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The 2008-09 Crisis in Turkey: Performance, Policy Responses and Challenges for Sustaining the Recovery

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THE 2008-09 CRISIS IN TURKEY: PERFORMANCE, POLICY RESPONSES AND CHALLENGES FOR SUSTAINING THE RECOVERY

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By Łukasz Rawdanowicz

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ABSTRACT/ Résumé

The 2008-09 crisis in Turkey: performance, policy responses and challenges for sustaining the recovery

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 policies 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. This paper relates to the *2010 OECD Economic Review of Turkey* (www.oecd.org/eco/surveys/turkey).

JEL Classification: C11; C32; E5; E6
Key words: Turkey, recession, counter-cyclical policy, outlook, fiscal consolidation, public finances

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La crise 2008-09 en Turquie: performance, réponses de politique économique et défis pour soutenir la reprise

La Turquie se remet de sa récession la plus grave depuis plusieurs décennies. La contraction massive du PIB s'explique en grande partie par l'effondrement sans précédent de la demande étrangère, aggravé par des effets de confiance négatifs et des problèmes structurels de compétitivité antérieurs à la crise. Contrairement aux récessions précédentes, la Turquie a pu se permettre des politiques contra-cycliques et les marchés financiers ont bien résisté. Pendant la crise, les autorités ont pu rapidement et sensiblement réduire les taux d'intérêt et mettre en œuvre des mesures de relance budgétaire. Cette expérience vraiment nouvelle a été possible grâce à une meilleure position macroéconomique, un cadre monétaire et budgétaire plus sain et une meilleure réglementation des marchés financiers. Le défi immédiat de politique économique est de sortir progressivement de la politique de relance et de prendre en compte les considérations de stabilité à moyen terme de manière à ne pas compromettre la reprise. Ce document se rapporte à *l'Étude économique de Turquie de l'OCDE, 2010* (www.oecd.org/eco/etudes/turquie).

Classification JEL : C11 ; C32 ; E5 ; E6
Mots clés : Turquie, la récession, la politique contre-cyclique, les perspectives, l'assainissement budgétaire, les finances publiques

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THE 2008-09 CRISIS IN TURKEY: PERFORMANCE, POLICY RESPONSES AND CHALLENGES FOR SUSTAINING THE RECOVERY

By Łukasz Rawdanowicz[1]

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 paper 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.

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, Figure 1). 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 inflationary shock stemming from exchange rate depreciation and higher food prices. Third, in 2007, Turkey was hit by the oil price shock, which was

1 . Economist in the OECD Economics Department. This paper builds on Chapter 1 of the 2010 OECD Economic Survey of Turkey. The views expressed in this paper are those of the author and do not necessarily represent those of the OECD or its member countries. The author thanks OECD staff member Andrew Dean, Robert Ford, Andreas Wörgötter, Rauf Gönenç for valuable comments. Excellent statistical assistance from Béatrice Guerard and secretarial assistance from Josiane Gutierrez and Pascal Halim are gratefully acknowledged.

particularly acute given its relative high energy intensity and a large dependence on imported energy. The econometric evidence presented in Annex 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). 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.

Table 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*).

