Republic of Turkey
Rating Report

B- NEGATIVE OUTLOOK

Credit strengths

- Large and diversified economy
- Resilient banking system
- Moderate levels of sovereign debt
- Comparatively high potential growth

Credit challenges

- Loose monetary policy and high inflation
- Inadequate reserves and dollarisation
- Inadequate governance and likelihood of deeper balance of payment, financial and/or political crisis

Rating rationale:

Large and diversified economy: Turkey's diversified economy (nominal GDP of circa USD 805bn in 2021) is expected to grow 2.3% during 2022 before 2.4% in 2023, after growth in 2021 was 11%.

Resilient banking system: Tier 1 capital adequacy of the banking system, while recently reinforced, had declined to 14.4% of risk-weighted assets as of Q3 2021; however, non-performing loans (NPLs) continued easing to 3.2% of aggregate loans as of January 2022. The resilience of the banking system is being attenuated as the sovereign draws on banking-system resources and economic mismanagement weakens financial institution balance sheets.

Moderate levels of central government debt: Turkish sovereign debt levels remain moderate under an international comparison. Although on an increasing trajectory, central government debt amounts currently to 38% of GDP – below that of most indicative sovereign credit-rating peers, allowing the government some time to amend weaknesses of an underlying policy framework.

Rating challenges include: i) ongoing deterioration of the nation's credit profile due to inadequate governance and likelihood of deeper balance of payment, financial and/or political crisis; ii) evolving vulnerabilities, associated with structurally loose monetary policy, high inflation, negative net foreign-currency reserves as well as elevated and rising sovereign FX exposure; and iii) possibility of heightened domestic instability in a period surrounding elections scheduled mid-2023.

Turkey's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Extraordinary adjustment – local currency[1] (notches)	Final rating (local currency)
		Weight	Indicative rating		Notches		
Domestic Economic Risk		35%	bbb		-2/3		
Public Finance Risk		25%	a-		-1		
External Economic Risk		10%	b+		-1	-2	B
Financial Stability Risk		10%	aa		-2/3	Extraordinary adjustment – foreign currency[1,2] (notches)	Final rating (foreign currency)
ESG Risk	Environmental Risk	5%	aa		0		
	Social Risk	5%	bb		0		
	Governance Risk	10%	c		-1/3		
Overall outcome		bbb-		0	-3	-3	B-

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. [1]For Turkey, an extraordinary two-notch adjustment is applied across foreign- and local-currency ratings to reflect significant weaknesses in macro-financial management. [2]A further one-notch adjustment is applied to the foreign-currency long-term ratings to account for an increasing risk of balance of payment crisis. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH.

Outlook and rating triggers

The Negative Outlook represents our opinion that risks to the sovereign ratings are tilted to the downside over the next 12 to 18 months.

Positive rating-change drivers

- Adoption of credible monetary, fiscal and economic policies
- Reduction of external vulnerabilities
- Reversal of deterioration in the governance framework

Negative rating-change drivers

- Deterioration in external sector stability
- Increasing macroeconomic imbalances owing to economic mismanagement
- Further erosion of democratic institutions and/or escalation of civil instability

Ratings and Outlook

Foreign currency

Long-term issuer rating	B-/Negative
Senior unsecured debt	B-/Negative
Short-term issuer rating	S-4/Stable

Local currency

Long-term issuer rating	B/Negative
Senior unsecured debt	B/Negative
Short-term issuer rating	S-4/Stable

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Bloomberg: RESP SCOP

Domestic Economic Risks

- **Growth outlook:** Turkey was one of several nations globally to have recorded positive economic growth during 2020 (of 1.8%), above a 0.9% growth rate in 2019, boosted by consumption and investment, and supported by loose monetary and fiscal policy. Growth recovery was buoyant during 2021 (11%), in line with our above-consensus expectations (10.8%), on the back of recoveries in industrial and services sectors. Turkey's economy is expected to grow 2.3% during 2022 before 2.4% in 2023, however, before a below-potential 2.5% over 2024-26 (growth potential estimated of 3.9%) – constrained by increasingly frequent economic crisis and current elevated inflation.

