

TURKEY ECONOMIC MONITOR

APRIL 2021

**NAVIGATING
THE WAVES**



TURKEY ECONOMIC MONITOR,
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NAVIGATING THE WAVES

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1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

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List of Abbreviations

ADV	Advanced Economies
AFR	Africa
ALMP	Active labor market programs
ALB	Albania
AR	Asset Ratio
BAT	Banks Association of Turkey
BGR	Bulgaria
BPS	Business Pulse Survey
BRA	Brazil
BVAR	Bayesian Vector Auto Regression
BRSA	Banking Regulation and Supervision Agency
CAB	Current Account Balance
CAR	Capital Adequacy Ratio
CB	Central Bank
CBAM	Carbon Border Adjustment Mechanism
CBRT	The Central Bank of the Republic of Turkey
CG	Central Government
CGF	Credit Guarantee Fund
CDS	Credit default swap
CHN	China
CMB	Capital Markets Board
COVID-19	2019 Novel Coronavirus Disease
CPI	Consumer Price Index
CVI	Corporate Vulnerability Index
ECA	Europe and Central Asia
EFI	Equitable Growth, Finance and Institutions
EMDE	Emerging Markets and Developing Economies
EMBI	Emerging Markets Bond Index
EM	Emerging Markets
ENB	Environment, Natural Resources and Blue Economy
ERP	Economic Reform Package
ESG	Environment, Social and Governance
EU	European Union
FCI	Finance, Competitiveness and Innovation
FinSAC	Financial Sector Advisory Center
FX	Foreign exchange
G-20	Group of 20
GDP	Gross Domestic Product
GEFR	Gross External Financing Requirement
GEO	Georgia
GIR	Gross International Reserves

GP	Global Practice
GW	Gigawatt
HCI	Human Capital Index
HD	Human Development
HICES	Household Income Consumption Expenditure Survey
HRV	Croatia
HUN	Hungary
ICT	Information and Communication Technologies
ICR	Interest Coverage Ratio
ICLS	International Conference of Labour Statisticians
IDN	Indonesia
IFC	International Finance Corporation
IFRS-9	International Financial Reporting Standard 9
ILO	International Labor Organization
IMF	International Monetary Fund
IND	India
ISKUR	Turkish Employment Agency
ITA	Italy
KGZ	Kirgizstan
LAC	Latin America and Caribbean
LFPR	Labor Force Participation Rate
LHS	Left Hand Side
MAR	Morocco
MAX	Maximum
MENA	Middle-East and North Africa
MFN	Most favored nation
MIN	Minimum
MOTF	Ministry of Treasury and Finance
MOM	Month-on-month
MSCI	Morgan Stanley Capital International
MSME	Micro, Small and Medium Enterprises
MTI	Macroeconomics, Trade and Investment
NEET	Not in Education, Employment, or Training
NEP	New Economic Program
NGA	Nigeria
NSA	Not seasonally adjusted
NPL	Non-performing Loan
OECD	Organization for Economic Co-operation and Development
OJT	On-the-Job Training Program
OxCGRT	Oxford COVID-19 Government Response Tracker
PAK	Pakistan
PISA	Program for International Student Assessment
PMI	Purchasing Managers' Index

POL	Poland
POV	Poverty
PPP	Purchasing power parity
PPI	Producer Price Index
PTA	Preferential Trade Agreement
QOQ	Quarter-on-quarter
R&D	Research and development
RHS	Right hand side
ROM	Romania
ROU	Romania
RUS	Russia
RWA	Risk-weighted assets
SA	Seasonally adjusted
SD	Sustainable Development
SDIF	Savings-Deposit Insurance Fund
SGK	Social Security Institution
SME	Small and medium size entrepreneurs
SPJ	Social Protection and Jobs
SSI	Social Sustainability and Inclusion
TEM	Turkey Economic Monitor
TFP	Total factor productivity
TL	Turkish Lira
TJK	Tajikistan
TRY	Turkish Lira
TUR	Turkey
TURKSTAT	Turkish Statistical Institute
TWF	Turkey Wealth Fund
UK	United Kingdom
UKR	Ukraine
US	United States of America
USA	United States of America
US\$	United States of America Dollar
UZB	Uzbekistan
VT	Vocational and Technical Courses Program
WB	World Bank
WBG	World Bank Group
YOY	Year-on-year
ZAR	South Africa

The Turkey Economic Monitor (TEM) periodically analyzes economic developments, policies and prospects in Turkey. The TEM was prepared under the guidance of Auguste Tano Kouame (WB Country Director, Turkey), Lalita Moorthy (Regional Director for Equitable Growth, Finance and Institutions, ECA) and Sandeep Mahajan (Practice Manager, Macroeconomics, Trade and Investment GP) by a core team including David Knight (Acting Program Leader, EFI Turkey), Pinar Yasar (Senior Country Economist, MTI GP), Erdem Atas (Research Analyst, MTI GP), Javier Baez (Senior Economist, POV GP), Metin Nebiler (Economist, POV GP), Etkin Ozen (Senior Financial Sector Specialist, FCI GP), and Gunhild Berg (Senior Financial Sector Specialist, FCI GP).

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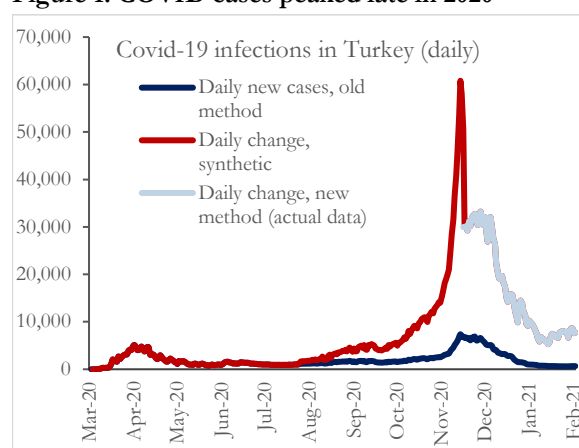
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EXECUTIVE SUMMARY

I. TAKING STOCK

COVID-19 has taken a heavy toll on Turkey, as it has across much of the world. New estimates of total COVID-19 cases indicate that the epidemic grew rapidly over November and into December (Figure 1), before a new round of restrictions were put in place to control the spread of the virus in late December. The expansion of COVID-19 in late 2020 followed a similar path to many European countries.

Figure 1: COVID cases peaked late in 2020

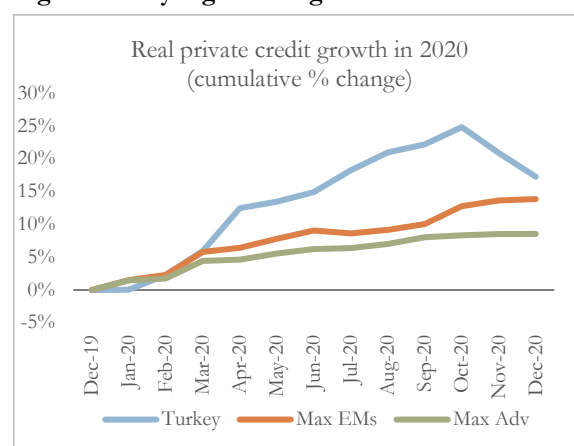


Turkey's economic growth performance in 2020 was strong compared to other countries, but poverty spread, and unemployment became more prevalent. Turkey's GDP grew by 1.8 percent in 2020, which was the fastest amongst G20 countries in 2020 aside from China. This was on the back of one of the strongest economic rebounds in the second half of 2020, largely achieved in the third quarter, but with positive growth continuing into the fourth quarter (Figure 4). Despite measures to support jobs and households, labor market and poverty outcomes nevertheless deteriorated. Indicators of domestic demand showed some signs of economic growth cooling early in 2021, although supply side measures such as industrial output remained robust.

Turkey responded to COVID-19 with a large economic stimulus program, focused on credit channels. In fiscal terms, Turkey's COVID-19 stimulus package amounted to nearly 12 percent of GDP when including tax deferrals and contingent liabilities. This is larger than the average for emerging market, G20 countries, and is similar in size to the stimulus packages of the United States, Australia and Canada. While the program utilized a broad range of fiscal tools, uniquely amongst G20 countries, Turkey's support was overwhelmingly provided through the banking sector, and was not realized as direct fiscal costs on the budget, but as contingent liabilities to the government in future.

Credit stimulus, loose monetary policy, and other regulatory measures to promote credit expansion drove a sharp increase in economic activity in late 2020. In addition to government measures to recapitalize a partial credit guarantee fund and state banks, policy interest rates were maintained below inflation and a series of financial regulatory measures introduced that incentivized banks to increase lending activities. The combined effect of these policies was to generate one of the largest credit expansions that the world saw in 2020 (Figure 2).

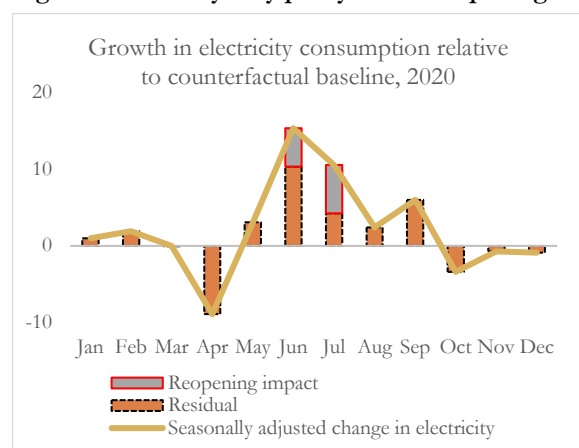
Figure 2: Very high credit growth in 2020



Note: Credit growth is not adjusted for FX valuation effects for Turkey or comparators.

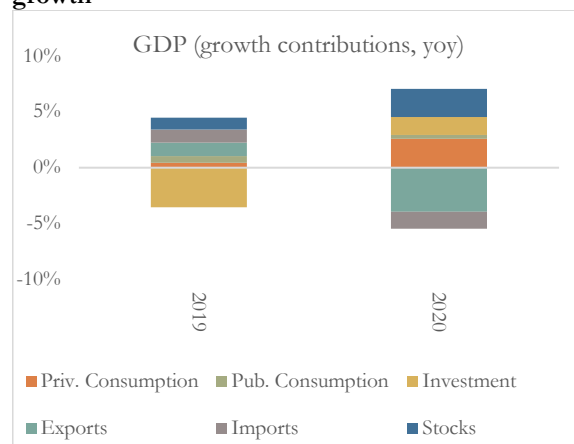
The direct fiscal response to the COVID-19 crisis was smaller in size and targeted, but provided important support to firms and households. On-budget fiscal expenditure was much smaller than the run-up of contingent liabilities, but supported important, targeted fiscal objectives. The major items supported with fiscal expenditure were payments to furloughed workers and those put on unpaid leave, additional lump-sum social support to households, and increased unemployment benefits. On the revenue side, several tax and government fee payments were deferred to reduce the cost burden on firms while economic activity was reduced.

Figure 3: Recovery only partly due to reopening



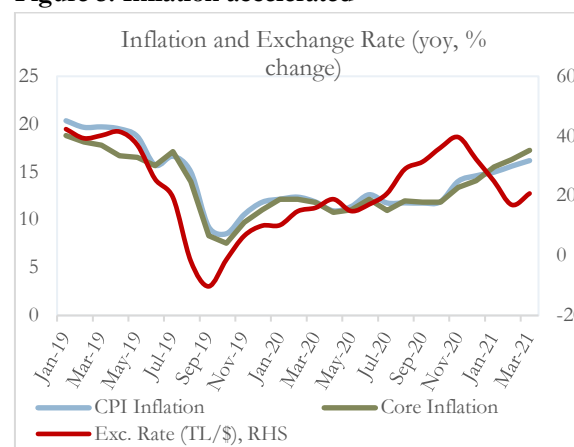
Reopening after the first wave also played a role in economic recovery. Turkey had swiftly introduced COVID-19 related restrictions that, although effective in limiting COVID transmission, were somewhat less disruptive than a full-scale lockdown. Following the first wave, mobility and business operation restrictions were relaxed in June and July. Based on the experiences of reopening around the world and using high-frequency electricity consumption data as a proxy for economic activity, reopening is estimated to have accounted for between one third and one half of the rebound in economic activity, indicating that other factors – namely stimulus – played a pivotal role (Figure 3).

Figure 4: Consumption and investment drove growth



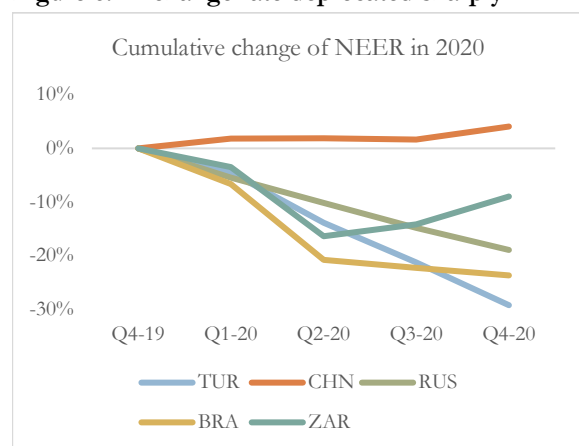
Economic risks emerged alongside recovery. Policy frameworks geared towards ensuring a strong recovery in 2020 also contributed to growing imbalances and risks, especially domestic inflation, currency depreciation and loss of external reserves. Inflation gradually accelerated, to reach an 18-month high of 16.2 percent by March 2021 (Figure 5). Facing capital outflows, falling exports, and rising imports the Central Bank financed most of Turkey's rising current account deficit using international reserves in 2020Q2. As reserves, net of short-term liabilities, reached unprecedented lows, the Central Bank limited further losses of reserves and the Lira began depreciating, ending the year almost 30 percent lower, further adding to inflationary pressures (Figure 6).

Figure 5: Inflation accelerated



Monetary and credit policies were significantly strengthened toward the end of 2020 to address the growing vulnerabilities. As vulnerabilities grew, the authorities implemented a raft of significant policy changes, geared towards stabilizing the economy and reducing the imbalances that had built up. The Central Bank raised its policy interest rate in a series of steps between September 2020 and March 2021, bringing the real interest rate back into positive territory (Figure 7). The Central Bank also took steps to improve transparency; reverting to a single policy rate, providing more forward guidance in Monetary Policy Committee statements, and publishing more high-frequency data of market interest. Both the Central Bank and the Banking Regulation and Supervision Agency (BRSA) withdrew regulation that had been introduced to support credit growth such as the “Asset Ratio” that had mandated commercial banks to actively use their assets, and reserve requirements linked to real credit growth.

Figure 6: Exchange rate depreciated sharply



Entering 2021, volatility was reduced, and risks were beginning to be addressed. Off the back of these revised policy frameworks, portfolio flows began returning to Turkey, the Lira stabilized and appreciated markedly compared to its low point in October 2020 and country risk premia, as measured by credit default swap (CDS) spreads, began falling.

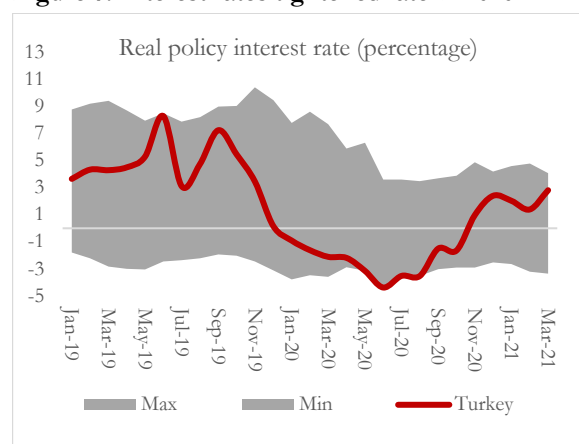
However, in March 2021, Turkey saw market turbulence and price volatility, reversing earlier gains. The exchange rate and Lira asset markets were buffeted by intense volatility following the replacement of the Central Bank Governor in March—the second change at the helm of the Central Bank in four months—amid fears that it

signaled a softening monetary policy stance toward price stability. The Turkish Lira experienced a 9.3 percent depreciation in one day, bond yields increased by close to 500 basis points in just two days, and the 5-year CDS spread experienced its sharpest one-day rise on record. Since then, statements committing to tight monetary policy meant volatility has eased for the time being.

The credit boom, along with a sharp fall in tourism receipts, drove the current account deeply into deficit in 2020. The economic rebound in the third quarter was driven by domestic consumption and investment, much spent on imported goods. A fast-rising import bill was driven by this demand as well as rising demand for gold imports as a safe haven investment. This combined with sharply lower exports of goods and services – especially tourism – to drive the current account from a surplus in 2019 to a deficit of 5.1 percent of GDP in 2020. After major disruption in the first half, exports began recovering later in the year with the resumption of supply chains.

Corporates and banks felt balance sheet pressure as corporate debt increased. The corporate deleveraging process, ongoing since 2018, was interrupted by the COVID-19 pandemic. Debt levels in the non-financial corporate sector increased by 9 percent of GDP in the first six months of 2020, the sharpest rise amongst emerging markets. The number of illiquid companies spiked in the second quarter of 2020 and measures of corporate vulnerability remained heightened throughout the year. Corporate sector vulnerability continues to be the main risk to banks susceptible to currency and asset quality shocks.

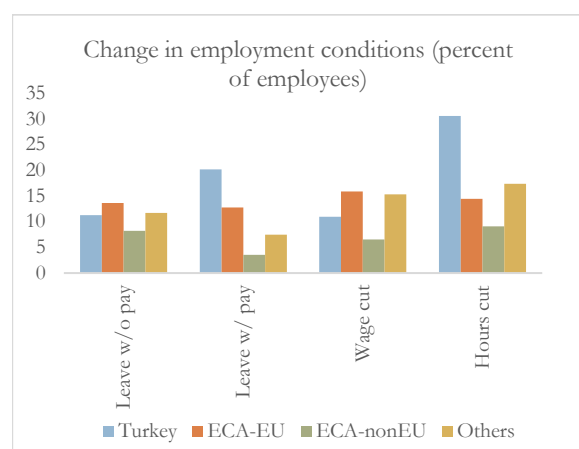
Figure 7: Interest rates tightened late in 2020



Note: Turkey compared to range of 12 other EMs; real 'ex post' interest rate.

Firms in Turkey were badly affected by COVID-19 in 2020. Firms in Turkey experienced a sharper drop in sales than comparators. Constrained by a government-imposed redundancy moratorium since the onset of COVID-19, Turkish firms responded by reducing working hours and putting more employees on paid leave (Figure 8). Female-headed firms were disproportionately affected, being concentrated in the hard-hit accommodation sector.

Figure 8: Workers' hours cut and others put on leave

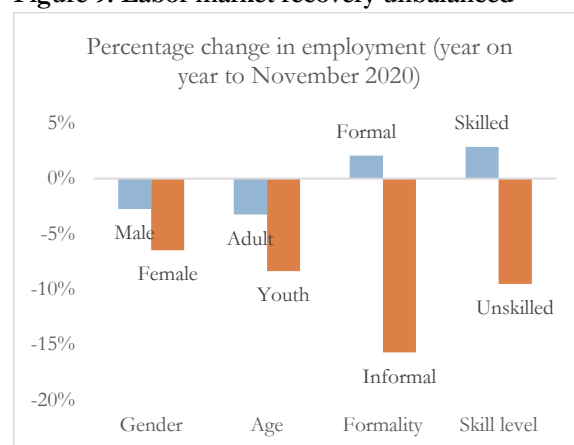


Note: Initial impact up to time of survey (June-July 2020)

Job losses compounded existing labor market disparities. Despite the redundancy moratorium, millions of jobs were reported lost in the second quarter of 2020. While overall the labor market saw a good recovery towards the end of the year, the recovery among female, youth, lower-skilled and

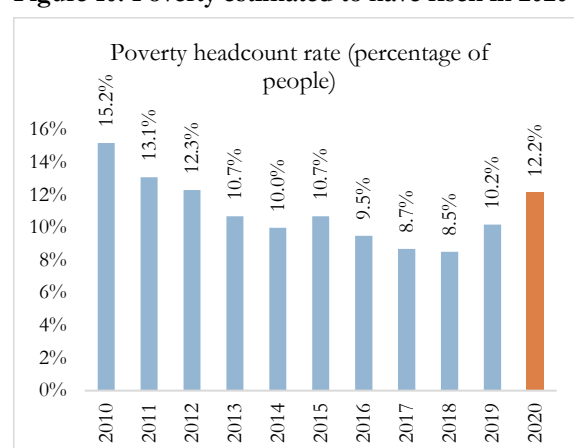
informal workers lagged behind (Figure 9). This asymmetric recovery exacerbated existing disparities as youth already had much higher unemployment rates and female labor force participation is far lower than expected given Turkey's levels of income and human capital.

Figure 9: Labor market recovery unbalanced



Poverty rose significantly in 2020. In conjunction with job losses affecting the poorer more, the proportion of people in poverty is estimated to have risen from 10.2 percent in 2019 to 12.2 percent in 2020 – following a significant uptick in 2019 – and presents a growing challenge. (Figure 10). Were it not for the fiscal measures to support workers and households, the increase in poverty would have been far worse.

Figure 10: Poverty estimated to have risen in 2020

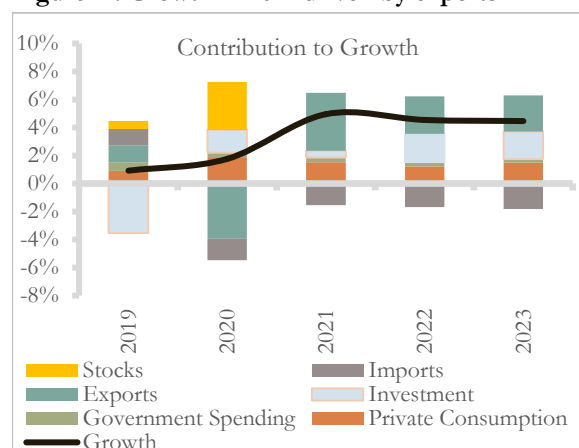


II. LOOKING AHEAD

Turkey is expected to see a rebound in real economy activity in 2021, but in an environment of macroeconomic uncertainty and elevated vulnerabilities. Turkey and much of the rest of the world will struggle to shake off the COVID-19 pandemic this year. Annual growth in Turkey is nevertheless expected to be a respectable 5 percent since the 'base' for comparison in early 2020 was exceptionally low (Figure 11). However, market pressures in March have heightened macro-financial risk and dampened Turkey's economic outlook, particularly by weakening the policy grip over inflation and exacerbating pressures over corporate and bank balance sheets.

Growth in 2021 is expected to be driven by export recovery and base effects. Turkey's economy had already recovered from its COVID-induced low by the end of 2020, and this level of activity is expected to be broadly sustained. Exports are expected to account for two-thirds of growth in 2021, normalizing from the severe shock of last year. Private consumption is expected to only contribute slightly to growth.

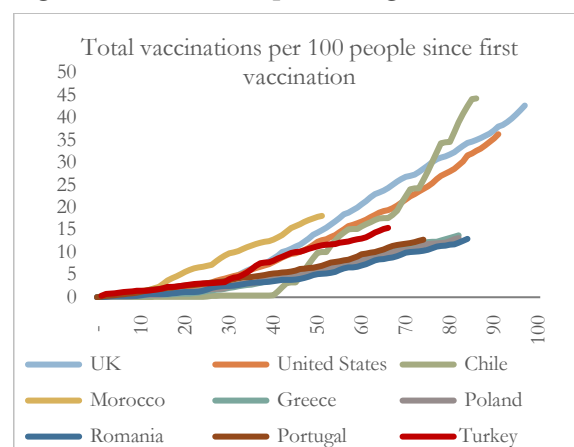
Figure 11: Growth in 2021 driven by exports



The resurgence of COVID-19 and risks to the progress of vaccination roll-out could apply the brake to growth. While Turkey's vaccination program, begun in January, has made good progress (Figure 12), risks to the security of supply of vaccination and capacity to scale-up at speed mean there is a wide range of estimates as to when the majority of the population could be fully vaccinated. Coupled with resurgent COVID-19

and the ongoing risk that uncontrolled outbreaks of COVID-19 can continue to emerge rapidly, the possibility that more restrictive controls would need to be reintroduced throughout the year could lead to lower than forecast growth.

Figure 12: Vaccination proceeding well

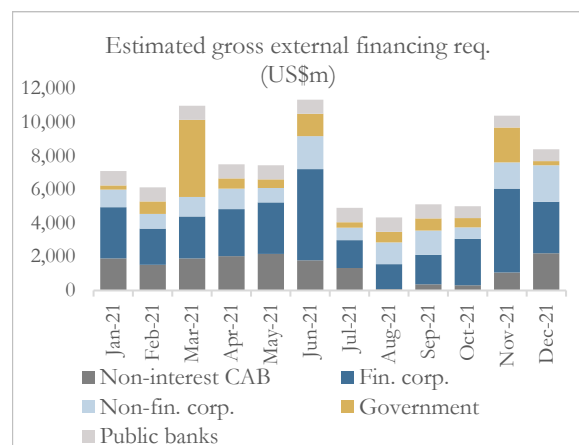


Heightened external volatility could derail growth. Rising inflation expectations in developed countries (the US in particular) and an intensification of market speculation over an end to very loose monetary policy in advanced economies could cause destabilizing movements in global liquidity away from emerging markets, akin to the *taper tantrum* episode of 2013. As in 2013, this could pressure central banks of emerging-market economies to raise interest rates to prevent significant weakening of their currencies and a build-up of inflationary pressures.

Sustained macro-financial pressures since 2018 have depleted policy buffers and left the Turkish economy vulnerable. Although external financing requirements remain sizeable (Figure 13), macroeconomic buffers such as international reserves are now lower and more reliant on the financial sector remaining healthy. Gross International Reserves (GIR) at the Central Bank, for example, fall short of the Central Bank FX liabilities to the commercial banking sector. Turkey may be less able to weather any severe bout of external volatility with fewer resources available to smooth excess external volatility. Such events would prove damaging to corporates, households and the financial sector, and inevitably lower growth prospects. Given these risks, the Central Bank would be advised to substantially raise the

level of GIR and to bring the level of reserves net of short-term drains back into positive territory.

Figure 13: Substantial external financing needs

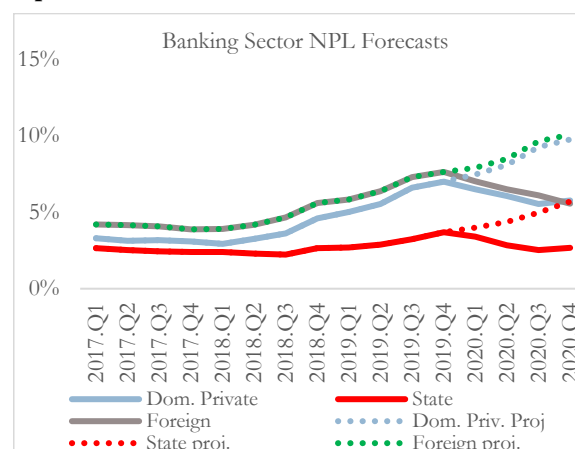


A firm commitment by the Central Bank to tame inflation will be necessary to restore macroeconomic stability. While Turkey has committed to a robust monetary policy stance to achieve a permanent reduction in inflation, the frequent changing of Central Bank governors in recent years has elevated uncertainty over the future course of policy, which has fed into deteriorating expectations of inflation and market volatility. The Central Bank would be well served by staying unambiguously committed to inflation-targeting and price stability as its primary mandate. Any premature softening of monetary policy would be contrary to the current policy position of the Central Bank and is likely to elevate inflationary expectations and lead to external pressures and weaker financial and corporate balance sheets. The Economic Reform Package (ERP) launched in March 2021 provides a useful anchor to support economic recovery and stability, but needs a sound macroeconomic policy framework to achieve desired results. Steps to consolidate Central Bank independence as part of the authorities' ongoing reform program would also support the objective of the ERP.

A focus on supporting the banking sector to restore its balance sheets will be key to reducing risks and paving the way for future growth. Rapid credit growth over the past year has added to problems of distressed assets in the financial sector. Forbearance measures, still in place since the onset of COVID-19, make the true state

of the banking sector's distressed assets not observable at present. But simulations to estimate non-performing loans (NPLs) and capital adequacy ratios suggest banks do have a substantial backlog of distressed assets to deal with. While unlikely to present major systemic risks, especially given the banking sector's prudent buffers, the NPL and Stage II loan ratios are estimated to significantly increase compared to their reported levels, were forbearance, loan deferrals and restructurings not in place (Figure 14). In addition to withdrawing forbearance measures, the authorities can support the orderly and efficient resolution of distressed assets by strengthening insolvency and debt resolution frameworks. Recently, the authorities made commitments to support NPL resolution, yet a holistic approach remains needed.

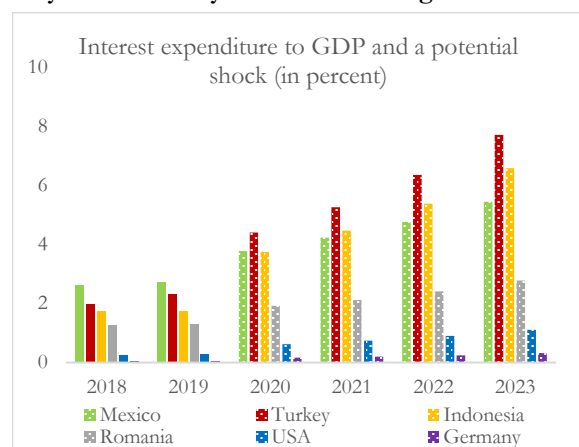
Figure 14: NPLs could be significantly higher than reported under forbearance



Although fiscal space is limited, there is room for important, targeted support to firms and households to help ensure an inclusive recovery. Turkey maintained a modest fiscal deficit over a difficult year in 2020, but a significant amount of public support in the form of guarantees and state bank capitalization may be realized on the budget in future. Coupled with Turkey's continuing high exposure to external market risk, this means that authorities should remain prudent to avoid large run-ups of public debt. While interest expenses are not presently high, Turkey would be challenged by an adverse financing cost shock (Figure 15). Nevertheless, the costs of continuing key, targeted post-COVID-19 on-budget fiscal support measures will be limited, and may be

important to secure a recovery that is likely to remain tentative throughout this year.

Figure 15: Simulations show government budget may be hard hit by external financing shocks



Measures that increase international market access and economic integration will support Turkish firms to grow and become more productive. While in most cases contingent on bilateral or multilateral agreements, the ability for Turkish firms to trade in goods and services and to invest internationally is an important route to increase demand and realize gains in productivity through the adoption of new technology and practices. As a Customs Union partner with the EU, it is important that Turkey moves together with the EU to secure common access to tariff-free trade with third-party countries.

Measures to incentivize a green recovery – and begin a green transformation – can keep Turkey at a competitive advantage as global markets decarbonize. While considerable uncertainty persists, developments in Turkey’s key economic partner, the European Union, indicate that decarbonization will be proceeding with increasing speed. Turkey can use the opportunity of adapting existing policy frameworks, including those related to COVID-19, to support firms in planning for an adjustment to low-carbon markets over time. Important measures would include both the planned strengthening of the institutional framework for greening the financial sector and a national emission trading scheme, as well as tax and spending programs that are linked to carbon emissions.

A more diversified and greener financial system would support a resilient, sustained recovery. Developing domestic sources of long-term finance and a green finance taxonomy would alleviate existing imbalances in the financial system and raise economic growth. However, a volatile economic environment and its symptoms have acted as a constraint on capital market and long-term finance development.

Finally, seismic shocks to labor markets are likely to have long-lasting effects, and social assistance, as well as active and targeted labor market policies, will be increasingly important to ensure people – especially women and the youth of today – do not miss the opportunity to fulfil their potential as productive members of society.

I. TAKING STOCK

Policy responses to the pandemic and its economic impact led to a sharp rebound in GDP in the second half of 2020. Taking account of quasi-fiscal measures to support credit, Turkey's stimulus program was larger than the average of G20 emerging market countries. A stimulus-induced credit boom and reopening in June and July drove a sharp rebound in economic activity, leaving Turkey as one of the few countries with positive growth in 2020. But this growth came with rising inflation, falling international reserves, a weaker Lira, a sharply expanded current account deficit and increasing corporate stress. In response, interest rates were tightened, and a series of measures aimed at promoting credit growth were removed. Entering 2021, volatility was reduced, and risks were beginning to be addressed. The Lira was more stable, capital inflows supported a recovery in international reserves and the banking sector was able to maintain its FX liquidity buffers. However, following the dismissal of the Central Bank Governor, Turkey saw pronounced market turbulence and price volatility in March, reversing earlier gains. While overall the labor market saw a good recovery towards the end of the year, the recovery among female, youth, lower-skilled and informal workers lagged behind. This, in conjunction with high inflation is likely to have hurt the poor more. Poverty is estimated to have risen substantially over 2020, and presents a growing challenge.

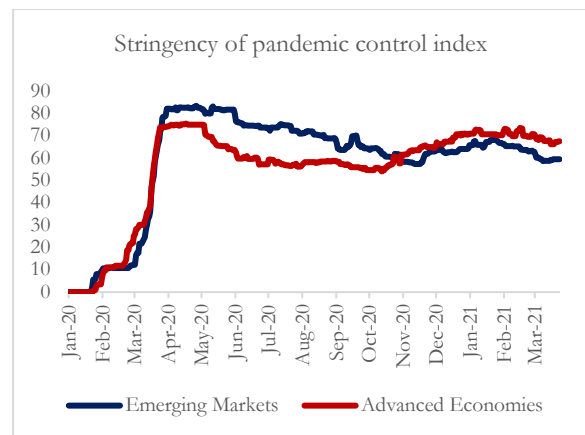
A.COVID-19 determined the course of the year worldwide and in Turkey over 2020

Countries worldwide struggled to control COVID-19, while supporting their economies

After a catastrophic economic impact in the first part of the year, the global economy has begun to recover, but the ongoing effects of COVID-19 are still very much apparent. COVID-19 in 2020 caused the worst global recession since World War II and a severe loss of life, while tipping millions more people into extreme poverty. This episode is expected to inflict lasting scars that push activity and income well below their pre-pandemic trend for a prolonged period. Global economic activity began growing again in the second half of the year, but remains some way from recovering to levels seen prior to the onset of the COVID-19 pandemic.

Overall, the global economy is estimated to have contracted by 4.3 percent in 2020¹. Advanced economies are expected to have contracted by 5.4 percent. While China followed a different, and more robust, path compared to many other countries, the group of emerging market and development economies excluding China are expected to have contracted by 5.0 percent in 2020.

Figure 16: COVID-19 restrictions were being re-imposed by the end of 2021



Source: WB Global Economic Prospects, Jan 2021; University of Oxford.

Notes: Figure shows the simple average stringency index for EMDEs. The shaded area indicates the regional range. The stringency index range is between 0 and 100, with 100 being the most stringent.

¹ This, and all projections presented in this section draw on the World Bank Group's Global Economic Prospects report, published in January 2021.

Since they relaxed COVID-19 restrictions in mid-2020, many countries have experienced new waves of COVID and needed to reintroduce restrictions. An incipient recovery was initially supported by a partial easing of stringent lockdowns. Resurgent outbreaks, however, have forced many governments to maintain or reintroduce lockdown measures (Figure 16). Some countries have experienced a sharp resurgence of infections and deaths, particularly amongst the high-income countries grouping (Figure 17, Figure 18). Nonetheless, pandemic-control measures in general have become better targeted and less economically disruptive.

Figure 17: Globally new COVID cases

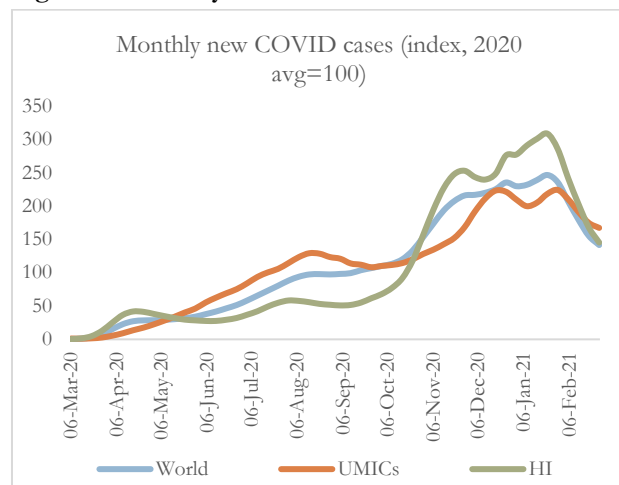
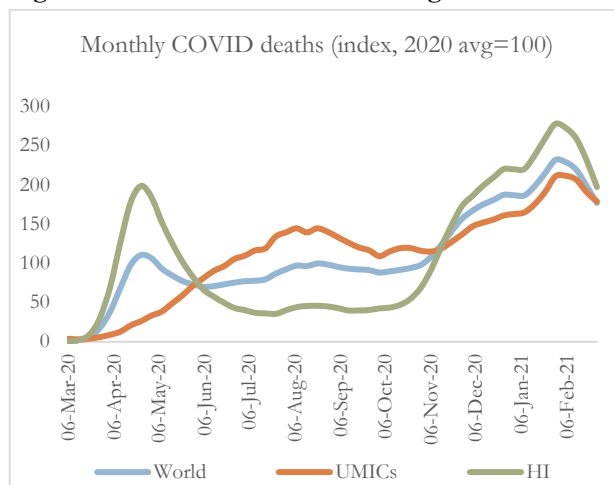


Figure 18: and deaths continued rising into 2021



Source: World Health Organization via Haver.

Strong policy responses and automatic stabilizers have led to gaping fiscal deficits in 2020. Drastic falls in consumption and trade taxes, measures to delay or lower tax payments and the COVID-19 related health, economic and social spending have led to some of the largest global fiscal deficits in recent history (Figure 19). Fiscal expansion has led to sharp increases in debt levels around the world. While deficits were trimmed by Q3, many countries' public finances remain deeply in deficit, with public sector debt rising commensurately (Figure 26).

Figure 19: and fiscal balances saw a massive deterioration

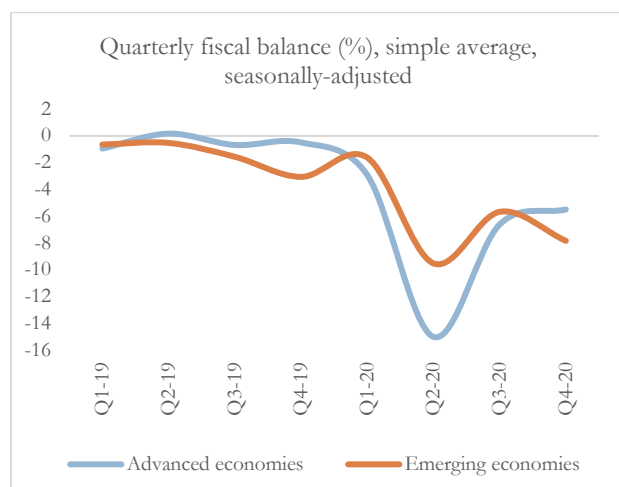
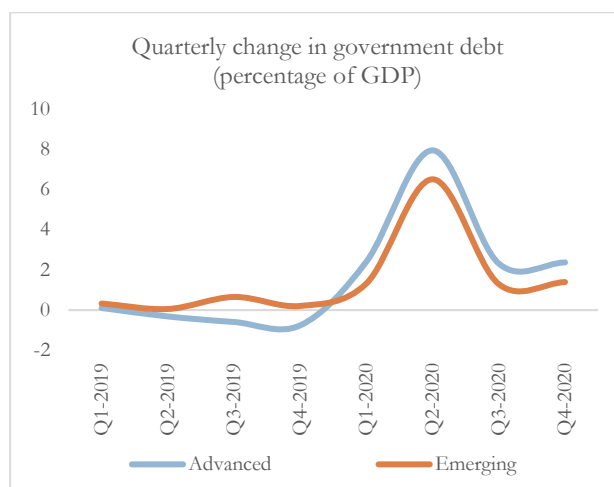


Figure 20: Government debt rising rapidly

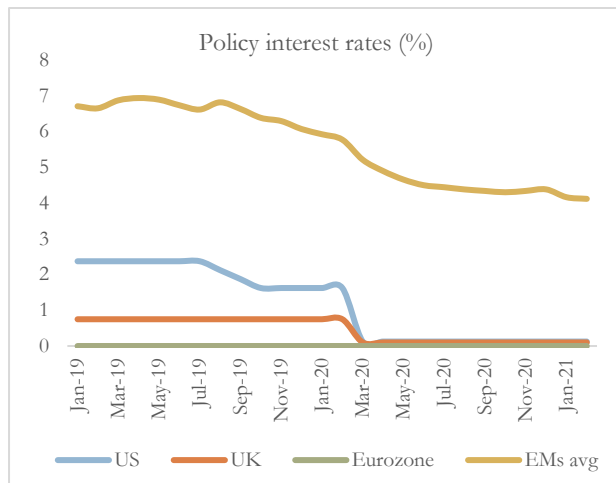


Source: Haver Analytics.

Notes: Based on a sample of 19 emerging and 12 advanced economies with data available for the whole period.

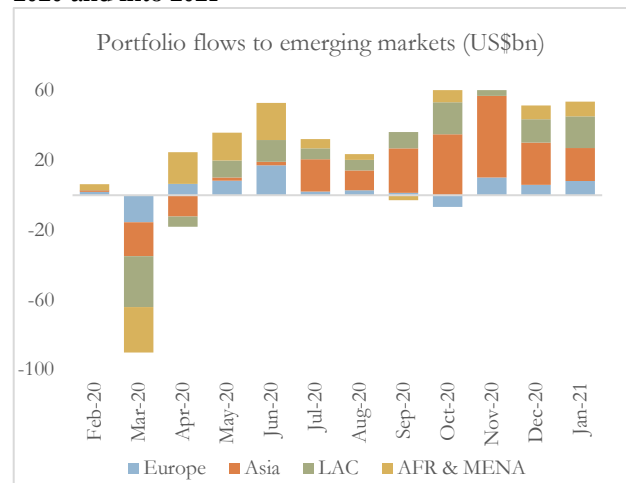
After collapsing in the aftermath of the pandemic outbreak, portfolio flows to EMDEs strengthened later in 2020, led by inflows to China and other parts of Asia. The aggressive policy actions of central banks prevented the global financial system from falling into crisis last year. Financial conditions are generally loose (Figure 20), as suggested by low borrowing costs, abundant credit issuance, and a recovery in equity market valuations. Portfolio flows to Asia have gained in strength, but have been positive in other emerging markets as well (Figure 21).

Figure 21: Interest rates falling in EMs over 2020



Source: Haver Analytics.

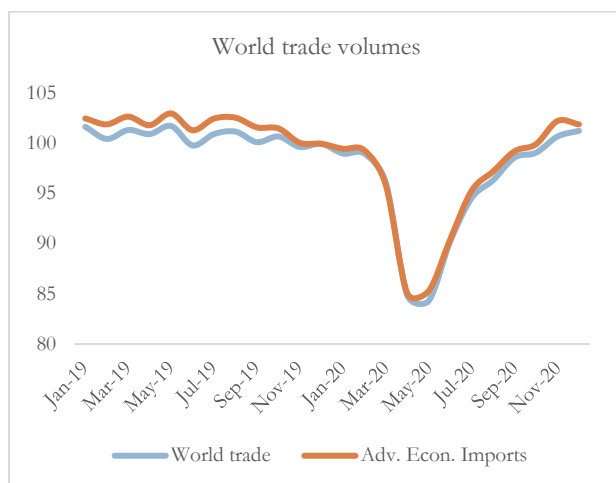
Figure 22: EM portfolio flows have been robust in late 2020 and into 2021



Source: Haver Analytics.

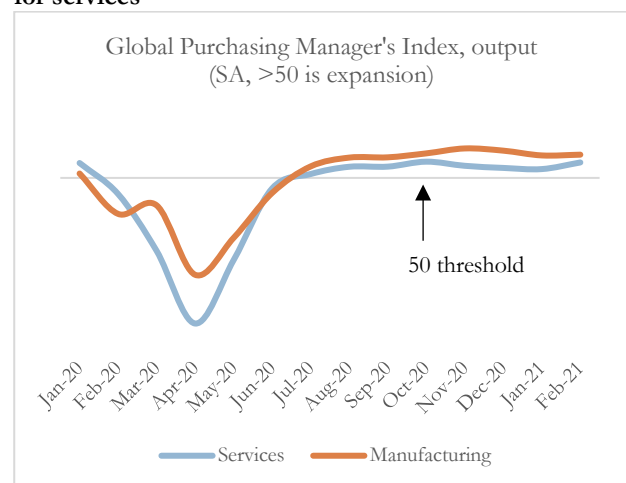
While globally, manufacturing and merchandize trade have recovered, services and investment remain sharply lower. Whereas activity and trade in goods has improved (Figure 23), the services sector remains anemic (Figure 24), with international tourism, in particular, still depressed (Figure 25). The fall in global investment has been pronounced, particularly for EMDEs excluding China (Figure 26). Most commodity prices rebounded from their mid-2020 lows as strict lockdowns were gradually lifted and demand firmed, especially from China; however, the recovery in oil prices was more modest amid concerns over the pandemic's lasting impact on oil demand.

Figure 23: But trade volumes have rebounded



Source: Haver Analytics.

Figure 24: Global PMI shows weak growth, especially for services



Source: IHS Markit via Haver Analytics.

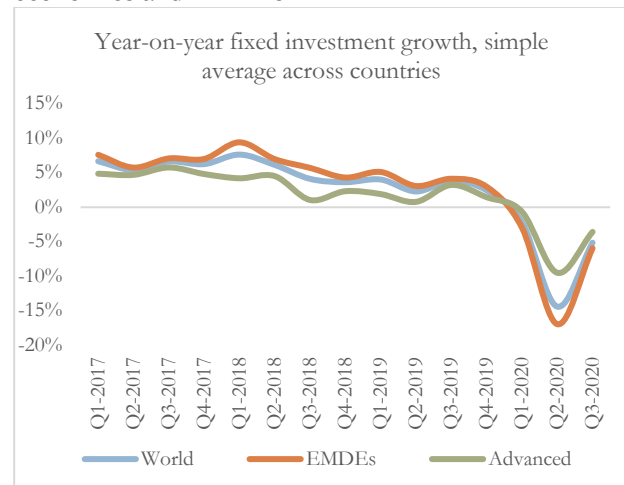
Figure 25: Tourism remains in the doldrums



Source: Haver Analytics.

Note: Sum over countries with data available for whole period

Figure 26: Investment remains low across advanced economies and EMDEs



Source: Haver Analytics.

Resurgent COVID-19 had called for re-imposition of control measures by late 2020

Data indicate a large increase in confirmed COVID-19 cases by the end of the year. As a nationwide testing program was rolled out, the authorities ceased reporting asymptomatic COVID-19 cases on July 28, 2020 before reverting to a case definition that includes asymptomatic cases on December 10, 2020. When the methodology was adjusted on December 10, as well as reporting daily cases from that date according to the newly revised definition, the authorities also reported the cumulative total number of cases detected to date according to that definition. The structural break is clear in Figure 28, as the total number of Covid-19 cases jumped by 1.2 million in a day. Extrapolating daily data on total confirmed cases suggests the COVID-19 spread may have peaked ²at around 60,000 cases around mid-November, before falling again to the point where the new data series began with around 30,000 daily cases at end-November (Figure 28).

² By a process of fitting data based on the consistent and related 'old method' series and the partial data for the 'new series', we are able to produce a synthetic series of what daily cases may actually have looked like over the whole period based on the new definition. In creating a synthetic series two criteria must be satisfied and a further two criteria are desirable:

Criteria 1: The number of daily infections must be equal to the historical series up to July 29 (essential)

Criteria 2: The total number of cumulative total infections must equal 1,296,539 on November 26, when the new series starts (essential)

Criteria 3: The 'new' series between July 29 and November 26 be a function of the 'old' series.

Criteria 4: There are no structural breaks (jumps) in the total number of cases and daily cases series.

