الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & BANKING SECTOR OVERVIEW

Turkiye

June, 2022

TRUST . TRANSPARENCY . INDEPENDENCE

Economic Review

The Republic of Turkey posted a nominal GDP of USD 803bn in 2021, marking YoY real GDP growth of 11.3%. Private consumption was the key driver for annual GDP growth contributing 9pps to headline growth (2020: 1.9%) while support from government consumption was limited at 0.3pps (2020: 0.3pps). A sizable push came from net exports which contributed 4.9pps to growth as opposed to 5.3pps negative contribution in full year 2020.

Table 1: Main Indicators

Amounts in US$'bn, unless otherwise stated	2017	2018	2019	2020	2021
Nominal GDP (US$ Bn)	859.1	797.2	760.4	717.0	802.7
GDP per capita (US$)	10,696	9,792	9,213	8,599	9,539
Real GDP - constant prices growth rate (%)	7.5	3.0	0.9	1.8	11.0
Inflation (CPI %)	11.9	20.3	11.8	14.6	36.1
Unemployment Rate (%)	10.9	11.0	13.7	13.1	12.0
Current Account Balance as % of GDP	-4.8	-2.7	0.7	-5.0	-1.7
Fiscal Balance as % of GDP	-1.5	-1.9	-2.7	-3.5	-2.7
Central Government Debt Stock as % of GDP	28.0	28.4	30.8	35.9	42.8
Gross External debt (US$)	451	427	416	433	441
External debt as % of GDP	52.5	53.5	54.7	60.4	54.9

Acceleration in vaccination campaign since June 2021 has provided much needed impetus to economic growth particularly in the services sector as quarantine measures have been eased, despite the intermittent surge of variants to the virus. Declining real purchasing power due to surging inflation, and spillovers of Russia-Ukraine conflict pose significant downside risk factors for 2022. On the upside, the carryover effects of the underlying growth momentum and 50% increase in the minimum wage will support domestic demand. Overall, we would look for around 3.5% GDP growth for 2022, and below potential growth rate, as most of the demand had been pulled forward to 2021, amidst currency volatility.

Following notable deterioration in 2020 mainly on account of gold imports and plunging tourism receipts after the Covid-19 shock, current account dynamics depicted significant improvement in 2021 whereby the deficit retreated markedly by 61% to USD14.0bn - 1.7% of GDP (2020: 5%). The improvement was led by favourable trade balance trends, decelerating gold imports, and as net travel receipts more than doubled over prior year. Improvement in trade balance was also supported by Turkey's proximity to key markets, allowing an advantage during disruptions to global supply chains. In the current year, a weak Lira will enhance exports. While initially, tourism receipts were likely to be boosted further, the Russia-Ukraine conflict is expected to put a dampener on arrivals; nevertheless, tourist inflows are likely to continue to grow. On the other hand, significant increase in energy prices has pressured the trade balance as net importer, which is to be further exacerbated during the current year, likely wiping out the benefits from any upside from exports or tourism. Current account deficit may well deteriorate to 5% of GDP in 2022.

Due mainly to the sensitivity of fiscal revenues to economic activity, budget deficit to GDP declined to 2.7% (2020: 3.5%) in 2021, while current year government revenues are likely to be supported by strong corporate tax and elevated VAT on imports. Income tax will be pressured as the Government has lifted income tax on minimum wage.[1] On the other hand, recent TRY weakness may push down domestic demand and pose downside risks to tax collection. Towards the end of the year, government announced FCY-protected TRY deposit schemes under which participating TRY account holders will be compensated for loss due to unfavourable exchange rate movements. This scheme increases the risks to fiscal discipline if the USDTRY gains well above the normal TRY-deposit rates in a specific period.

Central Government debt stock, on the other hand, expanded by 51.6% to TL2.7trn as of December 2021. Increasing share of FCY denominated debt in total stock has been noted in recent periods reaching 66% of debt, up from 56.2% in December 2020 and 49.7% in December 2019. IIRA notes further dollarization of fiscal space as the recently introduced FCY-protected deposit scheme acts as a contingent liability on the budget. Even with adequate fiscal cushion and relatively low debt to GDP, increasing sensitivity to Turkish Lira depreciation, elevates concerns on the adequacy of buffers.

Headline CPI at 36.1% YoY as of December 2021 (December 2020: 14.6%) evidences the price hike in recent months in almost all sub-segments. With monthly CPI reading of 5.5% in March 2022, annual headline consumer inflation increased to 61.1% mainly driven by transportation, food and housing and household goods, given global trends in food inflation, rising energy prices and Turkish Lira depreciation. On the whole, pricing pressures are evident in almost all segments. Hotels & restaurants segment has also experienced a hike on the back of easing quarantine conditions supporting demand for services. Core CPI and headline PPI has risen to 51.3% and 115.0%, implying further upward pressure on headline CPI.

After hiking the rates to as high as 19% in March 2021, CBT commenced monetary easing in September of the same year, effecting a cumulative cut of 500bps in four consecutive meetings and bringing the policy rate to 14% by December. However, rate cuts executed despite the acceleration of both core and headline inflation has resulted in significant depreciation pressure on Turkish Lira with USD-TRY closing the year with 50% gain compared to the eve of the September rate cut. Towards the end of the year, government announced an FCY-protected TRY deposit scheme which eased the pressure and the Turkish Lira recovered some of its losses, thereafter remaining range bound, since the beginning of the current year. Going forward, risk of rising inflation is deemed material, with transitory effects of supply-side factors fuelled by the Russia –Ukraine conflict, 50% hike to the minimum wage, and rigidity in pricing behaviour. Moreover, a real policy rate of negative 47.1% as of April 2022, poses significant risk to anchoring inflation expectations.