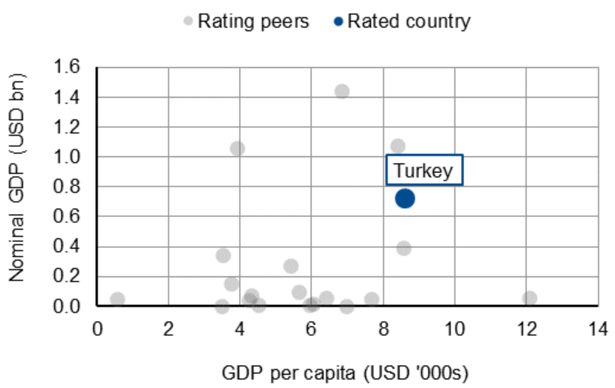
- **Inflation and monetary policy:** Inflation in February 2022 was 54.4% YoY, having risen significantly from a level of 8.6% as of October 2019. This was driven by supply-side factors such as rise of global energy, food and agricultural commodity prices, recovery in demand since Covid-19 crisis depths as well as depreciation of lira and associated consequences with respect to import inflation. Core inflation increased to 44.1% YoY. In view of likelihood for further significant global price pressures driven by the Russian further incursion in Ukraine on commodity prices as well as fresh supply-chain bottlenecks, Turkish inflation is seen rising further near term. Due to erosion in the independence of the central bank and a stated preference of President Recep Tayyip Erdoğan with respect to low interest rates, authorities' policy one-week repo rate has, rather than being increased in response to inflation of nearly 11x central-bank objectives, been cut, from 19% to 14% since September 2021.

- **Labour market:** Turkey's comparatively low rate of labour force participation and high unemployment (11.4% in January 2022, with 11.7% seen in 2022 (average) before 12.2% in 2023) remain important constraints on the nation's medium-run economic outlook.

Overview of Scope's qualitative assessments for Turkey's *Domestic Economic Risks*

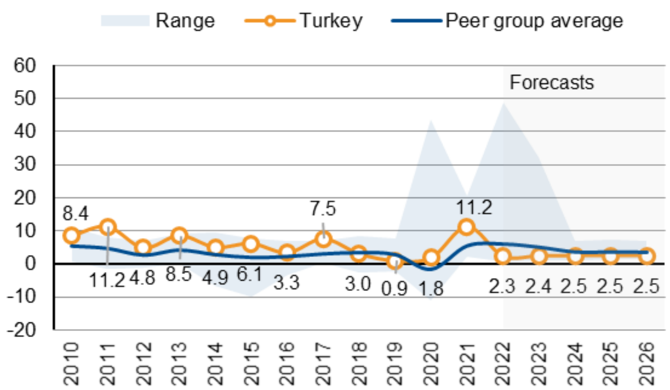
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Neutral	0	Strong growth potential, but realised growth has underperformed due to repeated crisis
	Monetary policy framework	Weak	-1/3	Monetary-policy coherence undermined by frequent changes in central-bank governance; weak monetary policy credibility, independence and effectiveness
	Macro-economic stability and sustainability	Weak	-1/3	Large and diversified economy; however, significant macro-economic imbalances including high inflation and elevated unemployment

Nominal GDP and GDP per capita, USD '000s



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH forecasts

Public Finance Risks

- **Fiscal outlook:** In the year prior to the pandemic, Turkey experienced a deterioration of the budget balance, seeing a general government deficit of 5.6% during 2019. Due to stronger-than-expected tax revenue, the budget deficit stood at 5.3% of GDP in 2020. Revenue recovery was aided especially by strong value-added and special consumption tax revenue, as well as significant transfers from the central bank plus high interest receipts. We expect fiscal deficits of an average of 5.9% of GDP during 2022-26, staying more elevated than pre-crisis.

