ECONOMIC & BANKING SECTOR OVERVIEW

Republic of Turkey

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Economic & Banking Sector Overview

The Republic of Turkey is the largest economy in the Middle East and North Africa (MENA) region, with a GDP of USD784.1b in 2018. Real Income levels have shown a declining trend since 2014 with the depreciation of local currency, with GDP per capita declining to about USD 9,632 in 2018 (2016: USD 10,53

Table 1- Turkey - Key Economic Indicators						
	2013	2014	2015	2016	2017	2018[1]
GDP - constant prices growth rate (%)	8.50	5.20	6.10	3.20	7.4	2.6
Inflation (Annual CPI , %)	7.4	8.2	8.8	8.5	11.9	20.3
Current Account Balance as % of GDP	-6.7	-4.7	-3.7	-3.8	-5.6	-3.5
Fiscal Balance as % of GDP	-1.0	-1.1	-1.0	-1.1	-1.5	-2.0
Central Government Debt Stock as % of GDP	31.4	28.8	27.6	28.3	28.3	28.8
External debt as % of GDP	41.2	43.4	46.4	47.4	53.4	56.7

Turkey's GDP growth decelerated to 2.6% in 2018 following a high base of 7.4% growth registered in 2017, as the sharp devaluation of the local currency in the month of August 2018, resulted in a slowdown in domestic demand and dampened the already weak investment appetite of the private sector. GDP adjusted for seasonal and calendar day effects contracted on QoQ basis in both Q3 and Q4 of 2018 by 1.6% and 2.4% respectively.

For the year 2019, Turkish government foresees 2.3% growth while market expectations and forecasts of international organizations are notably weaker. IMF projects a 2.5% contraction for the economy in the ongoing year. Overall, GDP growth in 2019 is expected to be well below its long-term trend, and is forecasted to pick up gradually from 2020 onwards. High inflation (at 19.5% as of April 2019 despite the several ad-hoc measures and temporary tax reliefs for certain categories of goods such as autos), significant monetary tightening and an increasing unemployment rate are likely to continue to pressure the economy in the near term.

Turkish Lira's depreciation against USD and Euro has been relatively steep since November 2016 until September 2018 due to Federal Reserve Rate hike and as USD appreciation against other currencies continued during this period. The lira depreciated by 28.6% against USD and 25.4% against Euro during the year 2018. With a pass through of depreciation and increased global commodity prices, annual inflation reached 24.5% as of September 2018 posing significant challenges to the economy. In response, the CBRT raised policy rate to 24% with a 625 bps increase in September 2018 and following a cumulative 500bps increase in April, May and June 2018. The policy rate has recently seen a cumulative 750bps cut during July and September meetings with significant fall in inflation.CBRT's most recent inflation estimate for 2019 and 2020 stood at 14.6% and 8.2% respectively. However, uncertainty over the course of cost factors and pricing behavior continue to pose risks to the inflation outlook.

Balance of Payment position witnessed a marked correction in the second half of 2018 with large contraction in imports and sustained growth of exports. Higher tourism revenues were another supporting factor. As a result, current account deficit came down to USD27.8bn in 2018 from USD 47.5b during 2017. The trend was maintained in the beginning of 2019 with 12-month cumulative deficit contracting further to USD17.0bn as of February. Going forward, the improvement is expected to continue in tandem with pressured domestic demand, resilient exports and better tourism revenues. However, the quality of financing of current account deficit has deteriorated in 2018, reflected in reduction in reserves and a net outflow in the financial account.

Over the years, the government has demonstrated fiscal discipline, which has assisted in implementing appropriately countercyclical policies as needed. Fiscal deficit has remained well below the Maastricht Criteria of 3%, despite being elevated in 2018 at 2.0% (2016: -1.5%). In 2018, annual budget deficit is registered as TL72.6b, 52% higher vis-à-vis the prior

[1] *External debt data pertains to Q3'18.*

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year due to state sponsored incentives to boost economic activity. In the first quarter of 2019, budget deficit realized stood at a significantly higher TL36.2bn (Q1'18: TL20.4bn) as the revenues grew 30.4% whereas expenses increased 35.4% on YoY basis. Nevertheless, fiscal deficit is likely to go further up.

Net FCY position of the non-financial sector continues to be one of the key vulnerabilities of the Turkish economy. As of Feb'19, net FCY position stood at negative USD197.3bn which is deemed high and has the potential to severely undermine private sector debt-payment capability in the foreground of continued pressure on the TL. Meanwhile, it is worthwhile to note that this position was higher before the deleveraging began following last year's volatility (March'18: -USD220.9).

Despite the tailwinds, economic activity could derive strength from government initiatives to kickstart demand such as higher than expected minimum wage, loan restructuring facilities, new loans and employment campaigns for SMEs. Expectations of double digit growth on the tourism front and resilience of exports, despite the weakening of economic activity of key partners in EU, maypush GDP growth through an expected uplift in net exports.

Banking Sector

Comprising 75% of the Turkish financial system, the banking sector has continued to grow, albeit at a slower pace in 2018, in tandem with slowdown in the economic activity. Total loans expanded 14.8% in 2018 (2017: 21.0%) despite the inflation of FC denominated loans following Turkish Lira depreciation. Banking sector assets had reached TL3.87tr as at December 2018 (18.7% higher than prior year-end level), and stood at about 1.04 times the GDP. Despite continuous growth, Turkey remains underpenetrated in terms of banking assets in relation to GDP, vis-à-vis the EU average.

