

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 indispensable 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

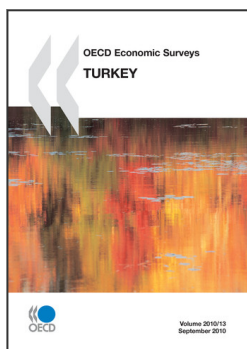
Although remaining barriers in product markets are less binding than in the labour markets, further relaxing anti-competitive product market regulations would stimulate productivity growth and put pressure on labour markets to be more flexible. In the light of OECD's analyses of Turkey's product market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



From:
OECD Economic Surveys: Turkey 2010

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-tur-2010-en

Please cite this chapter as:

OECD (2010), "Assessment and recommendations", in *OECD Economic Surveys: Turkey 2010*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-tur-2010-3-en

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