الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

IIRA Revises the Foreign Currency Ratings of the Republic of Turkiye; maintains short-term ratings

Manama, April 29, 2022– The Islamic International Rating Agency (IIRA) has revised the long term and short term foreign currency ratings of Republic of Turkiye ('Turkiye' or 'the Country') to 'BB+/ A3' (Double B Plus / Single A Three) while also lowering the local currency ratings at 'BB+/A3' (Double B Plus / Single A Three) on the international scale. Meanwhile, the outlook on the ratings has been revised to 'Stable'. Ratings had been placed on a negative outlook on June 11, 2021, on the basis of expected exacerbation in macroeconomic imbalances arising in large part due to the stress inflicted by the pandemic. Given that most of the risks highlighted thereby have materialized, the long-term ratings have been accordingly revised, while short-term ratings have been maintained. Persistent inflation, low reserve coverage of external debt, potential deterioration of the current account with higher energy prices weighing on the import bill, and decreasing predictability of the monetary policies are key drivers of the rating action.

The credit rating of Turkiye is supported by the strong growth momentum on the back of robust domestic demand and recovered external demand in 2021, and largely maintained buffers in the banking sector. The accelerated pace of vaccinations starting from June 2021, combined with continued strong economic activity and supportive external demand buoyed GDP growth to reach 11% in 2021, with some of the growth representing brought forward demand from 2022, due to sharp depreciation of the currency in Q4'2021.

However, monetary easing in the face of rising inflation has fed into an inflationary spiral via notable depreciation of Turkish Lira. Hence, CPI realizations have exceeded the Central Bank of Turkiye's (CBT) estimates by a wide margin. Annual Consumer Price Inflation (CPI) accelerated to 36.1% by the end of 2021 and further to 61.1% as of March 2022 as pass through impact of significant Turkish Lira depreciation, strong demand and supply side dynamics weighed in.

CBT's cumulative policy rate cuts amounting to 500bps from September 2021 to December 2021, despite the acceleration of both core and headline inflation, have also put 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 fueled by the Russia-Ukraine conflict, 50% hike to the minimum wage, and rigidity in pricing behavior. Moreover, a real policy rate of negative 47.1% as of April 2022, poses significant risk to anchoring inflation expectations.

For the year 2022, low lending rates, and improvement in exports aided by a weak Lira will be supportive for economic growth. Given the continued momentum in the current year and carryover effects from 2021, demand is likely to remain strong with IIRA's forecast for GDP growth being 3.5% for 2022. Downside risks are noteworthy in case of a long drawn-out conflict in the region, inflation pressuring domestic demand, rising cost of imports, a weakened currency and associated financial stability risks.

Initial forecasts for 2021 pointed to around 3.5% fiscal deficit in relation to GDP, however, driven by both strong tax collections on the back of invigorated economic growth and fiscal prudence, fiscal indicators outperformed expectations and deficit to GDP materialized at 2.7%. Revenue performance has benefitted from increased taxes which rose around 40%. Recovery in profitability of corporates resulted in almost 70% increase in corporate income tax, also making a sizable contribution to total tax collections for the year. With the government opting to bear the burden of the currency shock and inflation, via elimination of some taxes such as income tax on minimum wage, and increasing transfers to lower income citizens, risks to the fiscal outlook are higher for 2022. Furthermore, new deposit scheme announced towards the end of the last year, linking return on Turkish Lira deposits to the USD-TRY values with related cost to be borne by the Treasury, is a contingent liability and poses risk to the fiscal position in the current year. Even with adequate fiscal buffers given relatively low government debt to GDP, increasing sensitivity of the debt stock to Turkish Lira depreciation, despite the reduction in the share of FX in total domestic borrowings in 2021, elevates concerns on the sufficiency of such cushions.

Current account dynamics depicted notable improvement in 2021 with deficit around 1.7% of GDP as goods trade balance improved, gold imports decelerated notably, and net travel receipts surged by 109% over the prior year. Improvement in trade balance was also supported by Turkiye's proximity to key markets as there were disruptions in global supply chains. Significant depreciation of Turkish Lira in Q4'21 may continue to boost exports. While there maybe pressure on tourism inflows given the prevailing geopolitical crisis, tourism receipts may continue to scale up from prior year. However, commodity price dynamics unfolding in the early part of the current year, on account of the Russia Ukraine conflict, are likely to increase the overall burden of essential imports, most notably through energy price escalation. The overall current account deficit is nevertheless likely to deteriorate significantly from prior year to about 5% of GDP.

External debt stock grew modestly by 1.9% in 2021, however, it declined to 54.9% of GDP (2020: 60.4%) given the surge in GDP. Meanwhile, maturity profile of debt stock reflects gradual shortening. International reserves amounted to 64.8% of short-term external debt on a remaining maturity basis denoting improvement over 49.6% in 2020, yet the current levels of reserve coverage are deemed to be relatively low.

Despite banking sector largely holding up till now, sharp depreciation of Lira has elevated the financial stability risks posing a threat to asset quality prospects. Around 42% of the lending book is FCY denominated, and dollarization has steadily increased over time, albeit depicting a decline in the last few months following the introduction of the FCY protected deposit scheme.

There could be a further negative rating action if:

a) Fiscal deficit deteriorates significantly and rise in government debt stock accelerates,

b) External debt position weakens,

c) Banking sector buffers narrow down due to the lagged impact of TRY depreciation.

There would be a positive rating action if:

a) Notable decline in headline inflation by the end of year 2022 from its steep level currently, appears sustainable, with expectation of convergence towards CBT’s medium-term targets in later periods,

b) CBT’s international reserves grow notably on the back of most recent regulatory directives,

c) Institutional policy making framework can be perceived as being more predictable.

For further information on this rating announcement, please contact IIRA at iira@iirating.com