Türkiye

country diagnostic

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Country diagnostics are a European Bank for Reconstruction and Development (EBRD) tool for identifying the main obstacles to entrepreneurship and private-sector development in the economies where it operates. They also help to shape the Bank's priorities and project selection in formulating new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in that country.

Each diagnostic assesses national progress and challenges in developing a sustainable market economy. Private-sector development and entrepreneurship are at the heart of the Bank's mandate, but in all of the Bank's investee economies, the private sector faces a range of problems and obstacles. The country diagnostic highlights the key challenges facing private firms and shows where each economy stands relative to its peers on the Bank's six transition qualities – competitive, well governed, green, inclusive, resilient, and integrated – highlighting the main deficiencies and gaps in each.

The diagnostics draw on a range of methodologies and best practices for assessing how big certain obstacles are. Extensive use is made of the Bank's in-house expertise and surveys, such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, the World Economic Forum and the Organisation for Economic Co-operation and Development (OECD).

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The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

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List of abbreviations

AI	artificial intelligence
CBAM	Carbon Border Adjustment Mechanism
CSO	civil society organisation
ETS	Emissions Trading Scheme
FATF	Financial Action Task Force
FDI	foreign direct investment
GHG	greenhouse gas
ICT	information and communications technology
M&A	mergers and acquisitions
MSMEs	micro, small and medium-sized enterprises
NDC	Nationally Determined Contribution
NPL	non-performing loans
OECD	Organisation for Economic Co-operation and Development
PPP	public–private partnerships
R&D	research and development
SOEs	state-owned enterprises
STEM	science, technology, engineering, and mathematics
TCMB	Central Bank of the Republic of Türkiye

Executive summary

Türkiye has advantages and potential when it comes to each of the six qualities of a sustainable market economy. The country's vibrant and resilient private sector and large domestic market position it well to be a manufacturing hub and to benefit from shifts in global trends. Its e-government initiatives have improved the business environment for firms and enhanced governance, advancing its digital transformation. Türkiye could be an energy trading hub thanks to its vast renewable energy potential and strategic geographical location. Its human capital base is solid and its demographics are favourable, giving it a potentially important comparative and competitive advantage. The financial sector has weathered domestic and global shocks and, together with growing capital markets, could provide the private sector with the long-term sustainable financing it needs to support its growth and development. Türkiye's infrastructure and location give it access to multiple regional markets and set it up to become a regional transport and logistics hub. Moreover, the country's close engagement with the European Union (EU) is a strong incentive for it to implement reforms and align with the EU acquis.

Türkiye needs to overcome the challenges facing the private sector to achieve its ambitions and realise its potential. For Türkiye to become a high-income country and secure a position among the world's largest economies, the authorities need to reinvigorate the structural reform agenda and address systemic issues affecting the country's long-term growth potential. This includes enacting the policies set out in the 12th Development Plan 2024-28 and the Medium-Term Programme 2024-26.

Between 2018 and 2023, the policymaking environment was volatile and focused on the short term. A strong presidential system was introduced in 2017, with decision-making concentrated in the presidency and ministries retaining a reduced role. A constantly depreciating currency, spiralling inflation and volatile interest rates have hit the economy. In addition, the period between 2018 and 2023 was characterised by low policy predictability, discouraging both foreign and domestic investors. Much-needed structural reforms have been postponed because of short-termism and pre-election promises. Despite these challenges, the economy, driven by the private sector, has shown considerable resilience to domestic and external shocks, including currency crises, the Covid-19 pandemic and fallout from Russia's war on Ukraine. This resilience is testament to Türkiye's strong economic potential and the business dynamism that has driven the economy forward, as well as the economy's ability to overcome problems arising from the unpredictable policymaking environment that has undermined it. Since June 2023, orthodoxy has returned to Turkish policymaking, prompting investors and ratings agencies to improve their outlook for the country. As presidential and parliamentary elections are not scheduled until 2028, the policymaking environment could become more predictable. Policymaking has already started to pivot towards long-term sustainable growth strategies that are coherent and coordinated across the entire economy.

Türkiye needs to escape the middle-income trap by increasing productivity. While the private sector has been resilient and competitive in world markets in many areas, the growth in competitiveness has slowed in recent years amid economic turbulence. Specifically, micro, small and medium-sized enterprises (MSMEs) have low productivity and face difficulties in accessing the skills and finance they need. In addition, they are struggling to adjust to the twin green and digital transformation. Large regional disparities in competitiveness persist, with those regions close to unstable neighbours struggling to attract investment and diversify their production.

Perceptions of governance have deteriorated in recent years, including on the rule of law, corruption, freedoms and intellectual property rights. Türkiye's international survey rankings on the perception of governance and corruption have deteriorated in recent years. The surveys point to declining standards in the rule of law, limited transparency on procedures, growing centralisation and a concentration of power, limited enforcement of intellectual property rights and difficult licensing arrangements. However, some progress has been made on strengthening governance through digital transformation, and as well as on the fight against money laundering and the financing of terrorism. Further reforms in this area have the potential to improve the business environment and investment climate substantially. Meanwhile, the regulatory and institutional framework supporting good corporate governance is relatively advanced.

The green transition and the decarbonisation agenda need to accelerate and become more ambitious. Türkiye is one of the countries in the EBRD regions most impacted by climate change, and energy-intensive industries could be highly affected by upcoming carbon tariff initiatives. The authorities' commitment to developing renewable energy is strong, underpinned by the country's abundance of wind, solar and geothermal resources and incentives to diversify towards renewable energy. However, further progress is needed on moving away from fossil fuels (particularly coal) and strengthening the regulatory framework for renewables. Plans to adopt carbon markets are advancing and low-carbon pathways for hard-to-abate sectors are being developed, but a long-term climate strategy is still a work in progress. Recent climate developments have highlighted the need to accelerate climate adaptation policies.

Türkiye's human capital development needs to catch up with Organisation for Economic Co-operation and Development (OECD) comparators. Significant disparities exist between men and women, preventing the private sector from reaching its full potential, while informality and skills mismatches are common, hampering the country's green and digital transformation. Regional inequalities are substantial in terms of access to services, skills and financing. Moreover, while Türkiye is one of the top refugee-hosting countries in the world by number of refugees hosted, there is a need to ensure that refugees can improve their lives and contribute to the economy through active participation in the labour market.

The private sector could benefit from greater access to finance. Türkiye's well-regulated financial sector has enjoyed significant growth since 2008 and banks benefit from high liquidity, profitability and asset quality, as well as relatively low rates of non-performing loans (NPLs). Meanwhile, Türkiye's financial sector is heavily dominated by the banking sector, notably public banks, which crowd out privately owned banks. While the banks have weathered the turbulent macroeconomic conditions well, recent years have also seen the emergence of a nascent non-bank financial services sector, which has significant untapped growth potential. There is also potential to increase private-sector access to long-term local-currency financing, including underserved segments of the population (such as women, youth, MSMEs and those in less developed parts of Türkiye), promote financial inclusion and support the private sector's contribution to long-term sustainable growth.

Türkiye's regional infrastructure quality needs to improve and to adapt to earthquake risks through greater disaster management and crisis preparedness. Türkiye has significant potential to become a transport and logistics hub, thanks to its geographical position, existing transport infrastructure and plans to expand the domestic transport network. The private sector could play a greater role in this area, and well-structured frameworks are needed to increase its participation. There is also a need to narrow regional gaps in the quality of and access to infrastructure, particularly municipal services, which are strained due to high urbanisation rates. The February 2023 earthquakes could have a lasting impact on Türkiye's growth path, finances, regional development and human capital. Post-earthquake reconstruction will be a priority for the foreseeable future, given the large needs involved. As with other sectors, progress on the country's twin green and digital transformations is crucial, including in the maritime, logistics and transport sectors, to improve Türkiye's participation in global value chains. Lastly, digital infrastructure and accessibility should be improved, to align with peers and allow Türkiye to capitalise fully on its vast potential as a regional hub.

1. Private-sector development in Türkiye requires a stable and predictable political and economic landscape

Türkiye's private sector is resilient, despite the unpredictable political and economic landscape. Since 2018, the operating environment for the private sector has been challenging. The introduction of a strong presidential system of government, with the president effectively standing over the other branches of the state, has resulted in the increased centralisation of power, exacerbating governance challenges. The private sector suffers from a policymaking approach that is driven by the long election cycle and guided by short-term considerations. The economy has been hit by the interplay between a constantly depreciating currency, spiralling inflation and volatile interest rates. In addition, recent years have been characterised by low policy predictability, which has discouraged both foreign and domestic investors. At the same time, Türkiye finds itself trapped in the middle-income bracket, with no significant advancement since 2018, and needs to implement much-needed structural reforms, which have been postponed because of the short-term nature of policymaking and pre-election promises. Nevertheless, the economy has shown resilience to domestic and external shocks, including currency crises, the Covid-19 pandemic and the fallout from Russia's war on Ukraine. This resilience is testament to Türkiye's strong economic potential. Going forward, the decision to hold presidential and parliamentary elections concurrently could promote greater policy consistency and a longer-term perspective. As the next elections are not scheduled until 2028, the authorities could have a window of opportunity to undertake reforms in line with the objectives set out in the 12th Development Plan 2024-28 and the Medium-Term Programme 2024-26.

Policymaking between 2018 and 2023 was volatile and strongly influenced by short-term political calculations

Geographical and economic factors underpin a pluralist political environment. Türkiye has powerful regional centres that counterbalance the central administration. The geopolitical mosaic that defines Türkiye's political economy is made up of Istanbul, the largest city in Europe, with a population of 15.7 million, Ankara (nearly 6 million people), Izmir (4.5 million) and a series of other urban regional centres with their own identity, bolstered by a diversified economy with a strong private sector. The main national parties have to maintain broad appeal to encompass Türkiye's diverse demography.

Political pluralism fosters a competitive electoral landscape. Many observers expected an opposition candidate to win the May 2023 presidential elections and, despite President Recep Tayyip Erdoğan's eventual victory, the contest went to a second round. The country's citizens are highly motivated to vote: the turnout in the first round of the 2023 presidential election was remarkably high, at more than 87 per cent. A competitive political landscape exists, despite the lack of a level playing field for opposition parties and more than two decades of Mr Erdoğan as Prime Minister, President and leader of the Justice and Development party (AKP). The March 2024 local elections were hard fought and the results in Istanbul and Ankara were unpredictable.

The combination of a highly competitive electoral landscape and weak institutions and governance has favoured a populist style of leadership. Accountability is maintained through elections rather than checks and balances. A charismatic leader such as President Erdoğan, experienced in inspiring voters with grand visions and projects, can thrive in such an environment. The downside is that decision-making has become focused on the President, while a governing style characterised by constant campaigning tends to lead to policymaking being guided by short-term considerations.

The shift to a more centralised political and administrative structure gained momentum after the attempted coup in 2016. After a referendum in April 2017, a series of constitutional amendments were adopted that introduced a strong presidential system and, in June 2018, Mr Erdoğan was elected to the new presidency. The post of prime minister was abolished and the President took over as chair of cabinet meetings. The supervision of ministries shifted to the Presidential Administration and became subject to tighter political control. International bodies with responsibility for monitoring democratic standards criticised the new system for lacking an effective separation of powers.

Economic policymaking during the 2018–23 period lost guidance from well-established bureaucratic institutions. Macroeconomic policies were not shaped in line with medium- and long-term policy documents, such as the Medium-Term Programme and development plans, and became short sighted. In 2018, President Erdoğan replaced Mehmet Şimşek as Deputy Prime Minister with responsibility for macroeconomic policy. Over the following five years (2019–24), the Governor of the Central Bank (TCMB) was replaced five times,[1] reversing a major gain of the reforms implemented in the early 2000s of granting greater independence to the TCMB. Towards the end of 2021, an unorthodox policy of progressively cutting interest rates in the belief that it would lead to a reduction in inflation was implemented (see below). The TCMB, surrendering to political pressure, lost sight of its inflation goal.

The introduction of a presidential system, combined with the waning of institutional and civil society accountability mechanisms, has weakened governance. Türkiye recorded sharp slippage on almost all the World Bank Worldwide Governance Indicators between 2017 and 2022 (see Chapter 3). A European Commission Report on EU Enlargement in November 2023 highlighted a series of governance reversals, including weak independence of the judiciary, restrictions on civil society and a lack of progress on tackling corruption.[2]

A key question for the future is how and to what extent a centralised, populist style of leadership is compatible with Türkiye's dynamic, pluralist and competitive economy. The two have coexisted for some time. However, slowing investment (particularly foreign direct investment [FDI]), stagnating growth in gross domestic product (GDP) per capita and worries about the competitiveness of exports suggest that this has come at a cost and that this coexistence may not be sustainable in the long term.

One major test would be the trajectory of Türkiye's long-term relationship with the EU, which needs to be strengthened. Close engagement and the continuing prospect of membership, even if long term, would ensure that the risks of democratic backsliding and governance reversals were limited. For the last two decades, EU accession talks have been pivotal in the modernisation of Türkiye's economy and business environment. After the European Council granted Türkiye the status of candidate country in December 1999 and accession negotiations were opened in October 2005, this presented a strong incentive for Türkiye to implement reforms and align with the EU's acquis.[3] However, accession negotiations have remained at a standstill since 2016, reducing the motivation to progress towards this anchor of the structural reform agenda. Nevertheless, Türkiye's greatest potential and advantage lie in its long-term relationship with the EU. On the one hand, this could provide direction for the country's economic reform agenda. On the other, any potential orientation of the Turkish economy towards less open, state-dominated economies would pose greater risks to democracy and governance. The Turkish authorities have cooperated with the United States of America, the EU and the United Kingdom on compliance with sanctions against Russia, although serious concerns remain relating to the re-routing of trade through Türkiye.

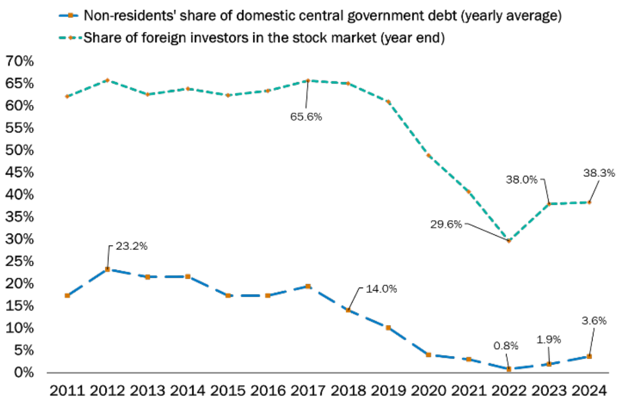
The economy has shown significant resilience in the face of a depreciating currency, soaring inflation, volatile interest rates and limited policy predictability

Turkish growth has demonstrated significant resilience in recent years, despite major challenges. Türkiye was among the few countries that managed to grow during the Covid-19 pandemic (by 1.9 per cent in 2020). In 2021, growth exceeded 11 per cent,[4] driven by private consumption and net exports. The 2022 growth rate (of 5.5 per cent) exceeded expectations and continued to be driven by private consumption, which was supported by credit measures as part of a set of unorthodox policies (see below). Growth remained robust in 2023, at 4.5 per cent, despite the impact of the February 2023 earthquakes (see Box 3), with nominal GDP exceeding the US$ 1 trillion threshold for the first time (estimated at US$ 1.1 trillion or €1 trillion), making Türkiye the 18th-largest economy in the world.[5] Moreover, the resilience of Türkiye's industrial sector, especially among large firms, is notable (see Chapter 2). The banking sector demonstrated robustness, effectively navigating periods of unorthodox monetary policy and their subsequent reversal (see below and Chapter 6). This resilience positions Türkiye well for continued economic progress, despite the challenges posed by global and domestic economic and political uncertainties.

[1] Murat Çetinkaya (TCMB governor since April 2016) was replaced in July 2019 by Murat Uysal, who stayed for 16 months before being replaced by Naci Ağbal in November 2020. The latter lasted only four months, before being replaced by Şahap Kavcıoğlu in March 2021. He remained during the period of unorthodox monetary policy, before being replaced by Hafize Gaye Erkan after the May 2023 elections. She resigned in February 2024 and was replaced by Deputy Governor Fatih Karahan.
[2] See European Commission (2023a).
[3] The collection of common rights and obligations that constitute the body of EU law.
[4] Only the third time on record that growth was in the double digits.
[5] After the United States, China, Germany, Japan, India, the United Kingdom, France, Italy, Brazil, Canada, Russia, Mexico, Australia, South Korea, Spain, Indonesia and the Netherlands.

The Turkish lira has depreciated sharply since 2018. In the decade to 2018, the Turkish lira depreciated by around 10 per cent on average per year against the US dollar. However, in the six years since 2018, the currency has lost around a quarter of its value per year on average, while in 2022 alone, it lost about half of its value. This was largely due to unorthodox monetary policy and political influence on the TCMB. In addition, the exchange rate management regime was unpredictable, with the authorities intervening at times to defend the currency, creating additional uncertainty. The currency instability and depreciation increased the cost of imports, raising production costs for businesses. This was particularly the case for firms that sell mainly in Türkiye and for which imported raw materials comprise a big part of total costs. However, the depreciation boosted exporting firms' competitiveness, notably those whose costs are mostly in Turkish lira (TRY). At the same time, the currency instability and depreciation influenced market sentiment significantly, leading to hesitancy among foreign and domestic investors. Türkiye is a low-savings country that needs to attract foreign capital to cover a persistent deficit in its current account. Since 2018, there has been a decline in the share of foreign ownership in the stock market (BIST) and TRY-denominated government bonds. By the end of 2023, the share of foreign ownership in the stock market had fallen sharply to 38 per cent from 65 per cent at the end of 2018 (Figure 1.1). Meanwhile, the share of foreign ownership of TRY-denominated government bonds had decreased to less than 2 per cent by the end of 2023 from 14 per cent in 2018 and a peak of 26 per cent in April 2013. Lower portfolio flows into Turkish bonds and shares have left Türkiye ever more reliant on short-term syndicated loans extended to local banks and vulnerable to the tightening of global financial conditions.

Figure 1.1. Share of foreign investors



Source: Turkish Statistical Institute.

Inflation spiralled during the same period, to the highest rates in a quarter century. Türkiye is accustomed to high inflation rates, averaging close to 40 per cent for the last four decades, and even higher inflationary episodes (for example, 70 per cent, on average, between 1988 and 2002) (Figure 1.2). In the following two decades to 2022, inflation was contained at around 10 per cent on average per year. However, in 2022–23, inflation accelerated sharply, averaging 72.3 per cent in 2022 and 53.9 per cent in 2023. This was the result of a combination of external and internal factors. The global economic challenges included the war on Ukraine and the resulting fluctuations in international commodity prices and supply-chain disruptions. Domestically, the challenges included the depreciation of the TRY, the easing of monetary policy as part of the TCMB's unorthodox policy, fiscal stimulus ahead of the May 2023 elections, tax hikes after the elections, and hikes in pay (increases in the minimum wage, public-sector wages and pensions). While pay hikes may have shielded wage-earners from the effects of past inflation to some degree, they fuelled future inflation, with market expectations consistently above the TCMB's estimates for the latter.

Central bank policies have fluctuated widely. In 2018, the policy interest rate was hiked three times from 8 to 24 per cent, due to the TRY crisis (Figure 1.3). The central bank began to cut rates in July 2019 and they reached an historical low of 8.25 per cent in May 2020 during the Covid-19 pandemic, before starting to rise again in September 2020 to contain inflation. However, in the period from December 2021 to June 2023, amid major turmoil at the helm of the TCMB, the policy rate was cut to 8.5 per cent, despite spiralling inflation, reflecting the President's view that cutting interest rates would lead to lower inflation, contrary to economic theory and the experience of countries around the world. In addition, other measures to spur growth and support the TRY were implemented, such as the foreign-exchange protected deposit accounts (KKM),[6] credit support measures[7] and other macroprudential measures.[8] However, in June 2023, orthodoxy returned to monetary policymaking and the policy rate was hiked nine times in ten months, by a cumulative 4,150 basis points to 50 per cent in March 2024 (it was maintained at this level in July 2024). Moreover, the TCMB started to phase out the KKM scheme, introducing selective credit-

[6] Which protects deposits from depreciation.
[7] Such as reducing the cost of borrowing for banks and consequently corporate loans, extending the repayment terms, and providing guarantees for loans, and creating new loan funds to provide cheaper financing to specific sectors.
[8] Such as a securities maintenance rule for foreign-currency deposits and for loans, a commission on foreign-currency required reserves, and export revenue conversion rules.

tightening measures and gradually removing the macroprudential measures. The return to orthodox policy has prompted ratings agencies to improve their ratings and outlooks for Türkiye, after a series of rating and outlook downgrades from late 2021.

