

I. COUNTRY CONTEXT

A. Political and Social Context

1. **Turkey's economic development has global significance, given its size, role as a regional power, and strategic location, bridging East and West.** Turkey is a member of the Organization for Economic Co-operation and Development (OECD), as well as a regional power, bridging East and West. Turkey has one of the world's 20 largest economies, with a population of 70.6 million. Gross Domestic Product (GDP) reached US\$400 billion, and GDP per capita reached US\$5,500 in 2006, following a spectacular recovery from a deep economic crisis in 2001.⁶ Turkey is **one of the large middle-income partners of the World Bank Group (WBG).**⁷

2. **In parliamentary elections in July 2007,** Turkey's governing party (the Justice and Development Party) won an absolute majority in Parliament and a renewed mandate to form a single party government. In August 2007, Mr. Abdullah Gül, former Minister of Foreign Affairs, became Turkey's 11th President. The new Government is pursuing an ambitious program of economic and institutional reforms, underpinned by an agenda for comprehensive constitutional reform.

3. **The prospect of Turkey's European Union (EU) accession remains a key anchor of political and economic reforms.** The accession negotiations started at the end of 2005, but an impediment emerged soon thereafter, related to Turkey's obligation to implement fully the Additional Protocol (October 23, 1970) to the Agreement Establishing an Association Between the European Economic Community and Turkey (the *Ankara Agreement*, September 12, 1963). At the end of 2006, the EU decided to suspend the negotiations of 8 out of 35 chapters. Popular support for Turkey's EU accession is rather uneven in the EU member countries and has also weakened in Turkey itself. Notwithstanding temporary setbacks, the EU harmonization agenda and accession process are expected to continue in the years ahead. Indeed, the Government has prepared a six-year program of economic, social, and institutional harmonization with the EU *Acquis Communautaire*. In its Action Plan, dated October 8, 2007, the Government reiterated its commitment to implement EU-related reforms, highlighting their importance for Turkey's own development. Negotiations on one chapter, science and research, were opened and provisionally closed in June, 2006. As of October 2007, negotiations on three out of 35 chapters of the *Acquis* were open.

4. **Turkey has been successful in reducing poverty. At the same time, some social indicators lag behind those of countries with similar or higher incomes.** According to Government statistics, poverty was reduced from about 28 percent in 2003 to approximately 18 percent in 2006, pulling more than 7 million people out of poverty. Less than 0.01 percent

⁶ The Turkish authorities are completing work to update the data series for Turkey's GDP to account for the structural evolution of Turkey's economy. The update, which is expected to revise GDP upwards and to be released in the coming months, may affect key macroeconomic indicators.

⁷ Turkey is the largest borrower in the Europe and Central Asia Region, and it has been the third largest World Bank borrower in terms of new commitments of over US\$1.5 billion during the last three years. Turkey is currently IFC's fifth largest exposure after Russia, India, China and Brazil. As of September 2007, IFC's committed portfolio totaled US\$1.6 billion.

of the population is extremely poor, living on US\$1 or less a day.⁸ Nevertheless, infant and maternal mortality rates are well above those of most comparator middle-income countries, inequality is high, there are significant regional differences and migration to major urban centers continues at a rapid pace. Social inclusion remains a challenge.

B. Recent Economic Developments

5. **Turkey produced a spectacular recovery after the 2001 crisis and people's lives have improved significantly.** During the past five years, Turkey's vibrant private sector rebounded, and economic growth exceeded 7 percent on average. Inflation was brought down from 70 percent in 2001 to single digits, although the inflation target was significantly missed in 2006, in part on the account of high oil prices. Net public debt fell from over 90 percent of GNP in 2001 to 45 percent in 2006. Improved macroeconomic stability led to reduced spreads in international capital markets and higher levels of FDI, especially in the past two years.

6. **Good policies and credible external anchors have been critical for Turkey's economic success since the 2001 crisis.** Turkey's impressive economic performance is due first and foremost to credible and sustained stabilization, with strong fiscal discipline at its core, combined with an ongoing structural reform agenda. Two International Monetary Fund (IMF) programs, WBG support of the structural reform programs, and the beginning of the EU accession negotiations in 2005, constituted the external anchors of the successful program.