[1]Government has eliminated the income tax on minimum wage starting from year 2022 while all employees salaries upto the minimum wage will be exempt from tax as well. This regulation is expected to create around TL70bn negative impact on prospective tax collection for the year 2022 ceteris paribus amounting about 4.8% of expected fiscal revenues.

Turkish Banking Sector

Total assets of the banking system depicted an annual growth of 50.9% to TRY9.2trn by December 2021 on top of a 36% gain registered in 2020, as sharp depreciation of the TRY in the last quarter of 2021 caused a translation effect on FCY assets in local currency terms. Participation banking sector has been on an accelerated growth pace with government initiatives to boost the sector; market share in terms of deposits has grown to 10.5% from 9.3% at the end of 2020 and 6.1% at year-end 2017. The segment is due to see some consolidation and hence strengthening.

During the year 2021, loan growth for the sector remained muted compared to 2020 due to relatively tight monetary stance of the Central Bank in the first three quarters of the year. Sharp deceleration in TL business lending was one of the key arguments for rate cuts enacted by the Central Bank of Turkey from September onwards. Following the succesive rate cuts, there was an acceleration in commercial loans taking loan growth to 37%, whereas the FCY adjusted lending growth was much lower, though healthy at 12.8%. Growth came mostly from TL loans, whereas FCY loans contracted by 1.6%. Around 42% of Turkish banks' lending portfolio was denominated in foreign currency as of December 2021 (2020: 34.2%). Significant depreciation of Turkish Lira is a key risk factor to monitor from asset quality perspective.

In terms of segments, TL business loans and consumer loans depicted growth rates of 20.5% and 20.2% respectively. Lending growth this year could be supported by loose monetary policy of the CBT and the recapitalization of state banks whereas slowdown in economic growth may weigh on the downside. Persistent inflation is likely to impact purchasing power and demand for consumer finance. However, as of April of 22nd, year-to-date loan growth had already reached 13.9%.

Table 2: Banking Sector Indicators

%	2017	2018	2019	2020	2021
NPLs to Total Loans	3.0%	3.9%	5.4%	4.1%	3.1%
Specific Provisions to NPLs	79.3%	68.3%	65.1%	74.9%	79.7%
Loans to Deposits	126.6%	122.6%	109.6%	108.3%	95.9%
Capital Adequacy Ratio	16.9%	17.3%	18.4%	18.7%	18.3%
Return on Assets	1.6%	1.5%	1.2%	1.1%	1.2%

At the end of 2021, gross non-performing loan ratio for the sector stood at 3.1% (2020: 4.1%), whereas loans under close monitoring at just above 10% as of September 2021, have been recently stable. Potential deterioration in asset quality is considered moderate given the current strong trend in economy and increased provisioning coverage levels. Indeed, at the end of December 2021, Stage-3 provision cover for the sector stood at 79.7%, up from 74.9% in December 2020. On the other hand, aggregate ECL coverage for NPLs stood at 161% (2020: 130%) and will act as a mitigating factor against possible weakening in asset quality. IIRA will continue to closely monitor asset quality indicators for potential impact on overall health of the banking sector as currency weakness may take a toll on repayment capacity of borrowers.

Total deposits surged by 53.5% in 2021 on top of a 34.6% increase in 2020. Turkish Lira deposits increased by a healthy 21.6%, yet due to the depreciation of the currency, the share of foreign currency and precious metal deposits has grown to 64.5% from 55.3% at the end of 2020. As deposit growth of the sector had been in excess of loan growth, we have observed retreat in the loan to deposit ratio for the banking sector to 95.9% by December 2021 (2020: 108.3%, 2019: 109.6%). At the end of year 2021, Liquidity Coverage Ratio ("LCR") of the sector stood at 148.0% (2020: 148.2%). On a positive note, deposits funded 57.6% of total assets as of December 2021 up from 56.6% in December 2020 with lower reliance on wholesale funding.

Dollarization in deposits has been one of the key concerns in the last few years as it had been on a rising trend due to a loose monetary policy. During most of the year 2021, dollarization had been stable at 55% as of September. Following the CBT's rate cuts and Turkish Lira's depreciation, the ratio reached 64.5% at the end of December. As of April 22nd, dollarization ratio was reported at 57.0%[2] as there was notable conversion from FCY and precious metals accounts to Turkish Lira deposits. IIRA notes that the dollarization trends need to be followed closely from the financial stability point of view as negative real deposit yields may further enhance dollarization in the banking system despite the incentives offered by the Government to the TRY depositors.

ROAA rebounded to 1.2% in 2021 with 57% YoY increase in net earnings of the sector as significant improvement in fee income and provision reversals coupled with improved spread income supported profitability. Going forward, net spread income is likely to benefit further from CBT's recent rate cuts feeding into wider spreads which would support overall profitability.

As of March 2022, capitalization indicators remained strong with aggregate CAR and CET-1 ratios at 20.4% and 15.6%, respectively, calculated using last 252- days average of foreign currency parities. The capital bases of state banks have strengthened through injections from the Sovereign Wealth Fund amounting to TL51.5bn in March 2022. Meanwhile, in the month of April 2022, BRSA revised the calculation of capital levels dictating the use of exchange rates which had been effective at the last day of the year 2021. The latest revision would lower the sector's headline capitalization levels. However, IIRA deems capital buffers as adequate given the prospects of better internal capital generation.

[2] BRSA Weekly Data

الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency