الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

ECONOMIC & FINANCIAL SECTOR OVERVIEW

Republic of Turkey

July, 2021

TRUST . TRANSPARENCY . INDEPENDENCE

ECONOMIC OVERVIEW- The Republic of Turkey

The Republic of Turkey is a diversified economy, and is classified in the upper middle-income category as per the World Bank country classification. Turkey was one of the few countries that was able to post GDP growth in 2020, at 1.8%. GDP growth was driven by strong domestic demand supported by the credit stimulus provided by the government. There was also deferred domestic demand in the economy, given below potential growth performance in 2018 and 2019.

The New Economy Program (NEP) envisages 5.8% and 5.0% GDP expansion in the years 2021 and 2022, respectively. Turkey's growth projections are underpinned by recovery in domestic demand, in addition to expected contribution from exports and turnaround in investment appetite as well as moderate growth in tourist inflows which dipped significantly in the year 2020. To this end, pace of vaccinations and the containment of the pandemic is deemed crucial. By the end of May 2021, about 20% of the population had received at least one vaccine dose. Recent procurement of 120mn doses of the vaccine, being the first part of a total 270mn doses acquisition deal (likely to be sufficient in view of a population of around 84mn) has helped the acceleration of vaccine drive in terms of scope and pace from the month of June.

IIRA forecasts Turkey to register GDP growth rate of at least 5% for the full year 2021, with upward potential of up to 6%. Key downside risks stem from prolonged effects of Covid-19 on economic activity and the vaccination drive being slower or less effective than expected. On the upside, expected improvement in tourism with prospective acceleration of vaccination campaign from June, and continuation of positive trends in exports, support growth prospects for the current year. Growth is likely to decelerate next year as base effect dissipates, however, strengthening of the external position is expected to allow growth in the year 2022, to persist close to its potential of about 4%.

Table 1: Key Macroeconomic Indicators

Amounts in USD'b, unless otherwise stated	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Population ('000)	78,741	79,815	80,810	82,004	83,155	83,614
Nominal GDP (US$ Bn)	867.1	869.2	859.1	797.1	760.8	717.0
GDP per capita (US$)	11,085	10,964	10,696	9,792	9,213	8,599
Real GDP - constant prices growth rate (%)	6.1	3.3	7.5	3.0	0.9	1.8
Inflation (CPI Year-End, %)	8.8	8.5	11.9	20.3	11.8	14.6
Unemployment Rate (%)	10.3	10.9	10.9	11.0	13.7	13.2
Current Account Balance as % of GDP	-3.2	-3.1	-4.8	-2.7	0.9	-5.1
Fiscal Balance as % of GDP	-1.0	-1.1	-1.5	-1.9	-2.9	-3.4
Central Government Debt Stock as % of GDP	28.8	28.9	28.0	28.4	30.8	35.9
Gross External debt (US$)	399	408	454	443	435	450
External debt as % of GDP	46.0	46.9	52.8	55.5	57.1	62.8

A weaker global economy along with travel bans by many countries has substantially impacted Turkey's exports and tourism in 2020. Further, higher gold imports led to a current account deficit of USD36.7bn vis-à-vis a USD6.8bn surplus in 2019, despite significantly lower average energy prices. Moreover, portfolio outflows surged, causing sharp decline in official reserves. In October 2020, an announcement put estimated reserves in a gas field off the Black Sea coast at 405 billion cubic meters. With the additional discovery of 135billion cubic meters announced in June 2021 total natural gas discovery in Black Sea has reached 540 billion cubic meters. Turkey imported 45.21 billion cubic meters of natural gas in 2019; the discovery will potentially fulfil about 12 years of requirement for the country. Considering that Turkey's energy bill amounted to USD41.7bn in 2019 and USD28.9bn in 2020, this is likely to meaningfully support the country's external balances after commencement of extraction from the field in 2023.For 2021, IIRA expects current account deficit to narrow to 3.5% from 5.1% in 2020 despite notable increase in oil prices. Indeed, there was an evident decline in 12-month rolling current account deficit as of April 2021. Meaningful improvement depends on realization of expectations regarding continued tight monetary policy and its impact on consumer loans and hence imports, normalization of gold imports supported by recent legislative measures, and improvement in tourism revenues.

