



# OECD Economic Surveys: Turkey, September 2010

OVERVIEW





# Summary

Turkey was directly affected by the global crisis, but showed considerable resilience thanks to important reforms implemented after the 2001 crisis. The adverse external shock originating in financial market turmoil and propagated by a sudden collapse of world trade was amplified by domestic confidence effects. With the experiences of the 2001 banking crisis fresh in mind, companies and households cut investment and durable goods consumption. The strong macroeconomic policy framework provided support for the economy. Moreover, confidence building and credibility were considered more important than a possibly short-lived fiscal stimulus. Now, with the recovery under way, a golden opportunity for structural reforms arises from the sharp drop in real interest rates in the wake of the acknowledgement of Turkey's solid fundamentals by international investors. The government should grasp this opportunity and introduce structural reforms which make most out of this positive shock. Further strengthening the macroeconomic policy environment will be necessary to minimise the risk of a boom-bust scenario.

Potential growth in Turkey is held back by high inactivity and not sufficiently broad-based productivity growth, which is also linked to serious skills mismatches. The low capacity to create new jobs is clearly linked to excessive labour market regulation, which provides incentives for informal arrangements, which in turn hinder productivity growth. Informal firms have less access to finance, cannot efficiently participate in innovation networks and invest less in human capital. Their productivity is therefore much lower than in fully formal, rule-abiding firms. Furthermore, product market regulation is not conducive to market entry and network monopolies have too much pricing power. The fiscal policy framework was successful in bringing down public debt after the 2001 crisis, but became pro-cyclical in the run-up to the crisis and fiscal accounts are not yet fully transparent. Monetary policy succeeded in bringing inflation to single-digit levels but still faces challenges in reaching a lower inflation environment on a sustainable basis.

The recent government initiatives to strengthen the macroeconomic policy framework and advance structural reforms are welcome and should be broadened and accelerated in order to meet the challenge of providing Turkey's rapidly growing population with jobs and accelerate catch-up with the OECD average.

The urgent need for labour market reforms is well known. Turkey should therefore move forward and allow more experimentation with new rules on a voluntary basis. Such measures should be closely monitored and the results used to establish nationwide reformed rules, which can be rigorously enforced without hindering job creation. Simultaneously, product market regulations should be aligned with OECD best practice so as to boost productivity growth and competitiveness. Education policy reforms as outlined in previous Economic Surveys are necessary to remove widespread skills mismatches.

The new draft law establishing a fiscal rule is very welcome and has the potential of considerably improving fiscal performance over time, as well as removing the current pro-cyclical bias of fiscal policy. Its discussion in Parliament, initially planned for June 2010, was postponed. In order to allow an effective monitoring of compliance with the rule it will be important to pass the draft law on the Court of Accounts. Turkey's position in international ratings does not fully reflect reformed and sound fundamentals. Making more progress with fiscal transparency, strengthening the inflation targeting framework and preserving financial stability will therefore be important.

# Assessment and recommendations

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## *From robust post-crisis recovery to sustainable growth*

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Turkey weathered the crisis remarkably well due to its strong macroeconomic policy framework and important structural reforms implemented after the 2001 crisis and GDP growth in 2010 is expected to be high. The challenge for policymakers now is to ensure that the cyclical recovery be followed by sustained and sustainable growth over the longer run. This will require the following further interrelated steps:

- First, *fiscal policy should be gradually tightened by removing discretionary stimulus and by allowing automatic stabilisers to reduce the deficit as the economy recovers.* Fiscal consolidation will be necessary for stabilising public debt and ensuring fiscal sustainability. Strengthening fiscal institutions to increase fiscal transparency is necessary to fully implement the consolidation plan which was initially included in the 2010-2012 Medium Term Programme (MTP), and is expected to be reiterated in the 2011-2013 MTP, which was to be published during summer 2010. The credibility and transparency of fiscal policy would then mitigate potential negative effects of consolidation on domestic demand via enhanced international and domestic confidence.
- Second, *the Central Bank of the Republic of Turkey (CBRT) should maintain the hard-won credibility of monetary policy by removing the exceptionally large monetary stimulus as it has already foreshadowed.* The normalisation of the monetary stance has to ensure that the gradually declining inflation targets, to 5% at the end of 2012, are met, and thereby to entrench lower and stable inflation expectations. Achieving this goal calls for accompanying fiscal and structural policy measures.
- Third, *the international competitiveness of the business sector needs to be reinforced to avoid an excessive deterioration of the trade balance when growth strengthens.* This notably calls for improving labour and product market regulations to lower labour costs and to support market entry and investment in the higher-productivity, modern sector of the economy.
- Fourth, impediments to higher employment need to be removed to overcome the entrenched dualism between the highly productive and well protected jobs in the formal sector and low-productive and unprotected jobs in the informal sector. It is important to enact the well-identified labour-market reform agenda involving more flexible employment forms, lower minimum wages and lower taxes.

Stronger growth, higher income and saving, as well as social and political stability depend to a large extent on such a broad-based reform push.

The strength of the ongoing recovery gives grounds for well-deserved confidence about medium-term economic prospects, but the persisting structural weaknesses of the economy threaten the sustainability of strong long-term performance. Risks to the recovery remain predominantly external, not the least originating from the concerns about sovereign debt developments in some European countries.