Method

The daily percentage change in total cases is calculated for the period July 29 and November 26 using the following equation:

$$New_series_d = g \left(\frac{Old_series_d}{Old_series_{d-1}} \right) + constant$$

Where g is determined so to satisfy:

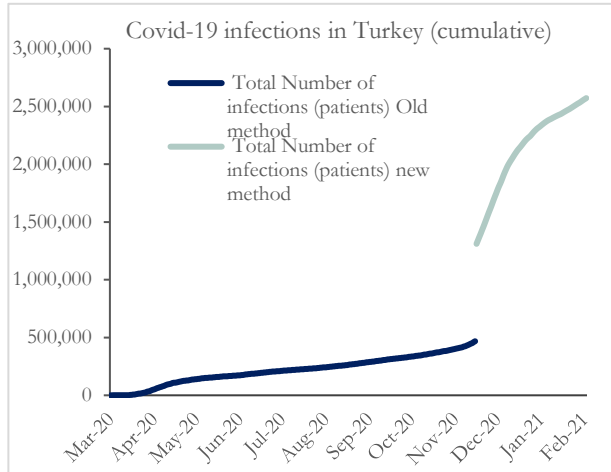
$$\sum_{July\ 29}^{Nov\ 26} Cases = 1,296,539$$

And the constant is set so to satisfy:

$$New_cases_{July\ 30} - New_cases_{July\ 29} = TREND(New_cases)$$

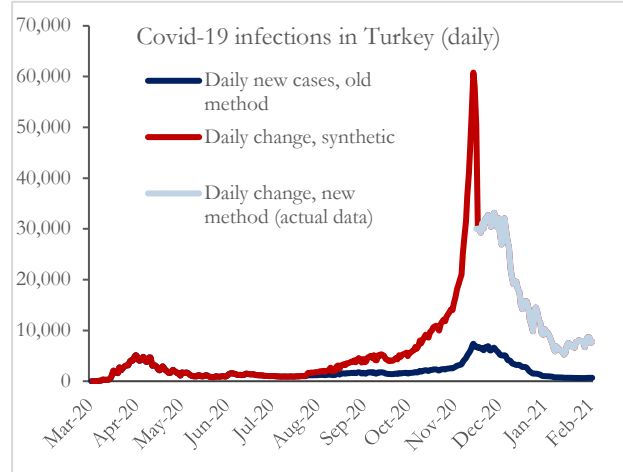
This gives a value of g of 3.397, and a value of the constant of 2,326. The value of g ensures that the series grows sufficiently to hit 1,296,539 total cases on November 26.

Figure 27: Methodological changes in reporting



Source: Ministry of Health, Turkey.

Figure 28: Resurgence of the pandemic in Autumn

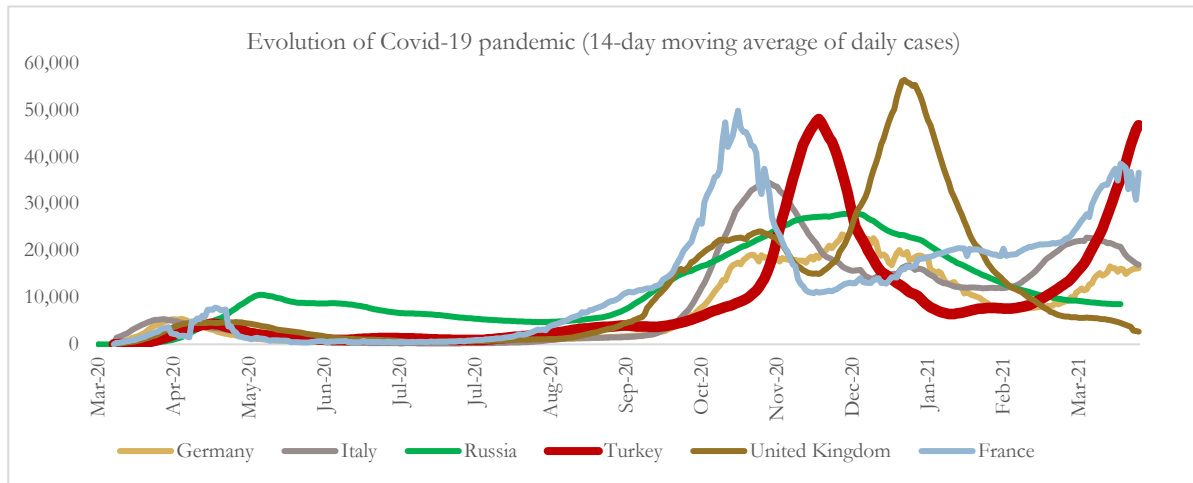


Source: Ministry of Health, Turkey, WB staff calculations.

Note: Daily new cases, old method corresponds to the number of patients announced by the Ministry of Health.

The second wave of the pandemic evidentially hit Turkey hard. As well as several other countries including Germany, Italy, Russia and United Kingdom, Turkey has experienced a significant surge in the number of COVID-19 cases starting from October 2020 (Figure 29). The size of the second wave was well above the first wave, as daily cases rose above 40,000 in selected countries³.

Figure 29: The second wave of the pandemic in autumn outpaced the first wave across countries



Source: University of Oxford, WB staff calculations.

Note: Turkey's Covid-19 cases in the July 29-December 10 period based on a WB Staff estimation as described in this section, for compatibility with other countries.

Like many countries that experienced a surge in the pandemic, Turkey re-imposed restrictions as COVID-19 increased again. The reopening that had started in June 2020 was reversed through the reintroduction of lockdown measures starting in November, including all-day weekend curfews, night curfews, restaurant and school closures, public transportation restrictions for the elderly, and reduced office utilization for civil servants. Moreover, flight suspensions to several countries were introduced, particularly following reports of emergent COVID-19 variants. The introduced measures had a relatively limited impact on manufacturing activity compared to the early phase of pandemic as restrictions were less strict and mostly

³ This could also be related to the improved testing capacity of countries relative to the first wave.

focused on the services sectors, rather than manufacturing. Following an easing of restrictions in the first quarter of 2021, restrictions were again tightened again in the middle of April following a sharp increase in the number of cases.

The authorities extended salary support and introduced new measures to support suffering households and businesses. Salary support schemes including short-term work allowance and support for workers on unpaid leave was extended until the end of March 2021. The tax payments of closed businesses were deferred, and a direct income support package for cafes and restaurants was introduced. In addition, several private and state banks postponed loan repayments and eased conditions for NPL restructuring for MSMEs and households.

Despite a significant rise in the number of cases, Turkey experienced relatively fewer deaths. The cumulative number of COVID-19 cases in Turkey had reached 2.8 million by the middle of March 2021, with more than 34 million COVID-19 tests conducted over the same period. Despite these high numbers, Turkey has relatively fewer COVID-19 cases per million people than comparator counties, and has recorded amongst the lowest deaths per million population (Figure 30, Figure 31).

Figure 30: Relatively low Covid-19 cases...

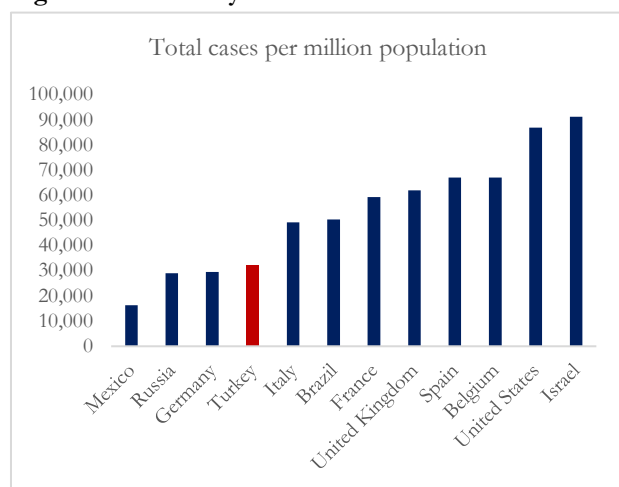
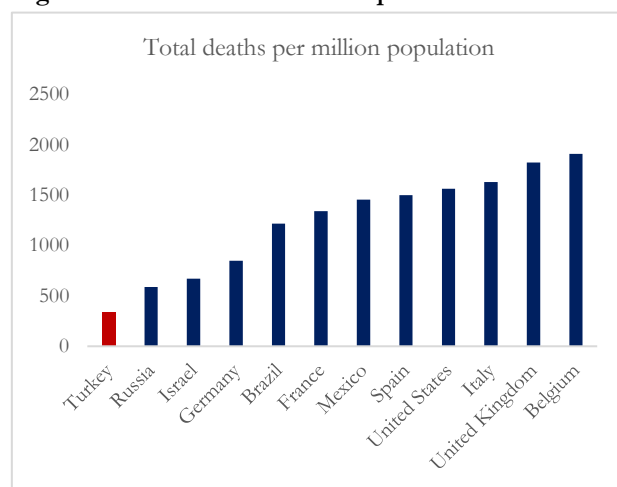


Figure 31:... and also low losses per million



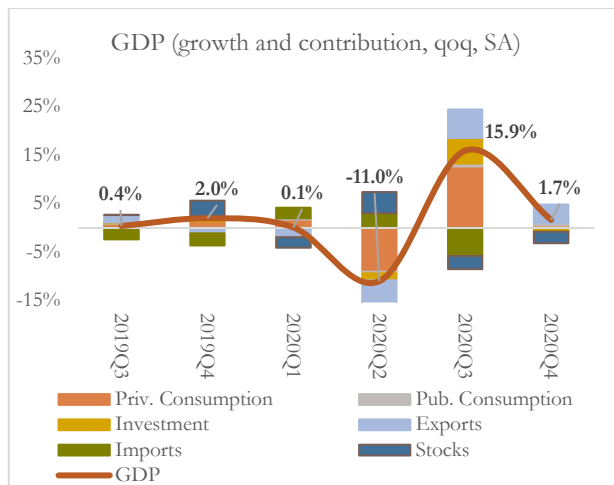
Source: Our World in Data.

B.A sharp rebound in late 2020, accompanied by rising pressures

The economy rebounded strongly in the second half...

Policy responses to the pandemic and its economic impact led to a sharp rebound in GDP in the second half of 2020. GDP recorded the sharpest contraction (-11 percent, qoq) of the past decade in the second quarter of 2020. However, driven by credit expansion and reopening, there followed a rapid rebound in GDP. GDP grew by around 16 percent over the third quarter, largely driven by private consumption (Figure 32). The contributions of exports and investment were sizable as well. Positive growth in Q4 as well, driven by exports, meant that Turkey was among the few countries to record positive overall growth, of 1.8 percent in 2020 (Figure 33). Both industry and services contributed to this rebound in the second half (Figure 34).

Figure 32: Sharp rebound in GDP in 2020 H2



Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Figure 33: Solid yoy growth in three quarters more than made up for losses in Q2

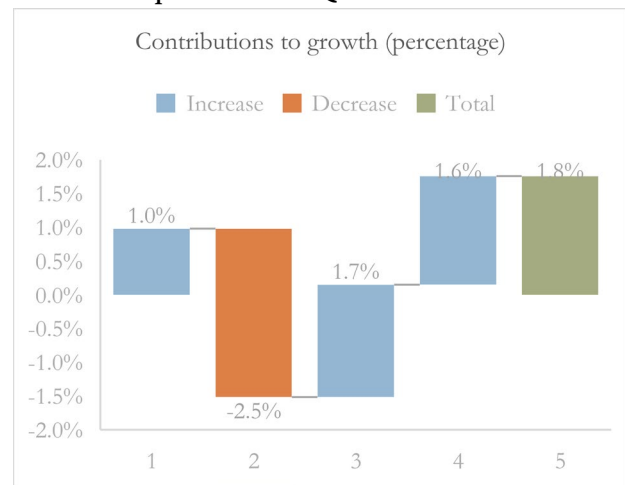
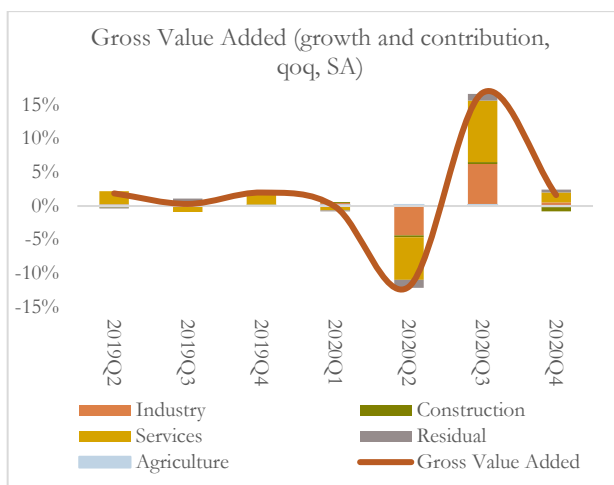
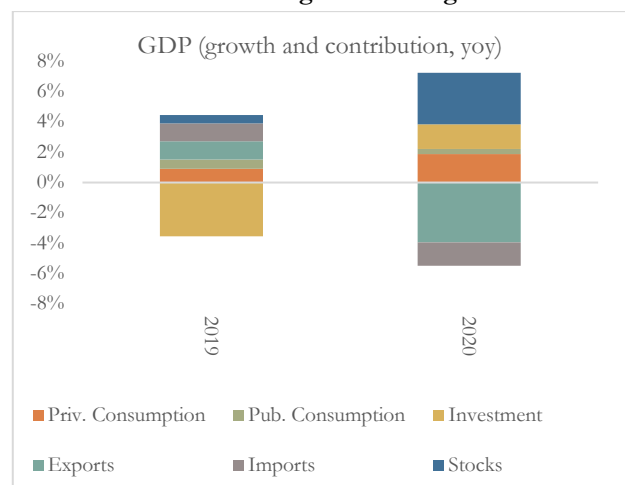


Figure 34: ...driven by both industry and services



Source: Haver Analytics, TURKSTAT, WB Staff estimates.

Figure 35: Not only consumption, but also a large accumulation of finished goods drove growth



Manufacturing rebounded sharply in response to these developments. The Purchasing Managers' Index (PMI) for manufacturing indicates the speed at which manufacturing sector activity accelerated after April 2020 (Figure 36), industrial production restarted, and capacity utilization rates returned to pre-pandemic levels (Figure 37). Turkey's rebound in 2020Q3 was much sharper than the average for both emerging markets and the Euro zone. However, Turkey's PMI fell slightly in 2021Q1 whilst PMI in Euro area and the U.S. continued to rise.

Figure 36: Turkey's rebound was more notable compared to other countries.

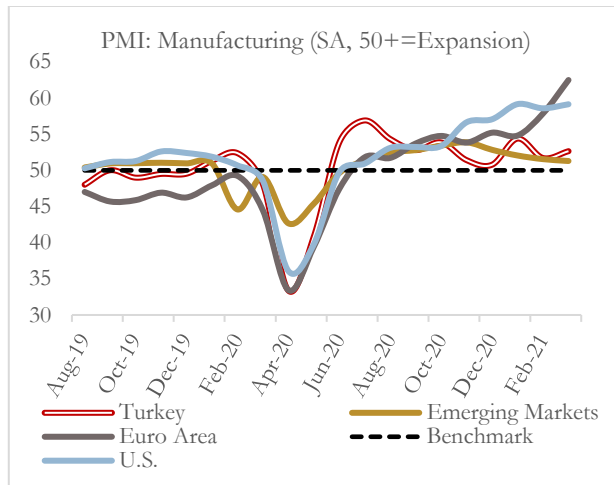
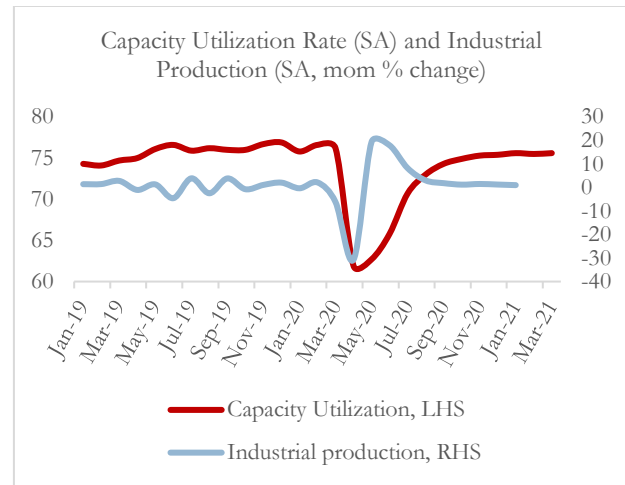


Figure 37: Capacity utilization reaching almost pre-pandemic levels



Source: Haver Analytics, TURKSTAT, CBRT and IHS Markit Economics.

The recovery in manufacturing was broad-based across all sub-sectors. Major export sectors, basic metals, apparel and road vehicles sectors recorded strong rebounds (more than 25 points) in their PMI output in 2020Q3 compared to the previous quarter (Figure 38). Following the stoppage in the second quarter, manufacturing led firms in the EU started growing again, as indicated by PMI levels of above 50 from June onwards, thereby increasing demand for intermediate inputs from Turkey. In addition to external demand, the vehicles sector benefitted from a surge in domestic demand backed by favorable credit conditions specific to vehicle purchases. The food sector, which contracted modestly unlike other sectors, had the lowest rebound. The second round of restrictions led to a decline in the PMI output of all sectors at the end of the year. Excepting the food and chemicals sectors, all sectors' PMI (output) fell to below 50, marking the lowest reading since the sectors began recovery from the pandemic-related downturn in June 2020.

Losses in labor productivity of the industry sector were reversed to some extent with the recovery in economic activity. Public measures to stem job losses coupled with the drop in production in Q2 led to a fall in production per employee of almost 20 percent, year-on-year (Figure 39). However, industry production per hour worked actually rose, as hours worked fell dramatically. And as production in industry picked up again, these trends reversed.

Figure 38: Large exporting sectors recovered fast

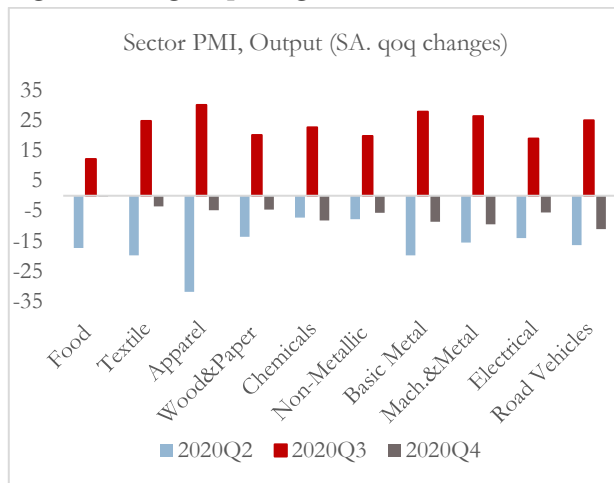
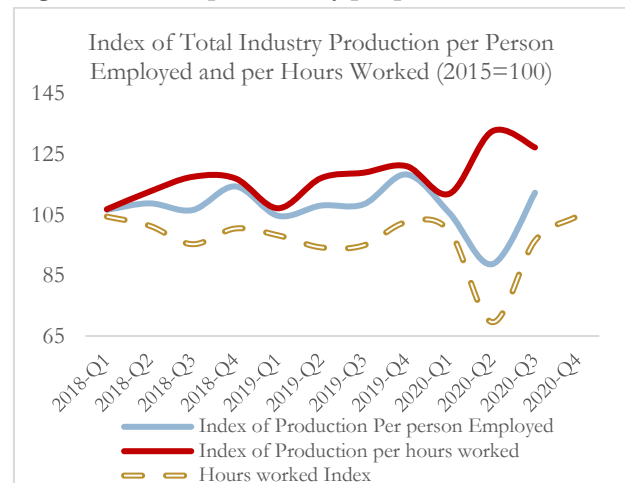


Figure 39: Labor productivity per person recovered



Source: IHS Markit Economics, TURKSTAT, Ministry of Industry and Technology and CBRT.

All service sub-sectors rebounded as restrictions were eased in the second half of 2020. With strict restrictions in place during most of 2020Q2, all services sectors except ICT⁴ suffered dramatically. Food and accommodation, administration and support and transport and storage sectors were especially impacted. Reopening that began in early June coupled with government stimulus led to a quick rebound in most services sub-sectors (Figure 40). The reopening of restaurants and cafes and the resumption of domestic flights supported the rebound in accommodation and food sectors. Foreign visitor arrivals increased gradually as international flights resumed and land borders reopened in early June, and hotel occupancy rates had increased to 45 percent by September (Figure 41). For real estate, abundant credit drove a record level of house sales.

Figure 40: A sharp recovery in all services sectors

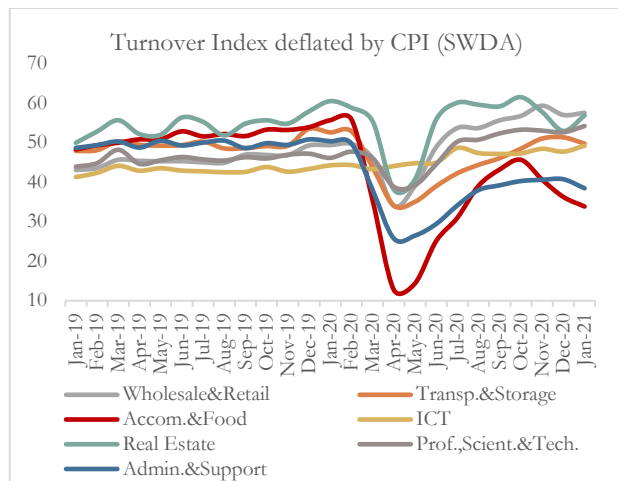
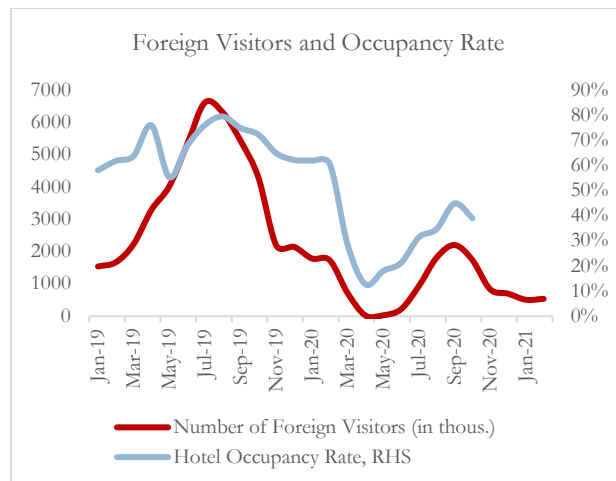


Figure 41: Gradual improvement in the tourism sector



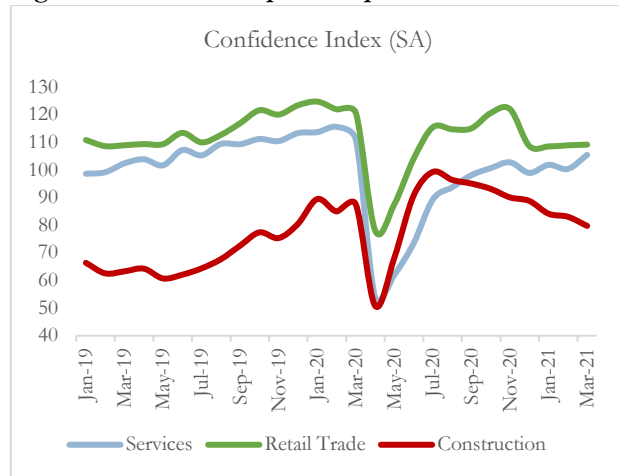
Source: Haver Analytics, TURKSTAT and Hotel Association of Turkey.

Confidence in services sectors also recovered, almost reaching pre-pandemic levels. Following a plunge in confidence⁴ in April, confidence in retail trade and other services sectors picked up quickly, driven mainly by improvements in demand and price expectations over the following three months (Figure 42). A TURKSTAT survey reports the factors limiting services sector activity. According to the survey results, whilst more than 60 percent of respondents were reporting no limiting factor before the pandemic, this ratio dropped to 30 percent in 2020Q2 and then rose to 50 percent recently with eased restrictions (Figure 43). In addition to pandemic related factors (other factors), insufficient demand seems to be one of the main factors limiting services sector activity, as expected. There is no remarkable change in limiting factors such as shortage of labor force and financial constraints between pre- and post-pandemic periods.

As policy frameworks tightened, credit growth cooled, and the credit-fueled growth momentum subsided. The tightening of credit conditions was quickly felt through a fall in credit growth (Figure 44). By mid-February, Lira-denominated credit growth was at around 1 percent quarter-on-quarter. Consumption indicators such as vehicle sales, imports and electricity usage also fell over this period, and on a seasonally-adjusted, quarterly basis showed no, or negative, growth in the first quarter of 2021 (Figure 45).

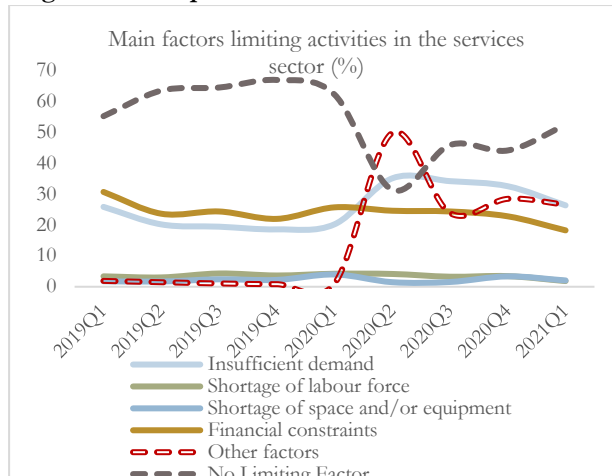
⁴ Based on the 'TURKSTAT' confidence survey. Sectoral confidence indices can take values of between 0 and 200. An index reading of above 100 indicates an optimistic outlook and a reading of below 100 a pessimistic one.

Figure 42: Confidence picked up with eased restrictions



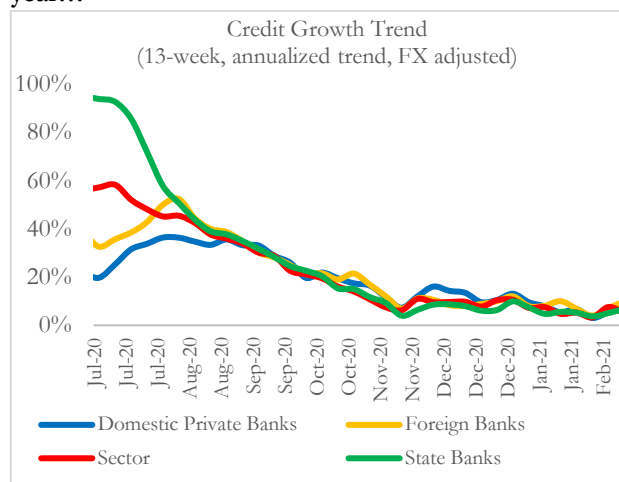
Source: TURKSTAT.

Figure 43: The pandemic and insufficient demand are



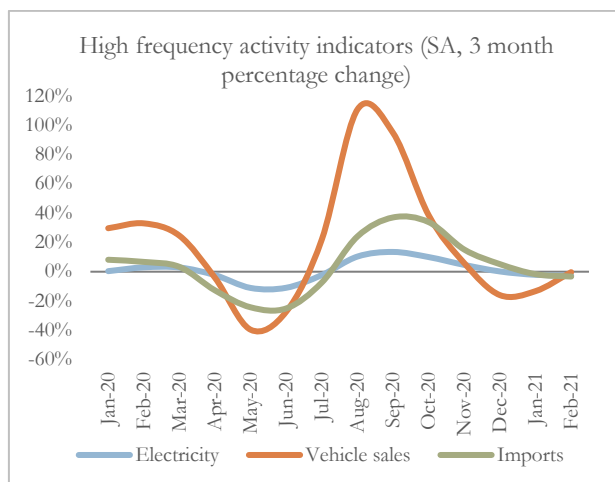
Note: Figures indicate the ratio of the number of enterprises affected by factor limiting activity, and the total number of survey responses.

Figure 44: Credit markets have been flat so far this year...



Source: Haver Analytics, BRSA, CBRT, WB Staff calculations.

Figure 45: ...and domestic activity is declining



Source: Haver Analytics.

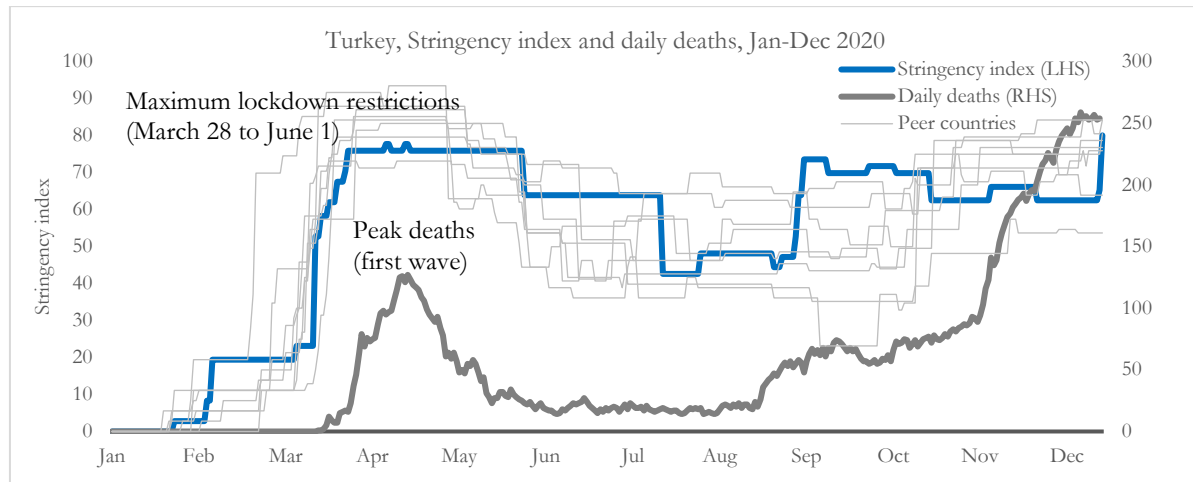
...as COVID-19 restrictions were relaxed

After imposing a comparatively moderate lockdown in March, Turkey began to slowly reopen from June 1. The Oxford COVID-19 Government Response Tracker (OxCGRT) has become the most widely used record of cross-country COVID-19 restrictions, and can be used to compare restrictions across countries⁵. Figure 46 shows the evolution of this index for Turkey over 2020, together with a selection of peer countries⁶ and a record of Turkey's daily COVID-19 deaths. The period of peak restriction in Turkey lasted between March 28 and May 31, with reopening only beginning 40 days after the peak in the daily death rate, one of the longest "wait times" in Europe. Whilst workplaces were never fully closed, the ban on non-essential travel was only lifted in June, and public transport fully reopened in July. Schools only reopened in late September, which together with Latvia was the longest school closure in Europe.

⁵ The database tracks information on containment and closure policies, such as school closures and restrictions in movement, and compiles a daily index ranging from 0 (no restrictions) to 100 (full lockdown).

⁶ Bulgaria, Spain, France, United Kingdom, Georgia, Greece, Italy, Poland and Romania.

Figure 46: COVID restrictions were relaxed in two phases, in June and July



Source: Oxford COVID-19 Government Response Tracker, World Health Organization, World Bank staff estimates.

Turkey had the strongest post-lockdown economic performance amongst peers, but this was only partially explained by reopening. Turkey's economic activity, proxied by electricity consumption, increased rapidly compared to the level predicted for a typical year, and rose much faster than peer countries, several of which never saw their electricity consumption record a level above the predicted value (Figure 47). But the size of Turkey's actual rebound is considerably larger than predicted by COVID-19 reopening alone. Turkey experienced a 15 percent increase in electricity use in June and a further 10 percent in July (Figure 48). Based on recent research⁷, the predicated impact of reopening on growth only explains around one third to one half of the increase, suggesting that other factors, namely the large credit stimulus, drove most of the observed economic expansion in the latter part of 2020.

Figure 47: Electricity use rebounded strongly in June...

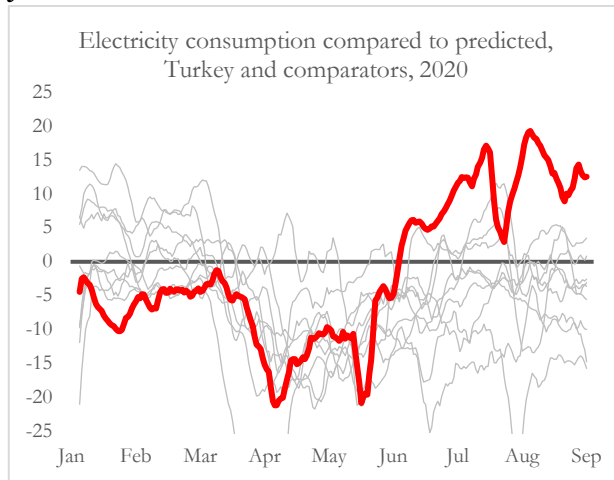
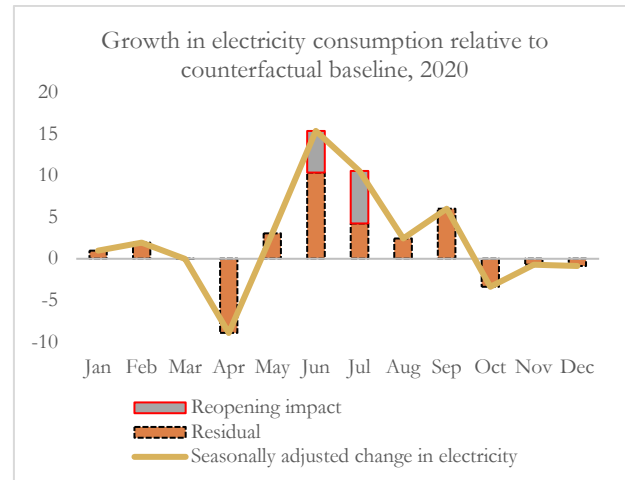


Figure 48: ...but only partially explained by reopening



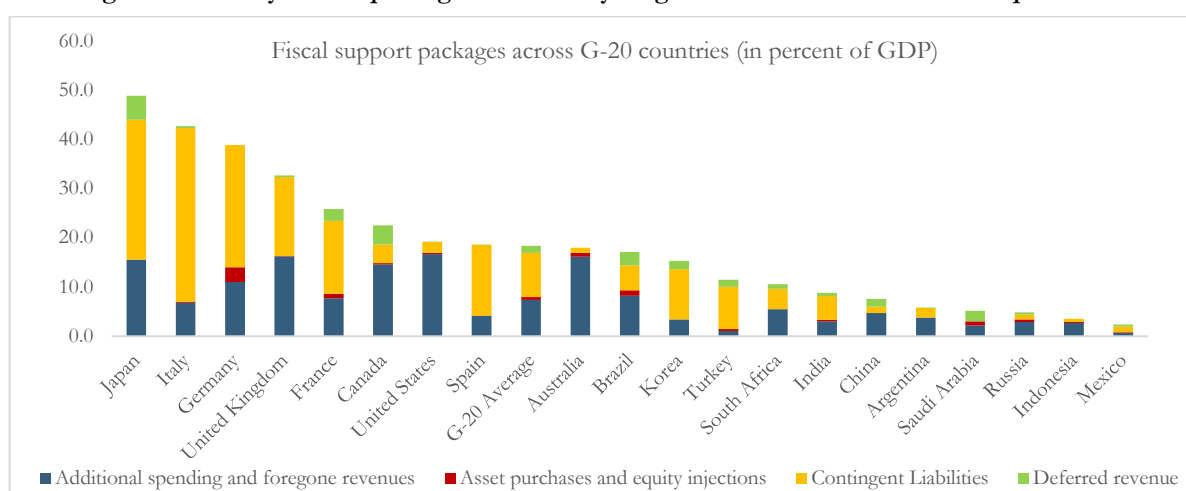
Source: Demirgüç-Kunt et al (2020), TEİAŞ World Bank staff data.

⁷ Demirgüç-Kunt, Asli, Michael Lokshin, and Iván Torre. "Opening-up Trajectories and Economic Recovery: Lessons after the First Wave of the COVID-19 Pandemic." World Bank Policy Research Working Paper 9480 (2020). Based on a cross-country analysis of electricity consumption and OxCGRT data on COVID-19 restrictions, this research estimates that the move from a full to partial lockdown sees an average 5 percent increase in economic activity (proxied by seasonally-adjusted electricity consumption), and the move from partial to fully open a further 6 percent. That longer wait times and slower reopening is associated with a faster rebound suggests that public trust and confidence that the pandemic is declining is important for economic recovery.

..and the government unveiled a large fiscal package and supported a wave of credit

Turkey's overall fiscal support package was one of the highest among G20 emerging market economies, but was overwhelmingly focused on support through the credit channel. Turkey's fiscal support package, at 11.5 percent of GDP (10.1 percent of GDP excluding deferred revenue), was the second largest amongst emerging markets after Brazil, and the 12th largest amongst all G-20 countries (Figure 49). But unlike most other economies, Turkey predominantly relied on indirect fiscal measures with 75 percent of the economic support package consisting of contingent liabilities (loan guarantees and quasi-fiscal operations). These measures were central to facilitating a large increase in credit, primarily via the state-owned banks. Direct fiscal measures, though smaller in magnitude, were generally well-targeted and effective. This included support to furloughed workers and public payments to workers on unpaid leave, additional social support transfers to households, rent and revenue support to small businesses, and tax and social security contribution deferrals for businesses.

Figure 49: Turkey's fiscal package relies mostly on guarantees rather than direct expenditures

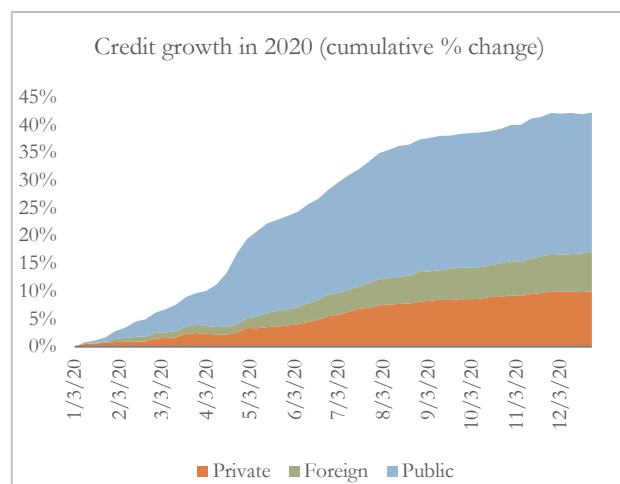


Source: IMF Fiscal Monitor Database, January 2021.

The policy response action was effective in stimulating a sharp credit expansion in 2020. Rapid loan growth was fueled by the countercyclical lending of state banks, an expanded CGF, and policy measures such as the BRSA's Asset Ratio, in place until end 2020, and that obliged banks to ease their cautious stance and provide more credit. By the end of 2020, overall domestic Lira lending from deposit-taking institutions had expanded by 42 percent over the year, of which state banks were responsible for 25 percent, private banks 10 percent and foreign banks 7 percent (Figure 50). The majority of the new lending went to corporate and mortgage loans, and the vast majority of credit growth was Lira denominated⁸. Overall, Turkey's real credit growth in 2020 was one of the highest amongst advanced and emerging economies (Figure 51).

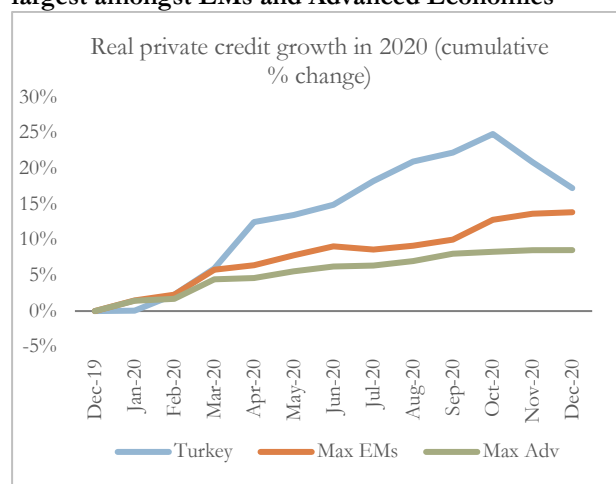
⁸ FX credit expanding by only a tenth (in nominal Lira terms), largely as a result of measures put in place recently to discourage domestic FX lending. FX lending declined around \$6 billion dollars throughout 2020. This decline was partly due to liability de-dollarization by firms incentivized by interest rate differential as well as the level of nominal exchange rate until after mid-year.

Figure 50: Huge credit stimulus, led by state banks



Source: BRSA; Haver; World Bank Staff calculations.
Note: Deposit money banks Lira loans only.

Figure 51: Turkey's credit stimulus was among the largest amongst EMs and Advanced Economies



Source: Haver; World Bank Staff calculations.
Notes: Maximum amongst 17 other emerging market economies and 11 advanced economies with data available. Nominal credit discounted using consumer price inflation. Credit growth is not adjusted for FX valuation effects for Turkey or comparators.

Turkey faced severe external pressure, and the Lira depreciated sharply

Turkey was exceptionally hard hit by capital outflows over 2020, with the central bank running down reserves in response. In the aftermath of the first wave, many emerging markets (EMs) saw capital outflows, and Turkey, along with Brazil and South Africa, was particularly hard hit, with these three countries experiencing a ‘sudden stop’⁹(Figure 52).¹⁰ Turkey’s very loose monetary policy, coupled with high inflation is likely to have exacerbated capital outflows in Turkey over the period. As Turkey faced the full force of capital flight, the Central Bank began to use international reserves at an unprecedented rate. In the first three quarters of the year, more than US\$40bn was recorded as use of reserves in official balance of payments data¹¹ (Figure 53). The lira nevertheless depreciated in the first half of the year, by 14 percent against a trade-weighted basket of currencies (Figure 54). However, pressure on the lira continued, and by the end of the year, despite a continued run-down of reserves, it had depreciated by 30 percent in 2020Q4 compared to 2019Q4 to become the worst-performing of thirteen EM currencies.¹²

⁹ Capital inflows fell to just over 2 standard deviations below their 5-year average in 2020 Q2. Eichengreen and Gupta (April 2016) classify an episode as a sudden stop when: (i) non-resident portfolio and other investment inflows decline below the average of the previous 20 quarters by at least one standard deviation; (ii) when the decline lasts for more than one quarter; (iii) and when flows are two standard deviations below their prior average of at least one quarter. Episodes end when capital flows recover to the prior mean minus one standard deviation

¹⁰ Capital flows in Turkey are highly volatile due to high dependence on external flows and high risk sentiment. The COVID-19 pandemic has exacerbated the volatility of capital flows and exerted pressure on the currency.

¹¹ The Balance of Payments reports transactions and financial flows between residents and non-residents. It is also possible that reserves may be used in transactions with residents which, while not being registered in the Balance of Payments, would still have an effect on the exchange rate. Therefore, the use of reserves may be greater than is reported here. However, for the purpose of comparison with other countries, this analysis maintains the BoP definition of use of reserves.

¹² The Lira was the worst performing currency amongst currencies of a group of emerging market economies, which are Malaysia, Indonesia, Thailand, Chile, China, Russia, Mexico, Argentina, Brazil, the Philippines, South Africa, and India.

Figure 52: Turkey experienced a sudden stop in 2020

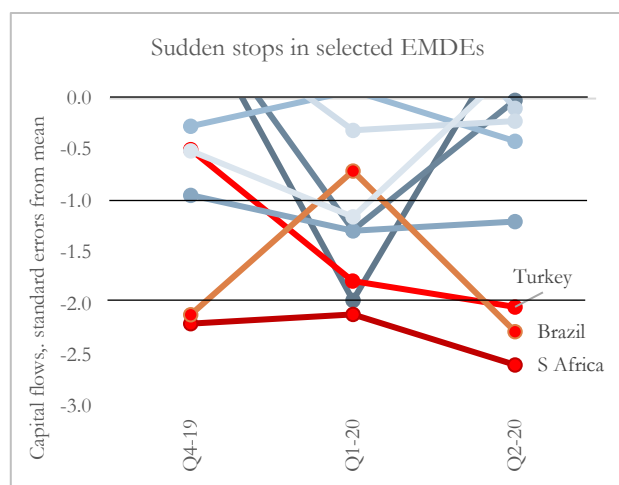


Figure 53: Turkey's central bank released a massive amount of international reserves

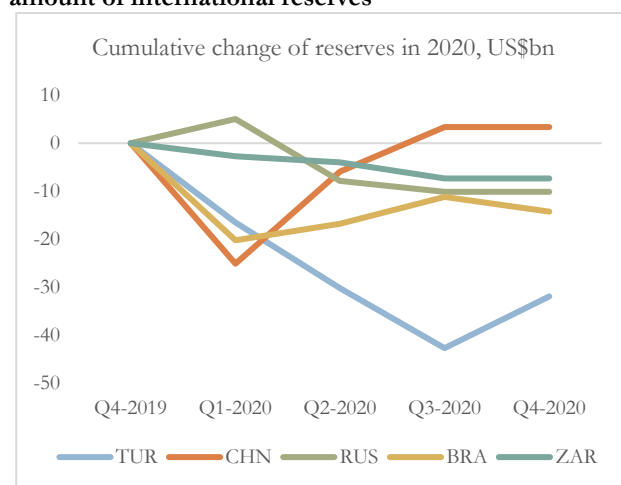


Figure 54: But the lira nevertheless depreciated throughout the year

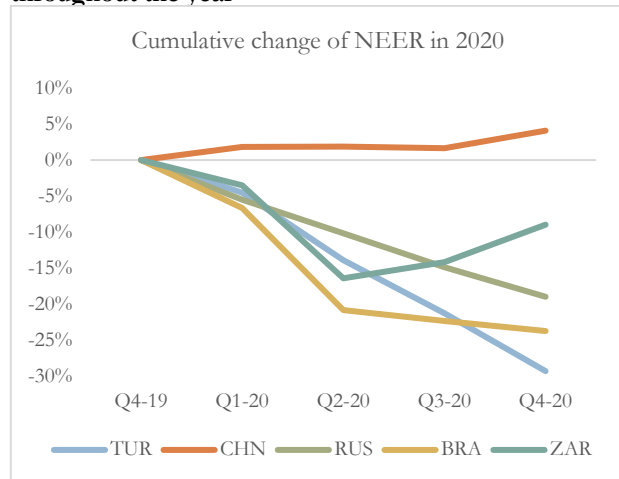


Figure 55: Portfolio flows recovered in line with other EMs

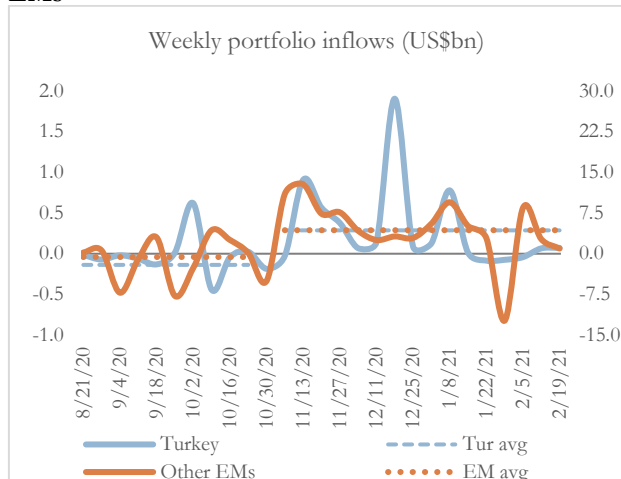
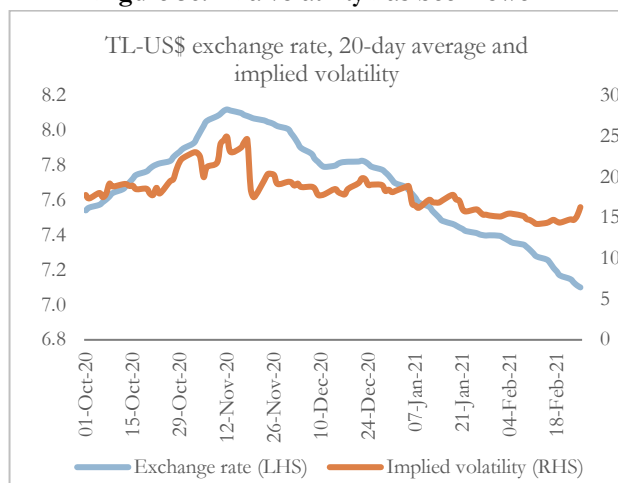


Figure 56: Lira volatility has been lower

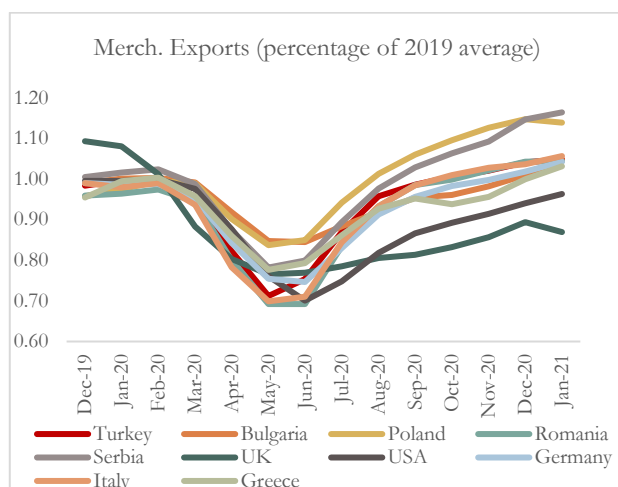


Source: Haver Analytics; Bloomberg, JP Morgan, International Institute of Finance
Note: One-month implied volatility of US\$-TRY in the options market

Portfolio flows to Turkey then rebounded, influenced by both domestic policy and global liquidity conditions. Portfolio inflows, which remained negative on average up to the end of October, have moved into positive territory with an average net inflow of US\$300 million each week since then (Figure 55). While this positive reversal has been supported by Turkey's tightening of monetary policy, it also reflects a broader return to EMs. The rebound in portfolio flows has only slightly outperformed the EM average, and this underlines the ongoing criticality of global market sentiment on EMs for Turkey, in addition to domestic conditions. Turkey's sovereign credit default risk spread price, which had reached 535 basis points in October, then almost halved to 283 basis points by early February, and while the Lira has steadily appreciated against the US\$, its volatility (measured as the range between minimum and maximum daily values over the past 20 days) has trended downwards (Figure 56).