Fiscal discipline has been a strong pillar of the economy since the early 2000s; prudence on the budget front is evident with the budget deficit to GDP ratio maintained below 3% and leaving the primary balance in surplus even in relatively weaker years. More recently, revenues have been supported by one-off streams as well as adjustments to indirect taxes. In 2020, the burden arising from fiscal support measures along with absence of one-off revenue sources caused the deficit to widen to 3.4% of GDP (2019: 2.9%), with the extent of deterioration remaining favorable vis-a-vis emerging market peers. Revenue performance has remained benign so far in 2021, supported by increased indirect tax generated on the back of rising domestic demand. As such government target deficit of 3.5% for the year, appears achievable. We may see fiscal consolidation following normalization of the economy in and beyond 2022.

Containing inflation has been a core challenge faced by the Turkish economy. Annual Consumer Price Index (CPI) in Turkey has been consistently above the Central Bank of Turkey (CBT) target of 5% and has remained in double digits since 2017. Year-on-year Consumer Price Index (CPI) was recorded at 11.8% in December 2019 and 14.6% in December 2020. The Turkish Lira also depreciated by almost 20% against the USD in 2020, feeding into domestic inflation. The Central Bank has forecasted 2021 inflation to close at 12.2%. Recent depreciation of Turkish Lira coupled with elevated international commodity prices and supply constraints in some sectors pose risks to headline inflation. IIRA expects CPI to close the year at around 15%.

In the beginning of 2020, in tandem with easing outlook for inflation, CBT undertook successive rate cuts bringing the policy rate to 8.25% in May 2020 from a peak of 24%. Effective policy rate or the weighted average cost of CBT funding declined to as low as 7.3% in mid-July and real rates touched -4.4%. CBT resumed to tighten its monetary policy stance by increasing policy rate in September 2020 by 200bps to 10.25% citing upside risks to inflation outlook. In subsequent months, rapid rate hikes brought the policy rate to 19% by March 2021.

Turkey's EU defined general government debt stock level increased by 41.4% to TL 2.0trn by December 2020 (end-2019:TL 1.4trn) to 42.6% of GDP from 32.6% at end 2019.Although the total external debt stock has remained broadly stable in recent periods, as a percentage of GDP, it depicted an increase. External debt stock reached USD435.1bn as of September 2020 (2019-end: USD434.5bn) which corresponded to 59.1% of GDP (2019: 57.1%).Even though the net FCY position of the non-financial corporates remains a key area of concern, we note the notable narrowing of the negative position, which fell to USD157.6bn at the end of December 2020 and which has improved over December 2019 and December 2018 readings of USD180.8bn and USD207.2bn respectively.

Turkey's external financing position poses some concern in view of higher external debt to GDP, shortened maturity profile, and declining coverage of short-term debt by international reserves.The proportion of short-term debt increased to 30.8% in 2020 while reserve coverage of short-term external debt has dropped significantly to 67.4%. While debt roll-over ratios remain comfortable, the relatively high external refinancing needs, leave the country vulnerable to investor sentiment.

Banking Sector

Banking sector assets had reached TL6.1trn as of December 2020 marking a 36% surge over prior year end, corresponding to 121% of GDP (2019: 104% of GDP). Concentration is evident with 78.2% of deposits held by the largest seven banks[1] as of September 2020. An emerging trend is the shift of sector assets towards state banks with their share in terms of assets having risen to 45.3% in December 2020 compared to 41% in December 2019 and only 31.9% in December 2015.

Recently, the market share of participation banks has accelerated reaching 9.3% in terms of deposits as of December 2020, up from 8.9% at year-end 2019and 6.1% for year-end 2017. Recapitalization of two state participation banks through tier-2 issuances and the launch of another state PB, Emlakbank, in March'2019 supported the growth in Islamic Banking segment. Recently, there were further attempts to increase penetration of Participation Banking in the Country via establishment of PB Division in the CBT and Presidential Office. Economic Reform Package announced on March 12, 2021, foresees three steps to be taken to provide impetus to Islamic Finance including launch of Centralized Shari'a Board for Islamic Finance segments, instituting independent Islamic Finance Compliance Ratings and establishment of participation financing

[1] Comprising 3 state owned banks (Ziraat, Halk, Vakif), 3 private-owned banks (Akbank, Isbank, YapiKredi) and one foreign bank (Garanti)

arbitration mechanism at par with international standards.From the governance perspective, Banking Regulatory and Supervisory Authority (BRSA) published the regulations concerning the PB Governance Framework in September 2019and allowed six months to achieve compliance with the requirements. These were a set of rules to converge the Turkish PB sector to global best practices.

