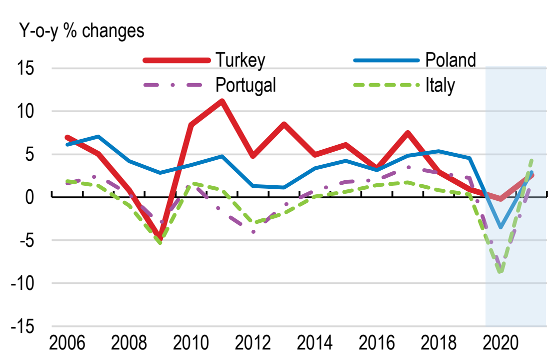
Executive Summary

The recovery from the first wave of the pandemic was strong but faced headwinds

The impact of the pandemic on economic activity unfolded later than in other countries in the region, but was sharp. Turkey managed to contain the number of COVID-19 cases relatively effectively in the first phase of the outbreak, thanks to a strong intensive care infrastructure and targeted lockdowns. Cases however surged again after the easing of containment measures in June and continued to increase sharply in Fall. Employment and aggregate demand contracted strongly in the first wave, then rebounded following vigorous government support. However, they are again facing headwinds. Tourism and hospitality sectors, which generate high demand for other products and services and provide employment across many regions, are particularly affected. The authorities have provided ample quasi-fiscal support to safeguard corporate liquidity, employment and incomes of households. The Central Bank flanked these measures with a more expansionary monetary stance and financial policies promoted massive credit expansion. The government began to scale down these measures after an increase in the current account deficit and inflation, a weakening in investor confidence and a sharp exchange rate depreciation between July and October.

Figure 1. The short-term recovery was sharp

Real GDP



Source: OECD Economic Outlook: Statistics and Projections (database).

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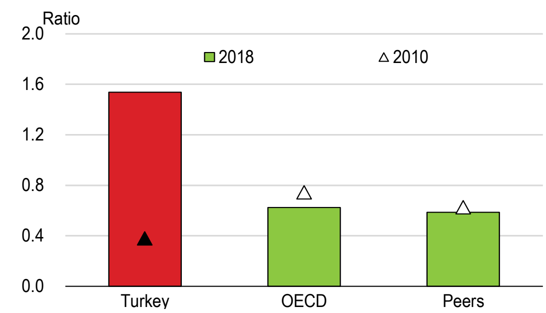
Given Turkey's relatively modest social safety nets and elevated corporate debt, a full recovery from the COVID-19 crisis is expected to take time. The high leverage reflects a build-up of corporate debt since 2010, exacerbated by the increased value of foreign currency denominated debts following depreciation episodes of the Turkish Lira. Businesses started to deleverage after the financial turmoil of 2018, but the pandemic will further impair the health of corporate balance sheets.

Figure 2. Recovery prospects are complicated by high debt burdens

Debt-to-equity ratio, non-financial corporations



Note: Debt-to-equity ratio is calculated as the sum of debt securities (LF3) and loans (LF4) over shares and other equity (LF5) of incorporated non-financial corporations based on non-consolidated data. Peer countries refer to the Czech Republic, Chile, Italy, Mexico, Poland, Portugal, and Spain. OECD and peer country averages are unweighted.
Source: OECD (2020), OECD Annual National Accounts Statistics (database), Table 720 – Financial Balance Sheets.

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Table 1. The upturn will be gradual

(Annual growth rates, %, unless specified)

	2019	2020	2021	2022
Gross domestic product	0.9	-0.2	2.6	3.5
Private consumption	1.6	0.8	3.9	5.7
Government consumption	4.3	2.7	2.1	0.1
Gross fixed capital formation	-12.4	5.6	2.6	3.8
Exports	4.9	-19.1	7.6	7.4
Imports	-5.3	7.7	9.3	8.8
Unemployment rate (%)	13.7	13.2	13.7	14.5
Consumer price index[1]	15.2	12.2	12.0	10.0
Current account balance (% of GDP)	1.2	-4.7	-4.6	-4.8

