TURKEY

Highlights

- **The economy grew by 4.0 per cent in 2015.** Growth was driven by private consumption, on the back of frontloading of imports consumption, a large refugee influx and stronger government transfers. The currency weakened against the dollar by 25 per cent in 2015, and by 12 per cent against the euro.
- **The government has announced a new action plan to reinvigorate growth.** The plan aims to improve the business environment and revive the structural reform agenda. The implementation of structural reforms is ongoing, albeit in some segments slower than initially expected.
- **Improvements continued in the energy sector.** Amendments to regulations were made to ensure better compliance with licensing requirements and efficient pricing. The government has also submitted to the United Nations its plan for a significant reduction in greenhouse gas (GHG) emissions by 2030.

Key priorities for 2017

- **Further improvements are needed in infrastructure.** Secondary legislation to allow for private companies to operate on the existing railway network has been published, but implementation remains to be seen. While several large-scale public transport and infrastructure projects are on target, the privatisation of highways and bridge crossings remains slow. And despite a good track record of public-private partnership (PPP) deals, Turkey still lacks a single and overarching PPP law.
- **Capital markets should be developed further.** Steps should be taken to increase the low domestic savings rate, expand the small institutional investor base, enhance limited foreign participation in the corporate bond market, ensure efficient intermediation of long-term funds and identify a market-relevant floating-rate benchmark.
- **Enhancing inclusion remains challenging.** Regional, youth and gender inclusion should be improved for a more inclusive growth. While a large population of 2.7 million Syrian refugees created additional pressure on labour markets, with employment of Syrian refugees taking place mostly in the informal sectors, their integration into the economy is important for sustainable progress.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	2.1	4.2	3.0	4.0	3.0
Inflation (average)	8.9	7.5	8.9	7.7	7.5
Government balance/GDP	-1.7	-1.3	-0.9	-1.0	-1.9
Current account balance/GDP	-6.1	-7.7	-5.5	-4.5	-4.4
Net FDI/GDP (neg. sign = inflows)	-1.2	-1.1	-0.7	-1.6	-1.4
External debt/GDP	43.1	47.4	50.4	55.4	n.a.
Gross reserves/GDP	15.1	15.9	15.9	15.4	n.a.
Credit to private sector/GDP	57.9	70.1	74.6	80.0	n.a.

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Macroeconomic performance

The economy grew by 4.0 per cent in 2015, on the back of strong domestic demand. Private consumption increased due to frontloading of imports (to avoid pass-through of currency weakening to their prices), the large refugee influx and their spending, and somewhat stronger government transfers. The contribution of net exports to growth remained negative amid rising tensions in the Middle East and Russian sanctions imposed towards the end of 2015. Economic growth stood at 3.9 per cent year-on-year in the first half of 2016, with the positive effects of a 30.0 per cent hike in the minimum wage in January 2016 and higher government spending, being offset by a sharp fall in tourism receipts (following terrorist incidents in early 2016). Meanwhile, inflation remained high at 7.3 per cent in September 2016, above the central bank's target of 5.0 per cent for the fifth consecutive year.

Currency volatility remained high throughout 2015. The lira weakened against the dollar by a cumulative 25 per cent year-on-year in 2015, on the back of expected monetary tightening in the US, diverging monetary policies between the Federal Reserve Bank and the European Central Bank, worsening investor sentiment towards emerging markets, and elevated regional and domestic political uncertainty following the inconclusive June 2015 parliamentary elections. The weakening versus the euro was 12 per cent, implying limited improvement in trade competitiveness. Volatility in the financial markets recurred in the aftermath of the failed coup in July 2016.

The large external imbalance is still a major vulnerability, but public finances and banks remained stable. The current account deficit eased to 4.3 per cent of rolling GDP in August 2016, from 5.7 per cent at the end of 2014, mostly due to a declining energy import bill, on the back of lower oil prices. However, gross external financing needs are estimated at around 25 per cent of GDP in 2016, leaving the country exposed to global liquidity conditions. Meanwhile, public finances remain strong: with public debt standing slightly below 35 per cent of rolling GDP and the budget deficit standing at 0.9 per cent of GDP in August 2016. The banking sector remained stable, with low, albeit-rising, non-performing loans (3.3 per cent in August 2016) and comfortable capitalisation. However, banks' increasing reliance on external foreign currency funding leaves the sector exposed to global liquidity shocks.