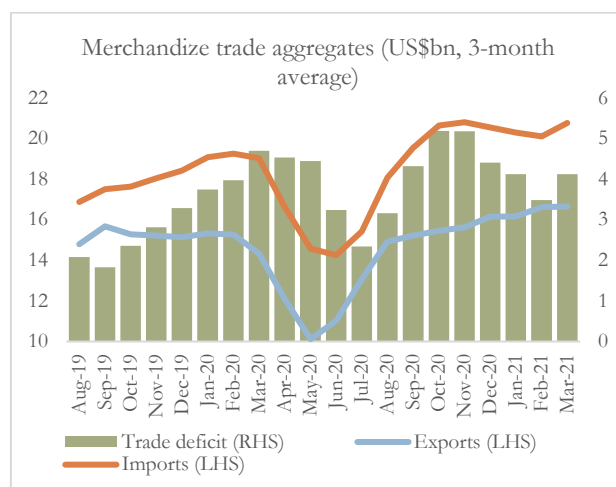
Merchandise exports and services are now recovering in line with demand in advanced Europe. From October onwards, merchandise exports had recovered above their average level in 2019, and were 5 percent higher by January, and the trade deficit was narrowing (Figure 58). This export performance is in the mid-range of emerging markets in the same neighborhood (Figure 57), and generally better than advanced economies. However, activity indicators like the Purchasing Manager Index indicate that Eurozone activity remains weak, with German output growing only slightly (Figure 61). Given that Europe is Turkey's largest export market, this weak demand is likely to have dented the export recovery to date. Exports to non-EU countries also show a strong upward trend (Figure 59) and Turkish PMI suggests that new export orders are losing pace (Figure 62). Services exports are similarly growing, and by December had begun to bring down the current account deficit (Figure 60).

Figure 57: Exports recovered relatively well...



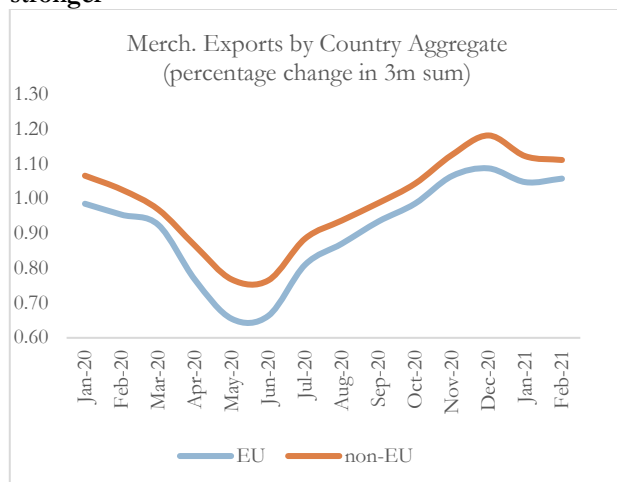
Source: Haver Analytics.

Figure 58: ...and the trade balance is narrowing



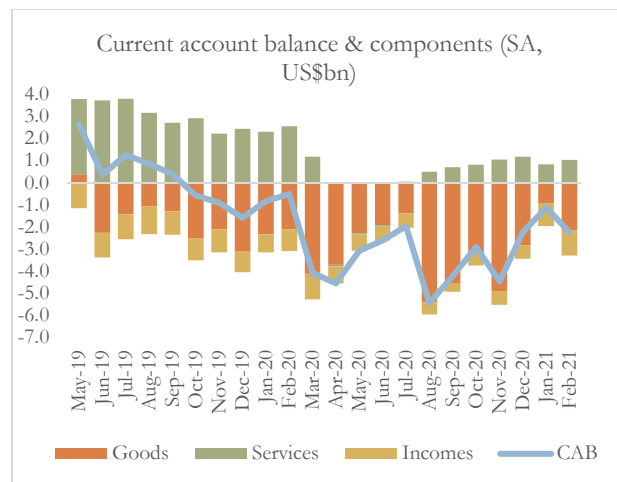
Source: TURKSTAT.

Figure 59: Export growth to non-EU markets is stronger



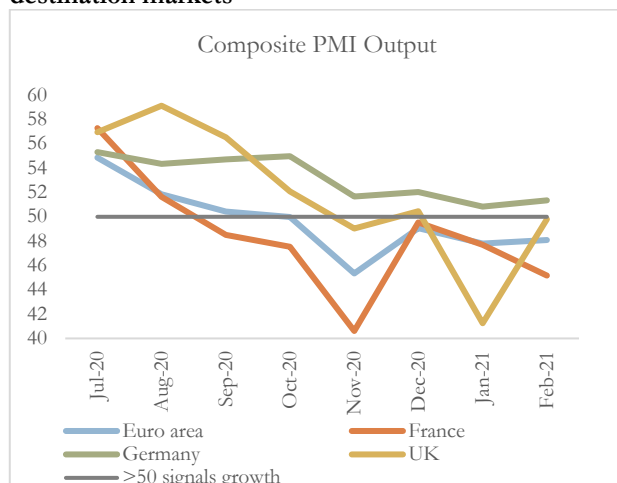
Source: Haver Analytics.

Figure 60: Net services receipts also strengthening...



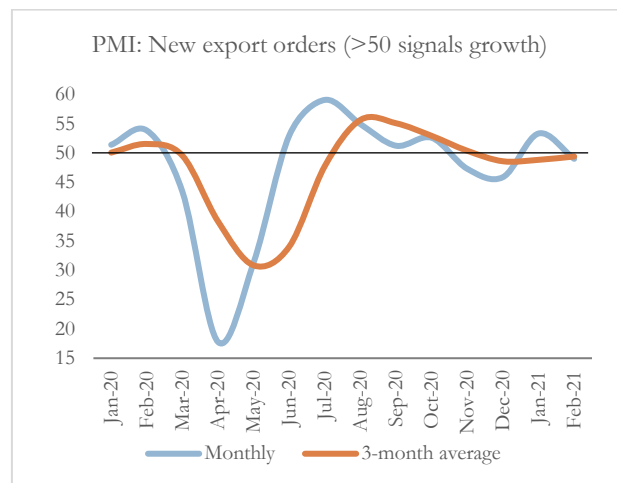
Source: Central Bank of Turkey.

Figure 61: ...but limited by weak demand in destination markets



Source: IHS Markit via Haver Analytics.

Figure 62: ...and new demand is weakening



Source: IHS Markit via Haver Analytics.

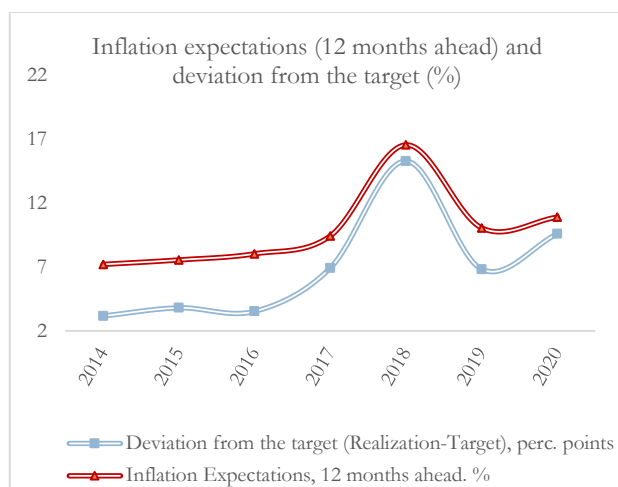
Inflation accelerated as the effects of monetary and credit stimulus played out

Inflation accelerated in the second half of 2020 due mainly to depreciation of the Lira, rising international commodity prices and deteriorating inflation expectations. Consumer price index (CPI) inflation reached 15 percent - three times the target - and domestic producer price inflation (PPI) hit 25 percent at the end of 2020 (Figure 65). CPI and PPI further accelerated to 16.2 percent and 31.2 percent in March, respectively. Inflation has persistently overshoot the 5 percent target over the past decade with sizable deviations in recent years and rising inflation expectations¹³ (Figure 63). Turkey recorded the highest deviation of inflation from its target among many peer countries in 2020 (Figure 64). The diffusion index also reached its highest level since the August 2018 shock, indicating strong broad-based price pressures (Figure 66). The sharp depreciation of the lira coupled with high exchange rate pass-through, the credit-driven boost to domestic demand and deteriorating inflation expectations led to a jump in consumer and domestic producer prices (Box

¹³ Kose et al (2019) found for a group of emerging and developing economies that inflation targeting, high central bank transparency, strong trade integration and a low level of public debt are associated with better-anchored long-term inflation expectations.

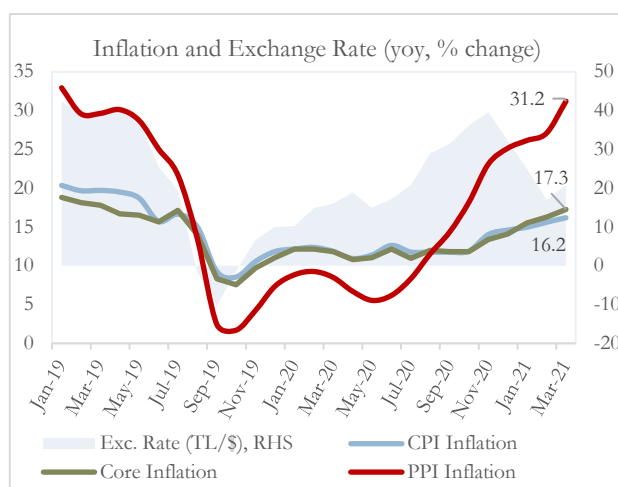
1). Supply constraints and rising international commodity prices also exerted pressure on producer prices in addition to the effects of exchange rate depreciation. Inflation remained high in 2021Q1.

Figure 63: Deviation from the target and inflation expectations move in parallel



Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Figure 65: Inflation resurged in the second half of 2020...



Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Figure 64: Turkey shows the largest deviation among peer countries

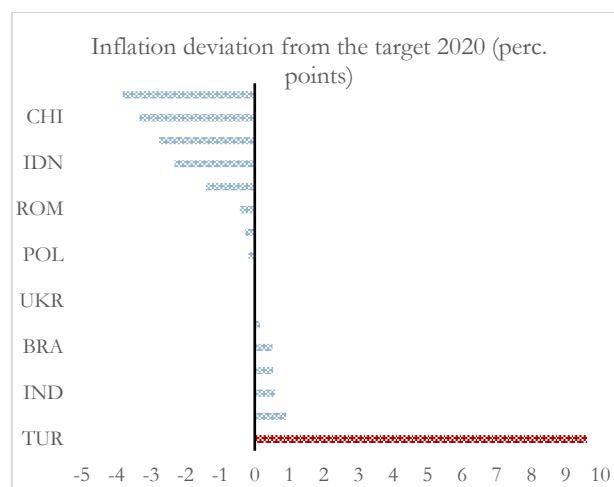
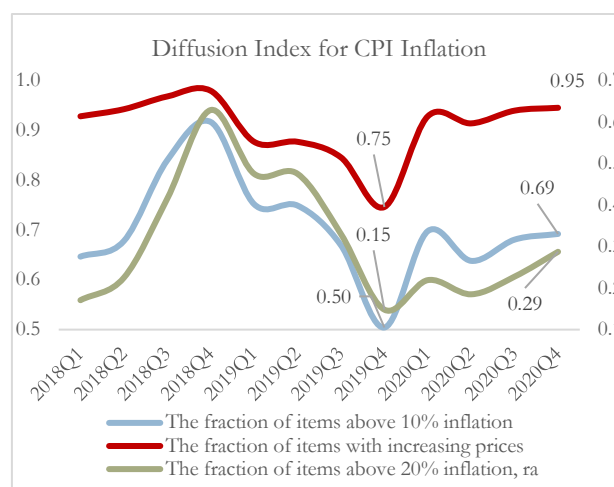


Figure 66: ...with strong broad-based price pressures

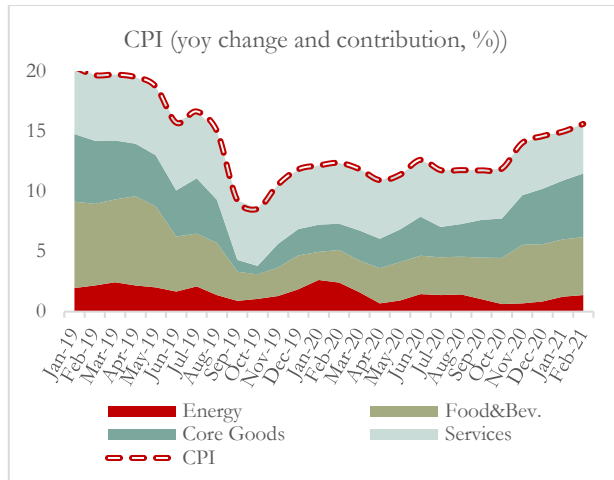


Food and core goods, particularly durables, were the largest contributors to inflation. Food and core goods accounted for almost 65 percent of the rise in inflation by the end of the year, while the contribution of energy was negligible (Figure 67). Among food items, the rise in the price of unprocessed food was notable (26.3 percent yoy in December). Currency depreciation, seasonal factors, drought and an upward trend in international food prices were the main drivers of high food inflation.¹⁴ Over most of the past decade, food price inflation in Turkey has been significantly higher than international food prices. However, by end 2020, international food prices had reached a six-year high and were exerting upward pressure on domestic food prices (Figure 68). Rising food prices then had a knock-on effect on prices in hotels, cafes and restaurants

¹⁴ Considering the importance of reducing food inflation, especially for price stability, the government recently took a step to perform an early warning function by carrying out a detailed and timely analysis of data on the prices of food and agricultural products. In this regard a new unit the “Food and Agricultural Product Markets Analysis Division” was established at the CBRT. The recently announced Economic Reform Package includes measures to address structural issues contributing to price volatility in the agriculture sector, including ensuring intermediaries operate competitively and efficiently.

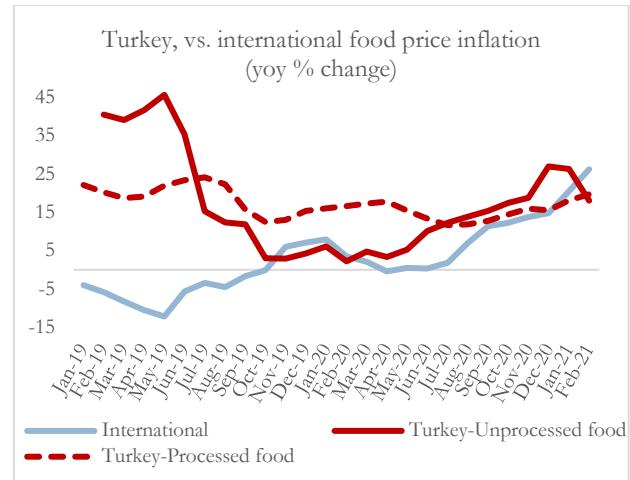
services, which reached 13 percent. Transportation inflation has also started to pick up. Core goods inflation rose to 17.2 percent (yoy) at the end of the year, driven mainly by a sharp surge in durable goods inflation (30 percent yoy) on the back of strong credit stimulus.

Figure 67: Driven mostly by core goods and food prices



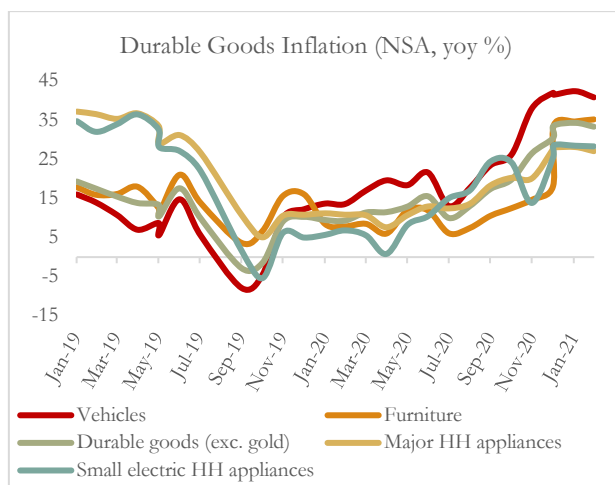
Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Figure 68: Rising international food prices add pressure on domestic prices



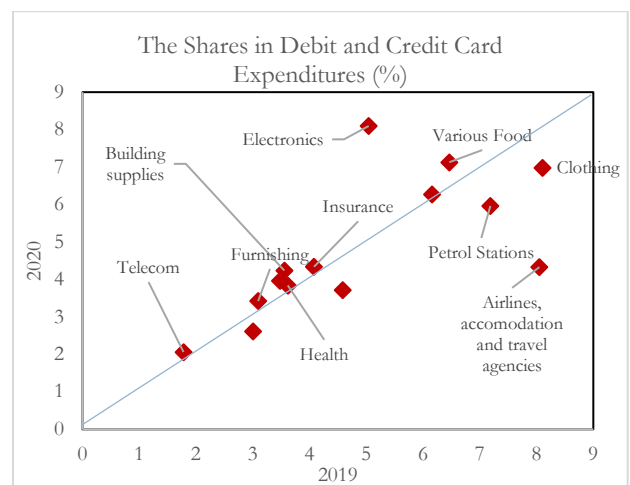
Prices of durable goods, which are more sensitive to exchange rate developments and credit momentum recorded a sharp rise. The credit-driven demand stimulus was reflected as a big price hike in some durable goods such as automobiles, furniture and white goods, which are more exposed to credit momentum and exchange rate developments. Automobile prices recorded 42 percent (yoy) price hikes at the end of the year, whilst the prices of white goods and household appliances increased by 25-30 percent (yoy) (Figure 69). The increase in special consumption tax rates on cars in 2020 also contributed to the rise in automobile prices. Similarly, furniture prices rose by around 20 percent (yoy) as home purchases reached record levels.

Figure 69: Inflation of some durable goods jumped backed by massive credit expansion



Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Figure 70: Consumer consumption patterns have changed with the COVID-19 pandemic



Source: CBRT.

Note: The biggest share belongs to Market and Shopping Centers, which was at 16.9 percent in 2019. The share increased by more than 4 percentage points to 21.1 percent in 2020. As it has a high share compared to other items, it was not presented in the figure.

Consumption patterns changed dramatically during the COVID-19 pandemic, understating the actual rate of consumer inflation. During the pandemic, consumers decreased their spending on transport, restaurants, hotels, recreational, cultural and sporting events, and clothing, while increasing their spending on food worldwide (IMF, 2020).¹⁵ Credit and debit card expenditures in Turkey confirm similar trends and show more spending at shopping centers, on electronics and food and less spending on clothing and fuel. The share of airlines, accommodation and travel agencies in the total almost halved in 2020 compared to 2019 (Figure 70). These changes in spending patterns were reflected in CPI weights in early 2021.¹⁶ Applying these new weights to 2020 CPI expenditure groups shows that CPI inflation would have been 0.4 percentage points higher.¹⁷

Box 1: Drivers of Core inflation-Phillips Curve Estimation

Core inflation accelerated rapidly in 2020, particularly in the second half 2020 to over 14 percent at the end of 2020. Sharp currency depreciation was among the key drivers of this rise. However, other factors such as inflation expectations played a role. For a better understanding of inflation dynamics in the recent period and to decompose core inflation (defined as CPI excluding unprocessed food, alcoholic beverages, and tobacco) in terms of drivers, a reduced-form Phillips curve is estimated:

$$\pi_t = \alpha_1 \pi_{t-1} + \alpha_2 \pi_{exp} + \alpha_3 gap_t + \alpha_4 \Delta exc_t + \alpha_5 \Delta exc_{t-1} + \alpha_6 \Delta pimp_t + \mu_t \quad (1)$$

where π_t is quarterly (seasonally adjusted) annualized core (D index-excluding unprocessed food, alcoholic beverages and tobacco) inflation; π_{exp} is 12 months ahead inflation expectations; gap_t is the output gap; exc_t is the quarterly average exchange rate (TL/US\$) and $pimp_t$ is US\$ denominated import price. The model covers the inflation targeting regime period of 2006:1-2020:4.

Table 1: Phillips Curve Estimation Results

Dependent Variable: CPI inflation (quarterly, seasonally adjusted annualized), 2006Q1-2020Q4

	Model 1
Lagged inflation	0.32* (0.084)
Inflation expectations (12 months ahead)	0.65* (0.100)
Output gap	0.19*** (0.106)
Δ Exchange rate	0.34* (0.054)
Δ Exchange rate_{t-1}	0.15* (0.056)
Δ Import Price	0.59* (0.089)
Dum20191	-0.15 (0.026)
Adjusted R-squared	0.82

Note: Standard errors are in parentheses. *, ** and *** refer to statistical significance at 1, 5 and 10% level.

Constant parameter estimation results suggest that the largest contribution to recent inflation comes from inflation expectations with a coefficient of 0.65 and exchange rate depreciation with a coefficient (sum of

¹⁵ Under-weighting of rising food prices and over-weighting of falling transport prices are the main causes of the underestimation of inflation. The COVID-19 indexes based on spending changes in CPI imply that CPI underestimated inflation over February-May 2020 for 65 out of 83 individual economies (IMF, 2020).

¹⁶ In the basket, the weights of food and beverages, housing and furnishings were increased, whilst the share of services items was decreased.

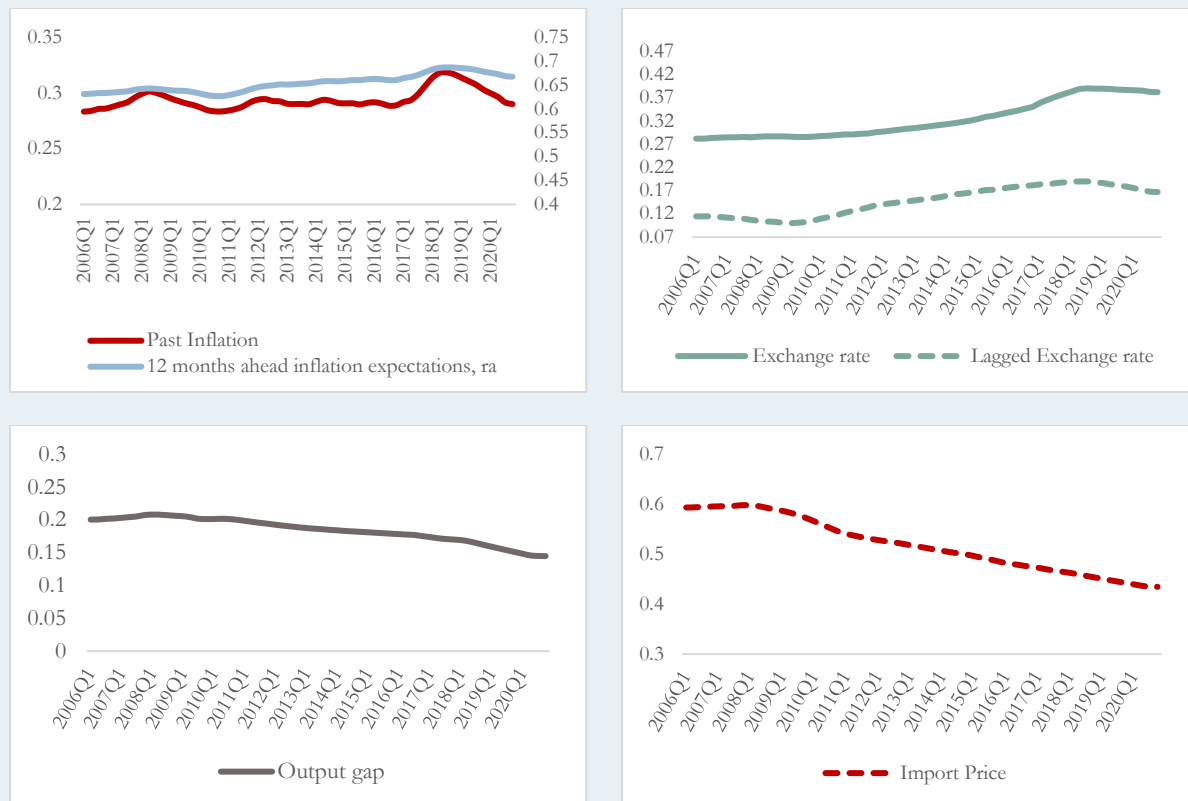
¹⁷ If we apply 2021 shares to CPI inflation for the period of April-December 2020, inflation rises by 0.1 percentage points.

exchange rate coefficients) of around 0.5. This impact is not only felt through imported consumption goods, but also through the sharp rise of cost of production and its pass through to consumer prices. The coefficient of import price inflation is around 0.6. Inflation in Turkey has strong inertia with the coefficient of past inflation at around 0.32. The coefficient of the output gap is estimated to be around 0.20. The estimations of different samples (2006:1-2020:4) suggest that the coefficients change over time.

To capture the behavioral change in coefficients, a time varying parameter reduced-form Phillips curve is estimated. The estimation results show that there is a variation in the coefficients of the model. Both the coefficients of expectations and past inflation have also declined over time, albeit slightly. While the coefficient of the output gap is found to be relatively stable, the pass-through from the exchange rate, on the other hand, has risen notably. These findings seem to be consistent with the results of Kara et al. (2017) and Koc et al. (2021).

Based on the time varying parameter estimation results, core inflation is decomposed into contributions from its determinants for 2018-2020 on a quarterly basis. The results indicate that one of the main drivers of core inflation was sharp depreciation of the Lira, particularly in the second half of 2020 due to rising macroeconomic imbalances triggered by massive credit expansion and a relatively loose monetary stance. In addition to the rise in prices of imported consumption goods, the pass-through from the rising cost of production due to deprecation and pandemic-related factors on consumer goods impacted inflation adversely as well.

Figure 71: Time Varying Parameters of the Model 1



Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Note: These coefficients are obtained from time varying parameter estimation with flexible least squares. Eviews add-in 'Tvpuni' was used. Flexible least square estimation with Kalman filter produces similar results regarding the coefficients of exchange rate and import price. However, the coefficient of inflation expectations, past inflation and output gap is found to be relatively stable compared to the above results.

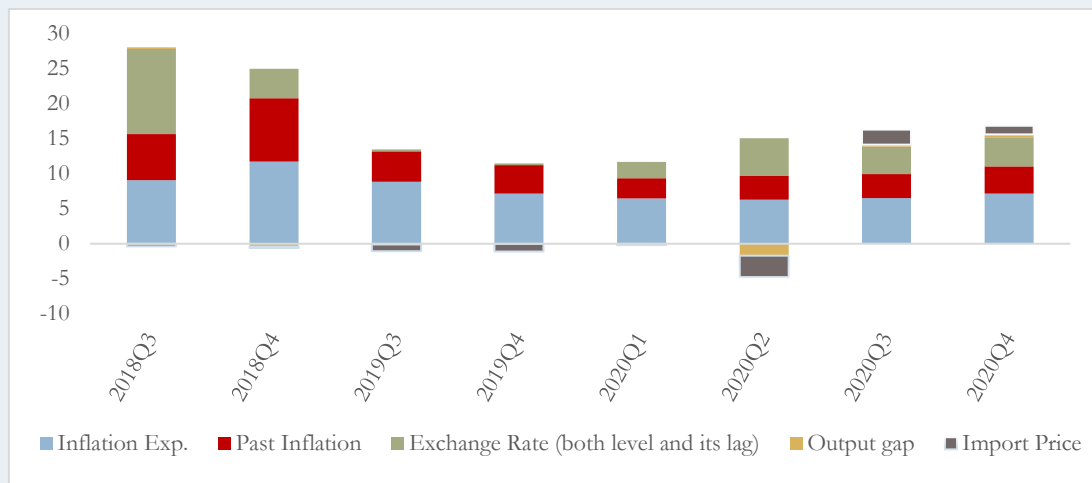
The exchange rate pass through from producer prices to consumer prices tends to be relatively low during periods of weak demand. The demand for product groups differed during the pandemic due to strong credit stimulus. Thus, as indicated in the recent inflation report of the CBRT, the exchange rate pass-through was high in product groups where demand was high supported by credit stimulus, such as white goods and automobiles. On the other hand, depreciation of the TL had a more limited impact on clothing and some services items due to weak demand.

Strong recovery in 2020H2 reversed the demand driven disinflationary impact on core inflation. Massive credit expansion led to a big jump in demand for durable goods such as automobiles, electronics and white goods, and led to demand pressure on inflation. On the other hand, demand for clothing and hardest-hit services items such as accommodation, travel and entertainment were muted. The contribution of the output gap to core inflation was negligible in 2020, as the output gap moved to positive territory in the second half of 2020.

On the import price side, there was no contribution to core inflation, unlike the previous year. This was due mostly to weak global demand, particularly in the first half of 2020.

Inflation expectations also had a significant impact on the rise of inflation in 2020, being the largest contributor. This underlines the importance of inflation expectations in controlling inflation. Gulsen and Kara (2021) found that expectations seem to be more sensitive to exchange rate movements during depreciation periods. This also confirms that exchange rates play a more important role in driving inflation expectations, beyond the dimension of pass-through to domestic prices.

Figure 72: Contributions to Core Inflation (annualized, percentage points)



Sources: Haver Analytics, TURKSTAT, WB Staff estimates.

Corporate and bank balance sheets faced pressure, obscured by forbearance measures

The corporate deleveraging process, initiated in 2018, was interrupted by the COVID-19 pandemic. From late 2018, corporate debt started falling, from 71.4 percent of GDP in 2018Q2 to 65 percent at the end of 2019. But the need for liquidity following the COVID-19 disruption saw corporate debt leaping back up to around 77 percent by 2020Q3. Whilst corporates continued FX deleveraging process, they increased their TL borrowing which significantly contributed to the rise in total debt ratio. Indeed, among peer countries, Turkey

saw the sharpest increase (more than 11 percentage points) after Russia in terms of the corporate financial debt to GDP ratio in 2020 (Figure 73)¹⁸. Most of this increase stemmed from TL denominated debt.¹⁹

Figure 73: Corporate debt burden remains relatively high

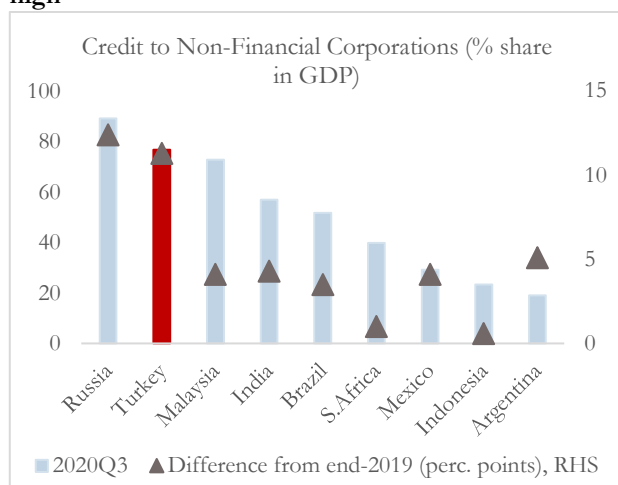
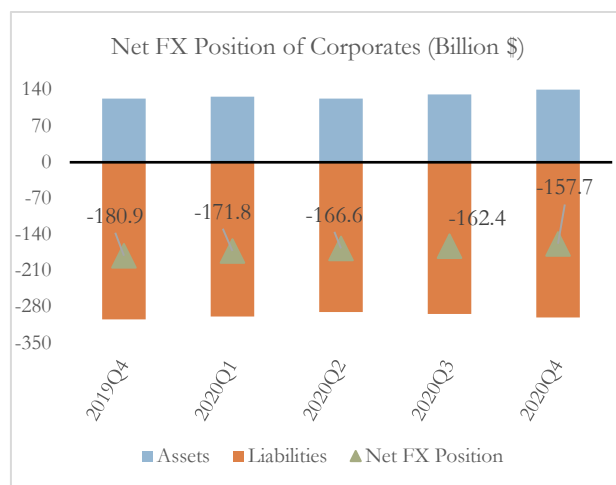


Figure 74: Net FX position of corporates has declined



Sources: BIS and CBRT.

The net FX position of corporates improved during 2020. FX liabilities declined by US\$6 billion over 2020 as corporates refinanced with lira debt (Figure 74). Short term domestic FX debt to the domestic banking sector declined by US\$4.4 whilst import payables rose by US\$2.8 billion in the same period. FX assets of corporates on the other hand have increased by around US\$20 billion largely through deposits in both domestic and foreign banks. As a result of these changes, the net FX position improved by more than US\$20 billion to US\$158 billion (around 22 percent of GDP).

Monetary tightening started in late November 2020 led to rises in the external debt rollover rates of corporates. TL lending rates, which dropped to below 10 percent at the end of 2020Q2 amid a loose monetary stance, started to rise with the policy shift in late November 2020. The weighted average interest rates for commercial loans almost doubled to 19 percent at the end of 2020. This led corporates to decrease their borrowing in TL terms. This is reflected in rising external debt rollover rates of close to 100 percent for corporates through the end of the year, supported by a relatively lower cost of borrowing in FX.

Accumulation of debt is evident among listed companies and solvency pressures persist due to high levels of overall debt. Deleveraging of listed companies was also interrupted in early 2020 and an index of debt to equity displayed a sharp rise in 2020 (Figure 75). Turkey's increase in the debt-to-equity ratio was sharper than the equivalent for the MSCI Emerging Markets Index.²⁰ Elevated corporate debt coupled with a plunge in earnings put pressure on the interest coverage ratio (ICR)²¹. The ICR fell to levels very close to the sustainability threshold in the first half of 2020. However, the subsequent surge in demand and rapid rise in inflation led to a recovery in nominal earnings in the second half of 2020, and thus a rebound in the ICR (Figure 76).

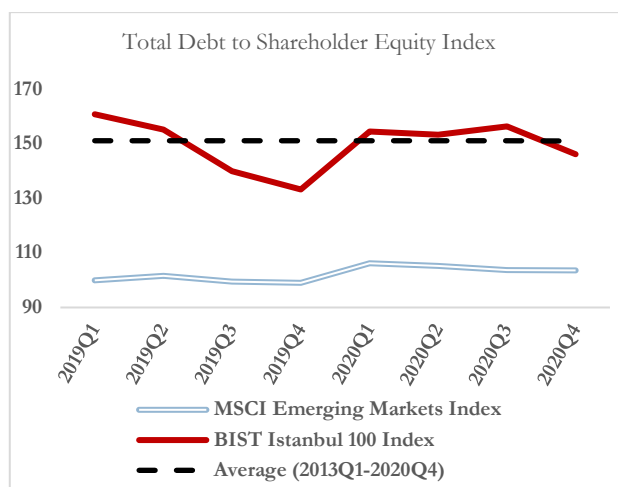
¹⁸ The corporate financial debt to GDP ratio of Russia and Chile increased by around 13 percentage points over the same period.

¹⁹ Around 33 percent of this increase is due to currency depreciation and the remainder is due to TL loan increase. Tighter macro-prudential regulations since May 2018 made it more difficult for some relatively small-sized corporates to access FX loans from the domestic market.

²⁰ The MSCI Emerging Markets is an international equity index that tracks stocks from 24 emerging market countries, including Turkey. All corporates, both financial and non-financial, are presented for comparison with other emerging market economies.

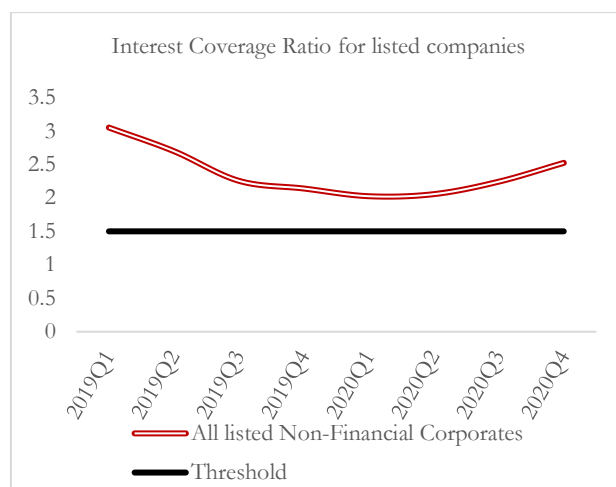
²¹ The ratio of earnings before interest and tax to interest expenses.

Figure 75: Turkish traded companies increased their leverage during the pandemic



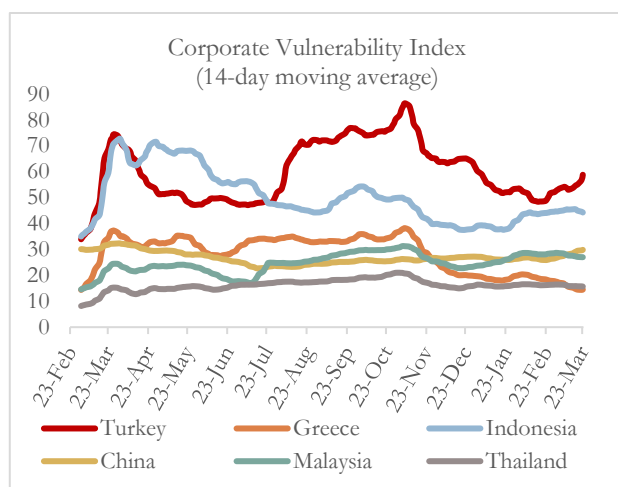
Source: CBRT.

Figure 76: Contributing to solvency pressures



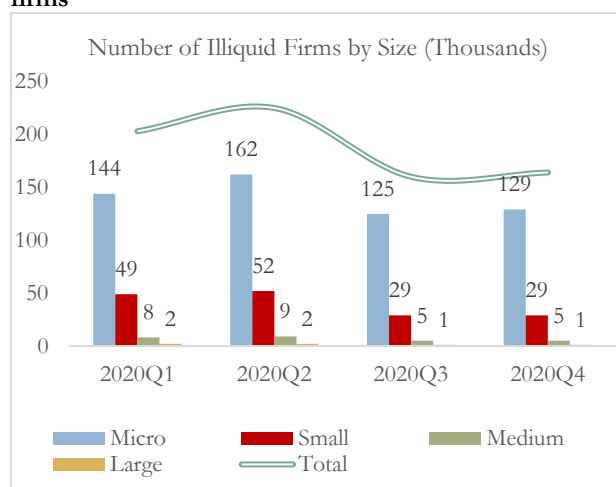
The pandemic led to a rise in corporate vulnerability and disrupted cash flows. Reduced earnings induced by the COVID-19 pandemic have deepened existing corporate solvency and liquidity problems. Corporate vulnerability – as measured by probability of default – has risen sharply since August 2020, and remains high compared to selected peer countries (Figure 77). Recent analysis of the effects of COVID-19 on firms' liquidity by the CBRT²² shows that the number of illiquid firms increased in the second quarter of 2020, declined in the third quarter supported by credit expansion, and increased slightly at the end of 2020 with the impact of reintroduced restrictions (Figure 78). The negative impact of the pandemic is more evident for smaller firms. As expected, the services sector has the highest ratio of illiquid firms to total number of firms.

Figure 77: Corporate vulnerability elevated



Source: NUS Credit Research Initiative, WB Staff estimates.
Note: Corporate vulnerability indices (CVI) are value weighted. The value-weighted CVI sums up the individual probability of defaults with their market capitalizations as weights.

Figure 78: Reflected to a rising number of illiquid firms



Source: CBRT, Inflation Report, 2021:1.

²² CBRT, Inflation Report 2021-I, Box. 2.2.

Despite the impact of COVID-19 on the private sector and individuals, there has not been a deterioration in reported bank asset quality metrics due to rapid credit growth and forbearance²³. Rapid loan growth, payment deferrals, and forbearance measures have helped banks keep asset quality metrics favorable. Official NPL ratios across all banks had declined from 5.4 percent in December 2019 to 4.1 percent as of February 2021 (Figure 79). Stage 2 loans also declined from 12 percent in 2019 to 10 percent as of 2020 Q3 (Figure 80). Regulatory forbearance measures make it more challenging to assess banks' true asset quality²⁴, which is expected to have declined. The NPL ratio is likely to assume an upward trend in the period ahead due to a combined effect of phasing out regulatory forbearance measures related to forborne exposures, a slowdown in credit growth, and loans that were restructured, or that benefitted from postponed installments falling due.²⁵

Figure 79: Forbearance masks true NPLs...

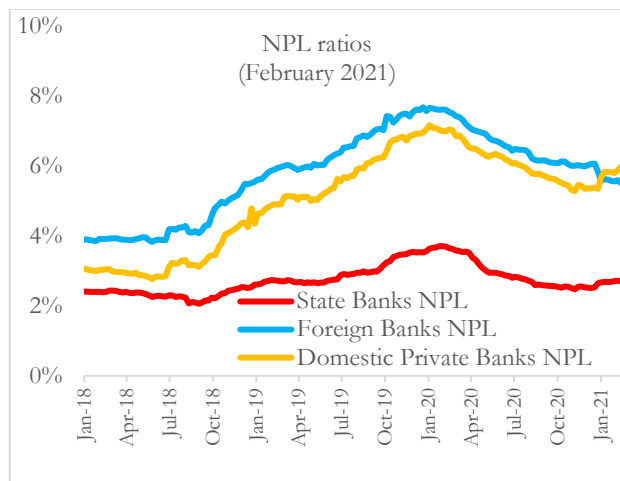
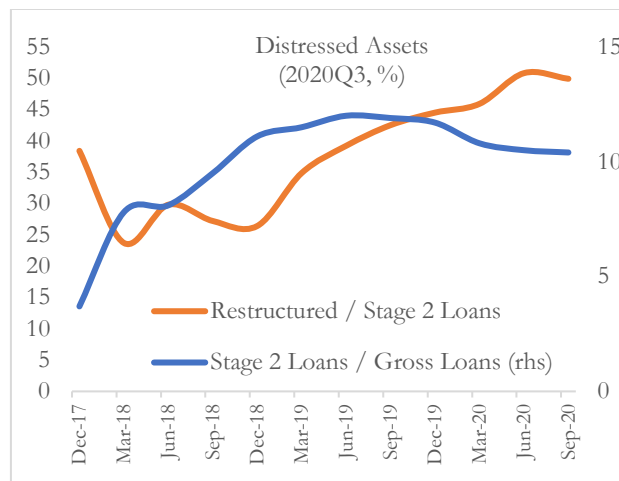


Figure 80: ...and Stage 2 loans...



Source: BRSA, Fitch Ratings, Haver, and Staff calculations.

Elevated corporate sector vulnerability due to COVID-19 remains the key risk to banks susceptible to FX and asset quality shocks. Banks' ability to restructure corporate debt in the near term is diminished by significant restructuring following the 2018 currency shock and an environment of higher interest rates. The loan-to-deposit ratio continued its sustained decline from over 120 percent in mid-2018 to just below 110 percent in December, though the decline stems mostly from reducing FX lending's share in total loans (Figure 81). The slowdown in credit growth may help banks restore their balance sheets in the medium term, but ongoing COVID measures will continue to weigh on corporates' ability to service their new and restructured debt in a higher interest rate environment.

Banks continued to increase provisions for NPLs, despite forbearance measures in place. While extended forbearance measures helped alleviate pressures on reporting asset quality deterioration until the end of 2021Q2, banks have continued to increase IFRS-9 based provisions to build buffers against the expected rise in NPLs (Figure 82). The reserve coverage ratios for NPLs have increased to 81.5 percent (70.8 percent in 2019 Q4), 72.5 percent (60.8 percent in 2019 Q4), and 72.6 percent (64.1 percent in 2019 Q4) for state banks, domestic private banks, and foreign banks, respectively. Most of the banks also set aside free provisions for as an extra measure for NPL increases.

²³ Regulatory forbearance on loan classification was introduced in March 2020, and has recently been extended to the end of 2021 Q2. According to the measures, overdue loans are classified as NPLs after 180 days (previously 90 days) and overdue distressed assets are classified as Stage 2 loans after 90 days (previously 30 days).

²⁴ FinSAC on Borrower Relief Measures in the ECA Region, cautioned against relaxing regulatory definitions for NPLs and forborne exposures as this can undermine market discipline and distort the reliability of bank's financial information. The paper suggested that policymakers need to prepare and set clear exit strategies.

²⁵ Please also see, CBRT Financial Stability Report - November 2020, Volume 31.

While banks entered the COVID-19 crisis with higher capital buffers, built after the turmoil of 2018, they have also benefitted from forbearance measures. Banks had gradually built up their buffers after the 2018 currency shock, with an increase in the Capital Adequacy Ratio (CAR) from 16 percent in July 2018 to 18.4 percent by December 2019 (Figure 83). CAR declined slightly in 2020 Q1 to 17.9, but would have deteriorated more were it not for the help of forbearance.²⁶ State bank's CAR position declined more rapidly in the first half of 2020 given high credit growth, but was buttressed by capital injections from TWF to state banks²⁷ in May, and sector's CAR rose to 18.7 percent in December. Risk of slower growth, an increase in distressed assets, and further TL depreciation could weigh on risk-weighted assets and capital adequacy going forward.

Figure 81: ...but rebalancing continues

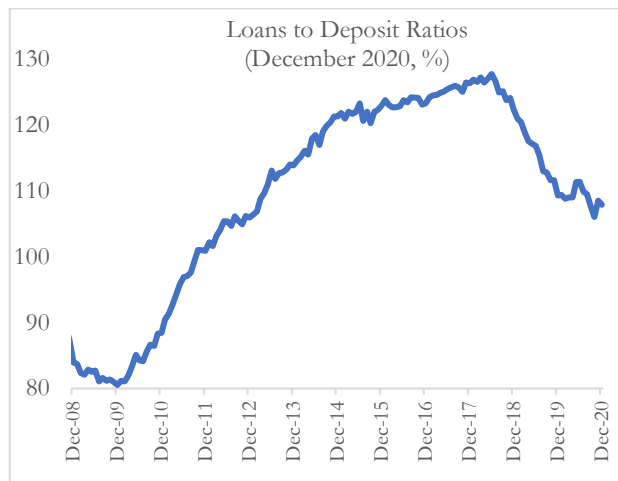


Figure 82: Banks remain prudent with provisions

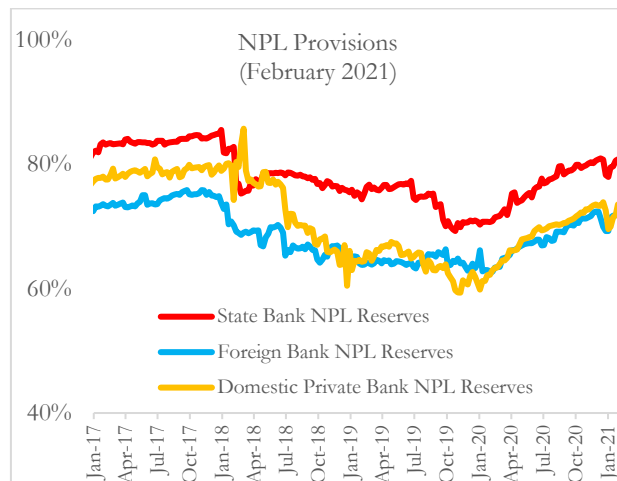


Figure 83: Capital Adequacy may deteriorate due to the rise in NPLs and stage 2 loans

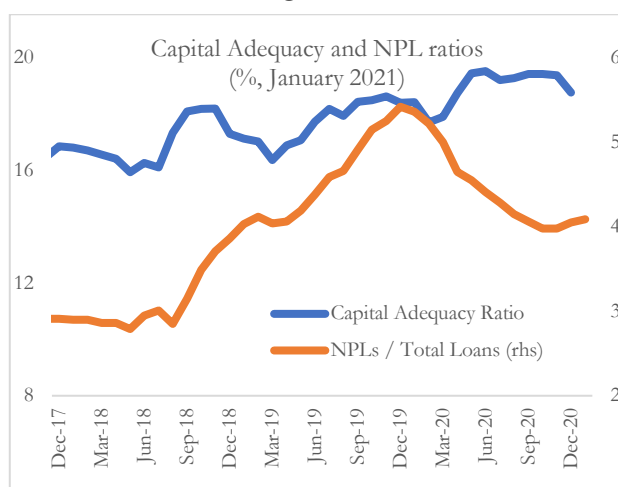
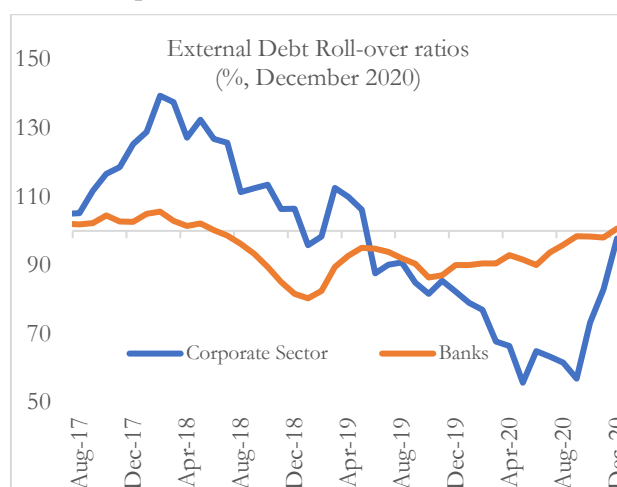


Figure 84: Improvement in risk premia encouraged banks to tap external finance



Sources: Haver Analytics, BRSA, CBRT, WB Staff estimates.