**Table 1. Recent macroeconomic developments and near-term prospects**

	2004 current prices (TRY bn)	2005	2006	2007	2008	2009	2010 <sup>1</sup>	2011 <sup>1</sup>
		Percentage changes, volume (1998 prices), unless stated otherwise						
Private consumption	398.6	7.9	4.6	5.5	-0.3	-2.3	5.7	5.8
Government consumption	66.8	2.5	8.4	6.5	1.7	7.8	2.1	2.8
Gross fixed capital formation	113.7	17.4	13.3	3.1	-6.2	-19.2	13.2	8.1
Final domestic demand	579.1	9.1	6.8	5.1	-1.3	-4.3	6.4	5.8
Stockbuilding <sup>2</sup>		0.0	-0.1	0.6	0.3	-2.3	2.3	0.0
Total domestic demand	573.8	9.2	6.7	5.7	-1.0	-6.4	8.8	5.9
Exports of goods and services	131.7	7.9	6.6	7.3	2.7	-5.4	8.4	8.8
Imports of goods and services	146.4	12.2	6.9	10.7	-4.1	-14.4	16.8	13.6
Net exports <sup>2</sup>		-1.3	-0.3	-1.3	1.7	2.8	-2.1	-1.6
GDP at market prices	559.0	8.7	6.8	5.0	0.5	-4.9	6.8	4.5
GDP deflator		6.8	9.5	5.9	12.1	5.5	7.1	6.5
<i>Memorandum items</i>								
Consumer price index		8.2	9.6	8.8	10.4	6.3	9.5	6.6
Private consumption deflator		8.3	9.8	6.6	10.8	5.4	8.7	5.7
Current account balance (% of GDP)		-4.6	-6.1	-5.9	-5.6	-2.2	-4.5	-5.9
Nominal GDP (TRY bn)		649	758	843	951	954	1 090	1 213
General government financial balance <sup>3</sup> (% of GDP)		-0.7	-0.2	-1.6	-2.5	-5.8		
Public debt <sup>3</sup> (% of GDP)		52.3	46.1	39.4	39.5	47.8		

*Note:* National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. There are differences between national accounts data published by Turkstat and those used by the OECD, as the OECD calculates annual series from quarterly figures (for all member countries). There are also discrepancies concerning labour market series, which are due to differences in the definition of institutional labour force and of working age. The latter is defined in Turkey as “above 15” while the OECD defines it as “between 15 and 64”. See *OECD Economic Outlook Sources and Methods* ([www.oecd.org/eco/sources-and-methods](http://www.oecd.org/eco/sources-and-methods)).

1. *OECD Economic Outlook* projections, published in June 2010 (based on data available up to May 2010).
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
3. Turkish authorities' data.

*Source:* *OECD Economic Outlook 87 Database* and SPO (2009a), *Medium Term Programme*.

### *During the global crisis, Turkey was affected markedly by the foreign demand shock...*

During the global crisis, the peak-to-trough decline of Turkey's GDP of nearly 14% was the deepest in the OECD. The massive output contraction is largely explained by the unprecedented foreign demand shock, which prompted a free fall in exports and in turn in industrial output and investment and precipitated a sharp loss in business and consumer confidence, which greatly amplified the initial shock. This episode confirms that worldwide economic developments in general and Turkish export performance in particular are central for cyclical developments in Turkey, despite the rather low share of exports in GDP. Despite the sharp contraction of output, employment held steady, reflecting large-scale labour hoarding facilitated by wage adjustments, including cuts in informal wage payments, and employment support

measures. Nevertheless, due to strong working-age population growth and rising labour force participation, the unemployment rate increased by 3 percentage points to 14% in 2009.

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*... but the rebound has been stronger than expected*

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After four quarters of sharp contraction in output, GDP rebounded strongly beginning in the second quarter of 2009. The upturn was fuelled by robust export and private consumption growth. The recovery in Turkey was the strongest in the OECD area as measured by the cumulative increase in GDP from the trough until the first quarter of 2010 by over 10%.

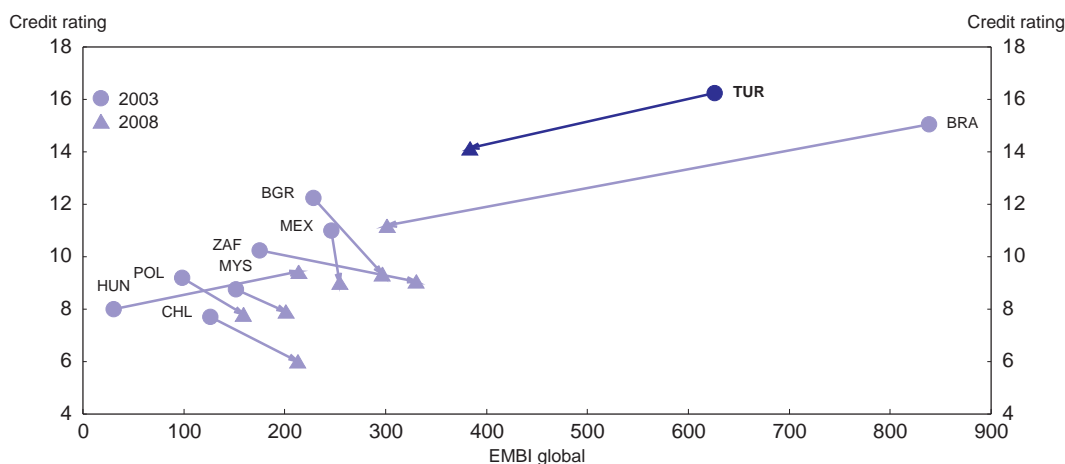
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*A strong macroeconomic policy framework and robust financial supervision yield a dividend on international capital markets*

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Economic development in Turkey has traditionally been characterised by booms and busts, reflecting tensions arising from competitiveness losses, over-indebtedness and the associated erosion in confidence. The strengthening of its macroeconomic policy framework in the 2000s broke this pattern and was rewarded with a considerable decline in risk premia. Further improvements of the fiscal and monetary policy framework and a continuous adaptation of financial sector supervision are necessary to safeguard this achievement, build on it and embark on a stable and rapid growth path to generate sustainable convergence with the OECD average income level.

**Figure 1. Credit rating and risk premia**



Source: Bloomberg, Datastream, Standard & Poor's and CBRT.