Figure 1.2. Inflation (per cent)

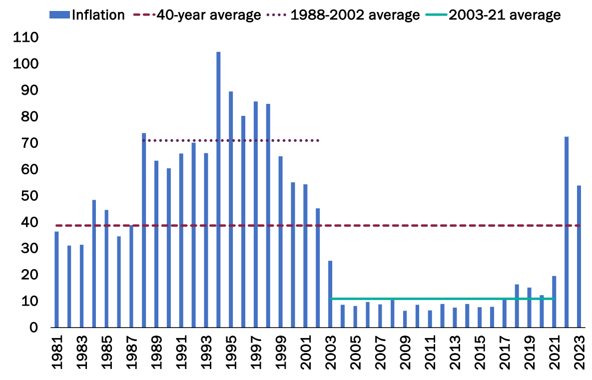
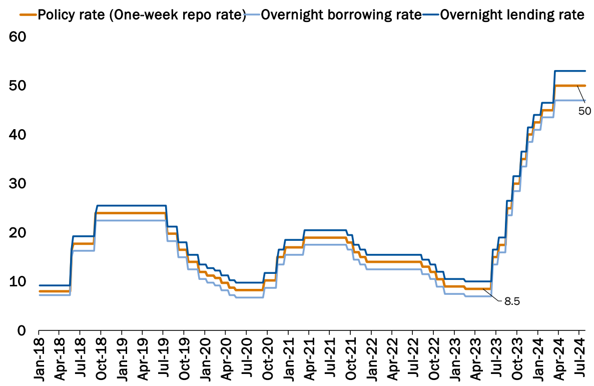


Figure 1.3. Policy rate (per cent)



Source: TCMB.

The period of unorthodox monetary policy, coupled with unorthodox fiscal policy, decreased predictability and increased uncertainty and short-termism. On the fiscal front, policies included reducing corporate and dividend tax rates and exempting certain goods and services, as well as domestic government bonds, from tax (the return to orthodoxy saw tax hikes). Added to that, four different individuals have held the post of Minister of Treasury and Finance since 2018.[9] These frequent shifts in policymaking, personnel and direction have posed significant challenges for businesses in terms of strategic long-term planning. Most key economic stakeholders, including public and private entities, both domestic and international, have been focused on the short-term outlook and objectives and are holding back much-needed investment. This short-term focus[10] is worrying, as the private sector needs to be able to forge medium- to long-term plans if it is to help realise Türkiye's potential.

Conflicting messages on the future of fiscal and monetary policy and economic plans impact businesses. Fiscal and monetary policy are likely to remain tight, limiting government spending (consumption and investment). Private consumption, meanwhile, could slow because of measures to combat inflation, such as limiting credit growth, which usually supports private consumption. However, governmental plans and programmes forecast growth to remain strong (see Boxes 1 and 2). The two potential drivers of economic growth, therefore, would be higher net exports and private investment, as public and private consumption and public investment could remain limited. Low growth in key markets, such as the EU, could curb growth in net exports, however, on top of the negative impact of disinflationary measures on export competitiveness. At the same time, difficulties in accessing finance and the prohibitive cost of borrowing (see Chapter 6) could cap private investment, already being held back by the political and economic environment. Hence, the drivers of growth remain unclear, complicating the decision-making process for private-sector firms, which may face difficulty in reorienting themselves and adjusting to challenges. They would benefit from clearer guidance from the authorities on growth strategies.

Fluctuating and unfavourable exchange, inflation and interest rates, coupled with heightened uncertainty, have caused profound disruption to the economic operating environment for the private sector. Investor confidence has been eroded, while the business climate has been destabilised and become more complex and challenging. High inflation has increased income inequalities[11] and production costs, complicated

[9] Naci Ağbal (Minister of Finance since November 2015) was replaced in July 2018 by Berat Albayrak (President Erdoğan's son-in-law), who became Minister of Treasury and Finance and stayed for over two years before being replaced in November 2020 by Lütfi Elvan. The latter stayed for a year and was replaced in December 2021 by Nureddin Nebati, who oversaw the unorthodox policy period. After the May 2023 elections, Mehmet Şimşek was reappointed as Minister of Treasury and Finance (he had held the role of Minister of Finance in 2009-15).
[10] For example, on the next minimum wage announcement, the next elections, the next inflation data release or the next monetary policy decision announcement.
[11] This is evidenced by the fluctuating share of compensation of employees in total gross value added, which decreased from 34.7 per cent in 2019 to 26.3 per cent in 2022 then increased to 32.8 per cent in 2023. In addition, the median household income in Türkiye saw a significant decline from US$ 8,134 (€7,264) in 2019 to US$ 4,395 (€4,171) in 2022, before slightly recovering to US$ 5,044 (€4,665) in 2023, further highlighting the growth in economic disparity.

pricing strategies for even the most agile firms, and fuelled uncertainty and caution. Inflationary pressures and other economic trials and tribulations have exacerbated the already present challenge of retaining skilled professionals and fuelled tensions between market players, such producers and consumers, employers and employees, property owners and tenants, and firms and suppliers. The interest-rate hikes have had a significant negative impact on borrowing costs and economic activity, and the effectiveness of higher interest rates in controlling inflation has weakened as the TCMB's credibility has declined. The volatile and politically influenced policy environment has reduced certainty and confidence.

Moreover, the composition and quality of growth has worsened. For years, growth has been driven by the high-productivity, export-led manufacturing sector, but a construction boom displaced manufacturing as the economy's engine in recent years. The construction sector is notoriously sensitive to interest rates, which factored in the unorthodox policy of keeping rates low. At the same time, on the demand side, consumption has overtaken investment and net exports as the main driver of the economy, reducing the quality of growth. On the one hand, private consumption has not been weakened by higher inflation, as consumers expected inflation to rise and resorted to frontloading major consumption decisions, particularly when it came to cars, white goods and imported luxury items. This trend has been reinforced by negative real interest rates, which encourage people to borrow and spend rather than save. Moreover, part of the population has a high propensity to consume and its wealth tends to increase in such turbulent economic times because of high dollarisation and some wealth being tied up in property, which increases in value. On the other hand, investment and exports have been held back by a variety of challenges (see Chapters 2 and 3).

Türkiye needs to escape the middle-income trap by boosting productivity and may see a window of opportunity

Türkiye is caught in the "middle-income trap", struggling to transition to higher income levels and to a growth model based on productivity and innovation. Broadly defined, the middle-income trap occurs when investment in innovation is low, export competitiveness is limited, the investment environment is challenging and inequalities are widening. While Türkiye is striving to shift from labour-intensive industries to sectors demanding higher knowledge and capital intensity, this transition faces several challenges, and there is a need to reform both the country's economic structure and human capital development.

Türkiye faces hurdles in its labour and export markets, hindering its competitiveness and the move to higher value-added manufacturing. Rising labour costs and skills mismatches impact Türkiye's ability to compete effectively in global markets. Brain drain and low labour participation rates, particularly among women, compound the difficulties in developing the skilled workforce necessary to advance innovative industries (see Chapter 5). These challenges have impeded Türkiye's ability to attract the necessary talent to drive growth in the higher value-added sectors. While several government initiatives have supported technological development and created opportunities to increase growth and productivity, modest research and development (R&D) investment[12] has hindered the advancement and diversification of export products.

Medium-term plans are in place, but implementation is crucial to success. Policymaking has already started to pivot from short-term reactive policies taken with the next elections in mind, which undermine economic development, to long-term sustainable growth strategies that are coherent and coordinated across the economy. The authorities published two important policy documents in 2023: the 12th Development Plan (2024-28) and the Medium-Term Programme (2024-26) (see Table 1.1 and Boxes 1 and 2). As the next elections are not due until 2028, the authorities now have an opportunity to push forward on key economic reforms and address the challenges and gaps outlined in the rest of this report, without having to worry about the short-term electoral consequences.

Table 1.1. Macroeconomic indicators

	Türkiye (2004–23, average)	Türkiye (2019–23, average)	OECD (2019–23, average)	Medium-Term Programme 2024–26 (average)	12th Development Plan (2028)
GDP growth (in per cent)	5.4	4.8	1.9	4.5	5.0
GDP per capita (US$)	10,078	10,179	43,001	13,816	17,554

[12] In 2019-21, Türkiye's gross domestic spending on R&D averaged 1.36 per cent of GDP, with an upward trend during the period. However, this figure was still considerably lower than the corresponding OECD average of 2.88 per cent.

Inflation (per cent, year on year, end of year)	16.6	38.3	5.2	18.9	4.7
Unemployment (per cent)	10.4	11.7	6.2	9.8	7.5
Central government budget (percentage of GDP)	-3.1	-4.1	-3.3	-4.2	-2.0
Current account balance (percentage of GDP)	-4.1	-2.7	1.0	-2.7	-0.2

Source: International Monetary Fund World Economic Outlook and national authorities.

Box 1. Türkiye's 12th Development Plan 2024-28[13]

The 12th Development Plan serves as a roadmap for Türkiye's economic and social advancement to 2028. It emphasises economic growth, innovation, green and digital transformation, and social inclusion, highlighting a comprehensive approach to development. Its commitment to human development, equality of opportunity, environmental sustainability and renewable energy reflects an understanding of the interconnected nature of modern economies and the need for holistic growth strategies. As such, the plan aligns with the EBRD's Strategic and Capital Framework over the five years to 2025, namely, the green, inclusive and digital transformation of the economies in which the EBRD operates.[14]

The plan lays the groundwork for a 30-year journey. It aligns with Türkiye's 2053 vision of becoming a high-income country and securing a position among the world's largest economies. It is a blueprint for an era of competitiveness and innovation, steering Türkiye towards a future of productive, technologically advanced and high-value-added export-oriented growth.

In terms of economic objectives, the plan targets an increase in GDP from US$ 1.1 trillion (€1 trillion) in 2023 to US$ 1.6 trillion (€1.4 trillion) by 2028. In addition, it aims to increase GDP per capita from US$ 12,415 (€11,509) in 2023 to US$ 17,554 (€14,851) in 2028. This shows the plan's focus on improving the economic wellbeing of individuals. An annual growth rate of 5 per cent is projected throughout the period, outlining the plan's economic growth ambition.

The manufacturing sector is set for growth and transformation, with its contribution to GDP expected to reach 26.9 per cent by the end of 2028. The plan sets ambitious sectoral targets for technological advancement: the share of medium-high-technology products in manufacturing industry exports is projected to increase from 37 per cent in 2023 to 44 per cent by 2028. Furthermore, the contribution of high-technology industries to manufacturing exports is expected to grow from 3.7 per cent in 2023 to 5.5 per cent in 2028. The services sector is also poised for growth, with its contribution to GDP anticipated to rise to 57.0 per cent by the end of 2028. The agricultural sector's contribution is projected at 6.2 per cent over the same period.

The plan envisions ramping up investments and implementing critical policy reforms, with a dedicated focus on the twin green and digital transformation across the economy. The plan underlines the importance of leveraging the twin green and digital transformation through large-scale investment, particularly in the key sectors of chemicals, pharmaceuticals and medical devices, electronics, machinery, electrical equipment, automotive and rail-system vehicles. It emphasises enhancing productivity and structural transformation in these sectors, with a view to fostering export-oriented, technology-intensive, high-value-added production. This sector-specific approach is part of a broader strategy to ensure sustainable and strong growth, compatible with the goal of twin green and digital transformation, thereby aligning with global economic shifts and technological advancements.

The plan places a strong emphasis on urban transformation, targeting areas at risk of natural disaster and those with structurally risky buildings. The aim is to foster healthy and safe living conditions through the transformation and widespread dissemination of information on safer living practices. This approach is integrated into the broader goal of enhancing disaster resilience, particularly in earthquake-prone areas.

In addition, the plan highlights a commitment to strengthening the rule of law, democracy, good governance, smart, sustainable cities, infrastructural investments in railways and ports, and investments in science, technology, engineering and mathematics (STEM) education and upskilling.

[13] See Presidency Strategy and Budget Office (2023).
[14] See EBRD (2021a).

Box 2. Türkiye's Medium-Term Programme 2024-26

Türkiye's Medium-Term Programme sets macroeconomic targets for the three years to 2026. It projects a steady increase in GDP growth from 4 per cent in 2024 to 4.5 per cent in 2025 and 5 per cent in 2026. Per capita income is expected to increase gradually, as highlighted in the 12th Development Plan. The unemployment rate is projected to increase slightly from 10.1 per cent in 2023 to 10.3 per cent in 2024, before declining to 9.3 per cent in 2026. The programme aims to create an average of 909,000 jobs annually. In addition, it outlines strategies such as vocational training, educational reform and public-private collaboration in critical industries. A forecast substantial drop in inflation to the single digits by 2026 reflects the TCMB's robust disinflation strategy. Key policies involve maintaining inflation targeting, the effective use of central bank tools and fiscal discipline. While taming inflation could be difficult and painful, Türkiye's experience in lowering inflation in the period after 2002 shows that, with commitment to the right policies, it can be done.

On the external side, the programme focuses on improving the current account balance through quantitative and qualitative growth in exports of goods and services. The target for exports is set at US$ 302 billion (€255 billion) for 2026, up from US$ 255 billion (€236 billion) in 2023, assuming around 6 per cent growth per year. This aligns with efforts to boost export and travel revenues, including tourism revenues, which are expected to exceed US$ 71 billion (€60 billion) in 2026.

On the fiscal side, the programme targets the Maastricht criteria for the fiscal deficit of 3 per cent of GDP by 2026. The deficit exceeded 5 per cent of GDP in 2023 because of earthquake-related spending and the fiscal stimulus ahead of the May 2023 elections. While the budgetary gap could remain high in 2024, it is expected to decline in 2025–26, reflecting a strong commitment to fiscal discipline while addressing critical needs, such as earthquake recovery.

On the financial side, proactive credit management and monetary policies are aimed at ensuring stability and attracting domestic and foreign investment. Objectives under the programme include enhancing investments in TRY and expanding the presence of non-bank financial institutions to bolster financial stability and integrate Türkiye's financial system globally.

Disaster management should improve, focusing on resilience, especially in earthquake-prone areas. The objectives of the programme are to strengthen frameworks, raise disaster awareness and redevelop affected regions to revitalise economic and social life.

The programme shows the authorities' commitment to a comprehensive green transition, targeting net-zero carbon emissions by 2053. Priorities include renewable resources, energy efficiency, electrification and the circular economy. This entails climate-focused regulation, a national emissions trading scheme (ETS) and a low-emissions strategy (see Chapter 4).

The programme also aims to improve governance by simplifying administrative processes, encouraging private-sector investment and strengthening legal frameworks. Key measures include judicial efficiency, alternative dispute resolution and better enforcement. Streamlining permits, expanding digital processes and prioritising value addition, technology, research, green and digital transformation are focal points.

Box 3. February 2023 earthquakes underscore need for disaster preparedness and coordination

The earthquakes in February 2023 had a devastating impact on Türkiye, highlighting the need for greater disaster management and crisis preparedness.

On the humanitarian side, the confirmed death toll exceeded 50,000 in Türkiye. The earthquakes struck regions that are home to about 15 per cent of Türkiye's population.

The immediate aftermath saw over US$ 34 billion (€32 billion) in damages, equivalent to around 4 per cent of Türkiye's annual GDP.[15] The broader economic ramifications are extensive, with the overall cost estimated at US$ 84.1 billion (€78 billion).[16] This includes US$ 70.8 billion (€65.6 billion) for housing, US$ 10.4 billion (€9.6 billion) in lost national income and US$ 2.9 billion (€2.7 billion) in lost working days. These statistics underscore both the immense short-term direct financial strain and the longer-term economic challenges that Türkiye faces on its path to recovery and rebuilding.

The earthquakes have intensified Türkiye's pre-existing economic issues and regional disparities by impacting particularly economically disadvantaged areas. The affected regions contribute under-

[15] See World Bank (2023a).
[16] See Turkish Enterprise and Business Confederation (2023).

proportionally to Türkiye’s economy: 9 per cent of GDP, 11 per cent of income tax and 14 per cent of revenue from agriculture and fisheries.[17] The disaster exacerbated issues in infrastructure, economic capacity, agriculture and rural economy, leading to increased job losses, a reduction in incomes and deepening poverty, not least because of the region’s high share of refugees, mostly from Syria.

Potential long-term displacement from these areas could further deplete human capital, intensifying regional economic disparities. It is estimated that 3-4 million people have been displaced and only a small share of those that have relocated to other urban centres have returned to the region. This situation underscores the need for targeted recovery efforts to address the unique challenges faced by these regions and promote equitable development across Türkiye.

The response to the earthquake, including aid for the 13.5 million people affected and reconstruction, would increase the budget deficit. This rise in government spending occurs in the midst of Türkiye's efforts to maintain fiscal balance.

The focus for Türkiye's long-term recovery lies in effective rebuilding, policymaking and enhancing resilience against future disasters. Prioritising sustainable urban development and disaster preparedness are crucial to Türkiye's stability and growth. A master plan with sustainable, smart, and green solutions is needed.

[17] See Turkish Enterprise and Business Confederation (2023).

Transition indicators: Six qualities of a sustainable market economy

The EBRD transition indicators reflect Bank economists' assessment of the transition progress of the economies where the Bank invests. A sustainable market economy is characterised by six qualities: competitive, well governed, green, inclusive, resilient and integrated. This approach measures the status of each quality in a country, compared with the other economies in the EBRD regions.[18]

In the EBRD's 2023 Assessment of Transition Qualities (ATQs), Türkiye was more resilient (11th) and competitive (12th), but less green (21st) than the other economies in which the Bank invests (Table 1.2). However, relative to central Europe and the Baltic states (CEB), Türkiye lagged on all qualities, particularly the green and inclusive qualities, signalling the need to accelerate the transition to bridge the gap (Figure 1.4). Overall, based on a simple average of the six quality scores, Türkiye ranked 13th out of the 36 economies in which the EBRD operates.

Türkiye's average score was 5.68.[19] The country scored highest on the "resilient" (6.96) and "well-governed" (5.84) qualities, while its lowest scores were for the "green" (5.09) and "inclusive" (5.14) qualities. Relative to 2016, Türkiye became greener (up 0.34 point), more inclusive and integrated. However, it was worse governed (–0.12 point), less resilient and less competitive.

Figure 1.4. ATQs, 2023

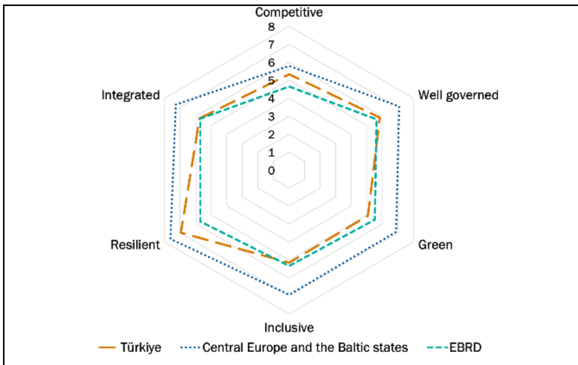


Table 1.2. Türkiye's ATQ scores and rankings, 2023

	2016	2023	EBRD ranking (out of 36)
Competitive	5.33	↓5.32	12
Well-governed	5.96	↓5.84	19
Green	4.75	↑5.09	21
Inclusive	4.88	↑5.14	19
Resilient	6.98	↓6.96	11
Integrated	5.71	↑5.75	17

Source: EBRD calculations.

[18] See EBRD (2023).

[19] The EBRD's ATQ scores are based on a distance-to-frontier approach, with the best-performing countries used as benchmark. The resulting scores are rescaled from 1 to 10, where 1 represents little or no progress and 10 represents the frontier.

2. Competitive: Preserving Türkiye's private-sector competitiveness necessitates upgrades in productivity

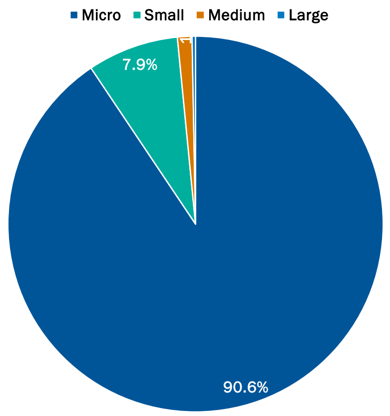
Competitive ATQ score = 5.32/10 (12th out of the 36 economies in which the EBRD operates)

Türkiye's private sector has been resilient, with a rapidly growing financial sector and a major tourism industry. Türkiye is competitive in world markets in several areas, playing a lead role in sectors such as transport, construction, electronics and home appliances. However, the growth in competitiveness has slowed in recent years amid economic turbulence, and the dichotomy between the landscape for large firms and that of MSMEs requires tailored policies to increase the overall productivity of private firms. MSMEs generally have low productivity and face difficulties in accessing the necessary skills and finance. In addition, they struggle to adjust to the digital transformation. Large regional economic disparities persist, with those regions close to unstable neighbours struggling to attract investment and diversify their production. Preserving and enhancing private-sector competitiveness is crucial in order to capitalise on Türkiye's entrepreneurial spirit and many comparative advantages, and to meet the ambitious targets set out in the five-year development plan.

