



Economic Survey of Turkey, 2008

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Summary

Far-reaching institutional and structural reforms following the 2001 crisis underpinned an unprecedented period of high growth until 2007. More recently, however, tensions arose and growth slowed down as a result of loss of competitiveness in large areas of the economy, the deterioration of international conditions, and a weakening of confidence domestically. New government initiatives to strengthen the macroeconomic policy framework, and upgrade the competitiveness of industry and its capacity to create jobs, would help the economy resume a stronger growth course. The main challenges in this respect are:

- Preserving the gains of fiscal consolidation and making fiscal policy more compatible with higher growth.
- Resuming disinflation and better aligning structural policies as well as fiscal policy with the inflation targeting framework.
- Reducing barriers to formal employment in order to mobilise the productivity potential and improve the resilience of the Turkish economy.

Consolidating macroeconomic policies

In the area of **fiscal policy**, the gains of recent fiscal-institutional reforms and vigorous fiscal consolidation should be preserved, and credibility enhanced, in the wake of transition from IMF monitoring. *This can be achieved by enforcing multi-yearly spending ceilings combined with a primary surplus target, aimed at continuing to reduce the public debt ratio.*

In the area of **monetary policy**, the disinflation strategy of the Central Bank needs the support of more comprehensive policies to improve inflation expectations, *including the full implementation of a robust fiscal framework, competition reforms to moderate service price growth, and encouraging social partners to adopt the inflation target as an anchor in pricing and wage behaviour.*

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Turkey. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

Bolstering the competitiveness and job-creation capacity of the business sector

The business sector has to cope with rising competition from low-cost countries, and trend real currency appreciation, by accelerating productivity gains, keeping wage growth in line with profitability, and innovating and differentiating products. *This should be achieved not only in the most sophisticated segments of industry, but also in traditional labour-intensive activities.*

Latent productivity and competitiveness potential should be mobilised by facilitating formalisation, thereby encouraging firms, which make fuller use of modern technology, skilled labour, capital and FDI resources.

Two top priorities in fostering the growth of the more productive part of the economy are: i) reforming labour market regulations to overcome the divide between law-abiding but rigid and very flexible but law-breaching employment practices; and ii) upgrading corporate finance markets to permit firms joining the formal sector to rapidly improve their capital base, productive capacity and productivity.

By deepening the recently started reform initiatives in these areas, Turkey can improve employment prospects for the growing urban working-age population, restore full confidence in its growth prospects, improve risk premium and its credit-rating, and thereby move to a faster catching-up path. ■

How to maintain high growth?

Over the past two decades Turkey has successfully shifted to a growth strategy based on open and competitive markets. However, recurrent macroeconomic instabilities slowed down trend growth. The recovery from the 2001 crisis has brought an unprecedented period of high growth and the first palpable signs of sustained catch-up and convergence. Currently Turkey is in the difficult transition period between the successful exits from “post-crisis recovery” to sustainable path of high growth. The main challenges that present themselves during this transition are:

- Preserving the gains of fiscal consolidation and earning credibility with a fiscal rule which allows prioritisation of expenditure programmes, avoids pro-cyclical policies and reduces the risk perceptions of international investors.
- Enabling monetary policy and inflation targeting to “go the last mile” by better setting other policies, in particular structural policies, on a firm disinflation trajectory, and ensuring that fiscal policy supports this objective.
- Reducing barriers to formal employment in order to mobilise the productivity potential and improve the resilience of the Turkish economy.

Achieving this transition is far from trivial, as witnessed by the nervousness of financial markets, increased exchange rate volatility, growing tensions in the economy, as well as a disappointing growth performance since mid-2007. Embarking on a new, sustainable path of high growth will require policy action, but internal as well as external political tensions complicate the decision making process. Finding the right exit from the transparency-increasing and credibility-generating IMF umbrella also needs attention. However, addressing the above mentioned challenges with decisive reforms will allow Turkey to more fully exploit its comparative advantages, reap the benefits from globalisation and open capital markets and improve its resilience in the face of adverse international shocks.