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*Fiscal performance needs to be consolidated given the serious fiscal challenges lying ahead*

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The budget deficit deteriorated primarily in line with automatic stabilisers. No fiscal cost was incurred on account of financial sector rescues and the public debt/GDP ratio remained below 50%. Transforming this good fiscal performance into a sustainable fiscal framework conducive to economic growth requires:

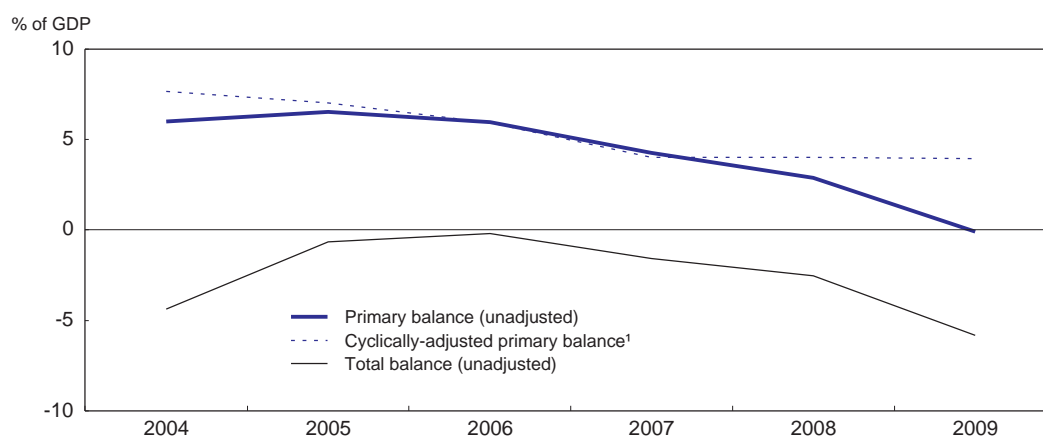
- i) restoring positive debt dynamics by returning to debt-reducing primary surpluses; any revenue windfalls should be used to accelerate consolidation;

*ii)* prioritising expenditure to respond to the steadily growing public spending needs in education, health, public infrastructure and other key public services while controlling aggregate spending;

*iii)* boosting revenue by reducing informality, widening the tax base, and shifting to a growth-friendly tax structure by, gradually alleviating the job-hindering social security taxes paid by the formal sector; and

*iv)* responding to ageing pressures by putting social security finances on a viable path taking account of the rapidly maturing demography.

**Figure 2. General government balance in the crisis**



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

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

### *The new medium-term fiscal programme and fiscal rule will help*

The authorities recently undertook two important fiscal policy initiatives.

- In order to preserve domestic and international confidence in the sustainability of public finances, the government announced in fall 2009 the MTP for the 2010-12 period. The MTP aimed at restoring debt sustainability by setting revenue, expenditure and balance targets for central and general government. The plan was based on a conservative macroeconomic scenario. It envisaged reducing the general government budget deficit (excluding privatisation revenues) from an estimated 7% of GDP in 2009 to 3.4% in 2012, and thus bringing the public debt/GDP ratio, which is expected to peak at around 49% of GDP in 2010, down to 47.8% of GDP in 2012. The new 2011-2013 MTP, which was due for June 2010, is expected to reiterate similar deficit objectives.
- The government submitted a draft fiscal rule law to Parliament in May 2010 and announced preparing the 2011 budget in compliance with it. The rule is to guide budgets based on deviations from the target budget deficit and the cyclical position. Both the MTP and the fiscal rule will provide highly welcome multi-year discipline. The draft was however not legislated in June 2010 as planned, and unfortunately its discussion was postponed. *Once adopted, the government should ensure rapid implementation. If a need arises after initial experience with the implementation of the rule, the authorities should stand ready to phase in a multi-year spending ceiling and a reserve account keeping track of accumulated deviations from deficit ceilings.*



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### *Achieving the intended improvement of general government fiscal transparency is crucial*

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Securing the transparency of fiscal outcomes and projections at the general government level is a prerequisite for implementing the MTP and the fiscal rule, and for addressing long-term structural fiscal challenges. Turkey has a good legal framework to secure the necessary degree of transparency, thanks to the *Public Financial Management and Control Law* (PFMCL). However, despite major progress in individual areas, the law is not yet completely operational and to date Turkey is still one of the few OECD countries which does not publish consolidated general government accounts according to international standards. The authorities reiterated that the publication of these accounts was imminent, but as of summer 2010 they were not yet released. However, the authorities already made available important components of the general government statistics. At the same time, quasi-fiscal activities outside the general government sector, after getting smaller in the first half of the 2000s, give signs of resurgence. Hence good complementary information is necessary for fiscal monitoring purposes. Against this background, *all provisions of the PFMCL must be enforced to ensure:*

- complete and consolidated quarterly general government accounts,
- full accounting of quasi-fiscal activities, such as the agriculture purchasing agency and the public housing administration, and
- credible audits, to guarantee the integrity of all accounts.

Producing a comprehensive fiscal transparency report and establishing an administratively independent monitoring agency to start an informed social dialogue on fiscal choices would strengthen the credibility of the fiscal framework.

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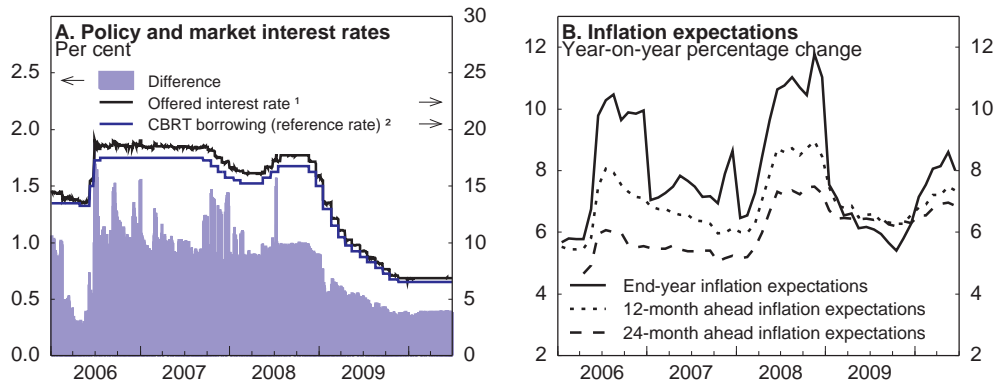
### *Inflation expectations should be kept anchored*

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Following the appropriately swift and large monetary stimulus in response to the crisis, policy interest rates have been left at historically low levels (6.5% for the overnight borrowing rate) since November 2009. In April 2010, the CBRT announced its exit strategy and started to withdraw liquidity measures introduced during the crisis. While the recovery has firmed and inflation peaked at double-digit levels, the monetary policy stance has remained expansionary. This stance has been motivated by CBRT's concerns regarding risks to external demand and the assessment that the increase in headline inflation is temporary. *The process of policy normalisation has already started through withdrawal of liquidity measures and should accelerate with an increase in policy rates before the end of the year.* The pace of removing the stimulus should be fast enough to avoid inflation expectations becoming durably unanchored. The increase in inflation and inflation expectations during the first half of 2010 creates risks, even if the recent inflation surge was driven primarily by one-off effects, and even if labour and output slack remains large. Over the medium term, inflation will crucially depend on the evolution of inflation expectations and all available tools at the disposal of the authorities should be used to avoid their upward drift.