Türkiye's resilient private sector is the fundamental pillar of the economy and is dominated by MSMEs

The private sector is the driver of the economy and has proved resilient despite consecutive shocks. It constituted 97 per cent of Türkiye's top 500 industrial firms as of 2023 and accounted for 97 per cent of turnover, 95 per cent of value added and 78 per cent of investment.[20] The economy is characterised by a few large, innovative and internationally integrated firms (11,212), a growing number of medium-sized family firms (47,323) with limited innovation and international presence, and a large tail MSMEs (more than 3.726 million) (Figure 2.1).[21] The private sector has shown resilience in recent years, despite successive shocks, such as the presidential election and the TRY crisis in 2018; the 2019 local elections, resulting in the opposition control of major cities; the Covid-19 pandemic in 2020; the war on Ukraine in 2022; and the February earthquakes and presidential and parliamentary elections in 2023.

Figure 2.1. Distribution of firms by size, 2022



Source: Turkish Statistical Institute.

There is a divide between large firms and MSMEs in terms of the challenges they face and the opportunities they forego as a result of political and macroeconomic uncertainty. Large firms, often conglomerates, account for a sizeable portion of value added (63.6 per cent) and employment (29.4 per cent) and have strategically diversified across various industries and export markets, providing a buffer against economic volatility and a boost to productivity (figures 2.2 and 2.3). Often, these large firms are conservatively run and well adapted to economic volatility, contributing to their sustained performance; some are joint ventures with European firms. Türkiye's history of high inflation and economic instability has equipped these businesses with the expertise to manage financial challenges effectively (see Chapter 1). Medium-sized family firms are equally nimble at dealing with economic volatility and have adjusted well, for example, by reducing dollar debts and adjusting to a depreciating lira since 2018. However, medium-sized firms often resort to informality, with some workers on the books and others not. Lastly, smaller firms adjust through informality as well as by other means. The line between firm and household in smaller companies is blurred, with risks pooled among family members. Moreover, four-fifths of the workforce in smaller firms puts in more than the usual 40 hours a week in their main job in response to adversity, one of the highest shares in the OECD,[22] though long hours often translate into low labour productivity.

[20] See Istanbul Chamber of Industry (2024).
[21] See Turkish Statistical Institute (2023a).
[22] See OECD (2024).

Figure 2.2. Distribution of firms by employment, 2022

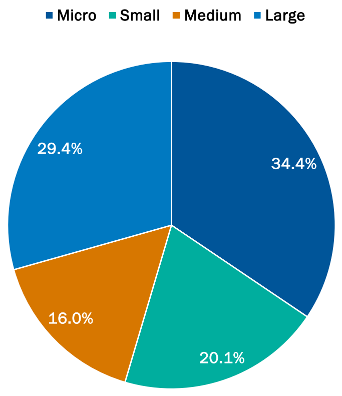
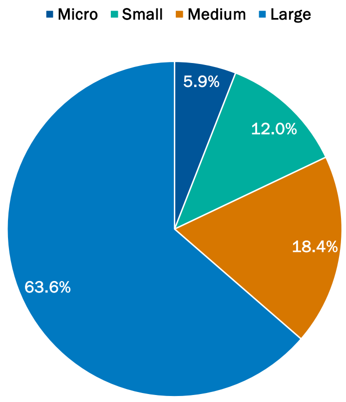


Figure 2.3. Distribution of firms by value added, 2022



Source: Turkish Statistical Institute.

MSMEs play a substantial role in the economy, but are mostly characterised by low productivity. They account for 70.6 per cent of employment (Figure 2.2), significantly above the EU average of 64.4 per cent.[23] They also account for 36.4 per cent of added value (Figure 2.3). MSME productivity, measured as value added per person employed, was around TRY 154,971 in 2022 (€7,733 at the then exchange rate), only one-sixth of the EU average of €46,483. Efficiency, scale, strong reliance on family members in management and weak governance often prevent mature MSMEs from expanding.

MSMEs need to adapt and transform to remain competitive. Amid intensifying global competition, firms need to engage in innovation and improve efficiency to adapt to shifting consumer preferences and technological advancements. Moreover, regulatory changes – for example, in the EU's green and digital standards and compliance requirements – add another layer of transformation and adaptation needs for MSMEs, to ensure they align with regulations and protect their role in supply and value chains in the context of the Customs Union with the EU. In addition, to adapt and transform, MSMEs need significant investment and access to finance, as well as policy support, as they do not have the financial capacity and expertise to implement the necessary changes, such as in the area of decarbonisation (see Chapter 4). MSMEs need to enhance their productivity, innovate and improve their ability to compete on a global scale. To bridge this gap, they must focus on increasing their value-added per employee, enhancing their export capabilities, and adopting more efficient and modern business practices. This transformation could involve using new technologies, improving access to finance and markets, and fostering a more supportive ecosystem for business growth and innovation. As the global economic landscape evolves, the ability of MSMEs to adapt and transform is crucial to Türkiye's overall economic health and competitiveness and to its escape from the middle-income trap.

Services, including trade, and manufacturing are the main sectors driving the economy

The services sector dominates the economy. It generates more than 50 per cent of GDP and employs 56.3 per cent of the workforce, encompassing a wide range of activities (Figures 2.4 and 2.5). Financial services, mainly banking, are growing rapidly (see Chapter 6). Türkiye is among the top five tourism destinations worldwide, attracting over 40 million visitors annually in recent years (except during the Covid-19 pandemic). Türkiye's strategic location, connecting Europe and Asia, makes it a vital transportation and logistics hub (see Chapter 7). Education and healthcare, two sectors where Türkiye has invested heavily, contribute to its sustained growth.

23 See European Commission (2023b).

Figure 2.4. Sectoral share of GDP (2023, per cent)

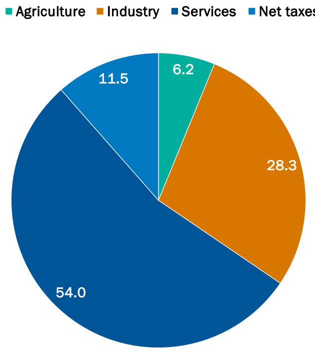
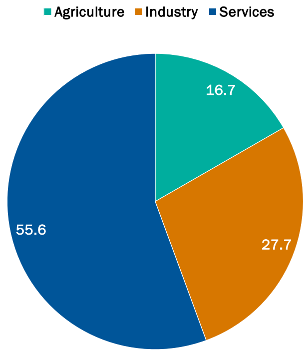


Figure 2.5. Sectoral share of employment (2022, per cent)



Source: World Bank World Development Indicators.

Turkish trade has made a strong contribution to economic growth over the past two decades, but remains low compared with peers. The liberalisation of tariffs on most industrial products as a part of the Customs Union with the EU since 1995 and the negotiation of free trade agreements have driven growth. Türkiye is among the world's leading producers of agricultural products, textiles, motor vehicles, transportation equipment, construction materials, consumer electronics and home appliances. Nevertheless, trade as a share of GDP, at 67 per cent in 2023, is lower than that of central Europe and the Baltic states (125 per cent of GDP), but higher than that of the OECD countries (64 per cent of GDP) and the average of the world’s upper middle-income countries (47 per cent of GDP).[24] Türkiye has improved its trade competitiveness by digitalising trade and customs procedures, including adopting single-window applications for customs (that is, the BILGE platform) and using digital technologies, such as blockchain and artificial intelligence (AI), in trade and exports. Foreign ownership remains limited outside the manufacturing and financial sectors, which have accounted for 55 per cent of FDI inflows since 2002. However, FDI inflows in Türkiye are lower than those of its peers; as a share of GDP, FDI was 1.5 per cent in 2022 (US$ 13.6 billion or €12.9 billion), below that of central Europe and the Baltic states (3.1 per cent of GDP) and upper middle-income economies (1.6 per cent of GDP). While net FDI in US dollar terms in 2021-22 was slightly above the average of the last two decades and reversed a declining trend since 2015 (Figure 2.6), it decreased in 2023 and, relative to GDP, was low by historical levels and below the levels of the mid-2000s, when Türkiye followed a more orthodox policy route (Figure 2.7). Moreover, while existing foreign investors have maintained their operations in Türkiye, new investors have been reluctant to invest there, mostly due to challenges inherent in the investment climate, including governance issues (see Chapter 3).

Figure 2.6. Turkish FDI (US$ billions)

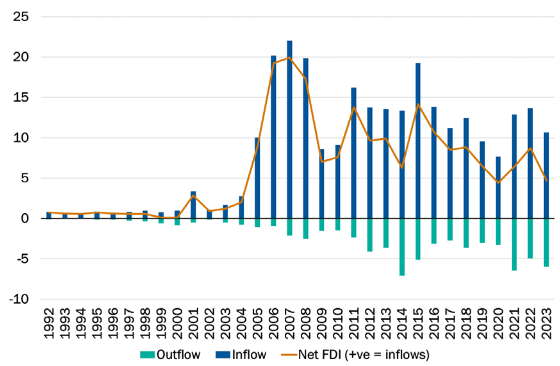
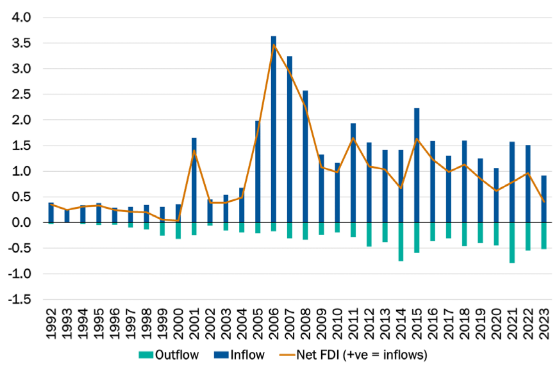


Figure 2.7. Turkish FDI (percentage of GDP)



Sources: TCMB.

24 Other things being equal, large economies tend to have a lower share of trade to GDP than small economies.

The manufacturing sector has undergone major transformation since the start of the Customs Union with the EU, but productivity remains an issue. Türkiye's industrial evolution has been marked by a gradual shift from traditional sectors (such as textiles and food processing) towards medium- and high-tech industries (such as automotive and electronics). However, this transition has not extended significantly to high-technology exports. Although employment in manufacturing in Türkiye is higher than the EU average, the share of employment in medium- and high-tech manufacturing is significantly lower, indicating room for growth and advancement in these technologically advanced industries. The contribution of the manufacturing sector to GDP increased from 18.4 per cent in 2019 to 19.4 per cent in 2023. Manufacturing exports increased from US$ 171.2 billion (€152.9 billion) in 2019 to US$ 241 billion (€222.7 billion) in 2023. Although there has been an overall increase in productivity in the manufacturing industry, small-scale firms have low levels of productivity. Türkiye ranks as the 40th most complex country on the Economic Complexity Index (ECI).[25] Compared with a decade ago, Türkiye's economy has become more complex, improving one position in the ECI rankings. The increase in complexity has been driven by a diversification of exports, with the gradual addition of new products to the export basket and greater trade integration. The industrial sector's response to economic challenges, coupled with its strategic diversification, underscores its strength and resilience in the face of internal and external shocks. Moreover, export competitiveness is boosted by the lower cost of shipping from Türkiye to Europe compared with countries in Asia, including China, as well as the shorter timeframe. For example, goods can be shipped from ports in Gaziantep in south-central Türkiye to the EU in less than 72 hours, compared with a minimum of one month from China. Moreover, Türkiye's maritime trade routes can vary between the Aegean and the Black Sea, increasing reliability (see Chapter 7). Some firms in Europe see Türkiye as a potential alternative as they seek to shorten and diversify their supply chains.

After two decades of improvement in the competitiveness of the private sector, progress has slowed or even reversed. Over the last two decades, Türkiye has made impressive gains thanks to broad-based macroeconomic and structural reforms, which have increased employment and average income, boosting Türkiye firmly into the upper middle-income bracket. Through an investment environment reform package introduced in January 2018, the authorities successfully improved the business environment, as highlighted in Türkiye's place (46th out of 67 countries) in the 2020 IMD World Competitiveness Ranking, positioning it ahead of other emerging markets and regional competitors. However, in recent years, this progress has slowed, reforms have waned, productivity gains have stuttered and growth has become increasingly dependent on externally funded credit and demand stimulus (Türkiye ranked 53rd out of 67 countries in the 2024 report).[26] Given the government's plans for a real appreciation of the Turkish lira – a cornerstone of the disinflationary path in the coming years – exporters need to focus on improving their productivity to be able to maintain and expand their presence in export markets.

Türkiye's participation in global value chains remains below potential. Several challenges limit firms' ability to innovate their way up global value chains. First, there is a lack of coordination between governmental bodies (see Chapter 3). Second, deficiencies in the education and training system have resulted in severe skills mismatches (see Chapter 5). Third, there is a lack of appropriate financing mechanisms to support innovative entrepreneurship (see Chapter 6). Fourth, Türkiye's limited investment in R&D has hindered the advancement and diversification of its export products. In 2021, R&D expenditure in Türkiye was 1.4 per cent of GDP, below the OECD average of 2.9 per cent, with just 11.2 per cent of firms spending on R&D, compared with 16.8 per cent in the OECD.[27] Nevertheless, Türkiye has shown notable progress in the R&D rankings and has been among the top improvers over the last decade, jumping from 68th place in the Global Innovation Index in 2013 to 39th in 2023.[28] Meanwhile, this rapid advancement in the digital age is fuelling demand for new roles, such as AI experts and cybersecurity specialists. Addressing the emerging skills gap in these advanced tech sectors, therefore, remains a pressing challenge that calls for proactive talent transformation.

Meanwhile, Türkiye's strong export growth performance since 2019 emphasises the potential for further development and diversification. The authorities' ambitious targets and support for technological initiatives has created opportunities for growth in recent years, particularly in advanced manufacturing and digital transformation. However, to fully capitalise on these opportunities and overcome future challenges, Türkiye needs to bolster its structural reform agenda and address systemic issues affecting its long-term

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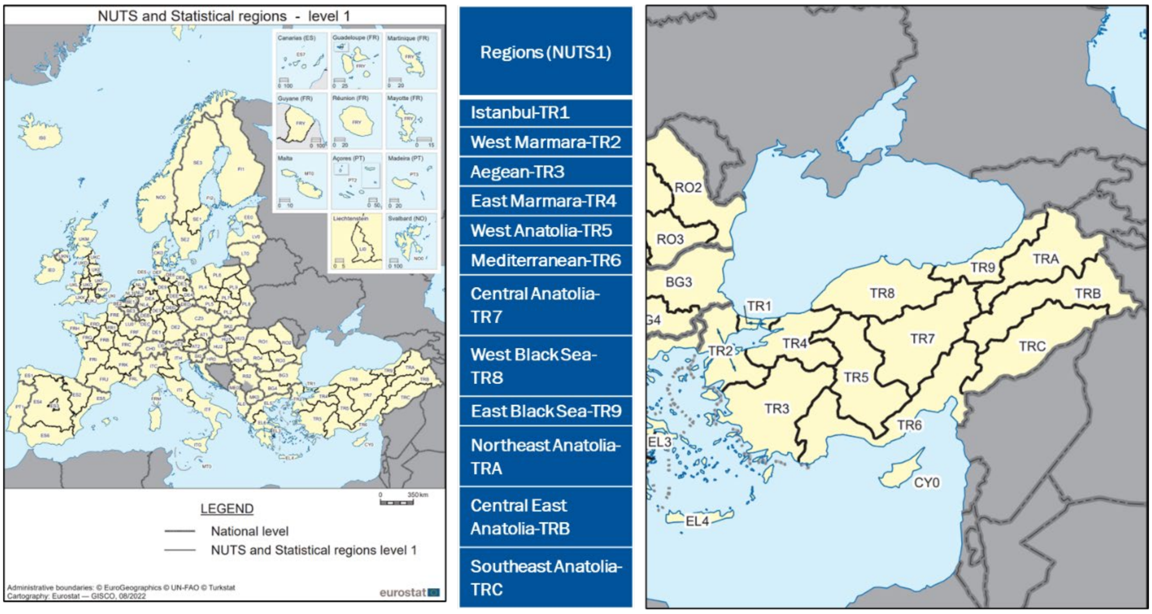
[25] See Harvard Growth Lab (n.d.).
[26] See IMD (2024).
[27] See World Bank (2021a).
[28] See WIPO (n.d.).

growth potential. This comprehensive approach is crucial for Türkiye to escape the middle-income trap and establish its industrial sector firmly in the advanced and high-value-added realm.

Competitiveness varies widely from region to region in Türkiye

Türkiye is a large country with a diverse regional industrial structure and varying regional productivity. Türkiye's wealth is concentrated primarily in Istanbul and the northwest and west of the country, while the east and southeast regions continue to suffer from less developed infrastructure, lower human capital, fewer economic opportunities, lagging educational levels, less economic diversification, less institutional capacity and higher levels of poverty and unemployment (Figure 2.8). Consequently, if Turkish competitiveness is to improve, closer attention will need to be paid to economic performance in and across the regions. Türkiye needs to step up its crisis preparedness, particularly with regard to earthquakes, including in those regions most prone to them (Istanbul, Marmara, Aegean and Eastern Anatolia), where re-urbanisation and the replacement of infrastructure and housing that is not earthquake-proof need to accelerate.

Figure 2.8. Türkiye's regions



Source: Nomenclature of Territorial Units for Statistics (NUTS), 2021.

Istanbul, the largest of Türkiye's 12 regions,[29] occupies a preeminent position in the national economic hierarchy. The Istanbul region is the uncontested economic powerhouse of Türkiye, significantly bolstering its overall economic strength (see Table 2.1). Its economic composition comprises a diverse industrial landscape, with a substantial focus on low-technology sectors (61 per cent of total manufacturing employment as of 2023). However, its relatively modest engagement in high-tech manufacturing (2.7 per cent of total manufacturing employment in 2023) highlights a potential area for growth and technological advancement. This economic structure carries implications for both business productivity and employee living standards, as many workers in low-technology industries face the high costs, such as high rents and transportation expenses, associated with living in a major metropolis. To address this challenge, low-tech industries and their labour force could be relocated to other regions, such as Anatolia, to enhance business productivity, improve the living standards of employees and narrow regional economic disparities. Moreover, Istanbul's proximity to seismic activity presents a significant risk to economic activity, which could be mitigated by relocating some industries to other regions (see Chapter 5).

Regions in the west boast strong infrastructure and a diversified economy, and benefit from proximity to Europe. In the northwest, the West Marmara region has a more balanced industrial mix, with an evolving economic base, as indicated by its moderate engagement in high-tech (3.1 per cent of total manufacturing

[29] As a candidate country of the EU, Türkiye is included in the Nomenclature of Territorial Units for Statistics (NUTS), which splits Türkiye into 12 regions.

employment as of 2023) and medium high-tech manufacturing (16.3 per cent of total manufacturing employment in 2023). The region is in transition towards more technologically advanced industries, which could contribute to its economic growth in the long term. In the southwest, the Aegean region, home to Izmir, is renowned for its prominence in tourism and agriculture and exhibits a strategic inclination towards medium high-tech manufacturing (18.5 per cent of total manufacturing employment in 2023). This suggests deliberate efforts to diversify and modernise its industrial base and boost investment in renewable energy, potentially increasing its economic resilience and competitiveness.

To the east of these regions, five regions perform well relative to the Turkish national average. The East Marmara region's technological progress and role in driving innovation are highlighted by its significant engagement in medium high-tech manufacturing (34 per cent of total manufacturing employment in 2023) and its high GDP per capita. The region of West Anatolia, meanwhile, leads on high-tech manufacturing (6.3 per cent of total manufacturing employment in 2023) and its high GDP per capita underscores its position at the forefront of Türkiye's industrial landscape. The Mediterranean region leans towards more traditional sectors, with a notable 56 per cent engagement in low-technology manufacturing. The Central Anatolia region (home to Ankara, the Turkish capital) has succeeded in diversifying its economy and enhancing its industrial base, with more engagement in medium high-tech manufacturing (16.5 per cent of total manufacturing employment in 2023) and the benefits of government investment in infrastructure and public services. Lastly, the West Black Sea region focuses on developing its medium high-tech manufacturing base (9.9 per cent of total manufacturing employment in 2023), contributing to Türkiye's economic development.