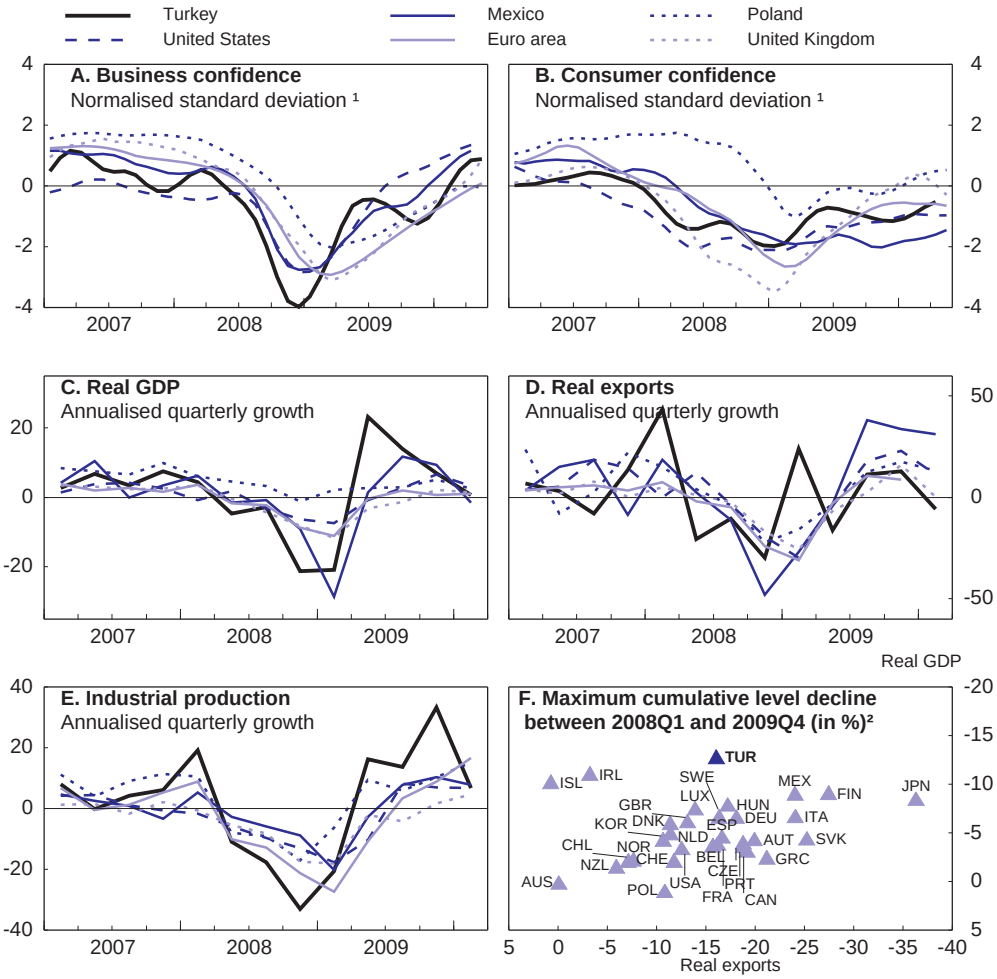
1. OECD Economic Outlook projections, published in June 2010 (based on data available up to May 2010).

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.

Figure 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.

The empirical analysis given in Annex 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) 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). 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 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).[2] 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 public revenues and expenditures in GDP (which are among the lowest in OECD; Figure A2.1 in Annex A2), 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

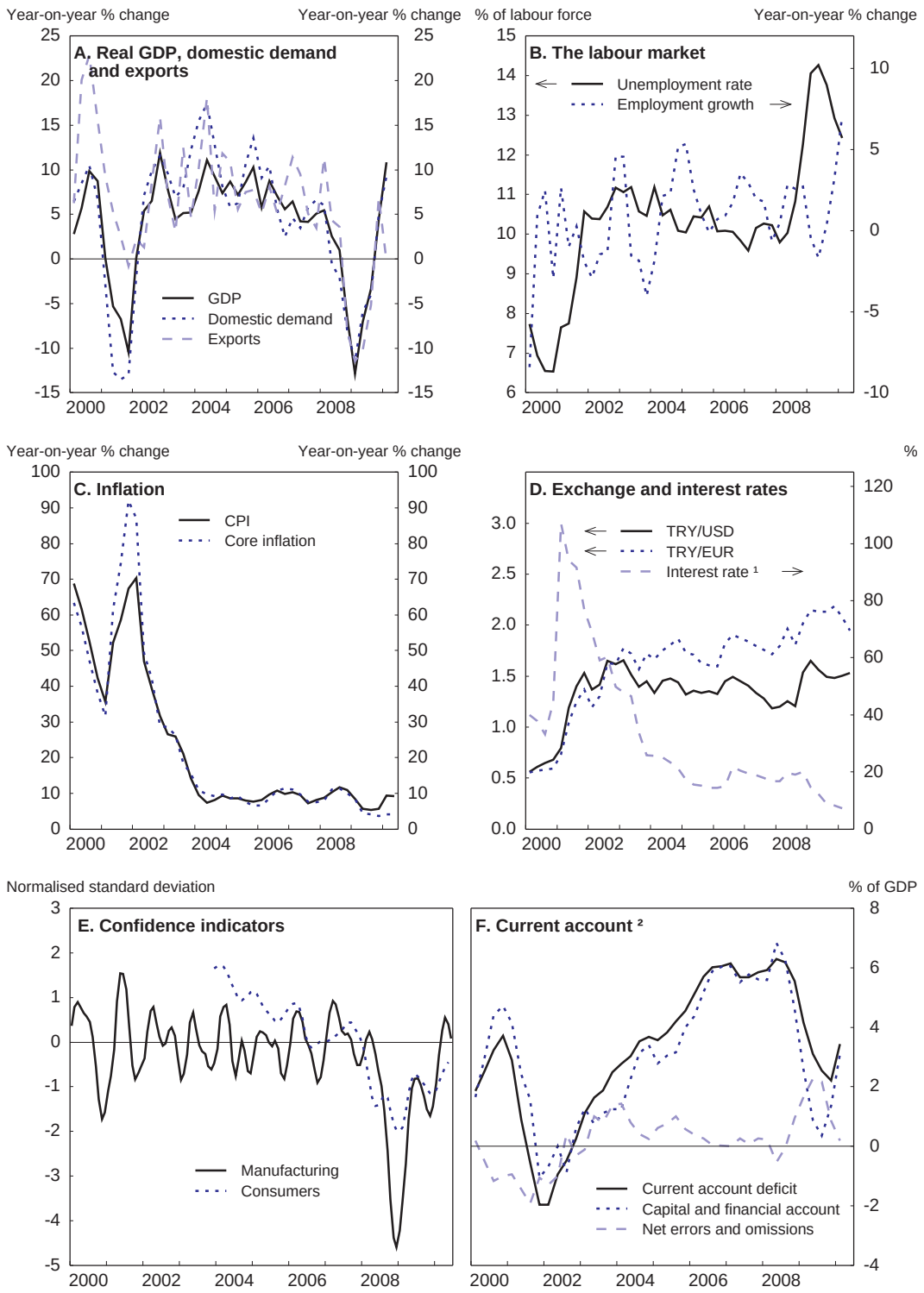
The rapid and sizable deterioration in economic growth triggered a prompt monetary and fiscal policy response. The improved macroeconomic framework and better economic situation prior to the crisis were instrumental in making counter–cyclical policies possible. The swiftness of monetary policy measures 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

