated at 27% and of debt/revenues at 219% in 2009. External vulnerability improved in recent years but remains in the bottom quintile of the distribution for emerging countries.
- Turkey lacked, as of the first quarter of 2010, policy rules that would impose additional discipline to the budget process. Such rules would make the improvements in debt dynamics more durable and predictable. This is a decisive factor for any sovereign country to eventually become investment grade.
- A fiscal rule targeting budget restraint would enhance Turkish authorities' fiscal credibility, particularly given the slippage that occurred prior to the onset of the crisis and the absence of an external anchor like the IMF or EU.
- Turkey may not benefit in the coming years of the same degree of government stability that it enjoyed during most of the decade. Policy volatility may be greater in the light of the electoral calendar. The rating also factors the political noise that comes with long-standing internal and external tensions.

Standard & Poor's

Standard & Poor's raised Turkey's long-term rating from BB– to BB on 17 February 2010. It kept the outlook positive, implying that further upgrades are possible in the coming period. When announcing the upgrade Standard & Poor's made the following points:

- The Turkish government's policy flexibility has improved as a result of its track-record in steadily reducing the debt burden.
- Turkey's regulatory institutions have been successful in preserving the solidity of the financial sector, despite external adversity. The banking sector is one of the strongest and least-leveraged in Eastern Europe.
- Turkey's local capital markets are continuing to develop, enabling the government to lengthen maturities of local currency debt.

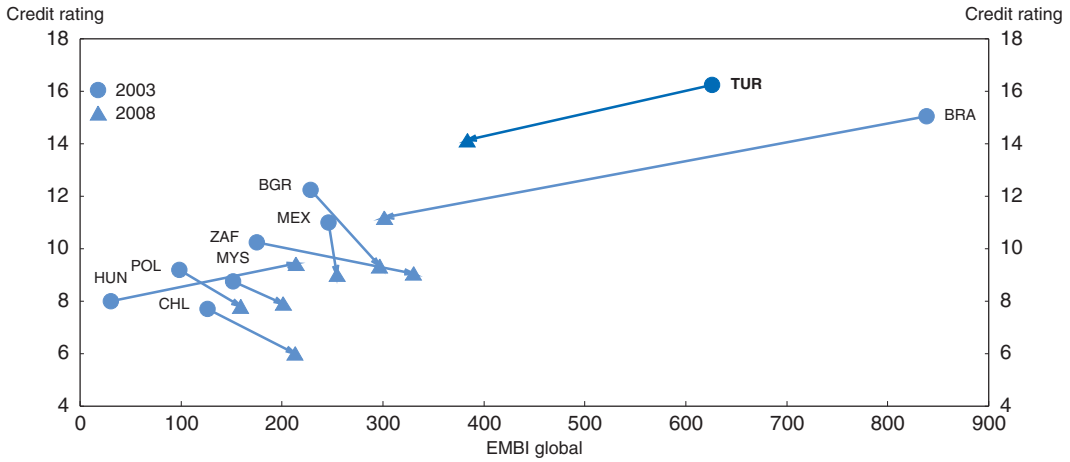
Box 2.4. **Turkey's perceived strengths and weaknesses** *(cont.)*

- The ratings on Turkey remain supported by the government's overall track record of sound economic and fiscal management.
- A further upgrade is likely over the next 12-24 months if the country returns to its prior rates of growth with less dependence on external funding.
- In contrast, the rating may be lowered if external pressures mount, if medium-term fiscal plans suggest fiscal loosening, or if the domestic political environment deteriorates significantly.

* This has taken Turkey in a peer group including Colombia, Indonesia, Philippines, Egypt, Latvia and Costa Rica.

Irrespective of ongoing discussions on the quality and pertinence of emerging country credit ratings in the present economic environment (Reisen, 2010), securing an investment grade would undoubtedly further Turkey's participation in the global capital market. As mentioned above this is a condition for having low-cost access to a large number of regulated international capital sources (such as commercial banks, pension funds and insurance companies). The correlation between emerging countries' credit ratings and risk premia is also well established (Figure 2.9). Research on reciprocal influences between credit ratings and risk premia suggest that causality links operate more strongly from the former to the latter (ECB, 2004), but feedback effects are also in force, and differences between ratings and risk premia never persist very long.[4] This is to be expected, as risk premia and rating decisions appear to respond to the same economic fundamentals (Box 2.5).

Figure 2.9. **Credit rating and risk premia**



Source: Bloomberg, Datastream, Standard & Poor's and CBRT.

StatLink http://dx.doi.org/10.1787/888932322081

To assess to what degree Turkey's rating reflects the improvement in macroeconomic fundamentals a multivariate model was estimated (Annex 2.A1). The ratings for Turkey and a set of comparable countries were statistically analysed on the basis of key fiscal, monetary, political governance and growth variables. The model explained a large share of

Box 2.5. **Findings on the determinants of credit ratings**

Existing research generally confirms the principal factors that rating agencies emphasise as shaping their decisions. Four main blocs of factors appear to determine statistically the credit rating of a country: *i)* macroeconomic performance (GDP per capita and real GDP growth); *ii)* quality and performance of the public sector (government debt, fiscal balance and perceived government effectiveness); *iii)* external balance (external debt, foreign reserves and current account balance); and *iv)* geographical position (EU membership and regional location). Each country has strengths and weaknesses in individual areas and performance improves or weakens in each of them through time. Country rating results from a combination of these influences.

Some main research results are:

- The reference study by Cantor and Packer (1996) documented that credit ratings were shaped by five main factors: the per capita income level, GDP growth, inflation, external debt and default history. This finding was subsequently updated and confirmed by Canuto *at al*. (2004) and Afonso *et al*. (2007).
- Mulder and Perrelli (2001) confirmed that ratings were predicted by macroeconomic fundamentals but tended to overshoot in crisis periods.
- Mora (2006) found that macroeconomic fundamentals explained the largest part of variations in ratings, but there was also a degree of stickiness in these decisions: ratings tended to stay above their predicted level before crises, match predictions during crises, and lag the improvement in fundamentals after crises.
- Bissoondoyal-Bheenick (2005) found that key macroeconomic ratios affected the rating of low rated countries more than that of high rated countries. Deviations from macroeconomic benchmarks by institutionally credible countries are more easily tolerated.
- Jaramillo (2010) corroborates that ratings granted by all three agencies were explained by five core variables: external public debt, domestic public debt, political risk, exports and financial depth. Her specification correctly predicts nearly 90% of investment grade status in all observations and two thirds of the upgrades and downgrades to and from investment grade.

the variation in ratings across countries and through time. Figures 2.A1.1 and 2.A1.2 in Annex 2.A1 summarise the results of the estimation. The main findings are:

- "Institutional effectiveness" for emerging countries and Turkey has the strongest influence on credit ratings. It encompasses factors such as the rule of law, the government's effectiveness, the presence of safeguards against corruption.[5] This is consistent with rating agencies' claim that institutional quality is becoming more important in evaluating emerging markets.
- Political stability has the second strongest influence on ratings. Emerging countries still inspire uneven degrees of confidence in the stability of their political institutions. Many countries improved their political credibility in the 2000s, but this was not the case in all of them. Political situations are more heterogeneous at the end of the 2000s and this contributes to the differentiation of ratings.
- GDP per capita growth matters strongly. This is congruent with rating agencies' insistence on the benefits of growth for fiscal and financial sustainability.

- Fiscal performance plays an important role. This impact increases when country-specific effects are taken into account. This may reflect the fact that the evolution of the fiscal indicator (of the public debt to GDP ratio) within each country may matter more for ratings than level differences across countries (rating agencies seem to display country-specific "degrees of tolerance" for the amount of the public debt burden, as corroborated by the empirical literature reviewed in Box 2.5).
- Monetary stability contributes to the improvement of ratings. Disinflation in emerging markets through the 2000s contributed positively across the board.
- EU members enjoy a supplementary rating premium.
- When comparing Turkey's actual rating to its statistically expected level, a negative residual is visible throughout the period. A negative "country fixed effect" confirms this discount. However, the handicap is not as large as sometime assumed: at end-2008 it amounted to two notches in Standard & Poor's rating (two notches that Fitch eliminated in December 2009, and that both Moody's and Standard & Poor's eliminated partly – by one notch – in January and February 2010). As of the end of 2008, Turkey's statistically expected rating position was not high enough to qualify for the investment grade. However, a continuing narrowing of Turkey's EMBI and credit default swap spreads in 2009 and in the first half of 2010 has confirmed its improving standing, and may herald future rating upgrades.

The estimation results help identify areas where further progress could improve Turkey's rating. Findings corroborate recent statements by credit rating agencies:

- Turkey's growth rate has slowed below potential since 2007. Resuming stronger growth would raise financial ratios to safer levels.
- Turkey has significantly improved its economic institutions (government effectiveness and the rule of law) in the 2000s, but their internationally perceived level is still weaker than in comparable countries. There appears to be room for additional progress.
- Political stability appears less robust than in benchmark countries. International and domestic surveys confirm this perception of persisting political uncertainties. This situation penalises Turkey's credit rating.
- Fiscal balances and public debt levels have improved significantly. At the same time, many other emerging markets have also improved theirs, and some of them performed outstandingly. Turkey has further room for relative improvement.
- The strength and transparency of fiscal institutions is a core area where additional progress by Turkey will matter for its future international capital market standing. Rating agencies have recently re-asserted the importance that they assign to the quality and transparency of fiscal institutions (Box 2.6).

Emerging countries' financial sector risks have not been included in the estimations but are known to play a growing role in ratings. The balance sheet strength and the managerial quality of Turkish banks and the rigour of banking supervision have been enhanced following deep banking sector reforms after the 2000-01 crisis (Chapter 1). At the same time, banks are possibly exposed to certain risks related to rapid credit growth before the global crisis and to interest rate risks. The pace of development of the banking sector justifies close prudential scrutiny. Fitch, which has developed special expertise in the assessment of banking sector risks, remarks that Turkish banks' very strong operating profits after the global crisis should not obfuscate the vulnerabilities arising from very rapid growth (Fitch, 2009).

Box 2.6. **Additional emphasis on fiscal transparency**

Rating agencies have recently re-asserted the role assigned to fiscal fundamentals. They mentioned new factors gaining weight in assessing fiscal strength. They have notably stated that they are broadening evaluations from "mechanical debt metrics" to the "quality of the fiscal environment and institutions".

In the 2008 version of its rating methodology, Moody's stressed that "each country's fiscal strength results from an intertemporal balance between liabilities and resources. The question is not so much whether the headline debt measures (such as debt/GDP or debt/revenues) are 'high' or 'low', but whether the debt is affordable or not, given all the other demands on public financial resources" (Moody's, 2008).

Standard & Poor's also included additional fiscal-institutional criteria among the ten parameters driving rating decisions (Standard & Poor's, 2010). The new fiscal criteria taken into account by Standard & Poor's are precisely areas where Turkey aims at making progress:

1) Fiscal flexibility

Standard & Poor's states: "Scores in this category are a function not only of surpluses and deficits, but also of revenue and expenditure flexibility, and the effectiveness of expenditure programs. General government is the aggregate of national, regional, and local government sectors, including social security. Off-budget and quasi-fiscal activities are included to the extent possible, with significant omissions noted."

"Sovereigns with strong scores are those which can adjust tax bases and rates without serious constitutional, political, or administrative difficulties. On the side of spending, effective spending programs provide the services demanded by the population and the infrastructure and education levels needed to underpin sustainable economic growth, all within the confines of affordable financing. Procurement and tendering procedures must be transparent. Arrears should be quantified and deficits reconciled to trends in debt."

Singapore receives the top score in Standard & Poor's fiscal flexibility indicators, despite significant financing needs in the past. "This is due to astute investment in public infrastructure and in education. Lower scores are given where government money is not spent as effectively."

Standard & Poor's adds that "looking forward, pension obligations are a pressure of growing significance for countries in which the population is ageing. The rating of some highly rated EU members could come under pressure if there is no further fiscal consolidation and no structural reform to counter the related financial problems."

2) Public debt burden

"Taxation and monetary powers of sovereigns permit them to manage varying debt levels over time. A sovereign such as Canada (with substantial debt but an unblemished record of honouring obligations and a strong capital market providing low-cost financing) receives a better score than some sovereigns in South America, which may have lower debt to GDP ratios, but also higher and more variable debt servicing burdens. Several investment grade countries have fairly high levels of debt, but also the wealth, the level of development, and the revenue-raising ability that allow them to support such debt levels."

3) Off-budget and contingent liabilities

"The size and health of non-financial public sector enterprises (NFPEs) and the robustness of the financial sector matter. NFPEs pose a risk because they have been generally formed to further public policies and often suffer from weak profitability and low equity bases. The indebtedness of non self-supporting NFPEs is a useful measure of this contingent liability."

Box 2.6. **Additional emphasis on fiscal transparency** *(cont.)*

"The financial sector is also a contingent liability, because problems impair a sovereign's standing when they lead to rescues of failing banks. Public banks may weigh heavily when they engage in subsidised lending, bank rescue operations, or exchange-rate guarantees that are not provided for in the government's budget."

"If such quasi-fiscal activities are sizeable, the usefulness of general government statistics as an indicator of fiscal performance is diminished."

Limited off-budget and contingent liabilities provide New Zealand with a top ranking in this category.

Other enhancements in international capital market status would bring additional benefits

Turkey's position in international equity investment indexes is also important. Growing numbers of investment funds make equity portfolio decisions according to positions in these indexes (Northern Trust, 2007). Recent research documents that upgrades in a country's position in international indexes influences directly equity risk premia, the price/earnings ratios, and therefore the equity capital costs (Hacibedel and Van Bommel, 2007; Bankovica and Pranevics, 2007). These effects should intensify with larger numbers of equity investors entering the global capital market.[6]

Prospects for Turkey's graduation in FTSE Global Equity Indexes illustrate the stakes.[7] The next stage for Turkey is to upgrade from "Secondary emerging" to "Advanced emerging" category. If and when this migration takes place, demand for Turkish equities is expected to increase and the equity capital costs of Turkish listed corporations are expected to decline (Box 2.7).

Box 2.7. **Upgrading Turkey from "Secondary emerging" to "Advanced emerging" indexes**

FTSE Global Equity Indexes cover 48 countries with open equity capital markets. Over 7 000 large, medium and small capitalisation stocks are included, representing 98% of the world's total "investable" market capitalisation. Countries are classified into four categories: Advanced, Advanced emerging, Secondary emerging and Frontier.

Countries' position among the four categories evaluates their level of "investability" for foreign investors. Criteria utilised include economic size, wealth, market quality, and market depth and breadth. All together, 25 factors are taken into account. Committees of senior fund managers, actuaries and other practitioners review classification decisions and migrations. Evaluations are shared with relevant national regulators and stock exchanges to establish a "pattern of dialogue". If a country is considered for an update or downgrade, it is put in a watchlist before a decision is made.

As of May 2010, Turkey is in the Secondary emerging group but FTSE has recently announced its inclusion in the watchlist for an upgrade to Advanced emerging. Together with Turkey, the Czech Republic and Malaysia are considered for an upgrade to Advanced emerging, Taiwan is considered for an upgrade from Advanced emerging to Advanced, Greece for a downgrade from Advanced to Advanced emerging, and Ukraine for possible inclusion as Frontier (Table 2.2).

Box 2.7. **Upgrading Turkey from "Secondary emerging" to "Advanced emerging" indexes** *(cont.)*

Table 2.2. **Advanced, Advanced emerging, Secondary emerging and Frontier countries in FTSE indexes**

Advanced	Advanced emerging	Secondary emerging	Frontier
Australia	Brazil	Argentina	Bahrain
Austria	Hungary	Chile	Bangladesh
Belgium/Luxembourg	Mexico	China	Botswana
Canada	Poland	Colombia	Bulgaria
Denmark	South Africa	Czech Republic	Côte d'Ivoire
Finland	Taiwan	Egypt	Croatia
France		India	Cyprus[1]
Germany		Indonesia	Estonia
Greece		Malaysia	Jordan
Hong Kong		Morocco	Kenya
Ireland		Pakistan	Lithuania
Israel		Peru	Macedonia
Italy		Philippines	Mauritius
Japan		Russia	Nigeria
Netherlands		Thailand	Oman
New Zealand		**Turkey**	Qatar
Norway			Romania
Portugal			Serbia
Singapore			Slovakia
South Korea			Slovenia
Spain			Sri Lanka
Sweden			Tunisia
Switzerland			Viet Nam
United Kingdom			
United States			

1. *Note by Turkey:* The information in this document with reference to Cyprus relates to the southern part of the island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of United Nations, Turkey shall preserve its position concerning the "Cyprus issue". *Note by all the European Union Member States of the OECD and the European Commission:* The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

Source: FTSE.

Fostering sound integration with the global capital market

Three major areas where ongoing progress in Turkey's economic policy institutions is relevant for Turkey's international capital market status are reviewed below: the predictability of fiscal policy, the effectiveness of monetary policy and the soundness of the financial system.

Predictability of fiscal policy

The new fiscal rule

To put Turkey's fiscal stance on durably sustainable ground, on 10 May 2010 the authorities announced introducing a formal fiscal rule (Box 2.8). The rule will support the targets of the Medium Term Programme (Chapter 1) and should provide a durable anchor in the longer run. The draft law was sent to Parliament on 26 May and was expected to be

adopted in June 2010, and apply immediately in the preparation of the 2011 budget. The draft was however not legislated as planned, and unfortunately its discussion was postponed.

Box 2.8. **The new fiscal rule**

The fiscal rule announced by the authorities on 10 May 2010 can be classified as a "growth-based balance rule". It sets a ceiling for general government budget deficit as a per cent of GDP, in relation to *i)* the deficit in the previous year; *ii)* the deviation of previous year's deficit from the long-term deficit target (this is a benchmark consistent with declining public debt: the public debt stock as a share of GDP, in Maastricht definition, is planned to decrease to about 30% in the long-run); and *iii)* deviations of GDP growth from the benchmark GDP growth rate in the current year. The rule therefore seeks to ensure convergence to the target deficit while making room for automatic stabilisers. The rule is formally given by:

$$\Delta a_t = -0.33(a_{t-1} - 1) - 0.33(b_t - 5)$$

where Δa_t denotes the adjustment required in the general government deficit to GDP ratio in year t, a_{t-1} is the general government deficit/GDP ratio in previous year $(t - 1)$ and b_t is the real GDP growth rate. The benchmark general government deficit/GDP ratio is set at 1% and the benchmark GDP growth rate is set at 5%. The coefficient determining the speed of adjustment in general government deficit with regard to the difference from the benchmark deficit target is set at –0.33. The coefficient providing room for lengthening the deficit if the current year's GDP growth deviates from the trend growth rate is also set at –0.33. This reflects the share of general government revenues in GDP and permits to offset revenue losses arising from the deviation (automatic stabilisation).

Policymakers have three "windows" for adjusting year *t*'s fiscal policy and outcomes to the requirements of the rule: *i)* in the spring of year $t - 1$, when preparing the background medium-term economic framework for the draft budget for year *t*; *ii)* in the fall of year $t - 1$, when finalising the budget before submitting it to Parliament; *iii)* in the spring of year *t*, when growth and fiscal projections become more precise. Spending and revenue adjustments for the current year can still be undertaken at this point.

Three complementary regulations back the rule. They provide additional safeguards in the areas outside central government control. They aim at ensuring that spending and revenue surprises in other general government layers do not undermine aggregate fiscal outcomes:

- Budgets of revolving funds will be in balance.
- There will be no net borrowing requirement by state-owned enterprises on an aggregate basis.
- An annual report will document the actuarial balances of pension and general health insurance systems.

The realisation of the fiscal rule, based on annual fiscal data, will be announced to the public in the Fiscal Rule Monitoring Report by the Ministry of Finance by the end of April after the closing of the fiscal year. The Turkish Court of Accounts (TCA) will audit all accounts and check their conformity with standards. The Planning and Budget Commission of the Grand National Assembly of Turkey will be informed about targets, updates, and any deviations from the target and underlying reasons in a special-agenda meeting within 15 days after the publication of the Medium Term Programme and the Fiscal Plan. This should provide a platform of political and technical accountability on the implementation of the rule.

The proposed rule appears robust in design and well adapted to Turkey's present circumstances. At the same time, it is demanding in terms of fiscal information at the general government level, and policymakers' ability to adjust revenues and spending in the course of a budget year. When implementing the rule the authorities should take into account other countries' experiences with similar rules and their own earlier experience with multiyearly fiscal management. Both set of experiences contain precious lessons (Box 2.9).

Box 2.9. **Lessons for implementing fiscal rules**

The IMF reviewed fiscal rules applied in 80 countries and analysed their implementation history and outcomes (IMF, 2009a). Four lessons deserve particular attention in the Turkish context:

- Rules are more effective when they are put into force after basic fiscal consolidation is completed. They should be implemented once public finances are on a stable and sustainable path. In Turkey, some degree of additional consolidation will still be needed during 2010-12, however, its size is relatively small and this should permit smooth implementation.
- A rule should not be introduced in an environment of heightened macroeconomic uncertainty. Policymakers should not be confronted too early with a trade-off between the strict enforcement of the rule and the needs of macroeconomic stabilisation. The majority of fiscal rules which were in application around the world when the global crisis hit were suspended to give way to anti-crisis policies. Turkey is on better ground in this respect, as the rule will be implemented when the global and domestic recovery should be in train.
- Fiscal rules as such do not reduce countries' risk premia. Nonetheless, they help countries which are already fiscally credible to reduce risk premia. In the light of the analysis in this chapter, a credible fiscal rule should be expected to accelerate Turkey's transition to investment grade. However, the introduction of a rule should not prompt any doubts on the integrity of fiscal transparency. The experience of other OECD countries suggests that fiscal transparency may tend to deteriorate in the presence of a fiscal rule.*
- A robust financial management infrastructure is a prime requisite for the credible implementation of a rule. Critical elements include: *i)* fiscal reporting systems comprehensive enough in terms of general government aggregates; *ii)* timely end-year and intermediate fiscal reports; *iii)* audit systems ensuring that all utilised resources are accounted for (including in sub-national governments, social security accounts and public companies); and *iv)* a pre-announced calendar of fiscal reports to facilitate the external monitoring of the rule.

Turkey's own experience with implementing a multi-year fiscal framework as mandated by the Public Financial Management and Control Law since 2006 (Box 2.10) provides also lessons for the implementation of the rule. The Annex 2.A3 summarises this experience and provides the following highlights:

- Turkey's macroeconomy is more volatile than in other OECD countries. Even if the planned fiscal rule is robust to GDP surprises (*i.e.* difference between projected and realised GDP growth), under the assumption that revenues are a constant share of GDP, other shortfalls against revenue targets may entail demanding adjustments in spending objectives.

Box 2.9. **Lessons for implementing fiscal rules** *(cont.)*

- Certain spending and revenue items show specific cyclical patterns. The authorities may wish to re-evaluate these patterns when implementing the rule. They can accommodate them or try to reduce their influence.
- Long-term spending pressures are in force, independently from cyclical variations. This is clearly the case in pension and health spending. Long-term projections are needed in these areas, to prepare adjustment strategies in other spending or revenue items.
- Irrespective of GDP fluctuations, revenues are difficult to project. Rate variations in taxes with the highest yields make this calculation difficult. Revenue planning will become more accurate with transition to a more stable tax structure (Annex 2.A1).

* Koen and Van der Noord (2005) documented that "fiscal gimmicks" came into play when fiscal rules start to bite or threaten to do so. A detailed analysis of general government accounting practices in Europe shows that this occurred on three occasions: *i)* in the run-up to the monetary union, *ii)* in the context of the sale of UMTS licenses, and *iii)* during cyclical downturns which worsened headline deficits. The distortions identified and corrected by Eurostat alone during 1993-2003 amounted to up to 1% of GDP or more per year in some of the most advanced OECD countries.

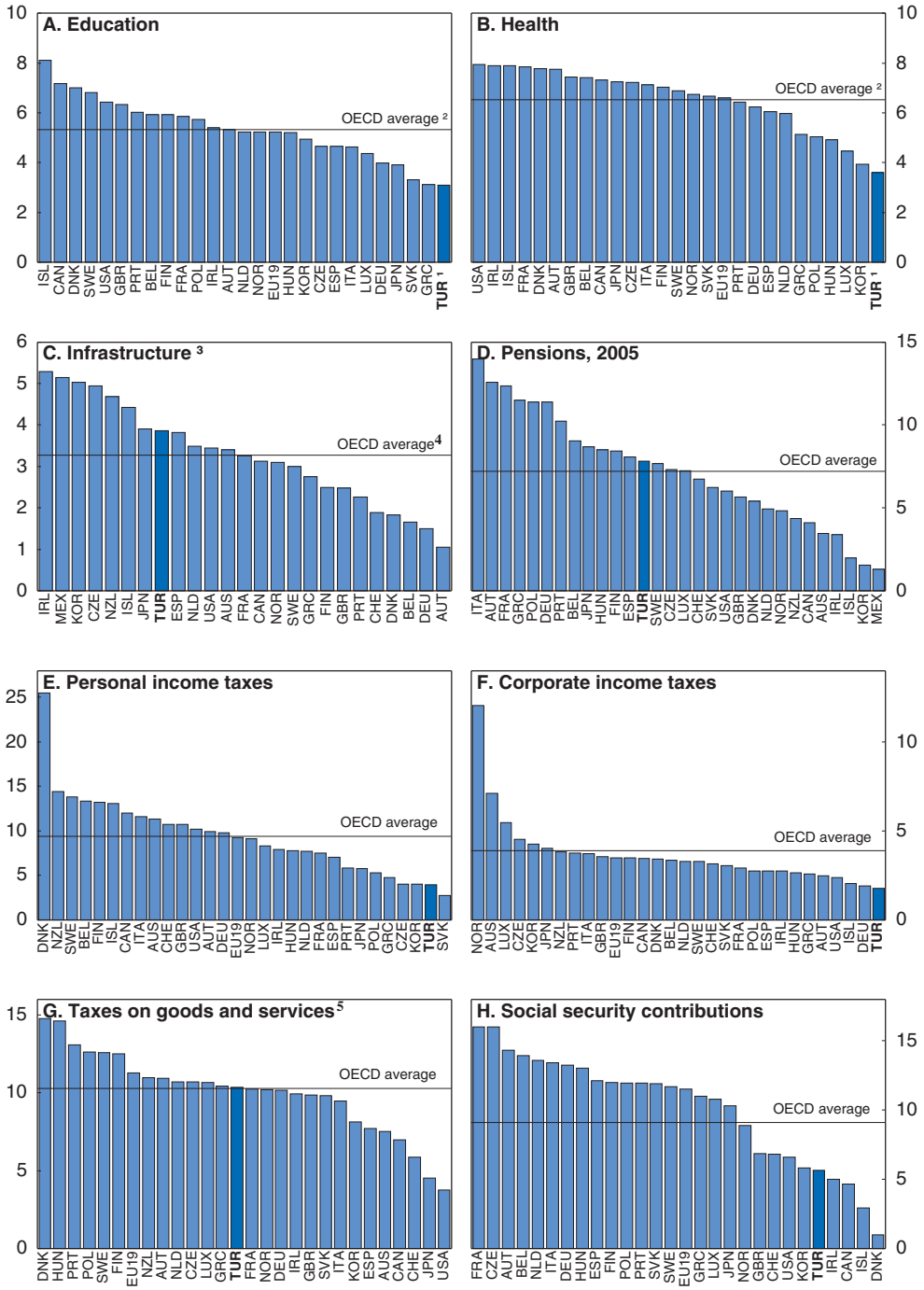
The rule does not prevent adjustments in spending and revenue structures

It is important to implement the fiscal rule without slowing the re-prioritisation of expenditure and the reduction of distortive taxes. Turkey has indeed compelling resource needs in a number of key public services (OECD, 2008). The detailed analysis in the previous *OECD Economic Survey of Turkey* suggested that several percentage points of GDP of additional public spending will likely be needed in education, health and physical infrastructure in the medium term. Figure 2.10 confirms that Turkey currently devotes a significantly lower share of its GDP to such services than other OECD countries. Medium-term fiscal policy will need to create room for such resource reallocation.