Türkiye's four eastern regions have varying economic profiles and suffer from mountainous terrain, limited infrastructure and a dependence on primary sectors. These regions face challenges in attracting investment and diversifying their economies, also because of their proximity to Türkiye's less stable and less developed neighbours, Syria and Iraq, which raises security concerns and social issues surrounding refugees. In the East Black Sea region, there is a focus on lower-tech sectors, reflecting its traditional industrial orientation. The region of Northeast Anatolia boasts modest economic indicators, with an inclination towards medium- and low-tech manufacturing, signifying the early stages of industrial development. The Central East Anatolia region's significant engagement in low-tech manufacturing (75 per cent) indicates a pressing need for technological advancement. The region of Southeast Anatolia's heavy reliance on low-tech manufacturing (75 per cent) highlights an urgent need for diversification and industrial advancement. Consequently, these regions require more investments and targeted policy support.

Table 2.1. Contribution of regions to Turkish value added (2019–22 averages)

	Share of value added (%)	Per capita income (US$)
Istanbul -TR1	30.4	15,554
West Marmara - TR2	4.7	10,261
Aegean -TR3	12.8	9,477
East Marmara - TR4	11.9	11,434
West Anatolia – TR5	11.5	11,300
Mediterranean -TR6	10.4	7,607
Central Anatolia -TR7	3.6	6,991
West Black Sea -TR8	3.6	6,253
East Black Sea -TR9	1.9	5,929
Northeast Anatolia -TRA	1.4	5,029
Central East Anatolia -TRB	2.2	4,558
Southeast Anatolia -TRC	5.7	4,934

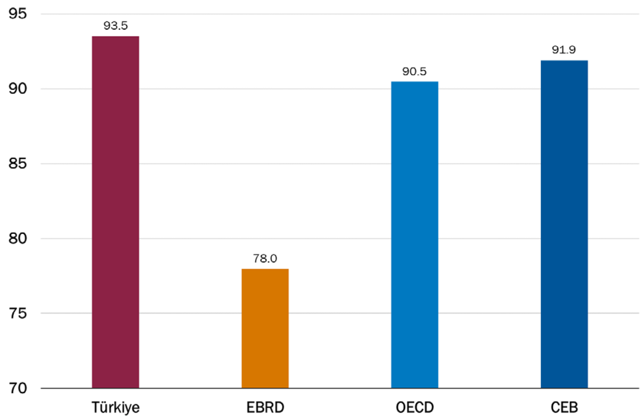
Source: Turkish Statistical Institute.

The digital transformation of the private sector is progressing well, albeit unevenly between large firms and MSMEs

Digital transformation is at an early stage for most MSMEs. While large private firms appear to be ready to meet the challenges of digitalisation, with adequate funding and transformational plans already in place, MSMEs face difficulties, limiting the uptake of modern technologies. Trust issues, often coupled with a lack of awareness and constrained access to finance, and a dearth of technical skills and sectoral expertise in the workforce are hindering the transition to digitalised business models. This demonstrates the need to support firms to achieve the expected outcomes of the government's planned twin green and digital transformation. Public and private agencies[30] are developing platforms to help MSMEs kickstart their digitalisation processes, access consultant expertise and participate in capacity-building training. Moreover, the authorities are providing financing to MSMEs to assess their green and digital maturity levels, as well as tax incentives to advance that maturity. However, such incentive schemes should be transformed with a longer-term view and be accompanied by concrete sectoral plans to ensure conflicting acts are not present in the market. Failing to address these hurdles could impede their and Türkiye's progress towards full digital transformation.

The authorities have been actively working on promoting digital transformation. Efforts are aimed at integrating and aligning with EU standards and regulations, enhancing information technology (IT) solutions, and fostering advancements in sectors such as banking, healthcare and media. In addition, the integration of Internet of Things solutions and smart-city projects is a focus, driven by local telecoms operators. As a result, Türkiye's score in the International Telecommunication Union's (ITU) Information and Communications Technology (ICT) Regulatory Tracker rose from 92.50 in 2018 to 93.50 in 2022, putting it above all of its peer groups (Figure 2.9).[31] Moreover, Türkiye is assessed to be G5 Advanced, with a score of 66.82 on the G5 Benchmark.[32] In 2021, the ICT market was valued at around US$ 30 billion (€25 billion), with an average annual growth rate of 23 per cent over the previous five years.[33] The sector boasts more than 2,000 active firms and employs more than 185,000 people, with a sizeable portion (58 per cent) under the age of 35. In addition, the smartphone ownership rate is high, and Türkiye is witnessing significant advancements in areas such as mobile gaming and cryptocurrency (see Chapter 6).

Figure 2.9. ICT Regulatory Tracker, 2022



Source: ITU (2022).

Türkiye is aligning its data protection and privacy laws with global standards, although the landscape needs to be developed further to support the private sector. Türkiye's approach to data protection and privacy is governed by the Law on Protection of Personal Data No. 6698 (DP Law). The recently published Draft Guideline on Genetic Data and Cookie Guideline clarify definitions and processing conditions for personal data within the scope of the DP Law. These guidelines align with EU legislation, though they differ when it comes to obligation to inform. In addition, Türkiye is reviewing its DP Law to amend the provisions on data transfer abroad, aligning more closely with the EU's General Data Protection Regulation (GDPR), a crucial priority for firms operating internationally.

Türkiye has revised its e-commerce law and introduced digital taxes, in line with global regulatory trends. The amended e-commerce law and e-commerce regulation, effective since 1 January 2023, have introduced significant changes to the e-commerce landscape, especially with regard to balancing consumer protection and the power of marketplace platforms.[34] These introduced the concept of escalating obligations based on net transaction volume, highlighting the authorities' active interest in

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30 Such as the Union of Chambers and Commodity Exchanges of Türkiye, the Small and Medium Industries Development Organisation and the Scientific and Technological Research Council.

31 See ITU (2022). The ICT Regulatory Tracker is an evidence-based tool that tracks the evolution of generations of telecommunications sector reforms (G1 = command and control approach to G4 = integrated regulation).

32 A tool that assesses levels of maturity of the national enabling environment for digital markets (Generation 5). See ITU (2023).

33 See Investment Office of the Presidency (n.d.a).

34 See Chambers and Partners (2023).

managing the impact of the rapidly growing e-commerce sector. The latter exceeded US$ 32 billion (€28 billion) in value in 2020, growing at annual rate of 66 per cent, with an online shopper growth rate of 59 per cent.[35] These numbers have increased significantly since the Covid-19 pandemic. Moreover, Türkiye, like other countries, has implemented a Digital Services Tax, in effect since March 2020.[36] This tax is part of a global trend to change how digital services are taxed, moving away from traditional principles that link tax liabilities to a physical presence in a jurisdiction. The tax is applied to a broad range of digital activities, including advertising services in a digital environment and digital content services. This move aligns with the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting, which seeks to develop a new solution for the taxation of the digital economy.

Private equity and venture capital firms are actively investing in the technology market, building on Türkiye's strong and improving entrepreneurial and start-up ecosystem and accelerating the digital economy.[37] The technology sector has seen a considerable number of mergers and acquisitions (M&A), and there is growing interest in investing in trending sectors such as mobile gaming, fintech and automotive technologies. This environment creates fertile ground for innovation and growth in the ICT sector, which is poised to grow thanks to M&A deals, new entrants and an increasing number of early-stage investments in ICT firms,[38] driven by the size of the economy, rising income per capita and a young population. Value-added tax exemptions and tax deductions provide incentives to scale up investments. Türkiye's start-up ecosystem (Türkiye Tech) has a higher value than its key Middle East and North Africa (MENA) ecosystem neighbours.[39] In 2022 alone, more than €1.6 billion was raised in venture capital investment in Türkiye, bringing the value of the start-up ecosystem to €39 billion, with many unicorns emerging within a short space of time. Platforms such as Mobilefest[40] offer opportunities for business leaders, technology providers and entrepreneurs to explore new digital transformation opportunities. Türkiye's total early-stage entrepreneurial activity rate, at 15.7 per cent, is higher than that of its peers,[41] highlighting a dynamic entrepreneurial landscape, a strong undercurrent of innovation and a willingness to engage in start-up activity.[42]

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[35] See Investment Office of the Presidency (n.d.b).
[36] See Norton Rose Fulbright (2021).
[37] See Norton Rose Fulbright (2022).
[38] See Investment Office of the Presidency (n.d.b).
[39] See Digital Transformation Office of the Presidency (2023).
[40] The biggest ICT exhibition in Eurasia, organised annually in Istanbul, focusing on communication and connectivity to create networking opportunities with industry leaders and influencers.
[41] Hungary (9.4 per cent), Poland (10.5 per cent), and Estonia (13.6 per cent).
[42] See Global Entrepreneurship Monitor (n.d.).

3. Well governed: Türkiye's governance needs to improve and the investment climate needs to level up with peers

Well-governed ATQ score = 5.84/10 (19th out of the 36 economies in which the EBRD operates)

Public governance is problematic, and Türkiye's ranking on various international surveys on the perception of governance and corruption has deteriorated in recent years. Surveys point to corruption, a decline in the rule of law, limited procedural transparency, growing centralisation and concentration of power, limited enforcement of intellectual property rights and difficult licensing arrangements. However, some progress has been made on strengthening governance through digital transformation. Further reforms in this area have the potential to improve the business environment and the investment climate substantially for the private sector. Meanwhile, the regulatory and institutional framework supporting good corporate governance is relatively advanced.

Private-sector investment requires stronger rule of law and control of corruption

Governance has deteriorated in recent years. Türkiye's performance on governance has worsened and remains weak relative to peers in central Europe and the Baltic states, as well as the OECD countries (Figure 3.1).[43] While the control of corruption, government effectiveness and regulatory quality peaked in 2012-14 and has been declining ever since, the rule of law and voice and accountability have been declining for the past two decades. All indicators of the World Bank's Worldwide Governance Indicators (except political stability) were at record lows in 2022 (Figure 3.2).[44] The most significant decline can be observed in the voice and accountability indicator, which captures perceptions of freedom of expression, freedom of association and a free media. While the strong presidency was expected to enhance the quality of public services and improve policy formulation and implementation, a steep decline is also observed in government effectiveness after 2014. Türkiye was classified "not free" in the Freedom in the World 2024 index and saw the fifth-largest decline in its score over the last decade.[45] Ahead of the May 2023 elections, the authorities approved a disinformation law that further stifled opposition campaigns and independent media and hindered free speech. In addition, they adopted a new law to control the selection of judges who would review challenges to election results.[46] Moreover, Türkiye's ranking in the World Press Freedom Index 2024 (158th out of 180) highlights governance challenges and significant concerns about media freedom and freedom of expression compared with better-performing countries in central Europe and the Baltic states (Latvia (12th), Slovenia (42nd) and Czechia (17th).[47]

Figure 3.1. Worldwide Governance Indicators (percentile rank)

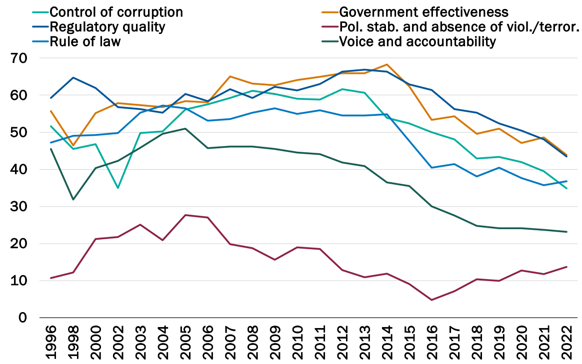
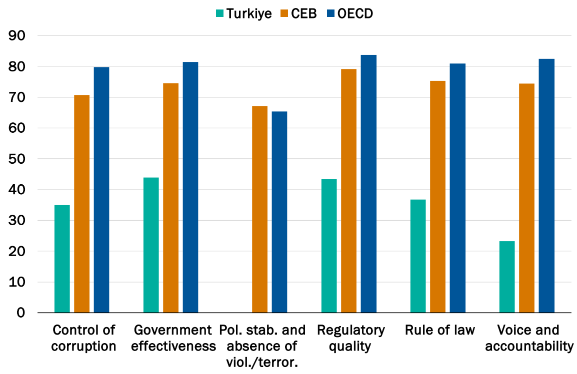


Figure 3.2. Worldwide Governance Indicators (percentile rank)



Source: World Bank (2022a).

43 See World Bank (2022a).
44 The rule of law was at its lowest in 2021 but increased slightly in 2022. See World Bank (2022a).
45 See Freedom House (2024).
46 See Freedom House (2023a).
47 See Reporters Without Borders (2024).

Corruption remains a challenge for businesses. Türkiye was ranked 115th out of 180 countries in the 2023 Corruption Perceptions Index with 34 points, Türkiye's lowest score in the last decade.[48] Türkiye is a party to most international anti-corruption conventions.[49] However, in reality, enforcement is patchy, including in the private sector. Mechanisms to investigate and punish alleged abuse and corruption by state officials remain inadequate, and exemption from punishment remains a problem. Moreover, concerns remain over the lack of a permanent, functionally independent anti-corruption prevention body and the limited level of coordination between various preventive bodies. There have been no regular awareness-raising campaigns on anti-corruption and there are no specialised law-enforcement authorities, prosecution services and courts dedicated to fighting corruption.

Despite the declining rule of law, perceptions differ between businesses and civil society organisations (CSOs), with the latter voicing concerns more openly. The operating environment for CSOs has experienced backsliding and continuous pressure. However, CSOs remain vocal and active participants in civic life, including by providing support to the people affected by the February 2023 earthquakes. In addition, the 12th Development Plan recognises civil society as a key contributor to the policymaking process, highlighting its active role in shaping future policy.

Türkiye's progress towards greater economic freedom has been slowed by institutional shortcomings. The country ranked 102nd out of 184 countries in the 2024 Economic Freedom Index, with low scores for government integrity and judicial effectiveness.[50] Türkiye ranked 41st out of 46 countries in the Europe region and its overall score was lower than the world average. It scored low and well behind the frontier group on judicial independence, framework for challenging regulations and enforcement of contracts. When it comes to the Sustainable Governance Indicators, Türkiye's score (4.78) indicates less effective governance than its peers in central Europe and the Baltic states (the Slovak Republic [6.5], Poland [6.0] and Hungary [5.5]), with potential impacts on foreign investment and economic diversification efforts.[51]

While Türkiye is party to most international human rights instruments and the European Convention on Human Rights is part of national legislation, implementation challenges persist. Increased concerns over the rule of law, including the independence and impartiality of institutions, have dented investor confidence, leading to historically low levels of FDI. As part of the 12th Development Plan, Türkiye aims to improve the rule of law, bolster democratic institutions and prepare a new constitution.

Türkiye has made progress in the fight against money laundering and the financing of terrorism and has been removed from the grey list of the Financial Action Task Force (FATF).[52] Türkiye was added to the list of jurisdictions subject to increased monitoring (the FATF's grey list) in October 2021.[53] In 2022, Türkiye updated its national plan to adhere to the FATF recommendations. To comply with the EU acquis and FATF standards, it introduced regulations pertaining to politically exposed individuals. In July 2023, the FATF found that Türkiye had strengthened its anti-money laundering/combatting the financing of terrorism framework and, in June 2024, removed it from the grey list.

The business environment could be improved through greater predictability, prioritisation and coordination

The private sector would benefit from clearer communication by the authorities and greater market predictability. While large and more advanced firms are more sophisticated and have more robust financial buffers, enabling them to adjust to rapidly changing economic conditions, micro, small and medium-sized enterprises (MSMEs), which dominate the economy, have limited internal financial resources and expertise for proper planning. While large corporations have more direct access to policymakers, MSMEs do not have such direct communication channels, though they do benefit from support and guidance from associations representing them. Given the global and domestic economic environment, private firms need clear communication and guidance from public authorities to be able to devise short- and medium-term plans.

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[48] See Transparency International (2022).

[49] Türkiye ratified the OECD Convention on Combating Bribery of Public Officials and passed implementing legislation in 2003 to make bribery illegal, Parliament ratified the United Nations Convention against Corruption in 2006, and Türkiye is a participant in regional anti-corruption initiatives, such as the G20 Anti-Corruption Working Group.

[50] See Heritage Foundation (2023).

[51] See Bertelsmann Stiftung (2022).

[52] See FATF (n.d.).

[53] Countries that are actively working with the FATF to address strategic deficiencies in their regimes to counter money laundering, terrorist financing, and proliferation financing.

Given the high investment and reform needs, prioritisation is required. While Türkiye's public authorities have a skilled workforce base and high-level plans already in place, a comprehensive and well-structured project selection and prioritisation framework is lacking on all levels. The authorities should focus on regulating the market to support the country's twin green and digital transformation, with clear communication guidelines. To balance the significant investment needed to realise announced plans and to limit public spending, it is important to rationalise large-scale investments, with detailed roadmaps, action plans, timelines and key performance indicators. Such an approach would ensure that investments materialised on time and yielded expected benefits. The utilisation of ex ante and ex post evaluation frameworks would enhance accountability and allow the efficient monitoring of investments and government initiatives. For example, there is an absence of transparent and open data on public contracts, undermining the accountability of public spending. Meanwhile, public procurement reforms, such as the establishment of an independent public procurement board with the power to void contracts, were implemented to increase transparency and reduce susceptibility to political influence.

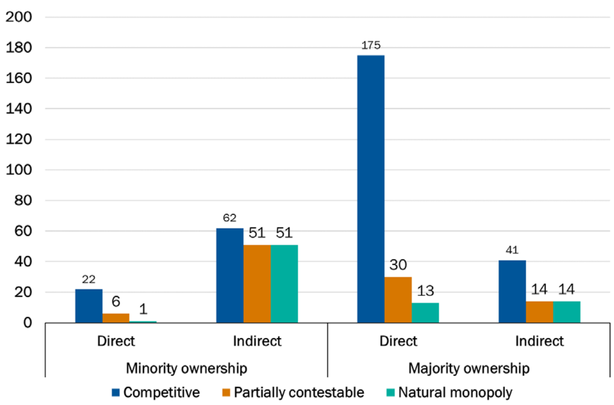
The industrial sector is structured around organised industrial zones (OIZs), enabling the implementation of targeted measures at a quick pace. Almost one-third of Turkish industry operates in more than 300 OIZs and the authorities plan to double this number in the medium to long term. The authorities are considering extending long-term financing to these zones to improve municipal services and to use public–private partnerships (PPPs) to realise large investments; however, draft regulation has yet to be presented. The establishment of management information systems in OIZs would allow the collection, monitoring and assessment of data to ensure better outcomes, including the promotion of equal opportunities in employment and entrepreneurship and new initiatives for green industrial zones.

Policy development and coordination continues to be centralised, preventing an inclusive, participatory and evidence-based policymaking process. Economic policymaking remains opaque, erratic and politicised. Foreign investors are concerned about frequent regulatory changes that occur with short implementation timeframes, a lack of consultation and inadequate evaluation of the broader consequences on sectors. Policy coordination and planning, and public-sector inter-agency cooperation need to be improved. Systematic and inclusive mechanisms for effective consultation with the private sector and CSOs on new legislation and policies are needed.

The regulatory and institutional framework supporting good corporate governance is relatively advanced. Based on asset size, Türkiye has the smallest public enterprise sector of the economies in which the EBRD operates. The energy and telecom sectors are largely privatised, although state regulators play a key role. The authorities continue to focus on increasing private-sector participation in various sectors, notably healthcare, transport and utilities, via PPPs and build-operate-transfer (BOT) contracts. There are plans to further privatise assets including power plants, port operating rights, shares in toll roads, and bridges. However, the implementation of modern governance best practices is strongest in the large, listed firms, while the majority of MSMEs, which are mostly family owned, are lagging.

At the same time, the state remains active in the economy, negatively affecting the private sector and its dynamism. In around one-fifth of firms with state participation, the state has a blocking minority stake under corporate law, particularly in the finance, mining, manufacturing and quarrying sectors (Figure 3.3).[54] Even with a minority stake, the state can intervene and influence decisions. Greater state presence is associated with fewer young firms, as a doubling of the state's share in a sector tends to lead to 10 per cent less entry, with a larger impact in competitive sectors.[55] However, firms in which the state participates are often bigger, more innovative, employ more workers and are more productive, particularly in natural monopoly markets and those firms where the state has a higher stake. At the same time, their productivity growth is lower, and often negative. Moreover, the growth in

Figure 3.3. Distribution of the businesses of the state in Türkiye, by type of market and ownership, 2019



Source: World Bank (2019).

Note: The number of state businesses is 480.