2. 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).

Figure 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.

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.

Table 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.

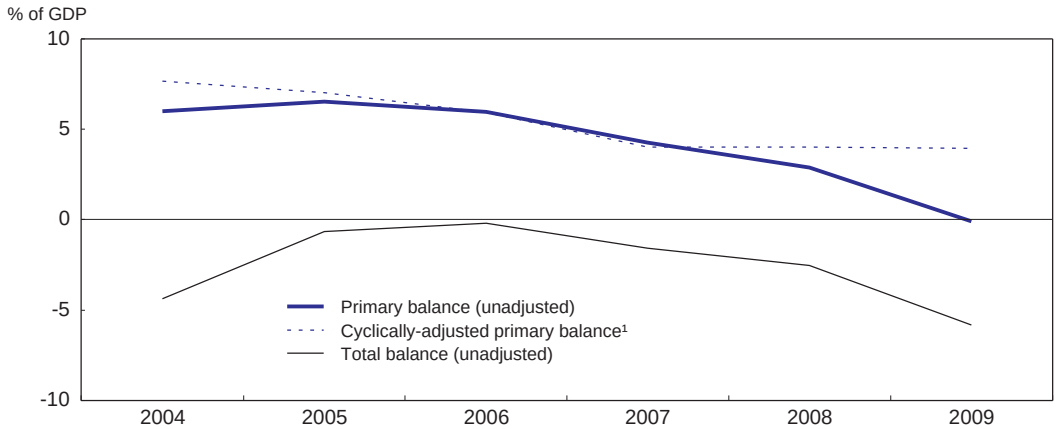
On the fiscal front, the government implemented an anti–crisis package (Table 2). It primarily envisaged spending measures (infrastructure investment, reductions in contributions to the pension and health care funds, hike in public servants' salaries, and transfers to sub–national governments), but revenue measures were also taken (temporary cuts in special consumption and value added taxes on selected goods).[3] 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.

3. 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).

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 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 A2), 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.[4] 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 3).[5]

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 and Figure 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.