The tax structure also raises important challenges (Figure 2.10). A high proportion of the tax take may need to be maintained on consumption, but the heavy burden of social security contributions on the formal sector will need to be reduced by enhancing enforcement and broadening the tax base. Both corporate and personal income tax revenues could be considerably increased if regulatory reforms would make formalisation feasible. Improving spending and revenue structures is a necessary goal for Turkey's fiscal policy after the implementation of the rule.

One related area which should be monitored closely to avoid an uncontrolled expansion of fiscal spending is the financial position of the social security system. Despite the advantageous demographic structure and recent pension reforms (OECD, 2008), the social security funds are in deficit (above 3% of GDP in 2009). This is primarily due to a drastic fall in effective retirement ages following various policy decisions in the 1980s and 1990s. The age limit for retirement was reduced to 38 and 43 for women and men respectively. As a result, on average, men pay premiums for 25 years and receive retirement pensions and free health insurance for 27 years, while women pay premiums for 20 years and draw benefits for 33 years (Zararsiz, 2010). The social security reform which was finalised in two steps in 1999 and 2008, after a difficult political process, raised the minimum retirement age to 60 for men and 58 for women applicable in principle from 2036, and to 65 for both genders, applicable in principle from 2048. However, actual retirement ages will increase more gradually and 65 will likely become the normal

Figure 2.10. **Structure of main general government spending and revenue**
% of GDP, 2008 (or latest available)



1. Year 2006.
2. Excludes Australia, Mexico, New Zealand and Switzerland.
3. Government investment.
4. Excludes Chile, Hungary, Italy, Luxembourg, Poland and the Slovak Republic.
5. Include taxes on production, sale, transfer of goods and services, and taxes on specific goods and services.

Source: OECD, *National Accounts Database*; SPO; and OECD, *Revenue Statistics – Comparative Tables Dataset.*

StatLink http://dx.doi.org/10.1787/888932322100

retirement age only in the mid-2060s.[8] Increasing the effective retirement age at a faster pace could considerably improve public finances as argued in OECD (2006) but this is admittedly not on the political agenda (Table 3.A2.1 in Chapter 3).

The financial position of the social security system also depends on the growth and employment performance of the economy and the evolution of benefits and costs in the pension and health legs of the system. These are difficult to predict. Although pension benefits are entirely parametric and are enshrined in the Social Insurance and General Health Insurance Law (SIGHL), the government can change them with a new law every year. This was the case in 2009. Following pension adjustments in January and July 2009 according to SIGHL (solely in line with CPI indexation), the government granted a discretionary increase in December 2009, which was not provided for in SIGHL and was not appropriated in the 2010 budget. This is estimated to entail additional expenditures worth 0.3% of GDP per year. Health costs for those insured by the social security institution, as well as for the beneficiaries of the newly introduced universal health insurance (equally managed by the Social Security Institution SGK) depend also on the evolution of the benefit package. In response to drifts in health spending in 2007-08, the government introduced drastic rationing measures in 2009, including user fees, annual budget caps for public and university hospitals, and mandatory reductions in pharmaceutical prices. However, the social consequences of such rationing are not easy to manage and policies may be expected to evolve in the future. Implications for public health costs are difficult to predict.[9]

Transparency requirements

The primary requirement for the effective implementation of the fiscal rule is timely and fully reliable general government accounts. Turkey has ambitious objectives in this area. At the same time, consolidated government accounts according to international standards are not yet published. Both Turkey's and other OECD countries' experience indicates that generating such statistics at the required level of quality is challenging. It implies solving a number of intricate technical issues (Box 2.10 and Annex 2.A3).

Box 2.10. **Ambitions and challenges of high quality general government accounting**

The fiscal accounting infrastructure of the fiscal rule is based on the Public Financial Management and Control Law (PFMCL) which has been in force since 2006. The PFMCL sets essential fiscal transparency objectives:[1]

- The central budget is maintained as the core instrument of fiscal policy. Its objectives and economic assumptions are made fully transparent. The central budget is monitored on a monthly basis.
- Quasi-fiscal activities are made transparent. Financial losses of state-owned entities implied by their policy responsibilities ("duty losses" in the Turkish parlance) are explicitly budgeted and reported.
- The accounts of the social security institutions, extra-budgetary funds and local governments are prepared together with the central budget.
- The Ministry of Finance is responsible for publishing quarterly consolidated general government accounts according to the ESA 95 standards.

Box 2.10. **Ambitions and challenges of high quality general government accounting** *(cont.)*

- The budget codification system is overhauled. Each spending item will be identified in "institutional", "administrative", "economic" and "functional" terms. This will help re-classify the current 34 500 line items of the budget (a far higher degree of detail than in any other OECD country) into meaningful spending programmes.
- To bridge fiscal policy with long-term economic policy, all ministries and government agencies are required to prepare strategic plans. These will be based on the national priorities outlined in national development plans.
- A three-yearly Medium Term Programme and Fiscal Plan will back the budget every year, providing a macroeconomic and fiscal framework for the period ahead. This framework has to include spending ceilings for each government department. Targets will be binding for the budget year and be indicative for the following two years.
- General government accounts will be audited by the Turkish Court of Accounts (TCA). A draft law was prepared to equip TCA with the necessary legal powers to audit comprehensively all general government entities (central government, local governments and social security funds). The draft law has been adopted by the Plan and Budget Commission of the Parliament and it is expected to be enacted soon.

The PFMCL was passed in 2003 and has been in principle fully in force since 2006.[2] Yet, as of May 2010, the full degree of transparency in fiscal accounts does not yet match its initial objectives. Major progress was achieved at the central government level. The Ministry of Finance started to publish many components of general government accounts. However, a consolidated set of general government accounts are not yet published. A useful proxy is provided by the "general state sector statistics" compiled by the State Planning Organization (SPO) every year. These statistics are published in the *Pre-Accession Economic Programme* prepared by the SPO and submitted to the European Commission. In addition, the Annual Programme prepared by SPO includes a description of fiscal developments based on "general government statistics". The Ministry of Finance confirmed in May 2010 that the relevant set of accounts according to international standards had already been forwarded to Eurostat for verification and their publication was imminent.

When general government accounts start to be published according to the ESA 95 standards, a range of specific challenges will likely be faced given the experience of other OECD countries (Annex 2.A1). The most important of these challenges are:

- The central government does not dominate the fiscal scene in Turkey (Annex 1.A4 in Chapter 1). It is compounded by other sizeable general government layers. The quality of fiscal reporting by these layers significantly influences the overall quality of general government accounts.
- The full implementation of the principle of accrual-based reporting may be difficult at the level of local governments and the social security institution.
- Exceptional revenue items played a major role in Turkey in certain years (such as voluntary settlements in tax amnesties), their accrual-based allocation across years should be done carefully
- Making quasi-fiscal activities fully transparent, in the spirit of the 2006 PFMCL, is not easy. State-owned entities carry on various policy responsibilities outside the realm of the general government sector. The financial costs of these duties should be reported as additional information.

Box 2.10. **Ambitions and challenges of high quality general government accounting** *(cont.)*

- Total public liabilities should be reported as part of the (already high quality) public debt statistics. Fully reporting local government debt, debt by municipally-owned corporations, the outstanding stock of government guarantees provided in the past to public-private partnerships, and the long-term liabilities of the public pension and health systems is still an ongoing task.

1. See OECD (2005) for a detailed analysis of this law.
2. The PFMCL was also accompanied by a number of supporting innovations: *i)* an online budget management system (*Say 2000i*) put in application in more than 1 500 government entities in 81 provinces and 850 districts; *ii)* a Public Debt Management Law (PDML): After years of decentralised and unstructured management, the monitoring of public debt is centralised. The Treasury is made responsible for most public borrowing and for producing quarterly and annual debt reports. From their very inception, these reports have been welcomed by all stakeholders (OECD-Sigma, 2008); *iii)* a Law on Metropolitan Municipalities capped the debt stock of metropolitan municipalities to 150% of their annual revenue and the debt stock of other municipalities is limited to their annual income. All municipal borrowing in excess of 10% of annual income will necessitate a formal authorisation by the Ministry of Interior.

The authorities have already started creating the required infrastructure, notably through close co-operation with Eurostat. They recently reiterated that full general government accounts according to ESA 95 will be at hand when the rule starts to function in 2011.

The IMF also helped produce comprehensive fiscal information under the Stand-By Arrangements between December 1999 and May 2008. It monitored fiscal developments through frequent reviews. These examinations involved occasional investigations on specific areas of fiscal risks, including financial balances of state-owned enterprises, of public banks and of the agricultural purchasing board. "Programme definitions" (or "IMF-definitions") of central government and consolidated public sector have been developed in this context – as proxies to replace fully-fledged general government accounts. Domestic and international investors and the general public relied on this hands – on monitoring of fiscal outcomes and Turkey built up its fiscal credibility and reputation under such close surveillance.

The monitoring of fiscal policy by independent research institutions, a common practice in many other OECD countries, is not yet well developed in Turkey. One of the sources of independent analysis of fiscal outcomes is the Fiscal Surveillance Reports published by the Economic Policy Research Foundation (TEPAV).[10] These reviews screen government published fiscal data and offer an independent evaluation of the fiscal stance. Authorities express, at times, technical disagreements with TEPAV's judgements. Nevertheless, this work remains a main source of independent technical analysis regarding fiscal developments. Recently, the Civil Society Center at Istanbul Bilgi University has started publishing handbooks to help the public to better monitor fiscal outcomes. This was a useful third-party innovation and four handbooks have already been published: Handbook to read budget documents, Handbook to read medium-term fiscal plans, Handbook to read social expenditures, and Handbook to read defence expenditures.

Possible improvements after the early experience with the rule

If early experience with the implementation of the rule reveals a need for additional supporting measures, the authorities could envisage introducing *i)* a multi-year spending

ceiling; *ii)* a reserve account monitoring cumulated deviations from rule targets; and *iii)* an independent fiscal council evaluating objectives, achievements and outcomes.

- **Spending ceiling:** The OECD budget policy department emphasises that to be effective fiscal rules should not require an excessive degree of sophistication in fiscal monitoring (Anderson and Minarik, 2006). Multi-year expenditure ceilings are suggested as simple complementary tools. The Turkish authorities could support the fiscal rule with a nominal aggregate spending ceiling. Such a ceiling can be adopted by the Parliament as a stand-alone law complementing the budget every year.[11]
- **Reserve account:** The rule does not have at present a mechanism to acknowledge and smooth the impact of past projection mistakes on the deficit ceiling. A possible remedy is to set up a virtual "reserve account", keep count of deviations, and ensure that this account stays within pre-defined limits. This mechanism may also make fiscal policy more efficient and reliable, by making drastic spending cuts or revenue increases less compelling (in response to spending or revenue surprises occurring in a budget year). The recently enacted fiscal rule in Germany has an account of this type that Turkish authorities may wish to consider after monitoring the magnitude of any projection mistakes.
- **Fiscal council:** An independent fiscal policy council can evaluate fiscal objectives and outcomes. It can produce a *Fiscal Policy Report* in the same spirit as the *Inflation Report*. Such institutions are in operation in several OECD countries (Annex 2.A4). In Turkey's current circumstances such a council may be established under Parliament, as in the United States and Canada, and report directly to the Plan and Budget Commission which has special responsibility in monitoring the fiscal rule (Box 2.8). Since thoroughly audited fiscal accounts are still in the making and quasi-fiscal activities continue to play an important role, such an institution should have a strong political weight and adequate legal powers. According to an OECD assessment (Anderson, 2009) successful parliamentary fiscal watchdogs are effective in: *i)* simplifying complexity in fiscal information, *ii)* promoting transparency of outcomes; *iii)* enhancing credibility of budget forecasts, *iv)* serving both majority and minority legislators and the general public by offering non-partisan services; and *v)* providing rapid responses to fiscal policy inquiries than are usually given by the executive branch.

Inflation targeting framework

Turkey's monetary policy gained strong credibility by cutting inflation from high double to single-digit levels in the 2000s (Chapter 1). An initially implicit, then explicit inflation target underpinned the action (OECD, 2008). Strengthening the inflation targeting regime would further consolidate the credibility and effectiveness of the CBRT:

- **Continuous inflation targeting.** Turkey could shift to a continuous inflation target from 2012. In the present framework, the inflation target is set for three years ahead, for December of each year (currently 6.5% for end-2010, 5.5% for end-2011 and 5.0% for end-2012). As the target level for the end-2012 is quite low, suggesting the imminent end of the disinflation in the following years, switching to a continuous target afterwards becomes feasible. This would require choosing the appropriate level of the inflation target and the width of uncertainty bands. The frequency of reviewing inflation target should also be set (the international practice in this respect varies considerably,

Rezessy, 2006). It will be useful to communicate these decisions, together with the underlying reasoning, early in advance.

- Shifting to continuous inflation targeting could help sustain permanently lower inflation, facilitate communication and better anchor long-term inflation expectations. Currently, if end-year inflation deviates by more than 2 percentage points from the target (*i.e.* it falls outside the so-called uncertainty band), the Central Bank of the Republic of Turkey (CBRT) must submit an open letter to the government explaining the reasons for the deviation and the measures to be taken to bring inflation closer to the target. Similar explanations are published in the quarterly Inflation Report, when quarterly inflation deviates from the end-year target by more than 2 percentage points. There is thus already a *de facto* mechanism of more continuous accountability without having a continuous inflation target. Adopting the continuous target would be in line with the common practice of developed and emerging inflation targeters (Rezessy, 2006). Continuous inflation targets, which are set in principle indefinitely but are subject to possible changes, may also facilitate the tasks of the monetary authorities (including communication) when inflation deviates significantly from the target due to a temporary supply shock. In such circumstances, a central bank may be in a better position to keep inflation expectations anchored by explaining reasons for inflation deviation and taking appropriate action without actually changing the inflation target.
- **Structural policies in support of disinflation.** Structural and microeconomic policies should support the inflation target. Counter-cyclical monetary policy is facilitated when wages and prices respond flexibly to the cyclical situation. The downward adjustment of wages is likely to be stronger in the informal sector, as wages there are not bound by the minimum wage. Thus, the burden falls more on the already-disadvantaged informal workers. To remedy this, wage setting mechanisms in the formal sector should be made fully responsive to market conditions. Price competition in service activities is equally important for the efficient operation of inflation targeting. Recent developments suggest that price rigidities in services have diminished, but competition authorities should ensure that price competition remains effective. This is particularly important in markets where underlying price pressures remain strong, such as education, health, housing, transportation and wholesale food distribution. Also, pricing and indirect taxation practices in network industries where many prices are set administratively should be managed by taking the inflation target into account, minimising volatility unrelated to input costs.
- **Foreign reserve accumulation.** International reserves provide insurance against financial instability and the policy of gradually increasing reserves should be sustained as currently intended by the CBRT (2009). High reserves indeed proved useful for limiting exchange rate depreciation in emerging markets in the 2008-09 global crisis. Turkey, as many other emerging markets, has been accumulating foreign reserves in the past decade. This was possible thanks to foreign exchange purchase auctions of the CBRT with pre-announced terms and conditions (Table 2.3).[12] Reserves amounted to around 22% of M2 at the end of 2009 (12% of GDP), but remained significantly below levels observed in countries like Argentina, Brazil, Bulgaria, Hungary and Romania. They were at a similar or higher level than in the Czech Republic, Korea, Mexico and Poland. There are no universal guidelines regarding the optimal level of reserves. For instance, Obstfeld *et al.* (2009) argue that the reserves should be proportional to the size of banking

Table 2.3. **Foreign exchange operations by the CBRT (USD million)**

	FX buying auctions	FX selling auctions	FX buying interventions	FX selling interventions	Total net FX buying
2002	795	–	16	12	799
2003	5 652	–	4 229	–	9 881
2004	4 104	–	1 283	9	5 378
2005	7 442	–	14 565	–	22 007
2006	4 296	1 000	5 441	2 105	6 632
2007	9 906	–	–	–	9 906
2008	7 584	100	–	–	7 484
2009	4 314	900	–	–	3 414

Source: SPO (2009), *Pre-Accession Economic Programme 2009*.

system, taking into account the exchange rate regime, trade and financial openness, and not just short-term external debt as was previously stressed in the literature.

Financial supervision

Prudent financial supervision is crucial for sound integration with the global capital market. Turkey painfully learned the lesson in the 2001 crisis and significantly strengthened its prudential regulations (Chapter 1). Turkish authorities have also demonstrated their readiness to adjust prudential regulations pre-emptively. Despite the low level of foreign currency exposure of households (around 4% of total consumer loans in 2009), in mid-2009 households were forbidden to take foreign exchange and foreign exchange index loans from foreign and domestic banks.[13] This regulation limits currency risks for households and slows credit growth given a still large interest rate differential. It is a welcome decision given the recent experience with pro-cyclical credit growth in foreign currency in several European emerging countries. Safeguards against foreign exchange rate exposure have therefore been developed, but there are still some challenges as fast innovation in the financial markets requires constant vigilance. An excessive growth of housing loans should also be avoided and minimum downward payment rules should be kept prudent.

Adopting Basel II and its new amendments should remain a prime objective of regulators. Basel II is likely to result in lower risk-adjusted capital ratios, particularly due to the required re-pricing of Turkish government securities which constitute a significant share of banks' assets. According to Basel I rules, government securities of the OECD countries are priced as riskless assets, whereas in Basel II they are valued according to their credit rating. The timing of Basel II adoption has not been decided yet, but the progress with implementing required rules continues. Turkey has also a strong interest in complying with amendments to Basel II aiming at countercyclical prudential supervision because it will face more such risks as its integration with the global capital market proceeds. The task should be made easier thanks to the admission of the Turkish Banking Regulation and Supervision Agency (BRSA) to the Basel Committee on Banking Supervision in May 2009 and Turkey's participation in the Financial Stability Board.[14]

Policy recommendations

Box 2.11 summarises the policy recommendations of this chapter.

Box 2.11. **Fostering sound integration with the global capital market**

- Continue to emphasise the full set of factors of macroeconomic performance and credibility as drivers of international capital market standing: fiscal credibility, monetary stability, sound financial supervision, external balances, high trend growth and political stability.
- Consider the full set of areas as forming an integrated agenda, as co-determinants of Turkey's standing. Weaknesses in specific areas are not compensated by superior performance in others.
- Indicators of international capital market standing – including country risk premia, credit ratings, and investment index positions – should be publicly monitored and discussed. They may be used and checked as benchmarks of economic policy performance.
- Pursue a dialogue with rating agencies' on Turkey's perceived strengths and shortcomings.
- Further improve Turkey's economic policy framework by:

Fiscal policy

- Improving fiscal sustainability by putting in place the announced fiscal rule and its fiscal management infrastructure.
- Ensuring that the fiscal rule does not hinder the re-prioritisation of spending and the reduction of distortive taxes.
- Publishing, as planned, quarterly and yearly complete and consolidated general government accounts according to the ESA 95 standards.
- Keeping the actuarial balances of the social security system in check.
- Adopting the new draft law on Turkish Court of Accounts to empower it for comprehensive general government auditing.
- If a need arises after initial experience with the implementation of the rule, be ready to phase in:

  i) a multi-year spending ceiling,

  ii) a reserve account keeping track of accumulated deviations from deficit ceilings, and

  iii) an independent fiscal monitoring agency.

Inflation targeting

- Consolidating the credibility of monetary policy and of the inflation targeting framework by shifting to continuous inflation targeting.
- Phasing in structural reforms enhancing wage flexibility in the formal sector and further price competition in non-tradable services.
- Continuing the policy of foreign reserve accumulation, as planned.

Financial stability

- Consolidating the rigour of prudential surveillance in the financial sector by aligning it with the international best-practice regulations. This calls for implementing Basel II regulations and adopting any new amendments for countercyclical prudential policy that are likely to be introduced following the global crisis.
- Continuing, and updating as needed, the current safeguards against excessive growth in housing loans and foreign currency exposure by households and enterprises.

Notes

1. There are at present five nationally recognised statistical rating organisations (NRSRO): Standard & Poor's, Moody's, Fitch, A.M. Best, and Dominion Bond Rating Service. They are certified by the Securities and Exchange Commission. Among the five only Standard & Poor's, Moody's and Fitch offer global rating services.
2. As an example, Basel II guidelines recommend to set capital adequacy coefficients for government securities in bank portfolios according to the ratings granted by certified agencies. Basel I regulations used OECD membership as the key criterion for risk provisioning for government securities.
3. For example, the 1997 Asian crisis revealed that the key source of shocks for certain emerging markets had moved from external imbalances to the accumulation of domestic private financial liabilities.
4. Sy (2002) provided a detailed examination of these gaps and concluded that when gaps between credit ratings and market risk premia become significant, excessively high spreads are generally followed by episodes of spread narrowing. This adjustment is more frequent than credit downgrades. In contrast, observations with excessively low spreads are generally followed by rating upgrades, rather than episodes of spread widening. Any substantive disagreement between markets and rating agencies is viewed as a signal that further technical and sovereign analysis is warranted.
5. The "institutional effectiveness" indicator is compiled by the Economist Intelligence Unit. It draws notably on sub-indicators taken from the World Bank database on public governance.
6. This so-called "radar screen effect" identified by Merton (1987) arises from the fact that more visible stocks attract more distant investors and thus require lower returns.
7. FTSE indices are used extensively by investors worldwide. Other widely followed emerging market indexes include MSCI by Morgan Stanley and WII by JP Morgan. FTSE is particularly communicative on its country classification principles, their shortcomings and their evolution. See: FTSE Emerging Market Indexes on *www.ftse.com/indices/index.jsp*.
8. More gradual transition to an effective retirement age of 65 is due to the provision in the pension law stipulating that individuals can retire at the minimum legal retirement age prevailing in the year when they have completed 20 years of contributions. For example, a man who starts work at age 20 in 2016 will complete 20 years of contributions in 2036 at age 40. On that year, the legal retirement age will be 60. This individual will therefore be able to retire when he reaches age 60 in 2056. As a result, many people will be retiring before 65 after 2048.
9. OECD (2006, 2008) provided projections for the social security system, based on Turkish government and World Bank scenarios – both produced with the help of the World Bank's PROST model. These projections are in need of reconsideration. The distribution of total employment between formal and informal jobs will notably alter with the *Plan of Fight against the Informal Economy*, with implications on spending (as the number of beneficiaries will increase) and revenues (as contributions collected will increase). The President of SGK estimated in mid-2010 that thanks to increased efforts to register informal workers, 500 000 new contributors were registered in 2009 and 2010, but 9 million workers had remained still unregistered (Zararsiz, 2010). He estimated that if these 9 million workers contributed to social security financing, despite additional health costs, the deficit of the social security system would be divided by ten and fall to 0.3% of GDP.
10. TEPAV is an economic research organisation sponsored by the Turkish Union of Trade and Industry Chambers (TOBB). It is located at TOBB University in Ankara.
11. The ceiling should be set in conformity with the three-yearly fiscal framework accompanying the budget. This does not imply that the framework cannot be changed from year to year. There are only a few OECD countries that maintain ceilings unchanged from year to year.
12. Since the introduction of the floating exchange rate regime, the CBRT also retains the option to conduct discretionary interventions to prevent unhealthy price formations that might occasionally arise from decreases in market depth. It has however not intervened since 2006 (Table 2.3) as the actual ability of the CBRT to affect exchange rate volatility is debatable. For instance, Çaşkurlu *et al.* (2008) show that between 2002 and 2005 the auctions actually increased exchange rate volatility, whereas the direct interventions reduced it.

13. In contrast, the access to foreign currency credit for companies, which was very strict, was relaxed. This was motivated by concerns about foreign debt statistics. Many companies were taking loans from foreign branches of domestic banks, which inflated foreign debt.

14. The Financial Stability Board, comprising G-20 countries, was established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. In April 2009, it replaced the Financial Stability Forum that involved G-7 countries.

Bibliography

Afonso, A. (2002), "Understanding the Determinants of Government Debt Ratings: Evidence for the Two Leading Agencies", *Working Papers 2002/02*, Department of Economics at the School of Economics and Management (ISEG), Technical University of Lisbon.