After the most severe of a succession of “boom and bust” cycles in 2001, a fundamental fiscal, monetary and institutional reform package was implemented. Backed by a favourable international environment and by the opening of accession negotiations with the EU, achieving an average growth rate of almost 7% in the period of 2002-07 made a welcome beginning to a process of catching up with the OECD average. Large numbers of jobs were created in industry and services amid exits from agriculture, while inflation declined. A primary fiscal surplus of around 6% of GDP was achieved for several years, and public debt was brought down and put on a sustainable path.

During the same period, accelerated capital inflows attracted by very high real interest rates and opportunities for lucrative rates of return, pushed up the exchange rate strongly in real terms – except during short periods of adverse international or domestic shocks. Trend appreciation helped with disinflation but also amplified the competitive challenges that Turkey's traditional export industries face from lower-cost emerging countries. Sophisticated industries coped well and created new employment opportunities but traditional industries, drawing on low-skilled labour, the abundant factor resource of the Turkish economy, tended to lose market share and faced sharply accelerated import penetration. Employment in these industries declined and with re-employment being hampered by skill and regional mismatches, net employment creation of the overall economy fell clearly short of the increase in working age population. The total employment rate declined as a result and the aggregate unemployment rate slightly increased.

An external imbalance arose due to strong domestic demand fuelled by capital inflows, increasing import penetration, and the global surge in energy and raw material prices. This higher external deficit increased Turkey's sensitivity to shifts in investor sentiment. Still, analyses developed for this Survey suggest that, in terms of economic fundamentals, Turkey's risk assessment by financial markets could have improved more than it actually did through the 2000s. The thorough revision of Turkey's national accounts in March 2008, resulting in GDP more than 30% higher and reducing the public debt/GDP and current account deficit/GDP ratios to relatively more benign levels, also reinforced prospects for a rating upgrade. However, this did not materialise due to the deterioration of international financial and domestic political conditions in the first half of 2008. These events reinforce the case for further structural reforms so as to reduce Turkey's dependence on favourable external circumstances.

In early 2008 important tensions arose in the domestic political environment, with a parallel deterioration of conditions in international financial markets. The exchange rate depreciated by about 14% in the first four months of 2008. While this allowed some recouping of the earlier competitiveness losses, interest rates also increased significantly, inflation outcomes and expectations accelerated further above targets, and the growth of Turkey's export markets slowed down. In these circumstances, consumer and business confidence weakened and macroeconomic projections for 2008 and 2009 are currently the weakest of the post-2001 period. *To stimulate an upturn, confidence in the stability of the overall governance environment should be restored, and the business sector should be provided with*

more supportive structural conditions. A return to a stronger growth path with a pick-up in employment growth would help strengthen domestic and international confidence and improve conditions for lower risk premium, a credit rating upgrade, and further investment and growth. If this improvement takes place Turkey would then likely face again the challenges of strong real currency appreciation, and this would reinforce the case for the acceleration of structural reforms needed to cope with it. ■

Is a new fiscal rule definitely needed?

After six years of very tight fiscal policies, bolstered by the agreement with the IMF which provided the central anchor, which has been decisive in restoring macroeconomic stability, Turkey faces a fiscal policy challenge of how to strike an appropriate balance between the conflicting time horizons of important objectives:

- preserving a rigorous fiscal policy stance while;
- strengthening the growth-enhancing public services; and
- simultaneously reducing the most distortive aspects of the tax system.

With the IMF agreement having come to an end in May 2008, Turkey should put in place a credible framework to preserve the confidence gained under IMF surveillance, while delivering the necessary changes in revenue and spending composition. The government's decision to publish fully fledged general government accounts according to international accounting standards from 2009 on will be an important step in enhancing fiscal transparency, and should be implemented according to schedule. Following the macroeconomic slowdown, which puts pressures on public finances, the transition to a new plan also needs to be supported by a robust fiscal management framework, to defuse the uncertainties of local and foreign investors. The recently announced Medium-Term Fiscal Framework provides a good guidance for the available fiscal room in the years 2008-12, but requires a broad range of measures.