Given the banking sector's significant utilization of foreign currency denominated funding, and increasingly high risk exposure to Turkey's corporate sector, which carries considerable FCY liabilities on its balance sheet, the banking sector is exposed to notable risk. As such the health of the banking sector would be a decisive factor in the continuing stability of the economy.

Turkey's banking sector comprises 50 institutions, comprising 32 conventional banks, 13 development and investment banks and 5 participation banks as of December 2018. Emlakbank, a state- owned bank, started its operations as a participation bank at the end of March 2019.

Conventional banks continue to form significant portion (about 88%) of the overall banking sector in Turkey, of which seven banks[2] command around 76% market share[3] as of September 2018. This could be viewed with caution in the light of high systemic risk, in the event of financial stress. The ongoing regulatory drive to create an Islamic finance center in Istanbul and driving the increase in participation banking assets share to 15% of overall assets by 2025, is viewed positively, given the potential of Islamic banking to serve as an alternative asset class and diversify system risks. However, the share of Islamic Banking has reached just above 5% of overall banking system (5.3% in terms of assets and 6.7% in terms of deposits as of December 2018) and is as yet considered to be at a scale which may be considered below potential.

As of year-end 2018 around 22% of total lending is allocated to consumers. Corporate and commercial loans constituted around 52% of total portfolio while SME financing has around 26% share. Business portfolio is reasonably diversified with retail & wholesale trade, construction, electricity & gas distribution, and real estate segments commanding dominant shares. Taking into account,consumer mortgage lending, total exposure to real estate and construction segment hover around 30% of aggregate financings; exposure to the sector is deemed high risk, given the unfavorable supply-demand dynamics of the sector.

Low credit demand and a difficult economic environment may translate into further deterioration in the quality of banks' financing portfolios going forward. At the end of 2018, absolute levels of non-performing Financings ("NPFs") have significantly grown by 51% from end- 2017 and its share in relation to total cash loans surged to 3.9% from 3.0%[4].

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

[3] *In terms of total assets*

[4] *As of March 2019, the ratio was slightly higher at 4.0%. However, for the Participation Banks, impairment ratio increased aroud 30bps vs. year-end 2018.*

There has also been a notable increase in 'past due but not non-performing' loans, partly attributable to IFRS 9 implementation. The vulnerability of the banking sector to weaker economic activity and depreciating currency due to sizable FCY debts in the non-financial corporate sector, remains a pressing concern.

The share of FCY deposits in total deposits had been on an uptrend and reached 53.7% as of March 2019 (2018: 48.8% 2017:44.2%). Despite this trend, the main driver of growth on the lending front hasbeen TL based commercial loans so that banks' utilization of swaps has been edging up over a timeline and leading to rising cost of funding for the system.

Profitability indicators trended downwards in 2018 on account of increasing provisioning expenses stemming from both asset quality deterioration and IFRS-9 implementation. Return on average assets was 1.4% in 2018 (2017: 1.6%). Pressure on spreads due to rising deposit costs also contributed to weaker profitability. For the year 2019, muted volume growth forecasts[6], expectations of increase in impairments, along with a steady margin environment are likely to push down the profitability metrics. As of March 2019, total net income of the banking sector retreated by around 11.7% compared to March 2018 mainly on account of specific provisions which upped 72% whereas Net Interest Income growth remained limited at 10%. Meanwhile, net earnings of the PB sector came down 3.9% YoY with a 66% increase in impairment expenses.

Table 2: Snapshot of the Turkish Banking Sector (%)[5]

%	2014	2015	2016	2017	2018
NPLs to Total Loans	2.9	3.1	3.2	3.0	3.9
Specific Provisions to NPLs	73.9	74.6	77.4	79.3	68.3
Loans to Deposits	121.6	123.4	123.6	*126.6*	*122.6*
Capital Adequacy Ratio	16.3	15.6	15.6	*16.9*	*17.3*
Return on Assets	1.3	1.2	1.5	*1.6*	*1.4*

Capitalization of the overall banking sector remained strong at about 17.3%[7] at end-2018 (Dec. 2017: 16.9%), supported by internal capital generation and tier-1 & tier-2 issuances, whereas the CET1 ratio also indicates sufficient risk buffers at an average of 13.8%. A couple of larger private banks issued fresh capital. Meanwhile, state-owned banks bolstered their capital base via tier-2 issuances in the last quarter of 2018. The capital base of the state-owned banks will be further supported by around TL28bn in aggregate throughgovernment's bond issuances planned in support of the local banking sector.

[5] As per the BRSA figures

[6] Monthly BRSA figures indicated that quarterly lending growth was somewhat above 5% in Q1'19 but mainly driven by state-owned deposit banks recording 8.7% volume growth while for private local banks and foreign banks booked respective growth rates of 2.6% and 3.7%. For PB sector, financing growth was about 3.5%.

[7] As of March 2019, retreated to 16.4% while CET1 ratio declined to 12.9%.

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