7. **The authorities implemented major reforms over the past five years.** In the financial sector, the Central Bank's independence was established and maintained, the banking sector was restructured, and the banking supervision was strengthened through the adoption of a new banking law and implementing regulations. In the public sector, the public procurement system was overhauled, and a new Public Financial Management and Control Law was adopted with a major impact on the transparency of public finances. In the agricultural sector, subsidies were drastically cut and replaced with direct income support. Privatization, especially in the past two years, picked up considerably. Privatization revenues in those two years (exceeding US\$16 billion) were almost twice as high as combined privatization revenues in the previous 18 years. The increase in Foreign Direct Investment (FDI) has been equally impressive. FDI inflows amounted to US\$2.9, US\$10 and US\$20 billion in 2004, 2005 and 2006, respectively. FDI inflows are expected to have reached US\$18.2 billion (about 3.7 percent of GDP) in 2007. This is an unprecedented sum in Turkey's history where annual FDI flows often amounted to no more than a mere US\$1 billion a year. Most recently, Turkey embarked on an ambitious social security reform, whose design has been supported by the Bank. The originally designed reform is currently being adjusted due to a ruling by the Constitutional Court from December 2006.

8. **Despite the good economic performance of the past years, macroeconomic vulnerabilities remain.** Turkey has weathered the recent uncertainties and the ongoing market volatility originating from US sub-prime mortgage losses, demonstrating much improved resilience of the economy. Nevertheless, the Turkish economy still faces significant risks arising from its large Current Account Deficit (CAD), at 8.2 percent of GDP

⁸ National poverty data, TurkStat.

at end-2006, comparatively high public debt burden, recent loosening in fiscal stance, and slowing disinflation process. The possible materialization of risks hinges on international as well as domestic events.

9. **Fiscal performance has been strong since 2002, notwithstanding a loosening earlier in 2007.** The primary surplus for the public sector averaged 6.7 percent of GNP in the period 2003-06. However, the large majority of public expenditures remain inflexible, including the public sector wage bill, transfers to cover the social security deficit, and servicing of public debt. This means the state has limited ability to invest in infrastructure and labor skills, and promoting Research and Development (R&D). The pending social security reform is critical for long-term fiscal sustainability. The 2007 primary surplus target of the overall public sector was revised to 6.7 percent of the Gross National Product (GNP) from 6.5 percent during the Sixth Review of the IMF Stand-By Arrangement (SBA). Nevertheless, the central government budget underperformed in the period January-October, 2007. In this period, the cumulative primary surplus of the central government, calculated as per the IMF definition, decreased by almost 36 percent on an annual basis—due partly to expenditure overruns in the first half of the year, and partly to lower than expected tax revenues as economic activity slowed down and domestic sales declined during 2007. In October 2007, the Government revised its year-end public sector primary surplus projection to 4.1 percent of GNP and set a headline primary surplus target of 5.5 percent of GNP for end-2008⁹. Achieving this headline primary surplus target is expected to be challenging unless revenue performance strengthens.

10. **The Central Bank adopted a formal inflation targeting regime in 2006.** According to the implementation framework, the inflation targeting approach adopted allows for reasonable flexibility, by attaching an uncertainty band of plus or minus two percentage points around the headline Consumer Price Index (CPI) program target. Reaching the historically low level of 7.7 percent end-year rate in 2005, inflation increased to 9.7 percent in 2006—at close to double the 5 percent end-year target. The annual rate of inflation at 8.4 percent as of November, 2007 was higher than the year-end target of 4 percent. Nevertheless, the Central Bank decreased its policy rate by 125 basis points between September and November 2007 in view of expected deceleration of prices in coming months owing to the lagged impact of monetary tightening. The end-2007 annual CPI inflation at 8.4 percent was above the upper uncertainty band.

⁹ See 2008 Annual Program and 2008 Economic Targets and Investments issued by the State Planning Organization.

Table 1: Selected Medium-term Macroeconomic Indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009
GNP Growth	-9.5	7.9	5.9	9.9	7.6	6.0	5.0	5.5	5.5
Investment (% of GNP)	18.4	16.7	15.6	17.9	19.6	21.0	21.0	21.5	21.6
Public	5.7	5.4	4.2	3.7	4.3	4.3	4.3	4.3	4.4
Private	12.7	11.4	11.4	14.1	15.3	16.7	16.7	17.2	17.2
CPI Inflation	68.5	29.7	18.4	9.3	7.7	9.7	8.4	5.2	3.9
Nominal Interest Rate	99.1	63.5	44.1	24.9	16.2	18.0	19.3	18.4	14.9
Current Account (billion \$)	3.4	-1.5	-8.0	-15.6	-22.6	-32.8	-36.0	-43.8	-41.6
Exports (f.o.b.)	34.4	40.1	51.2	67.0	76.9	91.9	112.7	129.9	145.9
Imports (f.o.b.)	-38.1	-47.4	-65.2	-90.9	-110.5	-133.2	-158.6	-182.3	-197.5
Capital Account (billion \$)	-14.6	1.2	7.2	17.8	43.7	45.6	49.4	52.3	48.3
Overall Balance (billion \$)	-12.9	-0.2	4.1	4.3	23.2	10.6	13.4	8.5	6.7

Source: Government, IMF and WB estimates.