Figure 3. General government balance in the crisis



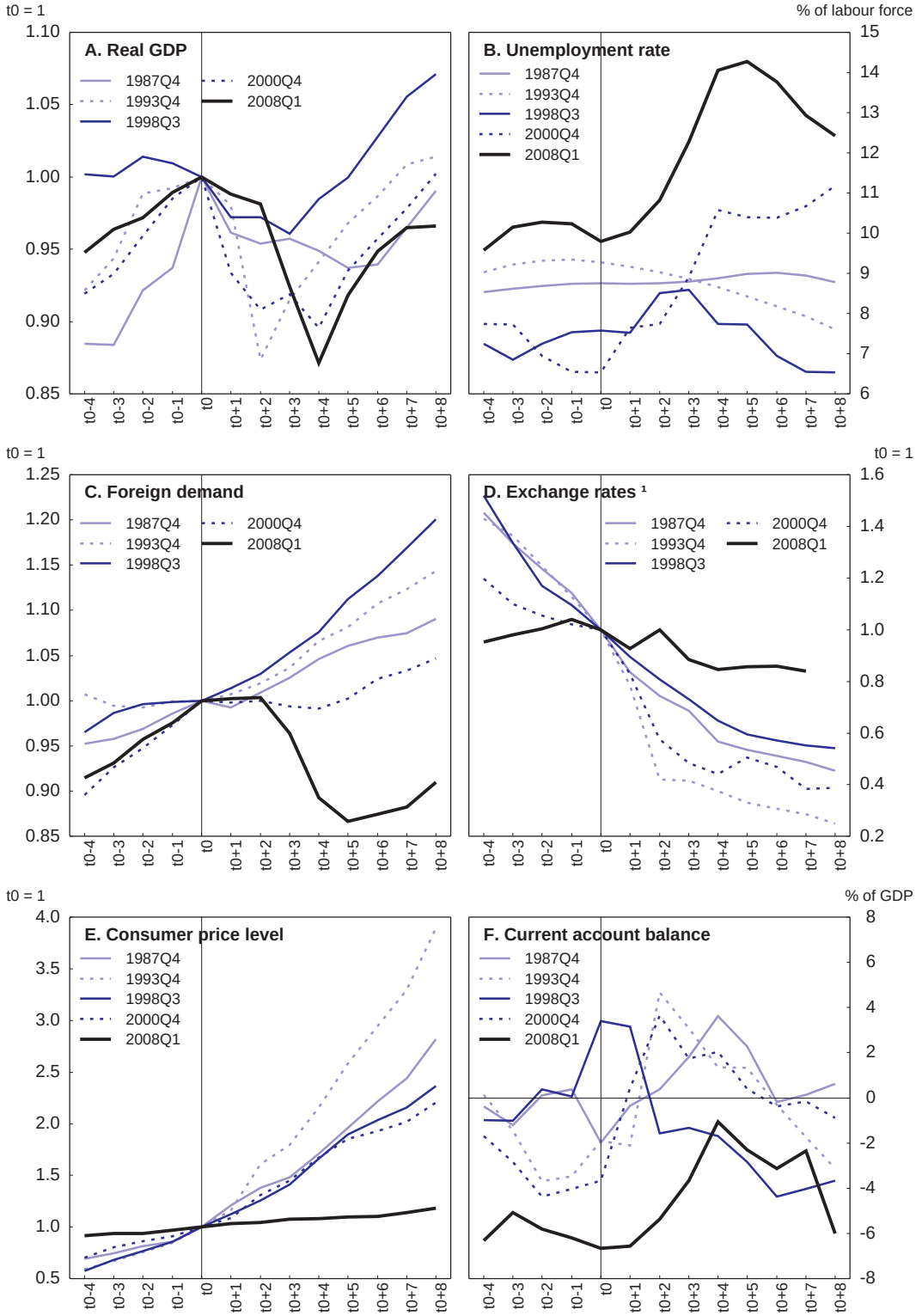
1. OECD estimates (see text for further information), % of potential GDP.

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

4. Previously undeclared income reported for clearance brought TRY 46 billion, nearly 5% of GDP.

5. 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).