²⁶ Capital adequacy related forbearance measures include the use of 2019 year-end FX rates in calculating foreign currency denominated risk-weighted assets (RWA) and the suspension of mark-to-market losses on securities in capital adequacy calculations (both due to be retracted at end-1H21), as well as a 0% risk-weighting on government foreign currency denominated bonds. The FX rate has been changed to a rolling 252-day average in December 2020, which decreased the impact of forbearance significantly. Apart from forbearance, CGF loans also have a low risk weighting for RWAs.

²⁷ Turkey Wealth Fund (TWF) has contributed TRY 21 billion (US\$ 3 billion) to shore up the capital of three public deposit banks.

Access to external financing has improved since 2018, but maturity mismatches remain. Banks, along with corporates, managed to increase their rollover ratios (Figure 84) and access syndicated loans at a reasonable cost during 2020 amid a chronic shortage of long-term financing (both external and domestic) coupled with persistent maturity mismatches. As of 2020 Q3, the share of assets having a remaining maturity of less than a year increased to 47 percent from 44 percent in 2019 Q4. The percentage of liabilities having a remaining maturity of less than a year also increased to 79 percent from 75 percent. Domestic and global monetary tightening pose risks to constraining loan tenors, while feeding additional vulnerabilities through heightened rollover risks for corporates.

The banking sector reduced exposure and market-based measures of risk, and volatility fell. Aided by credit cooling and a return to more orthodox monetary and economic policies, state banks' FX net positions improved from November, and were effectively closed by January (Figure 85). However, the banking sector is still exposed to currency mismatches²⁸ and refinancing risk, especially from deposit dollarization²⁹ that remains high, and that increased over the course of 2020 (Figure 86).

Figure 85: State banks' FX net open position recovers

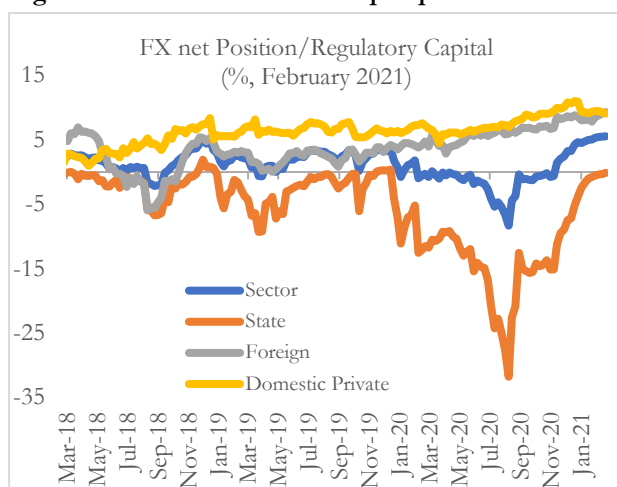
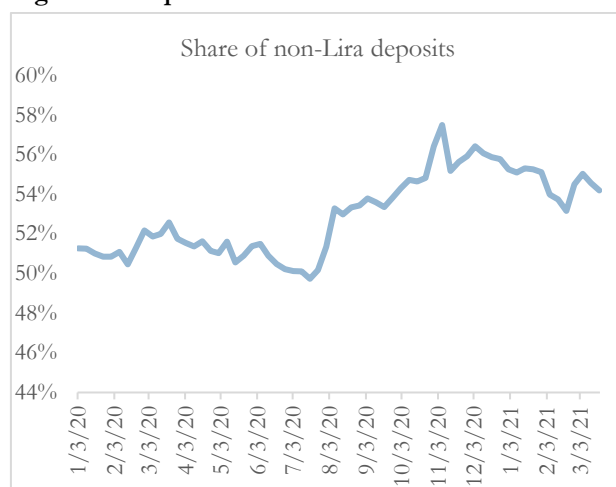


Figure 86: Deposit dollarization increased over 2020



Source: Haver Analytics, BRSA, CBRT, WB Staff calculations.

C. Policy frameworks were adjusted to restore macroeconomic stability

The fiscal policy framework remained strong, despite COVID-19 pressures

The 2020 fiscal deficit was moderate as targeted stimulus expenditure was offset by expenditure reprioritization and rising tax revenues later in the year. Turkey's fiscal position remained in noticeably good shape with a budget deficit of 3.4 percent, lower than many countries around the world and less than the revised³⁰ budgeted deficit of 4.3 percent. Total expenditure realization was in line with the revised estimate, and 10 percent higher than the original budget estimate for 2020 (Figure 87). Revenue exceeded the projection by 6 percent (Figure 88). Almost two thirds of the extra revenue stemmed from indirect taxes, following the boost to demand from the credit stimulus. Turkey's limited fiscal deterioration was accompanied by a massive credit stimulus, which may be reflected on the budget in future periods if and when contingent liabilities are realized. Current transfers accounted for almost half of the expenditure increase beyond the budget target.

²⁸ The banking sector is offsetting its on-balance sheet FX position with off-balance sheet transactions, mostly with currency swaps, including the swaps with the CBRT. While off balance sheet transactions may limit the exposure, they cannot solely protect the balance sheets against any external FX shocks.

²⁹ BRSA data shows that the share of FX deposit in total deposits is 55 percent as of April 2, 2021.

³⁰ This reflects the budget deficit cited in the New Economic Program for 2021, published in September 2020. This expenditure estimate accounts for in-year budget adjustments that were already made early in 2020 in response to COVID-19.

Expenditure increased by almost one percent of GDP, driven by COVID-19 related transfers to households and firms and rising interest costs. Total expenditures as a share of GDP rose by 0.9 percentage points in 2020, driven largely by current transfers. The authorities adjusted spending on capital and goods and services to help create fiscal space for public transfers, particularly for vulnerable households affected by the downturn. Most central government transfers are for health, retirement and social aid expenses, which accelerated rapidly in 2020. In fact, current transfers accounted for almost 60 percent of the increase in expenditures (Figure 90). Employment support programs (short-term work allowance, unpaid leave, etc.) are financed through the unemployment insurance fund, and so do not appear directly on the central government budget. Interest costs rose to 2.7 percent of GDP in 2020, due to a sustained increase in borrowing requirements (Figure 91).

Figure 87: Total expenditure was in line with NEP projection

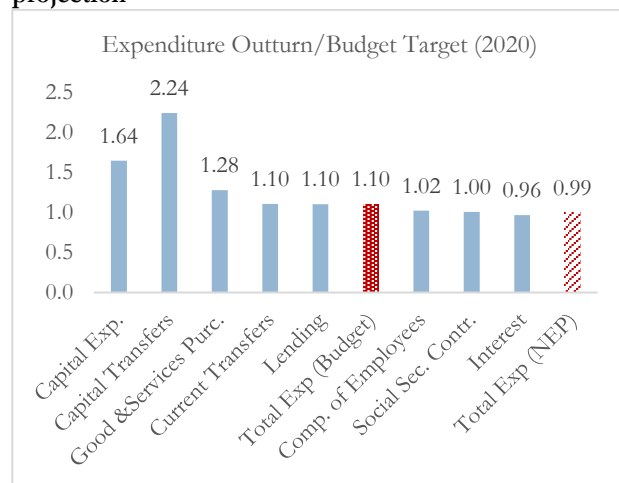
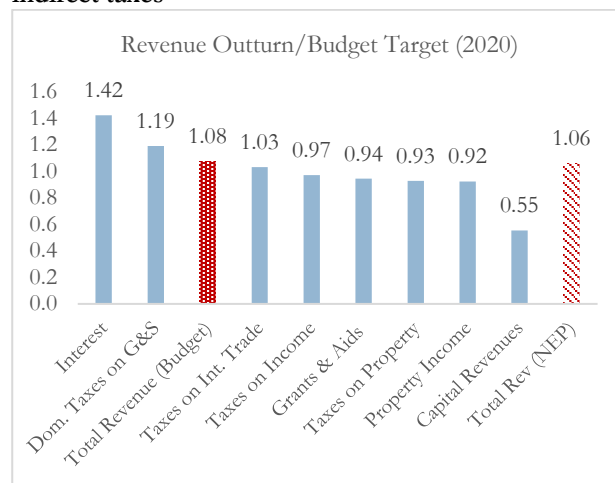


Figure 88: Revenue outturn was higher amid a surge in indirect taxes



Source: New Economic Program (2021-2023), MoTF and WB staff calculations.

Tax collections increased in 2020, as indirect taxes jumped later in the year. Direct tax collections as a share of GDP dropped by 0.4 percentage points due to cyclical factors and tax relief measures. However, this decline was fully offset by an increase in indirect taxes. The rapid recovery in domestic demand led taxes on goods and services to rise by almost 40 percent (yoy) in real terms in 2020H2 (Figure 92). Taxes on vehicle purchases increased sharply on strong demand and a rate increase. A big jump in imports in line with strong domestic demand led tax on international trade to rise by around 28 percent (yoy) in real terms in 2020H2. Overall, indirect taxes as a share of GDP rose by 1.3 percentage points in 2020.

Table 2: COVID-19 measures introduced by the Ministry of Family, Labor and Social Services

		Number of individuals/ households reached	Amount of assistance provided (TL m)
Social Support Program	Phase 1	2,111,254	2,111
	Phase 2	2,316,010	2,316
	Phase 3	2,003,582	2,004
Short Term Work Allowance	Workers	3,756,584	27,666
Unpaid Leave Subsidy	Workers	2,471,134	8,266
Unemployment Insurance	Individuals	994,608	5,082
Normalization support	Workers	3,183,435	3,206
Total			50,651

Source: Ministry of Family, Labor and Social Services, accessed on February 13, 2021.

Most COVID-19 related government support to households through employment measures continued through late 2020 and into 2021. The measures to support workers on unpaid leave, provide a short-term work allowance to furloughed workers, and prohibit the layoff of formal workers were first extended into 2021Q1. Short-term work allowance support and the prohibition of the layoff of workers were extended further until mid-May of 2021. The number of workers receiving short-term work allowance had reached 3.76 million by mid-February 2021 (Table 2). For around 2.7 million workers not eligible for short-term work allowance, but who were put on unpaid leave, the government provided a smaller benefit. Unemployment benefit payments were continued for people who lost their jobs prior to the COVID-19 pandemic. The government also introduced a new support program³¹ in August 2020, under which the government pays firms' social security premiums for workers who benefitted from the short-term work allowance, or who were sent on unpaid leave. So far, 3.2 million workers have benefitted from the normalization support. While these measures were still in place as of early 2021, the social support program (one-off support for vulnerable households) was ended in early 2021. However, households can still receive application-based social assistances in the context of pandemic social support program's third phase.

Table 3: Fiscal operations (CG, percent of GDP)

	2017	2018	2019	2020
Revenue	20.1	20.2	20.3	20.4
Direct Tax	5.6	6.2	6.0	5.6
Indirect Tax	11.5	10.4	9.6	10.9
Other	3.0	3.6	4.7	3.9
Expenditure	21.6	22.1	23.1	23.8
Comp. of Employees & Soc. Sec. Contr.	6.0	6.3	6.8	6.7
G&S Purchases	2.0	1.9	2.0	1.9
Current Transfers	8.6	8.6	9.3	9.9
Capital Transfers & Expenses	2.7	2.8	2.2	2.1
Interest	1.8	2.0	2.3	2.7
Other	0.4	0.6	0.6	0.6
Overall Balance	-1.5	-1.9	-2.9	-3.4
Primary Balance	0.3	0.0	-0.6	-0.8
Memo items				
GDP growth (yoy)	7.5	3.0	0.9	1.8
Inflation (yoy)	11.1	16.3	15.2	12.3

Sources: Haver Analytics, WB Staff estimates.

Government debt increased, and a growing share of the rising budget deficit was financed by external borrowing. A larger budget deficit and a depreciating lira led to an increase in overall central government debt from 31 to 36 percent of GDP (Figure 94). The deficit was increasingly financed through external debt, especially as the cost of domestic borrowing jumped 10 percentage points (Figure 93). The share of gross borrowing that was external had increased from 20 percent in 2020Q2 to 60 percent by the end of 2020. In addition to central government debt, general government debt amounted to an extra 4.1 percent of GDP as of the third quarter of 2020, while publicly-guaranteed debt amounted to an estimated additional 4.6 percent of GDP at end 2020.

³¹ This program also provides similar incentives for the employment of people aged below 25 and above 50.

Figure 89: Rising fiscal imbalances...

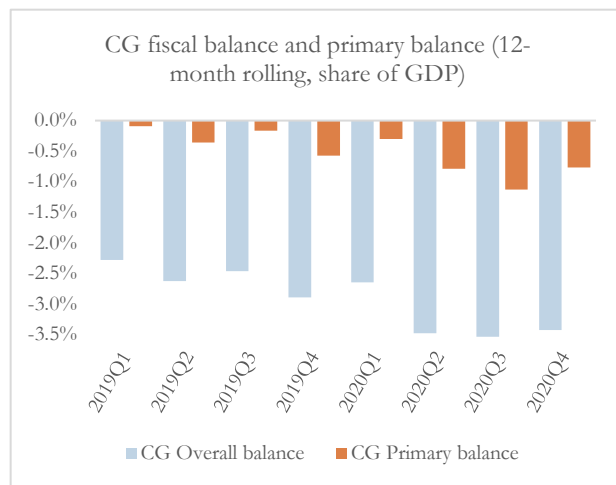


Figure 91: ...and interest expenditures

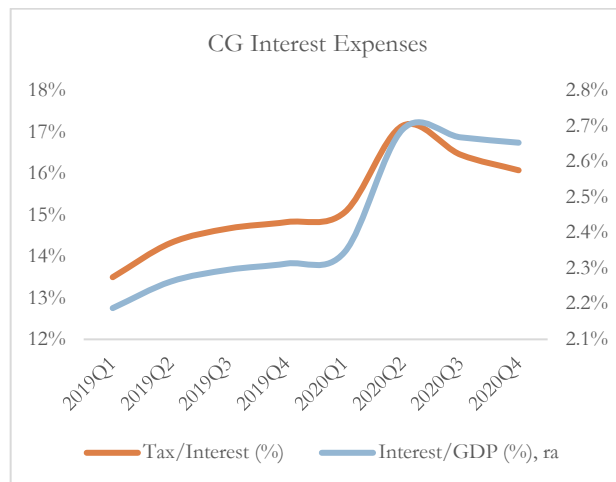


Figure 93: Deficit increasingly financed through external debt

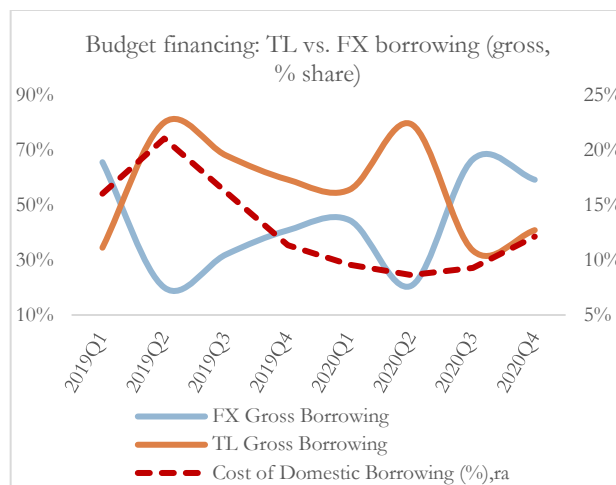


Figure 90: ...driven largely by rising current transfers...

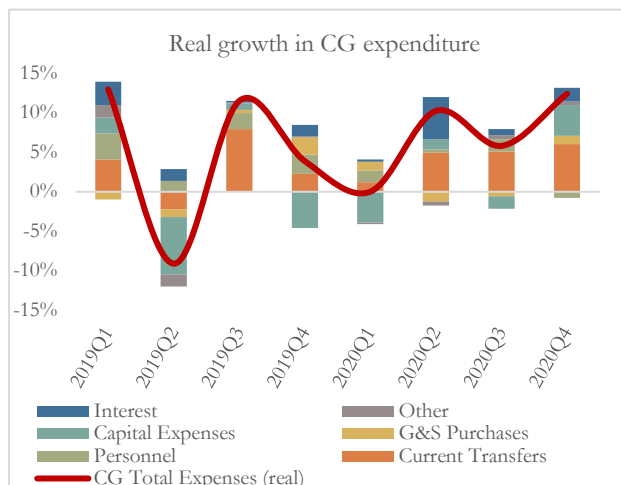


Figure 92: But an uptick in tax on G&S contained the deterioration

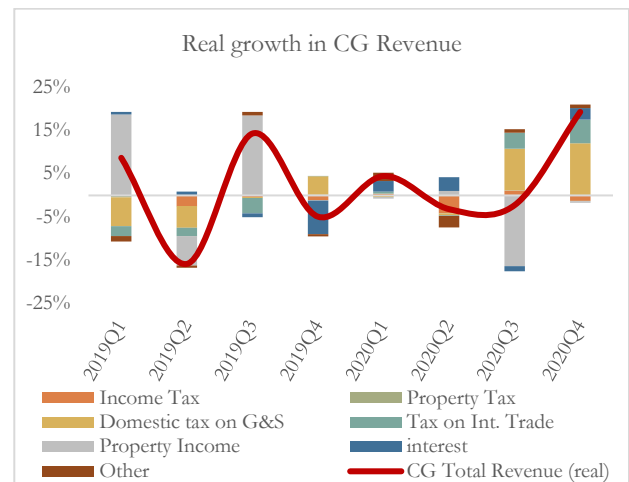
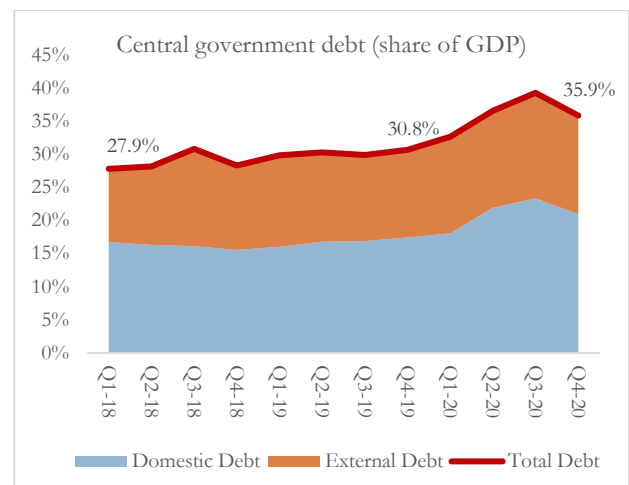


Figure 94: Contributing an increase in central government debt



Sources: Haver Analytics, MOTF, WB Staff estimates.

Exceptional regulation aimed at supporting domestic lending was withdrawn

Various exceptional measures aimed at boosting domestic lending and banking activity were repealed or relaxed in the second half of 2020. The BRSA, which had imposed limits on domestic banks' holdings of Lira swaps with offshore banks in the aftermath of the 2018 currency shock had again tightened between February and April, curtailing access to this market, although banks retain access to similar swaps in the domestic market. These limits were relaxed between September and November 2020, especially for longer-maturity swaps, enabling an expanded use of these offshore markets (Figure 95). Starting in August 2019, the reserves required to be held at the Central Bank had been linked to a bank's real lending growth rate, effectively enabling banks with higher loan growth to maintain a lower reserve ratio. In August 2020, these 'discounted' reserve ratios were increased substantially (by 200bps, less for some longer lira maturity term deposits and more for gold assets), for both lira and FX assets, and reserves held at the CBRT grew sharply in the second half of the year (Figure 96). The BRSA's new "Asset Ratio", introduced in April 2020, had also been instrumental in raising banks' lending, holding of Treasury debt and CBRT swaps, by mandating a certain level of domestic assets relative to deposits (Figure 97). As the policy framework was tightened, the Asset Ratio was first relaxed by allowing the inclusion of domestic FX loans to other banks in the ratio, and then abolished all together by the end of 2020.

Figure 95: Offshore swap restrictions were relaxed

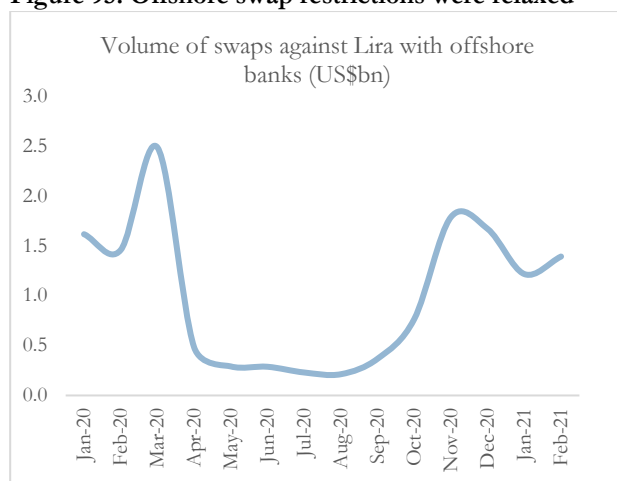


Figure 96: Required Reserves were increased

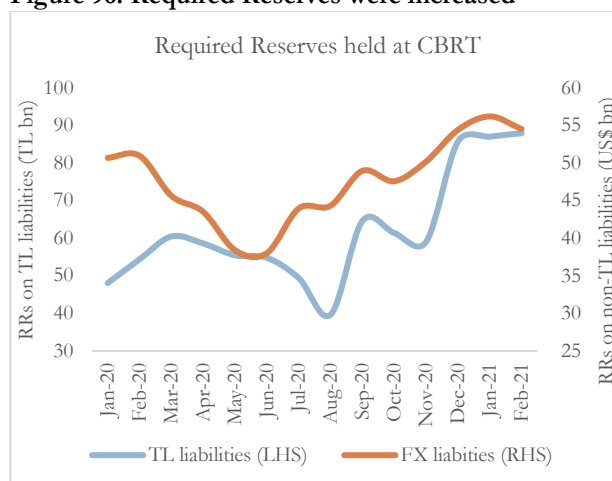


Figure 97: Asset Ratio repeal eased pressure on banks to lend

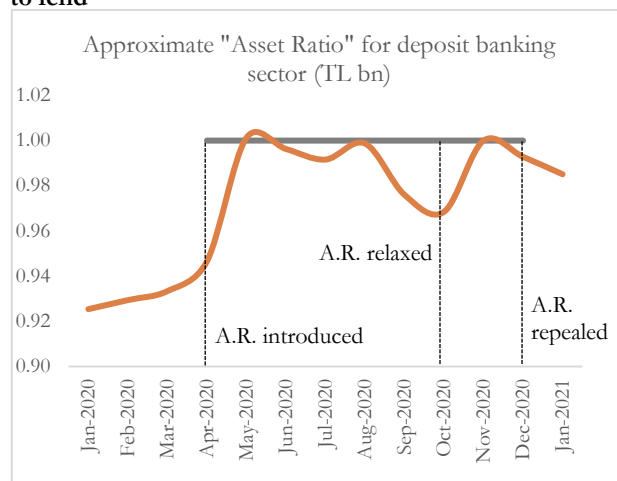
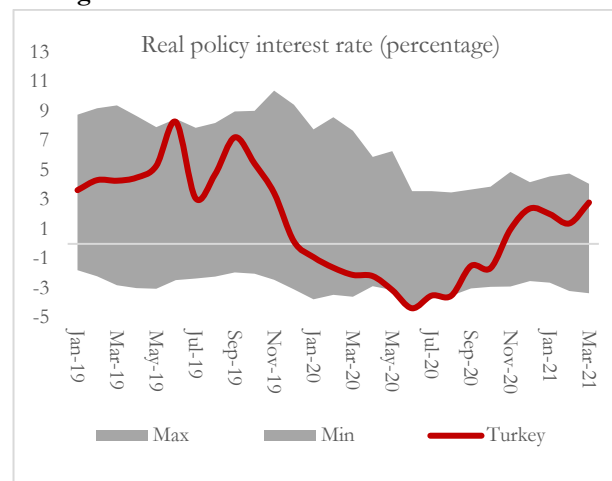


Figure 98: Real interest rates negative and lowest amongst EMs



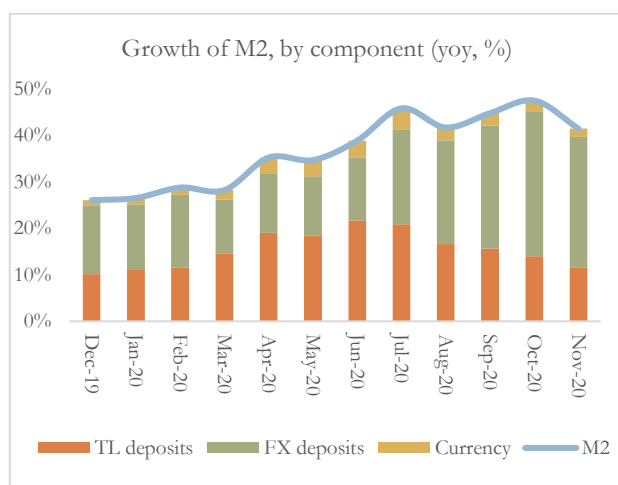
Sources: Haver Analytics, World Bank Staff estimates.

Note: Turkey compared to the range of 12 other EMs; real post rate is 'ex post' as inflation is discounted by realized year-on-year consumer price inflation; using the average cost of Central Bank funding for Turkey does not materially alter the trend.

Supporting monetary policy tightening as vulnerabilities grew

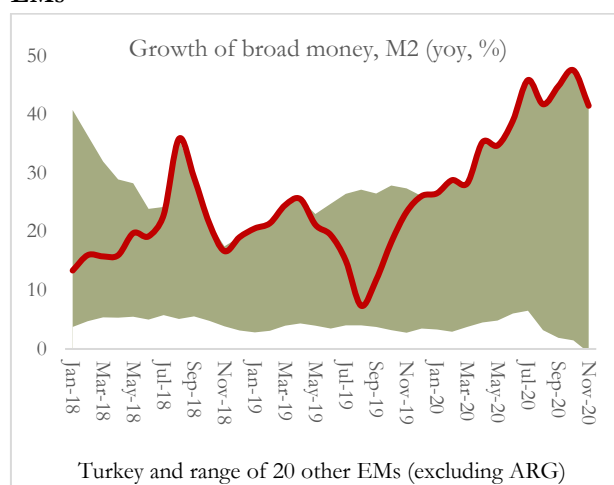
Turkey saw one of the sharpest monetary expansions amongst EMs in 2020. The CBRT took steps to ensure liquidity in the financial system and to help firms manage the COVID shock with targeted liquidity facilities, lowering real policy interest rates into deeply negative territory (Figure 98). Both FX and local currency denominated deposits in the banking system rose sharply. As the lira depreciated, FX-denominated deposits grew (Figure 99). With the lockdown hitting consumption and savings rising, lira deposits rose strongly. Overall, broad money supply growth had peaked at nearly 50 percent year-on-year by October (Figure 99). Also, the Primary Dealer banks were enabled to sell the government domestic debt securities that they have bought from the Unemployment Insurance Fund to the CBRT for a temporary period. This level of monetary expansion stood out amongst all EMs aside from Argentina (Figure 100).

Figure 99: Both FX and TL deposits grew strongly



Sources: CBRT, World Bank Staff estimates.

Figure 100: Money supply among the fastest amongst EMs

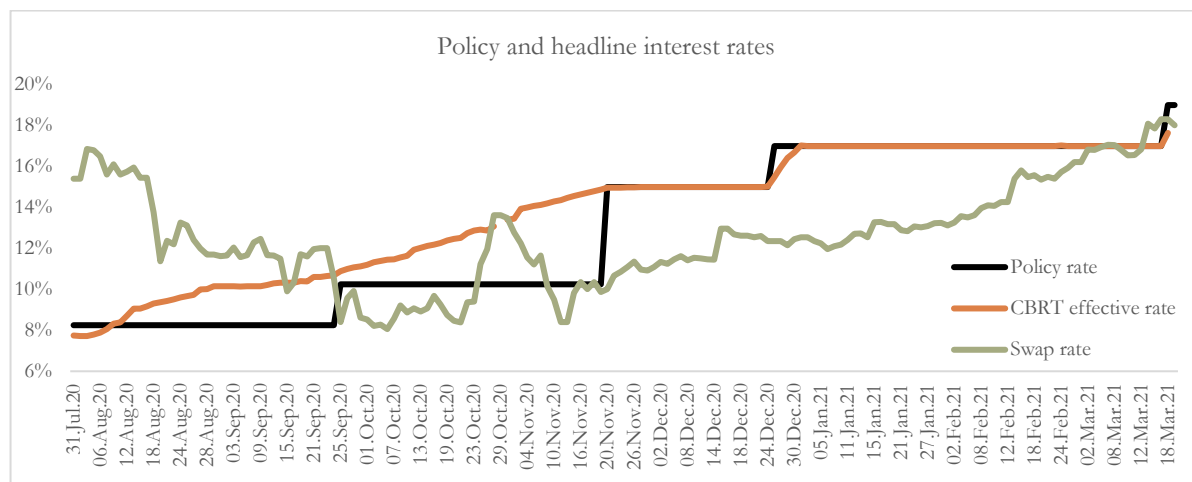


Sources: Haver Analytics, World Bank Staff estimates.

Since August 2020, the Central Bank began tightening monetary policy, gaining pace after the appointment of a new Governor in November. Initially, the Central Bank used its interest rate corridor, imposing quantitative limits on different CBRT funding windows to raise the average funding rate from below 8 percent to about 10.5 percent by late September, with a policy rate rise of 200 basis points on September 24 providing space for further tightening. With these measures, the CBRT's effective rate had risen to 13.5 percent by the end of October. Shortly after the appointment of the new Governor of the Central Bank in early November, the CBRT raised by 875 basis points to 19 percent (Figure 101).

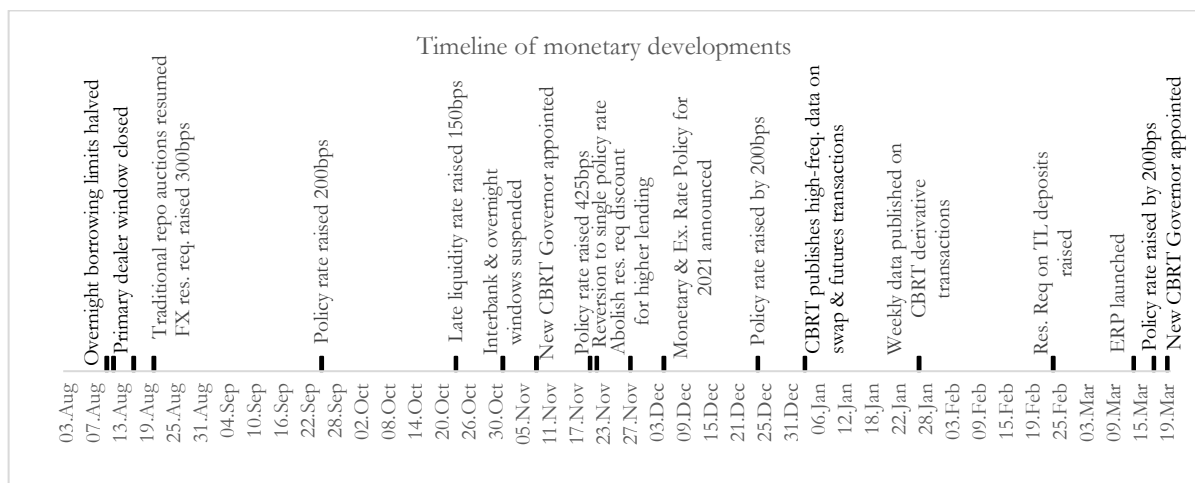
The Central Bank completed this move by reverting to a simpler policy framework and increasing information and forward guidance. In addition to changes in interest rate policy, the Central Bank increased the clarity and information on its forward-looking policy and started publishing additional data of market interest. In early August the window via which primary market dealers were able to access TL liquidity below the policy rate was closed. In a significant change from recent practice, the CBRT also reverted to the use of a sole policy rate in November, no longer actively managing liquidity using an 'interest rate corridor'. The CBRT also increased the level of forward guidance in Monetary Policy Committee Statements and began publishing detailed high-frequency data on CBRT derivative transactions (Figure 102).

Figure 101: The Central Bank's effective interest rate more than doubled between Sept-Dec 2020



Sources: CBRT, Haver Analytics.

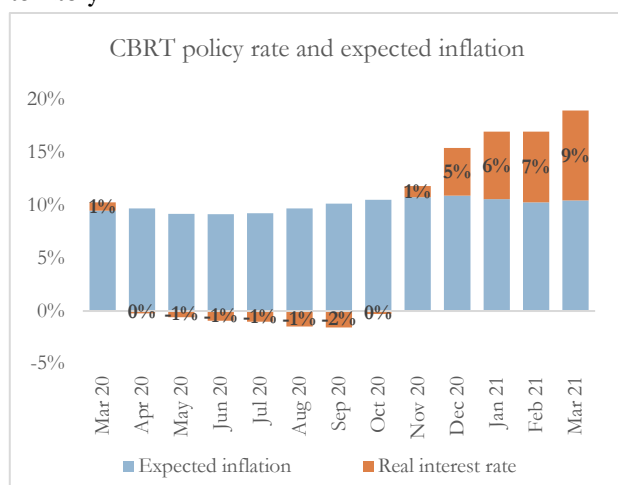
Figure 102: Monetary and financial policy reversals began in August and gained pace towards end-2020



Sources: CBRT, BRSA.

Monetary tightening reverted the negative to zero real yields seen in mid-2020 and commercial lending rates moved up. Based on both the policy rate and widely used instruments such as the one-year Treasury bond, yields adjusted for year-ahead expected inflation were negative during the middle of 2020. The real policy rate by this measure is now a relatively strong seven percent (Figure 103). Real expected yields (not adjusted for risk) on Treasury bonds moved into positive real territory in August and have risen to six percent so far in 2021 (Figure 104). TL lending rates, which had dropped below 10 percent by mid-2020, started to rise in August 2020. The rates increased even further with the policy shift in late November 2020. The weighted average interest rates for commercial loans almost doubled to 19 percent at the end of 2020 (Figure 105). This led corporates to decrease their borrowing in TL terms.

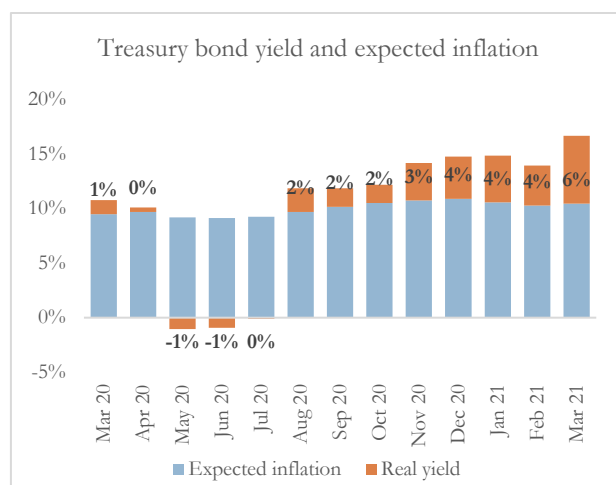
Figure 103: Policy rates moved out of negative real territory



Source: Haver Analytics, Central Bank of Turkey and World Bank Staff estimates.

Notes: Based on end of period CBRT policy (one-week repo) rate and one-year ahead expected inflation from CBRT Survey of Expectations

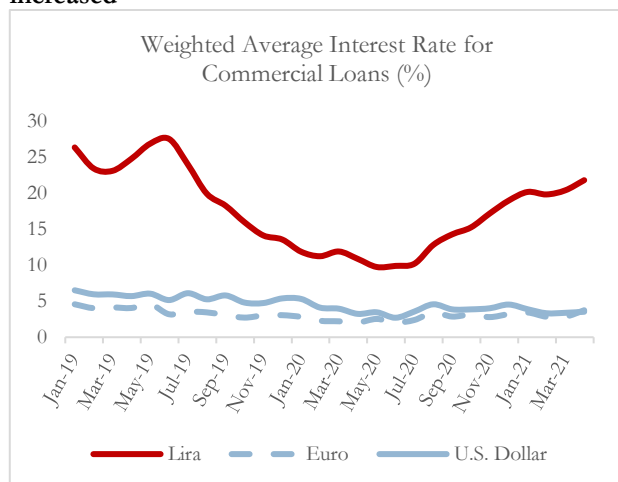
Figure 104: As did Treasury bond yields



Source: Haver Analytics, Central Bank of Turkey and World Bank Staff estimates.

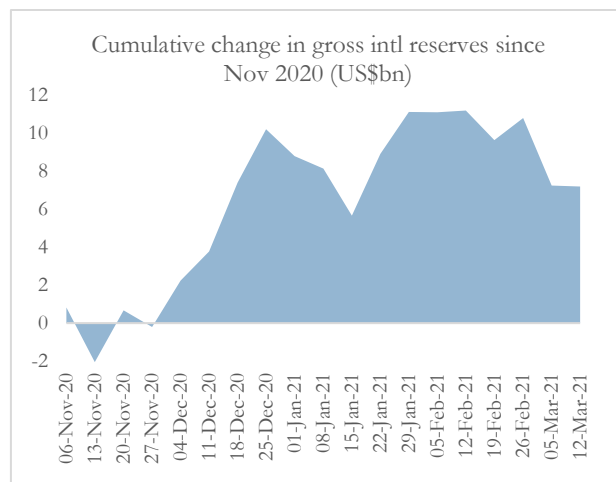
Notes: Based on average monthly one-year Treasury bond yields and one-year ahead expected inflation from CBRT Survey of Expectations

Figure 105: TL commercial lending rates have increased



Source: CBRT.

Figure 106: Gross international reserves were built up



Policy adjustments initially supported an improvement in central bank and corporate sector external positions. The CBRT has been gradually rebuilding international reserves, which stood US\$10 billion higher by mid-February 2021 compared to their level as at end October 2020 (Figure 106). However, with capital inflows to Turkey drying up after mid-February as rising inflation reduced real returns, and as investor sentiment globally became less positive towards emerging markets, this progress in building reserves has stalled.

D. Millions of people left behind after a year of turmoil

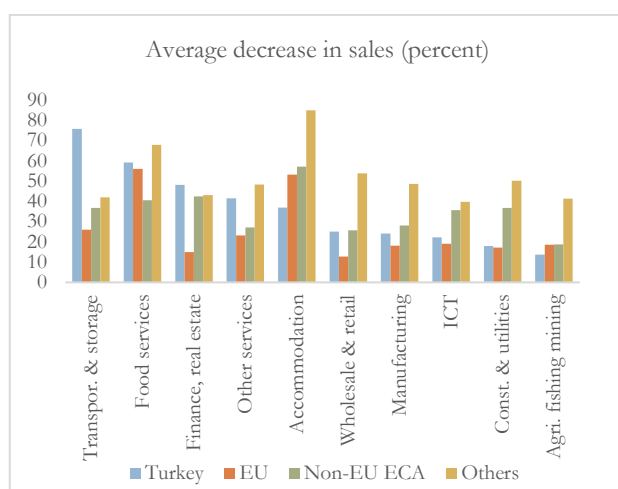
Firms have been severely affected

The World Bank has conducted a comparable international business survey that shows the impact of COVID-19 on businesses in Turkey relative to other countries. The World Bank, in coordination with the Union of Chambers and Commodity Exchanges of Turkey, implemented the Business Pulse Survey (BPS) in Turkey between mid-June and mid-July 2020, for which 1,508 companies were surveyed. At a similar time, the BPS took place in more than 60 countries around the world which were experiencing the first wave of the pandemic. This section compares the results for Turkey with a set of regional and emerging market comparator countries³².

Firms in Turkey were affected more severely, on average, than firms in other European and Central Asian countries. In Turkey, 69 percent of them were fully open before and during the survey period. 19 percent of the surveyed firms were partially open, 10 percent of establishments were temporarily closed, and 1 percent of firms reported they were permanently closed. Averaged over firms in all sectors, firms reported a drop in sales of 37 percent, greater than the average for EU and for non-EU ECA comparators, although below the 52 percent drop in the selection of non-ECA comparator countries.

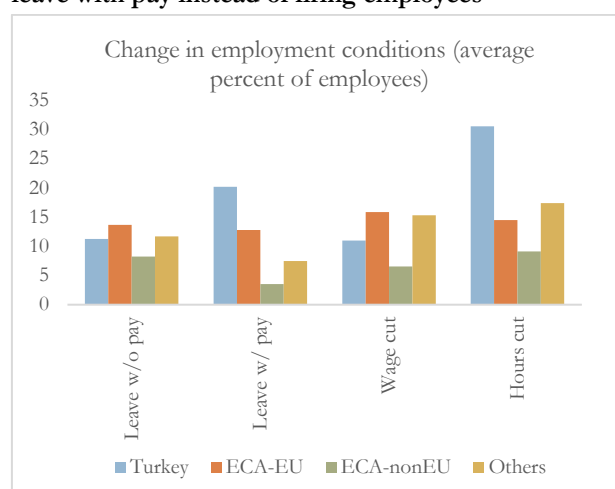
By contrast to comparator countries where accommodation experienced the largest decrease in sales, in Turkey, the logistics sector reported being the hardest hit. In Turkey, food services and accommodation also reported being severely affected, but transportation and storage reported a colossal 75 percent fall in sales (Figure 107). The financial sector reported a large decrease in sales in Turkey as in other countries.

Figure 107: Logistics hardest hit in Turkey



Source: Business Pulse Survey, World Bank Group

Figure 108: Turkish firms cut wages and provided leave with pay instead of firing employees



Source: Business Pulse Survey, World Bank Group

Female-headed firms were more likely to close during the pandemic in Turkey, being concentrated in the accommodation sector. Female-headed firms³³ tend to be much smaller than male-headed ones; a far more pronounced difference than seen in comparators. Female-headed firms experienced on average a similar impact on sales and a similar share of firms received support. However, the share of firms that declared being fully operational is significantly lower for female-headed firms in Turkey; a discrepancy not seen in comparators.

³² This section builds on the un-benchmarked analysis of Turkey's PULSE survey in the August 2020 Turkey Economic Monitor. Regional comparators are: Albania, Georgia, Uzbekistan, Tajikistan, Russia, Kyrgyzstan, Bulgaria, Croatia, Hungary, Poland, Romania, and Italy; and other comparators are: Brazil, India, Pakistan, Nigeria and Morocco.

³³ Defined as the gender of the owner, or the primary manager of the respondent firm.

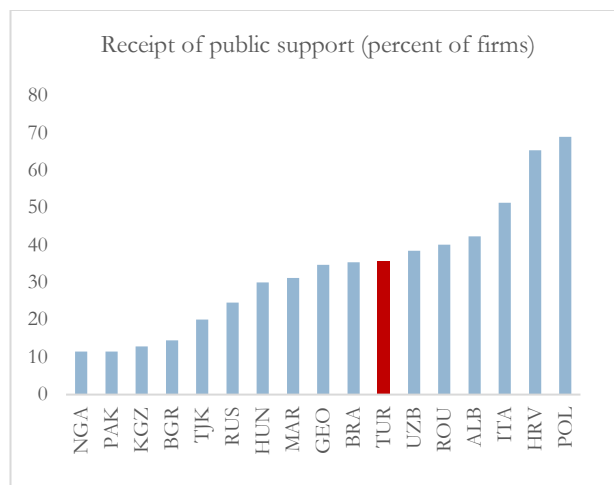
Such a large difference is likely related to the fact that the share of female-headed firms is by far the highest in the accommodation sector, with that share being much higher than in comparators. Moreover, Turkey has a lower share of female-headed firms than comparators in the wholesale and retail trade sector and in the agriculture, fishing and mining sectors, which were less hard hit by COVID-19.

Related to Turkey’s moratorium on layoffs, formal employment changed less, but workers were more likely to be put on paid leave. In April 2020, the Turkish government introduced a rule that temporarily prohibited redundancies. The BPS shows that on average, the number of employees did not decrease in any sectors in Turkey except agriculture, fishing and mining where a large portion of labor is seasonal with temporary contracts. By comparison, there was a considerable decrease in employment in comparator countries. Turkey does not differ significantly from the other countries in the sample in terms of the percentage of employees given unpaid leave. But firms in Turkey introduced paid leave more often, with the average firm issuing paid leave to 20 percent of its employees, likely supported by use of the government’s short-term work allowance (Figure 108).

Furthermore, Turkish firms stand out for implementing hour reductions. In Turkey, 11 percent of employees received wage cuts, which is in the mid-range of comparator groups. However, Turkish firms were far more likely to reduce employee’s working hours. On average, firms in Turkey reduced the workhours of 31 percent of their employees, approximately double the proportion in comparator groups. It seems that to cope with the moratorium on redundancies, firms in Turkey responded by seeking to lower the costs of their workforce during the COVID-19 shock by either putting employees on leave or else reducing their hours.

The share of firms in Turkey that received public support during the pandemic is in the mid-range of comparators. The BPS collects information on whether a respondent firm received any type of public support designed to mitigate the adverse effects of the pandemic. Turkey is in the mid-range, with mostly EU countries registering a higher proportion of supported firms (Figure 109). However, this might also be influenced by the timing of the onset of COVID-19, with some countries being impacted later than Turkey, and may not have fully rolled out support by the time of the survey.

Figure 109: More than a third of firms received public support



Source: Business Pulse Survey, World Bank Group

The pandemic led to a large-scale exit from the labor market, which has both a short- and long-term impact. By May 2020 the economy had lost 2.6 million jobs (9.2 percent of total employment) relative to the level observed a year before. While labor markets staged a partial recovery over the year, employment remained down by 3.9 percent in November 2020 compared to a year earlier. The contraction of employment in the non-agriculture sector was 3.2 percent, whilst job losses were more evident in the agriculture sector with a 7.4 percent contraction compared to a year earlier. The bulk of job losses were in the service, where many jobs are informal. Informal jobs continue to prevail amongst approximately 30 percent of the Turkish population, particularly in the agricultural sector. The labor force fell sharply to 30.6 million people in June 2020, but then reversed some of its losses and rose to 31.1 million in November thanks to the easing of restrictions in 2020H2. However, the labor force remains below the pre-pandemic level (around 1 million below the level of end-2019), with more than 50 percent of the losses borne by women. This translated to a drop in labor force participation to below 50 percent, close to its 2013 level.

Pre-existing labor market vulnerabilities were exacerbated, with female, lower-income, informal and unskilled workers the worst-affected. Initial labor market losses were unevenly distributed across the population. Most of the employment contraction was felt by informal workers, the lower-skilled, and women and youth³⁴ – groups that have traditionally experienced more limited employability and job quality. The job recovery over the latter part of 2020 thus benefitted much less those groups that were hit the hardest. For instance, as of November 2020, employment among unskilled workers remained 9.5 percent lower than the year before, whereas it had reverted to pre-pandemic levels for medium- and highly-skilled workers. A similar unequal pattern in the employment recovery is observed for women, youth and informal workers (Figure 110 to Figure 113).

Similar disparities can be seen in exits from the labor force altogether. Youth (ages 15-24) have borne the largest labor force participation losses, driven largely by women and semi-skilled workers. The rate of youth not in employment, education or training (NEET) has continued to climb since the COVID-19 outbreak (Figure 114). A total of 363 thousand young people left the labor force in the 12 months to November 2020, adding to significant youth employment losses since 2018. The share of NEET young people has increased by nearly 2 million people relative to a year ago, with the rate being considerably higher among females than males (34 percent versus 20 percent). At all education levels, around 60 percent of NEET are female, and the bulk of NEET youth have less than a high school education (Figure 115).