Turkey is in a strong position to move towards such a new fiscal strategy. Thanks to past fiscal restraint, public debt is on a sustainable path, and fiscal institutions are being modernised with changes in the legal and institutional framework, including a state-of-the-art *Public Financial Management and Control Law*. Under strong spending pressures, arising notably from the social security system, all provisions of the new law could not be fully implemented to date: spending drifts in 2007 gave warning signals of the urgency of the full implementation of the new framework. In addition, to supplement the earlier primary surplus benchmark, which fulfilled a key role through the 2000s in bringing public debt down and

putting public finances on a sustainable path, but is less useful as the only anchor for fiscal policy looking forward, multi-yearly spending ceilings for main spending categories would be helpful. The Survey suggests that *Turkey's new fiscal institutions should be fully implemented and enforced, and complemented with effective multi-year spending ceilings.*

The new fiscal framework rule should not only specify the primary surplus path which is compatible with sustainability of public debt, but also the total volume and structure of revenues which are necessary to finance the expenditure programmes under the ceiling. With fiscal policy now set on a sustainable path, which is protected by the framework, policy can provide adequate countercyclical flexibility to support the economy when GDP growth and tax revenues decline cyclically, as in 2008. In order to maintain credibility in the context of the recent fiscal slippages and the transition to a new arrangement with the IMF, *spending ceilings should be supported with an adequately defined primary surplus target which should be adjustable in the case of exceptional circumstances.*

Both on the expenditure and tax revenue sides, the new fiscal strategy will need adequate fiscal institutions as well as a strong political stance. Strong commitment of policymakers is in particular needed to:

- *clarify and enforce Turkey's top spending priorities, such as in the critical areas of infrastructure investment and education both for the young and adult population;*
- *shift to more cost-efficient supply arrangements in key public services, where the status quo is generally costly as well as difficult to monitor and calls for more market-responsive provision, including through competition among private sector suppliers;*
- *reduce the most distortionary tax wedges, notably by continuing to cut mandatory social security contributions, while closing the most blatant tax loopholes and strengthening tax enforcement; and*
- *fully implement the recently voted social security reform, and promote a less fiscally costly mandatory public scheme, which is complemented by larger voluntary private saving, in order to preserve the sustainability of the social security system and reduce distortionary tax wedges (see below). ■*

How to restore the credibility of monetary policy?

Monetary and exchange rate policy was a successful pillar of the post-2001 recovery. However when, encouraged by this success, the Central Bank set an explicit medium-term inflation target of 4% for 2007-10, this objective met with important challenges: On the one hand, inflation inertia together with adverse supply shocks meant that headline inflation settled in at around 9%. On the other hand, prospects for real interest rates and high rates of return became very attractive, fuelling strong capital inflows and currency appreciation. Thus the Turkish economy faces a typical challenge of successful catching-up economies – inflation inertia requiring a tight monetary policy, but competitiveness losses apparently going beyond the adaptation capacity of some sectors and generating pressures for lower interest rates and slower currency appreciation. The challenge became more evident in late 2007 and in the first half of 2008, when very high food and energy price increases fuelled headline inflation creating an upward risk for inflation expectations. *Core inflation* remained below *headline inflation* for a while but started to move towards it in spring 2008, creating concerns about a new inflationary spiral. In this context, monetary policy needs an orchestrated support from a variety of policies to restart the disinflation process. Only then will the Bank be able to use its instruments successfully to keep inflation around the target. In this context, it is important that the revision of the inflation target for the next three years announced by the Central Bank in June 2008 is seen as an exceptional measure in the wake of unforeseeable shocks. In this environment the Central Bank is rightly maintaining a tight policy stance despite the cyclical weakness of the economy in order to avoid a misperception of a loosening commitment to “go the last mile” in achieving low inflation rates.