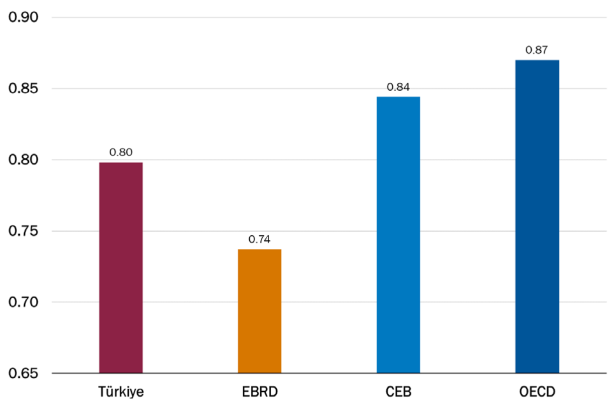
[54] See World Bank (2019).
[55] See Akcigit and Cilasun (2023).

firms with state participation may reflect their preferential access to inputs and markets and, hence, inefficiencies, as they may not be required to operate to the same standards and levels of performance as private firms to stay in business. Their corporate governance may also be worse than in private firms. In particular, as employment growth is positive and productivity growth is negative, the state may distort the allocation of resources by prioritising employment rather than efficiency gains. To improve the allocation of resources and raise productivity, labour and capital should move to sectors and firms where productivity is growing.

Türkiye has made significant advances in strengthening governance through digital transformation

Efforts continue to improve the quality of the business environment and provide firm-friendly services. The authorities have three key priorities when it comes to digital transformation, led by the Digital Transformation Office (DTO), namely e-government transformation, AI strategy and implementation, and cybersecurity. The OECD Digital Government Review was conducted at the request of the authorities and outlined that Türkiye had made significant strides in digital transformation, notably with the establishment of key components such as türkiye.gov.tr and the e-Government Gateway.[56] Türkiye was ranked 48th (out of 193 countries) in the e-Government Development Index, up from 53rd in 2018, with a score above the EBRD average, but below the OECD and central Europe and the Baltic states averages (Figure 3.4).[57]

Figure 3.4. E-Government Development Index (2022)



Source: UNDESA (2022).

The digital transformation strategy, led by a robust e-government system, is fostering an enabling environment for private-sector development. Türkiye has a well-functioning e-government system for its citizens, and the authorities plan to improve it for businesses in the short to medium term by automating business processes as part of its digital strategy (Digital Türkiye).[58] This could improve document submission and processing significantly and could create a more favourable business environment by cutting more red tape. In addition, the authorities could create a centralised database, agglomerating individual databases from different public authorities and allowing for AI-based assessments and calculations to improve the monitoring of public services, driven by predictive and preventative approaches. The DTO is mandated with the digitalisation of the public sector, while the Ministry of Industry and Technology leads on the digitalisation of the private sector. Moreover, the establishment of a National Information Security Agency is under discussion, underscoring the commitment to digital transformation. As of end 2022, the number of users of the Digital Türkiye Portal had reached 61.7 million, while 6,754 services from 942 institutions were offered on the portal, exemplifying the scale of Türkiye's digital advancement.[59]

Türkiye's strategic initiatives in AI and cybersecurity are critical drivers of its economic development and digital transformation. The National Artificial Intelligence Strategy 2021–25[60] is 35 per cent completed and, in the next two years, the DTO will largely focus on improving data infrastructure, supporting the introduction of cloud services to the public sector and enhancing centralisation, transparency and accessibility to data across governmental agencies and ministries. Such steps will require the introduction of adequate legislative and regulatory frameworks. The National Cybersecurity Strategy and Action Plan (2020–23)[61] aims to develop cybersecurity framework legislation and a corresponding ecosystem and to develop cybersecurity curricula and determine occupational standards in the field. The cybersecurity landscape is governed by various laws and regulations and is relatively fragmented.[62] Critical infrastructure

56 See OECD (2023).
57 See UNDESA (2022).
58 See Digital Transformation Office of the Presidency (n.d.a).
59 See Digital Transformation Office of the Presidency (n.d.b).
60 See Digital Transformation Office of the Presidency (2021).
61 See Digital Transformation Office of the Presidency (n.d.c).
62 See Chambers and Partners (2024).

sectors, such as e-communication, energy, water management, transportation, banking and finance, have specific security requirements. The banking and finance sector, under the authority of the Banking Regulation and Supervision Agency, must adhere to specific data protection and information security measures. The spectrum of cyber threats has expanded considerably, demanding innovative and dynamic responses. However, Türkiye faces challenges in cultivating cyber talent and the institutional environment does not promote innovative developments and technological solutions adequately in the cyber sector. In addition, the DTO is working on innovative initiatives, including creating a National OpenData portal, introducing e-correspondence, cybersecurity networks and an electronic public information management system.[63]

The 12th Development Plan prioritises the design and delivery of digitally integrated government services and the standardisation of municipal services through the e-Government Gateway. A comprehensive digital state strategy is to be prepared to outline the roadmap for Türkiye to follow. The strategy prioritises addressing cybersecurity threats and protecting personal information in the provision of digital government services. In addition, a digital state academy could be established to ensure that digital transformation needs are assessed and implemented adequately.

While recognising data as a strategic asset, there is a need to strengthen data governance approaches and enhance stakeholder coordination to establish robust data infrastructure and practices for the public sector, fostering greater public trust. Effective governance is vital for integrating digital transformation across the public sector, and the DTO enjoys strong support from national leadership and organisations countrywide. To better support public service design and delivery, the ecosystem of enablers would benefit from consolidating guidance and establishing clear standards to prevent digital transformation efforts from contributing to digital exclusion. The digital government strategy presents an opportunity to enhance institutional capacity. Increased capacity and adequate legislation are needed to fulfil the ambitious AI and cybersecurity strategies. In addition, Türkiye should ensure compliance with the EU regulation on cybersecurity, AI and the digital economy.

[63] See Digital Transformation Office of the Presidency (n.d.d).

4. Green: Türkiye needs more ambition, resources and policy reforms to accelerate its green transition

Green ATQ score = 5.09/10 (21st out of the 36 economies in which the EBRD operates)

Türkiye's commitment to developing renewable energy is strong, strengthened by its abundance of wind, solar and geothermal resources and incentives to diversify to renewable energy. This determination is underpinned by the economic rationale of lowering energy imports and narrowing the external deficit. However, further progress is needed on moving away from fossil fuels and strengthening the regulatory framework for renewables. The pressure to decarbonise is becoming more urgent in the context of the EU's Carbon Border Adjustment Mechanism (CBAM), which could have a major impact on Türkiye's energy-intensive industries. The decarbonisation of the economy would, in turn, preserve and enhance the competitiveness of the private sector in the energy market, as well as more broadly, capitalising on Türkiye's unique location and its potential to serve as an energy trading hub. Plans to adopt carbon markets are advancing, but a long-term climate strategy is still under development. Recent climate developments, particularly the increase in the number of droughts, have highlighted the need to accelerate adaptation policies. Consequently, it is crucial that Türkiye raise its climate aspirations.

Energy sector decarbonisation is progressing, but needs further support to accelerate renewable energy development and green hydrogen

Türkiye's energy sector has undergone significant growth, diversification and green transformation in recent years. Thanks to significant investments from local and international investors, installed power capacity has tripled in the past two decades and exceeded 110 GW by June 2024. Renewables (excluding hydro) increased from zero in 2005 to 31.3 GW in June 2024, and total installed renewable capacity (including hydro) accounted for 57.5 per cent of Türkiye's total installed power generation capacity – made up of hydro (29.2 per cent), solar (13.6 per cent), wind (11.1 per cent), geothermal (1.5 per cent) and other sources (including biomass) (2.2 per cent).[64] As a result of the developments in the last two decades, Türkiye is 11th in the world and fifth in Europe in terms of installed renewable energy capacity, as well as first in geothermal and third in hydro in Europe.[65] Renewables (solar and wind) are expected to account for 65 per cent of total installed capacity and 55 per cent of electricity generation by 2035.[66] Therefore, Türkiye needs to install approximately 5 GW of solar (3.5 GW) and wind (1.5 GW) power capacity each year to reach the goal of producing 60 GW by 2035. According to the plan, the share of fossil-based (coal and natural gas) energy generation should decrease gradually, but will not be completely phased out. Türkiye's final energy consumption mix has until recently been dominated by fossil fuels. In 2021, oil products accounted for the largest chunk of final energy consumption (36 per cent), followed by natural gas (26 per cent) (Figure 4.1). The industrial sector accounted for the largest share of final energy consumption (32 per cent), followed by transport (26 per cent) and the residential sector (21 per cent) (Figure 4.2). Türkiye's total greenhouse gas (GHG) emissions have been growing exponentially with economic growth. Its GHG and energy intensity remained stable until 2003, but have been on a downward trend ever since. Meanwhile, Turkish economic growth contributes less to GHG emissions than the average EBRD country. In 2022, the majority of GHG emissions stemmed from energy-sourced emissions (71.8 per cent), followed by industrial processes and product use (12.8 per cent), agriculture (12.5 per cent), and waste (2.9 per cent).[67]

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[64] See Ministry of Energy and Natural Resources (2024).
[65] See IRENA (2024).
[66] The National Energy Plan 2020-35 announced by the Ministry of Energy and Natural Resources in December 2022, prepared and aligned with Türkiye's 2053 net zero emissions target, aims to increase the share of renewable capacity and grid flexibility requirements and decrease the share of fossil-based (coal and natural gas) energy generation (but not completely phase it out).
[67] See Turkish Statistical Institute (2023b).

Figure 4.1. Total final energy consumption by source, 2021

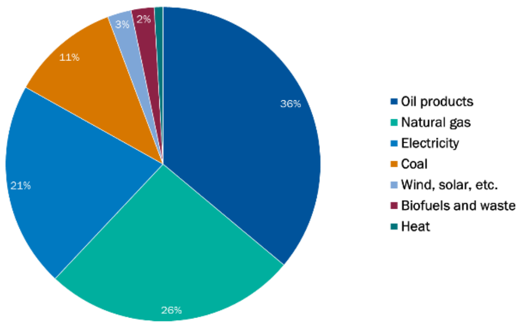
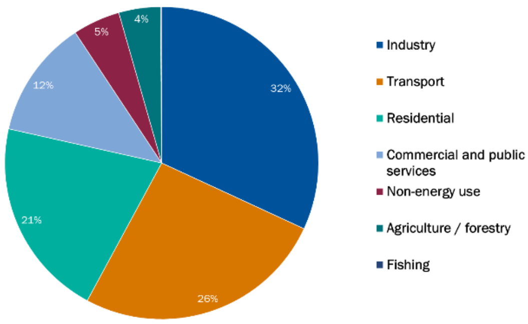


Figure 4.2. Total final energy consumption by sector, 2021



Source: International Energy Agency.

Clear and supportive policies and practices are needed to realise Türkiye's energy potential. Türkiye seeks to strengthen its overall energy independence to support energy security and improve its external position. This is done, in particular, through targeted hydrocarbon exploration and production, renewable energy development and by positioning itself as a regional energy trading hub. Moreover, Türkiye has abundant solar and wind potential; it ranks ninth in the EBRD regions when it comes to solar power potential[68] and 12th with regard to offshore wind power potential.[69] However, Türkiye remains heavily dependent on energy imports, and the economy is characterised by the inefficient use of energy and resources. The coal sector is supported by subsidies and a strategy for the phase-out of coal-fired power plants has yet to be put in place.[70] Natural gas is often allocated to domestic consumers for free or below market prices and on an export netback basis.[71] Relaxing local content requirements is necessary to expand foreign investment in renewables and accelerate the green transition further. Moreover, there is a lack of sufficient regional market integration to support energy competitiveness and supply security, and a lack of sufficient alignment with the EU acquis at interconnection points. Energy state-owned enterprises (SOEs) are dominant and inefficient. They hold a greater share of installed generation capacity in renewable energy (hydropower) than the private sector, which generates power largely from fossil fuels, and the state-owned electricity generation company (EÜAŞ) ranks first in terms of production capacity, with a 20 per cent market share.

Policy interventions in line with best international standards and private investment would yield considerable benefits for consumers, the green transition and regional energy security. Given Türkiye's ambition to become an energy trading hub, and boost energy security, there is a need to liberalise more fully the Turkish gas and power market, to align with the EU acquis and facilitate cross-border trading. Energy SOEs need to be reformed with the aim of supporting their efficiency, enhancing transparency, and facilitating the emergence of a level-playing field for the private sector to compete. In addition, Türkiye needs to develop an energy storage law, promote enhanced energy storage capacity[72] and develop the regulatory framework to increase grid flexibility, and make policy amendments to enhance smart grid systems and integrate renewables, demand response and digitalisation. Decarbonisation efforts in the power sector should be intensified, with a targeted date and strategy for coal phase out, to enable the energy sector to achieve its 2053 net-zero emissions targets.

Renewable energy and energy efficiency improvements need to be accelerated. It is important to work towards implementing targets set under the renewable energy and energy efficiency action plans and

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[68] See ESMAP (2020).
[69] See World Bank (2023b).
[70] The 12th Development Plan (2024-28) does not specify closure dates for coal-fired power plants.
[71] Netback is a benchmark to assess the profitability and efficiency of a company based on the price, production, transportation and sale of their products. Export netback is a common price-setting mechanism in which the price of a commodity is set in one place based on the value of the commodity in the market it is being sent to, minus the cost to move it to that market.
[72] The Energy Market Regulatory Authority released the latest legislation update in November 2022 for energy storage facilities, coupled with solar and wind power plants, to scale up renewable power and incentivise private-sector investments.

the renewable energy regulatory framework, and to support policies and strategies to increase energy and resource efficiency and support climate resilience and environmental performance. To this end, the Ministry of Energy and Natural Resources announced the Energy Efficiency 2030 Strategy and National Energy Efficiency Action Plan (2024-30) in January 2024. The action plan aims for a 16 per cent reduction in national energy consumption and a 100 million tonne reduction in emissions by 2030, with a total of US$ 20 billion (€18.5 billion) in energy efficiency investments. To overcome supply-chain shortages of renewable energy equipment and parts, effective supply-chain policies need to be developed and workforce skills in relevant sectors upgraded. On the investment side, physical infrastructure expansion and increasing renewable energy generation capacity should diversify the energy mix further, along with upgrades to the transmission and distribution network, not least after the considerable damage to infrastructure caused by the February 2023 earthquakes, including in the energy sector. Moreover, the use of energy-efficiency financing models should be promoted to accelerate the implementation of energy- and resource-efficiency investments.

A clearly defined investment strategy for the electricity transmission network, with targets for smart grids and capacity increases, is still lacking. The current electricity transmission network is not suitable to support fast charging systems in most regions and does not have the capacity to advance e-mobility and the electrification of the transport sector. To meet the target investment plan of 60 GW in renewable energy capacity additions by 2035, US$ 10 billion (€9.3 billion) of investment needs to be made in the existing grid.

The use of green hydrogen in the energy, industry, transport and heating sectors is key to achieving the net-zero emissions target. To plan the role of hydrogen in the green transformation, it is important to understand the potential and costs of hydrogen supply, as well the available renewable energy supply. Türkiye’s strong renewables record means it is well positioned to react quickly and develop green hydrogen.

Türkiye unveiled a new hydrogen technologies strategy and roadmap prioritising the production, transport and storage of green hydrogen. The Ministry of Energy and Natural Resources announced the strategy and roadmap in January 2023 through its subsidiary, the Turkish Energy, Nuclear and Mineral Research Agency, setting targets to reduce green hydrogen production costs and increase electrolyser capacity in line with Türkiye’s 2053 net-zero emissions target. The roadmap primarily covers the technological approach rather than the policy components.

Therefore, interventions are needed on the promotion, development and investment fronts. Green hydrogen and its potential uses, especially in the energy sector, should be promoted. Capacity should be strengthened through technical assistance to identify green hydrogen production potential and regulatory gaps. There is also a need to support the development of roadmaps, strategy documents and a regulatory framework, as well as the implementation of action plans. Public institutions should be helped to identify demand and production projections, technology levers and financing requirements for investment.

The implementation of the EU’s Carbon Border Adjustment Mechanism (CBAM) requires the decarbonisation of the industrial sector and the development of carbon markets

The EU’s CBAM[73] and the European Green Deal[74] highlight the need to decarbonise relevant sectors rapidly, particularly the industrial sector, to retain economic competitiveness. Türkiye, as the EU’s fifth-largest trading partner,[75] is particularly exposed to the impact of the CBAM, especially where energy-intensive industries are concerned. A study commissioned by the EBRD shows that the total CBAM costs to Türkiye could range from €138 million in 2027 to almost €2.6 billion in 2032 if a domestic ETS is not implemented and a carbon price is not set.[76] Another study suggests that the potential adverse impact of

[73] A tool for putting a fair price on the carbon emitted during the production of carbon-intensive goods entering the EU and to encourage cleaner industrial production in non-EU countries. In its transitional phase, which started in October 2023, it would only apply to imports of cement, iron and steel, aluminium, fertilisers, electricity and hydrogen. The definitive period starts on 1 January 2026.
[74] The European Green Deal should transform the EU into a modern, resource-efficient and competitive economy, ensuring no net GHG emissions by 2050, economic growth decoupled from resource use, and no person and no place left behind.
[75] See European Commission (2024).
[76] See EBRD (2021b).

the CBAM on the Turkish economy would range from a 2.7 per cent to a 3.6 per cent loss in GDP by 2030 compared with a business-as-usual scenario.[77]

While the private sector understands the risks and opportunities involved, the authorities' readiness and ambition are patchy. The government's future plans include new coal-fired power plants and there is no commitment as yet on a phase-out, despite plans to scale up renewable energy. Clear climate policy signals beyond the 2053 net-zero emissions target are lacking, despite the strong economic business case for the net-zero transition. When all costs and co-benefits are taken into account, the net economic impact of the net-zero pathway is positive over 2022-30 (a gain of US$ 15 billion or €13.9 billion) and this increases over longer time horizons (a gain of US$146 billion or €122 billion over 2022-40), largely due to reduced fuel imports and health benefits from lower air pollution.[78] Moreover, the updated Nationally Determined Contribution (NDC) of April 2023 was largely disappointing, as it did not provide early peak emissions estimates and the proposed decarbonisation pathway was economically unrealistic. While a long-term climate strategy is being developed, there have been no inclusive consultative processes so far among stakeholders to ensure policy coherence and consistency with parallel development policies, such as sectoral policies. Moreover, Türkiye ratified the Paris Climate Agreement only in 2021, with a five-year delay (the last G20 country to do so) and was not among the 118 countries that signed the Global Renewable Energy and Energy Efficiency Commitment at COP28. The Directorate of Climate Change was only established in 2021 after the ratification of the Paris Climate Agreement, with the mandate to create sustainable environmental and climate change policies. Meanwhile, a climate law remains stuck in the parliamentary process.[79]

After years of delays, Türkiye submitted an updated NDC in April 2023.[80] It was stronger than its Intended Nationally Determined Contribution (INDC), including comprehensive mitigation and adaptation actions and considering the means of implementation. The updated NDC aims to reduce Türkiye's GHG emissions by 41 per cent through 2030 compared with a business-as-usual scenario (with 2012 as a reference year). However, this would still lead to an increase in emissions. It is not compatible with the Paris Climate Agreement's 1.5°C temperature increase goal and has been deemed "critically insufficient" (Figure 4.3).[81] Other national strategies and commitments include setting a 2053 net-zero emissions target in 2021,[82] a national Green Development Initiative in 2021,[83] a national Climate Change Strategy (2010–23), a National Climate Change Action Plan (NCCAP, 2011–23)[84] and an online NCCAP Monitoring System. Lastly, the Medium-Term Programme for 2024–26 outlines green transformation as one of its objectives.[85]

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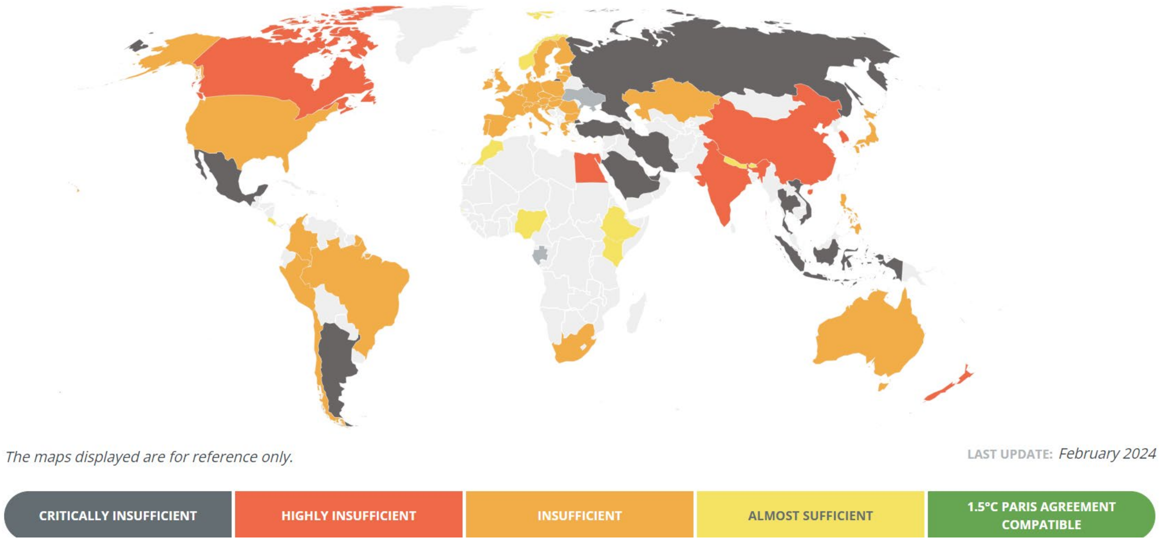
[77] See Acar, Voyvoda and Yeldan (2021).
[78] See World Bank (2022b).
[79] The Ministry of Environment, Urbanisation and Climate Change is leading work on a new climate law, together with a parliamentary committee. This is expected to be a framework law and to incorporate and streamline the climate targets announced in all relevant policies.
[80] See UNFCCC (2023a).
[81] See Climate Action Tracker (2024).
[82] See Presidency of the Republic of Türkiye (2021).
[83] See Presidency's Directorate of Communications (2021).
[84] See Ministry of Environment, Urbanisation and Climate Change (2011a).
[85] The Medium-Term Programme cites a list of policies and measures for green transformation, including the National Energy Efficiency Action Plan, a circular economy action plan, an emissions trading scheme, the Green Deal Action Plan, a green taxonomy, increased electricity generation from renewables, the promotion of energy storage, and hydrogen, carbon capture, use and storage, and the setting of standards for recycled secondary products.