Afonso, A., Gomes, P. and P. Rother (2007), "What Hides Behind Sovereign Debt Ratings?", *European Central Bank Working Paper Series*, No. 711, European Central Bank, Frankfurt.

Allen, R. (2009), "The Challenge of Reforming Budgetary Institutions in Developing Countries", *IMF Working Papers*, No. WP/09/96, International Monetary Fund, Washington, DC.

Anderson, B. (2009), "The Changing Role of Parliament in the Budget Process", *OECD Journal of Budgeting*, Vol. 1, Paris.

Anderson, B. and J. Minarik (2006), "Design choices for fiscal policy rules", *OECD Journal of Budgeting*, Vol. 5, Paris.

Arghyrou, M., A. Gregoriu and A. Kontonikas (2009), "Do Real Interest Rates Converge?", *Journal of International Financial Markets, Institutions and Money*, No. 19.

Baldacci, E., S. Gupta and A. Mati (2008), "Is it (Still) Mostly Fiscal? Determinants of Sovereign Spreads in Emerging Markets", *IMF Working Papers*, No. 08/259, International Monetary Fund, Washington, DC.

Banerjee, A. and S. Manmohan (2006), "Testing Real Interest Parity in Emerging Markets", *IMF Working Papers*, No. 06/249, International Monetary Fund, Washington, DC.

Bankovica, S. and J. Pranevics (2007), "How Does Inclusion in an Index Affect Stock Prices?", bachelor thesis, Stockholm School of economics in Riga.

Bernoth, K., J. von Hagen and L. Schuknecht (2006), "Sovereign Risk Premiums in the European Government Bond Market", *Discussion Papers No. 151, SFB/TR 15 Governance and the Efficiency of Economic Systems*, Free University of Berlin, Humboldt University of Berlin, University of Bonn, University of Mannheim, University of Munich.

BIS (2009), "Capital Flows and Emerging Market Economies", Committee on Global Financial System, January, Bank for International Settlements, Basel.

Bissoondoyal-Bheenick, E. (2005), "An Analysis of the Determinants of Sovereign Ratings", *Global Finance Journal*, Vol. 15(3), pp. 251-280.

Borensztein, E., K. Cowan and P. Valenzuela (2007), Sovereign Ceilings Lite'? The Impact of Sovereign Ratings on Corporate Ratings in Emerging Market Economies, *IMF Working Papers*, No. 07/75, International Monetary Fund, Washington, DC.

Cantor, R. and F. Packer (1996), "Determinants and impact of sovereign credit ratings", *Economic Policy Review*, October, Federal Reserve Bank of New York, New York.

Canuto, O., Santos , P.F.P. and P.C. Porto (2004), "Macroeconomics and Sovereign Risk Ratings", World Bank and University of Sao Paolo, *mimeo*.

Çaşkurlu, T., M. Pinar, A. Salih and F. Salman (2008), "Can Central Bank Interventions Affect the Exchange Rate Volatility? Multivariate GARCH Approach Using Constrained Nonlinear Programming", *Central Bank of Turkey Working Papers*, No. 806, Ankara.

CBRT (2009), *Monetary and Exchange Rate Policy for 2010*, Central Bank of the Republic of Turkey, 10 December, Ankara.

Ciarlone, A., P. Piselli and G. Trebeschi (2007), "Emerging Markets Spreads and Global Financial Conditions", *Temi di discussione (Economic Working Papers)*, No. 637, Bank of Italy, Economic Research Department, Rome.

Culha, O., F. Ozatay and G. Sahinbeyoglu (2006), "The Determinants of Sovereign Spreads in Emerging Markets", *Working Papers,* No. 0604, Research and Monetary Policy Department, Central Bank of the Republic of Turkey, Ankara.

Die Bank (2009), "The role of credit rating agencies", *www.die-bank.de/service/internet-translation-service/the-role-of-credit-rating-agencies*.

ECB (2004), "Market Dynamics Associated With Credit Ratings: A Literature Review" (by F. Gonzales, F. Haas, R. Johanness, M. Persson, L. Toledo, R. Violi, M. Wieland and C. Zins), *European Central Bank Occasional Paper,* No. 16, June, European Central Bank, Frankfurt.

Eichengreen, B.J. and A. Mody (1998), "What Explains Changing Spreads on Emerging-Market Debt: Fundamentals or Market Sentiment?", *NBER Working Papers,* No. 6408, National Bureau of Economic Research.

Ekinci, A. (2009), "Belediyelerin Mali Yapisi ve Borc Durumu Uzerine", Muhasebenet, 14.05.2009.

El-Erian, M. (2008), *When Markets Collide: Investment Strategies for the Age of Global Economic Change*, McGraw-Hill Professional.

Emil, M.F. and H.H. Yilmaz (2009), "Mali Saydamlik Izleme Raporu VII", TEPAV, Ankara.

Ersel, H. (2010), "Kamu Harcamalarinin Toplumsal Denetimi Gerekiyor", *Referans*, 15.02.2010.

European Commission (2008), "Proposal for a Regulation of the European Parliament and of the Council on Credit Rating Agencies", 12 November, Brussels.

European Commission (2010), "European Commission Warns Rating Agencies on Greek Downgrades", ForexPlaybook, 4 May, *http://forexplaybook.com/2165/european-commission*.

Feldstein, F. and C. Horioka (1980), "Domestic Saving and International Capital Flows", *The Economic Journal*, Vol. 90 (358).

Ferreira, A.L. and M. Leon-Ledesma (2007), "Does the Real Interest Parity Hypothesis Hold? Evidence for Developed and Emerging Markets", *Journal of International Money and Finance, No.* 26.

Ferrucci, G. (2003), "Empirical Determinants of Emerging Market Economies' Sovereign Bond Spreads", *Bank of England Working Papers,* No. 205, Bank of England, London.

Fitch (2009), Statement on Turkish Banking, July, *www.fitchratings.com*.

Fortune (2009), "TOKI: Pandora'nin Kutusu", *Fortune*, March 2009.

Fuentes, M. and S. Godoy (2005), "Sovereign Spread in Emerging Markets: A Principal Component Analysis", *Working Papers Central Bank of Chile,* No. 333, Central Bank of Chile, Santiago.

González-Rozada, M. and E.L. Yeyati (2008), "Global Factors and Emerging Market Spreads", *Economic Journal*, Vol. 118(533), pp. 1917-1936.

Grandes, M. (2007), "The Determinants of Sovereign Bond Spreads: Theory and Facts from Latin America", *Cuadernos de Economía (Latin American Journal of Economics)*, Instituto de Economía. Pontificia Universidad Católica de Chile, Vol. 44(130), pp. 151-81.

Hacibedel, B. and Van Bommel (2007), "Do Emerging Market Stocks Benefit from Index Inclusion?", *Said Business School Working Paper*, University of Oxford.

Hallerberg, M. and G. Wolff (2008), "Fiscal Institutions, Fiscal Policy and Sovereign Risk Premia in EMU", *Public Choice*, Springer, Vol. 136 (3), pp. 379-396, September.

Haugh, D., P. Ollivaud and D. Turner (2009), "What Drives Sovereign Risk Premiums? An Analysis of Recent Evidence from the Euro Area", *OECD Economics Department Working Papers*, No. 718, OECD, Paris.

Hilscher, J. and Y. Nosbusch (2007), "Determinants of Sovereign Risk: Macroeconomic Fundamentals and the Pricing of Sovereign Debt", *EFA 2007 Ljubljana Meetings Paper*.

IMF (2007), *Manual on Fiscal Transparency*, International Monetary Fund, Washington, DC.

IMF (2009a), "Fiscal Rules: Anchoring Expectations for Sustainable Public Finances", *Public Information Notice*, No. 09/139, International Monetary Fund, Washington, DC.

IMF (2009b), "Fiscal Rules-Anchoring Expectations for Sustainable Public Finances", Fiscal Affairs Department, International Monetary Fund, Washington, DC.

Jaramillo, L. (2010), "Determinants of Investment Grade Status in Emerging Markets", *IMF Working Papers,* No. 10/117, International Monetary Fund, Washington, DC.

Johnson, K. (2009), "Gross and Net International Financial Flows", *Council on Foreign Relations Working Paper*, Washington, DC.

Kamin, S.B. and K. Von Kleist (1999), "The Evolution and Determinants of Emerging Markets Credit Spreads in the 1990s", *BIS Working Paper,* No. 68, Bank for International Settlements, Basel.

Kannan, P. (2008), "Perspectives on High Real Interest Rates in Turkey", *IMF Working Papers,* No. 08/251, International Monetary Fund, Washington, DC.

Kirsanova, T., L. Campbell and S. Wren-Lewis (2007), "Optimal Debt Policy, and an Institutional Proposal to Help in its Implementation" in J. Ayuso-i-Casals, S. Deroose, E. Flores, and L. Moulin (eds.), "The Role of Fiscal Rules and Institutions in Shaping Budgetary Outcomes", *European Economy Economic Papers,* No. 275, April.

Kizilot, S. (2009), "2010 Yili Butce Degerlendirmesi, Vergi Politikalari ve Vergi Gelirleri", Isveren, Kasim.

Kizilot, S. (2009), "Yeni Tesvik Paketinin Getirecegi Mali Yukler, Butce Performansina Muhtemel Etkileri ve Alinabilecek Tedbirler", Isveren, August.

Koen, V. and P. van den Noord (2005), "Fiscal Gimmickry in Europe: One-off Measures and Creative Accounting", *OECD Economics Department Working Paper*, No. 417, OECD, Paris.

Lagarde, C. (2010), "French Pushes for Stricter Control over Rating Agencies", CriEnglish.com, 5 April, *http://english.cri.cn/6966/2010/05/04/1721s567366.htm*.

Lombardo, D. (2010), "A Fiscal Rule for Turkey: The MTP Proposal", *CBRT Seminar*, Ankara.

Loungani, P. and A. Razin (2001), "How Beneficial is Foreign Direct Investment for Developing Countries", *Finance and Development*, Vol (38)2.

Maier, P. and G. Vasishtha (2008), "Good Policies or Good Fortune: What Drives the Compression in Emerging Market Spreads?", *Bank of Canada Working Papers, No.* 08-25.

Mati, A., E. Baldacci and S. Gupta (2008), "Is It (Still) Mostly Fiscal? Determinants of Sovereign Spreads in Emerging Markets", *IMF Working Papers*, No. 08/259, International Monetary Fund, Washington, DC.

McGuire, P. and M.A. Schrijvers (2003), "Common Factors in Emerging Market Spreads", *BIS Quarterly Review*, December, Bank for International Settlements, Basel.

McKinsey Global Institute (2009), "Global Capital Markets: Entering a New Era", Washington, DC.

Mello, M. and R. Scherre (2008). "Real Interest Rates, Budget Deficits, and the Public Debt in Emerging Markets", paper presented at LAMES meeting in Rio de Janeiro.

Merkel, A. (2010), "Merkel Backs Creation of European Credit Rating Firm," Bloomberg Business Week, 10 May, *www.businessweek.com/globalbiz/content/may2010/gb2010055_734001.htm*.

Merton, R. (1987), "A Simple Model of Capital Market Equilibrium with Incomplete Information", Journal of Finance, Vol. 42(3).

Min, H.G. (1998), "Determinants of Emerging Market Bond Spread: Do Economic Fundamentals Matter?", *Policy Research Working Paper Series,* No. 1899, World Bank, Washington, DC.

Moody's (2008), "A Guide to Moody's Sovereign Ratings", *www.moodys.com*.

Mora, N. (2006), "Sovereign Credit Ratings: Guilty Beyond Reasonable Doubt?", *Journal of Banking and Finance*, Vol. 30(7), pp. 2041-2062.

Moser, C. (2007), "The Impact of Political Risk on Sovereign Bond Spreads – Evidence from Latin America", *Proceedings of the German Development Economics Conference*, Göttingen 2007, Verein für Socialpolitik, Research Committee Development Economics.

Mulder, C. and R.A. Perrelli (2001), "Foreign Currency Credit Ratings for Emerging Market Economies", *IMF Working Papers, No.* 01/191, International Monetary Fund, Washington, DC.

Nickel, C., P.C. Rother and J.C. Rülke (2009), "Fiscal Variables and Bond Spreads, Evidence from Eastern European Countries and Turkey", *ECB Working Paper Series*, No. 1101, European Central Bank, Frankfurt.

Nomura (2009), "Turkey: The Curious Case of Sovereign Ratings", Country View, 24 September, London.

Northern Trust (2007), "Emerging Market Investing: An In-Depth Analysis", Chicago.

Northern Trust (2009), "Rebalancing the World – Determining Appropriate Allocations in a Dynamic Equity Landscape", Chicago.

Obstfeld, M., J.C. Shambaugh and A.M. Taylor (2009), "Financial Instability, Reserves, and Central Bank Swap Lines in the Panic of 2008", *American Economic Review*, Vol. 99(2), p. 480-86.

OECD (2002), "OECD Best Practices of Budget Transparency,", *OECD Journal of Budgeting*, Vol. 1(3), OECD, Paris.

OECD (2005), "Reforming Turkey's Public Expenditure Management", *OECD Economics Department Working Papers*, No. 418, OECD, Paris.

OECD (2006), *OECD Economic Surveys: Turkey*, Vol. 2006/15, OECD, Paris.

OECD (2007), "OECD Budget Practices and Procedures Database", *www.oecd.org/gov/budget/database*.

OECD (2008), *OECD Economic Surveys: Turkey*, Vol. 2008/14, OECD, Paris.

OECD-SIGMA (2008), "Turkey Public Expenditure Management System Assessment", *mimeo*, Paris.

OECD-SIGMA (2009a), "Turkey Public Expenditure Management System Assessment", *mimeo*, Paris.

OECD-SIGMA (2009b), "Turkey Public Internal Financial Control", *mimeo*, Paris.

Ozatay, F. (2008), "Expansionary Fiscal Consolidations: New Evidence from Turkey", *Department of Economics Working Papers*, No. 08-05, TOBB University of Economics and Technology, Ankara.

Prasad, E., R. Rajan and A. Subramanian (2006), "Patterns of International Capital Flows and Their Implications for Economic Development", IMF Research Department, September, Washington, DC.

Reisen, H. and M. Soto (2000), "The Need for Foreign Savings in Post-Crisis Asia", in *Sustainable Recovery in Asia: Mobilizing Resources for Development*, OECD Development Centre, Paris.

Reisn, H. (2010), "Boom, Bust and Sovereign Ratings: Lessons for the Eurozone from Emerging-Market Ratings", *Vox Economics*, 19 May. *www.voxeu.org/index.php?q=node/5061*.

Rezessy, A. (2006), "Considerations for Setting the Medium-Term Inflation Target", *Magyar Nemzeti Bank Bulletin*, Vol. 1(2), p. 35-40, Budapest.

Rowland, P. and J.L. Torres (2004), "Determinants of Spread and Creditworthiness for Emerging Market Sovereign Debt: A Panel Data Study", *Borradores de Economia 295*, Banco de la Republica de Colombia.

Setty, G. and R. Dodd (2003), "Credit Rating Agencies: Their Impact on Capital Flows to Developing Economies", Financial Policy Forum.

Sevig, V. (2010), "2010 Yilinda Gelir Vergisi Uygulamasi", *Referans*, 5.01.2010.

SPO (2009), *Pre-Accession Economic Programme 2009*, State Planning Organization, December 2009, Ankara.

Standard & Poor's (2010), "Sovereign Credit Ratings: A Primer", *www.standardandpoors.com/products-services/RatingsDirect-Global-Credit-Portal/en/us*.

Sy, A. (2002), "Emerging Market Bond Spreads and Sovereign Credit Ratings: Reconciling Market Views with Economic Fundamentals", *Emerging Markets Review*, Vol. 3(4), pp. 380-408.

Tandberg, E. and M. Pavesic-Skerlep (2009), "Advanced Public Financial Management Reforms in South East Europe", *IMF Working Papers*, No. WP/09/102, International Monetary Fund, Washington, DC.

TC Maliye Bakanligi (2007), "Butce Sonuclarinin Aciklanmasi ve Mali Saydamlik Calisma Raporu", TC Maliye Bakanligi Butce ve Mali Kontrol Genel Mudurlugu, Ankara.

TC Maliye Bakanligi (2008), *2008 Yili Merkezi Yonetim Butce Gerceklesmeleri ve Beklentiler Raporu*, Ankara.

TC Maliye Bakanligi (2009), *2009 Yili Merkezi Yonetim Butce Gerceklesmeleri ve Beklentiler Raporu*, Ankara.

Teksoz, T. and K. Helvacioglu (2009), "Genel Saglik Sigortasi'nin Mali Surdurulebilirlik Acisindan Analizi", *mimeo,* TEPAV, Ankara.

TEPAV (2009), "2009 Yili Mali Izleme Raporu", TEPAV, Ankara.

Uribe, M. and V.Z. Yue (2006), "Country Spreads and Emerging Countries: Who Drives Whom?", *Journal of International Economics*, Vol. 69 (1), pp. 6-36, June.

White, H. (1980), "A Heteroskedasticity-Consistent Covariance Matrix Estimator and a Direct Test for Heteroskedasticity", *Econometrica*, Vol. 48(4), pp. 817-38.

Yenturk, N. (2009), Cok Yilli Butce ve Orta Vadeli Mali Plan Izleme Kilavuzu, STK Calismalari-Egitim Kitaplari Butce Izleme Dizisi, No. 2, Istanbul Bilgi Universitesi STK Egitim ve Arastirma Birimi, Istanbul.

Yenturk, N. (2009), Sosyal Koruma Harcamalarini Izleme Kilavuzu 2009-2010-2011, STK Calismalari-Egitim Kitaplari Butce Izleme Dizisi, No. 3, Istanbul Bilgi Universitesi STK Egitim ve Arastirma Birimi, Istanbul.

Yilmaz, D. (2009), "Kamu Mali Durusu", 26 Ekim 2009 Tarihinde Butce-Plan Komisyonu'nda yapilan konusma, CBRT, Ankara.

Yilmaz, H.H. (2009), "Son Donem Ekonomik Gelismeler Cercevesinde Kamu Saglik Harcamalarinin Surdurulebilirligi: Muhtemel Riskler Belirliyiciliginde Bir Degerlendirme", TC Saglik Bakanligi Strateji Gelistirme Baskanligi Seminer Sunumu, Ankara.

Yukseler, Z. (2009), "Gayrimenkul Sektorunde Gelismeler ve Olasi Sorunlar", *mimeo*, CBRT, Ankara.

Yukseler, Z. (2010), "Ortulu Mali Kuraldan Acik Mali Kurala Gecis", *mimeo*, CBRT, Ankara.

Zararsiz, E. (2010), "Social Security Institution Head Zararsz: We Have Exceptional and Advanced Practices", Zaman Online, *www.securities.com/doc.html*.

ANNEX 2.A1

Estimated models for EMBI spreads and credit ratings

Empirical determinants of emerging market countries' bond spreads and credit ratings have been extensively tested in the economic literature. Studies vary with respect to the estimation techniques, country coverage and the use of explanatory variables. The estimations presented in this Annex draw on the most common approaches applied in the literature, with an aim to assess the degree to which Turkey's bond spreads and credit ratings are explained by standard determinants and to what extent and in which direction they differed from their predicted level in the 2000s.

The following panel estimations were run for credit ratings and bond spreads:

$$SPRating_{it} = \alpha + c_i + \beta_1 GDPcap_{it} + \beta_2 Inf_{it} + \beta_3 Pubdebt_{it} + \beta_4 Inst_{it} + \beta_5 EUdummy_{it} + u_{it}$$

$$EMBIG_{it} = \delta + \mu_i + \gamma_1 Global_t + \gamma_2 Growth_{it} + \gamma_3 DebtX_{it} + \gamma_4 Pubdebt_{it} + \gamma_5 Polrisk_{it} + \gamma_6 EUdummy_{it} + v_{it}$$

where the dependent and explanatory variables are defined in Table 2.A1.1, c_i and μ_i are country-specific effects and u_{it} and v_{it} are error terms, i denotes the cross-sectional unit (countries), t indicates the time period. Country-specific effects account for the unobservable and time-invariant characteristics of the countries in the sample. The country coverage differs between the spread and credit rating estimations: the former includes nine countries,[1] while the latter 18 countries.[2] Both models are estimated over the 2000-08 period. The panels were estimated with OLS using White (1980) heteroskedasticity correction for calculating standard errors. Similar estimations were also undertaken for specifications without country-specific effects, which account for country-variability not explained by the explanatory variables.

There are two assumptions that can be made about the country-specific effect: the random effects assumption and the fixed effects assumption. To use random effects estimation, country-specific effects should be uncorrelated with the other explanatory variables, otherwise the random effects estimation gives inconsistent estimates and fixed effects estimation is preferable. The fixed effects approach was selected for these estimations, on the basis of Hausman specification tests.

Notes

1. Brazil, Bulgaria, Chile, Hungary, Malaysia, Mexico, Poland, South Africa and Turkey.
2. Argentina, Brazil, Bulgaria, Chile, the Czech Republic, Greece, Hungary, India, Malaysia, Mexico, Poland, Portugal, Romania, the Slovak Republic, South Africa, South Korea, Spain and Turkey.

Table 2.A1.1. **Definitions of models' variables**

Mnemonics	Definition	Data Source
SPRating	Standard & Poor's long-term country sovereign external debt rating. On the Standard & Poor's rating scale, the highest rating is AAA and the lowest is D. A lower rating indicates a higher probability of default. Letter-grades are transformed into numerical scores using a linear scale. The AAA rating has the value 1, AAA– has the value 2 and so on.	Bloomberg
EMBIG	J.P. Morgan's Emerging Markets Bond Index Global (EMBI Global) country spreads. EMBI Global tracks total returns for US-dollar denominated debt instruments issued by emerging markets sovereign and quasi-sovereign entities (Brady Bonds, Loans, Eurobonds, etc.).	
GDPcap	GDP per capita in US dollars, according to market exchange rates.	Statistical offices, central banks and the OECD
Growth	Annual growth in real GDP.	
DebtX	External debt to exports ratio.	
Pubdebt	Public debt to GDP ratio.	
Inf	Annual change in consumer prices.	
Polrisk	The Economist Intelligence Unit's (EIU) Political Risk Indexes measuring perceived political stability. The index covers the measures of government stability, internal violence, perceived corruption, military influence in politics, ethnic tensions, democratic accountability and the quality of the bureaucracy. The index ranges between 0 and 100, with 0 indicating the lowest and 100 the highest political risk.	Economic Intelligence Unit
Inst	The EIU institutional effectiveness rating. It ranges between 1 (the lowest) and 10 (the highest).	
Global	An indicator of global co-movement in EMBI's spreads estimated by principal component analysis.	OECD calculations
EUdummy	EU dummy which takes the value 1 for countries after their accession to the European Union and 0 otherwise.	