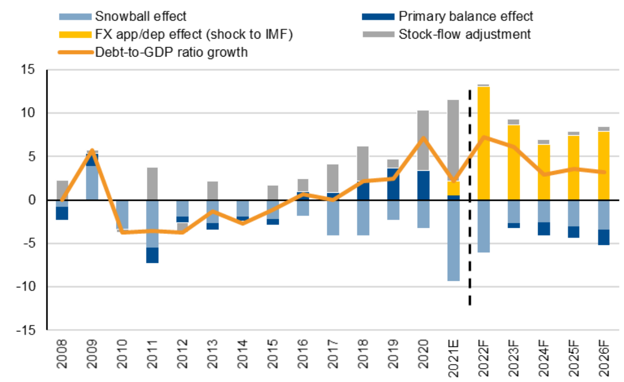
- **Debt trajectory:** The public debt trajectory has deteriorated since the Covid-19 crisis due to lira depreciation and budget deficits, with debt rising to 39.8% of GDP in 2020 before an estimated 42% in 2021 (against 27.4% as of a 2015 low). We envision increase of the government debt ratio to 65.0% of GDP by 2026. Under an adverse scenario of severe lira crisis (assuming currency depreciation of 44% and 35% in years 2022 and 2023 in this stressed scenario), general government debt rises to 80.3% by 2026.

- **Market access and debt structure:** As of January 2022, central government debt presented an average time to maturity of 5.4 years, rising from 5.1 years as of 2020. This is, however under pre-crisis values, which averaged 6.2 years over 2016-2019. Central government debt is 67% denominated in foreign currency as of January 2022, with this FX share having risen sharply from 27% as of mid-2013 – amplified by valuation effects on the state's foreign-currency liabilities due to lira depreciation. 97% of domestic debt is held by the resident sector, a sharp rise from circa 80% as of late 2017 after successive exit of international investors. The banking system alone holds 70% of outstanding domestic debt alongside a further 4.5% held by the central bank. For 2022, the Debt Management Office outlined a funding strategy designed to increase borrowing in local currency, raise market diversification for borrowing in foreign currency while keeping a strong level of cash reserves to curtail liquidity risk.

Overview of Scope's qualitative assessments for Turkey's *Public Finance Risks*

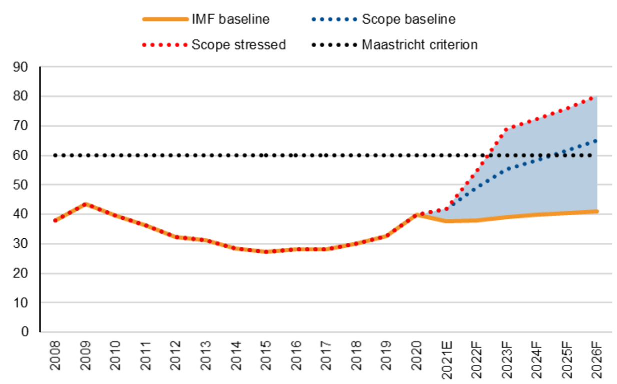
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Weak	-1/3	Wider deficits expected post-Covid crisis, linkage of fiscal compensation to lira losses reduces fiscal framework resilience
	Debt sustainability	Weak	-1/3	Weakening public-debt trajectory with high susceptibility to rises under adverse scenarios
	Debt profile and market access	Weak	-1/3	Developed domestic capital markets but very high FX share of government debt, high debt financing costs and lack of access to sources of bilateral and multilateral financing

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH forecasts

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH forecasts

External Economic Risks

- **Current account:** The current-account deficit increased to 5.0% of GDP in 2020. Afterwards, the current account recovered during 2021, although remaining in deficit of 1.9% of GDP, as goods and tourism services exports recovered. However, the trade deficit sharply reversed over an initial two months of 2022 amid increases of energy as well as grain imports. Contrary to central bank expectations for a current-account surplus this year, Scope sees the current-account balance reversing sharply to a significant deficit of circa 8% of GDP in 2022 – driven by rise of global energy and commodity prices.

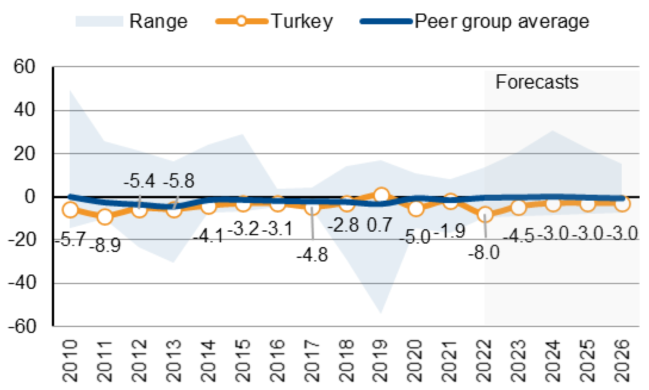
- **External position:** Turkey's external debt amounted to 57% of GDP as of Q3 2021, dropping from a 2020 level of 60.5%. As far as the composition of external debt, 52.8% is owed by the private sector, 41.5% by the public sector and 5.7% by the central bank. The short-term external debt stock on remaining maturing basis amounted to USD 171.6bn as of end-December 2021. Given significant short-term foreign currency financing, the banking sector remains vulnerable to effects of FX sell-off phases on capitalisation, asset quality and refinancing risk. The net international investment position (NIIP) improved to -28.6% of GDP in Q4 2021, from -53.8% in Q4 2020.