Figure 4. Comparing Turkish recessions



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

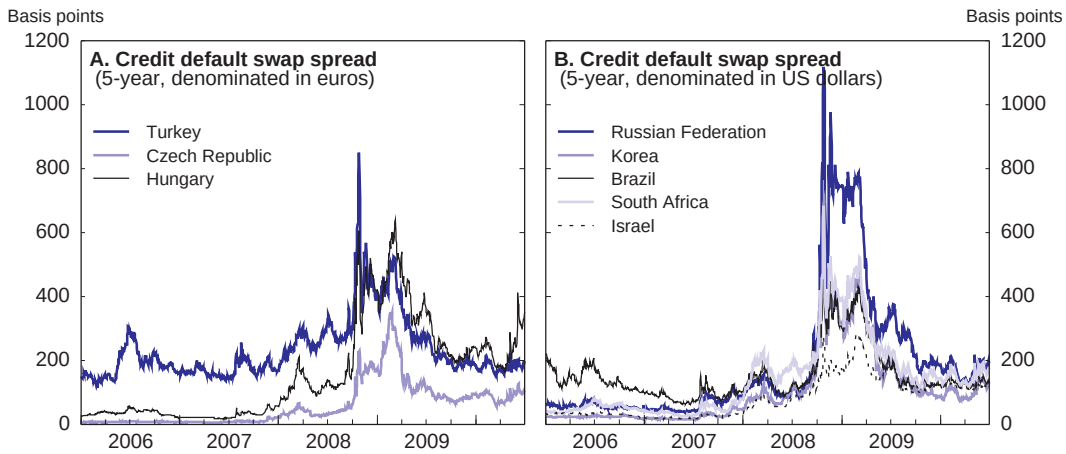
Source: OECD, OECD Economic Outlook Database.

The last recession was different from previous crises

Over the past two decades, Turkey has experienced five severe GDP contractions (Figure 4).[6] 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 (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 5), but since then they have substantially declined to roughly the pre–crisis level (Gönenç *et al.*, 2010). 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 5. Risk premia in emerging economies



Source: Datastream.

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

6. 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).

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 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 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 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 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 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.[7] GDP is projected to grow by 6.8% in 2010 and 4.5% in 2011 (Table 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 (Gönenç *et al.*, 2010). 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

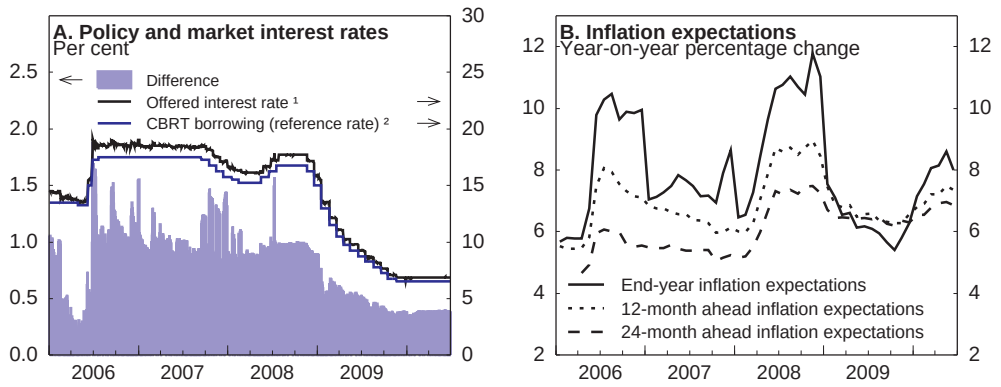
On the monetary policy side, in April 2010 the CBRT officially outlined its exit strategy, envisaging gradually removing liquidity measures, shifting to a 1–week repo interest rate as the policy rate and the tightening of the monetary policy stance. Even before this announcement, in August 2009, it had 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 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 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

7. 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.

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, 2008).

Figure 6. Monetary policy



1. Turkish interbank overnight offered rate.

2. The reference rate before 18 May 2010.

Source: CBRT and Datastream.

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 3; SPO, 2009a).[8] 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 points 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 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 A2).

8. 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).

Table 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.

The initial MTP targets looked realistic and they were based on a conservative macroeconomic scenario (Table 3; Figure 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 A2). 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 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 Gönenç *et al.* (2010). 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 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 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 (Gönenç *et al.*, 2010). 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.