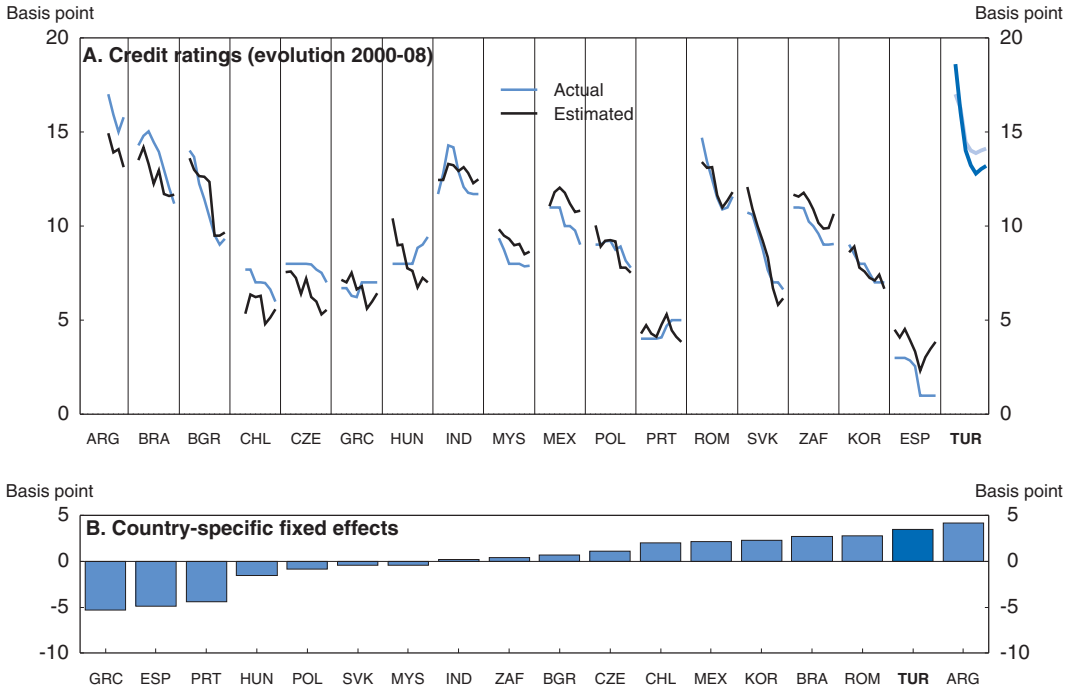
Table 2.A1.2. **Estimation results for EMBI spreads**

	Without country fixed effects			With country fixed effects		
	Coefficient	S.E.	t-stat.	Coefficient	S.E.	t-stat.
Global	0.31	0.13	2.47	0.59	0.08	7.47
Growth	–13.23	5.67	–2.34	–7.82	4.28	–1.83
DebtX	1.76	0.21	8.34	1.40	0.33	4.27
Pubdebt	2.41	0.91	2.64	6.81	0.87	7.86
Polrisk	6.68	1.87	3.58	0.80	2.49	0.32
EUdummy	–112.63	48.24	–2.33	60.23	29.26	2.06
Constant	–287.04	73.33	–3.91	–313.56	104.08	–3.01
Number of observations	97			97		
Adjusted R–squared	0.76			0.84		
F-test (country-specific effects)	F(8,66) = 7.29 (p–value = 0.00)					
Hausman specification test	χ^2_6 = 12.9 (p–value = 0.04)					

Table 2.A1.3. **Estimation results for Standard & Poor's credit rating**

	Without country fixed effects			With country fixed effects		
	Coefficient	S.E.	t-stat.	Coefficient	S.E.	t-stat.
GDPcap	–0.0001	0.00	–4.11	–0.0001	0.00	–6.05
Inf	0.11	0.03	4.31	0.04	0.01	3.76
Pubdebt	0.01	0.00	2.02	0.07	0.00	17.03
Inst	–1.10	0.15	–7.15	–0.61	0.22	–2.80
Polrisk	0.15	0.01	11.28	0.05	0.01	5.21
EUdummy	–1.09	0.25	–4.38	0.60	0.27	2.17
Constant	10.93	1.17	9.35	8.63	1.29	6.68
Number of observations	140			140		
Adjusted R–squared	0.90			0.98		
F-test (country-specific effects)	$F(17,116) = 27.2$ (p–value = 0.00)					
Hausman specification test	$\chi^2_6 = 60.9$ (p–value = 0.00)					

Figure 2.A1.1. **Actual and estimated credit ratings**[1]

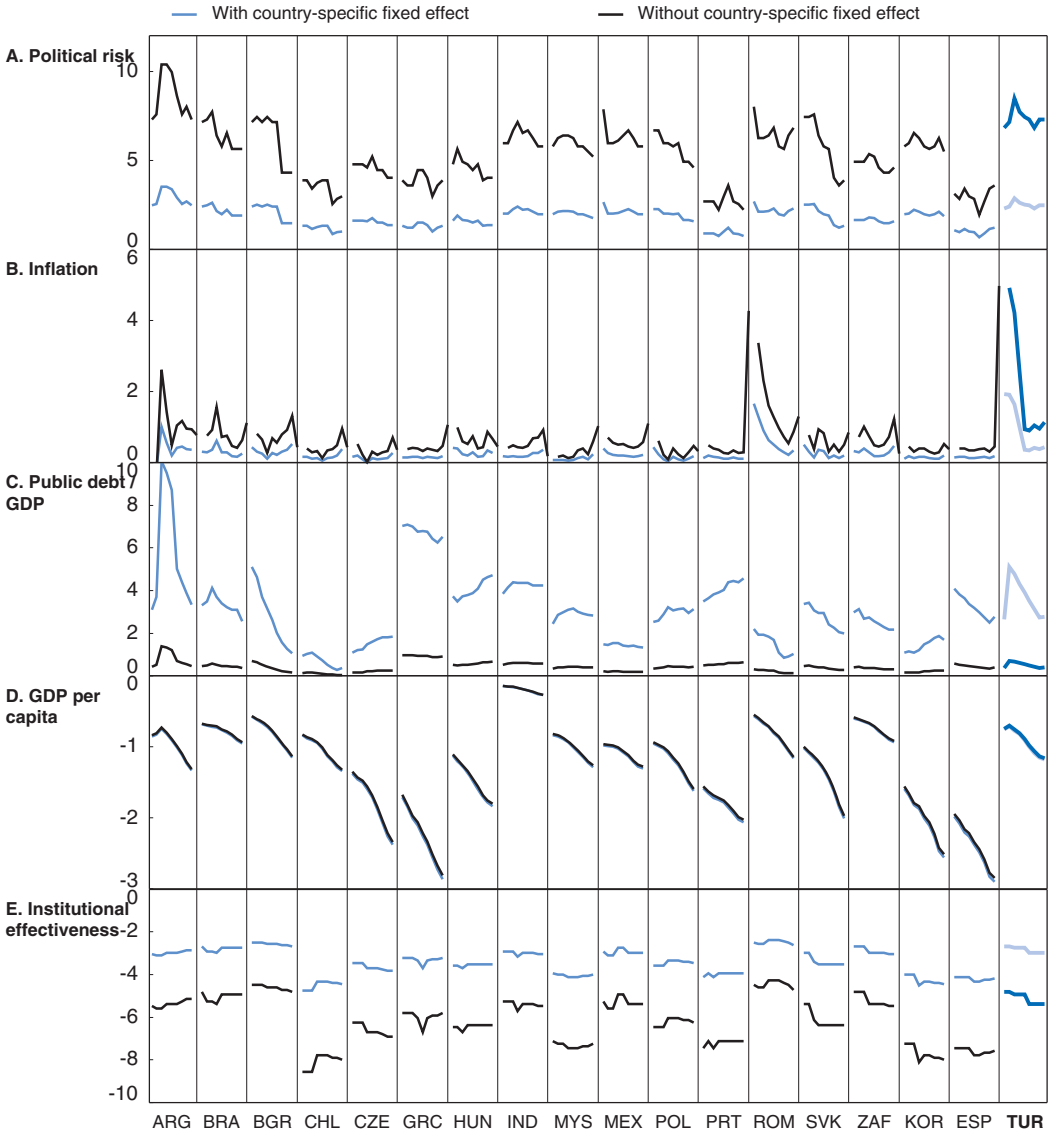


1. Standard & Poor's credit ratings converted to numerical values. A numerical decline indicates an improvement in rating.

Source: Datastream, Standard & Poor's and CBRT.

StatLink http://dx.doi.org/10.1787/888932322119

Figure 2.A1.2. **Estimated contributions to credit ratings**



Source: Datastream, Standard & Poor's and CBRT.

StatLink http://dx.doi.org/10.1787/888932322138

ANNEX 2.A2

Lessons from Turkey's past experience with multi-year fiscal planning

Turkey's experience with implementing a multi-year fiscal framework, as mandated by the Public Financial Management and Control Law, provides lessons for the future implementation of the fiscal rule. Figure 2.A2.1 compares the targets set in multi-yearly fiscal frameworks and annual budgets, with actual outcomes. The comparison highlights four main facts:*

- Turkey's macroeconomy is more volatile than in other OECD countries – independently from the impact of the last crisis. GDP growth was difficult to project all through the 2000s. Market forecasters had as much difficulty in projecting growth as the government authorities. In such circumstances, fiscal revenues are more difficult to plan and the operation of a growth-based balance rule may be more demanding. Revenue deviations from targets, especially if they go beyond the automatic stabilisation provided by the fiscal rule (which implicitly assumes a constant share of revenues in GDP) may entail additional adjustments in yearly spending objectives. Reconciling such fiscal policy responsiveness with the planned stability of the fiscal framework will be a challenge.
- Certain spending and revenue items show specific cyclical patterns in Turkey. The authorities may wish to re-evaluate these patterns when implementing the rule. They can accommodate them, or try to reduce their influence. This refers in particular to:
  - Personnel expenditures, which face pro-cyclical spending pressures.
  - Infrastructure investment and repairs, which systematically carry the burden of spending cuts.
  - Local government spending, which realises at above target levels in upturns and below target levels in downturns (both in real terms and as a share of GDP).
  - Corporate tax yields, which are sensitive to banks' profits, in turn depend on interest rate developments. Banks pay roughly one third of the corporate income taxes.
  - Value-added and other special consumption tax yields are very sensitive to energy prices. The effect arises from two channels: *i)* value-added and consumption tax rates

* Not all information used for these comparisons are displayed in Figure 2.A3.1. More specific data on spending and revenue targets and realisations were utilised. In addition, by construction, the multi-yearly targets included in Figure 2.A3.1 concern only the year following the issuance of the framework (for instance, targets for 2008 of a multi-yearly framework issued in 2007 are reported in the figure, but not the targets for 2009 and 2010).

on energy are very high; and *ii)* when administered energy prices are kept below-cost, energy enterprises withhold the taxes that they collect to off-set their financial losses.

- Taxes for products with low demand price elasticities (like tobacco, alcohol and energy), are systematically increased in downturns.
- Tax administration plays a revenue-increasing role through *ad hoc* amicable settlements.
- Factor incomes play a similar discretionary role through administrative increases in public utility prices.

- Long-term spending pressures are in force in general government balances, independently from cyclical variations. This is notably the case in pension and health spending. Long-term projections are needed in these areas to prepare adjustments in other spending or revenue items.
- Revenues are also difficult to project in terms of elasticity to GDP growth. Frequent rate variations in taxes with the highest yields make this calculation difficult (Table 2.A2.1). Revenue planning in Turkey can only be stabilised with transition to a more stable tax structure.

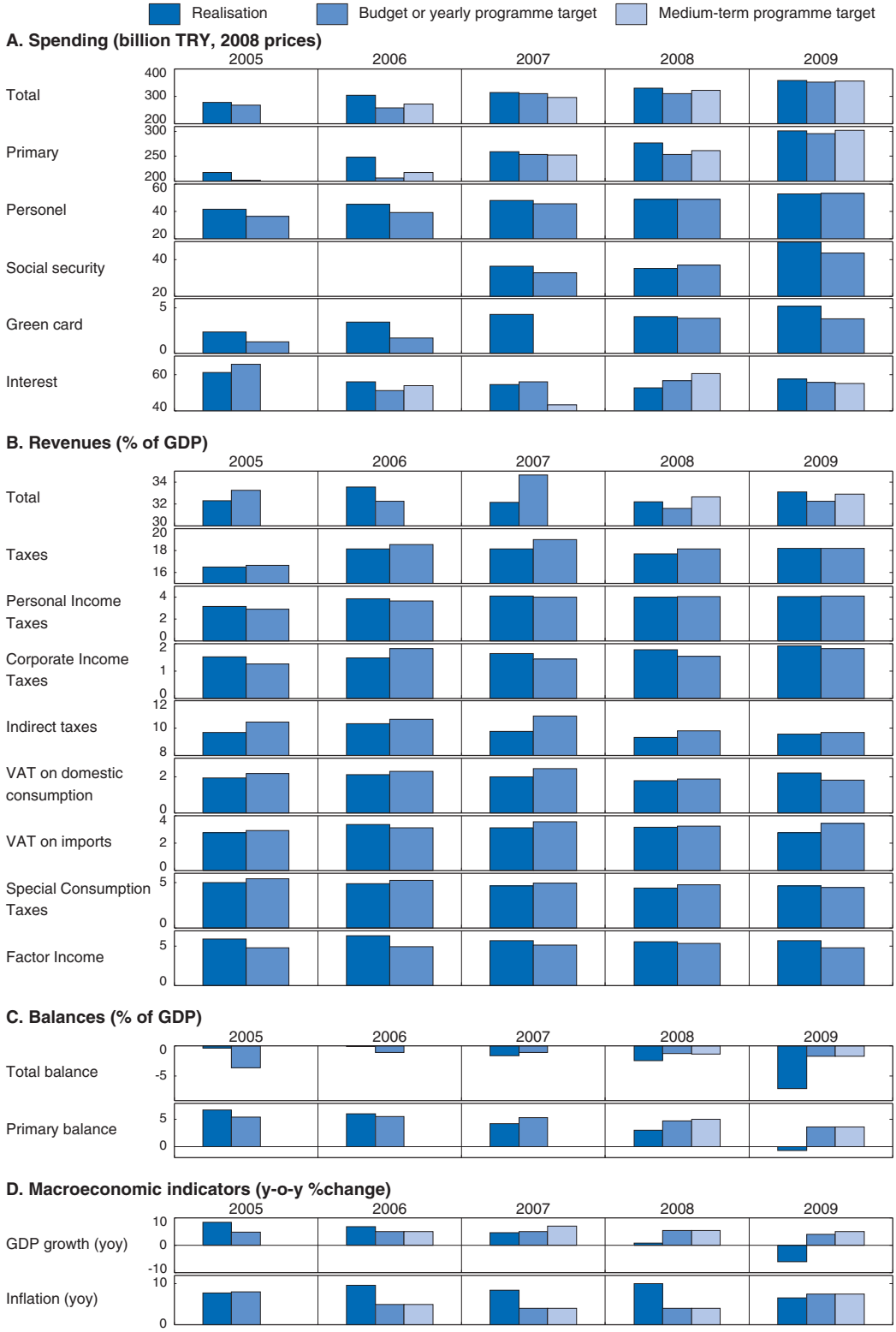
Table 2.A2.1. **Variations in tax rates**

	Cigarettes (%)	Beer (TRY per litre)	95-octane unleaded gasoline (TRY per litre)	LPG (TRY per kg)	Motor vehicles[1] (%)
2002	Aug.: 49.5		Aug.: 0.793	Aug.: 0.370	Aug.: 27.0
2003	Jan.: 55.3	Oct.: 0.750			Oct.: 30.0
		Aug.: 0.796			
2005	Aug.: 58.0	Jan.: 0.159		Jan.: 0.615	
		Feb.: 0.238			
		Feb.: 0.159[2]			
		Aug.: 0.238			
2006				Mar.: 0.743	
				Oct.: 0.794	
2007			Nov.: 1.477	Nov.: 0.930	
2008			July: 1.492		
2009	Dec.: 63.0	Apr.: 0.260	July: 1.692	July: 1.030	Mar.: 18.0
		Dec.: 0.350			June: 27.0
					Oct.: 37.0

1. With engines of less than 1 600 cc.
2. In February 2005, the tax rate was modified twice.

Source: Ministry of Finance.

Figure 2.A2.1. **Objectives and outcomes: recent experience**



Note: General government data presented in these figures are not yet published according to international accounting standards.

Source: SPO, Ministry of Finance and Turkstat.

StatLink http://dx.doi.org/10.1787/888932322157

ANNEX 2.A3

Some challenges of comprehensive general government accounting according to recent experience

OECD countries' and Turkey's own experience suggests that standard general government accounting may face a number of technical challenges. The authorities may wish to pay special attention to these challenges when they start to publish consolidated general government accounts in 2010:

Fully accrual-based recording of yearly spending: The Public Financial Management and Control Law (PFMCL) improved the accuracy of spending information on an accrual basis but certain omission risks remained: *i*) social security and local government spending are difficult to keep in line with *ex ante* appropriations and over-spending occurs, without being fully recorded in the respective years' expenses; *ii*) some accrued central government spending is underreported, notably in the area of construction. Certain construction projects are initiated without sufficient budget appropriation: when this happens, the corresponding expenditure is recorded on the following year's accounts.

These underreporting risks were reduced at the central government level after the adoption of the PFMCL, and are now estimated to be probably small, in the range of decimal points of GDP. However, risks persisting at the local government level have not been researched and cannot be estimated.

Underreporting risks also exist in the social security system. Health spending by the social security institution (SGK) is still not reported on accrual terms but on a cash basis. The insured have been given access to private health services, making the accrual-based recording of spending more difficult. In 2009, unrecorded yearly health arrears were estimated at TRY 2 billion (0.2% of GDP). The ongoing transition to universal health insurance may increase delays in the recording of spending.

Precise reporting of revenues: Exceptional revenue items play a particularly important role in Turkey, especially in certain years. Privatisation proceeds, real estate sales, sales of telecommunication licenses and transfers to central government budget from the Unemployment Insurance Fund (which has accumulated reserves amounting to 3% of 2009 GDP between 2004 and 2009) have been registered as "above-the-line" revenues to date, except in the "IMF programme" definitions and in pre-accession fiscal reporting to Eurostat (*e.g.* ESA Tables 2 and 9, and EDP Notification Tables). Also, revenues generated through voluntary settlements in tax amnesties are registered as ordinary income. In 2006, revenues arising from the clearance of overdue social security contributions generated 0.7% of GDP and have been recorded as current income. In 2009, corporate taxpayers were

able to legalise past unreported incomes, taxed at rates determined in the law. The ensuing revenues were recorded as ordinary income. Finally, transfers to the central budget from the *Deposit Insurance Fund* (which is in charge of resolving the assets of the banks liquidated in the 2001 crisis) are routinely recorded as current revenues. These items were however adjusted for in the recent ESA and EDP tables, in line with the international standards.

Full accounting for quasi-fiscal activities: State-owned banks, enterprises and other public entities may undertake policy-driven spending but, as these activities take place in the commercial sector, they are not reported as government spending. Such quasi-fiscal activities were a major concern until the 2001 crisis but have come under better scrutiny after the adoption of the PFMCL. All financial costs for policy responsibilities ("duty losses" in the Turkish parlance) should in principle be financed from the central budget and recorded as such. The Treasury publishes a complementary report on the financial balances of all enterprises in which the government has more than 50% of the stakes, which is an important step in documenting the financial costs of their policy responsibilities.[1] However, these channels of transparency face also enforcement challenges: *i)* certain state-owned enterprises (SoEs) are asked to fulfil policy responsibilities, notably in energy distribution, agricultural purchases and housing development without this being fully reported in the budget; *ii)* the number and size of municipally-owned enterprises (MoEs) have grown in the 2000s, but little information has been available on their financial position until their inclusion in Treasury's report on SoEs starting from 2010; and *iii)* SoEs and MoEs appear to have utilised additional off-budget borrowing in the recent period:

- The Agricultural Purchasing Agency (TMO), has resumed "support purchases" since 2007. When the national marketing co-operative of the hazelnuts industry hit a financial impasse in 2006, TMO resumed support purchases in this large sector of Turkish agriculture (Turkey is the world's largest hazelnuts producer). It has already accumulated stocks of nearly 500 000 tonnes. Much of this stock represents excess production relative to world demand. Its purchase value (*i.e.* the book value) of about TRY 2.5 billion (0.25% of GDP), risks remaining notional. TMO faces a similar financial burden with cereal purchases. It was directed to purchase 5 million tonnes of cereals coming from excessive production in 2009 for TRY 2.5 billion (0.25% of GDP). These purchases were partly funded by "duty losses" paid from the budget and partly via off-budget "onlent" borrowing provided by the Treasury. Direct borrowing by TMO has not been registered as general government debt, according to standard practice, because TMO is formally a commercial entity. It is only included in the total public sector debt (which includes commercial borrowing by all state-owned enterprises). The additional potential liability it represents for the general government sector (because TMO is more financially dependent on general government than other more self-sustained state-owned enterprises) is presently not separately identified.
- Several large-size SoEs operate in the energy sector: TEDAŞ's regional affiliates – retail electricity distributors, TETAŞ – a wholesale electricity distributor, TEIAŞ – an electricity transmission company, EUAŞ – an electricity producer, and BOTAŞ – a natural gas importer, transporter and wholesaler. They carry out policy obligations. TEDAŞ faces large technical losses (*i.e.* power illegally drawn by unauthorised users, of about 15%) in electricity distribution, and a low collection rate of its bills (of around 90%). These losses reflect a *de facto* public support to electricity consumption in disadvantaged regions and sectors (such as low income provinces and agriculture). However, they have not been

funded from the budget and have led to an accumulation of large debt arrears in the energy sector.[2] Other policy duties by energy SOEs included BOTAŞ's long-term "take or pay" contracts with foreign natural gas suppliers, which are geared to secure Turkey's energy security and entail large costs on certain years.[3]

- Following an important decision by the government in July 2008, electricity prices are in principle "cost-recovering" in the entire energy chain. TEDAŞ, which recorded net financial loss of TRY 382 million, TETAŞ, which recorded net financial loss of TRY 983 million and BOTAŞ, which recorded net financial surplus of TRY 293 million in 2008, are expected to become financially viable after this decision. However, the decline in natural gas demand and the increase of gas supply through low priced spot LNG imports have prevented a rise in natural gas prices.
- The Public Housing Administration (TOKI) also raises a transparency issue. TOKI is a public establishment with a unique legal status. It operates as a SoE producing and selling houses on long-term leases. It is provided free access to public land,[4] on which it builds housing via joint-ventures with private contractors. Its annual production has reached about 75 000 apartment flats. This includes subsidised "low-cost flats" (83% of TOKI's production and 53% of costs) and also higher quality "market-priced flats" (17% of production and 47% of costs). Most TOKI houses are available through long-term leases of about 20 years, financed by TOKI. The total balance sheet of the agency reaches TRY 20 billion (2% of GDP) but it is not clear if the total market value of its assets and all its liabilities are included. TOKI was initially under the scope of the PFMCL but was excluded by a special law in 2005. It is also exempted from the rules of the National Procurement Act. Its special status offered TOKI a large franchise and space of action, and permitted it to develop its activities very rapidly, but at the cost of financial and fiscal transparency.
- The last strand of quasi-fiscal activities is carried out by MoEs. They have grown throughout the country in local utilities, transportation, natural gas distribution and construction. The nature of their businesses (commercial *versus* quasi-fiscal) has not yet been analysed systematically. There are reports that their total debt stock has increased in the 2000s, despite recurrent arrangements with the Treasury which cleaned and took over periodically part of their debt (Ekinci, 2009). An important *communiqué* published by the Treasury in 2009, according to a Council of Ministers decree, gives the Treasury the authority to collect and publish annually the key financial and non-financial data of these enterprises. This initiative is expected to help disclose relevant information in the report on SoEs, starting from 2010. The *communiqué* covers all SoEs, including MoEs and enterprises in which the government has more than 50% of the stakes such as TOKI and state owned banks.

Full reporting of activities by extra-budgetary and revolving funds: Extra-budgetary funds (XBFs) have been reduced in size and their activities are now more transparent. In contrast, revolving funds in the public sector, which play a particular role in the health sector, are only monitored in cash terms.

- Since December 2000, 61 budgetary funds benefitting from special management arrangements and eight XBFs have been closed. Five XBFs remain active: Deposit Insurance Fund, Privatisation Fund, Defence Industry Fund, Social Solidarity Fund and Promotion Fund. These entities in principle do not raise fiscal risks, because they are not

authorised to borrow. In 2007, total spending by all five funds amounted to TRY 17 billion (1.9% of GDP).

- Most of the revolving funds operate in public and university hospitals, to offer "for fee" services. The amendment to PFMCL stipulated that all these funds should be closed by the end of 2007. However, this could not be realised because these structures help adjust service supply to demand and permit a more intensive utilisation of public assets. More than 40% of total public health spending is devoted to health service purchases from these funds. Revolving funds raise fiscal risks because they may engage spending without *ex ante* budget appropriations. The social security institution has also questioned the integrity of their pricing practices.[5] Total spending by revolving funds accounted for 2.1% of GDP in 2007, 2.3% in 2008 and 2.4% in 2009.

Comprehensive reporting of public liabilities. Documenting existing debt and projecting its future level is an essential component of fiscal transparency. The adoption of the Public Debt Management Law (PDML) and the publication of debt reports was a major step forward. However, additional improvements in debt reporting are needed. This regards primarily information on incompletely chartered public liabilities: *i)* the debt position of all general government layers including the non-guaranteed and domestic debt of local governments and their municipally-owned corporations (MoEs); *ii)* public liabilities arising from the outstanding stock of public guarantees other than current Treasury guarantees, including those granted to public-private partnerships in the past (PPPs);[6] and *iii)* the long-term financial balances of the social security system, which are currently not measured as an outstanding public liability.

Notes

1. The Treasury's report on SoEs provides standard financial indicators for 57 large SoEs and five MoEs. Two groups are distinguished. The first refers to in service SoEs which are not on the privatisation list and operate normally. They generated revenues of about 7.1% of GDP in 2009, and a positive net financial return of 0.54% of GDP. The second group refers to SoEs on the privatisation list: they achieved revenues of 2.6% of GDP in 2009, and a net financial balance of –0.09% of GDP. The net balance of the entire SoE sector was 0.06% of GDP in 2008, 0.45% of GDP in 2009, and is projected to be 0.23% of GDP in 2010.
2. TEDAŞ' impossibility to fund its technical losses and to collect fees forced it to build arrears *vis-à-vis* TETAŞ and EUAŞ, and through it to BOTAŞ. The total volume of energy arrears through these SoEs was estimated to reach almost TRY 30 billion at the end of 2009 (3.2% of GDP).
3. Some contracts led to financial losses in 2009 as a result of reduced energy demand in the economy. A similar outcome may occur in 2010. "Take or pay" compensation to Iran alone might reportedly attain $ 700 million in 2009 and $ 520 million in 2010. However, these losses could also be gradually reduced through time by consuming the gas surplus subject to the take or pay clause.
4. Government ownership of land is very large in Turkey.
5. The social security institution argues that revolving funds' pricing practices are not disciplined and are at times abusive. Revolving funds retort that delays in the collection of receivables from the social security institution and the rest of the public sector increase funding costs, and impose off-setting mark-ups.
6. PFMCL added a "risk account" to the budget as provision for risks from newly granted guarantees, but the total exposure arising from past commitments is not known. In the framework of pre-accession fiscal notifications to the EU, Eurostat has observed that information submitted on public guarantees (the so-called Table 3 in fiscal notifications) is not fully coherent for Turkey. The Turkish authorities have confirmed that they are working on reconciliation between different data sources.

ANNEX 2.A4

Experience of OECD countries with fiscal policy councils

The term fiscal policy council is generally used to describe a specialised institution funded by government which provides public advice on fiscal issues.[1] Such councils perform diversified tasks which vary across countries. They involve projections of national fiscal balances and public debt, microeconomic analyses of the budgetary impacts of specific projects. They therefore play the role of a fiscal watchdog. By disseminating fiscal analyses, fiscal councils can prevent governments inadvertently or deliberately concealing the extent of future imbalances implied by current policies or prevent adopting overoptimistic assumptions on the fiscal outlook. Thus, they provide objective and independent opinions on fiscal issues, supporting public discussions and decisions of the legislative bodies.

Fiscal councils are usually "independent", but the degree and type of independence from the executive authorities, and the Ministry of Finance in particular, vary across countries. Sixteen countries among 38 OECD and non-OECD members reviewed by the OECD Secretariat in 2007 indicated that they had either a specialised unit or some other kind of body to offer fiscal council services (OECD, 2007). However, a smaller number of national councils have built to date a minimum degree of influence at the domestic level, and ensuing international visibility. A first conference bringing representatives from most of these councils together was held in Budapest in March 2010.[2] The most internationally recognised fiscal watchdogs are:

- *Canada:* The Parliamentary Budget Office provides independent analysis to Parliament on the state of the nation's finances, the government's estimates and trends in the Canadian economy, and upon request estimates of the financial cost of any specific proposals.
- *Hungary:* The Fiscal Council of the Republic of Hungary was set up in 2009 as "an independent state institution that endeavours to ensure the responsible management of public resources"; It prepares macroeconomic forecasts which represent the baseline for budgetary decisions. It also provides comment and advices on fiscal planning more generally, within the context of existing fiscal rules.
- *Netherlands:* The Netherlands Bureau for Economic Policy Analysis (CPB) was founded in 1945. It is an independent research institute and has its own independent external advisory body. It provides economic and fiscal forecast as inputs into the budgetary planning process. It evaluates (at the political parties' request) the election programme of government and opposition parties.