Figure 3. Monetary policy



1. Turkish interbank overnight offered rate.
2. The reference rate before 18 May 2010.

Source: CBRT and Datastream.

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*The credibility of the inflation target would gain from a shift to continuous targeting and disinflation needs to be strengthened by structural policies*

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Until the end of 2012 inflation targets are set in terms of end-year inflation, which was the practice over the past five years. This approach is suitable during disinflation. However, as inflation is targeted to reach a relatively low level at the end of 2012, *shifting to a continuous target (as opposed to end-year targets) could be considered in the following years.* This might help sustain permanently lower inflation, better anchor inflation expectations and facilitate communication and accountability, including concerning the impact of temporary supply side shocks on inflation. As argued in the 2008 *Economic Survey*, disinflation needs to be supported by structural policies that are conducive to lower output and employment costs. In this regard, *maintaining fiscal discipline would be of key importance. In addition, competition policies should enhance the scope of competition in various service sectors. Authorities should also avoid measures that increase energy and food price volatility. When deciding on official minimum wages the fact that their impact on general wage formation will increase with reduced informality should be taken into account.*

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*Sustaining the robustness of the banking sector is key to stable growth*

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The robustness of Turkey's banking sector was a great advantage during the crisis and helped to support the recovery. The efficient functioning of the financial system will be instrumental for future growth by lowering capital costs for all borrowers in the economy, notably the small firms. *Turkey has to continue efforts to implement Basel II regulations and adopt any new amendments that are likely to be introduced following the global crisis.* Moreover, as the experience of many emerging markets demonstrates, shifting to an environment of low inflation and interest rates can lead to excessive credit growth and asset price bubbles. The authorities have already demonstrated their readiness to adjust prudential regulations pre-emptively by preventing households from taking foreign exchange loans. Evolution in the financial markets calls for constant vigilance and, if needed, for taking measures swiftly.

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*Turkey's international capital market standing is expected to improve further to the benefit of the entire economy*

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In the wake of its considerably strengthened macroeconomic policy framework and robust financial sector supervision, Turkey has significantly improved its terms of access to international capital markets, as witnessed by the ability to meet its external financing targets during the crisis. The open doors policy of the investors' relations office in the treasury may have helped to serve the information needs of investors during these turbulent times. As a result, during the crisis and in this post-crisis period, Turkey's risk premia evolved very favourably, significantly reducing the borrowing costs of government, banks and non-financial corporations. Turkey's sovereign credit rating was upgraded in recent months, although it has not yet reached "investment grade". Further improving Turkey's international capital market standing is important for lowering long-term capital costs and, thereby, stimulating long-term growth. Thus, *general government fiscal transparency and predictability should continue to be enhanced, external imbalances must be contained, the credibility of monetary policy and financial supervision must be sustained and the quality of public governance and the perceived political stability must be raised to higher levels*. However, in order not to waste the dividend of sound policy, far-reaching reforms to strengthen the supply side of the economy should be implemented.

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*The recovery has shown that economic and policy fundamentals are strong, but...*

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The recent crisis differed significantly from the previous recessions, regarding the contribution of macroeconomic fundamentals. Four factors are worth stressing:

- It was an external shock that triggered the recession, and not domestic macroeconomic imbalances as was the case in the past crises. The financial sector, which was re-capitalised and strongly supervised after the 2001 meltdown, proved very robust.
- The improved credibility of macroeconomic policy permitted the authorities to implement a countercyclical response without concerns about sustainability, increasing the impact of policy. Automatic stabilisers operated unconstrained, interest rates were cut to historical lows and liquidity support was provided.
- The strength of international confidence was very supportive: the country's risk premia rapidly reverted to their pre-crisis levels, keeping long-term borrowing costs of the government, banks and enterprises very low.
- Enterprises demonstrated remarkable flexibility and invention in adjusting to the drastically-altered situation in export markets. Given the weakness of the EU markets, they diversified into other markets (Asia, Russia, North Africa and Middle East) and increased their share in the traditional markets by improving the quality of their products and improving delivery terms.

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*...Turkey's interrelated structural weaknesses persist*