Figure 4.3. Climate ambition compared with the Paris Climate Agreement



Source: Climate Action Tracker (2024).

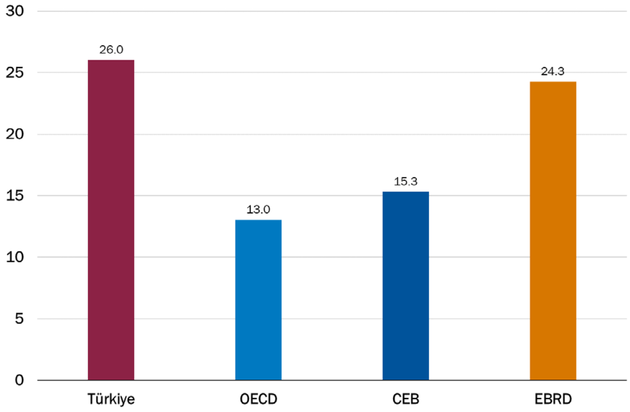
At the same time, plans to develop carbon markets are advancing. Türkiye is working towards establishing a national ETS[86] and assessing a potential linkage with the EU's ETS, in line with the goals set by the country's Climate Council in Konya in February 2022 and Türkiye's Green Deal Action Plan.[87] The pilot phase of the ETS could start in 2024 and run for a year before the full-scale version kicks in. A voluntary carbon market already exists, along with a functioning emissions monitoring, reporting and verification (MRV) system, which would facilitate the quick adoption of an ETS and the use of the instruments of Article 6 of the Paris Climate Agreement to achieve its climate target.[88]

There is, therefore, a need to decarbonise at a sectoral level while continuing to develop carbon markets. First, the implementation of industrial decarbonisation pathways for hard-to-abate sectors[89] would minimise the impact on these industries, both for large firms and their supply chains, which consist mainly of MSMEs. In this regard, the EBRD has supported the Ministry of Industry and Technology in developing low-carbon pathways (LCPs) for hard-to-abate sectors. Second, and at the same time, voluntary carbon market mechanisms should be implemented. Their role in reaching the net-zero emissions target and the implications of Türkiye's participation in Article 6 of the Paris Climate Agreement need to be assessed. To implement the climate law fully, the mechanisms to reach the anticipated outcomes should be clearly defined and a significant budget allocated to these goals. Third, other sectoral policies should be developed in line with Türkiye's medium- and long-term climate goals to boost national climate ambition, including a net-zero emissions target and climate-resilient pathway with sectoral breakdowns, coal phase-out and a second NDC (due for submission in 2025) that is informed by the long-term strategy being developed by the Ministry of Environment, Urbanisation and Climate Change. Lastly, work remains to be done to operationalise the net zero emissions target for 2053, including in terms of the necessary upskilling and reskilling of Türkiye's workforce.

[86] The Emissions Trading Scheme could be included in the climate law and the details of the mechanism could be defined in secondary legislation.
[87] Developed and adopted by the Ministry of Trade in July 2021 to align with the EU's "Fit for 55" proposals, maintain exporters' competitiveness within the customs union with the EU and attract green investment.
[88] Article 6 of the Paris Climate Agreement allows countries to cooperate voluntarily on implementing their NDCs.
[89] Carbon-intensive sectors such as steel, aluminium, cement and fertiliser.

Türkiye's private sector can play a role in climate change adaptation and the circular economy

Figure 4.4. $PM_{2.5}$ air pollution, mean annual exposure, 2019 (micrograms per cubic meter)



Source: World Bank World Development Indicators.

The physical impacts of climate change are affecting the private sector, urban areas and certain sectors, such as agriculture, water resources management and energy. Summer temperatures are rising, winter precipitation in western provinces is decreasing, surface water is being lost, droughts are becoming more frequent, land degradation is intensifying and the risks of coastal erosion and flooding are growing.[90] This situation could have negative effects on water and soil resources that are necessary for food production and food security and, therefore, on the development of affected areas, with particular impacts on women and youth. Half of the surface water in the Gediz and Greater Menderes Basins is expected to be lost by the end of the century, with agricultural, domestic and industrial water usage facing water scarcity.[91] Moreover, Türkiye is both the top destination for plastic waste in Europe and Europe's most exposed country to air pollution (see Figure 4.4).[92]

Ongoing initiatives to support adaptation actions and raise public awareness at the societal level should accelerate, including through private-sector participation. Türkiye prepared its first National Adaptation Strategy and Action Plan (NASAP) in 2011, covering the period to 2023. The process of updating the NASAP is ongoing at the Ministry of Environment, Urbanisation and Climate Change, based on detailed impact, vulnerability and risk assessments of many sectors. Moreover, there is a pressing need to develop and update climate change action plans at the municipal level. Reforms in the wastewater sector should be implemented, including the reuse of treated wastewater in landscape and agricultural irrigation, industrial processes and groundwater recharge, for recreational purposes, in domestic and industrial applications, and for feeding reused, treated wastewater to wetlands that are or could be dried out.

There is a need to expand the use of PPPs in municipal infrastructure to preserve water resources. The PPP law for municipal infrastructure investments is in place, with a specific focus on wastewater and drinking water. However, the secondary law and project agreement templates need to be developed and pilot projects need to be selected to showcase to municipalities the use of PPP for such investments. At the same time, drinking water supply and distribution network losses should be reduced, and drinking water supply management should be improved from source to tap, including through drinking water safety plans. In irrigation, rehabilitation and modernisation works need to be enhanced to increase water-use efficiency, and resilience to droughts should be improved. In the agriculture sector, increasing and optimising sustainable production would protect natural resources, ecosystems and biodiversity, taking into account future water availability under climate change scenarios.

Türkiye still needs to develop models for waste separation at source, waste management and the efficient recycling of municipal waste. Municipalities could use PPPs for this purpose, in order to benefit from the knowhow and financing capacity of the private sector. Moreover, strategic blended finance instruments should be developed to support climate change adaptation and to help Türkiye tap into its significant potential for scaling up circular business models (for example, industrial symbiosis, the use of secondary raw materials and alternative fuels), and the adoption of technologies and processes for material efficiency.

Türkiye is rich with critical mineral resources key to storage, battery and renewable energy technologies. Strategies are being developed by the Turkish Energy, Nuclear and Mineral Research Agency for the extraction and industrial use of critical minerals. However, the roadmap is still unclear as regards the availability of these minerals for industrial use. Miners with expertise in coal may be reassigned to the extraction of critical minerals.

[90] See UNFCCC (2023b).
[91] See Ministry of Environment, Urbanisation and Climate Change (2011b).
[92] See World Bank (2021b).

Meanwhile, climate activism is lagging global trends. Global climate activism is largely youth led, but in Türkiye, the participation of younger and more urban citizens in environmental movements is low, because of fears of possible legal repercussions as well as economic consequences. The decline in freedoms (see Chapter 3) and widespread economic difficulties (see Chapter 1) lead Türkiye's youth to perceive environmental issues as a secondary, more advanced problem and to fear negative repercussions of being involved in climate activism.

5. Inclusive: Greater equality could support Türkiye in capitalising fully on its solid human capital

Inclusive ATQ score = 5.14/10 (19th out of the 36 economies in which the EBRD operates)

Türkiye's human capital capacity, while advanced, lags its level of development, as well as that of OECD comparators. Significant disparities exist between men and women, preventing the private sector from tapping into its full potential. The latter is further negatively affected by skills mismatches and informality. Regional inequalities are substantial in terms of access to services, skills and financing. Moreover, while Türkiye is one of the top refugee-hosting countries globally by number of refugees, there is a need to ensure that refugees can improve their lives and contribute to the economy by actively participating in the labour market.

The participation of women in the labour force needs to improve

Türkiye's low female labour-force participation rate constitutes a major structural barrier to economic development. Although Türkiye's female labour-force participation rate has increased over the past decade, from 32.3 per cent in 2012 to 40.9 per cent in 2023, it remains by far the lowest within the OECD (the OECD average was 66.7 per cent in 2023).[93] National income rises as women enter the workforce, and Türkiye's low female labour-force participation makes it a clear outlier among the economies where the EBRD operates with similar levels of development (Figure 5.1). Türkiye was ranked 129th out of 146 countries on the 2023 Global Gender Gap Index,[94] mostly due by its low ranking on "economic participation and opportunity" (133rd).

Figure 5.1. Per capita income and female labour-force participation, 2022 or latest available

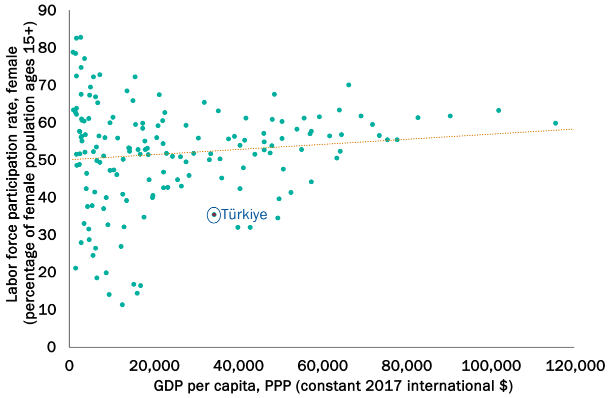
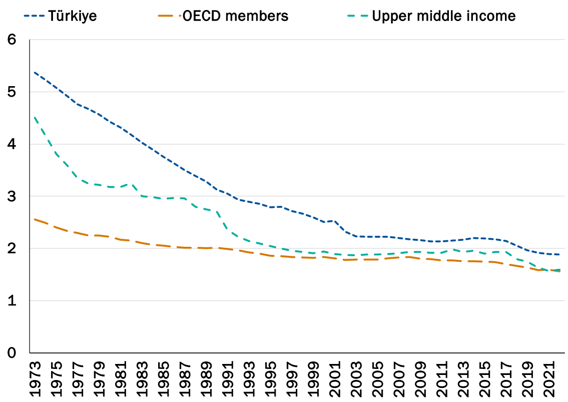


Figure 5.2. Fertility rate (births per woman)



Source: World Bank World Development Indicators.

Bringing more women into the labour market requires addressing women's unpaid care burden. Around 12 million working-age women cannot enter the labour market due to their domestic work burden.[95] On average, women spend about five times as much time on unpaid care and domestic work as men, giving Türkiye the largest gap among OECD countries.[96] In 2019, only 1.5 million out of around 9 million children under the age of six were beneficiaries of public or private early childhood care and education services, owing to the limited number of spaces available and related costs.[97] The rigidity of the labour market, with its high level of employment protection and low use of flexible forms of employment,[98] further limits women's ability to participate in formal employment.[99] Meanwhile, the fertility rate is declining, falling below 2 for the first time in 2019, though it remains higher than peers (Figure 5.2). As the replacement fertility rate (needed to maintain a

[93] See OECD Data Explorer (n.d.a).
[94] See World Economic Forum (2024).
[95] See EMAR (2024)
[96] See OECD Data Explorer (n.d.b).
[97] See EBRD and ILO (2021).
[98] The share of part-time work stands at 9.9 per cent, compared with 17 per cent within the EU.
[99] See Turkish Statistical Institute (2024).

constant population through natural growth) is 2.1, there is a risk that Türkiye will grow old before it becomes rich.

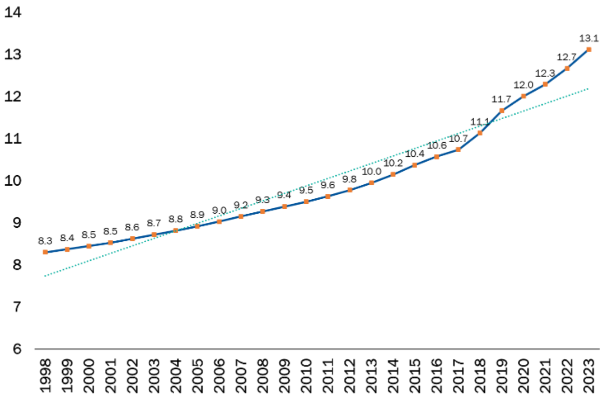
Women cite the high incidence of gender-based violence and harassment (GBVH) in the workplace and public life as a major barrier to their labour market integration. While precise data on harassment and violence at work is limited, the Confederation of Public Employees' Unions reports that one in two female employees indicate having been discriminated against at work due to their gender, and more than half of female civil servants (59 per cent) believe they faced mobbing at work.[100] Moreover, 55 per cent of women say they do not feel safe walking alone at night in the city or area where they live, while the level of intimate partner violence (over a 12-month period) is around three times as high in Türkiye as in the EU.[101] Other minorities have also faced intimidation, especially during the heightened emotion and rhetoric of the 2023 elections.

Addressing skills mismatches and informality would improve employers' access to human capital

Youth unemployment is persistently high because of skills mismatches and challenges in accessing finance and education. Youth unemployment stood at 17.6 per cent in 2023 (22.9 per cent for young women), with around one-quarter of young people not in education, employment or training (NEET) (around one-third of young women),[102] the highest level in the OECD countries (where the average is 13.6 per cent). At the same time, 72 per cent of employers reported difficulty in finding the skilled talent they need, indicating significant mismatches in the labour market.[103] This underscores the importance of developing policies aimed at integrating youth into the workforce, especially in innovative and entrepreneurial roles, to drive sustainable economic growth.

An increase in informality is contributing to human capital shortages, including for experienced workers. The 2023 Law on Retirement Age Victims (EYT, Law No: 7438)[104] could increase informal unemployment for years to come for those who will retire early, as well as lead to unfair competition between businesses employing uninsured retired workers at a lower cost with neither insurance premia nor income taxes.[105] This is because a large majority of now-retired individuals prefer to take up informal employment rather than continue to work in formal jobs. Moreover, informal employment is an increasingly common phenomenon among women and refugees and creates challenges with regard to a lack of decent working conditions and access to skills training, especially in the south-eastern provinces of Türkiye. In addition, the EYT law could significantly impact Türkiye's already-increasing age dependency ratio (Figure 5.3),[106] reducing the availability of funding for other human capital-strengthening measures, such as active labour-market initiatives.

Figure 5.3. Turkish age dependency ratio



Source: World Bank World Development Indicators.

Türkiye's twin green and digital transformation, as well as the future of work, may exacerbate existing skills gaps. Recent research indicates that renewable energy investments have the potential to create 300,000 new jobs across Türkiye by 2030.[107] However, energy firms, including long-standing EBRD energy

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[100] See EBRD (n.d.).
[101] See OECD Data Explorer (n.d.c).
[102] See Turkish Statistical Institute (2023c).
[103] See ManpowerGroup (2023).
[104] The EYT law, introduced in the context of the 2023 elections, removed the age requirement for individuals who started working prior to September 1999 and have contributed a minimum of 20 or 25 years to social security, enabling almost 2.5 million people to retire early over the coming period.
[105] See PWC (2022).
[106] People over the age of 64 as a percentage of the working-age population aged 15 to 64.
[107] See ILO and UNDP (2022).

clients in Türkiye, say current formal training for energy professionals is not fit for purpose and does not reflect the increase in demand for greater specialisation driven by the need for cleaner and smarter energy systems. While Türkiye is producing a solid number of new STEM graduates each year, lack of quality is an issue, with the signalling power of tertiary education degrees, in particular, deteriorating in recent years.

Significant gaps persist in bridging skills mismatches. A significant effort is being made to boost STEM education, with a special focus on nurturing young talent.[108] With 36.5 per cent of the population under the age of 25 as of 2023, there is a large pool of potential STEM talent. To capitalise on this demographic, various STEM centres and laboratories have been established across Türkiye and an increasing number of teachers are being trained to apply STEM education to real-world problems. Türkiye's talent pool is further supported by an increasing number of university graduates in the engineering and ICT fields. In 2021 alone, the number of graduates in those fields was over 60,000. However, there are challenges, including ensuring job opportunities in the field and addressing the brain drain issue, as many young, educated individuals are emigrating. Efforts such as the Teknofest[109] are part of Türkiye's initiative to engage the public in science and technology and to encourage innovation among youth.

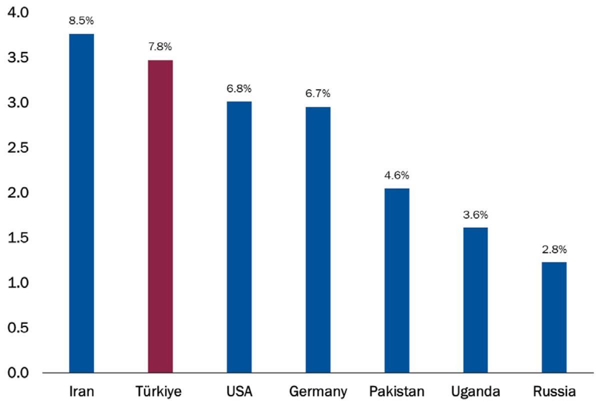
The worsening economic situation is negatively affecting the availability of human capital and contributing to brain drain. The high inflationary environment has contributed to a strong decrease in the gap between minimum and median wages,[110] creating motivational issues for employment and training, significantly reducing the "return on education", thus disincentivising knowledge and skills development. Moreover, it is estimated that more than two-fifths of wage earners are paid the minimum wage.[111] In addition, the high inflation environment is contributing to higher labour costs and difficulty in attracting the right skills, exacerbating the skills mismatches and brain-drain issues. In 2021, 73 per cent of Türkiye's 18- to 25-year-olds indicated that they would prefer to live abroad.[112] In 2023, nearly 80,000 Turkish citizens applied for asylum in the EU-27 countries.[113] Turkish citizens now make up the second-largest group of asylum seekers in Germany, with a 200 per cent year-on-year increase in applications in 2023.[114]

The combination of Türkiye's brain drain, aging population and lower fertility rates means it may need foreign labour. Türkiye is typically a source of migration, but in recent years, it has also become a destination, especially for migrants from neighbouring lower-income and war-torn countries. There is, therefore, a need to adapt policy and shift perspectives, both among policymakers and society, to best address the situation for both those who enter and those who leave the country.

Refugees and people with disabilities need to be better integrated into the labour market

Labour-market access for refugees remains a challenge, suggesting that Türkiye is not taking sufficient advantage of the available pool of labour, especially in its earthquake-affected regions. Türkiye hosts the second-largest refugee population in the world (after Iran), amounting to around 3.5 million people, including more than 2 million individuals of working age (Figure 5.4).[115] Legally, refugees – including Syrians under temporary protection – have the right to work in Türkiye, but require work permits to be able to start formal employment. In 2022, the number of permits issued to Syrian nationals stood at

Figure 5.4. Refugee and asylum-seekers, 2023 (millions, percentage share of world's total)



Source: United Nations Office of the High Commissioner for Refugees

[108] See Wilkes (2021).
[109] The largest aerospace and technology festival in the world in terms of number of participants, organised by the Turkish Technology Team Foundation (T3 Foundation) and the Ministry of Industry and Technology.
[110] The minimum wage has tripled since end 2022 thanks to three hikes in January 2023 (of 55 per cent), July 2023 (of 34 per cent) and January 2024 (of 49 per cent), bringing it from TRY 5,500 (€285) to TRY 17,000 (€538) (at prevailing exchange rates).
[111] See Confederation of Progressive Trade Unions of Türkiye Research Centre (DİSK-AR) (2023).
[112] See Konrad Adenauer Stiftung (2021).
[113] See Eurostat (n.d.).
[114] See Ilgin (2023).
[115] See UNHCR (2023).