- *Sweden:* The Swedish Fiscal Policy Council was established in 2007. The Council consists of eight members and is assisted by a secretariat with four professional economists. The mission of the Council is to provide an independent evaluation of the Swedish government's fiscal policy.
- *United States:* The Congressional Budget Office (CBO) has a mandate to provide the United States Congress with "objective, nonpartisan, and timely analyses to aid in economic and budgetary decisions on the wide array of programs covered by the federal budget and information and estimates required for the congressional budget process". Established in 1974, it provides non-partisan assessments of policy proposals that have a significant influence on decision making.
- *United Kingdom:* It should also be noted that the new United Kingdom government has set up an Office of Budget Responsibility, which will be the UK's Fiscal Council. The case for such a council in the UK was presented in detail in Kirsanova *et al.* (2007).

Notes

1. See for useful and internationally comparative information on fiscal councils, the "Fiscal Councils Webpage" maintained by Prof. Simon Wren-Lewis at Oxford University: *www.econ.ox.ac.uk/members/simon.wren-lewis/fc/fiscal_councils.htm*.
2. The programme and papers of the Budapest conference can be found at: *http://www.mkkt.hu/conference-on-independent-fiscal-institutions*.

Chapter 3

Regulatory reforms to unlock long-term growth

In the 2000s, Turkey has enjoyed rapid catching-up thanks to improving macroeconomic framework, increasing openness to trade and foreign investment and the great entrepreneurial spirit of Turkish businessmen. This was possible against the adverse business environment, reflecting restrictive product and labour market regulations, since the semi-formal and informal economy had a significant contribution to the expansion of the private sector. Productivity growth was strong, but labour utilisation remained very low, affecting negatively social cohesion and the growth performance. Looking forward, higher employment and productivity growth will not be possible without profound regulatory reforms. They primarily require labour market reforms to lower minimum wages, possibly via regional arrangements, to reduce severance payments and social security contributions and to introduce more flexible forms of job contracts. These reforms have been discussed for a long time, but political obstacles prevented implementing them. Resolving this deadlock calls for advancing an integrated strategy of labour reforms and formalisation via experimenting with new regulation on the voluntary basis to identify the most successful solutions that can be later rolled over to the whole economy. Moreover, Turkey has to ease further anti-competitive product market regulations by reducing barriers to entrepreneurship and foreign direct investment and by reducing government involvement in business. A successful implementation of these reforms would allow Turkey to enjoy golden decades.

Between the 2001 and 2008-09 recessions, Turkey grew rapidly and experienced a dynamic expansion of the private sector. This was made possible by decisive macroeconomic consolidation policy in the 2000s and important complementary institutional reforms (Chapter 1). However, the reform progress was less far reaching at the microeconomic level of labour and product market regulations. Consequently, the still poor business environment holds the development of dynamic enterprises. The formal business sector was faced in particular with strict labour market regulations, high labour costs and relatively costly market entry and competition conditions.

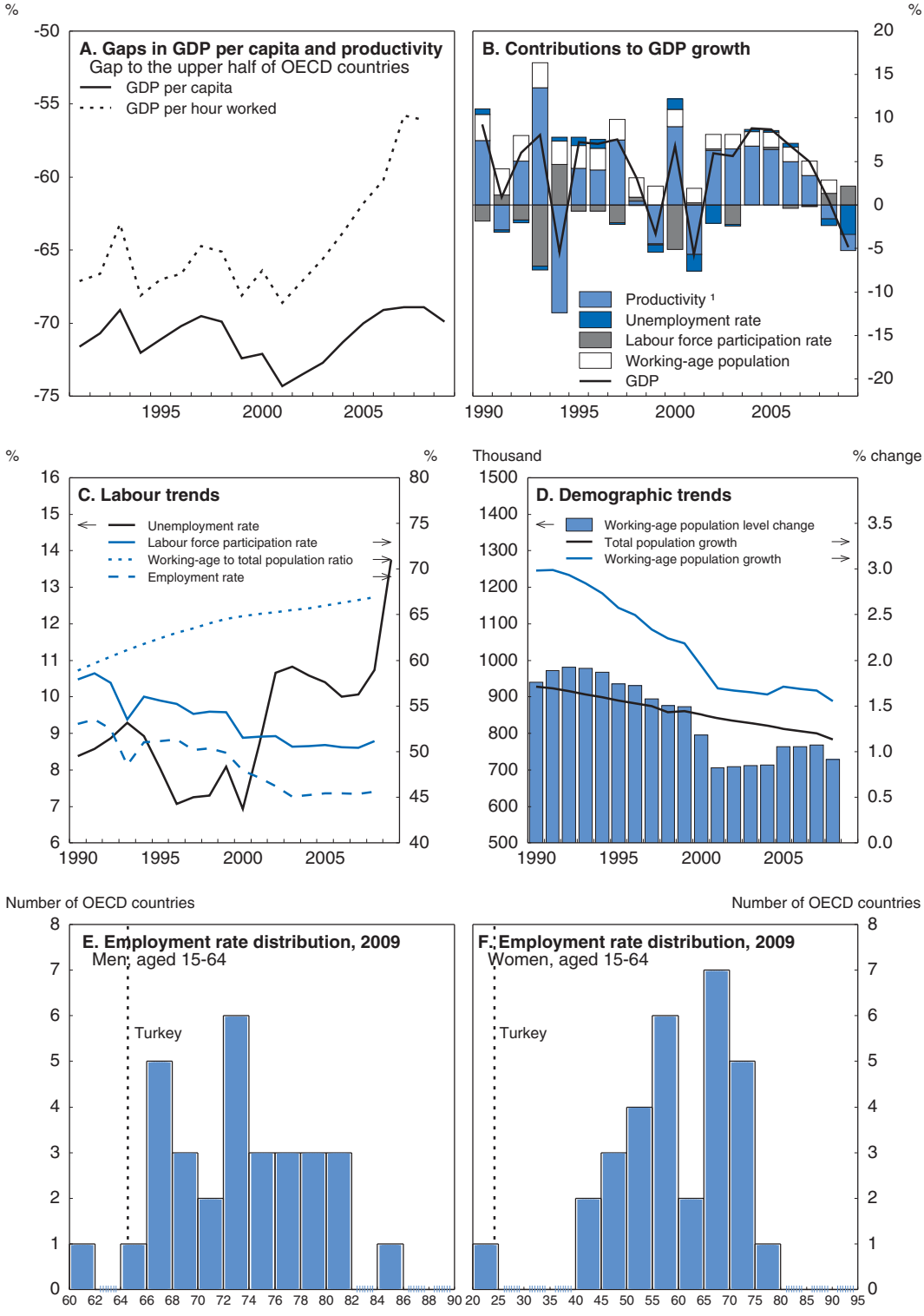
The costly and strict regulations have nourished informality and semi-formality as a way to circumvent them. This permitted large numbers of enterprises to lower operational costs, but also distorted competition, restrained productivity growth and burdened public finances. The structural reforms which are needed to permit the flexible operation of enterprises in compliance with the law are well identified, but political economy factors prevent their implementation. This has been especially the case for labour reforms. The recovery from the deep 2008-09 recession creates a good opportunity to advance the necessary reforms. Successful structural reforms would pave the path for higher GDP growth and employment. The challenges are serious, but the gains from overcoming them are large.

Against this background, this chapter analyses recent growth performance and re-assess the underlying structural deficiencies, focusing first on labour and then on product markets. This is accompanied by a discussion of lessons from past attempts at structural reform, both achievements and limitations, and possible avenues to reactivate them. Finally, the chapter sketches stylised long-term scenarios of economic growth to illustrate the benefits of structural reforms.

Performance has been strong in the 2000s but the income gap remains large

The income gap *vis-à-vis* the upper half of OECD countries has narrowed significantly since 2001 (Figure 3.1), mainly as a result of labour productivity growth, which was among the highest in the OECD. This was underpinned by the expansion of private sector strong investment, FDI inflows and competition. Many new enterprises entered the market, foreign know-how was more widely used, exports were diversified sectorally and geographically, and the industrial structure was upgraded (OECD, 2006a, 2008a). These impressive developments were achieved despite non-supportive labour and product market regulations, but were backed by macroeconomic consolidation and the great entrepreneurial spirit of the Turkish people. However, changes in labour utilisation were limited and provided a small contribution to growth. Following a decline in the 1980s and 1990s, the employment rate stabilised in the 2000s at a low level (slightly above 40%). Following the 2008-09 recession, the unemployment rate also increased. Despite the rapid catching-up in the 2000s, labour productivity and labour utilisation remain low and Turkey still has the lowest GDP per capita in the OECD (Figure 3.2).

Figure 3.1. **Evolution of GDP per capita growth and its components**



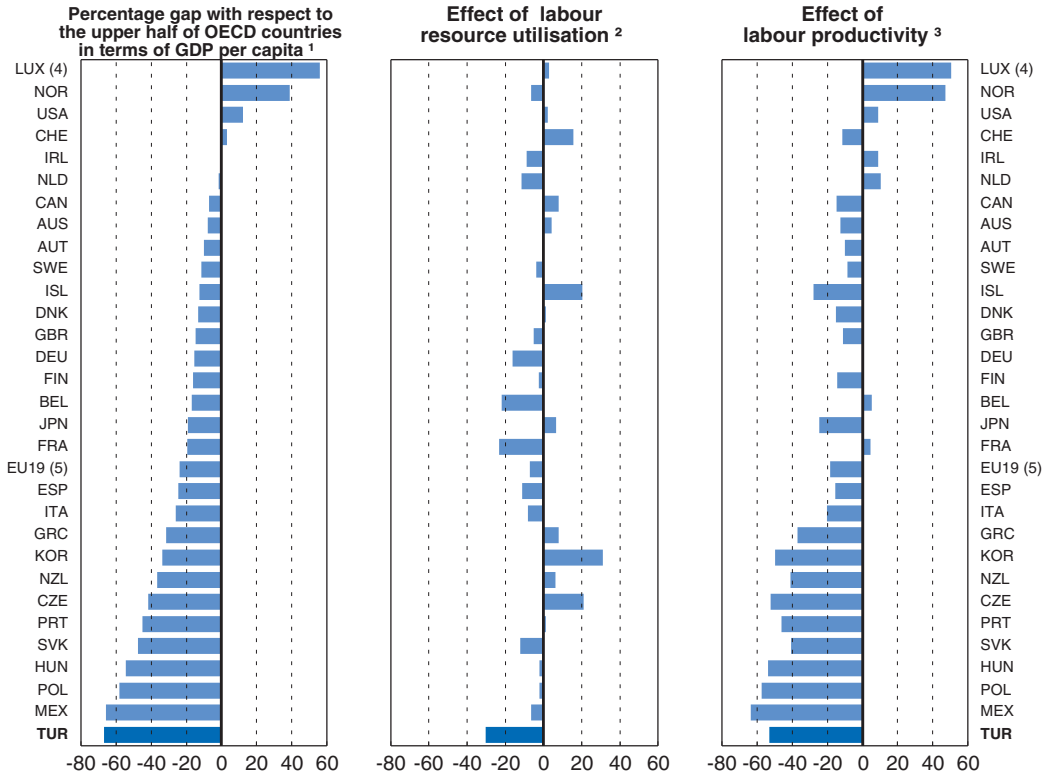
1. Labour productivity is measured as GDP per worker.

Source: OECD (2010), *Economic Policy Reforms 2010: Going for Growth*; *OECD Economic Outlook Database* and *OECD Labour Force Statistics Database*.

StatLink http://dx.doi.org/10.1787/888932322176

Figure 3.2. **The income gap remains large**

2008



1. Relative to the simple average of the highest 15 OECD countries in terms of GDP per capita, based on 2008 purchasing power parities (PPPs). The sum of the percentage gap in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita gap since the decomposition is multiplicative.
2. Labour resource utilisation is measured as total number of hours worked per capita.
3. Labour productivity is measured as GDP per hour worked.
4. In the case of Luxembourg, the resident population is augmented by cross-border workers in order to take into account their contribution to GDP.
5. EU19 is an aggregate covering countries that are members of both the European Union and the OECD. These are the EU15 countries plus the Czech Republic, Hungary, Poland and the Slovak Republic.

Source: OECD, *Economic Policy Reforms 2010: Going for Growth*.

StatLink http://dx.doi.org/10.1787/888932322195

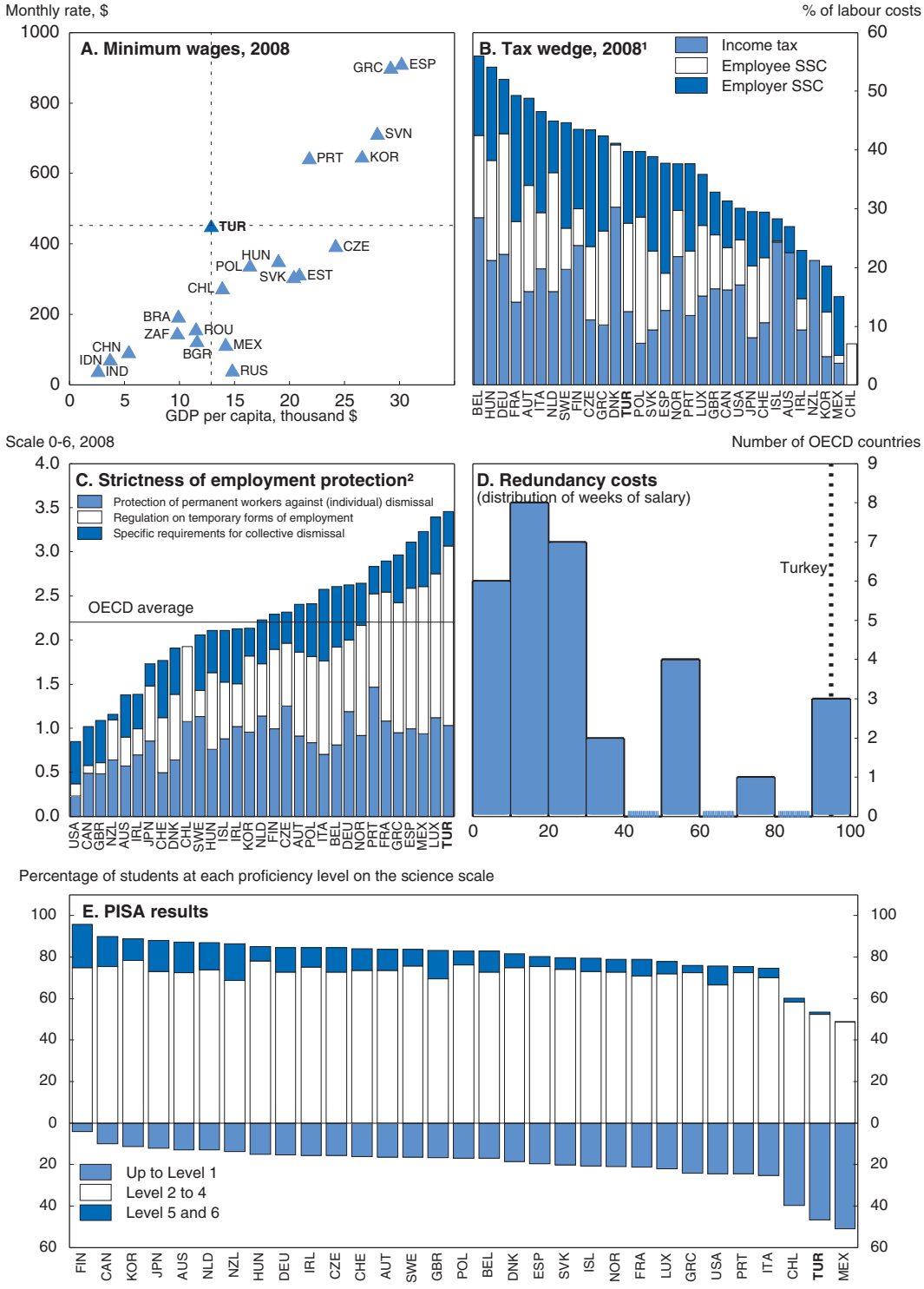
Obstacles to labour utilisation have been the key constraint on economic performance

Labour underutilisation reflects a combination of high labour costs, serious market rigidities, low human capital and deep structural and demographic changes.

Labour costs are high

High labour costs are the main constraint on job creation (Figure 3.3). They primarily reflect high legal minimum wages. Official minimum wages in Turkey are higher than in many countries in emerging Europe, which compete with Turkey and have higher GDP per capita (Figure 3.3). This undermines Turkish competitiveness for labour-intensive products (Saget, 2008). Minimum wages are also high given the average wage in the informal sector (OECD, 2008a). Finally, anecdotal evidence suggests that reservation wages, especially in poorer regions of Turkey, are significantly below the official minimum wage received by workers (OECD, 2008a).

Figure 3.3. **Structural deficiencies in the labour market**



1. Single person at 100% of average earnings, no child.
2. Index scale of 0-6 from least to most restrictive.

Source: ILO, *Minimum Wages database*; IMF, *World Economic Outlook* October 2009; OECD, *Taxing Wages Database*; OECD, *Indicators of Employment Protection*; World Bank Doing Business; and OECD (2007), *PISA 2006: Science Competencies for Tomorrow's World*.

StatLink http://dx.doi.org/10.1787/888932322214

On top of minimum wages, labour costs are boosted by labour tax wedges. Despite recent efforts to decrease them (see below), these remain high by OECD standards, reflecting high social security contributions (Figure 3.3).

Labour regulations are rigid

Job creation is also hindered by strict employment protection, in particular involving high firing costs for permanent workers. Severance payments are one of the highest in the OECD and in the world (Figure 3.3; OECD, 2006a). They entail high costs for companies and may create liquidity problems during cyclical adjustments. Moreover, firms employing more than 30 and 49 employees are subject to additional costly regulations, subjecting them to extra legal liabilities and requiring them to provide health, recreational and social facilities (OECD, 2006a, 2008a). Despite a number of improvements brought about by a new law in 2008 (No. 5763),[1] these conditions prevent many companies from expanding their employment beyond the 30 and 49 employee thresholds.

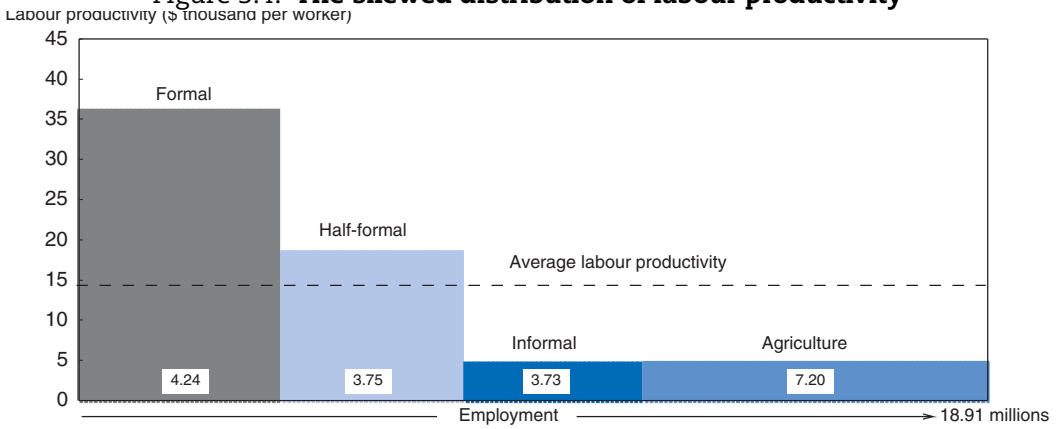
A telling example of how differences in legal and regulatory obligations distort incentives of enterprises to hire is found in the natural experiment provided by a legislative change implemented in 2003. At this date, dismissal costs increased for firms employing more than 30 employees. A careful statistical examination, recently undertaken by the OECD's Directorate for Employment, Labour and Social Affairs, shows that labour demand and job creation by different sizes of enterprises immediately reflected these changes, at the expense of large, higher productivity enterprises (Annex 3.A1).

Turkey also has very strict regulations regarding temporary work. In contrast to many OECD countries, temporary agency work is not legally authorised and fixed-term contracts are permitted only in highly specific circumstances. As a result of this set of constraints, Turkey is classified as the country with the strictest protection among OECD countries (Venn, 2009; Figure 3.3).

However *de facto* employment protection is less restrictive than implied by *de jure* indicators, as the informal and semi-formal sector is large and the share of self-employed is high. Semi-formality concerns business enterprises employing only part of their labour legally and the other part informally, and declaring only part of the wages actually paid to the employees to the tax and social security authorities in order to minimise taxes and social security contributions. Pure informality is mainly encountered in agriculture, whereas semi-formality prevails in other sectors of the economy. There are no precise measures of the actual extent of semi-formality. Informal employment constitutes 44% and self-employment 21% of total employment (around one third of informal workers are self-employed).[2]

The structure of the business sector mirrors such uneven compliance with laws. Strict labour and product regulations hindered the development of formal firms and nurtured a large population of informal and semi-formal firms. As a result, the business sector has a very thick-tail distribution of productivity levels, with modern firms modelled according to top OECD standards co-existing with informal and semi-formal entities with a much lower level of productivity. It was estimated that labour productivity in the informal sector was 80% below, and in the semi-formal sector 40% below, that in the modern, fully formal sector (OECD, 2006a; Figure 3.4). For informal and semi-formal firms, not only funding, investment capacity and capital intensity are reduced, but also access to professional labour markets and foreign direct investment is impaired (OECD, 2008a; World Bank, 2009).

Figure 3.4. **The skewed distribution of labour productivity**[1]



1. OECD estimates as of 2006.

Source: TURKSTAT, SPO and OECD (2006a), *OECD Economic Surveys: Turkey*.

StatLink http://dx.doi.org/10.1787/888932322233

These firms' preference to keep their activities small in order to minimise interaction with enforcement agencies also hinders economies of scale.

Expanding the formal sector requires a fundamental easing of the regulations in order to permit the spontaneous growth of enterprises and jobs in compliance with the formal regulatory framework. Without such reforms, the *de facto* rigidity will become more intense if the ongoing fight against informality turns out more effective and the share of informal and/or self-employed workers declines. This will occur in particular as migration from rural areas continues and the share of the self-employed and informal employees, who are prevalent in agriculture, declines.

Structural, human capital and demographic challenges are serious

As in many emerging markets, Turkey in the past decades has been undergoing industrialisation and the downsizing of the agriculture sector. This has involved migration of the rural population to the cities. The share of agricultural employment in total employment declined from around 50% at the end of the 1980s to around 23.7% in 2008, but it is still among the highest among the OECD countries. In 2009, it actually increased (by around 1 percentage point), but this reflects the effects of the severe recession rather than a structural reversal. Unpaid family workers constitute a high share in total employment in agriculture (around 45%) and small, subsistence farms are still prevalent (OECD, 2006a). Unpaid family workers in agriculture are principally women (around 78%). The large employment outflows from agriculture raise the supply of low-skilled workers who have difficulties in finding jobs in other sectors of the economy. This process, combined with complex socio-economic factors (see below), makes many women withdraw from the labour force. The apparent trend decline in Turkey's effective employment rate (Figure 3.1) reflects partly this withdrawal of women from the labour force associated with urban migration.

Structural shifts in employment are complicated by the fact that working-age population has on average low education. Professional and sectoral adaptability is therefore limited. According to the Turkish Labour Force Survey data, over 60% of the working-age population has less than high school education, though this share has

declined over recent years. Consequently, the average educational attainment of the working age population is less than seven school years. Moreover, gross schooling rates[3] remain below the OECD average and Turkish students, on average, do not perform well in international comparison[4] (Figure 3.3). At the same time, a small but well-trained group of workers perform well in the modern part of the business sector and are highly effective in absorbing international best practices.

The inflow of workers from rural areas creates challenges for absorbing them in the non-agricultural sectors, accentuating the challenge of the skill mismatch. The industrialisation of the economy requires higher skills and better education. In this regard, recent structural changes in the manufacturing sector have raised additional challenges. Labour-intensive manufacturing has been shrinking and new factories become more capital intensive, requiring less low-skilled labour. This change was evident, especially in the decline of the textile and clothing industries, where under the pressure of international competition Turkey has lost market share and closed down factories. In contrast, capital intensive and internationally competitive industries, such as steel, chemicals, and machinery and equipment (especially automotive), boomed in the 2000s (OECD, 2008a).

The employment of women is impaired by complex economic and social factors (SPO and World Bank, 2009). In 2009, the female labour force participation at around 26% was by far the lowest in the OECD and the gap in employment rates between men and women of more than 40 percentage points is the highest in the OECD (Figure 3.1).[5] In 2009, over 12 million women declared being a housewife as a reason for not participating in the labour market (45% of the total inactive population). On the economic side, female labour supply is discouraged by low salaries, especially when compared with the cost of child and elderly care. Poor working conditions are another deterrent. Women, in particular the less educated, are more often offered jobs in the informal sector which require long working hours. Social barriers involve a gender-based division of labour and patriarchal mindset. Women spend six times more time on daily household chores and child/elderly care than men. This is also affected by the insufficient availability of child and elderly care facilities (Toksöz, 2007). Family burdens are especially high for less educated women, strengthening the positive relation between education status and labour force participation. Female school enrolment continues to be lower than for men and the illiteracy rate for women, at 18%, is more than four times higher than for men.[6]

Growth in the Turkish working-age population makes sufficient job creation even more challenging. Though the increases have been moderating, they are still high by OECD standards (Figure 3.1). Between 2004 and 2009, the working-age population has increased each year by around 800 thousand people. New entrants to the labour market have longer education enrolment records, but they nonetheless face significant problems with finding a first job. The youth unemployment rate is almost twice as high as the overall unemployment rate and it is among the highest in the OECD.