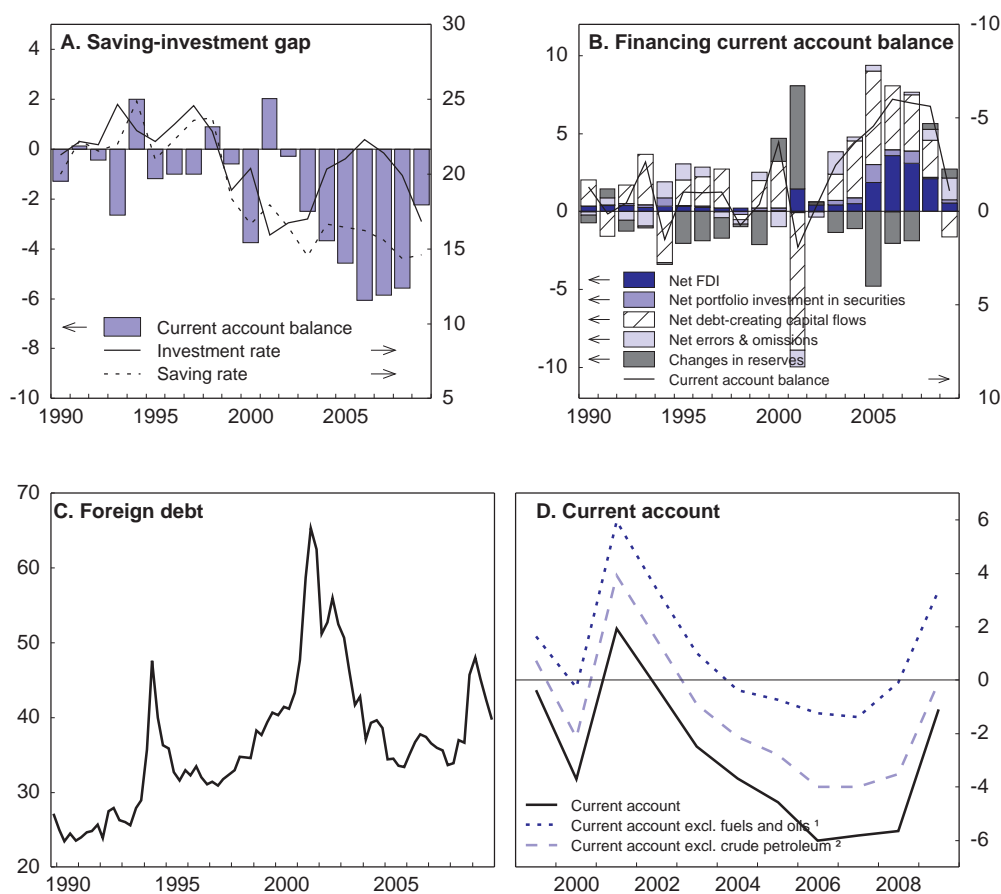
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Turkey suffers from two structural weaknesses which hinder growth. First, international price competitiveness tends to deteriorate during cyclical upswings, worsening the current account deficit. As growth strengthens, capital inflows gather pace, the exchange rate appreciates, and minimum and average wages in the official sector accelerate. As a consequence trade-exposed activities are squeezed, and so are business and household confidence, employment, income and savings. As a result of this recurrent pattern, the internal and external imbalances of the economy widen.

Second, and relatedly, the economy fails to make satisfactory use of its labour resources. Employment in industry and services does not grow strongly enough to absorb the rapidly growing working-age population and the high rate of migration from rural areas. Consequently, the employment rate, at just above 40%, remains the lowest in the OECD area. Migration to cities, combined with complex socio-economic factors, causes many women to withdraw from the labour force, keeping the employment rate for women at just above 20%, which is more than 40 percentage points lower than for men. The labour utilisation challenges are complicated by the recently accelerated shift in the manufacturing sector from low-skill intensive branches towards more capital intensive ones. The twin structural challenges of the economy are therefore related: the difficulty to improve durably the employment rate (the internal balance) goes together with the difficulty of equilibrating the trade and saving-investment balances (the external balance). As a result the economy risks being trapped on a path of low employment, income and savings with periodically large adjustments to restore internal and external equilibrium.

**Figure 4. External balances**

In % of GDP



1. Excluding net exports of processed and unprocessed fuels and oils and gasoline (according to Board Economic Categories).
2. Excluding only imports of crude petroleum.

Source: OECD, *OECD Economic Outlook Database*, IMF, *International Financial Statistics Database* and CBRT.

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### *Structural reforms can mitigate external imbalances*

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To avoid external balances undermining macroeconomic stability and sustainable growth, the authorities could consider measures to mitigate the excessive widening of current account deficits. This would primarily involve improvements in the competitiveness of the trade-exposed sector and increasing saving. In the recent past, high labour costs and real exchange rate appreciation led periodically to the deterioration of price competitiveness, resulting in export market share losses. Non-price competitiveness, *i.e.* the ability to innovate and improve product quality, has improved but is still limited to the small modern sector of the economy. Thus, public policies should boost both sources of competitiveness. This involves helping maintain employment costs in line with productivity, preventing excessive real exchange rate appreciation by keeping fiscal and monetary policy in line with the fundamentals of a rapidly growing catching-up economy, and supporting business development and innovation. Providing more information to social partners about the macroeconomic constraints for wage increases so as to avoid contributing to an accelerating wage-price spiral could help in this respect. Higher domestic saving would also help contain current account deficits. As the effectiveness of direct measures to lift saving, except for increasing budget balances, is limited, the authorities should focus on improving the employment and income generation potential of the economy. In the medium to long term, the current account balance would also benefit from lowering the energy import dependency through an ambitious energy policy to diversify towards renewable and environmentally-sound sources of energy, including nuclear energy. Given Turkey's specific geophysical conditions, particularly high safety standards for nuclear energy should be ensured.

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### *Job creation in the high-productivity, modern sector should be fostered through decisive labour market reforms*