- **Resilience to short-term external shocks:** Gross official reserves (including gold) stand circa USD 110.3bn as of 6 March 2022, moderately under a 21 November 2021 level of USD 128.4bn. While these reserves cover circa 90% of short-term external debt (from late 2020 lows of 61%), around USD 20bn of reserves are denominated in less liquid Qatari rial and Emirati dirham, reflecting swap arrangements with the governments. If we deduct use of short-term FX swap liabilities with domestic banks that are currently being excluded from central bank FX liability data, swap-corrected net foreign assets are around a record-low USD -58.3bn in February 2022, declining from a level of USD 18.5bn as of year-end 2019 (and USD 56.2bn as of 2011 peaks). In addition, Turkey's access to foreign currency via international channels has been restricted during recent currency crises – potentially undermining resilience during future adverse contingencies.

Overview of Scope's qualitative assessments for Turkey's *External Economic Risks*

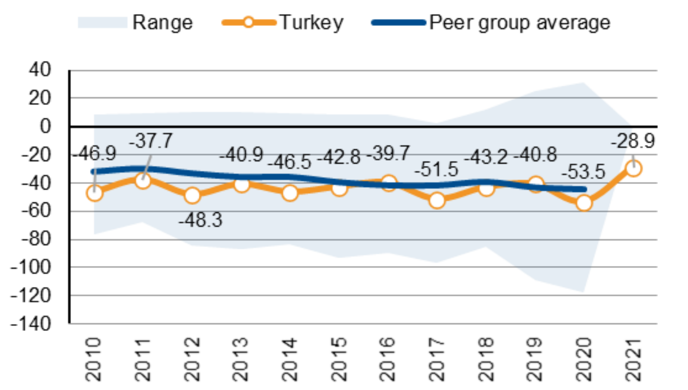
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Current account resilience	Weak	-1/3	Diversified exports; however, jump expected in 2022 current-account deficit amid exposure to rises of energy and commodity import prices
	External debt structure	Weak	-1/3	Moderate external debt; improvement in the net international investment position
	Resilience to short-term external shocks	Weak	-1/3	Inadequate reserve coverage of short-term external debt; significantly negative net reserves ex-swaps

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH forecasts

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

Financial Stability Risks

- **Banking sector:** The Turkish banking sector remains resilient on aggregate: credit growth of state-owned banks accelerated during 2020, before slowing over a first three quarters of 2021. The tier 1 capital ratio, while recently reinforced, had declined to 14.4% of risk-weighted assets as of Q3 2021, from 16.4% at Q2 2020 – amid depreciation of lira and associated effects on the lira-equivalent value of foreign-currency loans. Due to an increasing discrepancy between the share of banking deposits and funding in foreign currency (58%) and that of loans in foreign currency (39.5%), periods of FX sell-off increasingly disproportionately affect financial-system liabilities and capital cushions. Turkey's sovereign wealth fund recapitalised the three largest state-owned banks via TRY 48.6bn (or USD 3.3bn) of capital injection in February. Non-performing loans declined to 3.2% of aggregate loans as of January 2022, after reaching highs of 5.7% in December 2019. Banking profitability is stable. However, higher market volatility could undermine asset quality and profitability near term.