Growth is expected to moderate to around 3.0 per cent in 2016 and 2017. In 2016 and 2017, the positive effects of macro-prudential measures and some recovery in tourism receipts in 2017 will be more than offset by lower private investments on the back of the rising cost of production, due to the higher wage bill; a higher cost of funding due to rating downgrades; and slightly higher oil prices. Key risks for the growth outlook stem from a larger than expected rise in oil prices, interruption to the renewed structural reform efforts, a larger than expected capital outflow due to the rating downgrade, or deterioration of regional tensions. However, the political consensus on structural reforms, if preserved, would help ease some of these risks.

Major structural reform developments

The government has announced a new action plan to reinvigorate growth. The new plan, announced in early December 2015, is a combination of election promises and structural reforms, and is aimed at improving the business environment and growth. Reinvigorating the stalled structural reforms is key to achieving long-term potential growth of around 4 per cent, but costs associated with subsidies and wage hikes, as part of election promises, might jeopardise the fiscal discipline in the longer run. While most of the election promises were already realised in the first quarter of 2016, implementation of structural reforms is ongoing, albeit at a slower pace than initially anticipated. Preserving the political consensus, achieved in the aftermath of the failed coup in July 2016, would help quicken the successful implementation of the structural reform agenda.

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Reforms in the energy sector have continued. Following the amendments to the Unlicensed Generation Regulation in March 2016, any unlicensed generator within the same region can only be allocated a maximum of one megawatt capacity of wind and solar power plants. This should lead to improved compliance with the licensing requirements. An amendment to the Electricity Market Law, passed in June 2016, ensures that winners of auctions for electricity generation on renewable energy resource areas will be determined based on the lowest offer for the electricity sale price. While this allows for welfare gains, it may dent the viability of business opportunities if there is aggressive bidding by electricity generators. While privatisation of hydroelectric power plants continued in 2016, challenges remain in the gas market, such as achieving supply security and increasing private sector participation. Meanwhile, the Turkish government submitted to the UN Framework Convention on Climate Change (UNFCCC) its Intended Nationally Determined Contribution (INDC) in September 2015, ahead of the 2015 Paris Summit (COP 21), for a 21 per cent reduction in greenhouse gas emissions from the business-as-usual level by 2030.

Despite improvements, challenges remain in infrastructure. The Turkish State Railways was reorganised in 2013 and the Directorate General of Railway Regulation was later established to ensure sustainable operations in the sector. In August 2016, the secondary legislation that would allow for private companies to operate on the existing railway network was published but successful implementation remains to be seen. Privatisation of highways and bridge crossings is still slow, although several large-scale public transport and infrastructure projects remain on target. Despite a good track record of public-private partnership (PPP) deals, Turkey lacks a single PPP law, hampering a coordinated approach across all sectors and limiting the extent of possible PPP types. Work has been carried out in the Ministry of Health to build capacity for supporting efforts to design the methodology for value-for-money assessments for future PPP projects and two new units, dedicated to investment model and operation planning, have been established.

Pressures in the labour market have intensified as a result of the refugee crisis. A large population of 2.7 million Syrian refugees has created pressures on labour markets, as they remain mostly employed in the informal sectors. Efforts are being made to integrate Syrian refugees into the labour market; a new regulation on work permits was issued in January 2016, which allows companies to formally hire Syrian workers, albeit with a strict requirement that their share in total employee number does not exceed 10 per cent.

Efforts to improve the banking sector successfully continued. Turkish banking legislation is fully compliant with Basel III risk-based capital and liquidity coverage requirements as of March 2016. This follows Turkey's joining the Basel Committee's Regulatory Consistency Assessment Programme (RCAP) in September 2015 and amendments to secondary regulations in the banking sector between October 2015 and February 2016. In February 2016, the Banking Regulatory and Supervision Agency issued a regulation to determine systemically important banks and to impose additional core capital requirements for these banks depending on their system-wide importance. However, there is a transitional period until 2019.

Improvements to the capital market have been made, but challenges remain. Following the strategic cooperation agreement of Borsa Istanbul with NASDAQ in 2014 to operate all markets under a single trading platform (BISTECH), Borsa Istanbul issued a listing directive in November 2015, to improve its operations. As of March 2016, asset management companies are required to set up an internal control mechanism to conduct operations more efficiently. The Capital Markets Board issued a draft amendment in November 2015 to increase the financial strength of issuers, but the draft is not enacted yet. However, the low domestic savings rate, small institutional investor base, limited foreign participation in the corporate bond market, and lack of efficient intermediation of long-term funds remain the main issues for further development.