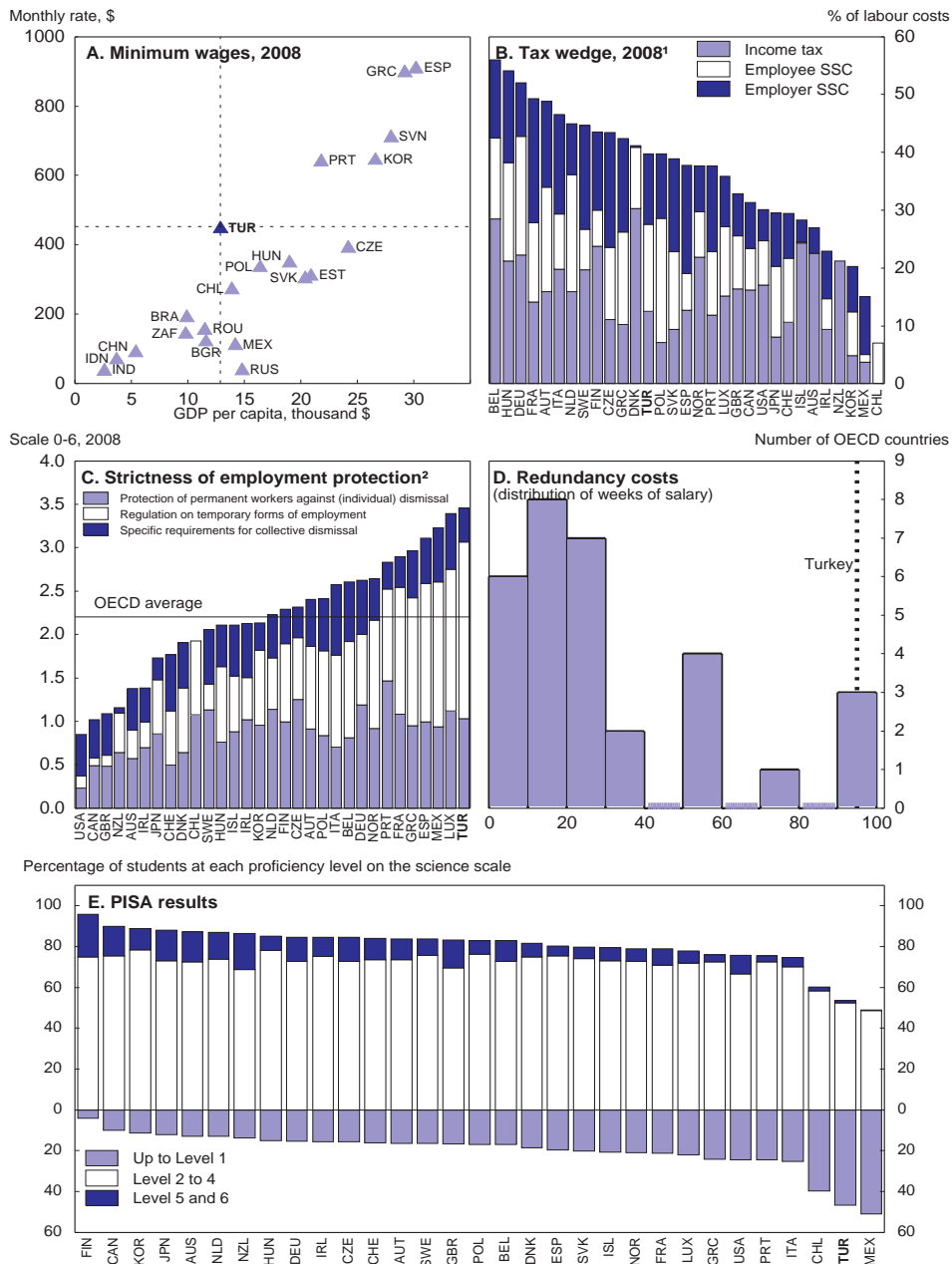
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As emphasised in past *OECD Economic Surveys*, the growth of the high-productivity and more competitive formal firms and their employment capacities are impaired by an unsupportive legal and regulatory framework. The primary problem pertains to labour market regulations, though there are also some challenges in product market competition. Turkey has one of the OECD's most protective, but also most costly, labour legislation environments. This concerns in particular the severance payment system and employment protection regulations for temporary workers. As a consequence employment creation in the formal sector remains subdued and a large part of business activity takes place in a semi-formal or informal sector. Five barriers to employment stand out, and as long as these obstacles are not tackled, the growth of jobs and incomes in the high-productivity, modern sector would continue to be severely hindered:

- The nation-wide minimum wage, at around 60% of the average wage, remains excessively high, particularly in regions and enterprises where productivity is too low to make them affordable, and where prevailing living costs would justify lower minimum wages.
- Compulsory social security contribution rates remain high, despite their recent reduction, creating a high wedge between gross employment costs and net worker incomes.
- Employment protection for permanent workers in the formal sector is very strict, notably due to one of the most costly severance payment systems in the OECD.

- Temporary work is highly constrained to specific circumstances, making its utilisation practically impossible in the formal sector.
- Despite recent modifications, the employee-related obligations of enterprises rise with the number of employees, discouraging firms from increasing employment beyond certain thresholds.

Figure 5. The labour market



1. Single person at 100% of average earnings, no child.
2. Index scale of 0-6 from least to most restrictive.

Source: ILO, *Minimum Wages database*; IMF, *World Economic Outlook*, October 2009; OECD, *Taxing Wages Database*; OECD, *Indicators of Employment Protection*; World Bank, *Doing Business*; and OECD (2007), *PISA 2006: Science Competencies for Tomorrow's World*.

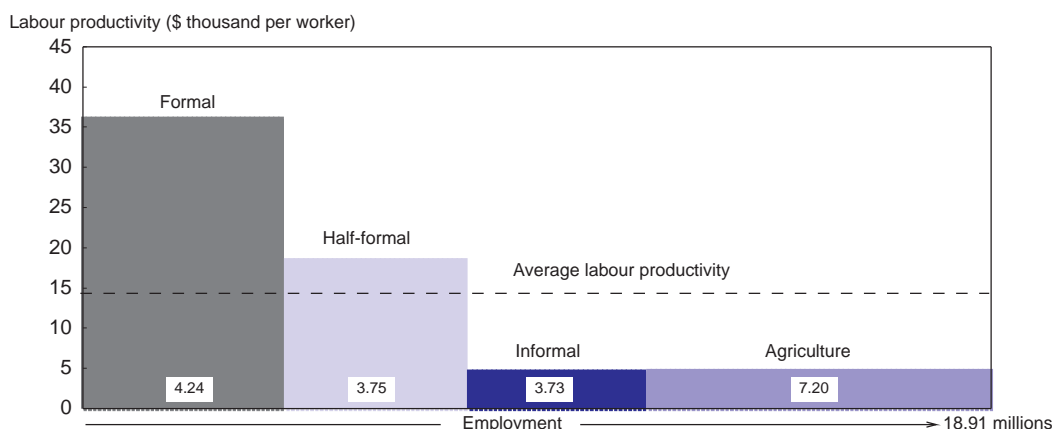
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*Semi-formality and informality have exhausted their potential to stimulate the economy, but remain entrenched*

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Escaping into semi-formality allows companies to achieve employment flexibility and reduce their labour costs, but forces them to operate at the margin of the law and deprives them of full access to financing, high-skilled workers and international co-operation. It therefore lowers their productivity. It has been estimated that labour productivity in the informal sector is 80% below, and in the semi-formal sector 40% below, that in the modern, fully formal sector. The contribution of semi-formality to the development of the Turkish business sector has therefore reached limits. The standard labour market reforms needed to free the development of formal businesses are well known, and acknowledged by the authorities, but political economy factors prevent their implementation. No progress has been achieved in reforming the minimum wage, the large severance payments or the temporary work systems. As in other OECD countries, the divergence of interests between labour market “insiders”, who are highly protected by the existing legal framework, and labour market “outsiders”, who are employed informally or remain inactive, makes reforms difficult. If this political economy challenge were to be addressed within a broad-based reform initiative, employment and growth-friendly reforms would be easier to implement.