1. Based on yearly average.
Source: OECD (2020), OECD Economic Outlook: Statistics and Projections (database).

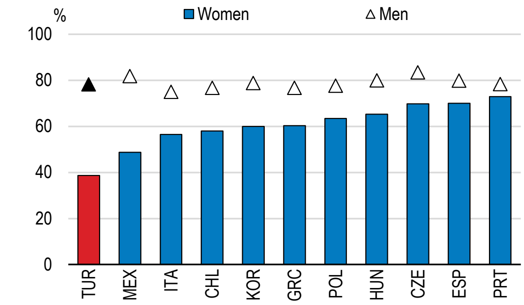
Turkey went into the COVID-19 crisis with sound public finances but extensive off-balance sheet commitments. This resulted from massive government stimulus in 2019 and 2020 and came mainly in the form of government credit guarantees and through lending by public banks. In particular, concessional credits by public banks to households and businesses during the pandemic has increased the share of quasi-fiscal expenditures and amplified contingent liabilities for public finances. Addressing weak fiscal transparency by publishing a regular Fiscal Policy Report encompassing all contincent liabilities would help to improve confidence on financial markets, increasing room for fiscal manoeuvre.

The pandemic amplified monetary policy challenges. Inflation is high and has long been stuck well above the official target of 5%. Actual and expected inflation rose after the COVID-19 shock. Monetary policy interventions related to the pandemic supported economic activity, the exchange rate and liquidity of banks. They also added to concerns whether monetary policy prioritises growth and employment over price stability. Faced with massive capital outflows and a sharp exchange rate depreciation, the Central Bank started to tighten liquidity in August, increased the policy interest rate in late September, the effective funding rate in October, and, as this proved insufficient, again the policy rate in November. It also normalised its policy framework. Foreign reserves remained nevertheless low and risk premia high.

The pandemic exacerbated structural challenges related to high unemployment, low labour force participation and widespread informality. The crisis has hit the informal sector workers and the self-employed the hardest because they are concentrated in labour- and contact-intensive activities where physical distancing is hard to apply. They are also excluded from employment-related social safety nets. While there has been progress in creating quality jobs over the past 15 years, bringing with it major gains in well-being, challenges have remained. The number of jobs decreased strongly after both the 2018 financial turmoil and the COVID-19 shock. Labour force participation, in particular by women, is still very low. High legal employment costs, including one of the OECD's highest minimum-to median-wage ratios and some of the most restrictive permanent and temporary employment regulations, and an expensive severance system, foster informality. They impede a more efficient allocation of resources towards the relatively narrow but gradually growing share of fully formal firms and higher technology start-ups.

Figure 3. Labour force participation is low

15-64 year-olds, 2019



Source: OECD (2020), OECD Labour Force Statistics (database).

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Reducing greenhouse gas emissions and local air pollution, as well as preserving land and coastal resources are pressing issues. Greenhouse gas emissions increased at the fastest pace of the OECD in the past decade. Poor air quality is a major concern, in particular in large cities. Turkey, with its distinct natural assets, should seize the opportunity to make green recovery measures a more important part of its stimulus packages .

Turkey's position in international governance benchmarks displays major room for progress. Reinforcing the governance environment, as envisaged in the 2019-23 National Development Plan, requires improvements regarding rule of law, public integrity and judicial credibility. Turkey should catch-up with international standards on the fight against corruption, such as bribery, money laundering and terrorism financing. Progress in fighting corruption would also constitute the necessary base for other policies to work more effectively.

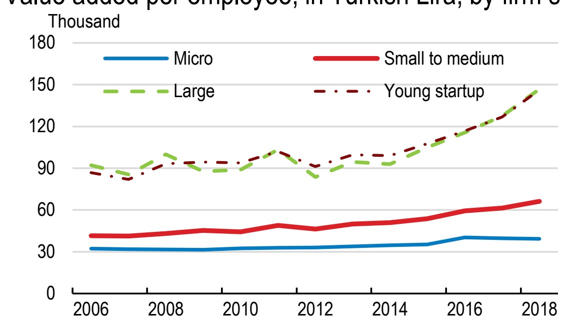
Structural reforms are key to recovery and raising well-being

The entrepreneurial vigour of the economy is remarkable even under difficult macroeconomic conditions and regional geo-political tensions. However, only a minority of firms create high quality jobs in best practice business organisations. The majority of small-and-medium sized businesses draw on informal or semi-formal employment, management and legal and administrative (including tax) compliance practices. Structural reforms to allow more flexibility in labour markets, more competition in product markets and major progress with the quality of governance would help to unleash Turkey's full potential by improving productivity, job creation and fostering digital transformation. There is also room for more trade opening in agriculture, services and public procurement. Macroeconometric simulations for this Survey found that a package of reforms could lift Turkey's GDP per capita level by more than 10% over 10 years as compared to a scenario with no policy changes.