C. *Medium-term Prospects*

11. **Conditions are in place for Turkey to sustain a growth rate of around five percent in the medium term.** The strong growth in private investment expenditure in the period 2004-2006 – despite a slowdown in 2006, and the robust industrial production growth starting from the last quarter of 2005 are indicative of the improved prospects for sustained growth and employment generation. The medium-term projection of economic growth averaging 5 percent annually during 2007-2012 is underpinned by: (a) strong external anchors, supporting enhanced confidence in the policy framework; (b) improved macroeconomic stability, which would stimulate private investment and consumption demand; (c) stronger export performance, which would permit faster import and output growth; and (d) strong external inflows, including FDI.

12. **Turkey's large Current Account Deficit (CAD) is a source of concern.** Together with the strong recovery in the economy, the CAD began widening in 2003. It continued deteriorating due to rising oil prices and the growing trade imbalance stimulated by the appreciation of the currency caused by reverse currency substitution and large capital inflows. After reaching a record high of 8.2 percent in 2006, the CAD to GDP ratio is expected to have narrowed to an estimate of 7.4 percent in 2007 due to slowing domestic demand and a moderate recovery in tourism revenues. In 2008, the CAD is projected to be around 8 percent of GDP again, because of the evolution in domestic demand, slowing global growth, high oil prices, and the recent appreciation of the YTL.

13. **The quality of financing of the current account deficit has significantly improved, though risks remain.** The share of non-debt creating inflows (FDI plus net errors and omissions) in total capital inflows grew to 51 percent in 2006 from 27 percent in 2004. Net FDI inflows reached a record high of US\$19 billion in 2006, corresponding to 4.8 percent of GNP and covering almost 60 percent of the CAD. Nevertheless, debt-creating inflows still account for a significant share of total inflows. Maintaining high levels of non-debt creating inflows will be important for the continued sustainable financing of Turkey's current account deficit.

Table 2: Baseline Debt Dynamics

Public Debt Forecasts (in % of GNP)	Actual							Projection			
	2001	2002	2003	2004	2005	2006	2007H1 4/	2007	2008	2009	2010
Gross Debt Stock	107.5	93.6	83.4	77.4	71.6	63.2	58.5	55.1	52.0	48.0	44.9
Gross Domestic Debt Stock	71.1	56.3	56.4	54.5	52.9	46.3	43.5	42.0	40.4	37.4	35.1
Net Debt Stock	90.5	78.5	70.4	63.5	55.4	44.6	40.7	39.2	36.2	33.2	31.4
Net Domestic Debt Stock	52.8	46.2	48.3	46.0	46.9	39.3	37.7	35.7	34.4	32.4	31.1
Domestic Interest Payments 2/	23.0	15.9	14.8	11.7	7.6	6.0	6.1	6.5	7.8	7.0	5.4
Dom Debt Amortization	25.5	24.7	24.3	29.2	27.6	20.6	17.6	15.2	13.6	7.9	9.0
PSBR 3/	16.7	12.5	9.6	4.8	-0.7	-0.7	2.2	2.4	2.1	1.7	1.1
Net External Debt Stock	37.7	32.3	22.1	17.5	8.5	5.2	3.0	3.6	1.8	0.8	0.3
Macroeconomic Indicators											
	2001	2002	2003	2004	2005	2006	2007H1 5/	2007	2008	2009	2010
Nominal Interest Rate (%)	99.1	63.5	44.1	24.9	16.2	18.0	19.3	18.4	14.9	12.4	10.6
CPI Inflation (% Dec/Dec)	68.5	29.7	18.4	9.3	7.7	9.7	8.6	8.5	5.2	3.9	4.0
GNP growth rate (%)	-9.5	7.9	5.9	9.9	7.6	6.0	5.2	5.0	5.5	5.5	5.0
Primary Balance (% of GNP) /3	5.1	4.2	6.3	7.0	6.8	6.7	4.3	4.1	5.5	5.0	4.0
1) For the Central Government											
2) For the Consolidated Public Sector											
3) Figures are in terms of annualized GNP as of June, 2007. Stock variables are as of June 2007; others are annualized as of this date.											
4) As of June, 2007.											
Source: WB											