Figure 110: Informal workers...

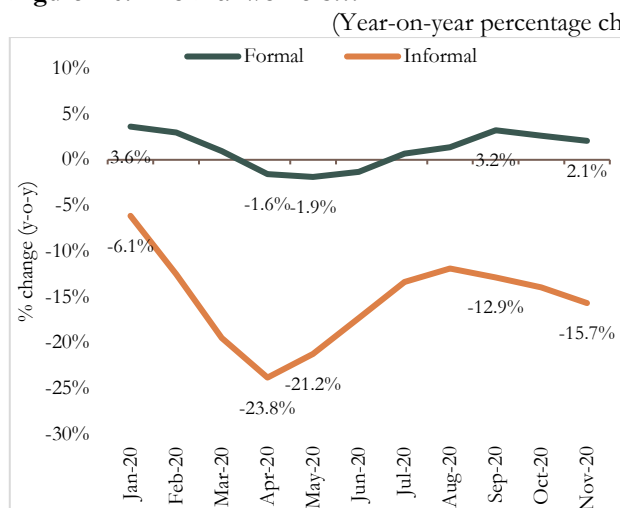
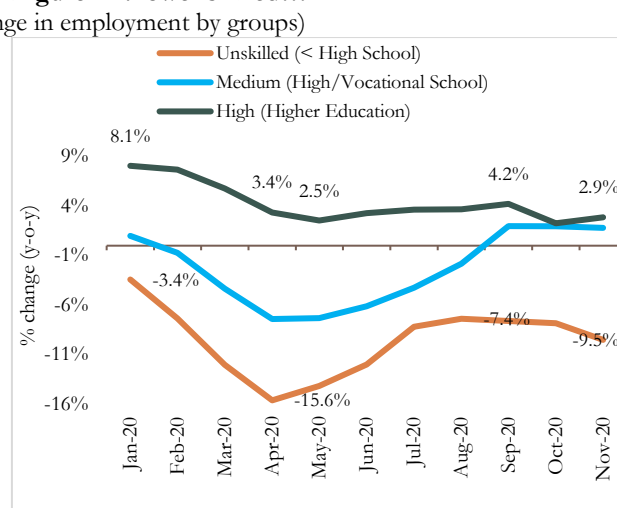


Figure 111: lower skilled...



³⁴ The definition of 'youth' accords with the Turkish national definition of ages 15 to 24, except where stated.

Figure 112: female...

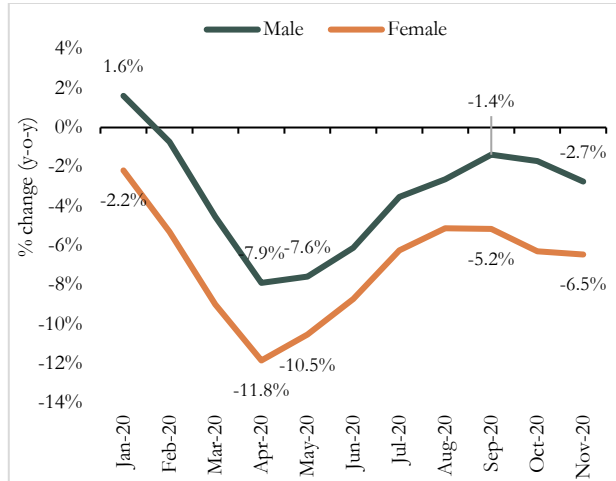
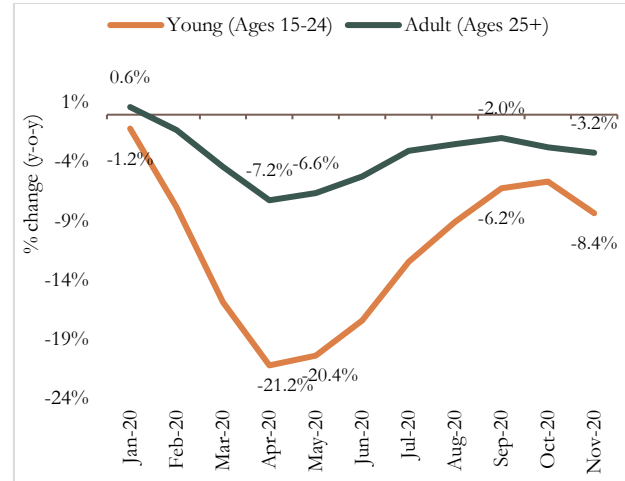


Figure 113 and young workers saw greatest job losses



Source: World Bank calculations using monthly reports from the Labor Force Survey.

Figure 114: Youth NEET rates very high for women

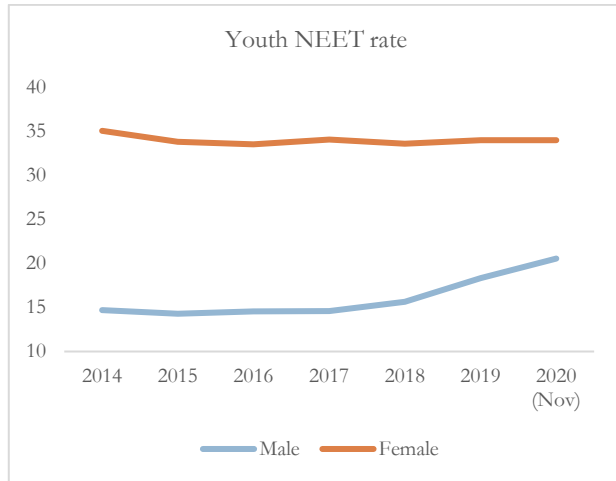
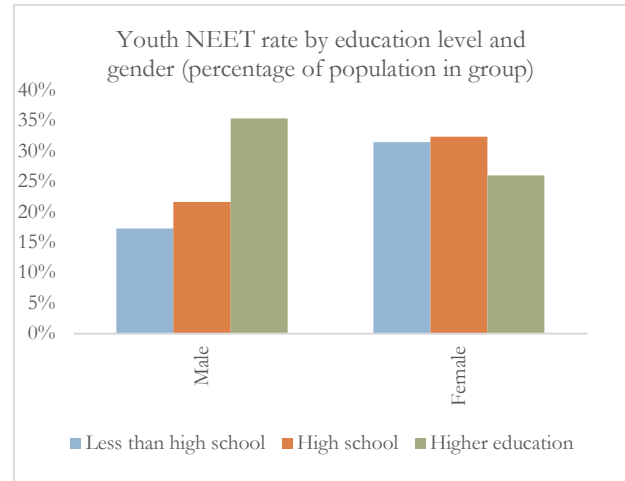


Figure 115: across all levels of education



Source: TURKSTAT.

Figure 116: Youth LFPR has fallen

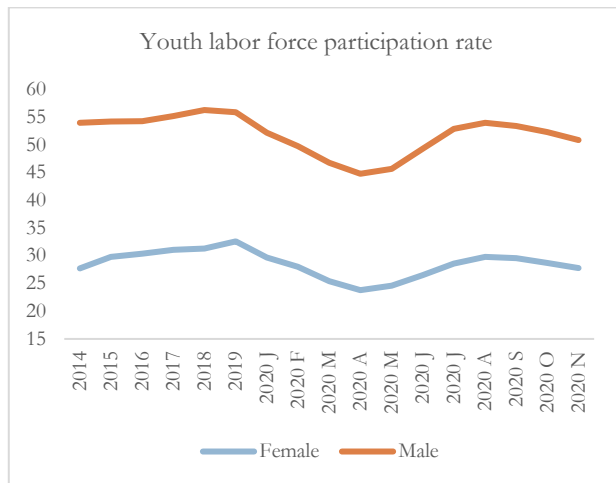
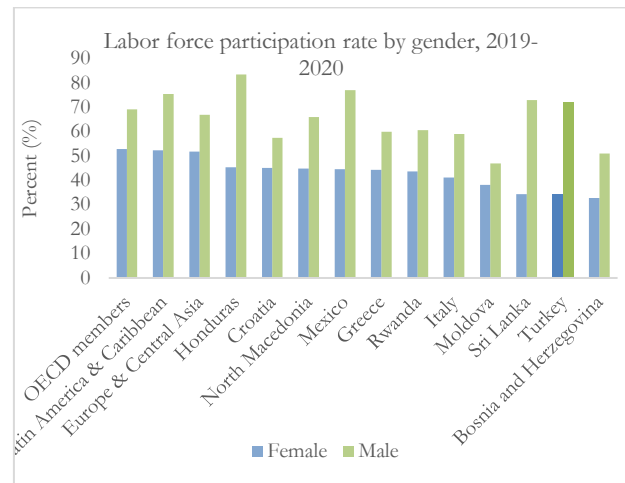


Figure 117: and is far below comparators for women



Source: TURKSTAT.

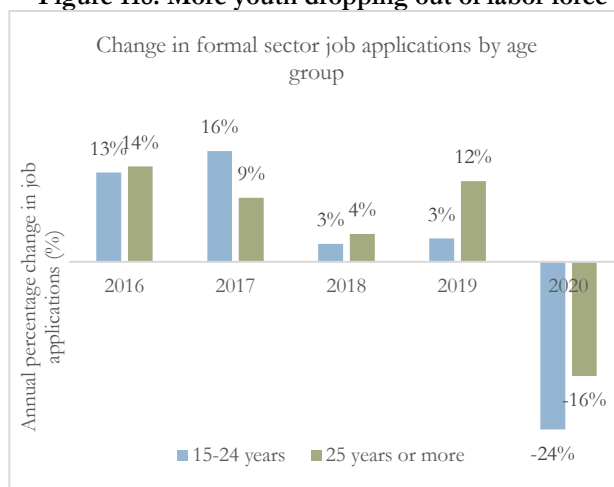
Source: World Development Indicators, World Bank Staff estimates

Female labor force participation continues to lag that of males. Labor force participation losses over the period of November 2019 to November 2020 reversed nearly three years of progress. The labor force participation rate (LFPR) decreased to 49.3 percent from 52.5 percent a year earlier, and females lag considerably behind, particularly amongst youth (Figure 116). The LFPR remains highest among the most highly educated, and lowest among the low- to mid-skilled. Female labor force participation, at 30.6 percent, continues to be less than half that of males, at 68.4 percent. Female LFPR is considerably lower than comparable regional averages such as Central Europe and the Balkans (45.2 percent) and Latin America and the Caribbean (41.5 percent) and far below the level of high-income countries (Figure 117).

Females exiting the labor force continued to do so largely due to family roles. Exit from the labor force was dominated by household responsibilities, accounting for 31 percent and driven by women; 46 percent of women who leave the labor force cited this as the factor, compared to zero percent among men. As shown in Box 2, the vast majority of women report increased responsibilities at home during COVID-19, while less than half of men reported the same. This represents 9.8 million work-able women; were these women to work, this would represent an increase of nearly 30 percent of the labor force. Discouragement and retirement showed an increase relative to pre-COVID levels, notably among women.

The unemployed are also more likely to be women and first-time job seekers. Official unemployment rates do not currently provide an accurate picture of labor market dynamics as there have been large-scale labor force exits over the past year³⁵, while the redundancy moratorium means that people cannot be laid off. Nevertheless, a large gender gap is clear from the data. Unemployment stands at 15 percent among women compared to 12.2 percent among men, and 25 percent among youth. Younger and first-time job seekers tend to lack the breadth of skills and networks needed to adapt or transfer between jobs and sectors. Data from the formal sector demonstrates younger workers aged 15-24 years were disproportionately more likely to drop out from the job search compared to workers aged 25 years or above (Figure 118). In addition, COVID-19 job protections do not apply to workers in the informal sector who, prior to COVID-19, comprised over thirty percent of the workforce. The lack of employment support to these workers accentuates labor market and welfare segmentation which unemployment rates do not show.

Figure 118: More youth dropping out of labor force



Source: World Bank staff using Kariyer.net³⁶ data.

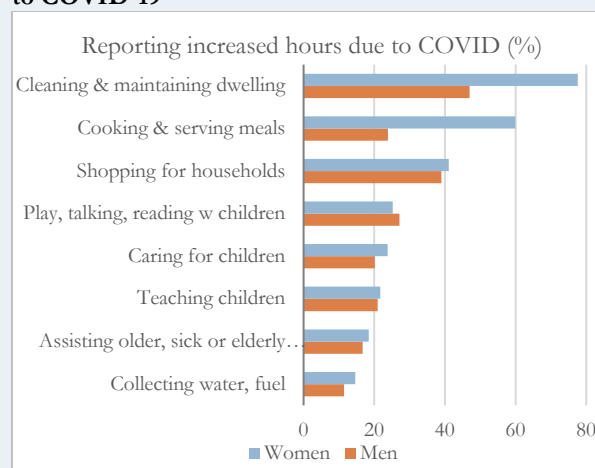
³⁵ In March 2021, labor market statistics were updated to include supplementary indicators in addition to employment and unemployment, in line with the 19th International Conference of Labour Statisticians (ICLS) Resolutions of the International Labour Organization (ILO) and the relevant EU regulations. Data publication was also changed from three-month moving averages to independent monthly estimates. These datasets were not available at the time of preparation, and currently available breakdowns with the new datasets are not sufficient to complete the analyses presented in this section, which is why an analysis based on the previously published datasets are presented in this section.

³⁶ This database represents a significant formal sector job search engine in Turkey, used to monitor formal sector job vacancies by the Central Bank of Turkey and other institutions. In 2019-2020, monthly job openings ranged between 80,000-100,000. The bulk of job

Box 2: Constraints to Women's Economic Empowerment and Covid-19

Unpaid care work constrains women's economic opportunities. Women in Turkey have traditionally been the primary caregivers for children and elderly family members, and are responsible for most household tasks. They do five times as much unpaid care work than men and cite household and family duties as their main reason for not joining the labor force. This is exacerbated by an insufficient supply of quality childcare affordable enough to justify joining the labor force when compared to expected earnings. During the pandemic, care centers have limited their activities or closed altogether, and, although both men and women's unpaid work at home has increased, women have reported a far greater increase compared to men, raising further their constraints on participating in the labor force according to a recent survey by UN Women³⁷. Women also face constraints on entrepreneurship. Women in Turkey are less likely to be entrepreneurs than men (22 percent of men and 9 percent of women are self-employed), partly because of social and cultural constraints, but also because of barriers in access to finance, and skills gaps.

Figure 119: Women report more home duties due to COVID-19



Sources: Turkstat; Cinar, K. & Kose, T., 2018. The Determinants of Women's Empowerment in Turkey: A Multilevel Analysis. South European Society and Politics. Vol. 23.; World Bank, 2018. Turkey Country Gender Assessment; World Bank. 2015. Supply and Demand for Child Care Services in Turkey. A Mixed Methods Study; Kalaylıoğlu, Y, et. al. 2020. The Economic and Social Impact of COVID-19 on Women and Men: Rapid Gender Assessment of COVID-19 Implications in Turkey. UN Women Turkey Office.; Tuzun, Ipek & Takay, Bahar, 2017. Patterns of female entrepreneurial activities in Turkey. Gender in Management: An International Journal, Vol. 32 Issue: 3; World Bank. 2009. Female Labor Force Participation in Turkey, Trends, Determinants and Policy Framework. Report number 48508-TR. ; Cebeci, T. 2014. Performance of Female Employers in Turkey.; Kizilaslan, N., and M. Karaomer.

The first year of COVID-19 has also deepened labor market challenges faced over the mid- to long-term, including learning and skills needed for a changing economy. The long-term impact on the labor market is both tied to the impact of the adult labor force, young new labor market entrants, and school-age students at risk of learning losses. While Turkey's overall human capital index (HCI) prior to COVID was on par with most middle-income countries, challenges were already apparent. Learning losses are expected to lead to HCI and growth losses³⁸, particularly for poor and low-income households, unless targeted measures are taken to safeguard skills. On average, for example, one year of school closures in Turkey has been estimated leading to a 40-point decrease in reading and mathematics PISA scores, which could reverse recent gains and

openings tend to be found in manufacturing (30 percent), followed by wholesale and retail trade (11 percent), information and communication technology (11 percent) and the remainder in formal sector services such as accommodation, finance, real estate, administrative, and health services (roughly 5-8 percent per sector).

³⁷ UN Women, with the support of SAM Research and Consulting, conducted a survey of 1,508 men and women between 19-25 April, 2020. The survey was conducted on the basis of Computer-Assisted Telephone interviewing. It was based on a multi-stage random sample frame, evenly split between men and women, and was statistically-significantly representative in terms of socio-economic development and regions.

³⁸ World Bank (2020). Human Capital Project Report, Turkey Snapshot. Washington DC: World Bank.

harm future productivity³⁹. The impact is expected to be worse for low-income households and non-native Turkish speakers. Turkey's share of NEET, at 26 percent, is higher than other countries with a comparable HCI. Female labor force participation, at 34 percent, is also far lower than other countries that have a similar HCI amongst females (Figure 117). Given these risks to learning, the pandemic has potential long-term scarring effects on the labor market unless adequately addressed today.

Figure 120: More youth are NEET

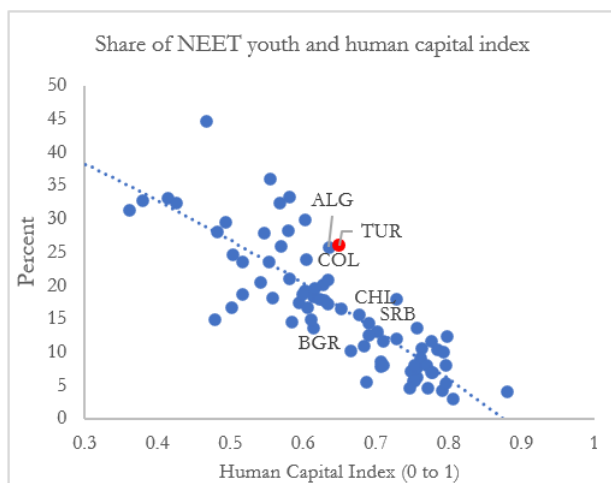
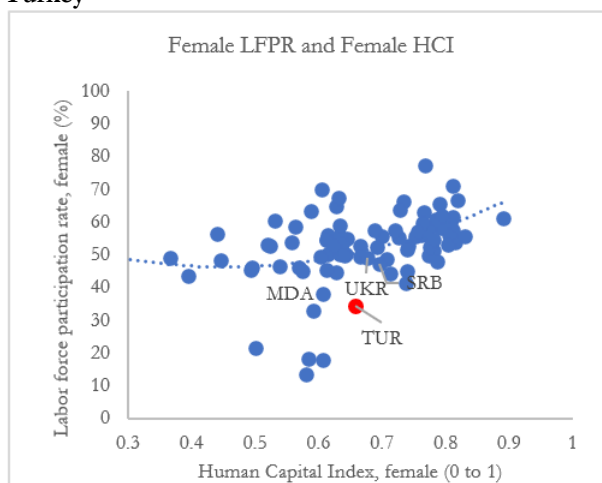


Figure 121: And far fewer women in the labor force in Turkey



Source: World Bank staff using Turkstat data and (for female labor force comparisons) and World Development Indicators data.

Note: Data for NEET and LFPR relates to 2019, HCI 2020. Share of youth not in education, employment or training (NEET) is the proportion of young people who are not in education, employment, or training to the population of the corresponding age group. The age group can be youth (ages 15 to 24); persons ages 15 to 29; or both age groups, depending on national definitions.

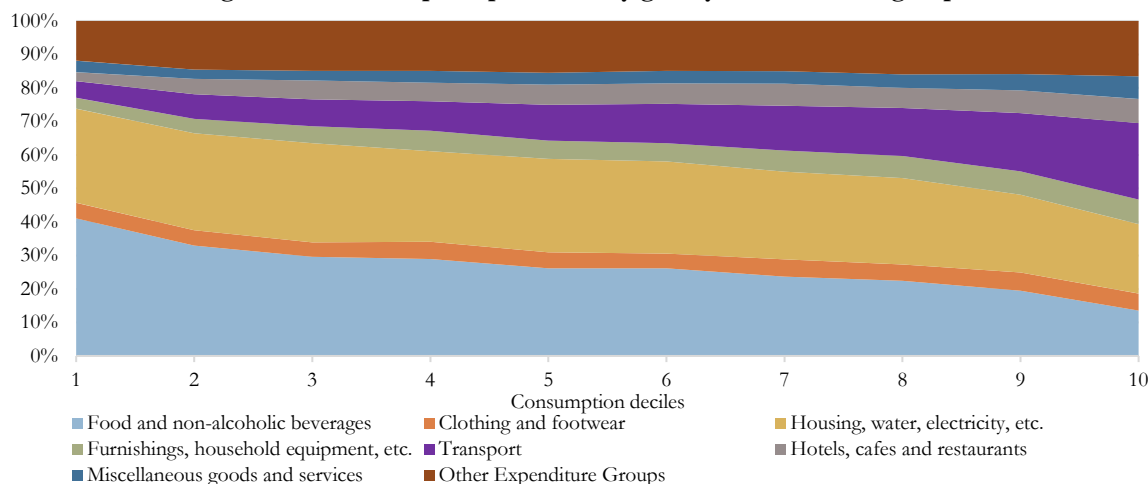
Elevated inflation hit lower income households

Considering the persistent high inflation in Turkey, it is important to understand how inflation affects low-income households. If not offset by proportional increases in income, inflation can diminish the purchasing power of individuals, undermining their ability to maintain the same level of consumption. Inflation, while conventionally presented in average terms, can in fact affect different households differentially. Inflation can be regressive if prices rise relatively more for items that are consumed more by households from the bottom of the income distribution. The regressive nature of price changes can be more pronounced in periods of high inflation as has been the case in Turkey since 2017, as inflation has remained in double digits. In particular, the period following the exchange rate instability of the summer of 2018 witnessed the highest episode of inflation since the early 2000s. In this context, it is important to examine the nature of inflation in Turkey over recent years.

Varying consumption patterns across income groups in Turkey suggest that households may indeed be affected differently by inflation. Figure 122 shows how expenditure groups have varying shares in the overall consumption across expenditure deciles. People from the bottom of the distribution would be hit the hardest when prices of food and housing rise, while better-off households will experience relatively higher inflation when prices of transportation increase, for instance.

³⁹ World Bank (2020). Turkey Safe Schooling and Distance Education Project Appraisal Document, Annex 4 COVID-19 Learning Loss Assessment. Report No: PAD3962. Washington DC: World Bank.

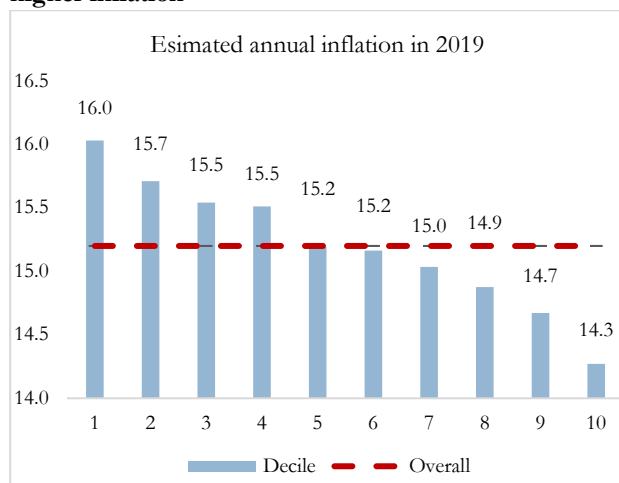
Figure 122: Consumption patterns vary greatly across income groups



Source: Household Budget Survey 2018, Turkstat; World Bank Staff estimates

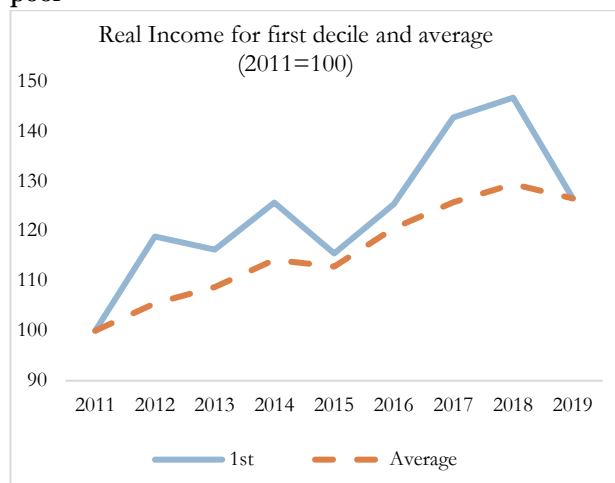
Analysis using highly disaggregated consumption and price data shows that the high inflation episode following the 2018 currency shock hurt the poor significantly more. The Turkish Household Income Consumption Expenditure Survey (HICES) and price data from the Turkish Statistical Institute (TURKSTAT) can be used to gauge the distributional effects of inflation. Decile-specific inflation rates were computed using household-level consumption baskets and disaggregated price information for 12 expenditure groups⁴⁰. Data for 2019 reveals that households from the bottom of the distribution bore higher price rises⁴¹. While overall CPI⁴² increased by 15.2 percent, the level of inflation experienced by households from the lowest decile reached 16 percent, almost two percentage points above the inflation borne by the top decile (Figure 123). A similar gap occurred between the Bottom 40 and Top 60 inflation rates, at 15.7 percent and 14.9 percent, respectively.⁴³ While most expenditure groups saw significant price increases, inflation was higher for expenditures on food and non-alcoholic beverages (19.5 percent) than for transportation (9.8 percent).

Figure 123: Lower income households experienced higher inflation



Source: World Bank calculations using data from Turkstat.

Figure 124: High inflation depressed incomes of the poor



⁴⁰ This analysis diverges from the official methodology used to calculate consumer price inflation, which uses prices in the current year and consumption weights from the previous year. The rationale for this is that, given significant changes to consumption patterns, applying current weightings can reveal the sensitivity of results to this assumption.

⁴¹ A similar inflation incidence analysis could not be carried for 2020, since household-level expenditure data was not available.

However, an examination of the actual changes in prices across expenditure groups for 2020 suggests that the effects of inflation were borne more evenly across all income groups.

⁴² On a 12-month average basis.

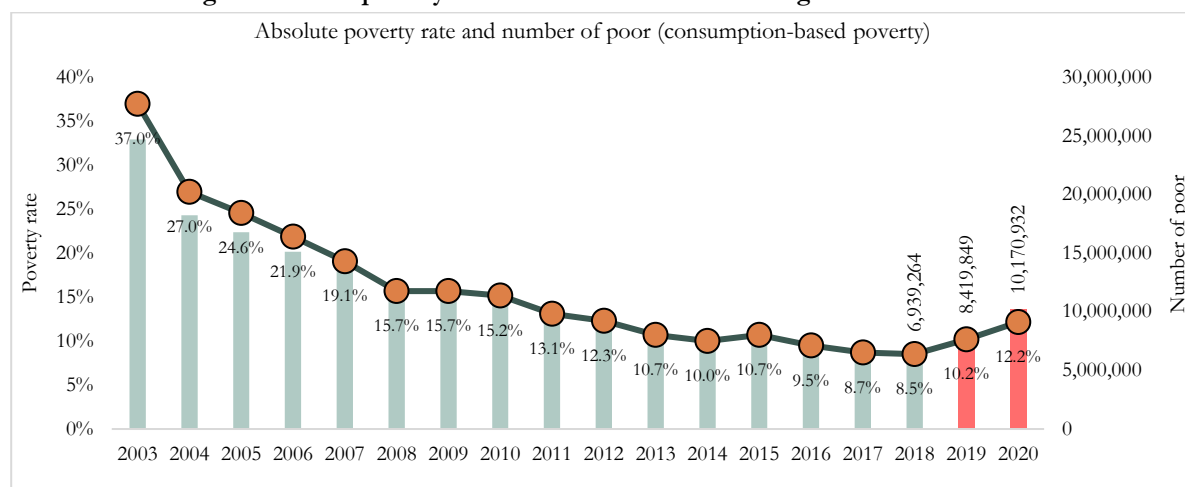
⁴³ The differences between the bottom, middle and top of the distribution are statistically significant at the 95% confidence interval.

Over 200,000 additional people could be counted as poor due to the regressive effects of inflation in 2019. The poverty line is updated for each year using the overall change in the CPI. This methodology can underestimate poverty by a non-trivial amount if the bottom of the distribution experiences higher inflation. Adjusting the threshold for 2019 using decile-specific inflation suggests that 209,000 additional individuals could be deemed poor (an increase in the poverty rate of 2.2 percent) compared to the standard calculations that rely on the average CPI to adjust for annual changes in prices. In 2015, a year when the price gap between low-income and the overall CPI was even larger, the number of poor was underestimated by 342,000 individuals (4.2 percent). In recent years, the inflation elasticity of poverty has been close to 1 – in other words – an increase in prices not offset by income leads to a proportionally similar increase in the poverty rate, as can be seen in Figure 124.

And millions more are now in poverty

A key feature of Turkey's growth over the past two decades has been inclusiveness, but this is now under threat. The incidence of poverty⁴⁴ fell by 77 percent between 2003 and 2018, from 37 to 8.5 percent. But this impressive poverty reduction was set back by the 2018 downturn, which caused a loss of over a million jobs, created significant upward pressures on prices and raised poverty to 10.2 percent in 2019. This translated into nearly 1.5 million additional poor, a total of 8.4 million nationally, erasing almost all gains achieved in the three years preceding the economic turmoil (Figure 125). In fact, the social and economic burden of the 2018 economic turmoil fell mostly on lower income households. While consumption shrank by 0.7 percent between 2018 and 2019 for the median Turkish family, households from the bottom 20 percent experienced a much worse contraction that ranged from 5.5 to 14.6 percent.

Figure 125: The poverty rate is estimated to reach its highest level since 2012



Source: World Bank calculations using data from Turkstat

Note: Poverty is measured as the proportion of people with per capita consumption of below \$5.5 a day 2011 PPP. *Source:* World Bank calculations using HBS 2003-2019.

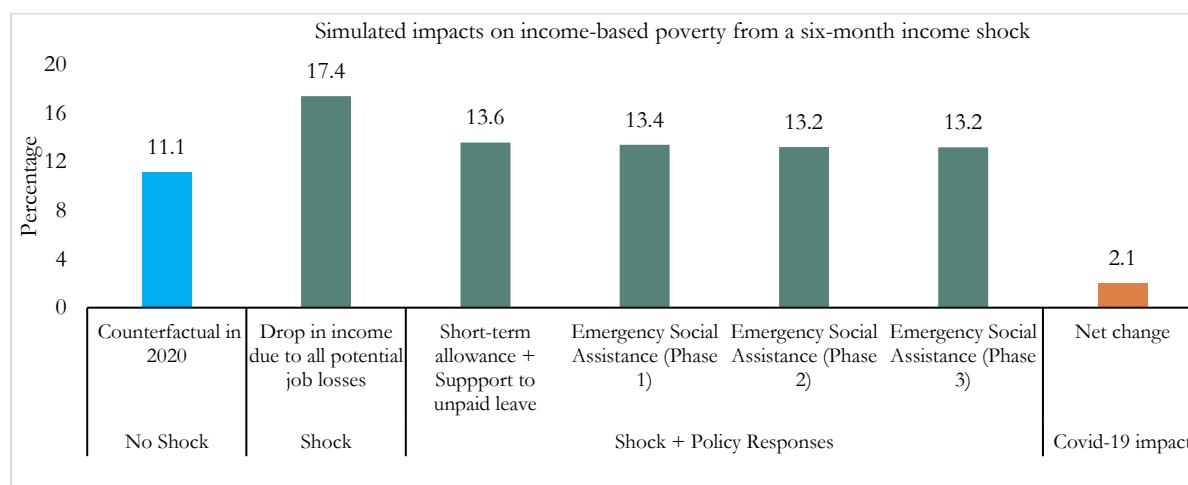
Following shortly after the last shock, the impact of COVID-19 is expected to increase poverty even further. Simulation analysis of the effects of Covid-19 on household incomes (as opposed to modeling the impacts on consumption which require further assumptions)⁴⁵ reveals the scale of the potential poverty effects

⁴⁴ Measured as the share of households with consumption levels below the World Bank's poverty line for Upper-Middle Income Countries (\$5.50 per person per day in constant 2011 purchasing power parity prices)

⁴⁵ The simulations were performed using income-based, rather than consumption-based poverty measures since the former approach does not require making assumptions about the magnitude of the marginal propensity of households to consume across the distribution, which is a parameter that likely changes during crises, as well as about the ability to smooth consumption through the use of savings and other buffers. Moreover, poverty trends and levels in Turkey are highly comparable when using income or consumption as the measure of household welfare.

of this shock.⁴⁶ The poverty rate may have increased by as much as 2.1 percentage points by the end of 2020, equivalent to pushing another 1.6 million people below the poverty line (Figure 126). As a result of the two back-to-back shocks, Turkey could have entered 2021 with over 3 million new poor, totaling 10 million nationally, an increase of 40 percent compared to the number of poor in 2018. The high effects of Covid-19 on poverty in spite of overall positive growth are explained by the stark inequalities in the burden of the employment contraction. Consequently, the bottom 40 accounted for 60 percent of the job cuts. In contrast, most individuals from the upper half of the distribution kept their jobs, while some groups (for instance, those from the top decile) even enjoyed net job gains (Figure 129). Had the government not acted swiftly, simulations show that the impact on poverty could have been even worse – almost three times as much. In this respect, the social emergency package – introduced shortly after the first round of lockdowns – which included social transfers, unemployment insurance benefits and unpaid leave subsidies – was important in avoiding even worse effects of the COVID-19 pandemic.

Figure 126: Poverty can increase by up to 1.6 pp in 2020, corresponding to 1.6 million new poor



Source: World Bank calculations using HBS-2019 and monthly reports from the Labor Force Survey

Note: Poverty is measured as the proportion of people with per capita consumption of below \$5.5 a day 2011 PPP. *Source:* World Bank calculations using HBS 2003-2019.

The economic turmoil translated into downward economic mobility for other income groups and contributed to keeping inequality high. One of the most remarkable accomplishments of the broad-based process of economic progress in Turkey has been the growth of the middle class, more than doubling since the early 2000s and making it the largest socioeconomic group in the society. Yet, the shocks of the past three years stalled that expansion, shrinking the middle class by 4 percentage points (77 percent of that explained by the COVID-19 crisis alone), namely 3.3 million individuals who passed to a lower income group. At the same time, many non-poor, but vulnerable households (comprising 26.7 percent of the population prior to COVID-19) have likely exhausted their buffers and could be one shock away from sliding into poverty (Figure 128). Following a trend set in earlier years, the uneven burden of the 2018/19 economic turmoil and the 2020 pandemic on low-income households has furthered income and consumption inequality. The Gini coefficient in 2019 reached 0.42 (up from 0.41 in 2017), and is expected to stay high in 2020. Other indicators also point to a worsening of inequality.

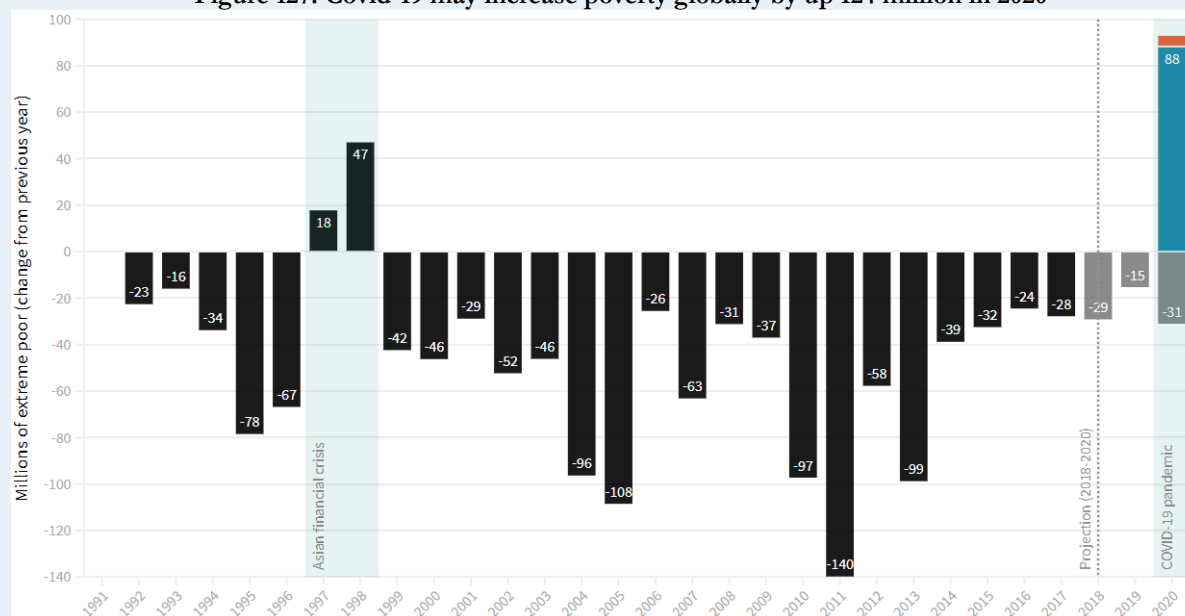
⁴⁶ Poverty in Turkey is measured using the Household Budget Survey (HBS), compiled annually by TUIK. Due to the mobility restrictions imposed to curb the spread of Covid-19, HBS was not collected in 2020. This, in addition to long lags between data collection and the public release of the survey data, makes it necessary to rely on micro-simulation, or imputation methods to estimate the effects of Covid-19 on poverty in 2020.

Box 3: The Effects of Covid-19 on Global Poverty

Covid-19 and its associated health and economic crisis have affected every corner of the globe, partly reversing the steady gains in economic progress and poverty reduction achieved over the past two decades in most developing and emerging economies. The [latest World Bank projections](#) suggest that the Covid-19 pandemic will result in a substantial increase in poverty in much of the world. Based on the January 2021 forecast from the Global Economic Prospects, it is estimated that up to 124 million people globally would be pushed into extreme poverty in 2020 (considering the \$1.90 per person per day in constant 2011 purchasing power parity poverty line), with South Asia and Sub-Saharan Africa each contributing roughly two-fifths of the increase. At the \$5.5 poverty line for Upper-Middle Income Countries, the relevant yardstick for Turkey, global poverty is projected to increase by 210 million people, with more than half of the new poor in South Asia, with Europe and Central Asia accounting for a small share (2.4 percent, equivalent to over 5 million extra poor).

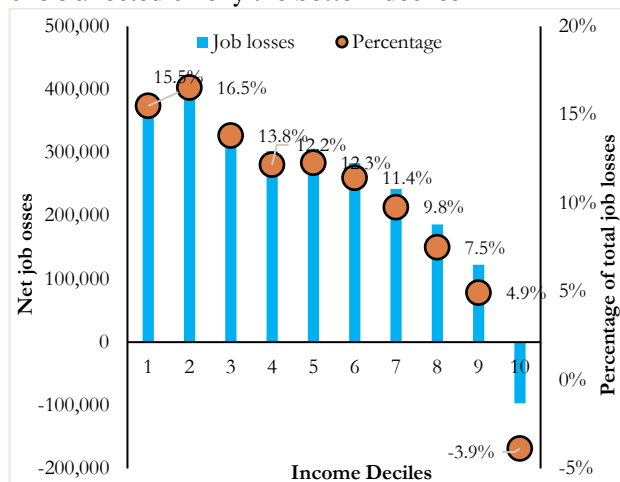
Figure 127 shows the annual change in the number of global extreme poor from 1992 to 2020. The increase in poverty caused by Covid-19 is not only significant in size, but also unprecedented in the last two decades to 2020. Before Covid-19, the only setback in global poverty reduction had occurred during the Asian financial crisis of 1997 and 1998, which increased extreme poverty by 18 million in 1997 and by a further 47 million in 1998, with about half of the increase in absolute numbers due to Covid-19. The increase in poverty may not be short-lived. While the numbers for 2021 remain highly uncertain and contingent upon the evolution of the pandemic and the vaccine roll out, nowcasting of poverty up to 2021 shows that the estimated Covid-19 induced poor is set to rise to between 143 and 163 million in 2021.

Figure 127: Covid-19 may increase poverty globally by up 124 million in 2020



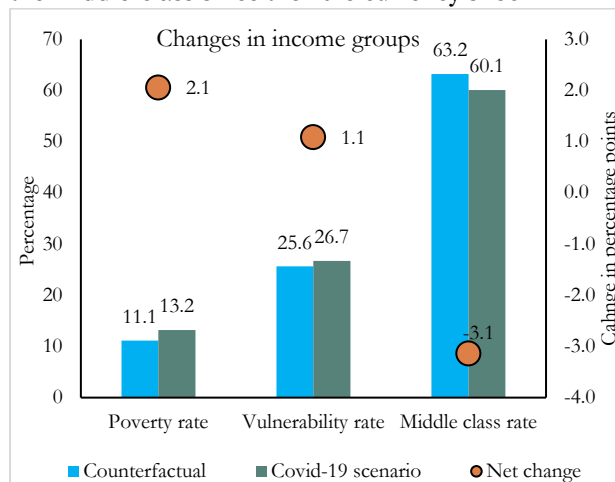
Source: [Lakner et al. \(2020\) \(updated\)](#), [PovcalNet](#), [Global Economic Prospects](#). Note: Projections for years 2018-2021 are based on updated estimates of Lakner et al. (2020). For 2020, we show both (a) the number of people that were expected to move out of extreme poverty had the COVID-19 pandemic not happened (Pre-COVID-19 counterfactual scenario, gray bar) and (b) the number of people who are pushed into poverty under the COVID-19-baseline scenario (blue bar) or the COVID-19-downside scenario (blue + orange bar). The “new poor” induced by COVID-19 is the sum of (a) and (b). For instance, under the COVID-19-baseline scenario in 2020, the “new poor” is equal to $88 + 31 = 119$ million. Similarly, under the COVID-19-downside scenario in 2020, the “new poor” is equal to $88 + 31 + 5 = 124$ million. We thank colleagues at USAID for the inspiration behind this figure.

Figure 128: Job losses at the peak of the COVID-19 crisis affected chiefly the bottom deciles



Note: Net change in employment between April 2019 and April 2020. Negative numbers correspond to net job gains. Source: World Bank calculations using TurkStat data.

Figure 129: More than 3 million people dropped out of the middle-class since the 2018 currency shock



Note: "Poor" denotes the share of people with per capita consumption of below \$5.5 per capita a day in 2011 PPP, "Vulnerable" denotes the share of people with per capita income of above \$5.5 and below \$11 per capita a day 2011 PPP and "Middle Class" denotes the share of people with per capita income of above \$11 per capita a day 2011 PPP. The change in the share of the income group in the population (orange circle) is measured on the right vertical axis. Source: World Bank calculations.

II. LOOKING AHEAD

Coming after such a challenging year, Turkey is expected to see robust growth in 2021. However, the outlook is beset with uncertainty, and will require prudently tight monetary policy, supportive fiscal and financial sector policies, and control over COVID-19. Turkey has made good progress in vaccination roll-out, but the road ahead is long and new COVID outbreaks may undermine recovery in 2021. While the policy framework is presently geared towards stabilization, the replacement of the Central Bank Governor has unsettled markets and raised questions over its future direction. The baseline assumption of this report is that monetary policy will remain suitably responsive throughout 2021 in order to tame inflation and boost investor confidence. But the report also recognizes that there is greater uncertainty around this baseline assumption. There remains space for accommodative fiscal policy to facilitate a full recovery in 2021, although increasing contingent liabilities and high exposure to external market risk suggest that fiscal expansion should be moderate and time limited. Strengthening insolvency and debt resolution frameworks will be important to de-risk the corporate and financial sectors. Turkey can raise potential growth by putting in place measures to incentivize a decarbonization transformation early, which would also be supported by the development of longer-term and sustainable finance sources with diversified financial markets. Reducing trade barriers and increasing market access for Turkey-based firms will also help support growth in the medium-term. Finally, seismic shocks to labor markets are likely to have long-lasting effects, and active and targeted social and labor market policies will be increasingly important to ensure people – especially women and the youth of today – do not miss the opportunity to fulfil their potential as productive members of society.

A. The outlook for growth is tentative in a risky environment

Respectable projected growth in 2021 reflects the gradually waning effects of COVID-19 and a low GDP base in 2020. The economy is projected to expand by 5 percent in 2021, followed by 4.5 percent growth⁴⁷ in the medium term (Figure 130). Effectively all growth achieved in 2021 is driven by the unusually low base of activity in 2020, and a more typical level of economic activity this year will yield high year-on-year growth. Growth is expected to be weak in the first half due to the impact of restrictions, relatively weak external demand, and a tight monetary stance, whilst GDP in the second quarter will be far higher than the previous year when the COVID-19 pandemic brought the economy to a near-standstill. These projections assume that tentative economic recovery is not undermined by the need to implement strict COVID-19 control measures for extended periods to deal with new outbreaks in Turkey or major export markets.

Growth in 2021 is expected to be driven largely by a rebound in exports. The composition of growth is projected to shift towards external demand as global activity picks up. Exports are projected to account for more than two-thirds of the growth in 2021. This will be driven mostly by goods exports, but an expected partial recovery in tourism will also contribute. The current account deficit is expected to fall to 3.7 percent of GDP in 2021, with a recovery in tourism, exports and recovery in gold trade balance. Private consumption and investment growth will decelerate from the peak reached in late 2020 and make modest contributions to growth. Public consumption is projected to increase by 2.4 percent in 2021.

Weak labor markets and high costs of borrowing will preclude strong private consumption growth in the near term. Inflation remains relatively high, yet large numbers of workers have yet to recover to their pre-COVID income level, whereby the scope for consumption growth is limited. Relaxation of restrictions is likely to support moderate growth in services consumption. And yet the high cost of borrowing and frontloaded purchases of durable goods in 2020H2 are expected to constrain non-services consumption demand,

⁴⁷ All GDP growth references refer to GDP in real (constant price) terms, unless stated.

particularly in 2021H1. Uncertainty regarding the continuance of the government's employment support measures beyond 2021H1 constitutes a downside risk for private consumption.

Figure 130: Exports will be the main driver of growth in 2021

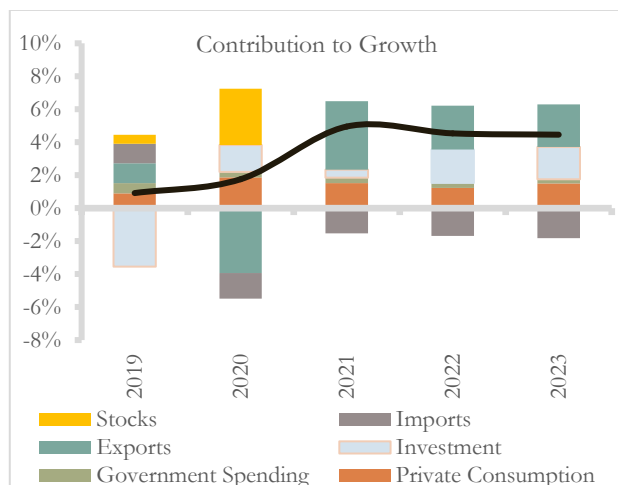


Figure 131: Debt overhang tends to be a drag on investment.

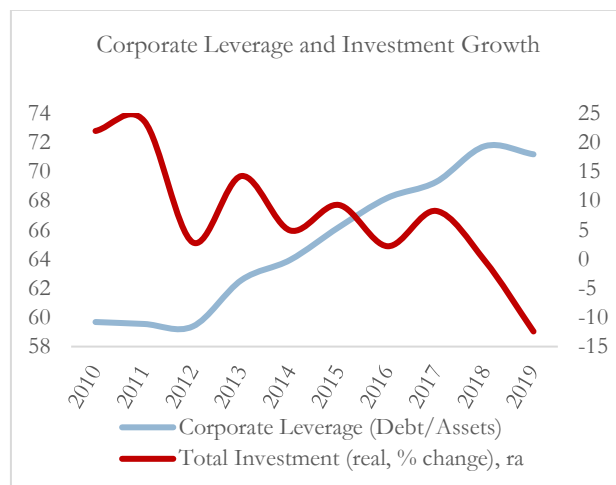


Figure 132: Rebound in EMDE investment insufficient to reverse losses during 2020.