Rigid labour market rules impose high costs on fully formal firms. Reducing the large non-wage labour costs, making statutory minimum wages affordable for lower productivity firms, and modernising labour regulations and social protections for permanent and temporary workers are particularly important in present circumstances. They would ease job creation in the formal sector. More recourse to bargaining at enterprise-level (along regional and firm conditions rather than one-size-fits-all national legislation) would help all firms, including the lower productivity ones, to comply with law, escape informality and access the know-how, labour and capital resources of domestic and global markets.

Figure 4. The productivity gap between small and large firms has increased over time

Value added per employee, in Turkish Lira, by firm size



Source: The Central Bank of the Republic of Turkey.

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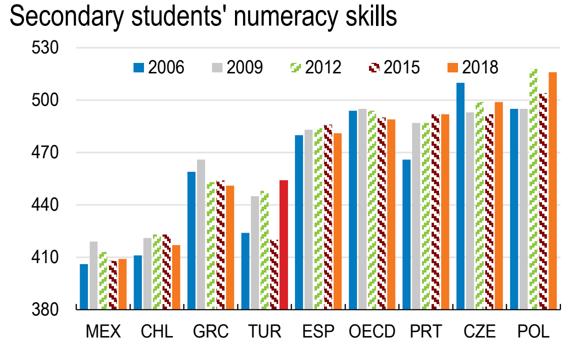
The pandemic amplified financial pressures on the productive sector, which was already strained by the 2018 shock. Some firms, which were already over-leveraged before the COVID-19 shock, now face debt overhang. Fundamentally viable firms should be supported, to the extent possible in non-debt-creating ways. At the same time, as in other OECD countries, the insolvency system is expected to face a wave of restructurings after the Covid shock. It started to be reformed with a framework agreement on financial restructurings, and more flexible arbitration and mediation rules. However, implementation lagged and the system remains costly, slow and has a low recovery rate. The eco-system of bad loan management, asset reallocations, equity investing and long-term investment financing will steer broad-based restructurings in the period ahead. Its performance will affect the future strength and productivity of the business sector.

Turkish firms lag behind in the adoption of advanced digital technologies and thus forego large dividends from digitalisation. Shortcomings in digital skills and limited access to fast broadband have formed bottlenecks to a more widespread adoption of the most advanced ICT tools and activities. There is also a digital divide between large and small firms and across socio-economic groups. During the COVID-19 shock, recourse to teleworking and other digital applications accelerated - despite Turkey's economic structure being less prone to these transformations. Strengthening vocational education and adult learning in digital areas would help the productive sector better tap the potential of technological change. Streamlining problem-solving skills in education would improve the related capacities of students, especially among girls and of students from socioeconomically disadvantaged backgrounds.

Figure 5. Educational outcomes need to be upgraded

Secondary students' numeracy skills



Note: Data refer to mean PISA score in mathematics.
Source: OECD PISA databases.

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The skills of the population should be improved more generally. There is a notable fringe of international-quality professionals in technical and management roles, and important progress was achieved in secondary and tertiary enrolments. Still, despite progress in OECD PISA test results, the average quality of education falls significantly behind. The heterogeneity of vocational education programmes and of academic degrees constitute a major challenge. Performance-based public spending, as prescribed by the well-designed but not fully implemented 2005 Public Financial Management and Control Law should be implemented in priority in education.