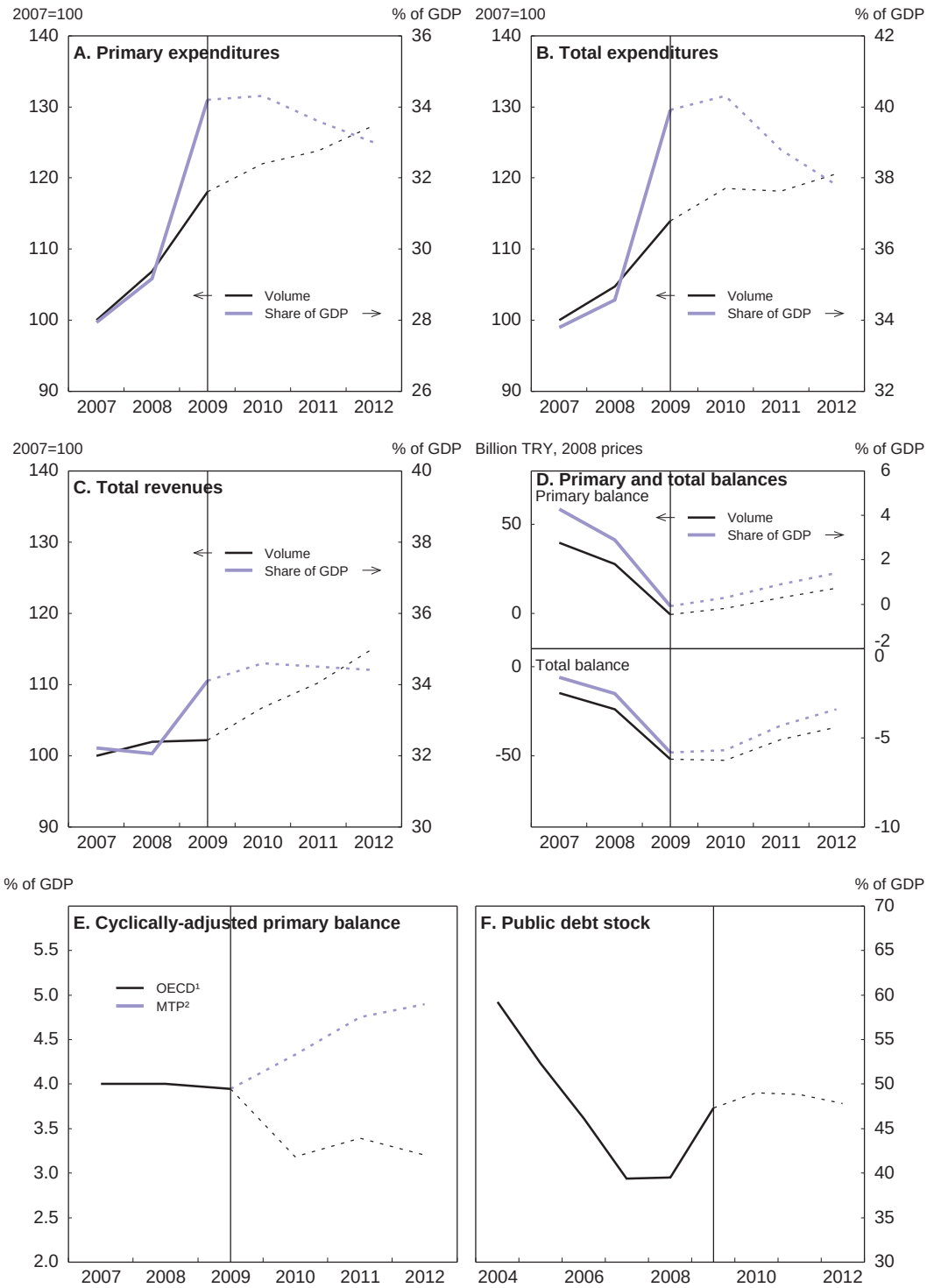
Fiscal consolidation would benefit from the improved transparency and predictability of fiscal policy (including the announced fiscal rule), better situation of the social security funds and stronger formalisation of the economy. These issues are discussed at length in Gönenç *et al.* (2010).

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;[9] such progress should be sustained. Policy mix could also benefit from more stable indirect taxation, which was frequently changed in the recent past (Gönenç *et al.*, 2010). 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; Gönenç and Rawdanowicz, 2010) 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.

9. 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).

Figure 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.

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ANNEX A1. EXPLAINING RECENT GDP DYNAMICS