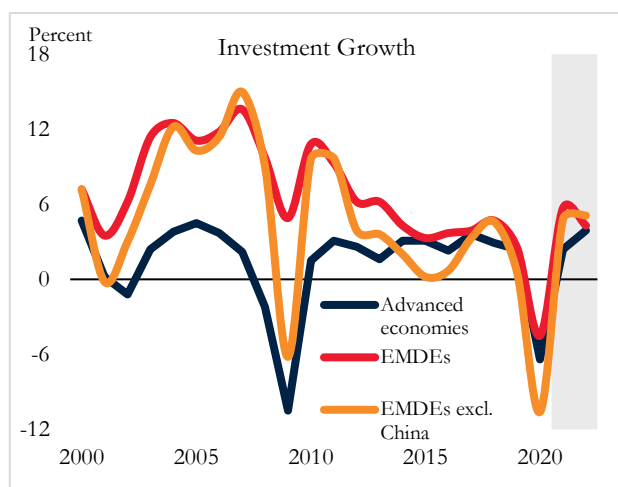
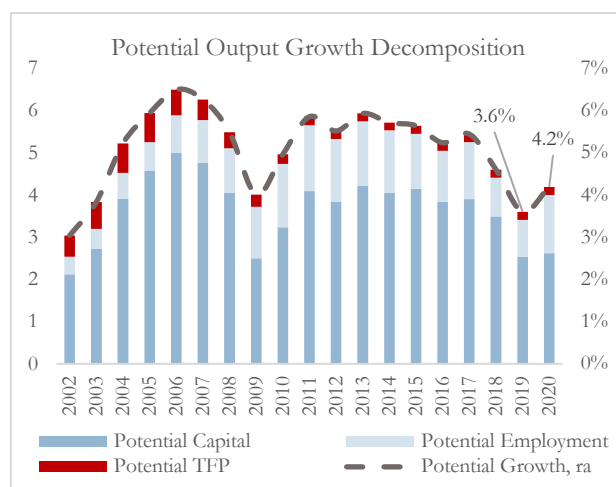


Figure 133: Weak investment can cause long-lasting damage to economic potential.



Sources: Haver Analytics, TURKSTAT, CBRT Sectoral Accounts, Global Economic Prospects January 2021, WB Staff estimates.

Efforts to lower inflation will be set back by heightened uncertainty and exchange rate depreciation, highlighting the importance of continued commitment to prudent monetary policy. Amid uncertainty over the future direction of monetary policy, market-priced inflation expectations immediately rose from 14.4 to 18.4 percent (Figure 142). Sharp depreciation, high inflation expectations and rising international food and energy prices along with a surge in production costs associated with the pandemic are likely to add pressure on prices. Inflation is projected to accelerate to 15.5 percent on average in 2021. Avoiding premature monetary easing is important to contain pressure on the Lira and stabilize inflation expectations, particularly in 2021.

Tight credit conditions and debt overhang will be a drag on investment in 2021. Low-cost credit availability has often been associated with bursts of growth in consumption and investment in Turkey over recent years. Yet the CBRT's forward guidance on monetary policy this year, and the need for the banking sector to restore its balance sheets following last year's credit boom, means that there is no room for such

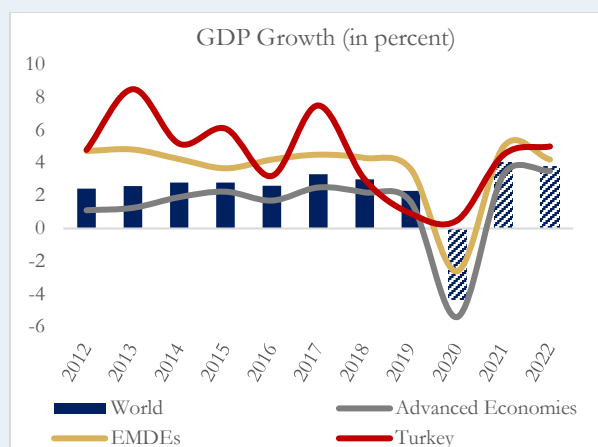
policy.⁴⁸ Corporate leverage increased in 2020 to contain the adverse impacts of the pandemic, and is likely to pressure investment (Figure 134). The outlook for external inflows is uncertain, especially given the possibility of a tightening of liquidity in emerging markets as advanced economies reflate, and of elevated policy uncertainty in Turkey. On balance, investment is not expected to see much growth in 2020, except for some recovery in the fourth quarter, supported by public investment. The pace of investment growth will be important for potential economic growth going forward (Figure 136).

Box 4: Global Outlook

As 2020 has so clearly and painfully evidenced, epidemiological developments can have a huge impact on the global economy. While there is reason to expect that COVID-19 will increasingly be controlled and immunized against over the course of this year, economic projections are sensitive to setbacks, such as the development of more virulent or fatal strains or delays in the roll-out of major vaccination programs.

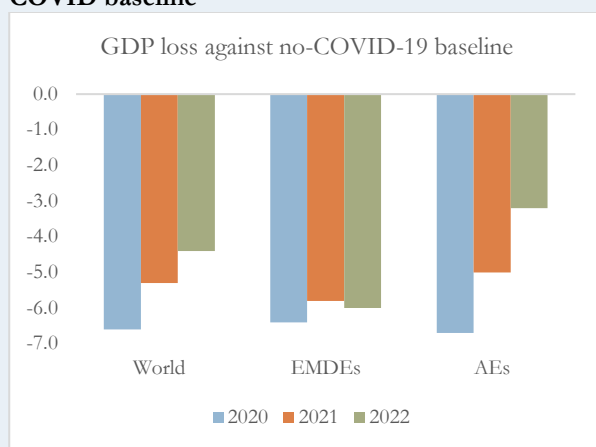
Global GDP is expected to expand 4 percent in 2021, predicated on good pandemic management and effective vaccination in many countries, continued monetary policy accommodation and diminishing fiscal support. After this year's pickup, global growth is envisioned to moderate in 2022 to 3.8 percent. Advanced economies are projected to recover, with growth reaching 3.3 percent and 3.5 percent in 2021 and 2022, respectively. Aggregate EMDE growth is envisioned firming to 5 percent in 2021 and moderating to 4.2 percent in 2022, although much of this recovery is due to China's rebound. Excluding China, the recovery across EMDEs is anticipated to be far more muted, averaging at 3.5 percent in 2021-22, as the pandemic's lingering effects continue to weigh on consumption and investment.

Figure 134: Global growth to rebound in 2021



Source: World Bank, Global Economic Prospects, January 2021.

Figure 135: But still be much lower than the no-COVID baseline



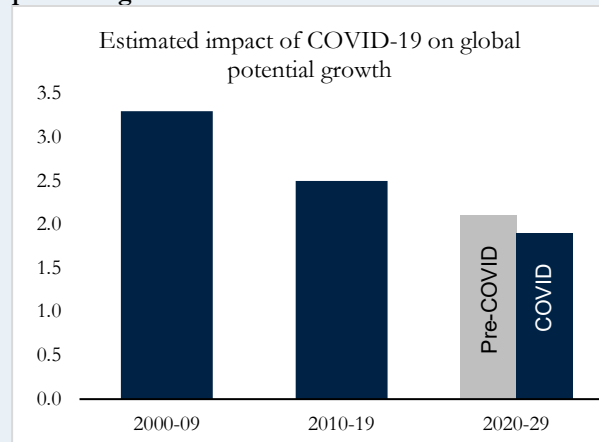
The level of global GDP in 2021 is forecast to be 5.3 percent below pre-pandemic projections — or about \$4.7 trillion, and by 2022, still 4.4 percent below pre-pandemic projections. The gap in EMDEs is nearly twice as large as in advanced economies as output remains dampened by lingering risk aversion on the demand side and the effects of diminished physical and human capital accumulation on labor productivity.

⁴⁸ Investment plunged particularly sharply in EMDEs excluding China as the pandemic took hold. The collapse in investment was much sharper in large EMDEs (excluding China) than in large advanced economies. Turkey was exceptional in recording positive growth in investment during the pandemic, supported by strong credit stimulus. The speed of investment will vary among the EMDE group, but is expected to be weak overall (Figure 133).

Most commodity prices rebounded in the second half of last year, but the pickup in oil prices lagged the broader recovery in commodity prices due to the prolonged impact of the pandemic on global oil demand. Oil demand fell 9 percent last year—the steepest one-year decline on record—and prices average \$41/bbl – 34 percent down on 2019. Oil prices are forecast to remain close to current levels and average at \$44/bbl in 2021 before rising to \$50/bbl in 2022.

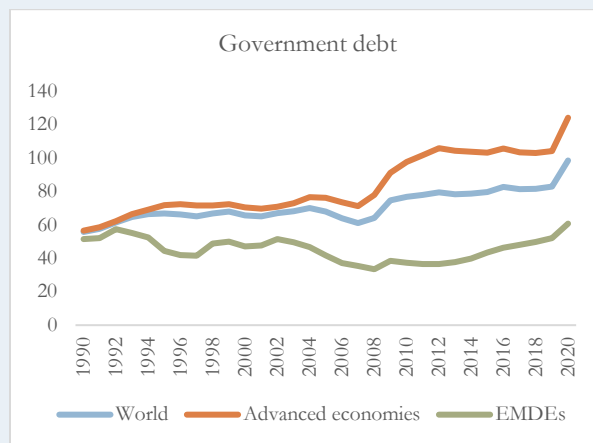
Even if the pandemic is brought under control, its effect on potential growth could be longer lasting than expected. Debt burdens have increased for both corporates and governments. This follows a decade in which global debt had already risen to a record high of 230 percent of GDP by 2019. High debt levels leave borrowers vulnerable to a sudden change in investor risk appetite. This is especially true for riskier borrowers and EMDEs dependent on capital inflows to finance large fiscal and external current account deficits. Banks' capital buffers are also under pressure due to falling profitability and asset quality deterioration. Defaults have already surged in the hardest-hit sectors and countries, and rising credit downgrades point to further strains in the future. These developments reduce the resilience of financial systems, particularly in countries with weaker banking systems, or without the policy space to provide sufficient support to stressed financial institutions.

Figure 136: COVID-19 estimated to have damaged potential growth



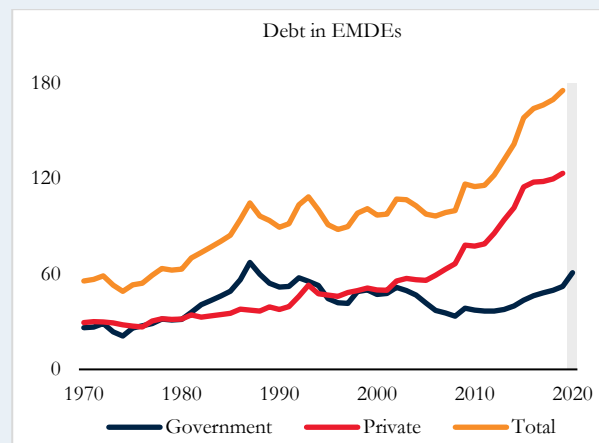
Source: World Bank, Global Economic Prospects, January 2021.

Figure 137: Government debt is on the rise



Source: World Bank, Global Economic Prospects, January 2021.

Figure 138: Including in EMDEs



Even once the pandemic has subsided, the global economic landscape is unlikely to return to its previous state. The pandemic will leave lasting scars on productivity, including through its effect on the accumulation of physical and human capital, which will exacerbate the downward trend in potential growth.

Source: World Bank, Global Economic Prospects, January 2021.

There is uncertainty over the baseline forecast, with both upside and downside risks On the downside, recent normalization could trigger a third wave of infections in Turkey that could necessitate a new lockdown and further dent domestic demand and production capacity, exacerbate uncertainty, and erode policy space. A similar flaring up of COVID-19 in important partner markets for Turkey, such as the EU, would also lower growth for Turkey via reduced exports and a possible new wave of supply chain disruptions. Premature

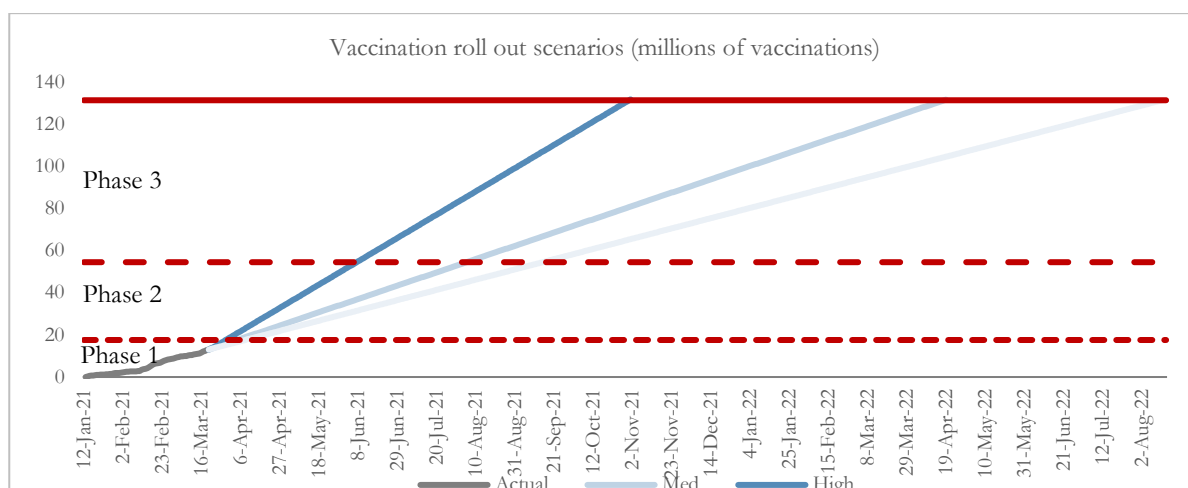
monetary easing, further loss of investor confidence and rise in macro financial vulnerabilities would also undermine growth and delay orderly recovery. On the upside, the recovery in the global economy could be faster than projected with effective and orderly vaccination developments. Turkey's experience to date provides important lessons on responding quickly and in a targeted and timely manner, which should help limit the likelihood of a downside scenario.

B. There are major uncertainties which could materially affect the path of growth this year

COVID-19 is a clear and present danger until the vaccination program nears completion

COVID-19 remains a risk while vaccinations do not provide full coverage. While it is likely that the first stage of vaccinations can be completed in the second quarter of 2021, there is a wider range of uncertainty over the timing of completion of future phases. Extrapolating from the vaccine rollout beyond the first six weeks in the UK, USA and Turkey, a range of scenarios suggest vaccination of health workers and the over 65s could be completed between mid-March and mid-April 2021. The second phase (see Box 5) targets a larger group of people – close to 20 million – of over 50s, public sector personnel and selected other groups. Depending on the cumulative progress in vaccinations, as well as the availability of vaccine supply, completing the vaccinations of this group might feasibly be achieved as early as late May, or else take up to September (Figure 139).

Figure 139: There remains a long way to reaching near-full vaccination rates



Source: Ourworldindata.org, World Bank Staff estimates.

Note: Numbers of vaccinations based on population estimates of targeted groups, two vaccines per person, and 100 percent coverage in group.

Box 5: Turkey's vaccination program to date

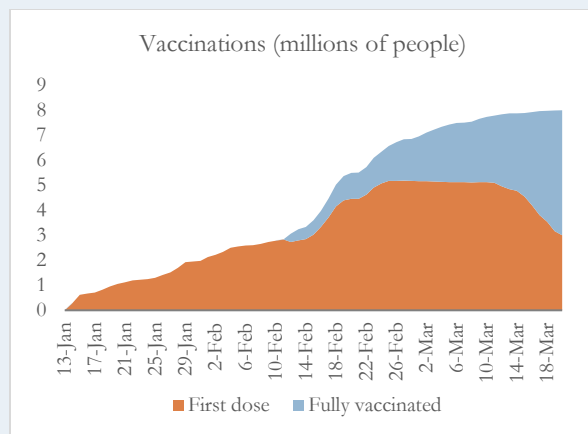
Turkey's phased vaccination program has begun. Turkey's timely purchasing and phased-in supply of the Sinovac's CoronaVac (100 million doses)⁴⁹ and Pfizer-BioNTech (4.5 million doses)⁵⁰ COVID-19 vaccines enabled a nationwide vaccination campaign to start in early January 2021. The first phase targets were the healthcare workforce, people above the age of 65 years, individuals with chronic illnesses, and front-line workers in critical sectors (See Table 3). By March 20, a total of 13 million doses had been administered, equivalent to around 15 doses per 100 people, with 5 million people having received their second dose (Figure 140). The speed of Turkey's vaccination program compares favorably with other large countries. Turkey's vaccination program has proceeded at approximately the same speed as the UK and USA programs

⁴⁹ <https://tr.euronews.com/2020/11/26/turkiye-covid-19-a-kars-50-milyon-doz-sinovac-as-s-icin-cin-ile-anlast>

⁵⁰ <https://twitter.com/drfahtetinkoca/status/1359542068654317570>

(Figure 141), and at end-February, Turkey has the fourth highest vaccination rate amongst countries with populations greater than 10 million, and is the best performing large developing country worldwide.

Figure 140: Vaccinations have proceeded quickly



Source: Ourworldindata.org

Figure 141: In line with some of the fastest worldwide

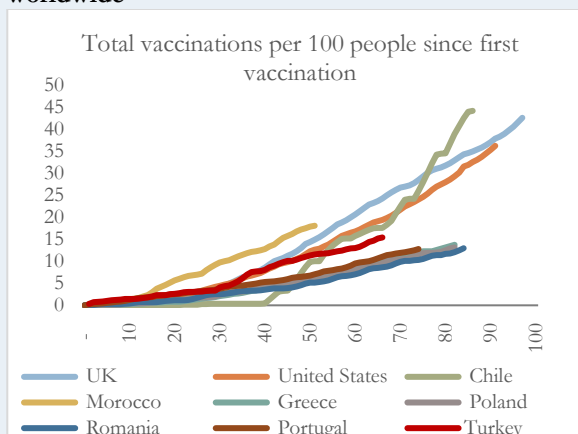


Table 4: Population targeting for Turkey's vaccination program

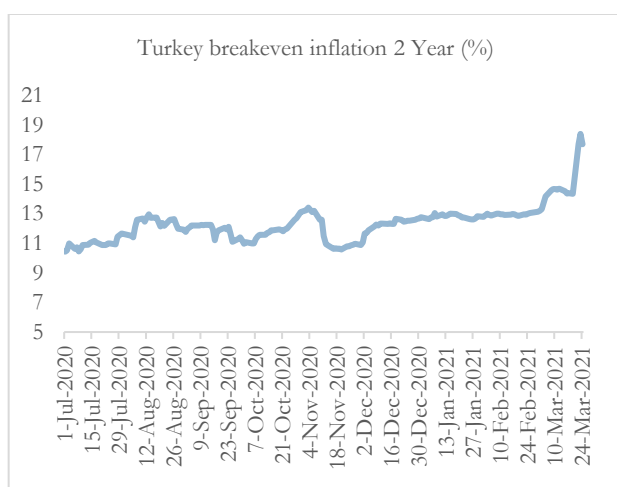
Stage	Group	Rank	Subgroup
1	A – Healthcare Workforce	A	
	B – Elderly people in nursing homes and people working in nursing homes	B	
	C - People 65 years of age and older	C1	People 90 years of age and older
		C2	People of the age group between 85-89
		C3	People of the age group between 80-84
		C4	People of the age group between 75-79
2	A – Priority Sectors for Service Delivery	C5	People of the age group between 70-74
		C6	People of the age group between 65-69
		A1	Ministry of Defense
		A2	Ministry of Interior
		A3	People with Critical Jobs
		A4	Police and Private Security Staff
		A5	Ministry of Justice
		A6	People in prison
		A7	Education Sector (teachers and instructors)
	B - People of the age group 50-64	A8	People working in the food sector
		A9	People working in the transportation sector
		B1	People of the age group between 60-64
		B2	People of the age group between 55-59
		B3	People of the age group between 50-54
3	A – People with Chronic Conditions	A1	People of the age group between 40-49
		A2	People of the age group between 30-39
		A43	People of the age group between 18-29
	B – Other Groups	B1	People of the age group between 40-49
		B2	People of the age group between 30-39
		B3	People of the age group between 18-29
4	People who have not been vaccinated		

Source: The Ministry of Health.

Turkey faces pronounced risk of disruptive external adjustment

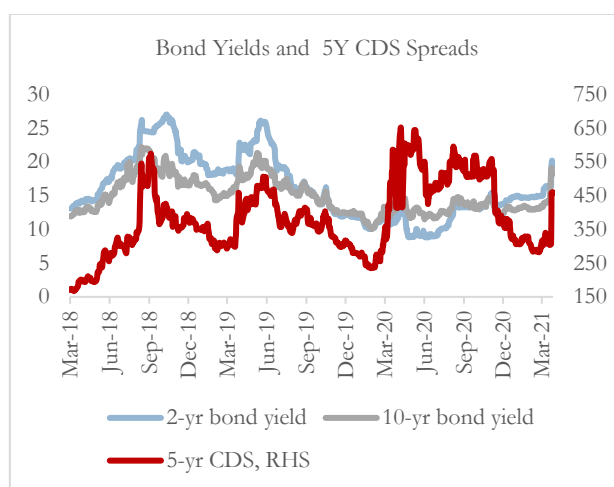
The risk of disruptive external adjustments has been heightened by the market response to recent events. As noted, the dismissal of the Central Bank Governor after four months in the role initially triggered a very sharp adjustments in Turkish financial and asset markets. Measures of sovereign risk, such as the 5-year credit default swap spread, experienced their sharpest one day rise on record (Figure 143). The Turkish Lira experienced a 9.3 percent depreciation in one day and the Borsa Istanbul saw its largest one-day losses. While clear communication of monetary policy and the CBRT's commitment to price stability since then helped calm markets somewhat, the sensitivity markets have shown to signals of a course change in monetary policy, and Turkey's continued, sizeable external financing requirements, suggest there is a high risk of further market disruption and external pressures on the Lira.

Figure 142: Market-based inflation expectations increased sharply...



Source: Central Bank of Turkey, Turkish Ministry of Treasury and Finance, World Bank staff estimates and calculations.
Notes: Excludes trade credits and foreign exchange deposits.

Figure 143: ...and indicators of risk spiked



Source: IMF, World Bank estimates.

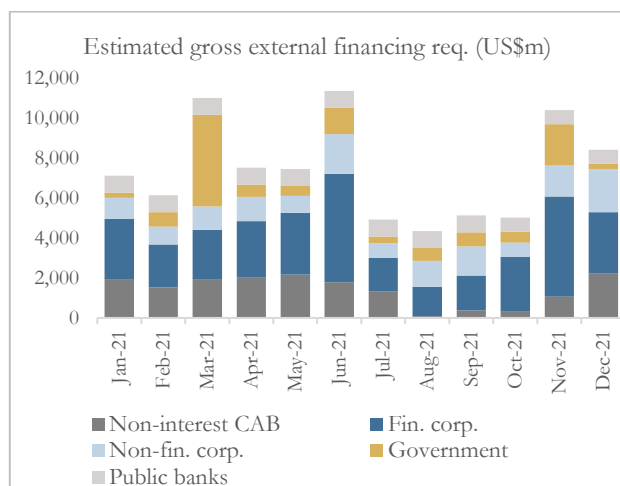
Recent market volatility heightens stress and risks in the corporate and banking sector. A sharp fall in the Lira and renewed uncertainties exert severe stress in the corporate and banking sectors. In common with many other countries, corporates have recently increased their overall debt leverage during the COVID-19 pandemic and their balance sheets have deteriorated significantly. A new round of permanent depreciation is likely to bring further cash flow and debt repayment problems in a fragile economic recovery environment. The corporate sector, which has around US\$18.5 billion of external debt (excluding trade credits) maturing in one year⁵¹, struggles with both high financing costs and currency shock at a time of worsening global financing conditions and high uncertainty regarding the pace of recovery. The high frequency corporate vulnerability index -as measured by probability of default- has already shown recent signs of heightened corporate distress. Those signs will in turn stoke concerns over the ability of banks to withstand a possible rise in distressed assets. Capital buffers are likely to be eroded by a falling Lira, and the securities portfolio could be negatively affected by rising bond yields.

Turkey may be exposed to further deteriorations in global liquidity. External financing shocks could hit Turkey hard, and a possible unwinding of quantitative easing in advanced economies could lead to a new period of turbulence. Inflation expectations are beginning to rise in the US after a long time, with the latest US\$1.9

⁵¹ The corporate sector has a short-term FX surplus of US\$25 billion. This is supportive of firms' capacity to handle short term currency shocks.

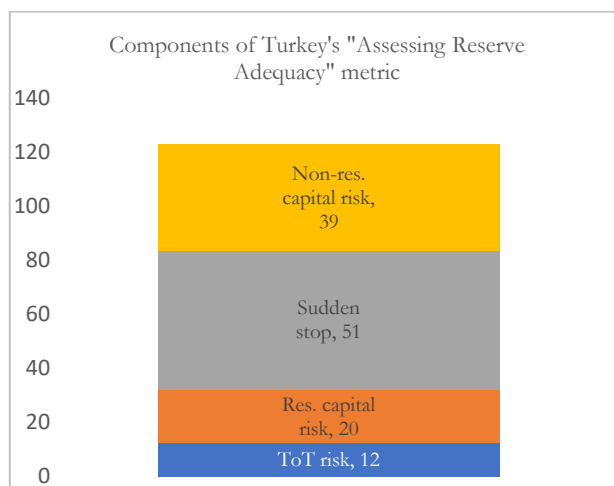
trillion fiscal stimulus package projected to close the output gap later this year. With these developments, US Treasury bonds, and other advanced market bond yields have begun to appreciably rise. An intensification of market speculation over an end to very loose monetary policy in advanced economies could cause destabilizing movements in global liquidity away from emerging markets such as Turkey, akin to the taper tantrum episode in 2013. As in 2013, this could pressure the central banks of emerging-market economies to raise interest rates to prevent significant weakening of their currencies and a build-up of inflationary pressures. Even when excluding foreign exchange currency, the deposits of non-residents and trade credits, the monthly GEFR is estimated at around US\$7bn in 2021 (Figure 144). Under normal market conditions, a large proportion of debt maturing is rolled over, whereby the net external financing requirement is considerably lower than this. However, should market sentiment deteriorate during high external repayment periods, Turkey may face external volatility. The IMF's "Assessing Reserves Adequacy" metric for Turkey is built up based on possible reserve needs in the event of different shocks, suggesting that in the event of a sudden stop, a large amount of reserves may be required (Figure 145).

Figure 144: External financing need remains substantial



Source: Central Bank of Turkey, Turkish Ministry of Treasury and Finance, World Bank staff estimates and calculations
Notes: Excludes trade credits and foreign exchange deposits.

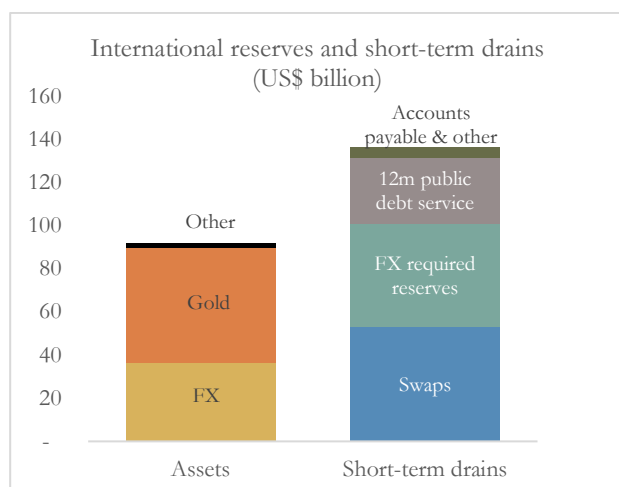
Figure 145: And reserve adequacy metrics suggest a substantial need in the event of a shock



Source: IMF, World Bank estimates

Building and maintaining buffers to the extent possible is the best insurance against external financing shocks. At a macroeconomic level, the CBRT will be able to more comfortably exercise its mandate of smoothing volatility in the exchange rate under any circumstances with a higher level of international reserves. Efforts to build reserves so far are yielding results and should be continued to the extent possible. As it stands, reserves net of predetermined and contingent short-term drains are at negative US\$45bn (Figure 146), US\$81bn below their level at the end of 2019. As can be seen in the GEFR (Figure 144), substantial external payments arise for the government, especially in March. To this end, it is prudent that the Treasury has expanded its FX deposits at the CBRT, which as of end February 2021, stood at nearly US\$18bn, and which is more than is required to settle external financing requirements in 2021. Banks continue to maintain adequate FX liquid assets to cover short-term FX liabilities falling due over the coming months. Short-term liabilities of the banking sector as of 2020 Q4 amounted to US\$ 86 billion (Figure 147). Still, the majority of banks' FX buffers are held at the Central Bank and constitute a large proportion on the Central Bank FX reserves. In the event of a future shock there will continue to be the risk of potentially competing demand for FX between the Central Bank and commercial banks. This would, again, be best addressed by the Central Bank raising the level of its own reserves.

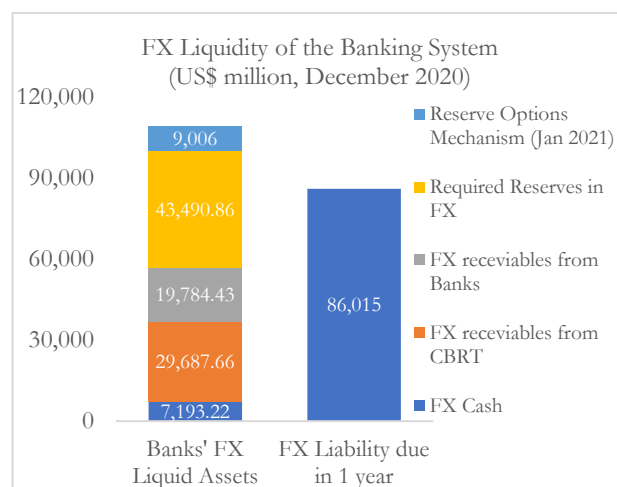
Figure 146: International reserves have fallen well below the level of short-term possible drains



Source: Central Bank of Turkey.

Notes: Data as of March 5, 2021. Short-term drains consist of predetermined and contingent drains within 12 months.

Figure 147: Banks maintain liquidity to meet ST FX liabilities



Source: Central Bank of Turkey.

C. Policy should be geared towards lowering risks in the near-term

As Turkey recovers from a succession of shocks, policy should focus on reducing the risk of further volatility. While Turkey's economy has recovered rapidly from both COVID-19 and previous shocks, it remains susceptible to further, damaging bouts of volatility. Even at the cost of some foregone growth in the short-term, policy settings should be tilted towards stabilization, until risks have been lowered and buffers increased. This would include stabilizing inflation around a credible policy anchor, building external reserves to comfortably withstand the external volatility Turkey will likely continue to face, resolving corporate distress, cleaning bank balance sheets and maintaining a prudent level of public debt, as well as accounting for contingent liabilities and possible debt service shocks.

Box 6: Turkey's new Economic Reform Package

The President of the Republic of Turkey launched a new Economic Reform Package (ERP) on March 12, 2021. The overarching focus on the ERP is on the "establishment and continuity of macroeconomic stability". The program is structured on two pillars, "macroeconomic policies" and structural policies" which each contain five focus areas each. While the ERP is focused on reforms within the remit of the central government, in order to be successful in achieving these high-level objectives, it will be necessary that monetary policy remains geared towards price and macroeconomic stability.

The ERP also contains a commitment for the program to be monitored on a quarterly basis. Successful coordination and implementation of a large number of potentially complex reform initiatives will be crucial to maximizing the positive impact of the program, and therefore a focus on implementation is positive. Related to that, several reforms represent important, but selective steps of broader reform programs, and complementary reform agendas could be considered as part of the implementation of the ERP. The following discussion summarizes several important reform areas under the ERP, but is not an exhaustive discussion:

Almost one third of the specific reforms enumerated under the ERP are within the area of public finance, making this a substantial focus for the reform in the coming period. The publication of a new quarterly

Public Finance Report offers the opportunity to convey regular updates on the progress towards fiscal policy objectives and in-year changes in fiscal policy. Several reforms are committed to in the areas of public procurement and coordinated budgetary and debt management of central and general government institutions. These reforms offer the potential to improve coordination, although in several areas, the authorities may face tradeoffs such as between domestic preference and quality assurance, centralized budgetary oversight and appropriate levels of operational flexibility for certain agencies. In these cases, a careful approach to reform, which may involve the implementation of novel approaches (such as net budgeting for certain budgetary units) would be called for. There is also a significant reform agenda in the area of revenue administration, with several reforms targeted at improving the customer experience, and reducing the compliance burden of the taxpayer. In addition to reforms to standardize and improve the efficiency of tax compliance, these measures could bring about the double dividend of improving the business environment, while also increasing the efficiency of the government's revenue collection.

In support of the CBRT's clear focus on price stability, the government focuses on supporting structural reforms. These consist of a number of measures aimed at addressing market failures in agricultural value chains that contribute to higher and more volatile prices, such as supporting a competitive and well-regulated agricultural intermediation market, improving cold chain supply chains and facilitating more flexible agriculture practices such as contract farming. In addition, the plan focuses on coordinated and evidence-based monitoring of price stability risks, including by establishing a price stability committee and an early-warning system to monitor emerging inflationary risks in a coordinated manner across government.

The ERP has a number of measures aimed at supporting financial sector development, including measures to facilitate the issuance of corporate bonds, the regulation of green bonds, and measures to improve the institutional framework for participation finance. These are all positive steps towards an important objective of financial sector diversification, which will be aided by the broader focus of the ERP of macroeconomic stability. The ERP also proposed a new regulatory framework for NPL venture capital funds. The impact of both this and financial sector diversification policies would be enhanced as part of a more holistic program of reform in these areas, with several supporting measures not explicitly addressed in the ERP.

The ERP supports structural policies across several areas related to investment, competition policy, consumer rights and industrial policy. In these areas, measures to consolidate and clarify the set of investment incentives, introduce an investment dispute mechanism and develop private sector focused sectoral coordination bodies in important areas like ICT and the health industry should help encourage domestic and foreign investment alike. Proposed improvements to retail trade regulations and fair-trading oversight are also positive steps.

Under the banner of the current account, the ERP contains measures to export growth in target markets, improvements to the oil and gas investment climate and a restructuring of EXIM bank to better support its objectives.

Employment-related reforms include measures to improve the attractiveness of vocational training and internship, as well as better coordination of employment incentive programs. A major new credit program will offer CGF loans linked to the number of new staff that firms hire and retain for a period of 2 years. The ERP contains a high-level commitment to green transformation and several measures aimed at supporting such a change. This includes the development of green bonds, green organized industrial zones, planning for circular economy reform, development of electric vehicle infrastructure and support for green technology R&D.

Source: Presidency of the Republic of Turkey (www.tcgb.gov.tr); World Bank Staff.

Tighter monetary policy should be maintained until inflation is under control

Anchoring inflation expectations through the continuation of a credible and transparent monetary policy stance is critical for the disinflationary process going forward. Empirical studies have found that persistent and sizable upside breaches of the inflation targets have weakened the anchoring power of the targets through time in Turkey.⁵² This is also evident from a recent survey conducted by the CBRT in which market participants ranked the inflation target as the least important variable in driving their forecasts of inflation⁵³. In the light of these findings, a continued commitment to the current policy stance of appropriately tight monetary policy to lower inflation in the short-term, and a conventional, transparent policy framework would help better anchor inflation expectations, support policy credibility, and achieve disinflation.

The existing monetary policy framework is appropriately geared toward reduced inflationary pressure and needs to be maintained. However, the disinflation path will be set back to the extent that there are price shocks to the economy. The sharp Lira depreciation in March that followed the replacement of the Central Bank Governor is one such example. The new Governor has appropriately committed to a continuation of existing policies to achieve a permanent inflation reduction. Avoiding premature monetary easing will remain critical to avoid excessive volatility in the capital markets, address dollarization, anchor inflation expectations and contain pressure on the Lira. The Economic Reform Package (ERP) launched in March 2021 provides a useful anchor to support economic recovery and stability but needs a sound macroeconomic policy framework to achieve desired results. Steps to consolidate Central Bank independence as part of the authorities' ongoing reform program would also support the objective of the ERP.

Fiscal policy plays an important role in securing the recovery, but increases in debt should be limited

Fiscal policy will remain important in supporting the recovery from COVID-19 in 2021. Increased government spending has supported both expanded health system capacity and COVID-19 monitoring and prevention (e.g. through social distancing and mobility restrictions), which will continue to be important over the course of 2021, along with an increased need for support to the nationwide vaccination program. Support to enterprises was mainly through deferral of social security premium payments and tax payments. In parallel, fiscal policy helped buffer liquidity support through the banking system by expanding the Credit Guarantee Fund, which does not affect the short-term fiscal stance, but is a contingent liability (Figure 148). Most of this support has continued in early 2021 to contain the pandemic. Given the lack of room for monetary policy to loosen, Turkey can continue to maintain responsive and flexible fiscal policy to manage the difficult recovery ahead so as to avert significant social and economic costs. Supporting vulnerable households and mitigating employment losses are of utmost importance.

Fiscal consolidation is expected to be gradual to contain the ongoing adverse impacts of the pandemic. Despite some erosion in the last year, Turkey still has fiscal space to support the economy. Premature sharp fiscal consolidation in 2021 might hurt vulnerable households and corporates and delay the orderly recovery. The general government deficit for 2020 is projected to be 3.5 percent of GDP as the need for additional support to cushion the economic and social impact of the pandemic will continue, particularly in 2020H1. However, fiscal support needs to be timely, targeted and time bound. A gradual fiscal consolidation is expected to take place in 2022 and 2023, as envisaged in the government's New Economic Program. The consolidation will come mainly from public transfers, which have grown sharply over the past couple of years. Public investment, which was cut sharply to create more room for transfers in recent downturns, is assumed to recover and support medium term growth. Public investment⁵⁴ will be important for raising potential growth

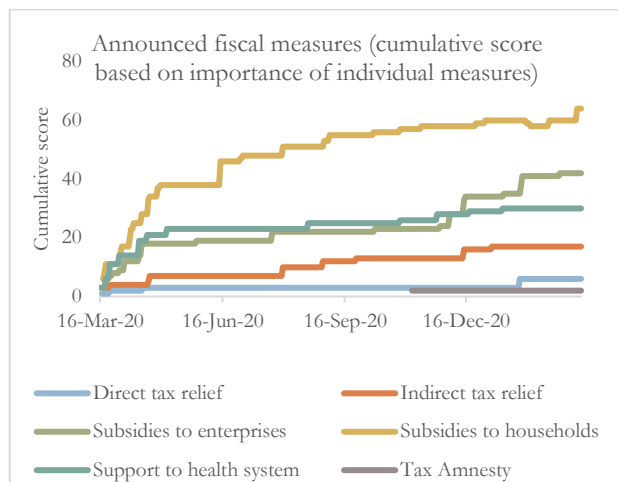
⁵² Gulsen and Kara (2021)

⁵³ Feedback results from survey respondents show that the top six variables driving the inflation forecasts of professionals are exchange rates, inflation outturn, monetary policy stance, oil prices, economic activity, and the near-term historical average of inflation.

⁵⁴ This requires careful prioritization and selection of investment projects, and further improvement in PIM efficiency to ensure good project outcomes and a high growth impact.

going forward, as it will take time for private investment to pick up. As temporary tax reductions and government spending on public transfers are withdrawn, the government deficit is expected to fall back to around 2.6 percent in 2023.

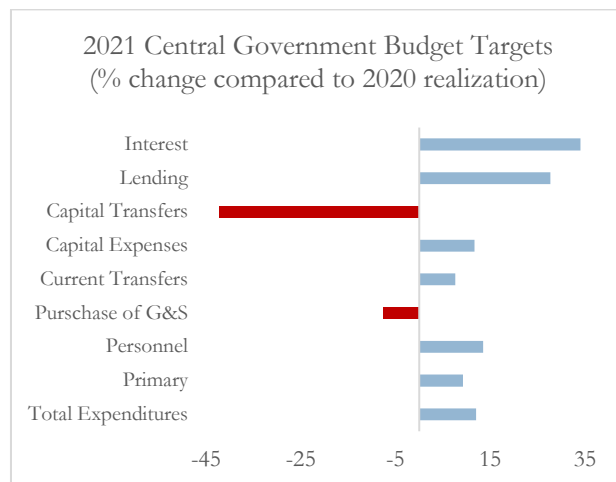
Figure 148: Support to health, households, and businesses was provided



Sources: WB Staff based on government announcements.

Note: Scores determined based on the magnitude of the announced measure, ranking between -3 and +3 (+3 being the most impactful in terms of coverage, number of people affected, and positive externalities).

Figure 149: Primary expenditure rise to be driven mainly by current transfers



Source: MoTF.

Ensuring that short-term responses are consistent with fiscal efficiency and sustainability is of course critical. Short-term measures that lead to too much debt or unaffordable expenditure, for example, could reverse economic recovery. Measures should be transparent, timely, targeted, and temporary. Risks to fiscal sustainability can also be mitigated through discretionary measures that can be easily reversed when the effects of the pandemic shock are over. The authorities' fiscal response to date seems to have been largely consistent with these principles. In the latest New Economic Program (2021-2023), the government envisages a gradual consolidation to help support a recovery. Only capital transfers and purchase of goods and services were set to decline in 2021, whilst almost 40 percent of the primary expenditure increase in 2021 comes from the rise in current transfers. Along with the ramp up in borrowing and rising interest rates, the burden on interest expenditures in the budget is envisaged to rise in 2021 (Figure 149).

Recently announced fiscal reform of the government (Box 6) would support rationalization of public expenditures, boost accountability and transparency and mitigate fiscal risks. One of the main focus areas of the recently announced reform agenda is building a stronger and more resilient public finance system. Implementation of a new quarterly Public Finance Report is a welcomed step which would help to promote transparent and open practices of fiscal management. The report could cover an appraisal of factors impacting fiscal outcomes, including the influence of policy changes, as well as quantified, forward-looking assessment of fiscal risks. A robust legal framework for PPPs would be another important step and could be complemented by regular reporting on PPP developments. Other efforts such as simplification of incentive schemes, a review of tax exemptions, and SOE reform could also support the rationalization of public expenditures.

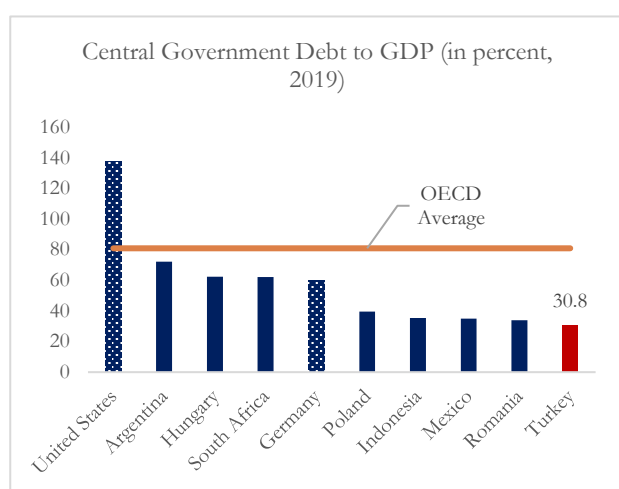
Rising public debt across advanced economies and historically low interest rates have led some to speculate that countries may be able to abandon previously held prudential debt limits. Debt to GDP in the U.S. has risen from 77 percent in 2000 to 163 percent in 2020 Q3, while real interest rates declined from 4.3 percent in 2000 to -0.1 percent in 2020⁵⁵. The decline in interest rates across advanced economies has been driven by massive central bank liquidity injections since the 2008 Global Financial Crisis and persistently low

⁵⁵ Summers, L., Furman, J. 2020. "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates". Brookings Institution.

inflation rates. While high debt and low interest rates are associated with “secular stagnation”, there has been a recent tendency towards a new fiscal policy framework. A recent IMF⁵⁶ study advises a reconsideration of public finance rules in light of a persistent high debt environment. Summers et al. (2020) notes that although low interest rates have brought challenges for countercyclical monetary policy, they also create some opportunities for the economies in terms of improved debt sustainability and greater fiscal space for public investments.

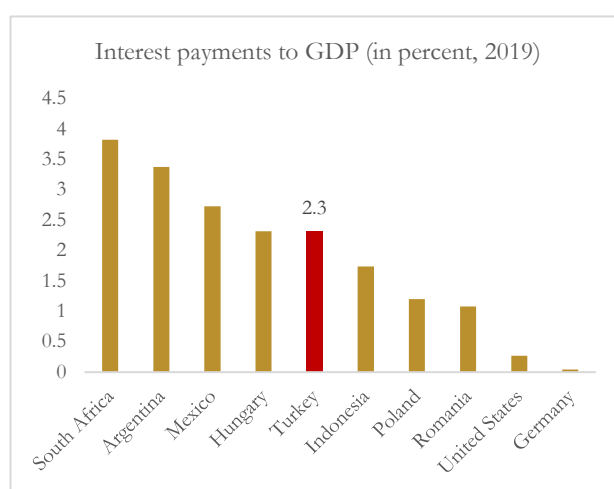
Debt levels in Turkey, as with most emerging markets, remain relatively low, although the interest burden is high. Selected major EM⁵⁷ economies’ central government debt to GDP ratio averaged at 38.1 percent in 2000, which has risen to 46 percent for a selection of major EMs, well below the OECD average of 81 percent in 2019 (Figure 150). Turkey’s central government debt to GDP ratio was 30.8 percent in 2019, the lowest amongst selected emerging market economies. However, Turkey’s central government interest payments to GDP ratio was 2.3 percent, placing it in the midrange and equal to the average for selected EM countries (Figure 151). By comparison, interest payments to GDP is only 0.27 percent for the US economy, and just 0.04 percent for Germany.

Figure 150: Turkey has relatively low public debt...



Source: Haver Analytics, OECD.

Figure 151: ...with a relatively higher interest burden



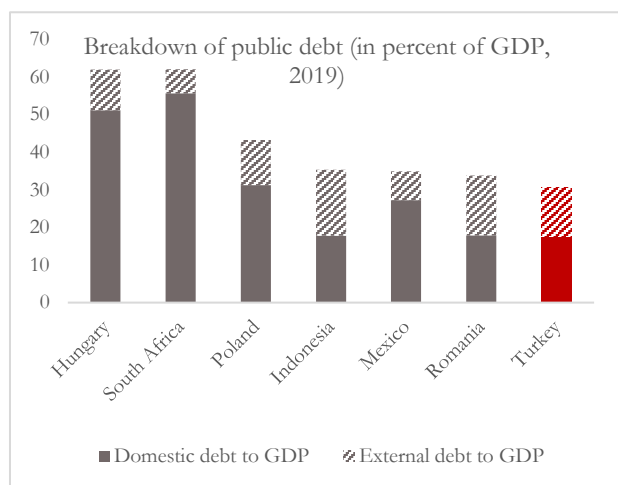
Source: Haver Analytics.

Turkey has a relatively higher proportion of external debt, and its external financing costs are also higher. Turkey’s public external debt to GDP ratio was 13.3 percent, compared to 17.5 percent for domestic debt to GDP in 2019 (Figure 152). This 43 percent share of external debt is one of the highest among major EMs, with only Indonesia being higher. While some emerging market economies such as Poland and Hungary were able to access external funding with very low spreads, thanks to their commitment to EU economic integration; Argentina, South Africa, Turkey and Mexico’s spreads were above 400 bps at end 2020, exceeding the EMBI global average of 357 bps (Figure 153). Higher country risk pricing for these EMs is likely a key factor explaining why these countries do not benefit in the same way from loose global liquidity conditions.

⁵⁶ International Monetary Fund, 2021. “Fiscal Monitor: Policies for the Recovery”. IMF, October 2021.

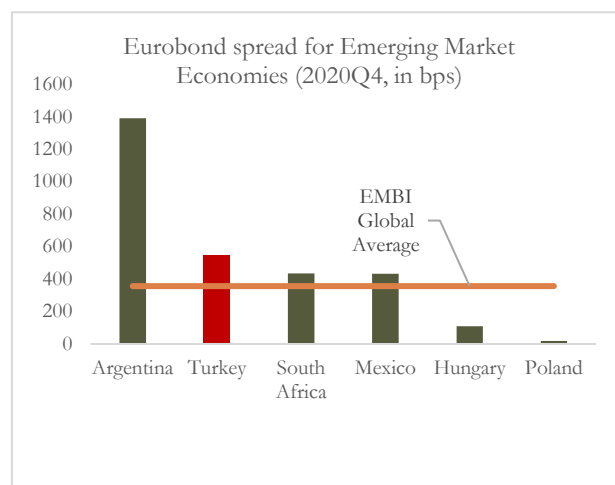
⁵⁷ Turkey, Romania, Mexico, Indonesia, Poland, South Africa, Hungary, and Argentina.

Figure 152: Debt breakdown differs among EMs



Source: Haver Analytics.