MAIN FINDINGS	KEY RECOMMENDATIONS
Social and economic support against the COVID-19 shock	
There are many firms and workers in temporarily affected but otherwise viable activities. Firms in tourism, hospitality and entertainment sectors are particularly affected.	Continue to support workers and fundamentally sound firms in temporarily affected activities.
Vulnerable households were supported with concessional loans and liability deferrals but are now heavily indebted.	Replace the concessional loans and the one-off transfer to households at risk of poverty into a targeted allowance for a limited period.
The youth unemployment has reached 25% and may increase further.	Grant an across-the-board employer and employee social security contribution exemption to all young workers (15-24) for a temporary period. Continue to strengthen vocational education.
Macroeconomic policy for a sustainable recovery	
COVID-19 government support measures have been excessively centred on quasi-fiscal channels. The authorities announced an intention to tighten fiscal policy in 2021.	Use the room available in public finances for transparent, temporary and targeted direct fiscal supports and resume fiscal tightening once the recovery is firmly underway.
Although the official public debt ratio is comparatively low, the potential cost of contingent liabilities which result from quasi-fiscal measures put upward risks on debt sustainability.	Outline and communicate a coherent macroeconomic policy framework encompassing fiscal, quasi-fiscal, monetary and financial policies. Publish a regular Fiscal Policy Report making transparent and projecting all public financial liabilities.
Inflation remains persistently above target and there are market uncertainties. on the actual degree of independance and the objective function of the central bank. Certain legislative measures reduced its managerial independence.	Restore the independence of the central bank, including with legislative measures. Maintain the real policy interest rate in positive territory as long as inflation and inflation expectations diverge from official projections and targets.
Foreign reserves are too low. They are reported according to international standards but there is market demand for more detailed net reserve gauges.	Replenish foreign reserves as conditions allow. Communicate actively on the foreign reserve position according to the information needs of financial markets.
Government-owned financial institutions and capital allocation regulations have considerably expanded in the financial and banking system. The two main regulations (the asset ratio and the selective differentiation of required reserves) are being phased out.	Re-evaluate and reduce the weight of government-owned financial institutions. Maintain a neutral framework for banks' credit allocation decisions.
Turkish banks are well-capitalized but the rapid increase of business and household debt during the pandemic may undermine loan quality.	The authorities should communicate on how they evaluate and address the risks of deterioration in banks' asset quality. The results of the stress tests of individual banks and of the banking system as a whole should be disclosed to the public.
Unleashing the potential of the business sector and improving job quality	
Some non-financial firms, which were already over-leveraged before the COVID-19 shock, will face debt overhang .	Encourage new equity injections and the re-capitalisation of non-financial firms in order to restore their investment capacity after the COVID-19 shock. Remove any remaining obstacles to their upscaling
Despite recent reforms, the capacity of the insolvency system may not suffice to deal with a large wave of COVID-19 induced insolvencies.	Implement the recently introduced arbitration, mediation and framework agreement measures for financial restructurings . Be prepared to phase in additional measures to help courts to deal with insolvencies in case of need.
There is room for further trade liberalisation in agriculture, services and public procurement in the context of the Customs Union with the EU. Additional custom fees were introduced temporarily in many goods markets after the pandemic. .	Make progress, in collaboration with EU partners, with the extension of the Customs Union agreement to agriculture, services and public procurement. Roll-back the temporary trade protection measures as planned.
Despite progress in recent years, the labour force participation of women remains low in international comparison.	Continue to facilitate labour force participation of women, including by increasing the provision and quality of early child education.
High employment costs and rigid employment rules are the principal economic cause of massive informality and semi-formality.	Make fixed-term and temporary work contracts more flexible and the severance compensation system less costly.
The level of gross domestic spending on R&D per GDP remains low.	Consider conducting an in-depth review of incentives to R&D to further boost R&D investment of businesses while ensuring a level-playing field for competition.
Institutional modernisation and green growth	
Turkey fell considerably behind in the perceived quality of governance institutions and rule-of-law. This amplifies risk premia and refinancing costs and discourages foreign direct investment.	Improve the quality of governance institutions and rule-of-law, with special focus on the independence and credibility of the judiciary, checks-and-balances over government powers, and a strategy of fight against corruption.

Greenhouse gas emissions grew fast over the past decade. They are projected to more than double from 2015 to 2030 but Turkey has pledged to reduce their business-as-usual level by up to 21% in 2030.	Implement a carbon pricing policy, applicable gradually after the COVID-19 shock and encompassing all sectors.
Urban populations are exposed to high levels of particulate matter, emitted principally by road transport, power generation and heating.	Prepare and publish daily local air quality indicators according to international standards in the entire territory. Develop a holistic strategy to improve air quality.
There is further potential for environmental performance-enhancing investments in public infrastructures and in the business sector.	Consider tax reliefs for energy-saving investments in the building sector. Continue to prepare the business sector to the introduction of border carbon taxes by trade partners.

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