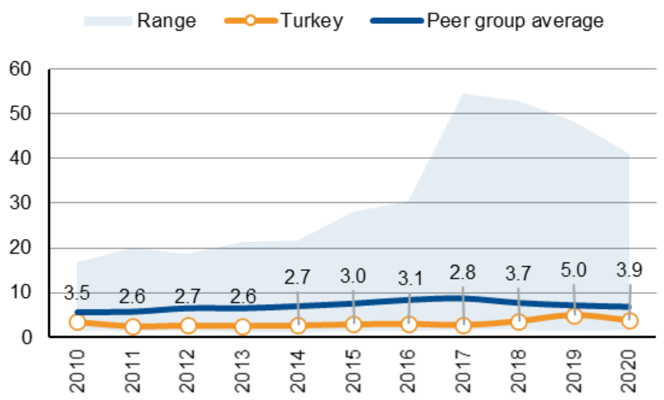
- **Private debt:** Risks associating with household indebtedness remain manageable, with household & NPISH debt of only 15.5% of GDP as of Q3 2021 (up 0.9pps compared against pre-crisis). Non-financial corporates (NFC) experienced an increase in indebtedness levels during the pandemic crisis, on the back of low-cost funding opportunities. However, NFC debt as a share of GDP started to drop during the first half of 2021 after having peaked at 77% in Q3 2020, reaching near pre-pandemic levels of 64.8% by Q3 2021.

- **Financial imbalances:** The housing market was severely impaired during the 2018 currency crisis, which had a negative effect on construction activity, house sales and house prices. Lower funding costs introduced in 2020 reversed this trend and brought strong recovery in house sales and construction costs. Nevertheless, the price-to-rent ratio remains in line with an EU average, signalling no present risk of extreme overvaluation. Non-financial corporates' net FX debt position was reduced to USD 114bn, from a 2018 peak of USD 223bn, related to sovereign crowding out of private-sector access to foreign-currency lending.

Overview of Scope's qualitative assessments for Turkey's *Financial Stability Risks*

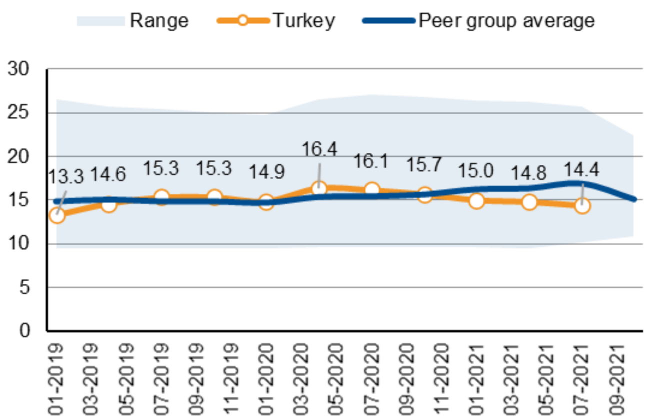
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Banking sector performance	Neutral	0	Resilient banking system able to provide significant liquidity to sovereign, low NPLs, FX sell-off periods impair capital ratios
	Banking sector oversight	Weak	-1/3	Banking system supervisory policies in the past have exacerbated macroeconomic imbalances – relating to state-coerced banking-system interventions in the exchange rate and in credit conditions
	Financial imbalances	Weak	-1/3	Moderate private-sector debt but still-high credit growth and significant (though rapidly declining) net FX liabilities of non-financial corporate sector; growing sovereign-bank nexus

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

ESG Risks

- **Environment:** Exposure to climate-related events and extreme weather events has increased over the last two decades, with especially a negative impact on agricultural production as well as water resources. Annually, CO_2 per capita emissions are close to EU-27 and UK levels and Turkey aims to reduce them up to 21% by the year 2030 (versus a business-as-usual scenario). The energy mix is dominated by fossil fuels (83.2%) with only 16% of aggregate energy supply composed of renewables. Turkey has recently accelerated investment into nuclear energy, with the first nuclear power plant (Akkuyu) expected to begin electricity production by 2023.