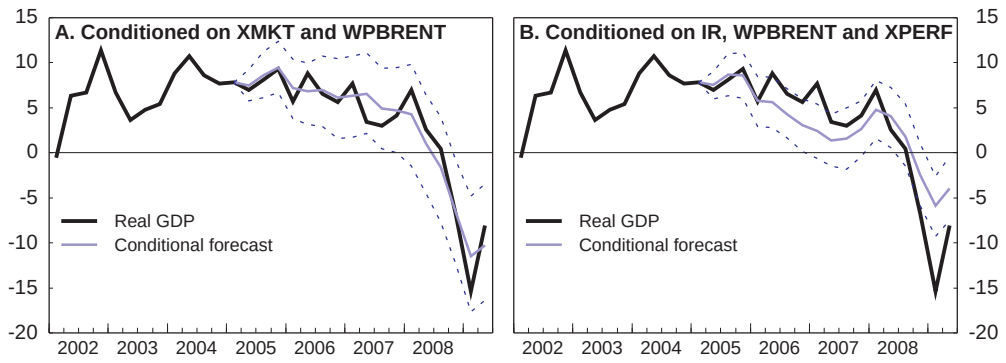
In order to investigate the triggers of the growth moderation in 2005–07 and the subsequent deep recession, a series of conditional forecasts based on an estimated Bayesian Vector Autoregression (BVAR) model are conducted. This approach is useful for illustrating stylised facts about the role of different factors in analysing certain economic developments. The methodology follows the approach by Jarociński and Smets (2008).[10] 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.

Figure 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.

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 A1.1). They contain sufficient information to obtain

10. Special thanks to M. Jarociński for providing programmes for estimating BVAR models and conditional forecasting.

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.[11] 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 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 A1.1).

11. 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 A2. 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

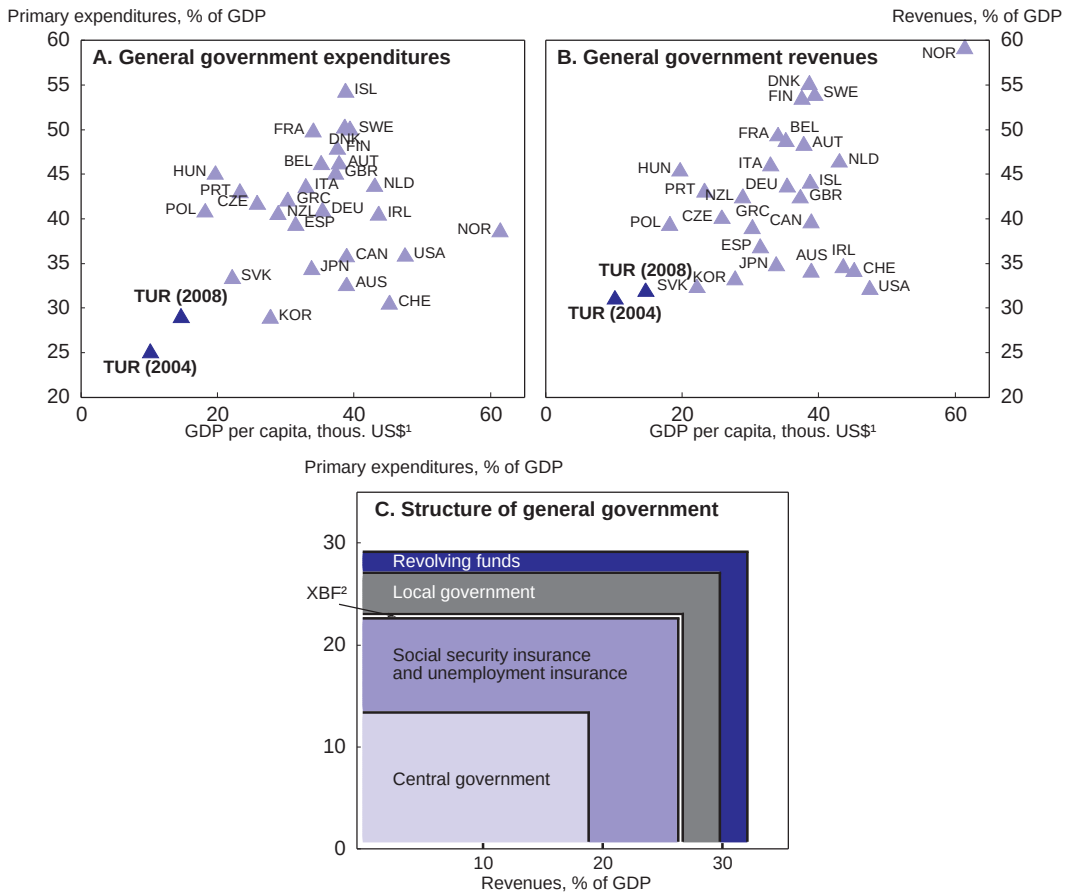
An overview of public spending and revenues on the basis of a general government concept highlights two important facts concerning the scope of government. First, the central government does not dominate the fiscal scene in Turkey, it is compounded by other major general government layers. Second, after accounting for those layers, the total amount of government spending and revenues nonetheless remains smaller than in other OECD countries (Figure A2.1). 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 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.