**Figure 6. Labour productivity<sup>1</sup>**



1. OECD estimates as of 2006.

Source: TURKSTAT, SPO and OECD (2006a), OECD Economic Surveys: Turkey.

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*An integrated strategy could help remove the political economy obstacles*

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In the light of the experiences of other OECD countries, the authorities may need to consider a more integrated approach to reforms. Such an approach would involve a roadmap for indispensable labour market reforms combined with regulatory reforms in the business sector. Together with less distorting and lighter regulation, the ongoing formalisation initiative would receive a welcome boost. In order to overcome the deeply entrenched and multifaceted political economy obstacles, the design, marketing and sequencing of a broad-based reform package should be made a unifying goal of a nationwide consensus-building consultation process. In order to underpin this process with Turkey-specific information and experience, policy measures should be implemented on an experimental basis with transparent monitoring of impacts. Making clear that existing rights are respected should generate confidence in the process. The possibility of demonstrating how reforms improve performance and building trust with labour unions by improving the



enforcement of labour rights and easing restrictions on trade union activity should increase the likelihood of reaching consensus for a broad reform initiative.

The experimental part of this reform package could include the following elements: *i)* introducing more flexible and less costly legal employment forms (with lower minimum wages, lower severance payments and more flexible temporary work provisions) on an initially narrow and experimental basis; *ii)* supporting business enterprises making use of these new forms of employment, also with the help of other structural reforms (see below). Participation in such policy experiments, which are in widespread use in some OECD member countries, should be voluntary and would in principle be limited to new labour contracts. An example could be the possibility for employers to offer labour contracts with flexible working time. Further aspects in an experimental phase would also be most likely of a regional nature, like allowing regions to implement a minimum wage with respect to the average wage of the region as opposed to the nation-wide average. Successful regulatory innovations could then be rolled out more broadly, before being considered for nationwide implementation.

Turkey's welcome *Strategy of Fight against Informality* should thus be enforced together with, and not independently from, such legal and regulatory reforms. Once reforms are implemented, a larger number of enterprises can grow fully within the law, becoming financially fully transparent and technically more productive. Such higher-productivity and more competitive firms can provide their workers with higher wages and better job and income security. These can be negotiated with worker representatives in collective agreements, supported by the ongoing modernisation of Turkey's legislation in this area. Less well-performing enterprises, and the national labour law, can then progressively converge with these higher norms, on the basis of inclusive productivity and income growth in the entire economy. If a common understanding between social partners could be reached on such a path of regulatory reform, formalisation, economic growth and social progress, some of the political economy obstacles to reform could be removed.

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### *Target human capital building and upskilling*

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The general level of human capital should be considerably increased in Turkey. Ambitious two-pronged policies and reforms are needed: first to improve education standards to equip the future labour force with better skills; and second to improve the skills and employability of the existing large pool of low-skilled workers. On the first challenge, efforts should be intensified to improve education attainment and quality. Recent reforms of curricula in primary, vocational and technical secondary schools are a good start. Given evidence that pre-school education contributes importantly to human capital formation, increasing enrolment rates for pre-school education from their present very low levels could be targeted. The efforts to improve the links between the education system, in particular vocational schools, and the labour market should also be stepped up. On the second issue, ambitious upskilling programmes in close co-operation with employers are the way forward. The challenge of these programmes lies in defining target groups, identifying skill needs and choosing effective and fiscally affordable upskilling instruments. Recent government initiatives in this area have been promising. In this context, Turkey is invited to participate in the recently launched OECD *Programme for the International Assessment of Adult Competencies* (PIAAC). This would help generate new internationally comparable information on the human capital endowment of working-age population and help the government further its upskilling policies. Many of the recommendations from the in-depth education policy chapter in the 2006 *Economic Survey* are still valid and strengthening education policy measures in the medium-term policy priorities is welcome (See Figure 5).



*Productivity growth would benefit from freer competition and smart public support*

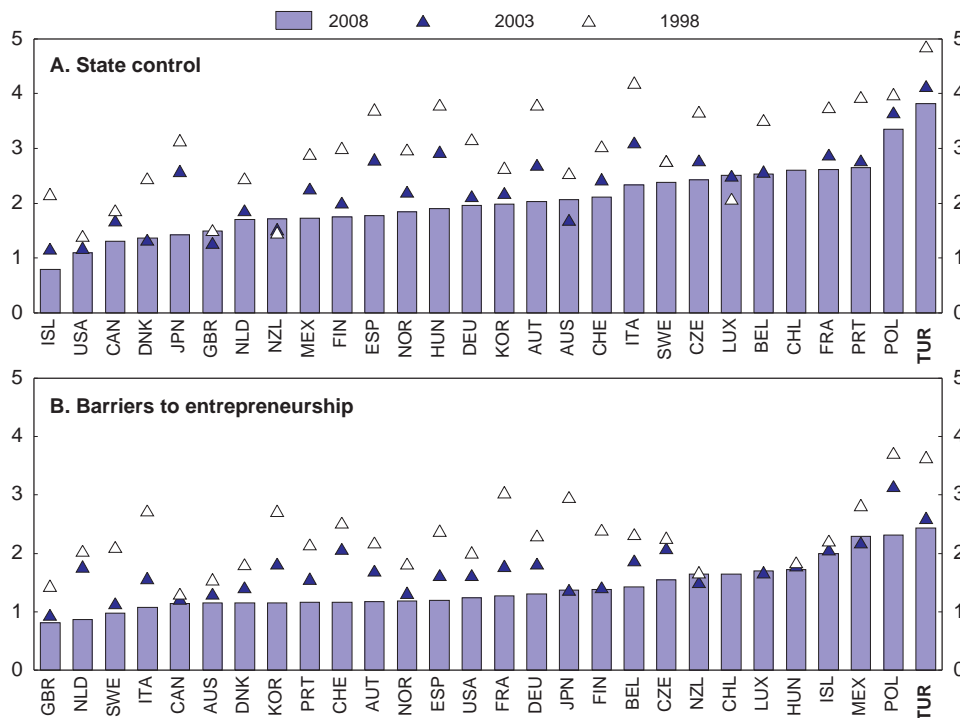
Although remaining barriers in product markets are less binding than in the labour markets, further relaxing anti-competitive product market regulations would stimulate productivity growth and put pressure on labour markets to be more flexible. In the light of OECD's analyses of Turkey's product market regulations, three issues stand out:

- reducing administrative barriers to formal entrepreneurship, in particular by implementing "one-stop shops" and "silence is consent" rules for company registration and some licensing steps;
- reducing government's involvement in business operations by eliminating the remaining price controls and by proceeding with unfinished privatisations in network industries; and
- further easing conditions for foreign direct investment.

In this regard, Development Agencies, which have recently been established in all regions of Turkey, offer an opportunity to improve business environment and to promote entrepreneurship and FDI through local actions. In addition, recent government incentives to enhance technological catching-up by supporting private R&D, technology transfer centres and co-operation between universities and private sector are welcome. Experience with Organised Industrial Zones (OIZs) also deserves special attention. Successful OIZs demonstrate highly positive externalities in terms of technology diffusion, the cost-effective provision of infrastructure and enforcement of regulations (including environmental norms). To ensure their efficiency and effectiveness, these policy measures should be continuously evaluated on the basis of their costs and benefits.

**Figure 7. Product market regulations**

Index scale of 0-6 from least to most restrictive



Source: OECD *Indicators of economy-wide regulation (PMR)* [www.oecd.org/eco/pmr](http://www.oecd.org/eco/pmr).

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*A stronger equilibrium path of growth is within reach, but calls for good policies*

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Turkey faces a large spectrum of future growth paths. On the higher side of this spectrum is a strong long-term growth path, involving enhanced competitiveness, higher employment, increased income growth, higher savings and lower external imbalances. This scenario is within reach but can by no means be taken for granted. It can only be achieved with good policies, which are also in line with the G-20 framework for strong, sustainable and balanced growth.

# Chapter summaries

## Chapter 1. After the crisis: ensuring sustained recovery and mitigating future macroeconomic volatility

Turkey is recovering from its most severe recession in several decades. The massive contraction in GDP is largely explained by the unprecedented collapse in foreign demand, which was aggravated in Turkey by negative confidence effects and structural problems with competitiveness prior to the crisis. In contrast to previous recessions, Turkey could afford counter-cyclical policies and the financial markets proved resilient. During the crisis, the authorities cut interest rates significantly and promptly and implemented fiscal stimulus. This truly novel experience was possible thanks to a better macroeconomic position, a sounder monetary and fiscal policy framework, and better financial market regulations. The immediate policy challenge is to gradually remove policy stimulus and address medium-term stability considerations in a way that does not jeopardise the recovery. Once growth gains full speed, the authorities will likely face the challenge of widening external imbalances and of ensuring a smooth functioning of the financial markets. The former will require improving competitiveness, raising domestic saving, attracting more FDI inflows and reducing energy import dependency. Improvements in many of these areas will require structural reforms in the labour and product markets.

## Chapter 2. Fostering sound integration with the global capital market

Turkey, like other fast-growing emerging countries, has significantly improved its terms of integration with the global capital market before as well as after the international crisis. Emerging markets' risk premia and interest rates are driven primarily by worldwide investment conditions and risk appetite, but steady progress in national economic fundamentals in the 2000s has considerably enhanced Turkey's credibility and reduced capital costs. In comparison to peer countries, Turkey has enjoyed a strong fall in risk premia, an important decline in domestic interest rates, but improvement in credit ratings has been comparatively slower. Taking place under an entirely liberalised capital account, the improvement of Turkey's access to the global capital market has broad effects on capital supply conditions in the entire economy. Real interest rates have declined, and funds of lengthened maturity are becoming available for a broader range of borrowers and fund users. This supports not only the post-crisis recovery, but also offers a basis for stronger and broader-based long-term growth. Estimates of this survey and academic research confirm that the prime determinants of international risk premia and credit rating include the fiscal situation, price stability, trade and growth performance, governance quality and political stability. Furthering improvements in these areas will help Turkey evolve into a fully normalised and resilient economy and foster its full participation in the global capital market.

## Chapter 3. Regulatory reforms to unlock long-term growth

In the 2000s, Turkey has enjoyed rapid catching-up thanks to improving macroeconomic framework, increasing openness to trade and foreign investment and the great entrepreneurial spirit of Turkish businessmen. This was possible against the adverse business environment, reflecting restrictive product and labour market regulations, since the semi-formal and informal economy had a significant contribution to the expansion of the private sector. Productivity growth was strong, but labour utilisation remained very low, affecting negatively social cohesion and the growth performance. Looking forward, higher employment and productivity growth will not be possible without profound regulatory reforms. They primarily require labour market reforms to lower minimum wages, possibly via regional arrangements, to reduce severance payments and social security contributions and to introduce more flexible forms of job contracts. These reforms have been discussed for a long time, but political obstacles prevented implementing them.

Resolving this deadlock calls for advancing an integrated strategy of labour reforms and formalisation via experimenting with new regulation on the voluntary basis to identify the most successful solutions that can be later rolled over to the whole economy. Moreover, Turkey has to ease further anti-competitive product market regulations by reducing barriers to entrepreneurship and foreign direct investment and by reducing government involvement in business. A successful implementation of these reforms would allow Turkey to enjoy golden decades.

*This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.*

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