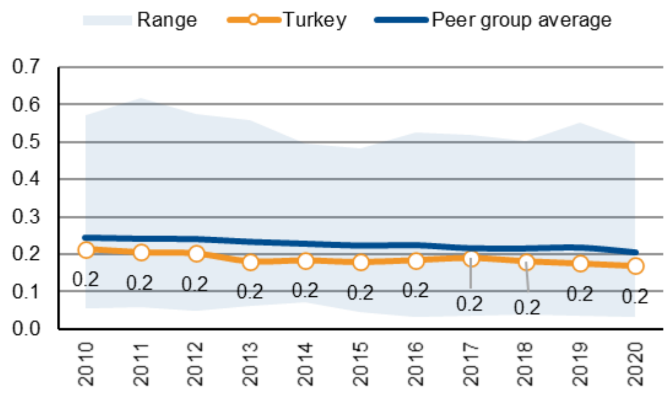
- **Social:** The economy has a comparatively low rate of labour force participation against that of peer economies, as well as comparatively high level of income inequality. The society has a healthy old-age dependency ratio and retains positive demographic growth, expected of 0.4% per annum over 2022-26 for the working-age population, although steeply moderating compared with 1.6% yearly over a previous decade. Progress has been made in reduction of absolute poverty and improvements of education. However, there has been weakening in government commitment to market-oriented reform, with a declining *sustainability* with respect to the economic growth model.

- **Governance:** The possibility for deeper economic crisis is likely to interact over a forthcoming period with institutional challenges ahead of scheduled 2023 presidential and parliamentary elections. We consider unlikely the prospect that President Erdoğan relinquishes power easily post-election, should current opinion polls be confirmed. Under the polling, the President lags significantly behind potential presidential candidates of main opposition Republican People's Party. Possibility of less democratic avenues being exercised to hold to power after 2023 alongside scenarios of civil instability, disputed election outcomes and further weakening of Turkish institutions affect the credit outlook. Geopolitical risks are also elevated. The Russia-Ukraine war poses risk for further financial-market spill-over, but also might present an opportunity for rapprochement with the West, with the government closing Bosphorus and Dardanelles straits limiting passage of some Russian vessels to the Black Sea.

Overview of Scope's qualitative assessments for Turkey's *ESG Risks*

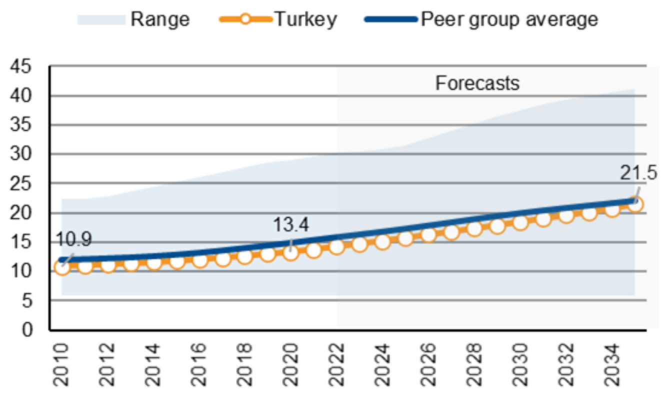
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental risks	Neutral	0	Exposure to natural disasters; improvement in certain areas on environmental management but deterioration in other facets
	Social risks	Neutral	0	Moderating but still positive demographic growth, high income inequality, moderate performance on health and health security preparedness indicators, moderate to weak educational outcomes
	Institutional and political risks	Weak	-1/3	Significant institutional challenges, geopolitical tension, civil/domestic security concerns including surrounding forthcoming electoral period