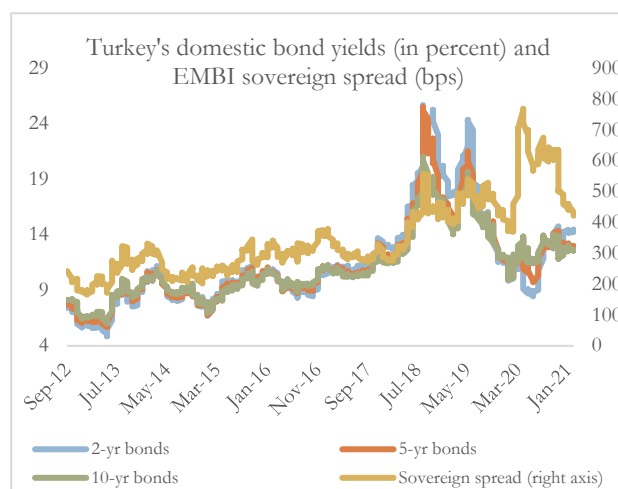
Figure 153: Conditions for external funding diverge



Source: JP Morgan/ Haver Analytics.

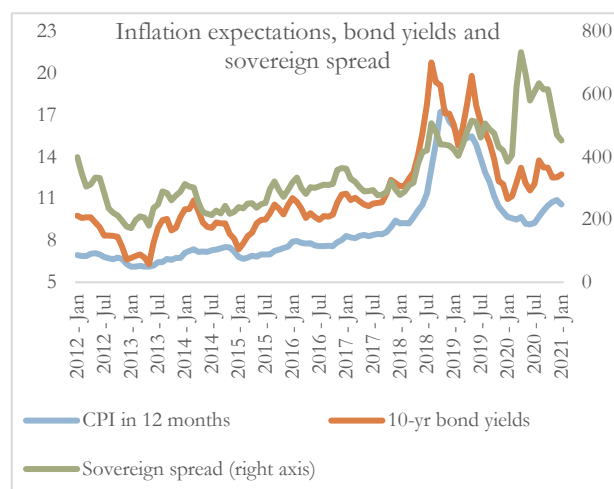
Turkey's domestic bond yields and EMBI sovereign spreads have been trending up since 2013. Turkey's inflation-adjusted cost of borrowing has increased significantly between 2013 and 2019. 10-year domestic bond yields had risen from 6.5 percent in early 2013 to 21 percent by the end of 2018, while sovereign spreads followed a similar pattern (Figure 154). Between 2012 and early 2020, the correlation between domestic bond yields and sovereign spreads was 0.9 (Figure 155). The relationship has weakened during the COVID-19 crisis due to the liquidity crunch, as well as the government policies in Turkey that helped reduce the cost of domestic borrowing⁵⁸.

Figure 154: Volatile trend in bond yields



Source: Haver Analytics.

Figure 155: High correlation with CPI expectations



Source: Haver Analytics.

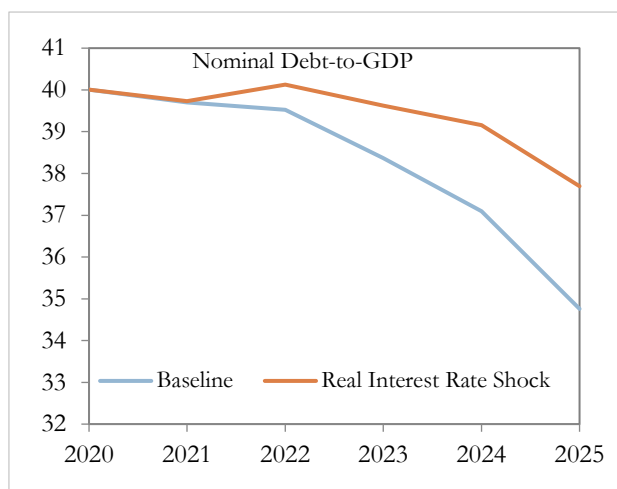
Turkey's public debt is sensitive to interest rate shocks. Under a scenario where the real effective interest rate is assumed to increase by 500 basis points, the government's borrowing cost increases to over 16 percent and the debt-to-GDP ratio remains above 37 percent over the medium term (Figure 156). In a different context, where the interest expenditure was assumed to rise by 2 standard deviations, Turkey's interest expenditures to GDP ratio immediately jumps from 2.3 percent to 4.8 percent from 2019 to 2020, while Mexico's interest

⁵⁸ See Turkey Economic Monitor, August 2020 for details.

expenditure responds to the same shock with a lower magnitude, despite its debt (Figure 157). On the other hand, the debt of advanced economies such as Germany and the US does not respond significantly to the shock.

Despite low public debt to GDP, Turkey is especially exposed to sharp increases in debt servicing costs. Continued high inflation expectations, as well as the volatile interest expenditure pattern raise sensitivities over fiscal policy in Turkey. Turkey and several other EMs may not be able to benefit from extremely loose global liquidity conditions, and therefore may continue to be constrained by country-specific macrofiscal factors.

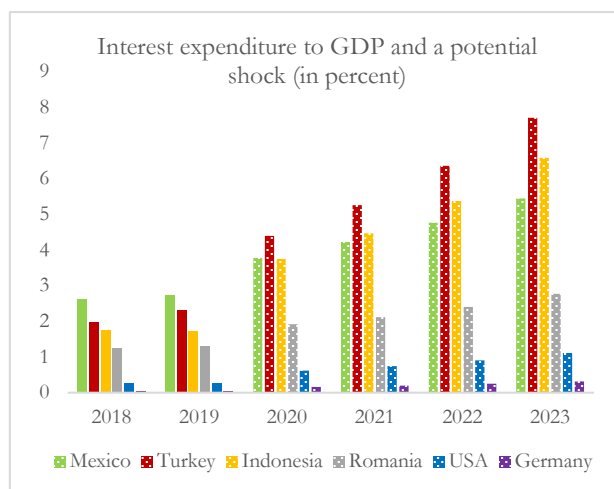
Figure 156: Increased debt burden with a real interest rate shock



Source: WB Staff calculations.

Note: A 500 bps shock was applied to Turkey's expected 2020 general government debt stock.

Figure 157: With rising interest burden



Source: Haver Analytics.

Note: A 2 standard deviation shock was applied to the 3-year moving average interest expenditure-to-GDP ratio after 2019.

Overall, Turkey cannot afford the luxury of increasing debt that advanced economies may be able to, but can increase fiscal space by seeking to lower country risk pricing. Despite the discussion in advanced economies of lower interest rates for longer, Turkey can ill afford to face a shock with higher debt levels, given its high susceptibility to shocks, which could lead to a sharp increase in debt costs. Such a scenario might arise for various reasons including a sharper-than-expected pick-up in the global economy, a domestic shock, or an increase in risk-aversion towards emerging markets such as Turkey. As a result, Turkey's current levels of debt – relatively lower than other EMs – is prudent, and it is too early to consider major expansionary fiscal policy. Instead, Turkey's current economic stance, focused on macroeconomic stabilization and gradually raising sustainable growth prospects can, over time, lead to improved financing terms, which could create the conditions for prudently raising debt levels in future.

NPL resolution and corporate insolvency frameworks will be crucial this year

Turkey's banking sector played a key role in alleviating the economic impact of COVID-19, but now the BRSA and banks need to prepare for an increase in NPLs, which will also impact capital positions. Strong credit growth in 2020 amid weak economic prospects coupled with loan repayment moratoria have led to a deterioration in underlying asset quality⁵⁹, currently masked by regulatory forbearance measures related to the classification of NPL and Stage 2 loans. A recovery this year could lower the risk of an NPL uptick once forbearance measures are phased out, although an extension of COVID-19 restrictions, a sharp slowdown in

⁵⁹ As noted below, banks have set aside extra provisions for possible increases in NPLs.

credit growth and rising interest rates following monetary tightening would increase the risk of asset quality deterioration and, eventually limit banks' support to economic activity (see Box 7). The high share of Stage 2 and restructured loans reveals underlying risks for NPL developments; however, conservative provisioning against expected credit losses exemplifies banks' prudent approach towards preparing for a surge in NPLs. An increase in distressed loans, heightened bond yields and continued Lira volatility will also pressure capital positions and eventually loan growth, especially once capital-related forbearance measures expire. Regulators and banks should be vigilant.

Box 7: Preventing an expected surge in NPLs from becoming a drag on economic growth

The COVID-19 crisis is one of the worst economic shocks in history. While it did not start as a financial crisis, signs are pointing towards increasing financial sector vulnerabilities globally. In particular once unprecedented regulatory forbearance measures are phased out, financial institutions will need to deal with a rise in non-performing loans (NPLs). The longer the pandemic lasts, the more businesses and consumers will struggle and the stronger the impact on repayment challenges will become, ultimately undermining economic growth. Preventing a prolonged episode of low growth and lackluster financial sector performance across the world requires a swift and comprehensive response, broadly comprising four measures:

- **First, a robust regulatory and supervisory framework is needed** so that banks properly identify NPLs and provision for credit losses. Banks have played a vital role in responding to the pandemic, providing credit to corporates and households struggling with a drop in liquidity. While this credit expansion makes banks more vulnerable to an increase in NPLs given fragile economic prospects, it should not be an excuse for undermining existing standards and diverting from international norms. In cases where internationally agreed standards on the definition of NPLs were relaxed, the time has come for an orderly exit from these measures. The same holds for broader borrower relief measures. Credible regulation and supervision are needed to instill confidence and prevent the build-up of more serious risks. Lessons from the Global Financial Crisis show that a wait-and-see approach only makes a bad situation worse when it comes to NPLs.
- **Second, banks need to get operationally ready for resolving rising volumes of NPLs.** This requires functional workout units in banks, internal policies for the management and resolution of NPLs, and methodologies for assessing the viability of distressed borrowers. The latter is vital for ensuring that borrowers considered non-viable do not benefit from constant loan restructurings, but are properly dealt with through the insolvency framework. Otherwise, inevitable credit losses just end up being delayed, while locking up resources and constraining the channeling of new credit to deserving companies.
- **Third, the COVID-19 crisis will test existing insolvency frameworks.** While unviable borrowers need to be dealt with expeditiously, potentially viable, but distressed borrowers need an opportunity to be rehabilitated. Encouraging and improving out-of-court workouts for these borrowers is a top priority. At the same time, legal frameworks need to enable debt reduction, and institutions need to be able to deal with the to-be-expected increase in proceedings. Increasing digital procedures and simplifying administrative processes can contribute significantly.
- **Finally, a nationwide NPL reduction strategy can be an important component in lowering NPLs in a holistic and well-coordinated manner.** Active participation of the private and public sector is critical in these efforts.

Source: "COVID-19 and Non-Performing Loan Resolution in the European and Central Asian region". FinSAC Policy Note, December 2020 <http://pubdocs.worldbank.org/en/460131608647127680/FinSAC-COVID-19-and-NPL-Policy-Note-Dec2020.pdf>

Safeguarding banking sector stability calls for a transparent and well-communicated exit strategy from forbearance measures. Any extensions under improved health and economic circumstances exacerbate expectations that the borrower relief measures constitute a "new normal", making it increasingly difficult to

revert to the *status quo* pre-COVID-19. Public communication about these preconditions for revoking borrower relief measures is important in managing expectations and ensuring that the temporary nature of the measures is well understood by borrowers and banks alike.

Effective insolvency and corporate debt restructuring frameworks will be key elements of the COVID-19 recovery. Turkey was successful in preventing viable firms from being prematurely pushed to insolvency due to COVID-19, but now a growing number of firms may need an insolvency process to survive (Table 5). An enabling environment for corporate and consumer debt restructuring and an effective out-of-court debt restructuring framework are important to prevent a surge in insolvency filings, value-destroying liquidations, and asset fire sales. This can help preserve employment and reduce pressure on bank balance sheets, which would otherwise be affected by a surge in NPLs. SMEs, accounting for three-quarters of employment, will be particularly hard hit by this COVID-19 crisis. It is vital to ensure the smooth functioning of workouts and debt-restructuring mechanisms. At the same time, it will be critical to assess firm viability and identify zombie firms⁶⁰, to free up capital for lending in future periods.

Table 5: Options to respond to the COVID-19 challenges impacting solvency of firms and individuals?

	Key Challenges	Critical Responses
Phase 1	Preventing viable firms from prematurely being pushed into insolvency	Implementing one or more extraordinary measures for a limited period of time: - Increasing the barriers to creditor-initiated insolvency filings; - Suspending the director's duty to file and associated liability; - Ensuring complementarities with debt repayment emergency measures.
Phase 2	Responding to the increased number of firms that will not survive this crisis without going through insolvency	Ensuring the smooth functioning of workouts and debt restructuring mechanisms: - Establishing informal out-of-court, or hybrid workout frameworks; - Facilitating business rescue through bridge financing; - Extending procedural deadlines for a limited period of time; - Suspending the requirement to proceed to liquidation if the business activity of the debtor has stopped while undergoing reorganization; - Encouraging e-filings, virtual court hearings and out-of-court solutions in insolvency cases.
Phase 3	Addressing individual financial distress resulting from the crisis	- Implementing modern consumer bankruptcy frameworks, which are still non-existent or outdated in many Emerging Markets and Developing Economies; - Ensuring there are flexible options for debt rescheduling and repayment plans; - Enabling a debt forgiveness mechanism or discharge is important in facilitating a fresh start.
Source: "COVID-19 Outbreak: Implications on Corporate and Individual Insolvency" http://pubdocs.worldbank.org/en/912121588018942884/COVID-19-Outbreak-Implications-on-Corporate-and-Individual-Insolvency.pdf		

⁶⁰ Zombies are firms that earn just enough money to continue operating and servicing debt, but are unable to pay off their debt, thus diverting resources away from healthy, viable firms. Adalet McGowan et al (2017): "The walking dead: zombie firms and productivity performance in OECD countries," and Ricardo Caballero et al (2008) "Zombie Lending and Depressed Restructuring in Japan."

Box 8: Conditional Counterfactual Analysis of NPLs and CARs in the absence of government actions

The COVID-19 shock could have led to a significant increase in NPLs, while lowering CARs throughout 2020 without the authorities' swift action. This box illustrates how NPLs and CARs would have evolved in the absence of forbearance measures, loan payment deferrals and facilitated restructurings by comparing counterfactual outcomes to those observed in light of government and banking sector actions. The model, based on statistically significant impulse-responses and employing conditional counterfactual analysis, shows that NPLs could reach much higher levels within a short period if faced by demand and FX shocks. The highest NPL increase in relative terms is predicted for state banks, despite their low NPL base, but domestic private and foreign banks would also face noticeable increases. The decline in CAR, on the other hand, is predicted to be relatively limited.

Turkey's banking sector played a key role in tackling the COVID-19 crisis, but faced underlying asset quality deterioration, which is eased by regulatory forbearance measures to support borrowers and banks in weathering the pandemic fallout. The Turkish authorities introduced extensive regulatory forbearance measures to protect financial stability and viable borrowers from March 2020 onwards, shielding banks' balance sheets. Higher economic growth in 2021 could lower an NPL uptick risk once forbearance measures are phased out after 2021Q2⁶¹. Still, an extension of COVID-19 restrictions, tightened monetary and credit conditions, and recently heightened financial volatility may contribute to further asset quality deterioration. The impact of a rise in NPLs has been highlighted in previous editions of the TEM⁶², finding that asset quality shocks significantly decrease GDP and reduce CAR, leading banks to reduce loan supply and increase lending rates. But with corporate sector vulnerability elevated due to COVID-19 and a higher interest rate environment, the introduced regulatory forbearance measures and heavy loan restructurings make it difficult to assess to what extent such shocks have already been realized in 2020, and what the risk to banks' financial positions is in the upcoming period.

With this in mind, we first empirically identify the impact of COVID-19 on the NPLs and CARs of the domestic private, state, and foreign banks using publicly available group-level data⁶³. Second, by using the realized economic indicators in 2020, we employ conditional counterfactual analysis to understand the possible trajectories of NPLs and CARs in the absence of policy actions.

Estimating the Effect of Demand and Exchange Rate Shocks on NPLs and CARs

The starting point of our analysis is to employ a standard Bayesian Vector Auto Regression (BVAR) model, a popular tool for forecasting, policy, and scenario analysis of possible multivariate time series models, as they do not suffer from an endogeneity problem (Ogunc, 2019). It also allows dynamic interactions between the variables and works well with relatively short data samples. We set up a structural BVAR with sign restrictions using the Bayesian Estimation, Analysis and Regression (BEAR) toolbox of Dieppe et al. (2016).

Two major shocks, namely demand and exchange rate shocks, appear to affect NPLs and CAR adversely during the COVID period. Following the related literature, we employ the variables and sign restrictions listed in Table A. Conventionally, most of the time series econometric literature estimates the impact of demand or currency shocks based on a recursive identification scheme. However, such an identification scheme may have some disadvantages. First, selecting the correct ordering of the variables is difficult to establish. Different ordering of the variables in the model may lead to different impulse response functions. Second, such an identification scheme is not based on economic theory, but rather, on the speed at

⁶¹ Central Bank of the Republic of Turkey. 2020. "IV.1 Credit Developments and Credit Risk", Financial Stability Report, November 2020, pg 48.

⁶² <https://openknowledge.worldbank.org/bitstream/handle/10986/32634/Turkey-Economic-Monitor-Charting-a-New-Course.pdf?sequence=1&isAllowed=y>

⁶³ BRSA and CBRT

which different variables are assumed to adjust to different shocks. To address these issues, the sign restriction identification scheme, which is also more intuitive, is widely implemented via the methodology employed in Rubio-Ramirez et al. (2010)⁶⁴. By using this identification scheme, we assume that adverse demand shocks are generated through the GDP changes. Those shocks are assumed to reduce GDP, increase NPLs and reduce CARs. Similarly, a foreign exchange shock is generated through increasing FX volatility, which increases NPLs⁶⁵, reduces loan supply, raises interest rates, and decreases CAR.

Table 6: Sign restrictions enabling the identification of demand and currency shocks on NPLs and CARs

	GDP	Loans*	NPL	Implied FX Volatility**	CAR	Real Interest Rate***
Demand shock	-		+		-	
Exchange rate shock		-	+	+	-	+

*(Deviation from the trend), (**1-month, US\$/TRY, quarterly max-min difference), *** (Weighted average bank loan interest rates minus inflation)

The model is estimated at a quarterly frequency over the period of 2010Q4 to 2019Q4. GDPs are in year-on-year percentage change. FX shock is estimated by using the implied volatility of TL against US\$. Real interest rate, NPL ratio and CAR are included in year-on-year differences. Loans are taken as the difference from its trend and entered in the model as year-on-year differences.

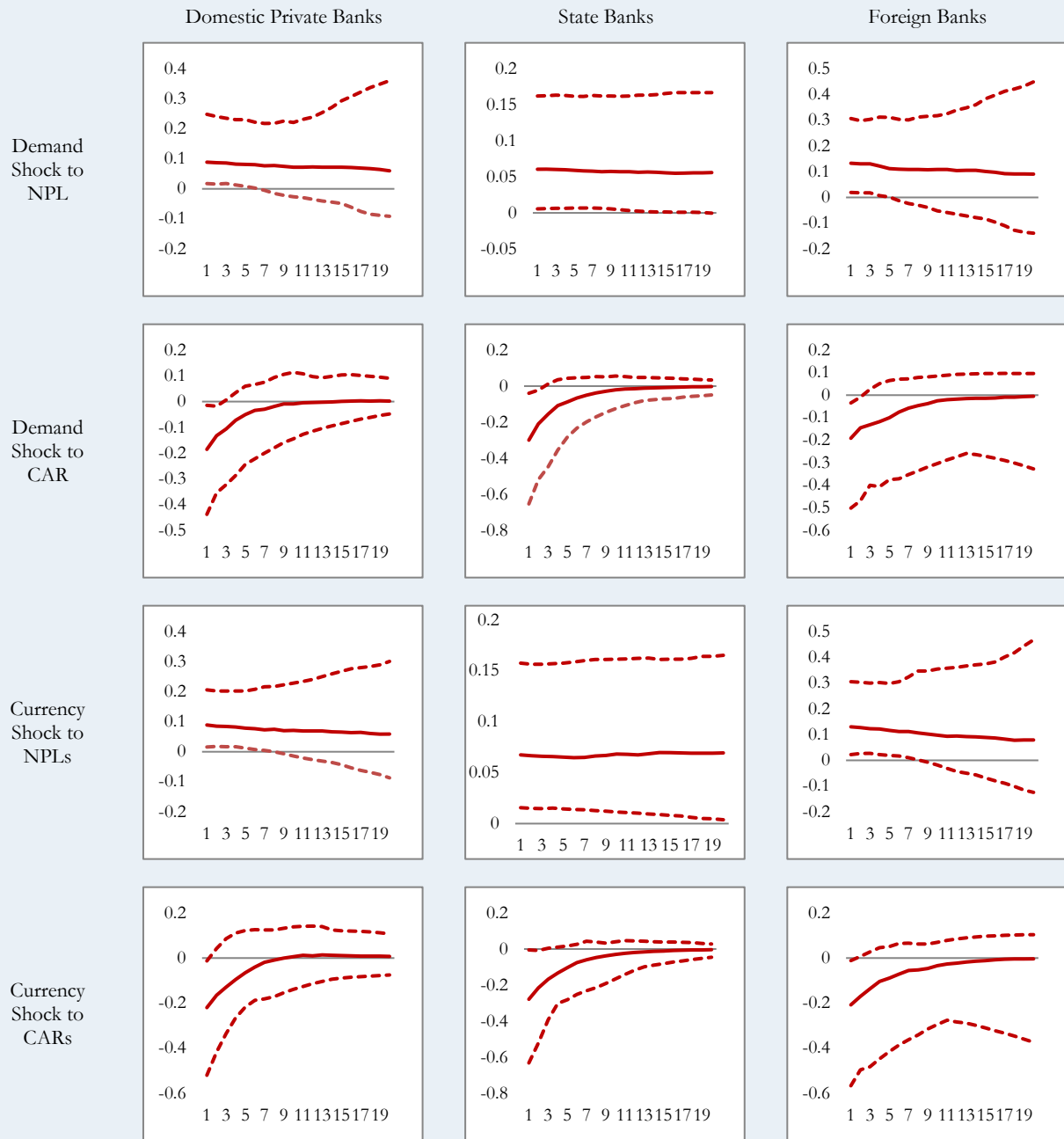
The figure below shows the responses of the NPL ratio and CAR to a one standard deviation shock to demand and exchange rate. It can be seen from the figure that a negative demand shock significantly increases NPLs for all banks on impact and causes a decline in CARs. The effect is sustained for at least 4 quarters thereafter. Following the depreciation of the Turkish Lira, similar results were observed, suggesting that a sizeable share of FX-denominated balance sheet items leads to an increase in NPLs and decline in CARs. Demand and FX shocks have a relatively greater adverse effect on the state banks' NPLs. Although the shape of responses to demand and FX shocks appears similar,⁶⁶ their magnitudes and uncertainty bands differ, and currency shocks to NPLs are relatively more persistent. In addition, uncertainty surrounding demand shocks is greater than for currency shocks. Both shocks reveal similar sign restrictions, but responses show that the exchange rate plays a critical role in shaping the expectations of economic agents and the overall performance of the economy.

⁶⁴ We assume a Minnesota prior distribution to obtain the posterior estimates. The structural model is identified with sign restrictions implemented using Arias, Rubio-Ramirez, and Waggoner (2014) methodology.

⁶⁵ Impact of the FX vulnerability on short term debt repayment is expected to be negative. On the other hand, NPL ratio stands for total non-performing loans over gross loans. Depreciation will create denominator effect, as well. Thus, the overall impact might not be clear. However, TL credits is around 2.4 trillion TL and FX credits are US\$167 billion (1.2 trillion TL, as of February 2021). Therefore, this denominator effect would be small. Moreover, FX shocks may not work only through the loan channel. Its impact on the economic activity and on the borrowers is assumed to be negative and may diminish the payment abilities of the borrowers.

⁶⁶ The general similarity of responses can be due to the similarity in transmission mechanism of exchange rate shocks and demand shocks. Depreciation of the exchange rate eventually leads to the lack of demand for imported goods and domestic goods produced with a share of higher imported intermediate goods. Ogunc et al. (2018) suggests that the exchange rate not only serves as a means of storing value and a hedge against inflation, but also plays a critical role in determining the general prospects for medium and long-term economic performance.

Figure 158: Impulse-Responses to negative demand and currency volatility shocks



Note: Figures show responses of NPLs and CARs to a one standard deviation negative demand shock and a one standard deviation currency shock. The Y-axis shows the percentage point differences to the previous year. The X-axis shows quarters. While the solid line shows the baseline estimation, dashed lines show the 85 percent confidence bands for the BVAR estimation.

Conditional Counterfactual Analysis of NPLs and CARs

We use the structural BVAR model findings and restrictions presented above to empirically estimate how NPLs and CARs would have evolved in the absence of forbearance measures, loan payment deferrals and facilitated restructurings by comparing counterfactual outcomes to those observed under the government and banking sector actions. Hence, we conduct a conditional counterfactual analysis for the 2020Q1-2020Q4 period. Realized GDP, implied US\$/TRY volatility, loan growth deviation from its trend, and real lending rates are used as conditions for the 2020Q1- 2020Q4 period. We use a 95-percent

confidence level for this exercise. Although the magnitude of the results may change depending on the different factorization schemes under BVAR, or any different specification in other methodologies, they are intuitively parallel to the literature and market assessments on the trajectory of the NPLs and CARs.

Figure 159: Counterfactual NPL ratio: Private banks

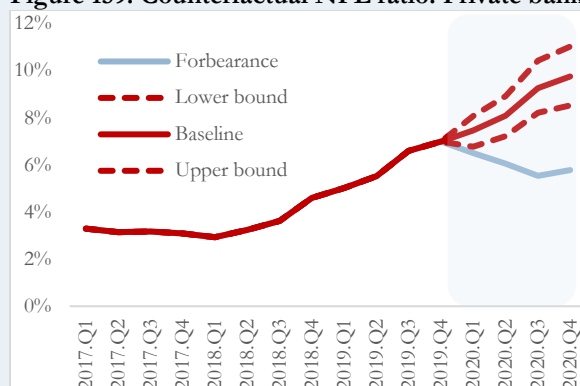


Figure 160: Counterfactual CAR: Private Banks

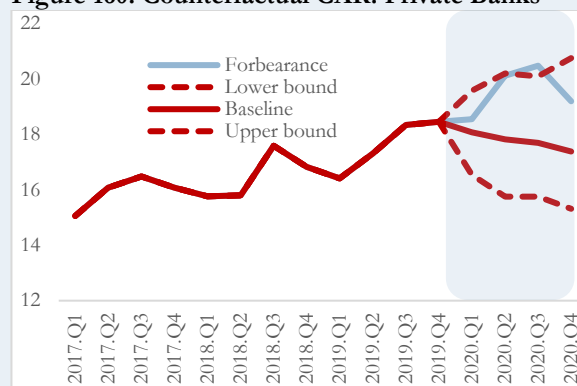


Figure 161: Counterfactual NPL ratio: State banks

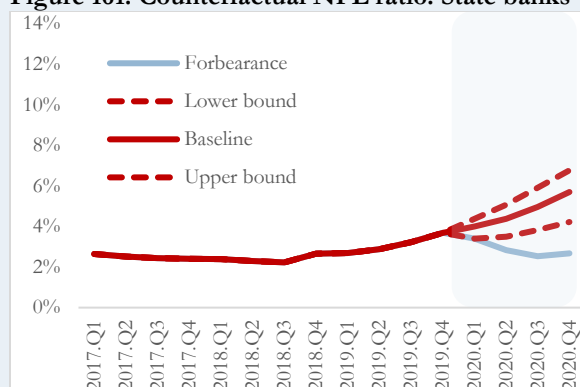


Figure 162: Counterfactual CAR: State Banks

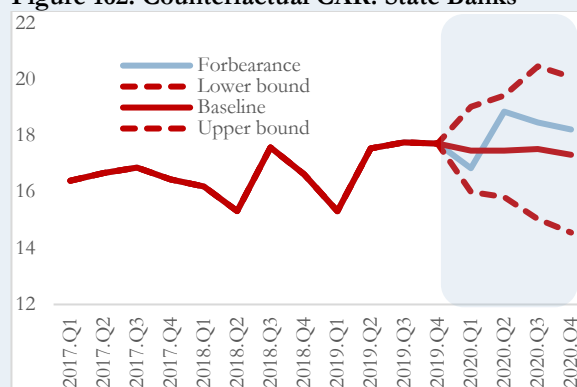


Figure 163: Counterfactual NPL ratio: Foreign banks

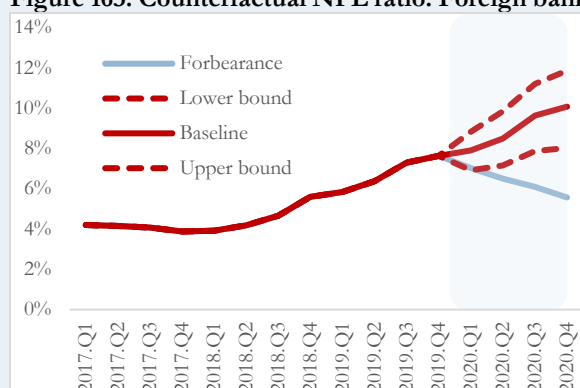
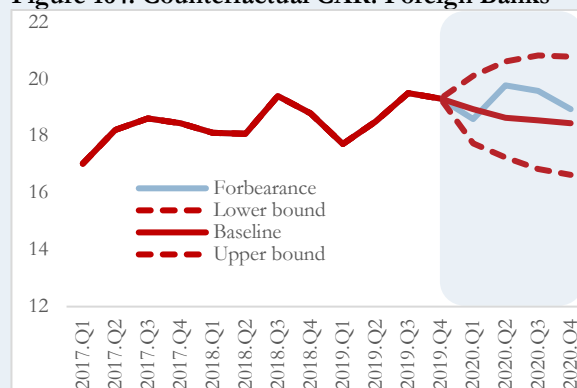


Figure 164: Counterfactual CAR: Foreign Banks



Estimation results assume that NPLs could escalate sharply due to weakened economic activity and currency depreciation without forbearance measures, loan deferrals and restructurings, given 2020 GDP, FX volatility and loan growth. As of 2020Q4, the NPL ratio would have been 2 times higher than the reported figures in state banks. Baseline results show that NPL ratios could have reached 9.7, 5.7 and 10 percent for domestic private, state and foreign banks, respectively, at the end of 2020. Those figures are also close to the reported Stage-II loan ratios of the aforementioned banking groups.

The decline in CARs would have been relatively limited. Indeed, historical data also shows that variation in CARs among bank groups is relatively low against adverse shocks indicating that banks are managing shocks well by deleveraging, decreasing risky loan books, loan restructuring and increasing their capital buffers. CAR estimates imply a relatively limited decline, to 17.4, 17.3 and 18.4 percent for private, state and foreign banks, respectively in the baseline forecast for the same period. The worst-case forecasts point to 15.3, 14.5, and 16.6 percent CAR ratios for the same period. Estimates showing a relatively limited decline in CAR are also similar to the banks' recent CAR announcements after deducting the forbearance impact they share with the public.

Overall, our conditional counterfactual estimations show that forbearance measures, loan payment deferrals and loan restructurings helped banks to manage pressure on both NPL levels and CARs. In fact, BRSA data⁶⁷ on loan classification forbearance, suggests that the impact of the forbearance of NPL past due day extension is limited to 70 bps on the banking sector's NPL ratio as of February 2021.

However, the impact of the demand and FX shocks may be sustained. Therefore, the banking sector requires a transparent and well-communicated exit strategy from forbearance measures in the second half of 2021 to preserve the credibility of the financial system. Strengthening NPL resolution, insolvency, and out-of-court corporate debt restructuring frameworks with an effective corporate viability assessment is also critical in order to protect corporates and the banks from spillovers.

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D. As a foundation for higher medium-term inclusive growth

If the prerequisite of improved economic stability is in place, a structural reform agenda can help to ensure raised, inclusive growth in the medium-term. Addressing near term challenges for the economy to ensure orderly recovery highlighted in the previous section is a key first step. Selected reform programs could then help mitigate the risk of long-term adverse effects of the pandemic and transition to a sustainable growth path. Reforms should include targeted measures to support the most vulnerable, encourage labor market flexibility, facilitate corporate debt relief and increase international economic integration.

The COVID stimulus offers an opportunity for building a more resilient, sustainable economy

The scale of post-COVID recovery programs can have a significant impact on transforming economies for the better. As the risk of uncontrolled COVID-19 outbreaks gradually abates, particularly with vaccine rollout in 2021, many countries around the world have now shifted their attention to recovery efforts, with stimulus packages underway.⁶⁸ The International Monetary Fund (IMF) estimates an unprecedented global fiscal response of US\$12 trillion as of October 2020.⁶⁹ As of October 2020, the Government of Turkey's estimated discretionary fiscal support package was TL646 billion (~ US\$ 92.5 billion, or 12.8 percent of GDP).⁷⁰

⁶⁷ Unpublished data received via exchange of letters with the authorities.

⁶⁸ OECD&IEA. 2020. Addressing the COVID-19 and climate crises: Potential economic recovery pathways and their implications for climate change mitigation, NDCs and broader socio-economic goals. Climate Change Expert Group Paper No.2020(4). France.

⁶⁹ <https://blogs.imf.org/2020/10/14/fiscal-policy-for-an-unprecedented-crisis/>

⁷⁰ <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#T>

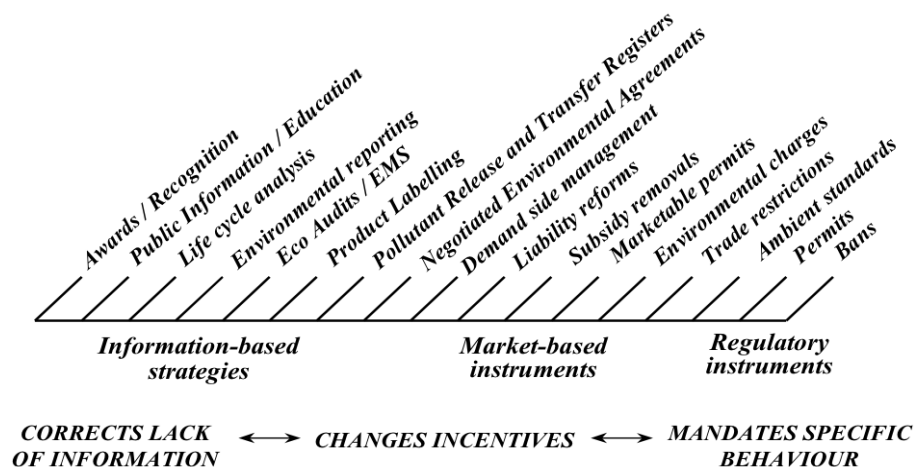
Given the magnitude of these stimulus packages, they will have a significant impact on a country's economic prospects, in addition to environmental and social effects with long-lasting implications in many cases.

The COVID-19 recovery phase offers Turkey an opportunity for rebuilding its economy on a more resilient, inclusive, and sustainable growth path—often referred to as “Building Back Better”. Fast paced technological developments and changing consumer preferences are transforming the global trade landscape; and countries need to adapt to maintain their competitive edge in global markets. This calls for well-targeted stimulus measures and structural policy reforms to rebuild more competitive, efficient, and resilient economies, so as to enable more sustainable growth.⁷¹ Turkey remains a resource-intensive economy with increasing carbon intensity and decreasing trends in material productivity, compared to OECD countries that are reducing their carbon intensity.

Turkey is already elevating climate and environmental policy, and linking this agenda to the recovery program could accelerate progress. A strong focus on cross-sectoral policies that stimulate technological innovations and modernize the economy can help Turkey improve material efficiency, maintain competitiveness, create jobs, and support overall development priorities. Stimulus used in this way would not cost more – but rather, be used more efficiently and for more sustainable outcomes.

The path to greener technology adoption in many sectors is quite established, and steps could be taken to align with the evolving requirements of the EU and other key trade partners. Stimulus resources could be used to incentivize resource efficiency and also position Turkish firms strategically if such instruments as the Carbon Border Adjustment Mechanism (CBAM) come to fruition. There are a wide range of instruments that can be used in combination to stimulate resource efficiency and improved environmental performance. These instruments can be categorized into three groups (Figure 165): Regulatory instruments that mandate specific behavior; market-based instruments that act as incentives for particular activities, and information-based instruments that seek to change behavior through the provision of information.

Figure 165: Range of environmental policy instruments



There are several opportunities for Turkey to utilize its current stimulus package in more targeted ways. Elements of Turkey's stimulus package are considered green, including the introduction of a “Green Tariff” for power generated from renewable sources, support for solar power, and extension of the Renewable Energy Support Scheme. Turkey is also committed to increasing solar energy production capacity by 1 GW, while the recently announced ERP includes commitments to support further green reforms (see Box 6). There

⁷¹ OECD&IEA. 2020. Addressing the COVID-19 and climate crises: Potential economic recovery pathways and their implications for climate change mitigation, NDCs and broader socio-economic goals. Climate Change Expert Group Paper No.2020(4). France.

are also further opportunities to orient COVID recovery support towards incentivizing green growth. Some of the short-term measures being undertaken by other countries include: i) bailouts with green strings attached; ii) nature-based solutions; iii) loans and grants for green investments; iv) green R&D subsidies; and v) subsidies or tax reductions for green products for environmentally relevant sectors such as agriculture, energy, industry, transport, and waste. As governments around the world are rolling out their recovery packages, many have committed to these green stimulus measures.

Box 9: Green COVID-19 recovery measures for various sectors: Country examples

Agriculture	- Spain's US\$13.5 billion commitment for sustainable agriculture and urban development⁷² - India's US\$780 million fund for afforestation is expected to create a large number of jobs to support low-income and vulnerable communities⁷³ - China's US\$4 billion Green Development Fund will support green investments along the Yangtze River economic belt
Energy	Australia's committed more than US\$233 million to hydrogen development - France's new 'Relance' stimulus package of US\$6.1 billion for green energy infrastructure and US\$7.4 billion for building renovations for energy efficiency. - The UK's US\$3.7 billion support for energy efficiency improvements in residential and public buildings and additional support for wind energy. - South Korea's US\$130 billion stimulus package, providing funding for the Korean 'New Deal' which includes funding for renewables, electric and hydrogen vehicles, and energy efficiency in buildings. - Germany's funds to coal workers and companies to phase out coal-fired power plants by 2038, support for renewable electricity, hydrogen, and provision of subsidies to avoid additional charges on consumers in financing renewable energy expansion.^{74,75}
Transport	- France's US\$7.7 billion bailout deal to Air France having green strings attached – a 50 percent reduction of emissions by 2030 and a minimum standard of 2 percent renewable fuel.⁷⁶ - Germany's commitment to €1 billion green innovation and industry transformation in the vehicle sector, €1 billion for customer rebates for EVs to 2025, and €1 billion for a scrappage scheme for older trucks to support fleet modernization.⁷⁷ - The UK's allocation of US\$2.5 billion for public investment in cycling and pedestrian infrastructure⁷⁸ and US\$250 million to support green R&D in aerospace. - China's (US\$379 million for EV charging infrastructure and US\$14 billion for railway infrastructure)
Manufacturing	- France's US\$1.4 billion for industry decarbonization and US\$264 million for circular economy efforts - The UK's US\$450 million fund for emissions reductions in heavy industry, including CCS and clean hydrogen, materials, new technologies, and efficient construction.

⁷² <https://www.miteco.gob.es/es/prensa/ultimas-noticias/el-idae-destina-24-millones-de-euros-en-la-segunda-tanda-de-convocatorias-para-financiacion-de-proyectos-renovables-innovadores-en-cinco-comunidades-autonomas>

⁷³ India TV (2020). <https://www.indiatvnews.com/business/news-nirmala-sitharaman-final-phase-of-announcement-economic-stimulus-package-11-am-live-updates-617884>, Jagran (2020). <https://english.jagran.com/business/economic-package-tranche-2-mnrega-support-free-foodgrains-for-migrants-s-0000-crore-additional-credit-support-for-farmers-10011841>, Economic Times (2020). <https://bfsi.economictimes.indiatimes.com/news/policy/key-highlights-of-the-finance-ministers-whole-economic-package/75797903>

⁷⁴ Carbon Brief (2020). <https://www.carbonbrief.org/coronavirus-tracking-how-the-worlds-green-recovery-plans-aim-to-cut-emissions>

⁷⁵ Recharge News (2020). <https://www.rechargenews.com/transition/germany-lowers-renewables-surcharge-to-cushion-covid-impact-on-consumers/2-1-894231>

⁷⁶ Routes Online (2020). <https://www.routesonline.com/news/29/breaking-news/291047/air-france-told-by-government-to-dramatically-cut-domestic-flying/>

⁷⁷ Reuters (2020). <https://de.reuters.com/article/us-germany-autos/germany-to-up-financial-aid-for-cars-sector-government-sources-idUSKBN27X1S7>

⁷⁸ Forbes (2020). <https://www.forbes.com/sites/carltonreid/2020/05/09/uk-government-boosts-bicycling-and-walking-with-ambitious-2-billion-post-pandemic-plan/#3a5ce00a3d7c>

Turkish firms can have doors opened worldwide with a new drive to reduce trade barriers

Reducing barriers to trade in goods and services will likely expand potential for Turkish businesses.

Turkey's applied 'most-favored nation' (MFN) tariffs are relatively high and have a large number of peaks. In 2019, Turkey's simple average of MFN tariffs stood at 10.0 percent, and at 4.5 percent on a trade-weighted basis (latest, 2018), putting Turkey in the mid-range of all countries (at 79th out of 138 countries)⁷⁹. In addition to import tariffs, most imported goods also have a standard-rate 18 percent value-added tax levied at the border. 7.2 percent of tariff lines are more than triple the average rate (of 10 percent) and Turkey is amongst 25 countries in the world with the highest number of peaks in its tariff profile. While agricultural tariffs are much higher, a substantial fraction (9.3 percent) of non-agricultural products also face MFN tariffs in excess of 25 percent.

Imports of a significant number of products from countries not in a customs union or free trade agreement with Turkey pay “additional duties” over and above the applied MFN rate. A World Bank analysis finds that the simple average of the additional duties across tariff lines is 16.8 percent, ranging from 0 to 30 percent. According to the current tariff schedule, these are to be applied until September 30, 2021, and lowered by 10 percentage points thereafter. The additional duties cover an estimated 9 percent of Turkey's 2019 imports, and do not apply to imports from countries with which Turkey has a free trade agreement. The additional duties cover 42 percent of textiles, clothing and footwear imports; 10 percent of other manufactured imports, and about 0.2 percent of food imports. On a geographical basis, they fall most heavily on imports from South Asia (39 percent) and East Asia (31 percent). The additional duties effectively reverse most of the “Everything but Arms” duty-free treatment that Turkey would otherwise be compelled to grant to countries such as Bangladesh, Cambodia, Myanmar, Nepal, and Pakistan. By estimated dollar value of 2019 imports, additional duties fall most widely on imports from China (US\$8.2 billion), India (US\$2.7 billion), the United States (US\$1.4 billion), and Japan (US\$1.3 billion).

Turkey's services restrictiveness is relatively high compared to OECD countries. In the OECD's Services Trade Restrictiveness Index for 2020, the average regulatory restrictiveness score for Turkey is 0.348, where 0 is completely unrestricted and 1 is completely restricted. This score shows that Turkey lags behind most OECD countries, especially in accounting, legal services, air transport, courier services, and broadcasting.

Revitalizing the EU-Turkey Customs Union can help realize greater gains from trade and GVCs

The EU-Turkey Customs Union covers the largest share of Turkey's trade, in the deepest relationship.

Customs unions are generally closer partnerships than a preferential trade agreement (PTA) offers, because they involve adopting a single customs area, with no tariff restrictions and a common external tariff. This arrangement can offer great benefits – without administrative restrictions at the border, goods can move quickly and freely providing just the kind of efficient, large and diversified economic area that highly-efficient GVC firms crave.

But the Customs Union remains incomplete, and it lacks mechanisms to ensure a level playing field with third parties. Many modern PTAs include deep provisions on topics such as services, regulatory coherence, and competition policy. While Turkey undertook to adopt the EU regulatory acquis when it joined the Customs Union, there is no systematic mechanism for services liberalization between the EU and Turkey. With services accounting for more than two-thirds of global GDP, more than three-quarters of foreign investment in advanced economies, and half of value-added in manufacturing exports, remaining barriers to services trade and investment are a significant lag on competitiveness.

⁷⁹ Based on the WTO's 2020 World Tariff Profiles report and simple-average MFN rates. MFN tariffs on industrial products alone are considerably lower: The simple average MFN applied rate is around 4.2 percent and trade weighted average MFN applied rate is 1.38 percent. Considering the duty exemptions under inward processing regime and the GSP, average MFN applied rates decreases further.

The fact that Turkey does not have PTAs with all countries that the EU does leads to an asymmetry of market access. Figure 154 shows Turkey's network of preferential trading agreements (light green) as well as those countries for which the EU has preferential agreements, but Turkey does not (dark green). For the second group of countries, the agreements modify the EU's external tariff, which is also the Customs Union tariff. Thus, Turkey is compelled to give duty-free treatment for goods from these countries without receiving reciprocal market access.

Figure 166: Turkey and the EU's preferential trade agreements in force



Source: Turkish Ministry of Trade, European Commission, World Bank Staff estimates.

Note: Light green denotes where Turkey has a PTA in force, dark green where the EU has a PTA in force, but Turkey does not.

At the same time, new large-scale EU-wide policy initiatives which have the potential to impact Turkish competitiveness are largely beyond Turkey's control. The EU Green Deal could impose border adjustment taxes affecting Turkey's exports, as well as a wide range of other environmental policies that could impact the cost of production and the eligibility of Turkish goods to enter the EU market. Similarly, the proposed Digital Single Market is significantly changing the regulatory environment for the digital economy in the EU. An important feature of these initiatives is that they are either in the design phase or under construction. Thus, non-EU firms operating in the EU market – including Turkish firms – face significant policy uncertainty going forward. The Government of Turkey is currently preparing a roadmap to support competitiveness and effective economic partnership in light of the European Green Deal.

Going forward, significant structural changes are needed to preserve and extend the benefits of the Customs Union. These could include, but are not limited to, an active program of deepening existing agreements between the EU and Turkey to include new subject areas; services liberalization by Turkey; discussions to resolve outstanding issues in the Customs Union; developing new mechanisms for Turkey to engage with EU-wide policy initiatives, and proactive responses from the private sector to anticipated changes in EU regulatory frameworks.

A more diversified and greener financial system would support a resilient, sustained recovery

Developing domestic sources of long-term finance would alleviate existing imbalances in the financial system and raise economic growth. Turkey's bank-centric financial system is exposed to several structural challenges. Banks account for 90 percent of all financial sector assets, while insurance and pension funds each constitute only around two percent. The financial system has long suffered a chronic shortage of long-term finance, especially in local currency. Having access to more Lira-denominated funding would reduce Turkish banks' and corporates' exposures to short-dated and FX-denominated debt, reduce rollover risks, and lower financial stability risks. Long-term finance is crucial for firms to invest and grow, and to fund Turkey's large investment and infrastructure needs.

Capital markets instruments can create momentum for long-term finance development in Turkey. Changes in the Capital Markets Law in the pre-COVID period were expected to encourage capital market development. Amendments to the Capital Markets Law that entered into force in February 2020 introduced global standards to Turkish capital markets laws, and were thus expected to encourage that development. These amendments introduced establishments such as the noteholders' meeting, security agents and project bonds. Other modifications included expanding the scope of crowdfunding, limiting the range of significant transactions of public companies, exit rights, and tender offer bidders.

But a volatile economic environment and its symptoms have acted as a constraint to capital market and long-term finance development. Macro-financial dynamics are among the most significant barriers to long-term domestic finance and capital markets development. These include; a challenging macroeconomic environment that dampens the confidence of foreign and domestic investors; a low national savings rate, high dollarization, and low sovereign credit ratings, and high local currency government bond yields across the yield curve and limited financial and capital market literacy. The COVID-19 crisis, as well as the recent financial turmoil, further amplifies these challenges.

Challenges also remain related to the issuers and investors' side and the regulatory framework. The most binding constraint is the small size of the institutional investor base. While pension funds have recorded rapid growth in recent years with the introduction of automatic enrollment, the insurance sector, pension funds and mutual funds together are only equivalent to six percent of GDP. There is a need to develop financial instruments for long-term finance, including, but not limited to sustainable and green finance purposes (Box 9: Greening the financial sector). In promoting the development of the insurance and pension markets, Turkey Wealth Fund consolidated six state-owned insurance companies under a single insurance and pension company to restructure the insurance sector and create economies of scale. However, a more holistic approach requires a regulatory framework to manage institutional investors' portfolio management and investment policies to increase the saving pool and encourage investing in longer-term, local currency and sustainable finance instruments.

SME finance is a critical area in need of long-term finance. Large and sophisticated corporates and banks enjoy good access to domestic and international financial markets. However, SMEs, which account for most of the corporate sector, continued to face severe challenges in accessing long-term finance. Bank financing has been the traditional source for SMEs. While the CGF has helped SMEs otherwise struggling to meet the high collateral requirements imposed by banks, high-interest rates and the short-term nature of bank financing remain a constraint.