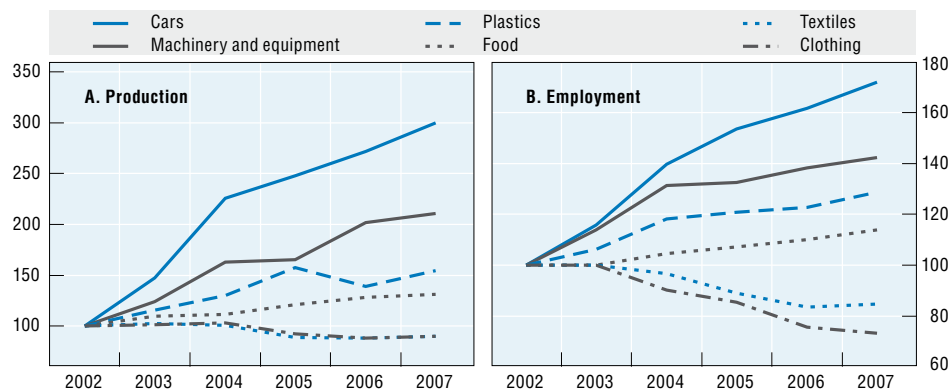
The Survey argues that Turkey’s monetary policy needs to be supported by policies which allow it to reach the target with reasonable costs. As is usually the case for a successful catching-up economy, potential output is a moving target and capacity constraints are either closed by imports or new investments. Tight monetary policy can put brakes on the economy, but its task will become prohibitively expensive if inflation expectations are not contained. In these circumstances, *additional policy tools could be used to reduce domestic inflationary pressures and thereby improve inflation expectations, such as competition reforms to achieve price moderation in services, a fully enforced multi-year fiscal framework, and employers and employees adopting the inflation target as an anchor in their pricing and wage policies.* The success of such policies would help alleviate the burden on the Central Bank’s policy interest rate as the unique instrument to increase the credibility of the inflation target. ■

Do formal sector firms need more flexible regulations?

The business sector’s successful post-crisis performance and employment creation capacity has come under strain, independently from the domestic and international shocks of early 2008. Mounting competition from low-cost countries and strong trend real currency appreciation has severely weakened the trade-exposed sector, notably cost-sensitive activities highly dependent on domestic inputs and low-skilled labour. Since low-skilled labour is the economy’s most abundant resource and these sectors have a large share in total output and employment, as well as exports, these strains spilled-over to the entire economy. Trade-sheltered activities were initially boosted by the household income gains stimulated by real currency appreciation. However, higher than expected inflation and rising unemployment curbed real incomes throughout the economy and also affected the non-tradable sector, contributing to a weakening growth performance. An upturn is only possible with the improvement of the competitiveness of Turkey’s labour-intensive activities.

Competitiveness gains needed to re-balance the dynamics of growth cannot come from a policy induced reversal of trend real currency appreciation, which is an integral part of the catching up process. External and internal shocks trigger depreciations but these generally prove to be of short duration while long-term dynamics of capital inflows remain very strong. In these circumstances the necessary competitiveness gains in the business sector can only be achieved by boosting productivity growth, moderating wage increases, and successfully differentiating its output (in order to be able to charge higher prices than lower-cost competitors). In other words, it is a flexible labour market as well as a competition-friendly product market environment which is needed to do the job. The Survey

FIGURE 1.
PERFORMANCES OF WELL-
PERFORMING, SQUEEZED
AND INTERMEDIARY
SECTORS, 2002-07
 2002 = 100



Source: TURKSTAT and OECD calculations.

confirms that manufacturing industry has been achieving remarkable performances in these areas but the gains are concentrated in the modern part of the economy. *Productivity growth and competitiveness gains need to be generalised to the entire economy with additional reforms.*

There are large productivity reserves latent in the business sector. They arise from a large part of economic activity still being carried out in informal and semi-formal activities. If more resources can be shifted to formal business activities, the aggregate productivity and competitive performance of the economy would benefit from better access to financial services, opportunities to deepen the division of labour and develop own comparative advantages as well as better incentives to invest in firm-specific human capital. Formal firms draw more effectively on the technology, skilled labour, capital and FDI resources becoming available in the rapidly globalising economy. *Overcoming the duality between formal and informal sectors, and accelerating the shift of resources to the formal sector, should be the centrepiece of Turkey's structural reforms.*

The government has launched a range of important initiatives to strengthen the business sector and Turkey has started to move up in various international rankings of doing business indicators. In particular, an Employment Package enacted in May 2008 entailed significant measures for reducing labour tax wedges and promoting national employment services emphasizing the upgrading of the skills of the labour force. However, progress has been limited in some of the most critical areas, and this also holds back the effectiveness of other reforms. Top priorities in fostering the development of the formal sector are:

- *a thorough reform of labour market regulations along OECD best practices; and*
- *accelerating the modernisation of capital markets to increase the benefits of formality and to stimulate investment, productivity and employment growth.*

Making product markets competitive and reducing the administrative burdens for doing business in the formal sector should also remain an ongoing objective, in particular in the service sectors where competition remains less vibrant than in trade-exposed activities. ■

Is labour market reform the top priority?

Labour market rules remain among the most rigid in the OECD area, even after the implementation of the 2008 employment package. Priority should be given to reforms to:

- *reduce the legal employment costs of low-skilled workers by containing the growth of mandatory minimum wages and creating a framework to differentiate minimum wages across sectors and regions;*
- *continue to cut mandatory social contribution rates, and increase the role of voluntary saving schemes in financing the social security system;*
- *make permanent labour contracts more flexible by reducing mandatory employment protection and promote negotiated forms; and facilitate more flexible forms of employment such as fixed-term contracts and agency work; and*
- *eliminate size thresholds in the application of the labour law. ■*

Why is financial transparency essential?

Corporate finance markets are currently underdeveloped in Turkey. Enhancing financial transparency is the key requirement for the development of markets for medium-to-long term bank loans, corporate debt securities, private equity placements and listed equities. These capital sources all have a role to play in the development of higher productivity and more competitive firms in the formal sector. Three areas are particularly important and have been addressed by the authorities, but progress has been slower than expected:

- transition to Basel II rules for corporate banking;
- adoption of a new Commercial Code prescribing that companies of all sizes produce externally audited accounts; and
- modernisation of collateral registers and the collateral regime.

The authorities should identify obstacles to progress in these areas and maintain efforts to increase financial transparency for the development of formal capital markets.

The enforcement of business regulations has recently been intensified and this is highly welcome. However, if structural reforms are not deepened in parallel, thereby reducing the costs of doing business in the formal sector, this may generate output and employment losses. *The government should develop and implement a comprehensive “formalisation strategy” combining continuing structural reforms in top priority areas with the stronger enforcement of rules and regulations.* ■

For further information

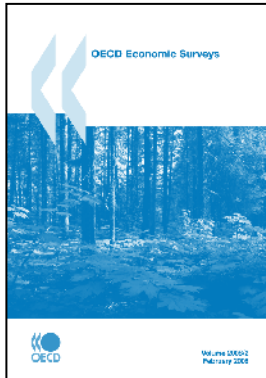
For further information regarding this Policy Brief, please contact:

Rauf Gönenç, e-mail: rauf.gonenc@oecd.org, tel.: +33 1 45 24 94 04, or

Rina Bhattacharya, e-mail: rina.bhattacharya@oecd.org, tel.: +33 1 45 24 14 71.



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Economic Outlook No. 83, June 2008.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2008 edition.

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Where to contact us?

OECD HEADQUARTERS

2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.centre@oecd.org
Internet:
www.oecd.org/berlin

JAPAN

OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.oecd.org/centrodemexico

UNITED STATES

OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

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