Executive summary

Growth is strong and living conditions have improved amid imbalances

- *The Turkish economy has grown very fast in the past two years despite adverse shocks*
- *Sustained job creation outside agriculture, which accelerated in the 2010s, has improved well-being, notably in less-developed regions*

Macroeconomic policies have become pro-cyclical

- *Macroeconomic policies have been strongly expansionary since the coup attempt in mid-2016*

Business sector modernisation is key to rebalance the economy and improve social cohesion

- *Rebalancing the economy, while keeping up growth, calls for improved export performance*
- *Large numbers of successful medium-sized firms have emerged*

Formalisation, digitalisation and deleveraging are key to improve firm performance

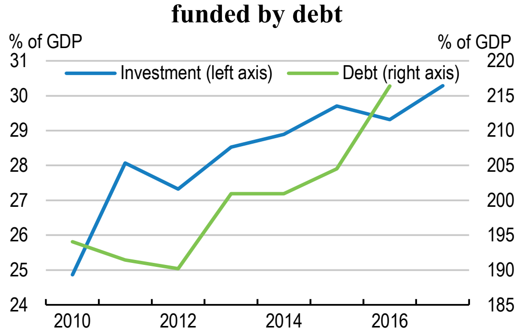
- *The government has committed to bringing Turkey's framework for doing business closer to international good practice*

Comprehensive education, governance and regulatory reforms would foster domestic convergence and social cohesion

Growth is strong and living conditions have improved amid imbalances

The Turkish economy has grown very fast in the past two years despite adverse shocks. This performance has been driven by policy stimulus and a dynamic, well-diversified but fragmented business sector. However, the current account imbalance arising from excessive reliance on domestic demand and external savings amplifies foreign financing needs, pushes up risk premia and increases vulnerability to external shocks. Overall investment has been strong, but it is overly funded by debt, raising questions about its quality and allocation (Figure A). At the same time, inflation remains far above target, undermining the credibility of monetary policy. Moreover, questions about the quality of public governance and departures from the cautious Medium-Term Programme 2018-20, sharp exchange rate depreciation and uncertainties on the future orientation of economic policies have added to perceived risk. Prudent and transparent fiscal and monetary policies are warranted to uphold confidence in this fragile environment.

Figure A. Investment is dynamic but increasingly funded by debt



Note: SNA debt definition using consolidated accounts.
Source: OECD (2018), OECD Economic Outlook and OECD Financial Accounts (databases).
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Sustained job creation outside agriculture, which accelerated in the 2010s, has improved well-being, notably in less-developed regions. The low-educated and previously inactive women have benefitted most. Material living conditions have improved faster than other dimensions of quality of life, such as work-life balance, environmental quality and subjective well-being. Important well-being inequalities endure between socio-economic groups, genders and regions. They arise from large gaps in the education, skills and earning capacity of individuals, as well as from substantial differences in the quality of infrastructure and in the productivity of firms in a deeply fragmented business sector. The presence of nearly 4 million refugees (around 5% of the total population) magnifies social inclusion challenges.

Table A. Real GDP growth is fast but inflation is high
Per cent change unless noted

	2017	2018	2019
Gross domestic product [1]	7.4	5.1	4.8
Private consumption	6.1	9.0	6.7
Gross fixed capital formation	7.3	9.3	7.2
Exports	12.0	8.1	9.9
Imports	10.1	5.7	5.0
Unemployment rate	10.9	10.2	10.4
Core consumer prices	10.1	13.0	10.5
Current account (% of GDP)	-5.6	-5.7	-4.3

1. Working-day adjusted.
Source: OECD Secretariat projections.

Macroeconomic policies have become pro-cyclical

Macroeconomic policies have been strongly expansionary since the coup attempt in mid-2016. Government spending rose considerably and a series of new consumption, investment and employment incentives have been granted. The government has also scaled up loan guarantees, which are now among the highest in the OECD as a share of GDP. The Medium-Term Programme 2018-20 foresees fiscal restraint, but policy was strongly pro-cyclical before the early presidential and legislative elections in June 2018. In response to drifting inflation expectations and episodes of sharp currency depreciation, the central bank tightened its effective funding rate by 500 basis points over April-June 2018 and delivered the long-expected normalisation of monetary policy around a standard policy rate. Fully restoring the credibility of monetary policy requires the commitment of all stakeholders to central bank independence and to the inflation target. Absent any shocks to household, business and international confidence, GDP growth is projected to slow but to stay around 5% in 2018-19 (Table A).