113,208.[116] The issuance of work permits to Syrian nationals slowed to 108,520 in 2023 ahead of the elections and because of administrative capacity constraints combined with a lack of knowledge among employers. While public attitudes towards refugees have hardened, including because of harmful rhetoric ahead of the elections,[117] employers are reportedly in favour of employing more refugees to address workforce gaps, including in the earthquake-affected regions. However, Türkiye maintains a maximum employment quota of one temporary protection beneficiary to ten Turkish employees per workplace. Moreover, to meet labour-market needs in light of Türkiye's changing demographics, there is a need to upgrade the skills of migrants to match demand.

Türkiye needs a better approach to dealing with refugees. Given an opportunity, refugees will look for ways to improve their lives and contribute to their hosting economies, like other migrants. The authorities should support their efforts by giving them the right to work, helping them to access jobs and including them in national education and health systems.[118] In addition, the presence of refugees can benefit host communities, with some using their assets to create firms and jobs.[119] Türkiye should capitalise on its own successful policy in hosting refugees, including by allowing internal mobility to lessen pressures on host regions near the borders, supporting access to the labour market to reduce financial and social costs, and delivering services through national systems to minimise costs and improve access, sustainability and equality.

People with disabilities face specific barriers to labour-market inclusion and suffer from a lack of accessible workplaces and limited employer knowledge of measures to effectively integrate them into their workforce. Employers often disregard Türkiye's mandatory 3 per cent employment quota for people with disabilities that applies to firms with more than 50 employees due to a lack of relevant audit and inspection mechanisms and the limited impact of fines for non-compliance. Employers may even formally employ people with disabilities, but ask them to stay at home, underlining the urgent need to build capacity and awareness as regards effective ways to integrate people with disabilities into the workforce. This is particularly important in light of estimates that up to 60 per cent of those injured during the February 2023 earthquakes (the number of injured exceeds 100,000) may have suffered a permanent disability.[120]

Narrowing regional disparities is essential, also with regard to the accessibility and affordability of digital technologies

Türkiye's economic activity is concentrated in a few provinces, resulting in stark regional disparities (see Chapter 2). The lack of formal jobs and limited access to education and training is restricting economic opportunities especially in the south-eastern parts of Türkiye. The February 2023 earthquakes have created new challenges for long-term regional convergence. Estimates show that between 3 million and 4 million people have left the affected regions in response to the earthquakes, reducing the supply of human capital in the local economies.[121]

Moreover, there is a lack of proper incentives to reattract public employees and other key workers to the earthquake-hit regions, which is crucial for re-establishing quality public services and restarting economic activity. Some municipalities are reported to have lost up to 40 per cent of their labour force.[122] A lack of finance (reported as a major barrier by 22.8 per cent of businesses currently not operating), physical damage (18.4 per cent) and loss of workforce (17.6 per cent) are the leading constraints on business activities in the aftermath of the earthquakes.[123] Competition for workers is high and especially challenging for MSMEs. The reservation wage for blue collar and skilled labour in the region has reportedly doubled and even quadrupled in certain sectors, such as construction.[124] Therefore, there is a need for a coordinated reconstruction plan and an efficient dedicated national body responsible for disaster recovery to support efforts on the ground.

There are opportunities to combine reconstruction and regional development in the earthquake-hit regions with a strong push for a green transition. This also applies to the energy sector transition and coal phase-out, which could affect certain regions of Türkiye more than others and which needs to be actively

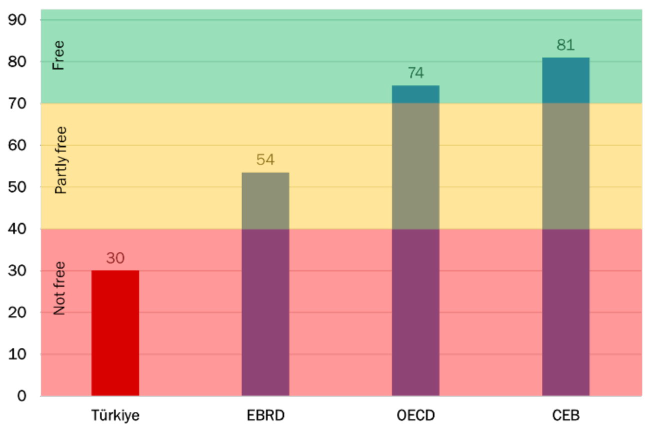
[116] See Ministry of Labour and Social Security (2024).
[117] See ODIHR (2023).
[118] See Tumen (2023).
[119] See Altındağ, Bakış and Rozo (2020).
[120] See AFAD (2023).
[121] See UNDP (2023).
[122] See EBRD and TEPAV (2023).
[123] Ibid.
[124] See Ganioğlu et al. (2023).

managed to ensure a "just transition" for those currently engaged in the sector. While miners constitute less than 1 per cent of Türkiye's labour force, they make up 20 to 40 per cent of employment in certain provinces such as Zonguldak in the Black Sea region of Türkiye.[125] Identifying transition pathways that take into account the human capital implications of future changes to the economic fabric of these regions is crucial, though there are significant capacity gaps in relevant line ministries that are holding back Türkiye's ability to prepare for a just transition.

In anticipation of the green transition, a more comprehensive approach to just transition planning is essential. This requires a well-structured institutional framework to support the transition, focusing on achieving the desired green transition outcomes, as well as retraining and employing the existing labour force in line with the needs of changing economic structures. At the same time, this creates an opportunity to increase employment for more disadvantaged groups, providing the planning is executed effectively.

The latest trends in internal migration can create opportunities for private-sector development. Cost-of-living increases and renewed concerns around heightened earthquake risks have resulted in an increase in internal migration away from Istanbul and the wider Marmara region, the most densely populated region of Türkiye. Around 2.2 million people have left Istanbul in the last five years due to earthquake concerns and for economic reasons.[126] In addition, several firms, including EBRD clients located in other parts of Türkiye, have noted an improvement in their access to talent resulting from a shift in young people's living preferences. This has the potential to contribute to a more balanced spatial allocation of human capital, though it requires continued investment in connectivity infrastructure and municipal services to increase the quality of life in different regions of Türkiye.

Figure 5.5. Internet freedom, 2023



Source: Freedom House (2023).

The affordability of internet services has become a significant issue and inequalities exist regarding accessibility. The ongoing economic crisis and rising inflation have made internet services more expensive for the most vulnerable parts of society, exacerbating the digital divide. Internet pricing remains high due to market concentration in broadband services, leading to excessive costs, and indirectly affecting wages and inflation. Moreover, internet freedom has steadily declined over the past decade, and Türkiye is assessed as "not free" in the Freedom of the Net index, with a score of 30 in 2023, behind all of its peer groups (Figure 5.5).[127] Türkiye ranks 43rd globally (out of 100 countries) in the Economist's Inclusive Internet Index Report, but second to last in Europe.[128, 129] In the "availability" and "affordability" categories, Türkiye sits at the bottom of the wider region. However, it is deemed the fifth-most internet ready country in Europe, thanks to increasing trust in government websites and apps as a result of Türkiye's successful e-government system (see Chapter 3). Türkiye has been advancing in terms of e-participation, as evidenced by its improved ranking in the United Nations E-Participation Index.[130] By 2022, Türkiye had risen to the 18th place from 37th in 2018. At the same time, however, the digital divide and inequalities between men and women in accessing digital technologies are exacerbating existing inequalities. Regional and educational attainment disparities exist when it comes to internet penetration and speed.[131] In the eastern regions, including the regions affected by the February 2023 earthquakes, women's digital participation rates are low, and women have limited access to the public sphere. Rural areas have poorer access than urban areas, and there is a slight gap between men and women, with more men having access to the internet, although there is no apparent gap between men and women when to comes to mobile phone access.

[125] See Turkish Statistical Institute (2023c).
[126] See Turkish Statistical Institute (2023d).
[127] See Freedom House (2023b).
[128] Based on scores in the "availability", "affordability", "relevance" and "readiness" categories.
[129] See The Economist (2022).
[130] See UNDESA (n.d.).
[131] See Ay and Kılıç (2023).

6. Resilient: Türkiye's financial sector could grow further to support private-sector development

Resilient ATQ score = 6.96/10 (11th out of the 36 economies in which the EBRD operates)[132]

Türkiye's well-regulated financial sector has enjoyed significant growth since 2008, and banks benefit from high liquidity, profitability and asset quality, as well as relatively low rates of NPLs. It is heavily dominated by the banking sector, particularly public banks, which crowd out privately owned banks. While the banks weathered the turbulent macroeconomic conditions well, recent years have also seen the emergence of a nascent non-bank financial services sector, which has growth potential. In line with Türkiye's own ambitions and to support the country's twin green and digital transformation, there is potential to increase private-sector access to long-term local-currency financing, promote financial inclusion and support the private sector's contribution to long-term sustainable growth.

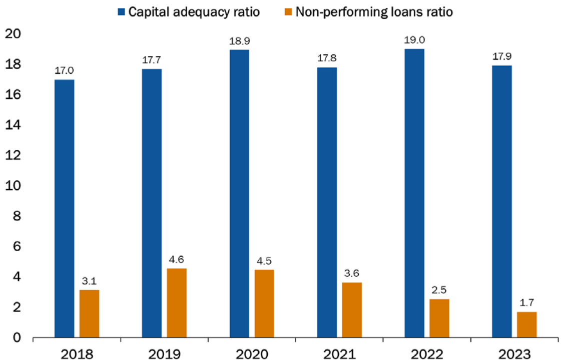
The banking sector fared well despite the turbulent macroeconomic environment, but some vulnerabilities may emerge

The banking sector was affected by both the period of unorthodox policy and by the return to orthodoxy. The banking sector navigated a period of highly stimulative but unsustainable monetary and fiscal policy (December 2021 to June 2023), marked by spiralling inflation, a considerable depreciation of the TRY and a collapse in investor confidence. The depreciation of the TRY could continue to have an inflationary impact on bank balance sheets, especially as rate hikes since June 2023 have not yet succeeded in reversing the losses in the nominal value of the TRY.[133] The TCMB's slow unwinding of the FX-protected deposit scheme (KKM) has yielded gradual results, with KKM deposits falling from their peak in August 2023 (26.2 per cent of total deposits) to 11.2 per cent as of July 2024. In August 2023, the TCMB removed the first-tier threshold of the security maintenance ratio requiring banks to hold a defined percentage of government securities as reserves against loans. This action relieved pressure on banks' margins.

The return to orthodox policy and the removal of macroprudential measures are still underway and may continue to affect the banking sector in the remainder of 2024 and beyond. A sustained return to and implementation of conventional economic policies over the long term is needed to boost investor confidence. In an environment of high interest rates, there is a need to reinvigorate markets that shut down during the period of unorthodox economic policy and their unwinding through interest rates hikes and the return to more orthodox economic policy. Policies should be adjusted to become more friendly to foreign investors to ensure their sustained return to Türkiye.

The Banking Regulation and Supervision Agency has remained positive on the sector's capital adequacy and resilience amid the various changes in the macroeconomic landscape. The banking sector's capital adequacy ratio stood at 17.9 per cent in December 2023 and should withstand the effects of removing FX-related forbearance without large gaps in the coming period (Figure 6.1). The sectoral NPL ratio was 1.7 per cent in December 2023, down from 4.6 per cent at end 2019, due to a combination of regulatory tightening, recoveries due to inflation and high credit volume growth between 2020 and the second quarter of 2023.[134] Despite these positive trends, there are concerns that MSME NPLs may come under particular pressure, although sector participants do not expect an acute, unmanageable rise. Loan-loss provisioning has remained robust, with specific provisions covering 85.6 per cent of NPLs as of November 2023. Meanwhile, asset-quality risk factors include future TRY volatility, persistently high

Figure 6.1. Capital adequacy and NPLs



Source: Banking Regulation and Supervision Agency.

[132] The resilient ATQ score covers both financial stability (70 per cent) and energy sector resilience (30 per cent). For the purposes of this report, energy sector resilience is covered in Chapter 4.
[133] As of July 2024, the policy interest rate (of 50 per cent) remained below the prevailing inflation rate (of more than 70 per cent year on year).
[134] In addition, the low level of NPLs is partially due to a difference in definition to international standards.

inflation eroding real wages and debt-servicing capacity, and the undue largesse of state-owned banks in lending decisions during the period of unorthodox economic policy.

Since 2016, there has been an upward shift in the importance of state-owned banks in the sector, and this has accelerated noticeably since 2020. As of March 2024, three state-owned banks[135] were among the four largest banks and accounted for 40 per cent of sector assets, up from 29 per cent in 2015. In 2023, the authorities placed TRY 111.7 billion (€4.4 billion at the average 2023 exchange rate) in these three banks. These injections have replenished their capital buffers amid TRY weakening and a rise in domestic-currency loan growth. This has led to the significant presence of state-owned banks in sectors such as agriculture, crowding out privately owned banks.

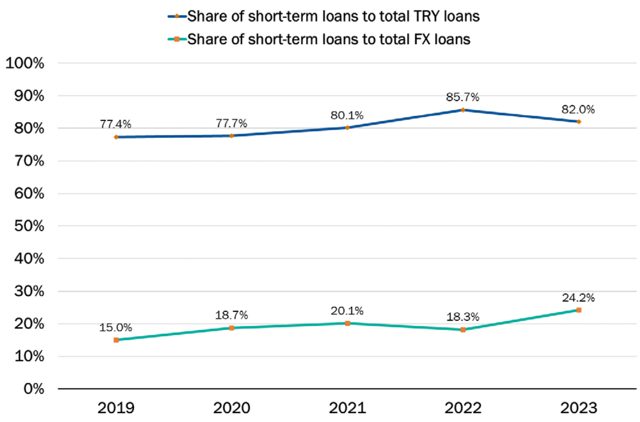
The TCMB's selective credit and quantitative tightening policies align with Türkiye's 12th Development Plan, focusing on sectoral and export-oriented growth. These measures, which include adjusting reserve requirements and setting growth limits on certain loans while exempting others, such as export and investment loans, are intended to support monetary tightening and economic development. The policies may lead to a tighter credit market, potentially affecting the banking sector's capacity to extend credit and, thus, overall credit growth. In addition, while this approach aims to control inflation and balance domestic demand, strategically, it supports sectors vital to Türkiye's economic growth and development. The policies' multifaceted impact reflects the complex interplay of monetary policy and strategic economic growth objectives, raising concerns about the expansion of the TCMB's role beyond its remit.

The banking sector is likely to continue to be influenced by various global and domestic factors. Changes in global interest rates, commodity prices and domestic political stability will play a crucial role in shaping the sector's trajectory. For instance, an increase in global interest rates could raise the cost of external borrowing, denting bank profitability and growth. Conversely, stable commodity prices and political stability could enhance investor confidence, supporting the sector's expansion.

Access to long-term TRY financing is essential for private-sector development, especially for MSMEs, and for the country's twin green and digital transformation

While financial inclusion has improved over the last decade, women's financial inclusion remains among the lowest in the EBRD regions, incommensurate with Türkiye's level of development. The authorities have taken meaningful action, including implementing the 2014 National Financial Inclusion Strategy and launching a follow-on strategy for 2022–25. In 2021, 73.4 per cent of adults had a financial institution account, compared with 67.7 per cent in 2017.[136] Still, Türkiye continues to lag its peers in terms of financial inclusion, and large gaps remain between men and women. Only 9.6 per cent of adults (6.3 per cent of women) have saved, while just 37.8 per cent (24.4 per cent of women) have ever borrowed from a financial institution. Despite reforms and equal rights in terms of assets and inheritance, social norms and traditional role expectations continue to supress women's financial inclusion. The gap between men's and women's account ownership narrowed by 6 percentage points to 23 per cent in 2021 but remains one of the largest in the world. Only 7.4 per cent of women are land (co-)owners and only 16.9 per cent (co-)own real estate.

Figure 6.2. Short-term loans to total loans



Source: Banking Regulation and Supervision Agency.

Due to prevailing high interest rates as part of the return to orthodox economic policy, access to finance in local currency is limited. MSME and commercial loan rates in TRY exceeded 60 per cent as of July 2024, curbing TRY credit demand, while lending rates in US$ hovered around 8 per cent. With interest rates expected to remain higher for longer, this will remain a constraining factor on the economy, especially for MSME lending in TRY. In contrast, banks have significant TRY liquidity and room for lending, with the average loan-to-deposit ratio at a multi-year low of around 80 per cent, down from a peak

[135] The three main state-owned banks are Ziraat, Vakıf and Halk.
[136] See World Bank (n.d.).

of about 124 per cent in mid-2018, and more than four-fifths of loans being short term (Figure 6.2). With most lending rates remaining negative in real terms, the TCMB's tightening may have a visible but gradual impact on loan growth, which could come down faster if the TRY stabilises or de-dollarisation picks up. Synthetic securitisation and/or unfunded portfolio risk sharing could support banks' ability to manage credit risk and improve capitalisation.

Economic instability, inflation and a challenging business environment disproportionately affect and increase barriers for already financially underserved groups, including MSMEs. The business environment is characterised by stringent regulation, taxation and bureaucracy. Over the last five years, several government programmes have been implemented to support MSME credit growth, though their effectiveness and impact have been limited. Fintech emerges as a promising avenue for bridging these financing gaps, offering accessible and customised financial services. However, the effectiveness of these solutions hinges on the establishment of strong supervisory and monitoring frameworks to ensure true financial inclusion. Globally, microfinance models offer valuable insights. These typically combine microloans with training and peer support, focusing on empowering underserved entrepreneurs, particularly women. In addition to addressing financial needs, this approach fosters broader social and economic development. For Türkiye, adopting such integrated financial solutions could be more effective. Diversified loan products, specifically tailored for women and youth entrepreneurs, could address unique challenges such as limited access to traditional credit facilities. Overall, a strategy that incorporates targeted financial support, leveraging fintech innovations and learning from global microfinance successes could significantly enhance financial inclusion and economic empowerment for these key groups.

Limited access to finance remains a major constraint on MSMEs. The bank-centric financial system and underdeveloped capital markets, coupled with macroeconomic instability, further impede the development of a more inclusive and diversified financial system. The growth of nominal loan volumes in recent years has not kept up with inflation, effectively constraining real supply to MSMEs. As GDP in current TRY terms increased more than fivefold from 2020 to 2023, the value of outstanding MSME loans grew by less than fourfold, while the overall loan-to-GDP ratio dropped from 71 per cent at end 2020 to 44 per cent at end 2023. Some 28 per cent of MSMEs cite the lack of access to finance as their main constraint on doing business, above peer-group levels.

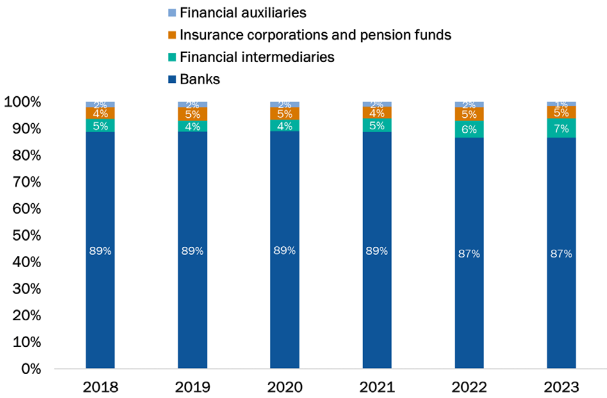
Women-led and/or -owned MSMEs account for 10 per cent of all MSMEs, and around 36 per cent of all businesses are youth-led or -managed. Across the economy, 11.3 per cent of firms have majority female ownership and female top managers lead 3.9 per cent of firms. The authorities are actively trying to increase women's participation in entrepreneurship, with a focus on cooperatives. However, programmes are often unsustainable and ineffective in supporting women's economic empowerment. Youth MSMEs encounter difficulties accessing bank financing, as they are often perceived as having a higher risk profile and financial products are not adjusted to their specific needs.