Labour market reforms are indispensible

Lessons from past reform efforts

The need to implement reforms that would alleviate key structural constraints to Turkey's long-term growth became increasingly evident in the second half of 2000s and such reforms were added to the political agenda. Progress has, however, been uneven and slower than with macroeconomic and banking sector reforms (Chapter 1). To gauge the

state of reforms in different areas, follow-ups on the past OECD recommendations in each individual area are analysed (Annex 3.A2). They are divided between the follow-ups given to priorities for stronger growth identified in OECD's cross-country *Going for Growth* project (Part A of Table 3.A2.1) and the recommendations issued in recent *OECD Economic Surveys of Turkey* (Part B). Four observations are worth stressing:

- First, structural and institutional reforms helping with macroeconomic consolidation continue to make progress, even if they faced a number of technical difficulties and delays (as in the area of fiscal transparency at the general government level, see Chapter 2).
- Second, reinforcing key public services remain a priority for the government, even if the large changes required raise financial and human resource constraints and administrative challenges.
- Third, product market liberalisation has progressed, but at an uneven pace across sectors: global reforms improving general conditions for doing business have advanced, but promoting competition and privatisation in large government-dominated sectors has proved more difficult.
- Fourth, labour market reforms have made little progress. A very deep divide between the employment and wage conditions in the formal and informal business sector persists. Job creation in the formal sector remains very costly and as a result a significant proportion of employment creation is diverted to lower quality jobs in the semi-formal and informal sectors.

The desirable labour market reform strategy for Turkey is now well charted. It includes three standard elements which have been advocated in the previous OECD *Economic Surveys*: *i*) reforming labour market regulations for both permanent and temporary contracts to facilitate job creation by reducing employers' severance costs with possible transition to a severance payment fund, and by liberalising temporary work and temporary work agencies; *ii*) allowing for regional differentiation of minimum wages to reduce the real minimum wage in the regions where productivity and living costs are low;[7] and *iii*) continuing to lower employers' social security contributions (currently at 14.5% of gross wages, excluding employers' contribution to the unemployment insurance fund of 2% of gross wages) in compliance with the fiscal framework to below 10% in the medium term (OECD, 2006a, 2007). Similar recommendations have been made by the World Bank (2007). This agenda is now increasingly acknowledged in government policy documents (SPO, 2009a, 2010). The latest Strategic Plan of the Ministry of Labour and Social Security stated that: "To make flexible employment more attractive, the degree of flexibility provided by the existing employment contracts will be evaluated, and the needed adjustments in the labour law will be effected in order to promote flexicurity in the labour market" (Ministry of Labour, 2008). The Medium Term Programme stated that: "To increase employment and reduce informality, flexible employment patterns will be promoted and diffused in compliance with the concept of flexicurity" (SPO, 2009b). The authorities have been preparing a comprehensive National Employment Strategy in this direction, which is expected to be released at the end of 2010.

The political economy obstacles to labour market reforms should be addressed

Political economy obstacles have prevented the implementation of this important agenda. Certain elements of reform have been initiated, but have stalled short of full

implementation. Other elements could not even be put on the agenda. Action is arrested in three important areas:

- *Severance payment reform*. A draft law along OECD best practices was prepared, but could not be proposed to Parliament because of the strong opposition of social partners. The proposal was based on monthly contributions by all employers to a Severance Payments Fund, which was to be liable for severance compensation to workers. This would reduce employer costs, and guarantee employee rights in case of enterprise defaults. Labour organisations were vocal in opposing this reform because they anticipated a risk of lower worker entitlements to compensation if employer contributions to the Fund were set below 8% of gross wages (the actuarial equivalent of the present law of 30 days of severance compensation per year of employment). Employees covered by collective agreements also opposed the reform because agreements usually entailed more generous compensation than what was mandated by the then prevailing law (up to between 40 and 60 days of salary per year of service). Many employers not regularly provisioning their severance liabilities also tacitly opposed the reform because it would impose additional obligations on them.
- *Liberalisation of temporary work*. A law on temporary work was adopted by Parliament in early 2009 after several years of technical work and inconclusive consultations with social partners (the trade unions never endorsed the proposal). The law aimed at permitting enterprises to hire temporary labour via private employment agencies. However, the President vetoed the law in June 2009 on the ground that it incurs risks of abusing workers, is incompatible with human dignity and lacks proper social protection as required by the European Union legislation.
- *Lowering minimum wages*. Average productivity and living costs in less advanced regions are clearly lower than in urban areas. This creates a wide gap between real official minimum wages in western and eastern regions. The government objective of securing minimum living standards and stimulating labour demand should take productivity and wage differences into account. However, these suggestions have faced vehement opposition.

Progress may be underway in reducing social security contributions. In October 2008, employers' contributions to disability, old-age and death funds were permanently reduced by 5 percentage points, to 14.5% of gross wages. The cut was smaller than the OECD recommendation to reduce them below 10% (OECD, 2006a, 2008a), but a larger cut could not be afforded, given revenue losses.[8] The 5-percentage point reduction is not a loss for the Social Security Institution, as it is compensated by the Treasury. All enterprises have been offered the reduction provided that they had no outstanding arrears with their social security contributions. In addition, employers' contributions for new young male workers (aged 18 to 29) and new female workers (without any age limit) were further reduced, but only temporarily.[9] In the context of regional policies, additional subsidies for employers' social security contributions for newly created jobs have also been granted. They amount to subsidising between 80% and 100% of contributions and are usually limited in time. Similar incentives were granted in 2009 for firms undertaking new big investment projects (see below).

While the additional reduction of social security contributions raises mainly a fiscal challenge, the other elements of the reform agenda face political economy obstacles, due to the conflict between insiders and outsiders to the formal labour market (Saint-Paul,

2002). Insiders, who are already employed and protected by existing law, oppose these reforms as they would reduce their acquired benefits (official minimum wages, indefinite duration contracts, employment protection and severance payments). In contrast, outsiders, who either work informally or are unemployed, enjoy none of these advantages and have an interest in the reforms as they would increase their chances of legal employment. This common political economy challenge of labour market reforms (OECD, 2009c) is found in Turkey in a particularly acute form because of the sizable gap between earning and employment conditions in the formal and informal sectors.

The task of Turkey's labour market reform is to marshal a politically acceptable reform avenue between insiders and outsiders. Little progress was achieved in the solution of this problem to date. The Turkish authorities could possibly draw on the experiences of other OECD countries which faced similar challenges in the recent past. These efforts deserve attention, even if none of them has achieved first-best objectives and most of them have encountered various challenges during their implementation (Box 3.1).

Box 3.1. **Lessons from recent OECD labour market reforms**

Three southern European OECD countries – Italy, Spain and Portugal – share with Turkey socially ambitious labour regulatory frameworks. Such frameworks aim at providing generous minimum income levels and employment protection for all workers, but are implemented in economic structures where only a part of the enterprises are productive and competitive enough to combine them with net employment creation. The aggregate employment rate in these countries falls short of the OECD average, while the informal sector provides an imperfect avenue for more flexible employment creation (although to a lesser extent than in Turkey). All these countries, participating in the general labour market reform efforts across OECD countries (OECD, 2006b), launched important reforms in the 2000s to make employment more flexible and less costly in their formal sectors (OECD, 2004b; Boeri and Garibaldi, 2007).

In Italy, reforms started with the so-called Treu package in 1997. The previously drastic sanctions applied in case of the violation of the fixed-term contract rules were eased, temporary work agencies were legalised, and new "atypical" labour contracts were encouraged by reducing social security contributions and pension provisions. The automatic conversion of temporary contracts into permanent contracts was removed. The package also eased regulations for apprenticeship and work training contracts. In 2000, additional flexibility was granted for part-time contracts and in 2002 private placement services were liberalised further. A "telematic labour exchange" was created. Finally the important "Biagi Law" was adopted in 2003, authorising additional labour contract types such as job on call, project work, supplementary work and job sharing.

In Spain a new type of permanent employment contract was created in 1997, reserved for young and disadvantaged workers, with reduced severance payment liabilities for employers. In 1999, compulsory social security contribution rates were lowered by 25-50% according to worker categories. An additional comprehensive set of market reforms was adopted in 2001, liberalising, among other things, part-time contracts and extending the new type of permanent contracts introduced in 1997 to new categories of workers. The package also introduced new severance payments for temporary workers.

Box 3.1. **Lessons from recent OECD labour-market reforms** *(cont.)*

In Portugal, the government, the employers' association (AIP) and the trade unions signed a Strategic Social Pact in 1996, jointly accepting the wider utilisation of atypical job contracts. The Pact extended time limits for temporary work contracts and recommended a wider recourse to temporary work agencies. In 1999, new legislation was adopted on part-time work and trade unions were given additional legal and judicial rights. Conditions for recourse to temporary work were tightened in 1999 and a new joint statement was signed by social partners in 2001 regarding the rules for applying fixed-term contracts.

The three southern European OECD countries have thus made their labour legislation more flexible than in the past by introducing new, more flexible employment forms, but at the same time preserving the existing employment forms and their legal basis. This two-tier approach made new employment forms accessible to specific groups in the labour force. Targeted groups included young, female, elderly and other disadvantaged workers. New contract forms were optional, depending on mutual agreement between enterprises and their employees. Existing permanent contracts, however, were little affected by these legislative changes and a duality formed in the labour market.

New contracts were shown to account for a large share of job creation in the 2000s. They also resulted in the higher employment intensity of growth (Boeri and Garibaldi, 2007). Through both the legalisation of previously informal workers and new job creation in the legal sector, recourse to new labour contracts increased rapidly. The degree to which their effects are permanent remains debated, however, as empirical studies of this issue have led to conflicting results and certain researchers continue to argue that the introduction of new contract forms has no permanent effect, but merely increases employment volatility in the business cycle without long-term leverage on average labour demand (Boeri and Garibaldi, 2007). Nonetheless, positive impacts on the employment growth of specific and traditionally disadvantageous groups such as youth and prime-age women are clearly documented (OECD, 2004b).

A serious adverse effect of these reforms has been deepening labour market duality. Gaps between remuneration and job protection conditions for different types of contracts have widened in certain instances, raising obvious equity and efficiency concerns. These mounted given the observed serious asymmetries in the cyclical adjustment of employment. During the global crisis of 2008-09, almost the entire weight of employment adjustment in Italy, Spain and Portugal fell on workers with the new types of labour contracts. The rigid employment of incumbent cohorts and the excessive volatility of youth employment are now highlighted as a disincentive to human capital formation within enterprises. Therefore, governments have started to envisage new measures to diminish the protection and benefit gaps between different types of contracts. Expert organisations' advice also started to focus on the need to reduce excessive fragmentation in the labour market and to promote a more unified labour law, on a more flexible common basis (OECD, 2008b, 2009c; Schindler, 2009).

Turkey could also draw from OECD experience regarding the political economy of labour market reforms as discussed in Box 3.2 and *2008 OECD Employment Outlook* (OECD, 2008b). In particular, as reforms seem to be complicated by a general lack of trust among stakeholders, the government would have to build more social trust to increase chances of implementing the needed labour market reforms. In this respect, it could commit credibly to improving the enforcement of labour rights and easing restrictions on trade union

Box 3.2. **The political economy of labour market reforms**

Recent OECD work on the political economy of labour market reforms, based on the experiences of Germany, Italy, Spain and Mexico, suggests five interesting lessons for Turkey (OECD, 2009c).

First, credible information on the costs of non-reform is a major ingredient to the reform process. A credible exposition of the economic and social costs of the lack of reform is helpful. Producing such analyses is however not easy and should be done by respected and non-controversial institutions.

Second, the cost of reform for incumbents should not be hidden in the hope that reform can proceed more smoothly. They should be explicitly recognised and addressed. It is important to realise that the regulatory entitlements of labour market incumbents, which represent a sort of capital for them. Reforms that "grandfather" these rights or explicitly compensate workers for foregoing them progress more easily – although at the cost of inequity and inefficiency during a potentially long transition period.

Third, newcomers into legal employment can constitute a potential pro-reform constituency. The outsiders to the formal labour market have little weight at the beginning of a reform process, but they gain more as they start to participate in the legal sector. Consequently, they may become more politically vocal and influential and they can form a constituency for additional reforms.

Fourth, economic crises help trigger reforms, but post-crisis growth also facilitates their implementation. Other structural reforms fuelling growth, notably in the product market, are for this reason complementary with and supportive of labour market reforms. Reforms and policies which facilitate new enterprise creation, market entry and investment growth are for this reason a good bedrock for labour market reforms. This interaction is particularly relevant for Turkey as discussed below.

Fifth, in certain circumstances, however, reforming the labour market may be a precondition for stronger growth. If labour costs and regulations are a truly binding constraint on new investment and business development, strong employment growth may not be obtained without shaking up the labour market. In such instances, pilot programmes reducing labour costs and making employment more flexible in narrow areas (such as in special economic zones or for specific employee groups) may be a way forward, although they raise the risks of inefficient market segmentation. Restricting such innovations in time, through for example sunset clauses and review rules which give all parties a say on their future extension may also help obtain political support to reforms. Offering new contract forms as optional innovations, *i.e.* as contracting instruments made available – but not imposed – on freely negotiating parties can also help with their introduction.

activity in line with International Labour Organisation conventions. This could help convince trade unions to broaden their concerns from the protection of the narrow interests of their members to the needs of a wealth and job creation for the entire society. Turkey should find a way of engaging in such a win-win process in the structural reform of the labour market.

Advancing an integrated strategy of labour reforms and formalisation

In Turkey's circumstances, advancing the coordination of labour market reform and the strategy to overcome the divide between formal and informal sectors (*Strategy of Fight*

against Informality) could ease the reform process politically. Labour market reform would help reduce the cost of job creation and enterprise development, giving formalisation a serious impulse, while enterprise development and job creation in the formal sector would help generate the productivity gains and income growth needed for broader support, by both entrepreneurs and workers, to labour market reform (OECD, 2006a, 2008a). The *Strategy of Fight against Informality* does not at present draw sufficiently on this synergy (Government, 2009). It seeks to accelerate formalisation through a variety of sensible means, but without reforming the labour market. More assertively enforcing the existing rules and regulations without, as a prior, reforming the labour market, may lead to competitiveness, output and employment losses.

Drawing on the experience of other OECD countries, labour market reforms in Turkey could be re-activated in the following directions:

I) Consider introducing more flexible and less costly legal employment forms on an experimental basis. New employment forms[10] can be made available to special categories of workers in the labour market, in special regions or economic zones, or on an optional and voluntary basis. The recent government measures to reduce labour taxes in selected provinces are a step in this direction.

II) Support business enterprises experimenting with these new forms of employment, through for instance tax incentives. With the help of such incentives and other structural reforms facilitating market entry and business creation, try to foster a broad sphere of experimentation with such new forms of employment.

III) As the benefits of at least some of these innovations for the creation of higher quality jobs in the legal sector become visible, make the most successful innovative forms more broadly available in the economy by incorporating them into the standard labour contract. This is crucial for avoiding the entrenchment of the innovation and experimentation into durable labour market duality.

IV) The alleviation of legal and regulatory burdens in the formal sector would permit a larger number of enterprises to grow in full abidance with law. They can therefore operate transparently and gain access to financial markets, as well as to other productivity-enhancing resources becoming available in the globalised world economy (international co-operation, FDI, etc.). They can therefore increase productivity and competitiveness, and offer their workers better terms of employment.

V) Higher-productivity and more competitive enterprises have the resources and incentives to provide workers with higher than average income levels, job or income security, and other social benefits than the statutory minima prescribed by the law. Progress with Turkey's convergence with the EU worker representation legislation may help in this respect. Less well performing enterprises and the national labour law can then progressively converge with these higher norms, as productivity and incomes increase.

Given the existing large pool of low-skilled workers, upskilling programmes should be activated in support of these efforts. It is thus welcome that the Turkish authorities recently reiterated their commitment to such measures. However, the international experience with upskilling policies is mixed and policies should be carefully designed to be effective and cost-efficient (OECD, 2009b). The challenge lies in adequately defining the target groups, the skill needs and effective measures. In this context, extending the scope of the Labour Market Research Programme conducted by the Turkish Employment Agency (İŞKUR) has been a welcome development. The idea of the research is to assess labour

market needs and predict their future evolution to better design upskilling programmes. The scope of the activities carried out by İŞKUR within the framework of active labour market programmes has also been extended. Furthermore, the financing of these programmes was increased. In 2009, internship and entrepreneurship programmes were introduced along with public work programmes and vocational training courses. In 2009, 166 713 unemployed workers enrolled in training on the basis of this programme, 109 000 completed their courses, 34 000 are expected to complete in 2010 and 25 000 have found jobs. This is a very promising start. In order to better inform active labour market and upskilling policies, it is recommended that Turkey participates in OECD's new *Programme of International Assessment of Adult Competencies* (PIAAC). Through extensive surveys and tests, PIAAC will provide a new, systematic and internationally comparable evaluation of the human capital endowment of the working-age population in each participating country. Turkey's past experience with OECD's *Programme for International Student Assessment* (PISA) would help successfully undertake such an exercise.

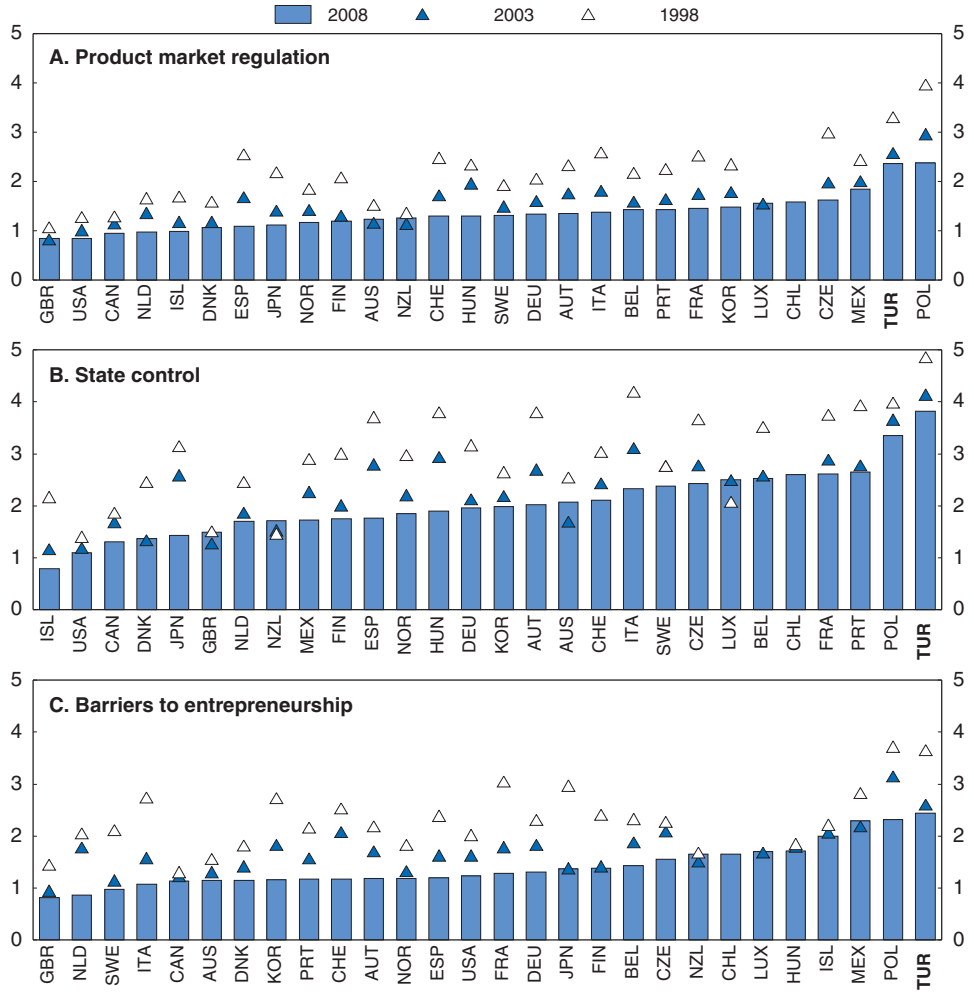
Improving education attainment and quality will be crucial for alleviating the skill mismatches, which are likely to persist in the coming decades. Such reforms would also benefit productivity growth. In this respect, efforts to improve links between the education system, in particular vocational schools, and the labour market should be intensified. The government has already taken several measures in this area. The curricula in primary, vocational and technical secondary schools have been revised, but the curriculum in general secondary education still needs overhauling. Over the medium and long term, education reforms should focus on increasing cognitive skills, as these prove crucial for economic growth (Hanushek and Wössmann, 2009). In this respect education at early years should be strengthened. The enrolment rate for pre-school education is low, 38.5% for the 4-5 age group in 2009-10 education year (Ministry of National Education, 2010), and it is very diversified regionally, with the lowest enrolment rates prevailing in poorer rural areas. Increasing pre-school enrolment could have positive effects on women labour participation.

Mobilising inactive people, especially women, will be key for raising the employment rate. In this respect, in addition to the measures introduced by Law No. 5763 (see above), a further elimination of economic barriers to women's participation, by lowering tax wedges and providing more child and elderly care facilities, should be given priority. The social barriers are likely to gradually ease with better and more universal education and higher incomes. The recent government initiatives in these areas are useful. In 2008, the government launched "Promoting Women Employment" and "Promoting Youth Employment" initiatives which envisage providing entrepreneurship training, career consultancy and guidance services between 2009 and 2012. The social contribution rates have been temporarily lowered for women (see above).

Product market regulations hold back productivity

Impediments to productivity growth in Turkey are complex and numerous, but product market regulations are a key factor.[11] Even though they have been eased over the past decade (Figure 3.5), Turkey continues to have a restrictive competition environment in the formal sector. A similar picture is given by the World Bank's Doing Business indicators, which show that Turkey made progress but remains still in a weak position in the global sample. It was ranked 84th among 155 countries in 2005, progressed to the 60th rank in 2007 and then retreated to 73rd in 2009. These fluctuations reflect in part the fact that other emerging countries have reformed more rapidly than Turkey in recent years.

Figure 3.5. **Restrictive product market regulations**
Index scale of 0-6 from least to most restrictive

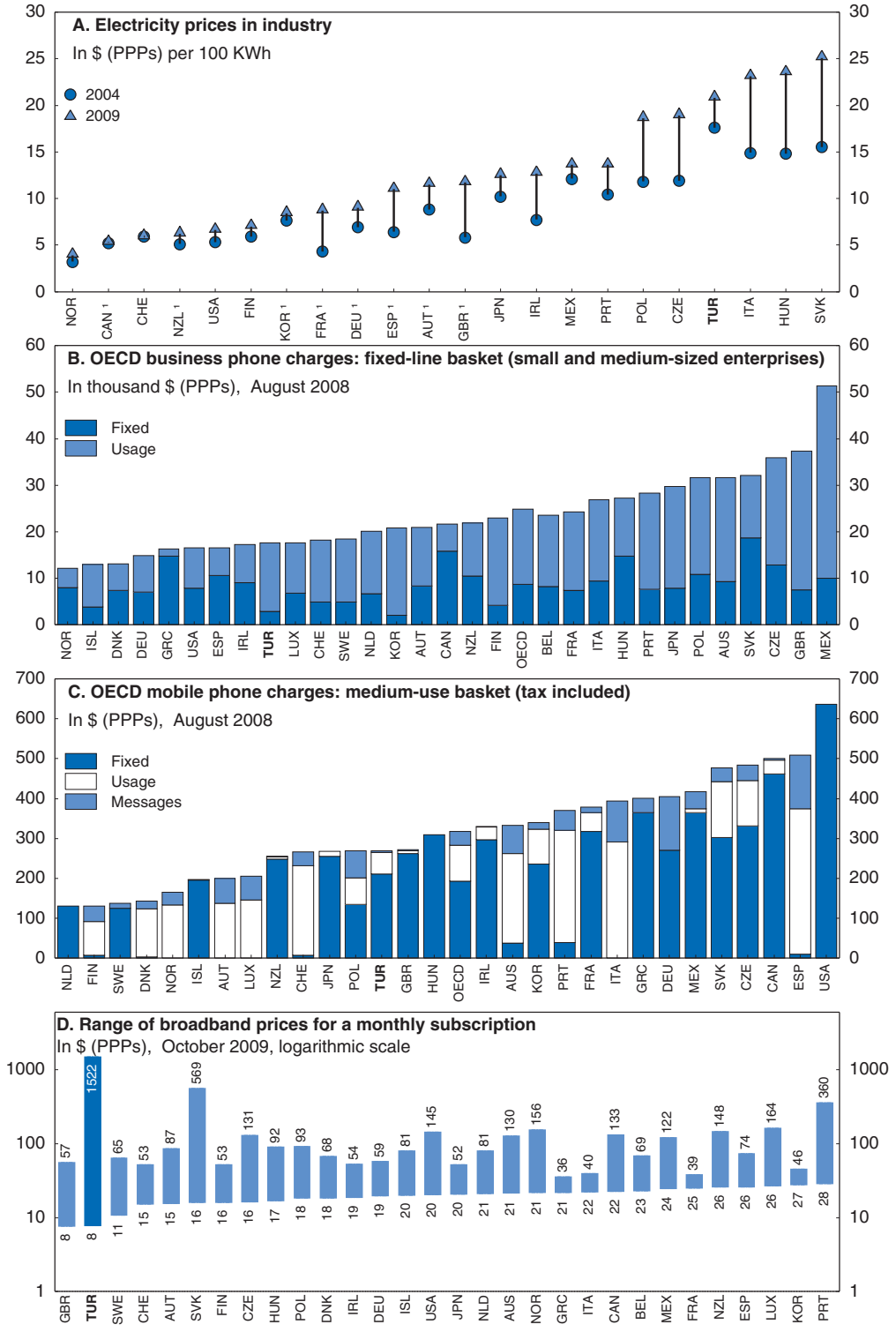


Source: OECD Indicators of economy-wide regulation (PMR) *www.oecd.org/eco/pmr*.

StatLink http://dx.doi.org/10.1787/888932322252

The tightest competition restrictions regard state control. Public ownership has been reduced in the past years due to privatisation in competitive sectors like petrochemicals, oil refining and distribution. However, public ownership still remains high by OECD standards. This applies especially to large network sectors such as electricity generation, natural gas distribution, postal services and rail transport. Moreover, government involvement in business operations is relatively intense. Command and control regulations continue to be used extensively, at the expense of incentive-based regulations (*i.e.* regulations which draw on price signals and competition dynamics). Price controls are used in several sectors such as air travel, road freight and mobile telecommunications and, according to the OECD product market indicator, the overall state price controls have intensified since 2003. Nevertheless, the international comparison of selected prices of electricity and telecommunication services suggests that Turkey has rather moderate prices in these sectors (Figure 3.6).