It is worthwhile to note that asset growth for the sector at 36% for the year 2020 was well above prioryear growth and driven by local currency depreciation.In 2020, loan growth also remained high, afterhaving bottomed out in the last quarter of 2019 at levels below zero on FCY adjusted basis.Growth in 2020 was driven by an easing of financial conditions, accelerating domestic demand, and a major regulatory push by BRSA in the form of minimum asset ratio. Following the spread of the pandemic, the uptick in volume growth was maintained due to both declining interest rates and state incentives comprising Credit Guarantee Fund.Overall, annual growth reached 34.8% on nominal basis with 43.7% rise in TL denominated loans and 20.5% increase in FCY loans.

A key supporting factor for credit growth was the increasing share of loans disbursed within the scope of Credit Guarantee Fund (CGF), wherein outstanding amount grew to TRY305bn as of year-end 2020 compared to only TRY188bn in the beginning of the year, and CGF allocated financing increasing to 10.5% from 8.5% at prior year-end.Starting in Q3'20, CBT has tightened liquidity which led to increasing cost of funding and hence higher loan rates whereas BRSA commenced gradual easing of the asset ratio regulation which terminated eventually in December 2020. Consequently, momentum of growth has decelerated since.Due to the tighter stance of the Central Bank and elevated lending rates, loan growth for the full year 2021 is foreseen to decelerate to 15%-20% on nominal basis.

Table 2: Banking Sector Indicators

%	2015	2016	2017	2018	2019	2020
NPLs to Total Loans	3.1%	3.2%	3.0%	3.9%	5.4%	4.1%
Specific Provisions to NPLs	74.6%	77.4%	79.3%	68.3%	65.1%	74.9%
Loans to Deposits	123.4%	123.6%	126.6%	122.6%	109.7%	104.6%
Capital Adequacy Ratio	15.6%	15.6%	16.9%	17.3%	18.4%	18.7%
Return on Assets	1.2%	1.5%	1.6%	1.5%	1.2%	1.1%

Impairment indicators of the banking sector deteriorated in 2019 following the lagged impact of sizable currency depreciation in H2'2018 with sector wide non-performing financing ratio (NPF) increasing to 5.4% from 3.9%. By December 2020, the indicator had improved to 4.1% due to the denominator effect of accelerated lending growth and forbearance measures, delaying recognition of impairments to over 6 months from 3 months. As per BRSA's directives announced in December 2020, forbearance measures will be effective until the end of June 2021. In the current year, economic revival should improve asset quality prospects while the lifting of forbearance measures in the second half of the year, coupled with rather high levels of loans under close monitoring hovering at 10.3% (2019: 11.1%) of total financings, are likely to result in uptick in impairment indicators. Services sectors, most prominently tourism linked businesses like hotels and restaurants may witness relatively sharper deterioration.