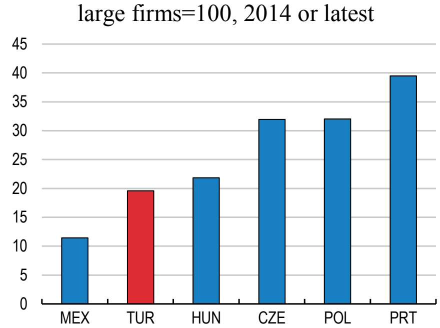
Business sector modernisation is key to rebalance the economy and improve social cohesion

Rebalancing the economy, while keeping up growth, calls for improved export performance. This requires productivity and competitiveness gains in the business sector. Turkish firms have successfully diversified into new sectors and export markets over the past decade but their relatively thin human capital base and very fragmented structure hold back further progress (Figure B).

Large numbers of successful medium-sized firms have emerged between low-productivity small informal businesses and state-of-the-art modern corporations. They have contributed importantly to the development of less advanced regions. However, their continued expansion requires stronger managerial and technical skills and additional investment capacity. The regulatory setting for enterprises remains more burdensome than in other catching-up OECD countries despite reform efforts, inflating the cost of operating formal rather than informal businesses and accounting for much of the current fragmentation (Figure B).

Figure B. Productivity gaps between different types of firms are very large

Labour productivity of small firms relative to large firms, large firms=100, 2014 or latest



Note: Small (large) firms are those employing less than 10 (more than 250) persons.
Source: OECD, Entrepreneurship at a Glance 2017.

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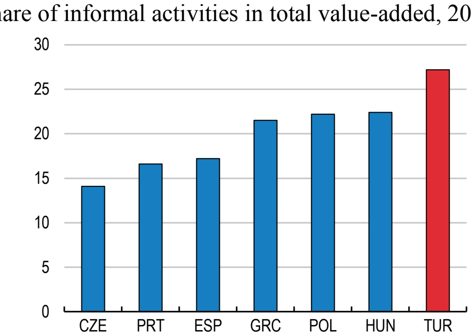
Formalisation, digitalisation and deleveraging are key to improve firm performance

The government has committed to bringing Turkey's framework for doing business closer to international good practice. This policy reinvigorates an earlier ambition which had fallen by the wayside in recent years. This Survey underlines three synergetic priorities:

i) **Informal and semi-formal firms should be incentivised to operate in compliance with laws and regulations.** This requires better adapted minimum wage, social security and tax provisions along international good practices. Regulatory forbearance should be avoided and full financial transparency vis-à-vis business partners and creditors should be secured. The provision of quality training programmes for their managers and workers to re-skill and up-skill would enable many of these firms to achieve steady productivity gains (Figure C).

Figure C. Informality has declined but continues to obstruct progress

Share of informal activities in total value-added, 2017, %



Source: Medina and Schneider, "Shadow Economies Around the World, 2018.

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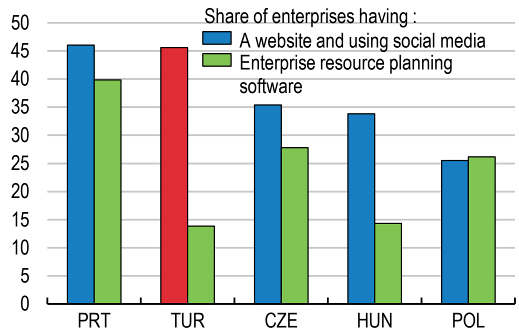
ii) **Turkey's firms show active interest in digital media and communications, but fall behind in core applications** (Figure D). Ongoing digital innovations become accessible to firms of all types and sizes, with increasing benefits and decreasing costs. Interfaces with the government and tax authorities on the one hand (e-government and e-taxation), and with business, global value chain and financial market partners on the other hand, are becoming more fluid and less costly. New policy initiatives aim at accelerating digital innovations. Both internal and external transformations require more professional management, additional worker skills, and further investment. State-of-the art digital upskilling programmes can support these transitions.

Figure D. Digitalisation advances but core applications fall behind

2017, % of all enterprises



Source: Eurostat (2017), The Digital Economy and Society Index.

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iii) **Turkish firms have accumulated excessive debt over the past decade.** Leverage is higher than in other catching-up countries. Evidence suggests that easier access to debt improved productive capital formation in Turkey over the past decade, but excessive leverage is now curbing additional investments. The most productive and highest-growth firms, including in the regions that are catching up, are the most leveraged, suggesting that non-debt financing alternatives would relax constraints on their growth.

While debt has steadily risen, profitability and internal saving rates have declined in many firms. Young ones, particularly R&D-intensive firms in high-technology sectors, appear to have higher needs for external funding. Given the more immaterial composition of their assets, and their already high debt levels, their future investments and development will largely depend on their access to external equity sources.

Beyond young firms, the access by profitable, but debt-constrained medium-sized family-owned firms to outside equity sources is equally crucial – and problematic. These firms are generally not fully formal and may refrain from full financial transparency and independent monitoring, perpetuating the standard information asymmetries which hinder outside equity participation. Global institutional investors and FDI firms also face risks arising from the gap between local and international governance standards. In particular, state aid transparency falls short of national legal requirements for the monitoring and control of state aid, hinting at a risk of a non-level playing field, especially between large investment projects. The fight against corruption should also be strengthened to back open competition.

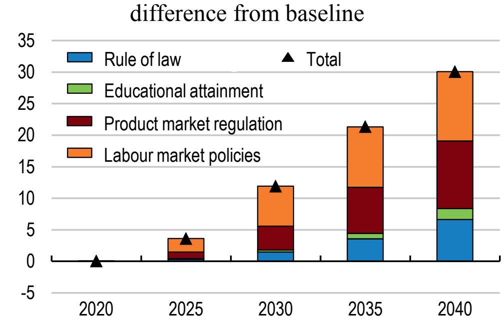
Freeing up equity participation in firms of all types, sizes and regions requires a supportive ecosystem. This includes legal and regulatory provisions, business practices and local professional expertise that Turkey largely lacks. One important component is equity-friendly corporate tax arrangements. There is also room to make public support to knowledge-based capital formation more efficient.

Comprehensive education, governance and regulatory reforms would foster domestic convergence and social cohesion

Furthering the modernisation of the business sector by accelerating the formalisation, digitalisation and re-capitalisation of firms of all types should be part of a long-term development and growth strategy. OECD research on long-term growth drivers highlights the importance of catching up with OECD good practices in the fundamental areas of i) education and human capital; ii) governance and rule of law; and iii) product, labour and capital market regulatory frameworks. Reforms in these areas would deliver very substantial growth and social cohesion benefits in Turkey (Figure E).

Figure E. Growth prospects hinge on reforms

Projected gains in real GDP per capita from gradual convergence with OECD good practices, % difference from baseline



Source: Estimations based on "OECD Long-term Scenarios for the World Economy" database.