Figure 3.6. **International comparison of selected electricity and telecommunication prices**



1. Instead of 2009: 2007 for Canada and Germany, 2008 for Austria, France, Korea, New Zealand, Spain and the United Kingdom.

Source: AIE, *Energy Prices and Taxes*; OECD (2009), *Communications Outlook*; and OECD Broadband Statistics (*www.oecd.org/sti/ict/broadband*).

StatLink http://dx.doi.org/10.1787/888932322271

Barriers to entrepreneurship and to competition in the formal sector are higher than in most other OECD countries (Figure 3.5). Persisting regulatory and administrative opacities play a particularly important role in this. The licence and permits system is complex and there are neither "one-stop shops" nor "silence is consent" rules. However, the recent establishment of Development Agencies could offer an opportunity to ease licence and permits system since these agencies are intended to operate as one-stop shops across the country (see below). Administrative burdens on start-ups (concerning the creation of both sole proprietor firms and corporations) remain more cumbersome than in most other OECD countries. Notwithstanding improvements in certain areas, Turkish managers stress that they spend increasingly more time in dealing with government regulations (Enterprise Surveys, 2009).

Liberalisation reforms in product markets, in particular in network industries, would foster competition, help increase productivity and back labour market reforms by reducing monopolistic rents and helping overcome the entrenchment of insider interests (Nicoletti and Scarpetta, 2005). Such reforms would contribute to reducing the duality in the labour market and back labour market reforms – even if the key divide between formal and informal employment occurs among competitive enterprises and is rooted in productivity and human capital differences within the competitive sector.

Regulatory enforcement at the local level in particular needs improvement. The local regulatory environments appear less transparent and less rule-based than at the central government level. Firms complain particularly about demands concerning "contributions to local community" (Dimireva, 2009). These distortions may be, paradoxically, more disturbing for domestic investors than for foreign investors because the latter are helped by the Turkish Foreign Investment Promotion Agency (Turkinvest).

A particular area where shortcomings in transparency and distortions to competition appear more frequently than in others is real estate planning and construction. Local enforcement in this area deserves thorough review and upgrading (Box 3.3). Its modernisation is also crucial for reinforcing the resilience of Turkey's physical infrastructure to natural risks. Turkey is exposed to important natural hazards, in particular to earthquake risks in the Istanbul/Marmara region. However, the majority of the outstanding building stock lacks formal authorisation and certification.[12] A response strategy is essential for human but also for economic and fiscal reasons. Minimum security norms should apply not only to new buildings but also to the existing ones.

Further product market reforms are needed to facilitate entrepreneurship in the formal sector

Although product market reforms are more advanced and the remaining barriers are less binding than in the labour markets, further relaxing anti-competitive product market regulations is needed. Such reforms would permit Turkey's exceptionally vibrant entrepreneurship culture to take hold in the formal sector rather than in the semi-formal and informal sector. Entrepreneurs could then operate more confidently and transparently, without feeling threatened by law enforcement and inspections. Such a new setting would provide a new impulse to productivity growth (Annex 3.A3) and would reinforce reforms in the labour markets.

A more competitive environment in the formal sector would benefit the productivity of both existing formal and informal firms. Formal firms would be exposed to more

Box 3.3. **Real estate planning and construction permits**

According to World Bank's Doing Business Indicators, Turkey ranks 133 among 183 countries in the area of construction permits. Average time spent dealing with such permits is lower than in comparator countries, but variations among regions and cities are very large. A recent review identified five key problematic areas in terms of bureaucratic procedures, without addressing in detail the risks that they entail in terms of distortions to competition. First, there are differences between sector-based strategies and urban development plans by different ministries. The coordination of spatial planning activities needs to be improved. Second, different government agencies happen to conflict on their respective areas of action. Two agencies may deal with the same issue without any authority to help solve their differences. Third, inspections related to construction permits are in the hands of the Ministry of Interior, which does not have special technical expertise. Ministry inspections focus on administrative procedures. Fourth, municipalities deliver certain permits and licenses, but few of them have adequate expertise to implement technical secondary legislation. Fifth, there are no standard procedures for the issuance of construction permits. No guidelines and handbooks exist to understand and implement the regulatory framework. The World Bank also mentioned that the recently established Development Agencies may provide opportunities for alleviating the related shortcomings in the investment and business environment.

Source: World Bank (2010).

competition and semi-formal and informal firms would have access to new productivity-enhancing resources. In the light of OECD's analyses of the present status of Turkey's product market regulations in international comparison, three priorities of product market reforms should be to:

i) *Reduce barriers to entrepreneurship.* Turkey's licence and permits system remains complex in international comparison. "One-stop shops" for market entry authorisations and "silence is consent" rules, which facilitate market entry in the formal sector in other OECD countries, are not in force. The streamlining of the legal and regulatory framework would reduce the hurdles faced by formal sector entrepreneurs. This would also help reduce the excessive discretionary powers of regulatory authorities, which increase the risks of corruption.[13]

ii) *Reduce government's involvement in business operations.* Further advancing privatisation and reducing price controls are needed. After major privatisations in the 2000s (petrochemicals, oil refineries and telecommunications), more challenging privatisations await the government. They concern large network firms in electricity generation, natural gas, railways, postal services, etc. Following the slowdown in privatisations due to unfavourable global conditions in the crisis, the government announced that planned privatisation would resume. They may however be made more difficult due to labour market considerations (Box 3.4). This is an area where stronger social consensus on desirable labour market regulations would facilitate product market reforms.

iii) *Further ease conditions for foreign direct investment.* Turkey has considerably reduced barriers to foreign investment in 2003 by enacting a law which eliminated the special regime of foreign owned corporations and granted full national treatment to all foreign enterprises operating in Turkey. Nonetheless, Turkey remains among the OECD

Box 3.4. **Handling the labour market impact of privatisation**

In 2004, the government announced a new regulation permitting the re-hiring of redundant employees losing their jobs in privatised companies in other public sector entities. A first list was published with job vacancies to which privatised enterprises' workers could apply. Their applications were to be given preferential treatment, outside the standard procedures of public sector hiring. A new status, the so-called 4-C status, was created for this purpose. The employees concerned would continue to be covered by social security, but could not be employed for longer than 11 months per year and could not be hired with permanent employment contracts.

The procedure was meant to be made progressively available to all workers employed in public entities included in the privatisation programme. One of its implementations concerned the privatisation of Tekel, the large state-owned producer and distributor of tobacco, cigarettes and alcoholic drinks. Tekel was privatised to British American Tobacco in February 2008.

In December 2009, the government announced that 12 Tekel factories would be closed, with 10 000 workers redeployed to other jobs in the public sector under the 4-C status. As Tekel employees were previously covered by a rewarding collective agreement regarding pay and other entitlements, the announcement sparked a large-scale industrial action. About 12 000 workers from across the country demonstrated in Ankara. On February 2010, workers from unionised industries participated in a one day national strike in support. Following a court case, the State Administrative Court (*Danistay*) judged, in March 2010, that the 4-C status did not comply with the rights and social protection guaranteed by the Constitution to public sector workers. It passed the regulation to the Constitutional Court for the verification of compliance with Constitution.

countries with comparatively restrictive rules. Sectoral investment restrictions such as on radio and TV broadcasting, energy and transport, and relatively cumbersome conditions for foreigners' work permits are two areas where additional liberalisation would be welcome.

In order to accelerate product market reforms, Turkey established a Coordination Council for the Improvement of the Investment Environment (YOIKK) at the end of 2001 (Box 3.5). This body steers and guides the reform initiatives and its actions have exerted a significant impact on the acceleration of product market reforms. This endeavour should be continued.

Productivity could be boosted by additional policy initiatives

Productivity growth can also be raised by supporting the development and dissemination of new technologies. The government goal of increasing R&D spending from 0.76% of GDP in 2006 to 2% of GDP in 2013 as targeted in the Ninth Development Plan is a welcome objective (SPO, 2006, 2010). It should be stressed, however, that the quality of R&D spending is more important than its level. In this respect, private R&D, which falls short of most OECD countries, should be encouraged. The government has introduced a number of incentives to boost R&D, including technology development zones (TDZs) and technology centres promoting a closer and more effective co-operation between universities and industry. In August 2009, it was decided to establish 36 TDZs and 20 technology centres. So far, 20 TDZs and 18 technology centres have become operational.

Box 3.5. **The Coordination Council for the Improvement of the Investment Environment (YOIKK)**

The Coordination Council for the Improvement of the Investment Environment (YOIKK) is a platform operating since 2001. It comprises high-level public and private sector representatives. It aims at streamlining business regulations and at facilitating the needed reforms. It has four key roles: *i)* identifying the main obstacles to market entry and doing business on the basis of the practical experience of private sector operators; *ii)* achieving a consensus within the public and between the public and private sectors on reform priorities; *iii)* taking leadership in setting specific reform targets and an associated timetable; and *iv)* providing a platform of accountability on reform policies.

The YOIKK is connected with an international high-level advisory board – the Investment Advisory Council. It includes top executives from multinational companies operating or interested in Turkey, the resident representatives of international institutions (such as the IMF, World Bank and European Investment Bank) and the chairpersons of the Turkish non-governmental organisations representing the private sector. IAC convenes yearly for a day, with the participation of the Prime Minister, and advises the government on reforms. IAC's recommendations become a roadmap for YOIKK for the following year. Each year the government reports on progress on each of the previous recommendations.

During its initial years, the main YOIKK achievements included the preparation of the following concrete proposals, which were implemented by the government: *i)* the reduction of company association procedures from 19 to three transactions; *ii)* a new FDI law abolishing pre-entry screening and minimum capital requirements, based on international best practices; *iii)* the reduction of the corporate income tax rates; *iv)* the establishment of the Investment Support and Promotion Agency of Turkey (Turkinvest) as a one-stop shop for foreign investors.

For 2010, YOIKK has established programmes for 12 Technical Committees created in the following areas: Company Establishment, Employment, Licensing, Location of Investment, Taxation and Incentives, Foreign Trade and Customs, Intellectual Property Rights, Investment Promotion, R&D, Legislation of Foreign Direct Investment, Small and Medium-sized Enterprises and Corporate Governance.

According to the authorities, YOIKK-led reforms are expected to improve Turkey's scoring in OECD's product market regulation indicators, at the occasion of the next update of these indicators.

TDZs enjoy tax incentives, including tax reductions on corporate profits and on income taxes for employees and VAT exemptions on products produced in these zones. Similar tax incentives apply to R&D companies that plan to employ more than 50 employees. As no comprehensive evaluation of the effectiveness of these recent programmes has been undertaken so far, it is difficult to assess their efficacy. The authorities have announced that all programmes will be evaluated and results will be published. The adoption and dissemination of technologies can also be facilitated by attracting higher FDI inflows (Chapter 1).

The reforms to boost productivity and employment may be supported by regional policies. These can not only spur company and job creation, and technology and infrastructure improvement, but also address big regional differences in economic development (World Bank, 2008). Regional development is high on the political agenda and the government introduced a New Investment Incentive System in 2009 (SPO, 2009a, 2010).

Incentives are differentiated across four designated regions and sectors as well as the size of the investment. The regions are selected based on a socio-economic development index and priority sectors are identified for each region. For instance, in the third and fourth regions, which cover mostly southern and eastern provinces, the focus is placed on agriculture, light manufacturing, tourism, health and education, whereas in the first and second regions the focus is mainly on high-technology industry. The incentives involve exemptions from custom duties, VAT, subsidies to interest on loans and employers' social security contributions, reduced corporate and income taxes and preferable land allocation. The system grants additional tax and social security incentives to investments started before the end of 2010. A review of the experience with this new investment incentive system could be included in the next *Economic Survey of Turkey*.

To ensure efficiency and effectiveness, these policies should be subject to thorough evaluation. This calls for a wide dissemination of information and disclosure of relevant economic information at the regional level, reporting on enterprise and job creation, output growth and productivity, and data helping explore links with the variety of support policies. The publication of up-to-date province-level economic data should be ensured. This especially applies to provincial GDP data, publication of which was discontinued in 2001. Experience with successful Organised Industrial Zones (OIZs) also deserves special attention. Successful OIZs demonstrate positive externalities in terms of industry clustering, cost-effective provision of infrastructure, dissemination of knowledge and technology, enforcement of environmental policies, co-operation between industry and universities.

Development Agencies (DAs) will be main instruments of the regional policy. DAs are being established in 26 regions across entire Turkey since 2006 to support business and investment activities in the regions. Their aim is to enhance co-operation and facilitate interactions between public and private sectors. DAs are expected to act as "one-stop" shops, intermediating between firms and official bodies in charge of granting licenses and other support measures. They could therefore help rationalise financial and non-financial support initiatives of local economic development. DAs will also carry out FDI promotion, through Investment Support Offices – which will be created in coordination with the national FDI promotion agency Turkinvest. DAs are also authorised to provide direct training services for enterprises in the areas of management, production, marketing, technology, finance and organisation. DAs are finally expected to develop regional innovation and cluster strategies and provide support for the joint activities of enterprises and universities.

Benefits of labour and product market reforms are large

According to the OECD analyses of the determinants of long-term growth, economic performance in the long run depends *inter alia* on convergence with international best practices of product and labour market regulations. The income gap in Turkey creates a vast scope for improvement and high costs of inaction. To demonstrate this, two simple, illustrative scenarios of long-term growth are presented in Annex 3.A3. They indicate that even a modest improvement in labour force participation and average labour productivity may make a major difference for GDP per capita and jobs over the long run. With a relatively restricted set of structural reforms improving labour utilisation and productivity, GDP growth can accelerate to over 6%, GDP per capita can be higher by around 14% and employment by around 10% (*i.e.* around 2.5 million workers) by 2020 than would be the

case if no such reforms were implemented and the past trends were preserved (Table 3.A3.1 and Figure 3.A3.1). If this ongoing reform agenda for Turkey is well orchestrated and fully implemented, actual GDP growth could be higher than 6% assumed in the growth acceleration scenario. The scenario is only indicative of possible gains in potential GDP and employment and should not be interpreted as the upper limit.

Policy recommendations

Policy recommendations are summarised in Box 3.6.

Box 3.6. **Reforming regulations to unlock long-term growth**

Employment

- Stimulate job creation in the formal sector by reforming the three sources of rigidity in legal employment:
  - *i)* reform labour market regulations for both permanent and temporary contracts to facilitate job creation by reducing employers' severance costs with possible transition to a severance payment fund, and by liberalising temporary work and temporary work agencies,
  - *ii)* allow for regional differentiation of minimum wages to reduce the real minimum wage in the regions where productivity and living costs are low,
  - *iii)* continue to reduce employers' social security contributions. A possible medium-term target would be reducing employers' contributions (which currently amount to 14.5% of gross wages) to below 10%. In addition, make the employment-related legal obligations of enterprises independent of employment size, to facilitate legal job creation and reduce incentives for informal employment.
- To alleviate the political economy obstacles to labour market reform, the authorities may wish to consider a new approach based on a more integrated strategy of regulatory simplification, formalisation, economic growth and social progress. The elements below should be considered:
  - *i)* The design, marketing and sequencing of the reform package should be made a unifying goal in a nationwide consensus-building consultation process.
  - *ii)* More flexible and less costly legal employment forms should be introduced on an experimental basis, with transparent monitoring of impacts.
  - *iii)* Business enterprises adopting these forms of employment should be supported, in order to foster a large sphere of natural experiment.
  - *iv)* Participation in such experiments should be strictly voluntary and should in principle be limited to new labour contracts.
  - *v)* Turkey's *Strategy of Fight against Informality* should be enforced together with, and not independently from, legal and regulatory reforms reducing the costs of doing business in the formal sector.
  - *vi)* Raise educational standards and coverage, and improve links between schools and the labour market.
  - *vii)* Address skill mismatches of the current labour force by carefully designed and regularly evaluated upskilling programmes.
  - *viii)* Strengthen efforts to increase the employment of women by tax incentives, better education and more accessible child and elderly care facilities.

Box 3.6. **Reforming regulations to unlock long-term growth** *(cont.)*

Productivity growth

- Ease anti-competitive product market regulations in the formal sector by reducing government involvement in business and limiting barriers to entrepreneurship.
- Improve access to new technologies by fostering private R&D and by attracting higher FDI inflows.
- Continue to experiment with recently introduced incentive schemes for investment and business development, including in the less advanced regions. Make the costs and benefits of these schemes fully transparent and evaluate them carefully in order to concentrate national and local resources on the most successful programmes.
- Resume the publication of province-level economic data for policy-oriented analyses of links between policies and performance at the regional level.

Notes

1. Law No. 5763, adopted in May 2008, reduced certain obligations associated with employment size thresholds: *i)* Enterprises employing more than 50 workers had to employ disabled, ex-convicts and terror victims (at least 3%, 2% and 1% of the workforce, respectively). Obligations regarding the ex-convicts and the terror victims were abolished, whereas the employer's social security contributions for the disabled started to be fully compensated by the Treasury; *ii)* Enterprises employing more than 50 workers had to establish job safety and health units, and hire job safety personnel and doctors. These obligations were partly relieved by giving employers an opportunity to share job safety and health units with other employers or to provide job safety and health services via outsourcing; *iii)* Enterprises employing more than 100 female workers needed to build breast-feeding rooms and enterprises employing more than 150 female workers needed to build kindergarten. These obligations were partly relieved by giving employers an opportunity to provide these services via outsourcing; *iv)* Enterprises employing more than 500 workers had to build a sport facility. This obligation was fully abolished.
2. According to the classification adopted in the Turkish Labour Force Survey (LFS), informal workers are those who are not registered with any social security institutions.
3. Gross schooling rates are calculated as a ratio of all entrants, regardless of their age, to the size of the population at the typical age of entry, in contrast to net schooling rates which account for entrants only at the typical age of entry.
4. The OECD Programme of International Student Assessment (PISA) was thoroughly analysed in the 2006 *OECD Economic Survey of Turkey* (OECD, 2006a).
5. The assessment of trends in women employment rates is complicated by the migration of rural population (as explained in the text above). However, some measures suggest that women employment has been on the rise. According to the Turkish LFS, the women employment rate in urban areas has increased from 14.6% in 2004 to 17.7% in 2009. Higher women employment in 2008-09 is believed to partially result from the recession, as the loss of family income forced many women to take up jobs (the so-called second earner effect).
6. According to the Turkish LFS, in 2009 the illiteracy rate was 4% for men at the working age and 18% for women at the working age.
7. Certain OECD countries implement regional minimum wages. These include the United States and Canada, where minimum wages are settled at the level of federal states and provinces; Mexico, where a tri-partite National Wage Commission decides on minimum wages for three broad geographical zones; and Japan, where separate minimum wages are set in each of the 47 prefectures (OECD, 1998).
8. An estimation of these costs was provided in the 2008 *OECD Economic Survey of Turkey* (OECD, 2008a).
9. Initially, employers could benefit from this measure between July 2008 and June 2009, but in February 2009 the window was extended until May 26, 2010. The employer's share of social

security contributions, which is calculated on the basis of the minimum wage, is reimbursed fully in the first year of the scheme and then the coverage gradually declines to 20% in the fifth year.

10. Entailing the combination of lower minimum wages, lower severance costs and easier temporary employment provisions.

11. Beyond regulations and informality, productivity growth has been hindered by low human capital (see previous section) and inadequate infrastructure (EC, 2009). These factors are not analysed in depth in this chapter.

12. After the 1999 earthquakes physical protection against earthquake risks was partially improved (OECD, 2004a). This concerned mainly public buildings, notably schools and hospitals, which were severely damaged. In contrast, progress was limited with the reinforcement of private houses and commercial buildings.

13. According to international surveys the risks of corruption increase in proportion to the legal and regulatory complexities which vest public officials with unnecessary discretionary powers *vis-à-vis* business enterprises (Aidt and Dutta, 2004; Tøndel and Søreide, 2008).

Bibliography

Aghion, P. and P. Howitt (1998), *Endogenous Growth Theory*, MIT Press, Cambridge, MA.

Aidt, T.S. and J. Dutta (2004). "Policy Compromises: Corruption and Regulation in a Dynamic Democracy", *Cambridge Working Papers in Economics*, No. 404, Cambridge.

Arnold, J., P. Höller, M. Morgan and A. Wörgötter (2009), "Structural Reforms and the Benefits of the Enlarged EU Internal Market: Much Achieved and Much to Do", *OECD Economics Department Working Papers*, No. 694, OECD, Paris.

Boeri, T. and P. Garibaldi (2007), "Two Tier Reforms of Employment Protection: A Honeymoon Effect?", *Carlo Alberti Working Papers*, No. 37, Rome.

Conway, P., D. de Rosa, G. Nicoletti and F. Steiner (2006), "Product Market Regulation and Convergence", *OECD Economic Studies*, No. 43, 2006/2, OECD, Paris.

Dimireva, I. (2009), "Turkey Investment Climate 2009", *EU Business News*, US Department of State.

EC (2009), "Turkey 2009 Progress Report", *Commission Staff Working Document*, No. SEC(2009)1334, European Commission, Brussels.

Enterprise Surveys (2009), "Running a Business in Turkey", *Enterprise Surveys Country Note Series*, No. 1, World Bank Group, Washington, DC.

Government (2009), *Action Plan of Strategy for Fight against the Informal Economy (2008-2009)*, Presidency of Revenue Administration, Department of Strategy Development, Publication No. 88, Ankara.

Hanushek, E.A. and L. Wössmann (2009), "Schooling, Cognitive Skills, and the Latin American Growth Puzzle", *NBERWorking Papers*, No. 15066, National Bureau of Economic Research, Cambridge, MA.

Hausmann, R., L. Pritchett and D. Rodrik (2005), "Growth Accelerations", *Journal of Economic Growth*, Vol. 10, p. 303-329.

Ministry of Labour (2008), *Strategic Plan 2009-2013* (Calisma ve Sosyal Guvenlik Bakanligi Stratejik Plani 2009-2013), Ankara.

Ministry of National Education (2010), *National Education Statistics. Formal Education 2009-2010*, Ankara.

Nicoletti, G. and S. Scarpetta (2005), "Product Market Reforms and Employment in OECD Countries", *OECD Economics Department Working Papers*, No. 472, Paris.

OECD (1998), *OECD Employment Outlook*, OECD, Paris.

OECD (2004a), *OECD Economic Surveys: Turkey*, Vol. 2004/15, OECD, Paris.

OECD (2004b), *OECD Employment Outlook*, OECD, Paris.

OECD (2005), *Economic Policy Reforms 2005: Going for Growth*, Vol. 2005 (1), OECD, Paris.

OECD (2006a), *OECD Economic Surveys: Turkey*, Vol. 2006/15, OECD, Paris.

OECD (2006b), *Boosting Jobs and Incomes: Policy Lessons from Reassessing OECD Jobs Strategy*, OECD, Paris.

OECD (2007), *Economic Policy Reforms 2007: Going for Growth*, Vol. 2007 (1), OECD, Paris.

OECD (2008a), *OECD Economic Surveys: Turkey*, Vol. 2008/14, OECD, Paris.

OECD (2008b), *OECD Employment Outlook*, OECD, Paris.

OECD (2009a), *Economic Policy Reforms 2009: Going for Growth*, Vol. 2009, No. 1, OECD, Paris.

OECD (2009b), *Designing Local Skills Strategies,* Local Economic and Employment Development, OECD, Paris.

OECD (2009c), *The Political Economy of Reform: Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries,* OECD, Paris.

OECD (2010), *Economic Policy Reforms 2010: Going for Growth*, Vol. 2010, No. 1, OECD, Paris.

Rodrik, D. (2007), *One Economics, Many Recipes: Globalization, Institutions, and Economic Growth*, Princeton University Press.

Saint-Paul, G. (2002), "The Political Economy of Employment Protection", *Journal of Political Economy*, Vol. 110(3).

Saget, C. (2008), "Fixing Minimum Wage Levels in Developing Countries: Common Failures and Remedies", *International Labour Review*, Vol. 147(1), International Labour Organisation, Geneva.

Sala-i-Martin, X. (2002), "15 Years of New Growth Economics: What Have We Learnt?", *Columbia University Discussion Papers*, No. 102-47.

Schindler, M. (2009), "The Italian Labor Market: Recent Trends, Institutions and Reform Options", *IMF Working Papers*, No. 09/47, International Monetary Fund, Washington, DC.

SPO (2006), *Ninth Development Plan 2007-13*, State Planning Organization, Ankara.

SPO (2009a), *Pre-Accession Economic Programme 2009*, State Planning Organization April, Ankara.

SPO (2009b), *Medium Term Programme 2010-2012*, State Planning Organization, September, Ankara.

SPO (2010), *2010 Annual Programme*, State Planning Organization, Ankara.

SPO and World Bank (2009), *Female Labor Force Participation in Turkey: Trends, Determinants, and Policy Framework*, forthcoming, State Planning Organization and World Bank, Ankara.

Temple, J. (1999), "The New Growth Evidence", *Journal of Economic Literature*, Vol. 37, p. 112-56.

Toksöz, G. (2007), *Women's Employment Situation in Turkey*, International Labour Office, Ankara.

Tøndel, L. and T. Søreide (2008), "Bureaucratic Complexity and Impacts of Corruption in Utilities", *CMI Working Papers*, No. 2, Bergen Resource Centre for International Development, Bergen.

Venn, D. (2009), "Legislation, Collective Bargaining and Enforcement: Updating the OECD Employment Protection Indicators", *OECD Social, Employment and Migration Working Papers*, No. 89, OECD, Paris.

Venn, D. (2010), "The Impact of Small-firm Exemptions from Employment Protection", *OECD Social, Employment and Migration Working Papers*, OECD, Paris, forthcoming.

Wacziarg, R. (2002), Review of Easterly's The Elusive Quest for Growth', *Journal of Economic Literature*, Vol. 40, p. 907-18.

World Bank (2007), "Turkey Labour Market Study,"*World Bank Reports*, No. 33254-TR, Washington, DC.