Figure A2.1. 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.

Evolution of fiscal balances in 2004–08

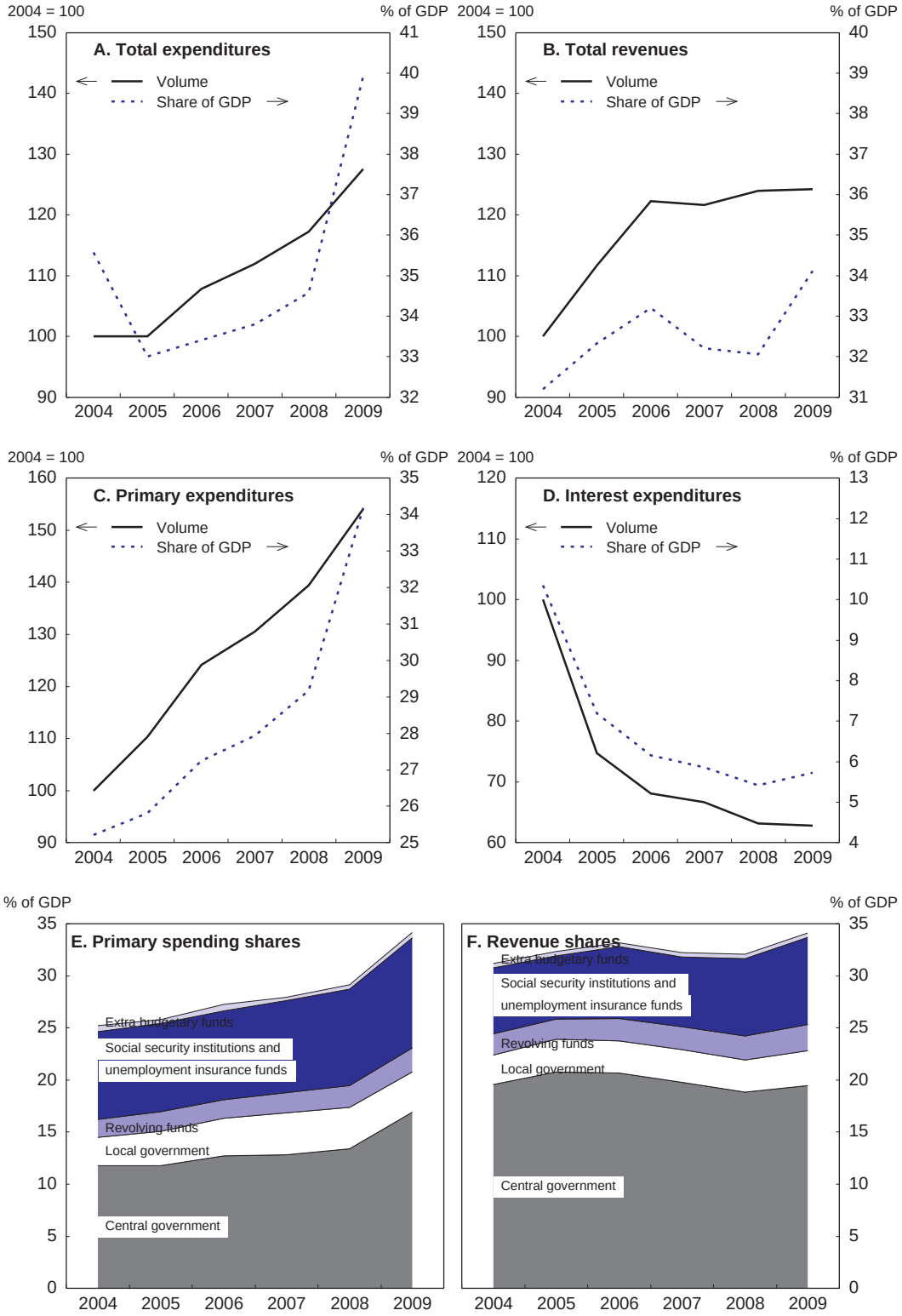
Seen from a general government perspective, primary expenditures grew by as much as 8% in volume per year between 2004 and 2008, suggesting pro–cyclical spending growth (Figure A2.2). Aggregate spending grew, however, below the trend growth rate of the economy up till the global crisis, thanks to lower 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.

Figure A2.2. General government spending and revenue



Source: SPO, Ministry of Finance and Turkstat.

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