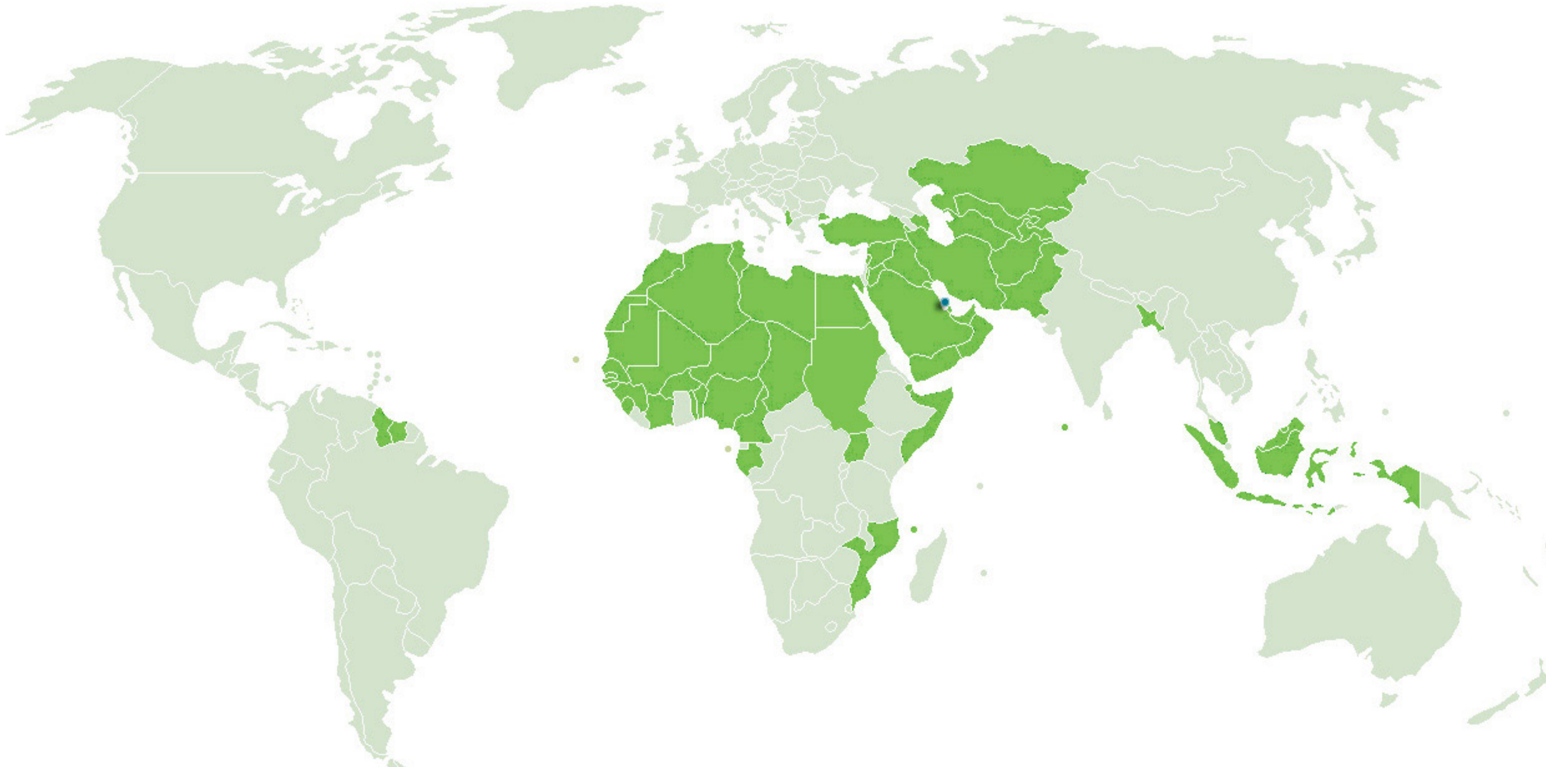
On a positive note, sector participants continued to create additional provisions which are likely to soften the potential impact of the lifting of forbearance measures in 2021. Stage-3 and stage-2 provisioning coverage of the sector improved to 74.9% and 15.3% by end 2020 (2019: 65.1%, 10.2%) respectively. Total ECL provisioning coverage reached 130.2% at the end of 2020, from 95.2% at prior year end. Along with TL14bn discretionary provisioning, we note that total provisioning levels for the sector remained close to 140%. Net impairment in relation to assets and equity at 0.6% and 6.4% (2019: 1.2% and 10.7%), suggests still robust asset quality.

Turkish banking assets are funded mainly by deposits to the tune of 56.6% as of year-end 2020 (2019: 57.2%, 2018: 52.6%). Increasing trend for deposit funding has been due to both strong deposit growth and the deleveraging of the sector since the appetite for FCY financings remained weak due to depreciating Turkish Lira. Moreover, the increasing share of demand and low-cost accounts is a favorable trend. At the end of September 2020, Liquidity Coverage Ratio ("LCR") of the sector stood at 148%. In addition, BRSA initiated forbearance towards regulatory minimum LCRs effective until end 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

the Banking sector to 105% by end 2020 (2019: 106%, 2018: 119%).

Due mainly to relatively loose monetary policy stance, the currency breakdown of deposits has been shifting towards foreign currencies. Consequently, FCY deposits made up over 55.3% of total deposits denoting 430bps increase compared to year-end 2019. Following the recent tightening which brought the average cost of CBRT funding to around 19% indicating 950bps increase from the lowest point inQ3'20, local investors are expected toswitch to Turkish Lira deposits gradually. Sustainability of such reversion depends on continued tight monetary stance allowing real returns for LCY deposit holders.

Despite strong growth in asset base, profitability indicators were only marginally lower with an ROAA of 1.1% for 2020 versus 1.2% for 2019. In 2021, net interest margins may narrow on account of higher deposit cost and maturity mismatch. We nevertheless expect profitability position to remain robust with expected decline in net margins to be compensated for by increasing fee income and lower expected charge-offs. Capitalization indicators remained strong with aggregate CAR and CET-1 ratios reaching 18.7% and 14.5% as of December 2020. The impact of forbearance on the aggregate CAR of Turkish Banking Sector amounted to 160bps at the end of 2020. Even in the absence of forbearance measures, capital buffers are considered adequate. IIRA will continue to closely monitor asset quality indicators for potential impact on overall health of the banking sector.



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