Upgrading Turkey's macroeconomic policy institutions to boost the recovery after the COVID-19 shock

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Past OECD Economic Surveys of Turkey had underscored that Turkey's transition towards more transparent and rule-based macroeconomic – fiscal, monetary and macrofinancial – and structural – product, labour and capital market- policy frameworks would better mobilise the potential of the economy and Turkish people and deliver stronger and more sustainable growth.

In the aftermatch of the COVID-19 shock, the 2021 Survey emphasises that the need to strengthen policy institutions and frameworks remains central to facilitate the recovery from the pandemic and to support the transition to a less volatile economy.

To support the economy during the pandemic, the government has some fiscal space to take necessary measures, at least in the short-term. However, so far, policymakers have relied almost entirely on quasi-fiscal channels like public bank lending and government credit guarantees (see Figure 1). This helped to minimise the immediate fiscal bill of the pandemic, but at the cost of transparency of the subsidy and its targeting to the businesses and households most in need. Further costs for public finances may also come in the form of contingent liabilities of a yet undetermined magnitude. The 2021 OECD Economic Survey recommends that future support related to the pandemic should be provided in a more transparent and coherent fiscal policy framework. Such a coherent policy framework should encompass fiscal, quasi-fiscal but also monetary and financial policies. The publication of a regular Fiscal Policy Report would contribute significantly to increase the transparency of all public financial liabilities.

The pandemic has amplified Turkey’s longstanding monetary policy challenges. Inflation had remained well above target for many years before the pandemic. The OECD Survey recommends to restore a strong institutional basis for monetary policy by restoring the independence of the Central Bank, including with the help of legislative measures reinforcing the inamovibility and extending the tenure of its management. Establishing an active communication system on various aspects of its foreign reserve position would address information needs of domestic and international investors for a more detailed net reserves gauages.

Despite significant progress in the prudential regulation of Turkish banks following good international practices since the 2000s, the economic implications of the COVID-19 shock are adding to pressures on credit quality, already weakened by the turning of the credit cycle in recent years. One concern relates to the large weight of banking and credit channels in financial intermediation, with a resulting significant increase in debt leverage in the business sector. Further, the role of government-owned financial institutions and capital allocation regulations considerably expanded. Related risks in the overall operation of the financial system increased with the Covid-19 shock, as government support was mainly provided through credit instruments further increasing firms' and households' indebtedness. Public banks gained a large weight in credit markets, and prudential leniency mesures delayed the reporting of bad loans and adjustments in bank balance sheets. The OECD Survey recommends to reinforce the institutional basis of macrofinancial policies, with policymakers communicating actively on how they evaluate and address the risks of deterioration in banks' asset quality, publishing the results of the stress tests of individual banks and of the banking system as a whole, and involving the Turkish Competition Authority to ensure a level playing field between public and private banks, as well as between public and private borrowers in access to finance.

Strengthening Turkey's macroeconomic policy institutions would increase policy credibility, reduce risk-premia, encourage long-term capital inflows and help to boost the recovery. As a result, improved domestic and international confidence, lower risk premia and thus lower long-term interest rates would provide a more favourable foundation for strong and sustainable growth. Building on the remarkably entrepreneurial and young population and a very dynamic business sector, a strong macroeconomic foundation would allow well-designed structural policies to lift employment rates of women and men, job quality, household incomes and well being. A priority should be to address informal and semi-informal practices, for example by reducing high employment costs and rigid employment rules but also to remove any remaining regulatory barriers to the upscaling of smaller firms. Increasing the provision and quality of early child education would allow for more inclusive employment opportunities. Improving the eco-system for equity financing, for example through incentives in the corporate tax system, would provide the business sector with additional means to grow in the aftermath of the pandemic.

Reference

OECD (2021), OECD Economic Surveys: Turkey 2021, OECD Publishing, Paris.
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