Türkiye's twin green and digital transformation requires significant levels of expertise and financing to the real economy. Authorities supervising and regulating banks, insurance firms and capital markets are all aware of these needs. The banking regulator cited the green transition as one of its top priorities. The insurance regulator stated that it needs further institutional capacity in these topics to be able to effectively oversee sectoral players' own green and digital transformation journeys. During a period of higher interest rates, short-term infrastructural finance could be provided using tools such as real-estate certificates. Long-term infrastructural finance could be provided through a variety of products, such as project bonds, sukuk, direct investment and co-investment, unlisted equity funds and unlisted debt funds. There is a need to support MSME lending, especially if the segment faces acute difficulty with access to finance in the coming period. Development priorities could be targeted, for example, underserved population segments and regions, green transition outcomes and digital transformation needs.

The green transition, a key priority for the authorities and the private sector, faces a significant hurdle in the limited access to finance, especially for smaller firms in relevant sectors. Achieving stringent green standards, crucial for maintaining competitiveness, requires consistent and robust financial support. This challenge is exacerbated for smaller firms that may struggle to secure sustained financing, essential for their adaptation and contribution to the green transition. To address this challenge, integrating advanced supply-chain management and digital emissions monitoring can be pivotal. In addition, effective supply-chain management, crucial to operational efficiency, plays a significant role in minimising the environmental impact of businesses. Enhanced emissions monitoring, backed by digital tools such as emissions tracking software and analytics, can enable firms to better manage their environmental footprint and comply with evolving green standards. Financial institutions have a vital role to play in this context. They can support the net-zero transition by managing financed emissions and aligning their portfolios with climate goals. This involves a detailed analysis of counterparty-level targets and sector expertise, and understanding the impact of government policies on emissions. Thus, banks and financial institutions can direct investments towards sustainable practices and technologies, accelerating the green transition. For Türkiye's green transition to be successful, it is essential to enhance access to finance for smaller firms, leverage digital tools for effective supply-chain management and emissions monitoring, and align financial institutions' strategies with environmental goals. This multifaceted approach will be crucial to achieving sustainable economic development and maintaining competitiveness in an increasingly eco-conscious global market.

Non-bank financial services have significant room to grow, as does the digitalisation of the financial sector

Figure 6.3. Financial sector assets (as a percentage of total)



Source: Banking Regulation and Supervision Agency.

The share of capital markets and non-bank financial institutions in the financial sector increased during the period of unorthodox policymaking in 2022–23. While banks still dominate the financial sector, with close to 90 per cent of financial assets, capital markets now comprise over 10 per cent. This shift has been further catalysed by Türkiye's young, tech-savvy population, which is increasingly drawn to mobile banking, digital financial services and cryptocurrency ownership. This demographic trend positions Türkiye on a path to becoming a regional, if not global, fintech base, as the young population is inclined towards innovative financial solutions and technologies. In this evolving landscape, the finance sector needs to closely monitor market trends, especially considering the challenges of inflation and the need for rigorous regulation to ensure market stability. The interest in cryptocurrencies and the growing trend of initial public offerings reflect a dynamic market that is becoming more diverse and complex. However, for Türkiye to fully capitalise on these trends, it needs to overcome challenges such as the need for more integrative regulation, increased investment in early-stage fintech projects and a more robust technological infrastructure. In addition, to make the most of the green transition, private-sector players should leverage the increasing variety of green financing instruments available. With environmental, social and corporate governance (ESG)-oriented investors on the rise, there is a valuable opportunity for capital markets to support sustainable initiatives. This is particularly relevant in the context of Türkiye’s young population, which is likely to be more environmentally conscious and supportive of green investments. The finance sector stands at a crossroads, where traditional banking is complemented by emerging fintech, driven by a young and tech-oriented demographic. The sector's ability to embrace digitalisation, manage inflationary pressures and align with global green transition goals will be crucial for its future growth and resilience.

Non-bank financial services, including insurance, asset management, leasing and factoring, all have significant room to grow. If there is a sustained return to economic normalcy, the large middle-class population can refocus on wealth creation and move away from income dependence, while corporate sectors can seek more advanced financial products and services and alternative financing methods to support the twin green and digital transformation needs of the real economy. The latter could benefit from increased access to private equity and venture capital, with value-added expertise provided to firms, as well as from public equity and debt financing via capital markets. Growing more traditional and safer financial products would slow the trend towards riskier and more volatile assets, which would also be supported by increased financial literacy. In recent years, some have been pouring their savings into high-risk stocks or cryptocurrencies, with 27.1 per cent of internet users in Türkiye owning cryptocurrency, the highest share in the world,[137] and Türkiye ranking 12th on the Global Crypto Adoption Index and fourth worldwide on raw crypto transaction volumes,[138] receiving approximately US$ 170 billion (€160 billion) between June 2022 and July 2023.[139]

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[137] See GWI (2023).
[138] Behind only the United States of America, India and the United Kingdom
[139] See Chainalysis (2023).

Recent years have seen transformative regulatory changes and innovations in the banking sector, particularly in digital banking and electronic money. The Banking Regulation and Supervision Agency has been instrumental in overseeing digital banking, introducing regulations to foster a safe and efficient digital banking environment. Key regulations include Law No. 6493 on Payment and Securities Settlement Systems, Payment Services, and Electronic Money Institutions, which provides a robust foundation for digital banking services. In addition, the emergence and regulation of the electronic TRY exemplify the sector's innovation and adaptation to technological advancements. These regulatory changes, along with the impact of the Covid-19 pandemic, have led to a dynamic shift in the banking industry. Digital customer onboarding and open banking are now integral parts of the sector, enabling banks and financial institutions to establish relationships with clients electronically, thereby reducing the need for physical paperwork. These developments have intensified competition and increased the feasibility of neobank[140] business models, highlighting a significant shift towards digitalisation and innovation in the sector. Regulations on the operating principles of digital banks and service-model banking have been implemented, focusing on banks that operate solely through digital channels.

The digital transformation of the financial sector could support the ambitions of the private sector. Banks are competitive and adept at navigating challenging operating environments. Their own digital transformation has been robust, serving the needs of households and corporates. The pandemic accelerated the adoption of digital solutions in the banking sector, highlighting the importance of technological advancements and digital banking in the face of operational challenges and changing consumer behaviour. As an example, with the recent introduction of open banking infrastructure by the TCMB, sector players have already introduced some services and are interested in deepening their product offerings. The digitalisation of the insurance sector could improve the country's limited penetration rate of insurance policies by opening new sales channels. However, the regulator should enforce new legislation to enable insurance firms to adopt digital systems. There is a need to continue to develop green, social, sustainable and other labelled (GSS+) financing policies to keep pace with global developments and enable firms to remain competitive on the global stage.

[140] Digital-only banks.

7. Integrated: Türkiye requires private-sector participation and faster green and digital transformation to become a transport and logistics hub

Integrated ATQ score = 5.75/10 (17th out of the 36 economies in which the EBRD operates)

Türkiye has significant potential to become a transport and logistics hub, thanks to its geographic position, existing transport infrastructure and plans to expand the domestic transport network. The private sector could play a greater role in achieving Türkiye's ambitions and realising its potential in this regard, and well-structured frameworks are needed to increase private-sector participation. Moreover, there is a need to narrow regional gaps in the quality of and access to infrastructure, notably municipal services, which are under strain due to high urbanisation. At the same time, post-earthquake reconstruction is likely to remain a priority for the foreseeable future, given the large needs involved. As with other sectors, the twin green and digital transformation is crucial, including in the maritime, logistics and transport sectors, to improve Türkiye's participation in global value chains. Lastly, digital infrastructure should be improved, to align with peer levels and allow Türkiye to capitalise fully on its potential as a regional hub.

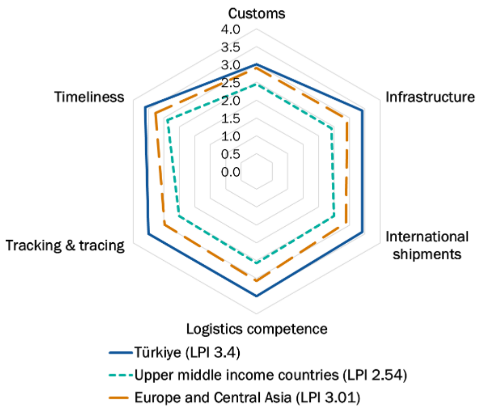
Türkiye is prioritising the development of its transport and municipal infrastructure despite challenges

Türkiye has significant potential to become a transport and logistics hub along the Eurasian network. Located at the crossroads of Europe and Asia, Türkiye plays a vital role in intercontinental transportation. To reap the benefits of its favourable geographical location, plans focus on the development of the Middle Corridor, the Baku-Tbilisi-Kars railway corridor, the Development Road in Iraq, connecting the Gulf region to Europe via Türkiye, and the Zengazur corridor. Through its involvement in international organisations, Türkiye plays an active role in international coordination for the alignment of transport and logistics standards and the harmonisation of practices. While some missing connective links hamper international operations, including around Van Lake, Kars and the Marmara Sea crossing, improvements to the network in the medium term would help Türkiye realise its transcontinental potential to a greater extent. Moreover, trade routes through Türkiye, such as the Middle Corridor, could provide alternative options when supply chains need to be remapped around disruption on other routes, such as the Red Sea route, including the Suez Canal.

To capitalise on Türkiye's geographical position, the authorities have emphasised the importance of developing both the east-west and north-south connections. A key priority for the authorities is to link the Turkish railway network to the European network effectively and solve current challenges, including in the Marmara Sea crossing, to ensure smooth east-west connections. In addition, the authorities have emphasised the potential complementarity, rather than competing priorities, between the Baku-Tbilisi-Kars lines and the Zengazur corridor. The Development Road, through Iraq, is perceived as a junction on both the east-west and north-south alignments, but the remarkably large investment needs involved, both in Iraq and in Türkiye, cast a shadow over the realisation of this plan. While Türkiye is taking active measures to remain involved in international fora, further cooperation with the international community and development partners would facilitate the implementation of internationally recognised approaches to project tendering and implementation, creating additional transparency and competition.

Türkiye has plans to expand its domestic transport network. In the past two decades, Türkiye has invested significant amounts to rehabilitate and modernise all modes of transport and logistics services. Its Logistics Performance Index score increased from 3.15 in 2007 to 3.4 in 2023, implying greater operational efficiency, but declined in the last decade, despite remaining above regional peers (Figure 7.1).[141] To build on these efforts, a significant expansion is foreseen in the Transport and Logistics Masterplan 2053, at a total estimated cost of €125.5 billion,

Figure 7.1. Logistics Performance Index, 2023



Source: World Bank (2023c).

[141] See World Bank (2023c).

generating estimated benefits of €156 billion.[142] This corresponds to €4 billion of annual investment and a €5 billion annual return, on average, over the next three decades. The net benefit to the economy is at the lower end, less than 1 per cent of annual GDP; however, this could be increased if the country's twin green and digital transformation were integrated into planning. This would open up new opportunities for multiple segments of the labour force and yield efficiency gains at all stages of project implementation and operations, should it be done in a comprehensive and well-planned manner. Against the backdrop of Türkiye's tight monetary and fiscal policies, the rehabilitation and modernisation of the network and good asset management practices should be given higher priority in order to maintain the existing network, and the private sector should play a leading role. Moreover, as the lion's share of the Transport and Logistics Masterplan 2053 is focused on the railway sector, it is crucial that spending be dedicated to developing freight transportation, combined with the development of integrated logistics centres to support a modal shift in addition to positive environmental outcomes.

While the private sector already plays a significant role in the development of transport networks, the use of well-structured PPPs would facilitate greater participation. PPPs, if backed by solid value-for-money assessments, would further enhance private-sector participation in large-scale investments, with high economic and social benefits. The Transport and Logistics Masterplan 2053 envisages greater utilisation of railways for freight operations. Given the limited capacity and financial resources of Turkish State Railways, ongoing efforts towards railway liberalisation in the short to medium term should continue. This includes approving a pending law in this regard to encourage the envisaged modal shift, open up space for private-sector operations and boost employment opportunities for men and women.

The high urbanisation ratio is putting a strain on municipal services, especially public transportation. More than 93 per cent of Türkiye's population lives in cities.[143] While municipal infrastructure in most regions is adequate and well maintained, domestic emigration in the aftermath of the 2023 earthquakes and years of refugee influx have put pressure on municipal service provision. Given the need to allocate higher funding for earthquake-affected regions, project prioritisation and better asset management practices in other regions would support efficient project selection and implementation and improve service quality. More inclusive public participation processes are needed to increase citizens' satisfaction with new infrastructure.

In the short to medium term, a key infrastructural priority for Türkiye would be the reconstruction and rehabilitation of assets in earthquake-hit regions. Post-earthquake reconstruction needs, in excess of US$ 100 billion (€93 billion), add to the already large investment needs across sectors. While the current focus is to rebuild the housing stock to address the housing crisis, the quick redeployment and rehabilitation of municipal investments should accompany urban reconstruction to ensure the livelihoods of neighbourhoods and a return to normalcy. Meanwhile, investments are being implemented slower than expected and much-needed crisis and risk management practices, as well as inclusive, participatory approaches, have not yet been properly integrated into planning, increasing the chances of similar outcomes in the event of new disasters.

The twin green and digital transformation is at the core of infrastructure policymaking

The maritime route is the most preferred mode of transport for Turkish exporters, accounting for 60 per cent of total exports. As the EU is Türkiye's largest export market and maritime decarbonisation efforts are underway in the bloc, Turkish exporters and maritime asset owners need to align themselves with the new requirements. A key change in the EU will be the inclusion of the maritime sector in the ETS from 2024, requiring non-EU ships arriving at EU ports to be taxed under the ETS regime if they exceed emission caps. Another key change is the introduction of the FuelEU Maritime initiative, which aims to increase the uptake of sustainable fuels by ships to reduce their environmental footprint. Accordingly, large vessels will be required to reduce the GHG intensity of the energy used on board by 80 per cent by 2050 and to connect to onshore power supply while moored. In addition, as GHG calculations will be based on the whole voyage, the situation in non-EU ports will have an impact on measurements. These developments require the Turkish maritime sector to prepare to cope with the challenges that could arise. In 2023, the Turkish authorities signed a memorandum of understanding with the EBRD on green investment to help decarbonise of the maritime sector, a major step towards achieving this goal. However, considering the sizeable investment needed to transform the maritime vessel fleet, as well as Türkiye's ports, a large-scale programme is needed to prioritise and implement investments.

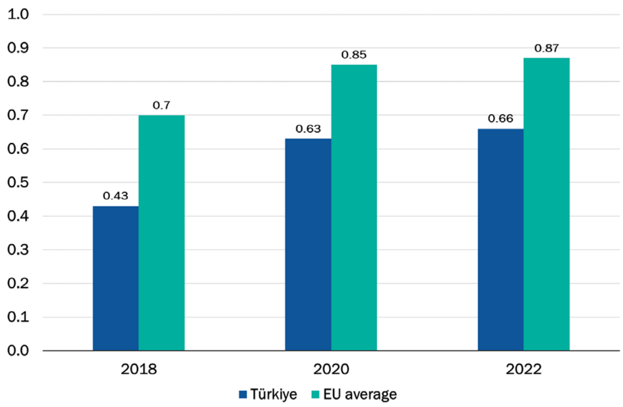
[142] See Ministry of Transport and Infrastructure (2022).
[143] See Turkish Statistical Institute (2023e).

Because of its role in global value chains, Türkiye's logistics sector could be heavily affected by changing market dynamics related to the twin green and digital transformation. In recent years, there has been a shift towards digitalisation, a re-evaluation of nearshoring strategies by manufacturers in the wake of the Covid-19 pandemic and an increase in the relevance of climate initiatives such as the Paris Agreement and the European Green Deal. While the logistics sector has been growing (by 16.1 per cent over the past decade, faster than GDP),[144] the decline in Türkiye's score and rank in the Logistics Performance Index over the past decade (from 27th in 2012 to 38th in 2023) signals a substantial opportunity for the sector to enhance its performance. The regulatory compliance requirements of the European Green Deal have a direct impact on logistics services, especially the implementation of the CBAM and its potential repercussions for the manufacturing sector. The logistics landscape is diverse, featuring prominent international players, along with a multitude of MSMEs. The latter serve as the backbone of the sector, making them an essential driver of the country's twin green and digital transformation. However, there is a need to establish robust institutional structures in MSMEs, increase access to long-term financing and develop information technology structures and data management. Moreover, green transformation is not part of the corporate culture. Given the importance of the logistics sector for Turkish producers' integration into global value chains, it is important to support the sector's alignment with international norms, both on the green and digital fronts, to ensure the success of Turkish exporters. Moreover, the cooperation between public, private and international development stakeholders should continue, to support the country's twin green and digital transformation.

The decarbonisation of the transport sector is a vital component of Türkiye's energy transition strategy. Türkiye expects electric vehicle sales to account for up to a quarter of the market by 2030. During the same period, investments in charging infrastructure will result in the installation of 160,000 charging stations (35 per cent of them fast-charging direct current units) throughout Türkiye. Further investment is needed to advance e-mobility and the electrification of public transportation. On the policy side, roadmaps and fuel-switching policies need to be developed for the transport sector's green transition.

Türkiye's digital infrastructure is improving. Türkiye has been able to increase the provision of digital public services to citizens and businesses and is working to improve its telecommunications infrastructure, which is crucial for a well-functioning e-government (see Chapter 3). Türkiye's Telecommunication Infrastructure Index[145] score has improved significantly (from 0.42 in 2018 to 0.66 in 2022), but it continues to lag the EU average (Figure 7.2).[146] Türkiye's telecoms market is developed, but still growing, with strong demand for high-speed data services.[147] 4G services are widespread and the transition to 5G is expected to offer new business opportunities. The authorities have allocated significant funds for 5G development, with initial implementation planned in major cities.[148] The Information and Communication Technologies Authority (BTK) leads the 5G efforts, promoting localisation and collaboration among various sectors. Among BTK's strategic objectives for 2019–23 are a focus on supporting R&D activities to establish "5G and beyond" national technologies, expanding fibre-optic infrastructure, supporting emerging technologies (such as the Internet of Things and machine-to-machine communications) and developing national cybersecurity capabilities. Providers of fibre-optic solutions are gaining market access, supported by the authorities' strategic plans and infrastructure investments from major internet service providers. However, infrastructural damage, including from earthquakes, and theft have exposed vulnerabilities in ensuring consistent connectivity and the quality of and access to digital infrastructure lags in rural areas.

Figure 7.2. UN Telecommunication Infrastructure Index



Source: UNDESA (2022).

[144] See Turkish Statistical Institute (2023f).
[145] A subcomponent of the E-Government Development Index.
[146] See UNDESA (2022).
[147] See US International Trade Administration (2024).
[148] See ITU (2020).

Access to and speed of broadband internet have progressed, but continue to lag peers. Around 92 per cent of households have broadband internet access, with mobile broadband prevalent.[149] About 61.9 per cent of households access the internet through fixed broadband and 88.5 per cent via mobile broadband. In 2022, the share of regular internet users was 83 per cent,[150] slightly below the EU percentage of household internet access and overall internet usage (90 per cent).[151] This highlights not just the advanced digital connectivity of the EU but also Türkiye's considerable progress and high degree of coverage. Türkiye has 69.6 million active social media users, more than four-fifths of its addressable demographic.[152] It has an average mobile speed of 48.85 Mbps,[153] below the average of central Europe and the Baltic states of 69.33 Mbps. Likewise, Türkiye's average fixed broadband speed of 43.48 Mbps is far below the central Europe and Baltic states average of 129.68 Mbps. Moreover, society's limited digital skills remain an impediment to the wider adoption of digital technologies.

Internet services are becoming more regulated and monitored. Türkiye has implemented laws regulating internet services through the High Council for Broadcasting, granting it authority to monitor and require licences for online video and streaming services. The regulation of content falls under Internet Law No. 5651,[154] which sets out responsibilities for content and of host providers. Amendments in 2021 included the definition of social network providers, increased fines and the requirement for providers with more than 1 million daily hits from Türkiye to have local representatives to ensure compliance with Turkish procedures and regulations. The Board of Access Providers, established under the amended Internet Act, addresses issues such as child abuse and drug crimes. In addition, the legislation safeguards personal rights, allowing the prompt removal of infringing content, but has faced criticism for potential constraints on internet freedom and concerns about free speech.

The surge in remote work, propelled by the Covid-19 pandemic and evolving work preferences, has fuelled demand for data centres in Türkiye. This requires swift infrastructural enhancements and strategic partnerships, posing challenges for operators. With limitations on the ability to use cloud services and transfer personal data, Türkiye is losing out on the opportunity to attract tens of billions of dollars in foreign investment flows into data centres.

[149] See US International Trade Administration (2024).
[150] See Statista (2023).
[151] See Eurostat (2022).
[152] See Statista (2024).
[153] See World Population Review (2024).
[154] See Kaya (2021).

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