Capital markets could promote SME finance in Turkey mainly through private markets, although these markets and regulatory frameworks have yet to be developed. The imposition of disclosure and governance requirements sets a high entry barrier for SMEs for accessing the stock exchange, and thus private markets including bank finance, private equity, venture capital and other sources are often more attractive for SME finance. Bond issuance is also challenging for SMEs, given the absence of strong governance structures and information disclosures. However, SMEs' characteristics render them unsuitable for public markets since they are not in a position to have the requisite financial disclosure, either because they cannot generate it, or

because the cost is too high. Equity financing solutions also require both that SMEs open their capital to outside shareholders, which many SMEs are reluctant to do because of their family structure, and that investors demonstrate a much higher risk appetite than many do.

The size of the SME financing gap calls for additional solutions to expand SME financing the world over. In advanced economies the low interest rate environment of recent years has resulted in lower returns for the large fixed-income holdings of institutional investors; as a result, their search for alternative investments, including SME finance instruments has increased. The increased interest of institutional investors in ESG investment also has a positive effect on SME financing. Financial technology has triggered the emergence of new capital markets solutions that allow start-ups and SMEs in need of funding to connect more directly with investors. Financing raised through electronic platforms has been growing at a fast pace over the past few years. Many emerging and developing economies are seeing their pension funds grow, financial technology is opening the doors to new mechanisms for market-based financing, and a growing middle class is increasingly investing in capital markets through mutual funds.⁸⁰

Alternative finance solutions are available for SMEs in Turkey, despite their insignificant size compared to bank finance. Both indirect solutions that offer SMEs refinancing facilities and direct finance solutions that provide SMEs direct access to capital markets could be financing alternatives. Depending on the level of market development and the regulatory environment, indirect mechanisms for SME financing instruments could be plain vanilla issuances by SME lenders, SME loan securitization, and SME structured notes. Direct debt finance solutions are receivable-based solutions, loan-based solutions, and security offering solutions. Direct solutions could be private equity and venture capital, equity crowdfunding, and SME offerings on equity finance. Nevertheless, concerns regarding macroeconomic volatility, governance issues on both investor and issuer sides in equity finance, and an enabling environment, especially the insolvency regime, diminish the development of innovative instruments.

Box 10: Greening the Financial Sector in Turkey

Turkey's financial sector and capital markets offer the potential to facilitate a green transition, mobilizing capital for sustainable and green recovery. Demand for green financing is likely to grow, particularly with the EU Green Deal coming into force (see page 67). The country can quickly benefit from the increasing ESG focused interest from domestic and international investors and issuers. A holistic approach including regulatory framework, a taxonomy, supervision, guidance, strategies, and innovative instruments is necessary. Among other enablers needed to achieve green growth⁸¹, a supporting and robust, vibrant financial system will be required with substantial financing needs intermediating through banks, insurers, and other capital providers. However, the financial system will need accurate, readily available, and equivalent databases, measurements, methodologies, guidelines, and frameworks to handle climate-related risks.

Climate change and environmental issues are increasingly recognized as important sources of risk and opportunity for the financial sector. A growing number of central banks and regulators across the globe have issued warnings on the impact of climate and environmental risks on their financial institutions and systems' stability. These risks can materialize through two channels: physical and transition risks. Physical risks stem from both gradual and abrupt impacts of climate change, including natural disasters relevant to Turkey, such as droughts, floods, and landslides, affecting economic performance and the value of real or

⁸⁰ "World Bank Group. 2020." Capital Markets and SMEs in Emerging Markets and Developing Economies: Can They Go the Distance?" World Bank. <https://openknowledge.worldbank.org/handle/10986/33373>

⁸¹ The World Bank defines green growth as that which is efficient in its use of natural resources, clean in that it minimizes pollution and environmental impacts, and resilient. It accounts for natural hazards and the role of environmental management and natural capital in preventing physical disasters.

financial assets. Transition risks derive from efforts to transition to a resilient low-carbon economy and improve local environmental conditions, creating significant economic adjustment costs across a broad range of sectors.

There is global recognition of the emerging role of financial sectors in mobilizing capital for green objectives, including for those laid out in national climate action plans and strategies. The benefits of aligning with the European Green Deal, which aims to facilitate public and private investments needed to transition to a climate-neutral, green, competitive and inclusive economy, further add to the demand for sustainable finance in Turkey, considering the EU's share in Turkey's external trade.

Green finance remains at an early stage of development in Turkey. Turkey's financial sector plays a crucial role in delivering on the green agenda and mobilizing capital for climate action. However, climate change poses risks to financial stability and the soundness of institutions. As the COVID-19 crisis has shown, major disaster events have direct impacts on the financial sector. They heighten levels of uncertainty regarding the medium to long-term macro-economic outlook and growth, increase public and private sector financing needs, cause structural changes to the economy, and influence wealth and income distribution. Climate and environmental crises can have a similar impact and threaten the stability of financial institutions and systems. With increasing knowledge and awareness of these risks and more frequent occurrence of extreme weather events, and understanding of transition risks, Turkey's financial sector must be ready and able to respond to a crisis caused by climate.

Domestic funding for green investments in Turkey depends mostly on the banking sector and faces many green financing hurdles. The banking sector in Turkey, which is a big part of its financial sector, which has played a crucial role in the country's growth of renewable energy production and the issuance of green bonds and mortgages, is well established and has taken measures towards sustainable finance. However, challenges to such initiatives involve, but are not limited to, unpredictable policy conditions, lack of knowledge and institutional capability, and a low degree of preparation to promote healthy green development.

In Turkey, green finance is understood by the financial sector as part of the broader sustainable finance agenda. The Turkish banks' market-led course to sustainable banking is aligned with national goals and international principles and good practice. This understanding takes place in a broad perspective within the framework of the UN Sustainable Development Goals.

The banking associations and financial sector's top players have undertaken voluntary industry-led initiatives. Turkish financial institutions have incorporated environmental and social issues with a blend of risk management and loan origination. In 2014, the Banks Association of Turkey (BAT) issued Turkey's voluntary Sustainability Guidelines for the Banking Sector. The Guidelines were prepared by a BAT working group on the Role of the Financial Sector in Sustainable Growth, with the participation of 18 banks. Sustainability guidelines were revised by the BAT in March 2021. In 2019 six leading Turkish banks signed the UN's Responsible Banking Principles to implement sustainability. Additionally, several financial and nonfinancial corporates devoted themselves to issuing sustainability reports to raise investor awareness and resilience against shocks.

Green financial regulations drive capital away from unsustainable investments

Investors and the financial sector need clear and credible guidance for a green economy from the authorities. The challenges related to funding green investments need a favorable policy and regulatory structure to be developed, accompanied by the institutional capacity to execute them. Providing best practice advice on sustainable finance to the banking sector will help contribute to better finance for green development. The authorities and regulators could maximize their efforts to guide financial sector players on environmental sustainability. Turkey needs to develop a holistic regulatory framework, guidance, a green

labeling taxonomy (possibly aligned with the EU taxonomy⁸²), strategies, and innovative instruments to expedite the greening of the financial sector and make it resilient to climate risks. Supervisors or regulators can be instrumental in enhancing awareness by carrying out an initial assessment of Turkey's financial sector's exposure to key sectors most exposed to climate risk (e.g., fossil fuels, power, agriculture, automotive, and steel). In the recent Economic Reform Package, the authorities shared their agenda to strengthen the ecosystem of green finance. The Capital Markets Board is assigned as the responsible authority to issue green bond and green sukuk guides in cooperation with the Presidency's Finance Office and Borsa Istanbul.

Financial institutions, including banks, insurance companies, and pension funds need to be more aware of the climate risks they face. Climate risk is a new and essential driver of financial risk. Financial supervisors must push financial institutions to manage this risk adequately. The information that the financial sector uses is only as vital as the corporate disclosures it is built upon. That is why the quantity, quality, and consistency of corporate reporting on sustainability-related information must improve. Credible and comparable information should be readily available for all market participants, shareholders, and other stakeholders. Reporting⁸³ aligned with the requirements of global accounting standards ensures a level playing field.

Capital market instruments are essential for sustainable finance to take off as the bank-dominated financial sector has a limited ability to provide longer-term sustainable finance at an affordable cost due to its short-term funding structure. Turkish firms are currently dependent on banks for their funding and to a marginal extent on the capital markets. They only have limited access to private funding markets, which are very small in Turkey. Turkish capital markets need to supply more diverse types of risk capital required to fund the green transition. Risk capital typically comes from venture capitalists, private equity funds, and investment funds.

Source: World Bank, Technical Note “Unlocking Green Finance in Turkey”, forthcoming

Addressing the youth, especially female youth, employment challenge critical for recovery

Both demand and supply-side constraints need to be addressed in Turkey to improve labor market entry and continuity for women and youth. Among multiple factors to be addressed, labor market dynamics reveal three specific constraints that should be addressed over the short- to medium-term. First, on the demand side, the growth of firms and their hiring practices suggest that job growth has not kept up with labor force growth. The mix of labor- versus capital-intensive activities and lagging productivity in job-creating sectors in agriculture and services have hampered job growth for low- and high-skilled workers⁸⁴. Second, on the supply-side, in certain sectors such as manufacturing, industry and, increasingly, services particularly with the onset of COVID-19, firms report a lack of adequate skills among applicants. Nearly 20 percent of firms find an inadequately skilled workforce is a major constraint to doing business.⁸⁵ The need for a digitally skilled workforce that responds to the demand of firms as the economy becomes greener and more knowledge-based is key. Finally, at the cross-roads between the demand- and supply-side, informality has remained relatively high at approximately 30 percent, suggesting that incentives within the labor market for firms to continue employing workers informally and for undeclared self-employment to persist remain high. This may be due

⁸² https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

⁸³ The Capital Markets Board (CMB) amended the Corporate Governance Communiqué to ensure that public companies take concrete steps to ensure sustainability. The Amendment entered into force on 1 October 2020. The CMB has also published the “Sustainability Principles Compliance Framework” which contains the principles that public companies should follow. However, there is no obligation to follow the ESG principles recently set out in the Corporate Governance Communiqué. But, public companies must issue publicly available annual reports indicating as to whether they comply with these principles, or the reasons for failing to do so.

⁸⁴ World Bank (2019). Country Economic Memorandum: Firm Productivity and Economic Growth in Turkey

⁸⁵ WBG Enterprise Survey 2019.

the perceived rate of return of labor costs in Turkey. The hike in minimum wage in 2016, for example, hampered firm growth notably among small and medium enterprises (SME)⁸⁶.

Policies to protect workers and households most negatively impacted by shocks have been expanded, yet remain modest in the face of COVID-19 challenges, particularly for women and youth. The choice of instruments is key to striking a balance between supporting immediate needs and building long-term resilience. While countries respond in different ways, in-kind and cash public support, either direct to workers and households, or via firms, will likely be needed over the mid-term. Currently, Turkey's main social and labor expenditure is equivalent to around 12 percent of GDP⁸⁷. By comparison with Turkey's major labor market programs, unemployment benefits amount to only 0.7 percent of GDP, active labor market programs (ALMPs) 0.4 percent, and employment subsidies 0.5 percent of GDP, although these figures may not account for expansion in 2020. In the OECD, the drop in economic growth during 2007-2009 of nearly 7 percentage points was met by an increase in social expenditures of nearly 3 percentage points of GDP on average in the OECD (17.7 percent of GDP to 20.7 percent of GDP).

In Turkey, a range of labor market policies and active labor market programs are available to protect vulnerable workers in the formal sector, but effects vary. Key labor market programs include unemployment benefits, ALMPs and wage subsidies. Wage subsidies, also known as employment incentives in Turkey, have tended to expand following shocks, such as the post-2008 and post-2018 periods. At least thirteen employment subsidies operate in Turkey, targeting different populations and firms, with a range of different parameters regarding duration and benefits. While some of these programs were introduced before 2008, several were introduced following the GFC. Among the registered unemployed, subsidies to cover wages and social security contributions are afforded to apprentices, interns and trainees not covered by full-time job contracts, amounting to an estimated 1.5 million individuals as of first quarter 2020. Of the employment incentives afforded for full-time jobs, one main subsidy scheme predominates, namely Scheme 5510 (or the Five-Points Scheme), benefiting nearly 70 percent of all firms receiving Social Security Institution (SGK) employment subsidies. Employment subsidies are primarily financed through the Unemployment Insurance Fund and the Ministry of Treasury and Finance. The four largest schemes reached a total of over 1.5 million firms (out of an estimated 3.5 million active SMEs)⁸⁸ and 9 million workers in 2019 (out of 28 million)⁸⁹.

COVID-19-associated expansions of employment subsidies in terms of wage protection and social security premia have further broadened the scope of beneficiary firms and workers. Although employment subsidies exist to promote formal job creation, the way they are designed may not respond to new economic realities. Their eligibility, benefit structure, duration, level and coordination with other labor market institutions, social assistance and social insurance requires revisiting. Previous work has shown that employment subsidies lead formal employment in small firms to increase through the formalization of existing informal jobs, and that impacts tend to be larger in sectors such as construction and manufacturing⁹⁰. Targeting the most vulnerable workers, notably first-time job seekers and women, would further improve efficiency and employment impacts, although the duration of impacts depends on productivity gains and labor costs over the mid-term.

Training-based active labor market programs covered 15 percent of the registered unemployed in Turkey⁹¹ in 2019, coverage which has generally increased anti-cyclically since 2007. In 2019, ALMPs

⁸⁶ World Bank (Bossavie, I.; Acar, A.; Makovec M) (2019). Do Firms Exit the Formal Economy after a Minimum Wage Hike? World Bank Policy Research Working Paper No. 8749. Washington DC: World Bank.

⁸⁷ TurkStat 2019; Republic of Turkey Social Security Institution (SGK) (2019). Organizational Profile and Overview of the Social Security System in Turkey. Ankara: SGK. Republic of Turkey and World Bank (2017).

⁸⁸ Union of Chambers and Commodity Exchanges of Turkey, <https://www.tobb.org.tr/KobiArastirma/Sayfalar/Eng/SMEsinTurkey.php>.

⁸⁹ World Bank (forthcoming), Evaluation of employment subsidy schemes, from progress reviews for June 2019 and February 2020.

⁹⁰ Betcherman et al., 2020; World Bank, forthcoming.

⁹¹ Registered unemployed defined as those registered with the Turkish national employment agency, ISKUR. On average, ISKUR data captures approximately 80 percent of the total unemployed as estimated through national labor force surveys conducted by the Turkish national statistics institute, TUIK.

accounted for nearly 568,000 beneficiaries (15 percent of the unemployed), compared to 1.013 million recipients of unemployment benefits (26 percent of the unemployed) (Figure 167). As of 2020, of the 423,133 beneficiaries newly enrolled in ALMPs, the national On-the-Job Training Program (OJT) remained the dominant choice (80 percent), with the Vocational and Technical Courses Program (VT) accounting for 20 percent. Among the nearly 1,400 VT courses on offer, clothing and textiles was the most common occupational skill in demand, accounting for nearly one out of three beneficiaries (26 percent). Among approximately 34,000 OJT programs on offer, one in four beneficiaries were in sales or retail occupations, followed by clothing and textile-related occupations (14 percent), with the remainder split across trades (metallurgy, furniture), hospitality, and other services.

ALMPs tend to cover younger, less-skilled workers and serve as a pathway to re-skilling and facilitating the transition to new jobs and sectors. Most ALMP beneficiaries are young adults under the age of 34 years (77 percent), heavily concentrated among 20-24-year-olds (33 percent). The majority of ALMP beneficiaries hold a primary or secondary education nearly split equally by educational level overall (74 percent), although vocational courses are skewed towards primary-schooled workers rather than secondary (51 versus 27, respectively). By gender, while no major differences are seen overall among on-the-job training, vocational course enrollment is skewed towards females relative to males (69 versus 31 percent, respectively) (Figure 169). These patterns have been generally constant over time.

The impact of ALMPs is tied to how responsive they are to the demand by firms for certain occupational skills, and shifts driven by COVID-19 will heighten the need for demand-driven training. Administrative and online job vacancy data highlights the need for social as well as technical skills in the formal sector and across regions⁹². The demand for skills may have shifted pre- and post-COVID with for instance, the need for service sector workers declining. Occupations including routine tasks (e.g. machine operators, call center clerks and product graders) and occupations requiring non-routine manual tasks (such as customer service) have historically been in high demand. Increasingly, IT-related and social skills (such as software knowledge, communication and teamwork skills) and professionalism (discipline, time management) are in high demand, particularly in regions with higher economic activity. As greater attention is given to building back better and the green economy as part of the COVID-recovery, targeting skills retraining at youth and first-time job seekers, particularly females, may be especially cost-effective.

Figure 167: Coverage rate of ALMPs has not been growing...

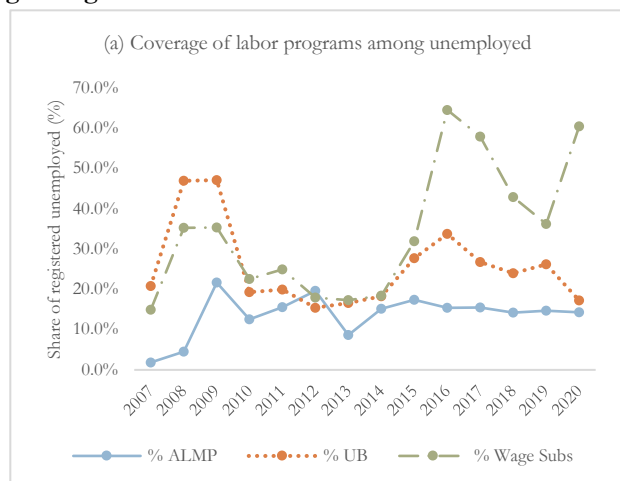
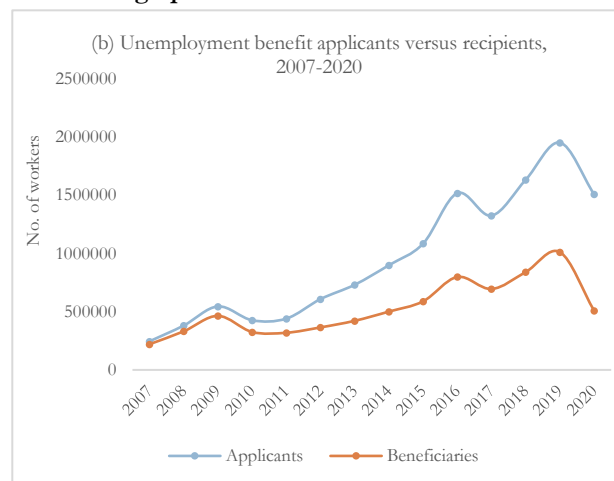


Figure 168: ...although unemployment benefits have been scaling up

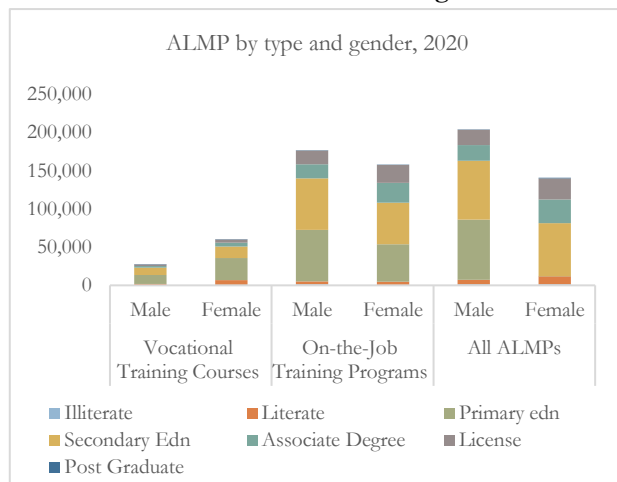


Source: World Bank staff using ISKUR data. Note: ALMP = active labor market programs; UB = unemployment insurance benefits; Wage Subs = wage subsidies for apprenticeships, interns and trainees (excludes full-time job contract incentives).

⁹² Turkish Employment Agency; Makovec, Nas Ozen and Demirel, forthcoming.

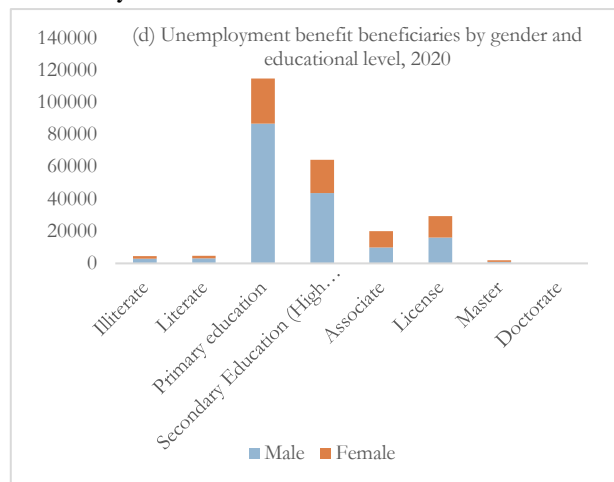
Unemployment benefits also tend to go to less skilled workers and have been increasing over time. Unemployment benefits are still relatively new in Turkey and coverage has been growing rapidly since their introduction in 2007, reaching 1 million beneficiaries in 2019 (Figure 168), with coverage hovering at 26 percent of all registered unemployed. Over 2020, coverage decreased by nearly half to 509 thousand, as labor force exits increased and the redundancy moratorium took effect. Unemployment benefits remain concentrated among workers with primary education (50 percent of beneficiaries), followed by secondary (27 percent), suggesting the program appears to be relatively progressive by educational level. Most beneficiaries tend to be younger at 25-44 years (over 70 percent), with 20 percent aged between 45-54 years, and the remainder older. As a policy instrument, unemployment benefits have gradually assumed a greater focus in Turkey.

Figure 169: On-the-job training more used by men, but more women access vocational training



Source: World Bank staff using ISKUR data.

Figure 170: And unemployment benefits are primarily claimed by men



Moving forward, policy options for realizing the full potential of Turkey's human capital in terms of jobs and welfare requires a range of both short- and long-term actions, including a more integrated, whole-of-government approach. Recommended policy options regarding jobs will depend on the specific policy constraint and aims sought, whether projecting jobs, stimulating earnings and benefits, compensating income losses, or fostering greater job creation. While emergency one-off, universal measures were useful early on, as impacts manifest, more systemic reforms may be more beneficial and cost-effective. First, regarding the demand for labor over the short-to medium-term, consolidation across Turkey's employment subsidies, unemployment insurance and ALMPs in terms of eligibility, targeting and monitoring will help better integrate women, youth, low-income workers, informal workers and the non-working poor into emerging, productive sectors. Second, ALMP financing can be strengthened through performance-based reforms to stimulate skills and on-the-job training for low- and semi-skilled vulnerable workers, and respond to new demand in growing sectors such as the green, digital and the digitized-economy. Finally, strengthening the school-to-work transition over the mid- to long-term can start at an early age through a coordinated approach to reforming the education system teaching models and linkages to ALMPs and firm growth. Measures that incentivize twenty-first century skills and widen eligibility to on-the-job training among secondary, vocational, and higher education students can prove effective. Harnessing such a whole-of-government vision will be an important pathway to boosting long-term job prospects in Turkey.

Annex 1: Medium-Term Outlook, Nominal

Key Macroeconomic Indicators

	2018	2019	2020	2021	2022	2023
Population (mid-year, million)	81.4	82.6	83.4	84.4	85.4	86.4
GDP (current US\$, billion)	797.2	760.8	717.0	720.0	776.3	825.6
GDP per capita (current US\$)	9792	9213	8599	9170	9089	9555
CPI (annual average, in percent)	16.3	15.2	12.3	15.5	12.0	10.0
Real Economy	TL Billion, unless otherwise indicated					
Real GDP	1756.1	1772.2	1803.4	1892.6	1978.4	2067.7
Private Consumption	1025.5	1041.5	1074.7	1102.1	1130.3	1162.6
Government Consumption	245.6	256.4	262.3	268.3	274.1	280.0
Gross Fixed Capital Formation	501.6	439.4	468.1	476.7	514.7	551.6
Net Exports	43.1	84.8	-12.4	34.9	48.6	63.8
Fiscal Accounts	TL Billion, unless otherwise indicated					
Total Revenues	1238.5	1429.9	1673.0	1942.8	2198.2	2461.4
Total Expenditures	1327.1	1561.3	1871.7	2153.2	2407.6	2665.9
General Government Balance	-88.6	-131.4	-198.7	-210.5	-209.4	-204.5
Government Debt Stock	1134.0	1404.6	2001.0	2423.6	2702.1	2983.9
Primary Balance	-9.3	-23.1	-51.9	-23.2	-1.4	5.8
Monetary Policy	TL Billion, unless otherwise indicated					
Broad Money (M3)	1994.7	2554.0	3421.5	-	-	-
Credit Growth (FX-adjusted, eop, y-o-y)*	1.0	8.5	37.5	-	-	-
Average Funding Rate (annual average, in percent)	17.7	20.7	10.5	-	-	-
Gross Reserves (in US\$ Billion)	93.0	105.7	93.3	-	-	-
o/w Gold Reserves	20.1	27.1	43.2	-	-	-
External Sector	US\$ Billion, unless otherwise indicated					
Current Account Balance	-21.7	6.8	-36.8	-26.7	-31.0	-32.8
Trade Balance (in goods and services)	-10.6	18.8	-28.3	-14.4	-19.4	-20.8
Exports	237.5	245.8	203.1	234.6	255.3	277.9
Imports	248.1	227.1	231.4	249.1	274.7	298.7
Net Foreign Direct Investment	9.2	6.3	4.7	6.4	7.8	8.6

Source: TURKSTAT, CBRT, Strategy and Budget Presidency, WB Staff calculations.

*FX-adjusted credit growth is calculated using end-year average exchange rate value of US\$/TRY since 2010 for adjustment.

Annex 2: Medium-Term Outlook, Percent of GDP

Key Macroeconomic Indicators

	2018	2019	2020	2021	2022	2023
Real Economy	Annual percentage change, unless otherwise indicated					
Real GDP	3.0	0.9	1.8	5.0	4.5	4.5
Private Consumption	0.5	1.6	3.2	2.5	2.6	2.9
Government Consumption	6.6	4.4	2.3	2.3	2.2	1.8
Gross Fixed Capital Formation	-0.3	-12.4	6.5	1.8	8.0	7.2
Exports	9.0	4.9	-15.4	19.5	9.0	8.5
Imports	-6.4	-5.3	7.4	7.0	6.5	6.0
Fiscal Accounts	Percent of GDP, unless otherwise indicated					
Total Revenues	33.0	33.1	33.1	32.5	32.2	31.7
Total Expenditures	35.3	36.1	37.1	36.0	35.2	34.4
General Government Balance	-2.4	-3.0	-3.9	-3.5	-3.1	-2.6
Government Debt Stock	30.2	32.5	39.6	40.6	39.6	38.4
Primary Balance	-0.2	-0.5	-1.0	-0.4	0.0	0.1
Monetary Policy	Percent of GDP, unless otherwise indicated					
CPI (annual average, in percent)	16.3	15.2	12.3	15.5	12.0	10.0
Broad Money (M3)	53.1	59.1	67.8	-	-	-
Gross Reserves	11.9	13.9	13.0	-	-	-
In months of merchandise imports c.i.f.	5.1	6.4	5.4	-	-	-
Percent of short-term external debt	79.2	86.0	67.3	-	-	-
External Sector	Percent of GDP, unless otherwise indicated					
Current Account balance	-2.7	0.9	-5.1	-3.7	-4.0	-4.0
Trade Balance (in goods and services)	-1.3	2.5	-4.0	-2.0	-2.5	-2.5
Exports	29.8	32.3	28.3	32.6	32.9	33.7
Imports	31.1	29.8	32.3	34.6	35.4	36.2
Net Foreign Direct Investment	1.2	0.8	0.7	0.9	1.0	1.0

Source: TURKSTAT, CBRT, Strategy and Budget Presidency, WB Staff calculations.

Annex 3: Gross Domestic Product, Production Approach

Gross Domestic Product: Production Approach

	2016	2017	2018	2019	2020
GDP (current, TL billion)	2626.6	3133.7	3758.3	4320.2	5047.9
Agriculture	161.3	189.2	217.1	277.5	333.3
Industry	514.9	646.8	837.3	941.5	1130.8
Construction	222.7	266.1	267.6	233.3	272.3
Services	1418.0	1677.7	2047.1	2439.7	2758.4
GDP (constant prices, TL billion)	1586.6	1705.7	1756.1	1772.2	1803.4
Agriculture	101.3	106.3	108.5	112.6	117.9
Industry	312.7	341.8	346.4	343.1	350.1
Construction	117.3	128.3	125.9	115.0	111.0
Services	870.3	936.1	980.8	1008.8	1019.4
Real GDP Growth (in percent)	3.3	7.5	3.0	0.9	1.8
Agriculture	-2.6	4.9	2.1	3.7	4.8
Industry	4.4	9.3	1.3	-1.0	2.0
Construction	5.1	9.4	-1.9	-8.6	-3.5
Services	3.4	7.6	4.8	2.8	1.1
GDP (constant prices, share)					
Agriculture	6.4	6.2	6.2	6.4	6.5
Industry	19.7	20.0	19.7	19.4	19.4
Construction	7.4	7.5	7.2	6.5	6.2
Services	54.9	54.9	55.9	56.9	56.5

Source: TURKSTAT, WB Staff calculations.

Annex 4: Gross Domestic Product, Expenditure Approach

Gross Domestic Product: Expenditure Approach

	2016	2017	2018	2019	2020
GDP (current, TL billion)	2626.6	3133.7	3758.3	4320.2	5047.9
Private Consumption	1560.4	1836.6	2111.0	2457.0	2864.5
Government Consumption	387.0	450.6	552.0	670.8	769.5
Gross Fixed Capital Formation	764.5	935.6	1114.7	1117.6	1372.8
o/w Construction	424.4	536.0	643.5	580.9	628.2
o/w Machinery and Equipment	279.8	323.5	379.4	417.2	576.5
Net Exports	-56.8	-115.4	-5.2	121.0	-189.6
Change in Inventories	-28.6	26.2	-14.2	-46.2	230.8
GDP (constant prices, TL billion)	1586.6	1705.7	1756.1	1772.2	1803.4
Private Consumption	963.4	1020.5	1025.9	1041.9	1075.2
Government Consumption	219.5	230.5	245.6	256.4	262.3
Gross Fixed Capital Formation	464.6	503.0	501.6	439.4	468.1
o/w Construction	247.7	278.5	285.2	233.1	216.7
o/w Machinery and Equipment	182.0	184.0	173.0	159.1	192.7
Net Exports	-22.8	-19.0	43.1	84.8	-12.4
Change in Inventories	-38.0	-29.3	-60.0	-50.2	10.2
Real GDP Growth (in percent)	3.3	7.5	3.0	0.9	1.8
Private Consumption	3.8	5.9	0.5	1.6	3.2
Government Consumption	9.5	5.0	6.6	4.4	2.3
Gross Fixed Capital Formation	2.2	8.3	-0.3	-12.4	6.5
o/w Construction	3.0	12.4	2.4	-18.3	-7.1
o/w Machinery and Equipment	0.2	1.1	-6.0	-8.0	21.1
Exports	-1.7	12.4	9.0	4.9	-15.4
Imports	3.0	10.6	-6.4	-5.3	7.4
Change in Inventories	-9.4	-22.9	104.8	-16.5	-120.3
GDP (constant prices, share)					
Private Consumption	60.7	59.8	58.4	58.8	59.6
Government Consumption	13.8	13.5	14.0	14.5	14.5
Gross Fixed Capital Formation	29.3	29.5	28.6	24.8	26.0
o/w Construction	15.6	16.3	16.2	13.2	12.0
o/w Machinery and Equipment	11.5	10.8	9.9	9.0	10.7
Exports	22.2	23.2	24.6	25.6	21.2
Imports	23.7	24.3	22.1	20.8	21.9
Change in Inventories	-2.4	-1.7	-3.4	-2.8	0.6

Source: TURKSTAT, WB Staff calculations.

Annex 5: Prices

Consumer and Producer Prices: End of period y-o-y, percentage change

	2016	2017	2018	2019	2020
CPI (All items)	8.5	11.9	20.3	11.8	14.6
CPI (Food and non-alc. Beverages)	5.7	13.8	25.1	10.9	20.6
CPI (Core C)	7.5	12.3	19.5	9.8	14.3
Alcoholic beverages, tobacco	31.6	2.9	2.4	43.1	0.7
Clothing and footwear	4.0	11.5	14.8	4.5	-0.3
Housing & Energy	6.4	9.6	23.7	9.9	9.6
Health	9.7	11.9	16.7	13.6	16.7
Transport	12.4	18.2	16.0	12.2	21.1
Communication	3.2	1.4	9.6	3.2	5.7
Recreation and culture	5.9	8.4	20.9	7.0	10.4
Education	9.5	10.5	10.2	14.5	6.8
Restaurants and Hotels	8.6	11.5	19.8	13.2	12.7
Miscellaneous goods and services	11.1	12.8	28.8	13.6	28.1
PPI (All items)	9.9	15.5	33.6	7.4	25.1

Consumer and Producer Prices: Annual average, percentage change

	2016	2017	2018	2019	2020
CPI (All items)	7.8	11.1	16.3	15.2	12.3
CPI (Food and non-alc. Beverages)	5.8	12.7	18.0	19.5	13.9
CPI (Core C)	8.5	10.1	16.5	13.4	11.2
Alcoholic beverages, tobacco	18.1	15.4	1.5	24.4	16.4
Clothing and footwear	7.4	7.1	13.6	5.6	5.7
Housing & Energy	6.6	8.0	15.8	13.4	12.4
Health	9.6	12.4	12.4	17.1	14.4
Transport	7.4	16.8	21.8	9.8	12.2
Communication	2.8	2.7	4.6	6.4	4.3
Recreation and culture	7.1	9.8	12.9	14.5	7.0
Education	8.2	10.0	10.5	13.5	10.5
Restaurants and Hotels	10.2	10.3	15.1	17.6	12.1
Miscellaneous goods and services	11.3	12.3	19.9	22.0	22.6
PPI (All items)	4.3	15.8	27.0	17.6	12.2

Source: TURKSTAT, WB Staff calculations.

Annex 6: Balance of Payments

Balance of Payments Statistics

	2015	2016	2017	2018	2019	2020
	US\$ Billion, unless otherwise indicated					
Current Account	-27.3	-27.0	-40.8	-21.7	6.8	-36.8
Trade Balance	-19.0	-19.4	-32.2	-10.6	18.8	-28.3
Exports of goods	154.9	152.6	169.2	178.9	182.2	168.4
Imports of goods	203.9	192.6	227.8	219.6	199.0	206.3
Services Balance	30.0	20.5	26.3	30.2	35.5	9.5
Primary Income Balance	-9.7	-9.2	-11.1	-11.9	-12.8	-8.7
Secondary Income Balance	1.4	1.5	2.5	0.8	0.8	0.3
Capital Account	0.0	0.0	0.0	0.1	0.0	0.0
Financial Account	-21.2	-21.7	-47.0	-10.9	1.3	-39.8
Direct Investment	-14.2	-10.7	-8.3	-9.2	-6.3	-4.6
Portfolio Investment	15.3	-6.6	-24.3	3.1	1.4	5.5
Other Investment	-10.6	-5.3	-6.2	5.6	-0.1	-8.7
Net Errors & Omissions	6.1	5.3	-6.2	10.8	-5.5	-2.9
Reserve Assets	-11.8	0.8	-8.2	-10.4	6.3	-31.9
Overall Balance	-11.8	0.8	-8.2	-10.4	6.3	-31.9
memo item:						
Energy Balance	-33.5	-24.1	-32.9	-37.8	-33.3	-24.2
Gold Balance	4.0	1.8	-10.0	-8.7	-9.3	-22.4
	Percent of GDP, unless otherwise indicated					
Current Account	-3.2	-3.1	-4.8	-2.7	0.9	-5.1
Trade Balance	-2.2	-2.2	-3.8	-1.3	2.5	-4.0
Exports of goods	17.9	17.6	19.7	22.4	24.0	23.5
Imports of goods	23.5	22.2	26.5	27.6	26.2	28.8
Services Balance	3.5	2.4	3.1	3.8	4.7	1.3
Primary Income Balance	-1.1	-1.1	-1.3	-1.5	-1.7	-1.2
Secondary Income Balance	0.2	0.2	0.3	0.1	0.1	0.0
Capital Account	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	-2.4	-2.5	-5.5	-1.4	0.2	-5.6
Direct Investment	-1.6	-1.2	-1.0	-1.2	-0.8	-0.6
Portfolio Investment	1.8	-0.8	-2.8	0.4	0.2	0.8
Other Investment	-1.2	-0.6	-0.7	0.7	0.0	-1.2
Net Errors & Omissions	0.7	0.6	-0.7	1.4	-0.7	-0.4
Reserve Assets	-1.4	0.1	-1.0	-1.3	0.8	-4.4
Overall Balance	-1.4	0.1	-1.0	-1.3	0.8	-4.4
memo item:						
Energy Balance	-3.9	-2.8	-3.8	-4.7	-4.4	-3.4
Gold Balance	0.5	0.2	-1.2	-1.1	-1.2	-3.1

Source: CBRT, WB Staff calculations.

Annex 7: Monetary Survey

Monetary Survey (TL Billion, , end of period)

	2016	2017	2018	2019	2020	2021-Feb
Total Assets	1894.5	2225.0	2717.9	3348.0	4474.7	4535.4
Net Foreign Assets	-42.3	-79.6	-3.1	187.8	82.5	93.9
Foreign Assets	561.8	631.2	876.0	1065.7	1194.5	1223.2
Monetary Authorities	380.3	417.1	499.1	638.6	698.4	698.7
Deposit Money Banks	181.5	214.0	376.9	427.1	496.1	524.5
Foreign Liabilities	604.1	710.8	879.1	878.0	1112.0	1129.4
Monetary Authorities	10.5	11.6	21.7	24.8	41.7	50.8
Deposit Money Banks	593.6	699.2	857.4	853.2	1070.2	1078.6
Domestic Credits	1936.8	2304.6	2721.1	3160.2	4392.2	4441.6
Net Claims on Central Government	174.5	178.2	289.3	420.9	734.2	761.7
Claims on private sector	1687.0	2025.9	2307.3	2585.0	3472.8	3493.7
Total Liabilities	1894.5	2225.0	2717.9	3348.0	4474.7	4535.4
Money	270.1	297.4	290.2	392.2	478.0	473.3
Currency in Circulation	111.3	118.5	119.1	140.7	173.7	167.4
Demand Deposits	158.8	178.9	171.1	251.6	304.3	305.9
Quasi Money	1245.5	1453.9	1794.8	2252.7	3065.3	3065.9
Time and saving deposits	682.4	764.1	876.9	991.8	1224.0	1250.1
Residents' foreign exchange deposits	517.6	631.4	862.2	1152.3	1746.2	1720.3
Securities Issued	0.0	0.0	0.0	0.0	0.0	0.0
Restricted Deposits	0.0	0.0	0.0	0.0	0.0	0.0
Other Items (Net)	378.9	473.7	632.9	703.1	931.5	996.2

Source: CBRT.

Annex 8: Central Bank Balance Sheet

Central Bank of Turkey Balance Sheet (TL Billion)

	2016	2017	2018	2019	2020	2021-Feb
CBRT Assets	345.4	396.2	461.2	646.5	820.2	816.0
Foreign Assets	381.0	436.8	506.9	638.1	699.5	698.7
Domestic Assets	18.2	16.4	-0.7	58.1	188.6	165.8
Treasury Debt: Securities	13.9	14.5	13.7	19.4	89.5	88.6
Cash credits to Public Sector	13.8	14.4	13.5	19.3	89.4	88.5
Cash credits to Banking Sector	37.6	48.1	80.9	102.6	138.4	148.8
Credits to SDIF	0.0	0.0	0.0	0.0	0.0	0.0
Other Items	-33.1	-46.1	-95.1	-63.7	-39.1	-71.5
FX Revaluation Account	-53.8	-57.0	-45.0	-49.8	-67.9	-48.5
CBRT Liabilities	345.4	396.2	461.2	646.5	820.2	816.0
Total FX Liabilities	260.9	299.7	347.2	419.8	673.5	714.9
Foreign Liabilities	10.0	9.1	21.7	24.7	41.7	50.8
Domestic Liabilities	251.0	290.6	325.5	395.1	631.8	664.1
Central Bank Money	84.5	96.5	114.0	226.7	146.6	101.1
Reserve Money	168.0	174.1	192.2	203.8	382.3	349.9
Other Central Bank Money	-83.5	-77.6	-78.2	22.9	-235.7	-248.8

Source: CBRT.

Annex 9: Fiscal Operations

General Government Budget

	2014	2015	2016	2017	2018	2019
TL Billion, unless otherwise indicated						
Revenues	691.2	799.2	904.3	1028.2	1238.5	1429.9
Tax Revenues	361.9	418.7	470.4	549.8	632.7	686.3
o/w Indirect	243.7	285.7	315.1	367.2	389.4	416.4
o/w Direct	106.0	118.9	138.1	164.3	221.3	245.0
Non-Tax Revenues	38.9	42.8	46.3	47.8	83.9	81.0
Factor Incomes	99.4	112.7	129.6	144.8	177.0	261.2
Social Funds	178.9	212.9	248.4	280.7	338.7	396.3
Privatization Revenues	12.1	12.1	9.6	5.0	6.2	5.1
Expenditures	701.9	801.5	940.5	1085.5	1327.1	1561.3
Current Expenditures	314.6	357.6	426.5	480.1	594.5	712.6
Investment Expenditures	66.9	81.1	91.4	115.1	141.6	115.2
Transfer Expenditures	320.4	362.8	422.6	490.3	591.1	733.4
o/w Current Transfers	295.8	339.4	399.9	466.4	564.2	698.1
o/w Capital Transfers	24.6	23.4	22.7	23.9	26.9	35.3
Overall Balance	-10.6	-2.4	-36.2	-57.3	-88.6	-131.4
Interest Expenditures	51.7	54.9	52.7	60.3	79.3	108.3
Government Debt Stock	585.4	643.3	735.4	878.3	1134.0	1410.3
Primary Balance	41.1	52.5	16.6	3.0	-9.4	-23.1
Percent of GDP, unless otherwise indicated						
Revenues	33.6	34.0	34.4	32.8	33.0	33.1
Tax Revenues	17.6	17.8	17.9	17.5	16.8	15.9
o/w Indirect	11.9	12.2	12.0	11.7	10.4	9.6
o/w Direct	5.2	5.1	5.3	5.2	5.9	5.7
Non-Tax Revenues	1.9	1.8	1.8	1.5	2.2	1.9
Factor Incomes	4.8	4.8	4.9	4.6	4.7	6.0
Social Funds	8.7	9.1	9.5	9.0	9.0	9.2
Privatization Revenues	0.6	0.5	0.4	0.2	0.2	0.1
Expenditures	34.2	34.1	35.8	34.6	35.3	36.1
Current Expenditures	15.3	15.2	16.2	15.3	15.8	16.5
Investment Expenditures	3.3	3.4	3.5	3.7	3.8	2.7
Transfer Expenditures	15.6	15.4	16.1	15.6	15.7	17.0
o/w Current Transfers	14.4	14.4	15.2	14.9	15.0	16.2
o/w Capital Transfers	1.2	1.0	0.9	0.8	0.7	0.8
Overall Balance	-0.5	-0.1	-1.4	-1.8	-2.4	-3.0
Interest Expenditures	2.5	2.3	2.0	1.9	2.1	2.5
Government Debt Stock	28.5	27.4	28.0	28.0	30.2	32.6
Primary Balance	2.0	2.2	0.6	0.1	-0.3	-0.5

Source: Strategy and Budget Presidency, Treasury and Finance Ministry, WB Staff calculations.

Annex 10: Banking Sector Balance Sheet

Money and Banking Statistics of Financial Institutions

	2015	2016	2017	2018	2019	2020
Assets	Billion TL, unless otherwise indicated					
Total assets	2338.3	2732.6	3263.0	3936.6	4659.4	6313.0
Net foreign assets	-397.5	-433.2	-521.4	-543.7	-514.9	-692.2
Claims on nonresidents	117.3	182.2	214.9	378.7	430.2	496.2
Liabilities to nonresidents	514.8	615.4	736.3	922.4	945.0	1188.4
Claims on Central Bank	260.3	295.8	355.3	372.6	396.7	640.2
Currency	12.9	13.6	15.2	15.8	15.7	18.2
Reserve deposits and securities	247.3	282.2	339.7	356.4	379.8	613.0
Other claims	0.1	0.0	0.3	0.4	1.2	8.9
Net claims on central government	231.0	242.9	279.5	395.1	571.2	901.5
Claims on central government	287.8	307.1	353.8	470.3	666.1	1034.2
Liabilities to central government	56.8	64.2	74.3	75.3	94.9	132.7
Claims on other sectors	1533.7	1790.7	2168.0	2492.8	2821.7	3767.6
Claims on other financial corporations	40.8	48.8	61.8	69.9	84.5	111.8
Claims on state & local governments	17.6	23.4	34.4	36.9	35.6	40.2
Claims on public nonfinancial corporations	3.7	3.8	5.5	11.4	31.8	35.6
Claims on private sector	1471.6	1714.7	2066.3	2374.5	2669.8	3580.0
Liabilities	Billion TL, unless otherwise indicated					
Liabilities to Central Bank	112.9	106.8	99.2	119.7	105.1	228.3
Transfer deposits included in broad money	230.4	282.3	343.9	398.4	617.9	1072.1
Other deposits included in broad money	881.7	1028.7	1184.3	1442.5	1734.8	2114.9
Securities other than shares included in broad money	27.4	26.3	38.9	36.4	50.2	45.9
Deposits excluded from broad money	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares excluded from broad money	1.2	1.5	2.3	1.6	11.3	10.9
Loans	12.3	17.4	30.4	53.5	56.7	73.2
Financial derivatives	1.6	2.7	2.7	4.1	4.2	5.5
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Shares & other equity	269.0	308.3	366.2	429.4	507.0	611.7
Other items (Net)	91.1	122.2	213.5	231.3	187.4	454.5

Source: CBRT, BRSA, IFS.

Annex 11: Banking Sector Ratios

Selected Ratios for Banking Sector (end of period)

	2015	2016	2017	2018	2019	2020
Liquidity Position						
Liquidity Requirement Ratio	143.5	135.6	144.5	143.8	147.7	148.2
Loan-to-Deposit Ratio	123.4	123.6	126.6	122.6	109.6	108.3
Capital Adequacy						
Core Capital Adequacy Ratio	13.3	13.2	14.1	13.8	14.2	14.5
Capital Adequacy Standard Ratio	15.6	15.6	16.8	17.3	18.4	18.7
Total Risk Weighted Assets (Net) / Total Risk Weighted Assets (Gross)	68.6	43.3	64.4	64.2	64.7	59.1
Regulatory Capital / Total Risk Weighted Assets	15.6	15.6	16.9	17.3	18.4	18.7
Profitability						
Profit (Loss) Before Tax / Average Total Assets	1.5	1.9	2.0	1.8	1.4	1.4
Net Income / Average Total Assets	1.2	1.5	1.6	1.5	1.2	1.1
Net Income / Average Shareholder's Equity	11.3	14.3	15.9	14.8	11.5	11.4
Net Interest (Profit) Revenues (Expenses) / Average Total Assets	3.5	3.7	3.8	3.9	3.9	3.9
Asset Quality						
Non-Performing Loans (Gross) / Total Cash Loans	3.1	3.2	3.0	3.9	5.4	4.1
Provision for Non-Performing Loans / Gross Non-Performing Loans	74.6	77.4	79.3	68.3	65.1	75.0
Credit Growth (FX-adjusted, y-o-y, in percent)*	10.7	10.2	18.2	1.0	8.5	37.5
Interest Rates (end-of-period)						
Weighted average of Central Bank Cost of Funding	8.8	8.3	12.8	24.1	11.4	17.0
Weighted average Interest Rate for Deposits	10.7	9.6	12.4	22.2	10.6	15.1
Consumer Loans Rate	16.4	14.7	17.7	33.1	15.3	21.9
Commercial Loans Rate	15.7	14.3	17.1	28.3	13.5	19.0
Off Balance Sheet Transactions						
Derivative Financial Instruments / Commitments	76.9	79.3	78.3	81.5	80.5	79.6

Source: CBRT, BRSA, IMF, WB Staff calculations.

*FX-adjusted credit growth is calculated using end-year average exchange rate value of US\$/TRY since 2010 for adjustment.



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turkeywebfdbk@worldbank.org