CO_2 emissions per GDP, $mtCO_2e$



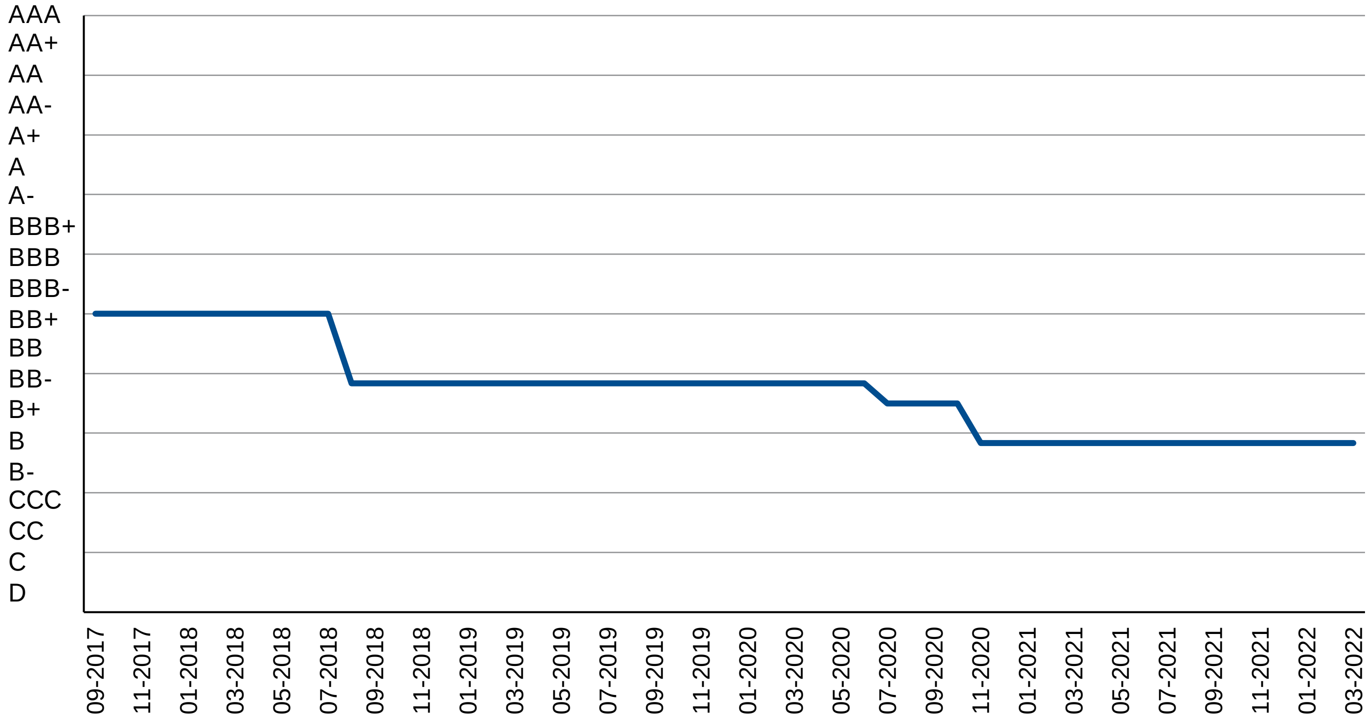
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard after the reserve-currency adjustment.

Peer group*
Ukraine

*Publicly-rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	10.9	10.6	9.5	9.1	8.6	9.4	9.9	10.9
Nominal GDP, USD bn	869.3	858.9	779.7	760.5	719.9	796.0	844.5	946.0
Real growth, %[1]	3.3	7.5	3.0	0.9	1.8	11.2	2.3	2.4
CPI inflation, %[1]	7.8	11.1	16.2	15.5	12.3	19.4	45.0	30.0
Unemployment rate, %[1]	10.9	10.9	10.9	13.7	13.2	12.2	11.7	12.2
Public Finance Risk								
Public debt, % of GDP[1]	28.0	28.0	30.2	32.7	39.8	41.9	49.2	55.3
Interest payment, % of government revenue	4.2	4.3	5.1	6.6	6.7	9.1	10.3	10.9
Primary balance, % of GDP[1]	-1.0	-0.9	-2.2	-3.6	-3.4	-0.6	-0.1	0.5
External Economic Risk								
Current-account balance, % of GDP[1]	-3.1	-4.8	-2.8	0.7	-5.0	-1.9	-8.0	-4.5
Total reserves, months of imports	5.4	4.8	4.2	5.1	4.6			
NIIP, % of GDP	-39.7	-51.5	-43.2	-40.8	-53.5			
Financial Stability Risk								
NPL ratio, % of total loans	3.1	2.8	-	-	-	-	-	-
Tier 1 ratio, % of risk-weighted assets	13.1	14.1	14.0	15.3	15.7	14.4	-	-
Credit to private sector, % of GDP	69.4	70.3	67.4	65.4	75.1	-	-	-
ESG Risk								
CO_2 per EUR 1,000 of GDP, $mtCO_2e$	184.9	190.5	181.9	175.8	169.3	-	-	-
Income quintile share ratio (S80/S20), x	-	-	-	-	-	-	-	-
Labour-force participation rate, %	56.6	57.6	58.1	58.1	-	-	-	-
Old-age dependency ratio, %	12.1	12.4	12.7	13.0	13.4	13.8	14.3	14.8
Composite governance indicator[2]	-0.5	-0.5	-0.5	-0.5	1.1	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economies
5y USD CDS spread (bps) as of 11 March 2022	670.4

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