14. **Foreign investors' substantial and growing exposure in Turkish assets—reflected in the rising share of foreigners' holdings in equity and bond market—has increased the economy's vulnerability to changes in global risk appetite.** As of November 2007, non-resident bond holdings amounted to YTL 35.7 billion, corresponding to about 31 percent of total market debt, while foreigners held almost 72 percent of Turkish equities. Such flows carry the risk of sudden reversals, due to a change in investors' risk appetite for emerging market assets. Turkey's flexible exchange rate regime and increased foreign exchange reserves help cushion against market volatility and mitigate the adverse effect of sudden reversals.

15. **Turkey's CAD is a particular concern because of its still substantial external debt.** The external debt to GNP ratio fell from 77 percent in 2001 to an estimated 50 percent in 2007. It is projected to increase in the near term, at a decelerating pace, before beginning to stabilize at the end of the CPS period. The projected upward trend in the period 2008-2009 mainly reflects an expected widening in the CAD in 2008. In this period, corporate sector external borrowing is expected to be the main driver of the projected increase in external debt ratio, as it has been in recent years. The gross external debt-to-exports ratio is projected to remain broadly stable, declining only moderately throughout the period.

16. The net public debt to GNP ratio, which fell from over 90 percent in 2001 to 45 percent in 2006, is projected to decline further, from about 40 percent in end-2007 to around 31 percent in 2011—in a scenario of sustained growth, adherence to fiscal discipline, and a stable external environment and exchange rate. (See Table 2 above). Either a lower than projected primary fiscal surplus or a depreciation of the Turkish Lira would imply correspondingly higher public debt as a share of GNP. Also, public debt remains sensitive to interest and exchange rate movements as floating rate notes and foreign exchange (FOREX) denominated debt accounted for about 57 percent of total debt stock as of June, 2007.

17. **The Central Bank has announced its goal to bring inflation down to 4 percent in the period 2008-2010.** In 2006, inflation had reversed its downward trend of the previous years and risen back to about 10 percent. In 2007, CPI inflation fell again to 8.39 percent—but inflation stayed well above the Central Bank’s 4 percent target and the upper uncertainty band of 6 percent. Nevertheless, the core CPI index – excluding energy, unprocessed food, alcoholic beverages, tobacco products and gold – remained around 6 percent during 2007. In the first months of 2008, possible increases in food and energy prices may lead to a temporary increase in annual CPI inflation. The annual CPI inflation is projected to fall to about 5 percent in end-2008.

II. TURKEY’S VISION AND KEY DEVELOPMENT CHALLENGES

Box 1: Government Program

The development program of the Turkish Government is set out in three key documents that outline Turkey’s overarching development goals, the medium-term reform agenda, and specific actions and responsibilities within the Government.

Ninth Development Plan 2007-2013: The Turkish General National Assembly approved this plan in 2006 and it has become Law No. 877. This framework provides a long-term perspective and represents unity in objectives by the public sector and civil society. It aims for an enhanced quality of life through an inclusive development process.

Government Action Plan: Separate short and medium-term plans translate the broader objectives of the Ninth Development Plan into specific operational actions for line ministries’ and Government agencies’ responsibilities. The Government issued a Quarterly Action Plan for the fourth quarter of 2007 and an Annual Program for 2008.

Program for Harmonization with EU Aquis: This is a detailed plan outlining the specific actions needed to be implemented to fulfill the 35 chapters for EU accession.

18. **The Government’s Ninth Development Plan for 2007-13 sets out a vision of Turkey with stable growth, a more equitable income distribution, and increased global competitiveness, as the country transforms into an information society and completes EU harmonization.** The development priorities embedded in the Plan are clustered around improved competitiveness and employment, equitable human and social development, and efficient provision of high-quality public services, with emphasis on the reduction of regional differences. The agenda for EU accession is a major cross-cutting theme. The following is a selection of Government action areas that are particularly relevant to the cooperation with the WBG.

A. Improved Competitiveness and Employment Opportunities

19. **Government policies aim to achieve sustained rapid growth and improved living standards through increased competitiveness and the creation of employment opportunities.** Maintaining sound macroeconomic policies, improving the investment climate, enhancing the flexibility of the labor market, upgrading the skills of the labor force, increasing access to investment capital, promoting the generation of knowledge and innovation, modernizing Turkey’s infrastructure and developing conditions for non-