World Bank (2008), "Turkey Country Economic Memorandum. Sustaining High Growth: Selected Issues. Expanded Report", *World Bank Reports*, No. 39194, Vol. II, Washington, DC.

World Bank (2009), "Turkey Country Economic Memorandum. Informality: Causes, Consequences, Policies", *World Bank Reports*, No. 48523-TR, Washington, DC.

World Bank (2010), "Turkey. Investment Climate Assessment. From Crisis to Private Sector Led Growth", *World Bank Reports*, No. 54123-TR, Washington, DC.

ANNEX 3.A1

The impact of the 2003 labour law change on job creation

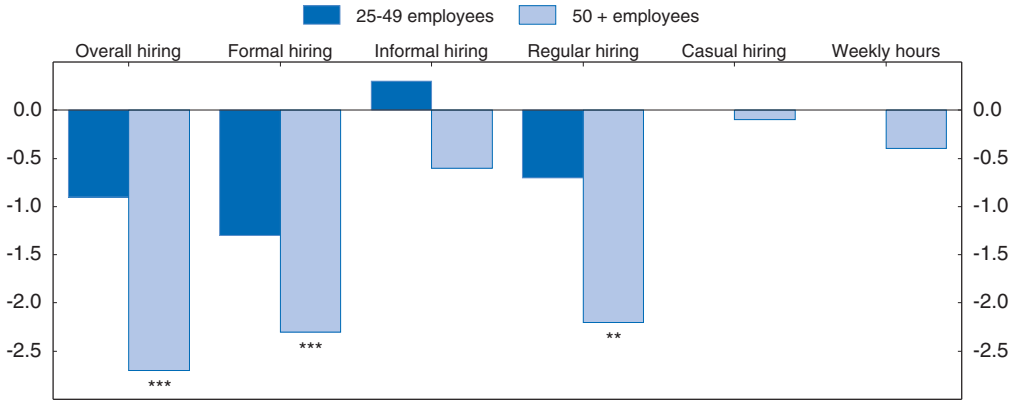
A reform of the Turkish Labour Code applicable from June 2003 increased dismissal costs for large firms, *i.e.* establishments with 30 or more employees. Large firms found to have made a dismissal without a valid reason are now required to either reinstate the worker within a month after the final decision or to pay compensation of 4-8 months' net wages in lieu of reinstatement. Additionally, the worker is paid maximum four months of the wages and other benefits that have accrued during the period he/she has not been reinstated until the final decision. This annex investigates the effect of this reform on the hiring behaviour of large firms.

The impact of the reforms is tested by comparing the estimated probability of hiring and hours worked between large and small firms prior to and after the reform. The analysis assumes that the reform only affected the behaviour of large firms and that, in the absence of the reform, the difference between large and small firms would have remained unchanged. The analysis excludes workers in the agricultural industry (where establishments with fewer than 50 employees, which account for the bulk of agricultural employment, are exempted completely from the application of the Labour Code) and about 10% of non-farm employees who report working in a non-regular workplace such as a marketplace, field, garden, at home or in a mobile workplace. Estimations are based on the Turkish Household Labour Force Survey data and they include controls for employee demographic and human capital characteristics (age, gender, marital status, educational attainment and occupation). In the absence of detailed information about firm characteristics, controls for industry and urban/rural location are also added.

The results presented below show the impact of the reform on the probability of being hired and on weekly hours worked of employees in large firms (above 49 employees) compared with those in firms with 10-24 employees (which are used as a control group). There was no statistically significant impact of the reform on workers in firms with 25-49 employees compared with workers in smaller firms. This is not entirely surprising because some firms with 25-49 employees did not face increased dismissal costs as a result of the reform (which applied only to firms with 30 or more employees). Firms that are just above the threshold for higher dismissal costs may be able to hide their true size and so remain relatively unaffected by higher dismissal costs. However, there was a clear impact of higher dismissal costs on workers in firms with 50 or more workers. The impact – a reduction of just over 2% in hiring probability – was limited to those workers who could be expected to be bound by the legal change: formal employees (*i.e.* those registered for social

Figure 3.A1.1. **Impact of reform on hiring probability (in percentage points) and weekly hours (in per cent)**

By firm size, compared with employees in firms with 10-24 employees



Note: *** indicates that marginal effects are statistically significant at 1% level and ** at 5% level.

Source: Venn, D. (2010), "The Impact of Small-firm Exemptions from Employment Protection"; *OECD Social, Employment and Migration Working Papers*, OECD, Paris, *forthcoming*.

StatLink http://dx.doi.org/10.1787/888932322290

security) and those with regular contracts (note that there is a large overlap between these groups). There was no significant impact of the reform on hiring probabilities for informal or casual workers. This suggests that large firms did not substitute informal/casual workers for formal/regular workers in order to get around the new requirements. Nor is there evidence that firms became more likely to adjust employment on the intensive margin by increasing hours rather than hiring new workers.

ANNEX 3.A2

Progress with structural reform: follow-up to OECD policy recommendations

Table 3.A2.1. **Follow-up to OECD policy recommendations**

Policy recommendations	Actions taken	OECD comments
A) *Going for Growth* priorities[1]		
Improve educational achievement. Fully enforce minimum schooling rules, revise the education curricula according to labour market needs, increase spending on education (financed by cuts in lower priority areas), fund schools on a per-pupil basis and provide them with more managerial responsibility.	A national campaign was launched to increase the school enrolment of girls in 2005. The number of classes was increased. Education curricula in primary and secondary schools were revised in 2006. Studies to revise the curricula in vocational and technical education according to needs of the labour market have gained speed in 2009 under the Vocational and Technical Education Strategy Document. Funding schools on per-pupil basis and managing schools through local authorities have been put into action through pilot studies in several cities and it will be rolled-over in 2010 according to outputs of pilot projects. Obligatory education has been extended to nine years (by including one year of pre-school education) in 32 provinces in 2009 and will be extended to all provinces within four years.	More action needed. Developing a very well performing education system should be a top policy priority for Turkey. All education layers from pre-school to tertiary education deserve close attention.
Reduce the minimum cost of labour. Reduce the minimum wage relative to the average wage. Cut the labour tax wedge, especially on low earnings (financed by spending rationalisation).	A personal allowance was introduced for all workers in 2008. Social security contributions were reduced for the early years of employment of young and female workers in 2008, and to a more limited extent for all workers. Additional reductions in employers' social security contributions and in income taxes in 49 provinces proved effective, and their validity was extended from end-2008 to end-2012. The Treasury temporarily paid the social security contributions of newly hired workers all around Turkey in 2009 (for a period of 6-12 months).	More action needed on a durable basis. A possible medium-term target is to lower employers contributions to below 10%, to be funded by spending cuts in lower priority areas. To avoid such a reduction in contributions leading to losses in pension entitlements, mandatory public and complementary voluntary pension schemes can be made distinct, allowing for higher contributions of employers to the latter scheme. Formal sector workers can be automatically enrolled in the voluntary scheme with an active opt-out option.
Reform employment protection legislation. Ease employment protection in the formal sector, both by reforming severance payments and by facilitating temporary work.	The Parliament adopted a new law authorising manpower agencies to offer temporary work services in 2009, but a presidential veto following strong trade unions' opposition suspended the reform.	Action needed.
Simplify product market regulations. Streamline product market regulations, in particular the sectoral licensing rules. Encourage greater competition in network industries.	The Competition Authority initiated an investigation of competition conditions in the energy sector in 2008.	More action needed.
Reduce the scope of public ownership. Facilitate the privatisation of national energy, telecommunications, transport and banking enterprises by removing barriers to foreign ownership.	Foreign ownership caps were raised and/or waived and privatisation tenders were opened to foreign investors in 2006, leading to the acquisition of controlling shares by foreign investors in telecommunications, oil refining and petro-chemical firms.	Planned privatisations should continue.

Table 3.A2.1. **Follow-up to OECD policy recommendations** *(cont.)*

Policy recommendations	Actions taken	OECD comments
Reduce administrative burdens on start-ups. Simplify regulatory requirements for small enterprises.	Regulations for registration and market entry of small enterprises were streamlined in 2006.	More action needed.
B) Specific recommendations in *Economic Surveys*		
	FISCAL POLICY	
Enhance the transparency and integrity of fiscal accounts by publishing up-to-date consolidated general government accounts, reclassifying all government expenditures into "programmes", implementing accrual based accounting at all government levels, ensuring that data reported by social security institutions and sub-national governments is complete, endowing the Turkish Court of Accounts (TCA) with legal and human resources to make it a credible scrutiniser of public finances.	Starting from 2009, components of general government accounts started to be published, but they are not yet consolidated. Central and local government accounts are published on accrual basis, retrospectively from 2006.	As planned, start to publish consolidated general government accounts according to national accounting standards, at quarterly and yearly frequency. Enact the new TCA Law which has already been adopted by the Plan and Budget Commission of Parliament.
Promote strategic budgeting by clarifying Turkey's spending priorities (notably in education, health and public infrastructure areas), by training public officials for strategic and result-oriented budgeting and setting multi-year performance objectives for key public services. Start *Spending Reviews* to assess performance.	By-laws and a guidebook on performance-based budgeting were updated in 2009. All general government administrations were provided training on performance based budgeting. 120 administrations prepared their 2010 budget proposals by including performance targets and indicators. "Spending Reviews" were initiated in areas such as "Home care for the disabled" and "Compensations for terror victims".	Pay special attention to performance in the most growth-sensitive areas such as education and infrastructure. Start *Spending Reviews* in these areas following successful experiences in the United Kingdom, the Netherlands and Canada.
Improve the quality and cost-efficiency of growth-supporting key public services by making use of international benchmarking, customer satisfaction surveys, employing highly-qualified and trained professionals and making greater use of Public-Private Partnerships (PPPs).	Accountability reports are published by all public administrations and sent to the Turkish Court of Accounts (TCA). Salary and wage levels of qualified personnel in the public sector were increased and public administrations were authorised to contractually hire information technology professionals. A draft Law on Providing some Investment and Services through Public Private Partnership Models is being prepared.	Explore further possibilities for making use of PPPs in telecommunications, energy, irrigation and transport, while taking full account of lessons from Turkey's own and other countries' experiences with PPPs.
Improve the structure of fiscal revenues by closing the most blatant tax loopholes, better enforcing direct and indirect taxes, enabling the Revenue Administration to cross-check taxpayers' income, expenditures and social security status, and gradually reducing tax expenditures.	A Large Taxpayers Unit was created in the Revenue Administration. A web-based information technology infrastructure connecting all tax offices was completed in 2009 and all concerned personnel received training for its utilisation. Work on preparing a consolidated tax declaration form for social security premia and income tax continues. Work on reviewing and simplifying tax laws also continues. Corporate Income Tax Law was re-written and the Personal Income Tax Law is being re-written. Other tax laws will be subsequently revised.	Work should continue on closing the most blatant tax loopholes.
	MONETARY POLICY	
Consolidate the inflation target as the nominal anchor in the economy by making it the main benchmark of social partners in price and wage determination, and use official inflation forecasts as the back-up anchor when there are deviations from the inflation target.	Since introducing the inflation targeting framework the Central Bank of the Republic of Turkey (CBRT) has been stressing the importance of the official target as the main nominal anchor in the economy. The CBRT uses a state-of-the-art model to construct inflation forecasts. Recent studies suggest that economic agents attach a significant weight on CBRT's inflation forecasts in forming their expectations. During the preparation of budget and the Medium Term Programme, CBRT's inflation target and forecasts are used (mainly in the determination of minimum wage, public sector wages and salaries, goods and services appropriations, agricultural support premiums, in addition to administered prices).	Consolidate CBRT's forecasts as the most technically credible forecasts available in the economy.

Table 3.A2.1. **Follow-up to OECD policy recommendations** *(cont.)*

Policy recommendations	Actions taken	OECD comments
Monitor price pressures in non-tradables such as housing, retail trade, transportation, energy (and other administered prices) which bear on inflation outcomes but are little affected by monetary policy, and advocate structural reforms to help contain these price pressures.	CBRT's Inflation Report monitors price pressures based on consumer price inflation, focusing on three subcomponents of goods: *i)* food, *ii)* energy, and *iii)* core goods. Service inflation, which covers most of the non-tradables, is reported for subcomponents: *i)* rents, *ii)* restaurant and hotels, and *iii)* transportation and other items. Service prices are further analysed in various subgroups, such as education, health, etc.	The CBRT should emphasise the most important structural and microeconomic reforms required to enhance price stability, improve inflation expectations, and reduce the output and employment costs of disinflation.
OVERCOMING THE DUALITY BETWEEN FORMAL AND INFORMAL SECTORS		
Facilitating formalisation with labour, capital and product market reforms		
Make formal labour markets flexible by aligning labour market regulations for both permanent and temporary contracts with OECD best practices, cutting employers' social security contributions, reducing the minimum wage in regions where productivity is lower, and permitting to set different minimum wages in the regions and enterprises where productivity is higher.	Social security contributions have been reduced by 5 percentage points in October 2008.	Make labour market reform the top structural policy priority of the government. Reduce the cost and rigidity of legal employment to foster job creation in the high productivity and human capital enriching modern business sector.
Develop formal capital markets by enhancing financial transparency in all enterprises, adopting the draft Commercial Code which prescribes audited accounts for all firms, and facilitating bank lending to small firms by achieving the planned transition to Basel II rules.	The draft Commercial Code is now in Parliament and support by all economic organisations and political parties is sought.	Once the draft Commercial Code is adopted, minimise small firms' compliance costs with compulsory audits and Basel II rules.
Expose product markets to further competition by formal firms by simplifying the many existing licensing rules, reinforcing the commercial justice system, minimising municipal authorisations for doing business, and implementing the EU liberalisation directives for network industries.	A Coordination Council for the Improvement of the Investment Environment (YOIKK) implements close co-operation between public and private sectors to improve the business climate. Several technical committees set priorities for easier market entry and product market competition, and monitor their implementation. A new Regulation on Opening a Business Place and Work License and its subsequent amendments have significantly simplified the licensing process, authorised declaration-based licensing, and streamlined the Environmental Impact Assessment requirements.	Carry on YOIKK activities as planned. Support managerial and technical know-how basis of new entrants through cost-effective, frequently evaluated training and technical extension programmes (notably through KOSGEB services in Organised Industrial Zones).
Supporting formalisation with social security reform		
Reduce the existing strong incentives for early retirement by reducing the social security benefits of those retiring before the normal retirement age (of 60 for men and 58 for women) in actuarially fair proportions, introducing a health insurance premium for pensioners, and accelerating the convergence of the official retirement age with the *de facto* informal-sector retirement age (65).	The social security reform was completed in 2008 after a demanding political process, and no such additional action are contemplated at present. Minimum retirement ages which will reach 58 for women and 60 for men in 2036 will continue to be increased gradually and reach 65 for both genders in 2048.	The low effective retirement ages represent a heavy burden for social security finances and provide additional incentives for informal employment of formal sector retirees. Increasing effective retirement ages should remain a policy objective.

Table 3.A2.1. **Follow-up to OECD policy recommendations** *(cont.)*

Policy recommendations	Actions taken	OECD comments
	Completing agricultural reform	
Pursue transition from "sheltered" to "competitive" agriculture by replacing product-specific subsidies with direct income support to farmers, promoting competition in all input markets and facilitating land consolidation, rationalising water utilisation with the help of cost-based water pricing and more active irrigation, and anticipating Turkey's liberalisation obligations in WTO and EU negotiations.	A new Law on Agriculture has provided the framework for agricultural support policies since 2006. It has institutionalised "area based" supports, including Direct Income Support (DIS) measures introduced since 2001. The share of DIS measures (that initially accounted for the majority of the support budget) was progressively reduced and complemented by area based measures. A new agricultural support strategy – aiming at aligning Turkey's agricultural policy with EU policies, increasing its competitiveness, and stabilising farm incomes – is being elaborated. Agricultural support payments will be differentiated across regions and products. Irrigation development and land consolidation efforts were accelerated, including in the framework of the South-Eastern Anatolia Project (GAP).	Further liberalise agricultural trade, in line with the anticipated commitments of member countries in the ongoing World Trade Organisation Doha Round.

1. Priorities identified in the 2005, 2007 and 2009 editions of *Going for Growth* (OECD, 2005, 2007, 2009a).

ANNEX 3.A3

Illustrative long-term growth scenarios

Despite the proliferation of the literature on economic growth, particular determinants of growth and their relative importance are still debated and their estimates remain uncertain (Temple, 1999; Sala-i-Martin, 2002; Wacziarg, 2002). The consensus has been reached however that certain economic policies and reforms do indeed boost nation's prosperity, making growth an endogenous process, and that policy recipes may differ across countries (Aghion and Howitt, 1998; Rodrik, 2007). Given inherent challenges with quantifying, even *ex post*, all the structural determinants of growth and with making growth projections, only two simple, illustrative scenarios of long-term growth are presented.

These scenarios are based on a standard decomposition of GDP growth, similar to the framework used in *Going for Growth* (OECD, 2009a). The focus here is to abstract from cyclical volatility. Potential output (GDPVTR) is decomposed into trend labour productivity per person in employment (TRPDTY) and potential total employment (ETPT), with the latter decomposed further into the trend labour force participation rate (LFPRS), working age population (POPT) and equilibrium unemployment rate (approximated by the non-accelerating inflation rate of unemployment - NAIRU).[1] In growth terms, denoted by Δ, the decomposition is given by:

$$\Delta GDPVTR = \Delta TRPDTY + \Delta ETPT$$
$$= \Delta TRPDTY + \Delta(1 - NAIRU/100) + \Delta LFPRS + \Delta POPT$$

To illustrate possible potential output growth in Turkey over the long term two stylised scenarios are presented (Table 3.A3.1 and Figure 3.A3.1). The first assumes the *status quo*, where the labour force participation rate and NAIRU remain at the current level and labour productivity grows at its average rate calculated over the past decade. In the second scenario, a gradual improvement in the three components of potential output is envisaged (Table 3.A3.1).[2] The resulting increase in GDP growth per capita can be almost treated as growth acceleration according to the definition of Hausmann *et al.* (2005), *i.e.* an acceleration of 2 or more percentage points for at least eight years. Working age population growth is taken to be exogenous and the same in two scenarios, and it is based on the UN demographic projections.

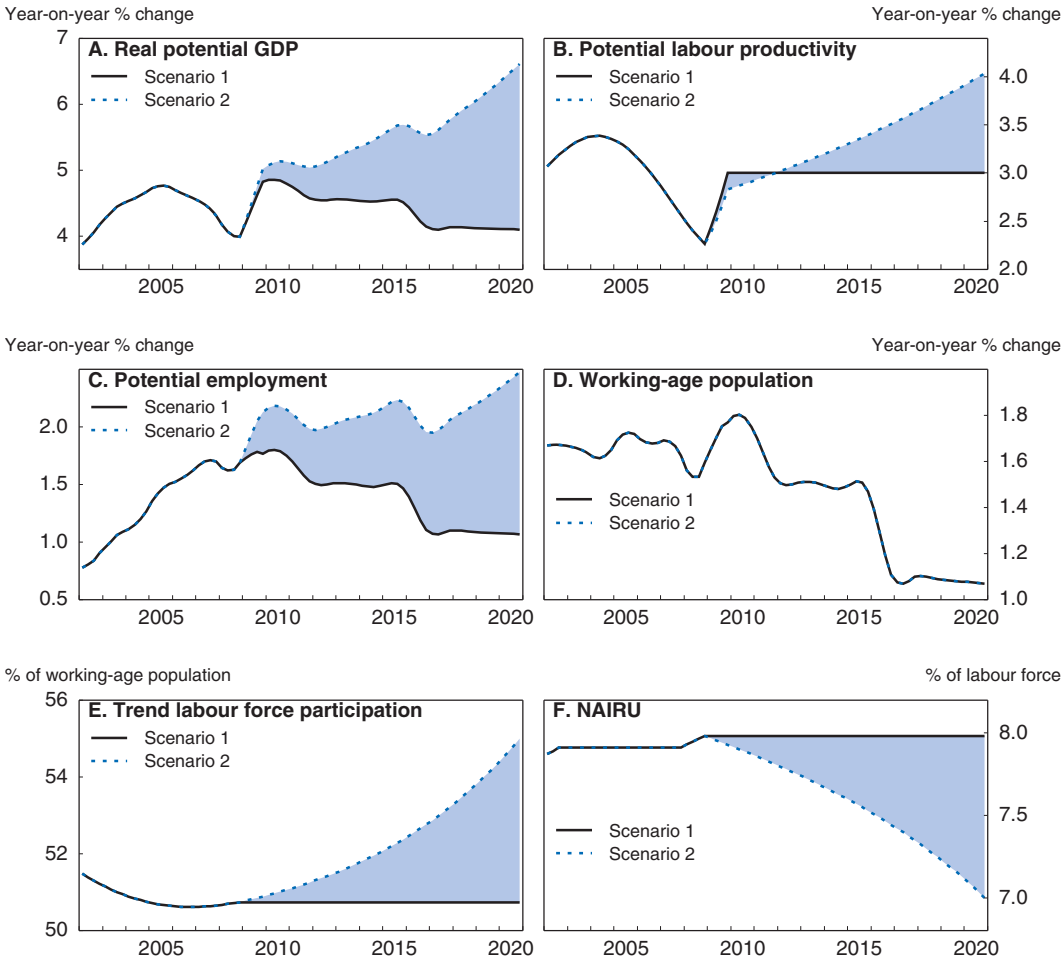
The assumed increase in productivity growth in the second scenario seems modest when compared with the full potential gains due to structural reforms. For instance, Conway *et al.* (2006) and Arnold *et al.* (2009) report that easing anti-competitive regulation in non-manufacturing sectors to the least restrictive in the OECD would increase annual

Table 3.A3.1. **Assumptions of GDP growth scenarios**

	Assumptions		Historic averages		Projected averages	
	Scenario 1 (*status quo*)	Scenario 2 (acceleration)	1998-2007	2003-2007	2009-2014[1]	2015-2020[1]
1. Trend labour productivity growth (TRPDTY)	3.0%	Gradually increases to 4.0%	2.9	3.1	3.0/3.0	3.0/3.7
2. Trend labour force participation rate (LFPRS)	Constant at 50.7%	Gradually increases to 56%	51.5	50.8	50.7/51.3	50.7/53.4
3. NAIRU	Constant at 8.0%	Gradually declines to 7.0%	7.8	7.9	8.0/7.8	8.0/7.3
4. Working-age population growth (POPT)	Gradually declines to 1%		1.8	1.7	1.6/1.6	1.2/1.2
5. Potential output growth (GDPVTR)	–	–	4.1	4.6	4.6/5.1	4.2/5.9
6. Growth in potential GDP per capita	–	–	2.7	3.2	3.4/3.9	3.2/4.9

1. The first number refers to the average for Scenario 1 and the second for Scenario 2.
Source: OECD and United Nations.

Figure 3.A3.1. **Long-term scenarios of potential output growth**



Note: Scenario 1 refers to the *status quo* scenario and Scenario 2 to the growth acceleration scenario.
Source: OECD calculations based on the *OECD Economic Outlook Database* and UN population data.

StatLink http://dx.doi.org/10.1787/888932322309

productivity growth on average by 0.8 percentage point over ten years. However, the effect is likely to be twice as big for less advanced and highly regulated countries, which seems to be more relevant for Turkey. Productivity growth could in addition increase thanks to improved education, stronger physical infrastructure, higher and more efficient R&D spending and higher ICT investment. Effects of these factors are frequently discussed in the literature but are not always adequately quantified.

The increase in labour force participation assumed in the second scenario is roughly equivalent to the situation where all people not seeking a job but available to work join the labour force by the end of the projection horizon.[3] Such an increase appears modest compared with the experience of some EU countries, which managed to increase the trend participation rate over the past decade by more than 5 percentage points. Higher labour participation would benefit from lowering the minimum wage for low-skilled workers, cutting the tax wedge, less restrictive employment protection legislation and from easing product market regulation. These reforms could also reduce the NAIRU. A decline of 1 percentage point, as assumed in the second scenario, is in line with the average fall in the NAIRU in the OECD countries over the past decade.

Notes

1. Trend variables are calculated using a Hodrick-Prescott filter.
2. No account is taken for a possible decline in potential output stemming from the 2008-09 recession.
3. Assuming that this group would grow in line with the working age population.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
PRINTED IN FRANCE
(10 2010 13 1 P) ISBN 978-92-64-08304-2 – No. 57445 2010

OECD Economic Surveys

TURKEY

SPECIAL FEATURE: INTEGRATION WITH THE GLOBAL CAPITAL MARKET

Most recent editions

Australia, October 2008
Austria, July 2009
Belgium, July 2009
Brazil, July 2009
Canada, September 2010
Chile, January 2010
China, February 2010
Czech Republic, April 2010
Denmark, November 2009
Estonia, April 2009
Euro area, January 2009
European Union, September 2009
Federal Republic of Yugoslavia, January 2003
Finland, April 2010
France, April 2009
Germany, March 2010
Greece, July 2009
Hungary, February 2010
Iceland, September 2009
India, October 2007
Indonesia, July 2008
Ireland, November 2009
Israel, January 2010
Italy, June 2009
Japan, September 2009
Korea, June 2010
Luxembourg, May 2010
Mexico, July 2009
Netherlands, June 2010
New Zealand, April 2009
Norway, March 2010
Poland, April 2010
Portugal, June 2008
Romania, October 2002
Russian Federation, July 2009
Slovak Republic, February 2009
Slovenia, July 2009
South Africa, July 2010
Spain, November 2008
Sweden, December 2008
Switzerland, December 2009
Turkey, September 2010
Ukraine, September 2007
United Kingdom, June 2009
United States, September 2010

Subscribers to this printed periodical are entitled to free online access. If you do not yet have online access via your institution's network contact your librarian or, if you subscribe personally, send an e-mail to **SourceOECD@oecd.org**.

Volume 2010/13
September 2010

ISSN 0376-6438
2010 SUBSCRIPTION
(18 ISSUES)

OECD*publishing*
www.oecd.org/publishing

ISBN 978-92-64-08304-2
10 2010 13 1 P