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MAIN FINDINGS	KEY RECOMMENDATIONS
Strengthening fundamentals	
Confidence in public governance and the rule of law has weakened, undermining domestic and international sentiment.	Strengthen the rule of law, judiciary independence and step up the fight against corruption.
Inflation and inflation expectations continue to vastly overshoot the target. Exchange rate depreciation pressures abated somewhat after the recent tightening and simplification of monetary policy.	Restore the credibility of monetary policy by committing all stakeholders to the independence of the central bank. Forward guidance should be provided on how the authorities plan to achieve the inflation target.
The level of fiscal transparency remains low. The actual fiscal stance cannot be accurately monitored.	Publish quarterly general government accounts according to international standards and a regular Fiscal Policy Report covering all contingent liabilities and quasi-fiscal activities of the government.
The Medium Term Programme 2018-20 foresees consolidation but actual policy is expansionary.	Tighten fiscal and quasi-fiscal policies, strengthen the macroprudential rules and rein in housing loans.
Macroprudential measures have been relaxed, quasi-fiscal expenditures have augmented and public banks have considerably expanded lending, raising risks of distortions in capital allocation.	Undertake a cost-benefit analysis of the credit guarantee system and normalise its size, tighten the macroprudential rules and contain the quasi-fiscal activities of public financial institutions.
There are major spending needs associated with structural reforms in education and social infrastructures (notably child and elderly care and early childhood education).	To reorient spending to top priority areas, implement the strategic and performance-oriented budgeting objectives of the Public Finance Law 5018 to help reorient spending. Grant more autonomy and resources per student to education institutions, against greater performance accountability.
There is a welcome momentum in digitalisation but it is unfolding unevenly in the economy and society	Complete and enforce a holistic strategy of digitalisation, encompassing education, life-long learning and infrastructure and internet access policies.
Rebalancing growth by reinforcing the tradable sector	
Investment is strong, but debt leverage has augmented considerably and more equity capital is needed to facilitate the physical and knowledge-based investments of high-potential firms.	Carry out a strategic review to identify and address the most binding constraints to the development of the currently weak ecosystem for equity financing of investment.
Knowledge-based capital expenditures fall below OECD averages and so does public support for R&D as a share of GDP.	Streamline the various R&D incentives schemes on the basis of cost-benefit analyses, and build on international best practices to improve take-up and efficiency of tax subsidies and grants.
Many family-owned medium-sized firms are over-leveraged. Even so, they refrain from reaching out to securities markets and external shareholders.	Encourage family firms through technical support and awareness campaigns to develop standard corporate governance, professional management and financial transparency.
FDI inflows and stocks are low, partly due to uncertainties about the policy framework and level-playing competition.	Streamline and stabilise business incentives. Report them according to state aid law, subject them to competition review, and monitor their impact on beneficiary firms' behaviour using the new Enterprise Information System (EIS).
Institutional and regulatory settings for firms remain rigid despite recent reform efforts, notably in labour markets, and continue to increase the costs of operating formally.	Evaluate the uptake of the various recent social security contribution cuts granted and make permanent those which have proven most supportive of formalisation, financing this through better tax enforcement.
Improving the allocation of bank credits and of government capital cost incentives	
The real cost of loans and equity in private markets is very high, reflecting high risk premia on sovereign borrowing rates.	To reduce the funding costs of the economy improve the international credibility of governance institutions, fiscal transparency and price stability.
A large share of small firms do not use bank loans, while bank financing of informal and semi-formal businesses is made more difficult by strict financial reporting obligations.	Enforce the compulsory auditing rules of the new Company Law. Reduce audit costs - while maintaining audit quality standards- via tax incentives in the early years of audited financial reporting.
Further improving well-being	
Despite rapid progress, female labour force participation remains very low in international comparison.	Facilitate further women's labour force participation, notably by increasing the provision and quality of early child education and child and elderly care.
Renewable energy sources are encouraged, but electricity generation from coal will continue to grow strongly.	Assess the additional impact on carbon emissions and use economic instruments such as harmonised pollution taxes and emission permits to reduce them.
Coastal protection initiatives appear insufficient to contain the damage caused by tourism.	Evaluate and manage more actively the environmental impact of massive transformations of land and sea.

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