Republic of Türkiye
Rating Report

SCOPE **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 pressures

Rating rationale:

Large and diversified economy: Türkiye's diversified economy (nominal GDP of circa USD 807bn in 2021) is expected to grow 5.8% during 2022 before 3.5% in 2023, after growth in 2021 of 11%.

Resilient banking system: Tier 1 capital adequacy of the banking system, while recently reinforced, has declined to 15% of risk-weighted assets as of Q4 2021 from 15.7% as of Q4 2020; however, non-performing loans (NPLs) continued to decline to 2.5% of aggregate loans as of Q2 2022. The resilience of the banking system is challenged by the sovereign drawing on its resources as the government's unorthodox economic policies weaken financial institution balance sheets.

Moderate levels of central government debt: Turkish sovereign debt levels remain moderate under an international comparison. Central government debt amounts currently to below 38% of GDP – below that of most indicative sovereign credit-rating peers, allowing the government some time to amend weaknesses of its underlying fiscal policies.

Rating challenges include: i) ongoing deterioration of the nation's credit profile due to inadequate governance and additional balance of payment, financial and/or political pressures; ii) evolving vulnerabilities, associated with structurally loose monetary policy, high inflation, inadequate 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.

Türkiye's sovereign rating drivers

<table>
<tr><th rowspan="2" colspan="2">Risk pillars</th><th colspan="2">Quantitative scorecard</th><th rowspan="9">Reserve currency adjustment (notches)</th><th>Qualitative scorecard</th><th rowspan="2">Extraordinary adjustment – foreign currency (notches)[1,2]</th><th rowspan="2">Final rating</th></tr>
<tr><th>Weight</th><th>Indicative rating</th><th>Notches</th></tr>
<tr><td colspan="2">Domestic Economic Risk</td><td>35%</td><td>bbb</td><td>-2/3</td><td>-2</td><td>B-</td></tr>
<tr><td colspan="2">Public Finance Risk</td><td>25%</td><td>bb+</td><td>-1</td><td rowspan="6">Extraordinary adjustment – local currency (notches)[1]</td><td rowspan="6">Final rating</td></tr>
<tr><td colspan="2">External Economic Risk</td><td>10%</td><td>bb-</td><td>-1</td></tr>
<tr><td colspan="2">Financial Stability Risk</td><td>10%</td><td>aa-</td><td>-2/3</td></tr>
<tr><td rowspan="3">ESG Risk</td><td>Environmental Risk</td><td>5%</td><td>aa</td><td>0</td></tr>
<tr><td>Social Risk</td><td>5%</td><td>bb</td><td>0</td></tr>
<tr><td>Governance Risk</td><td>10%</td><td>c</td><td>-1/3</td></tr>
<tr><td colspan="2">Overall outcome</td><td colspan="2">bb+</td><td>0</td><td>-3</td><td>-1</td><td>B</td></tr>
</table>

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 Türkiye, an extraordinary one-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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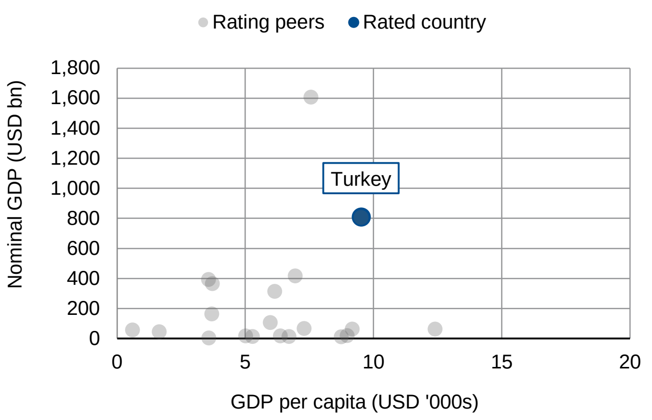
Domestic Economic Risks

- **Growth outlook:** Türkiye 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%), on the back of recoveries in industrial and services sectors. Türkiye's economy is expected to grow 5.8% during 2022 before 3.5% in 2023, however, before a below-potential 2.5% over 2024-26 (growth potential estimated of 3.9%). This reflects structural constraints given increasingly frequent economic turbulences and current elevated inflation.
- **Inflation and monetary policy:** Inflation in July 2022 was 79.6% 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, the 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 61.7% YoY. We expect Turkish inflation to remain elevated in the foreseeable future. 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 16x central-bank objectives, been cut, from 14% to 13% in August 2022.
- **Labour market:** Türkiye's comparatively low rate of labour force participation and high unemployment (10.3% in June 2022, with 11% seen in 2022 (average) before 11.8% in 2023) remain important constraints on the nation's medium-run economic outlook.

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

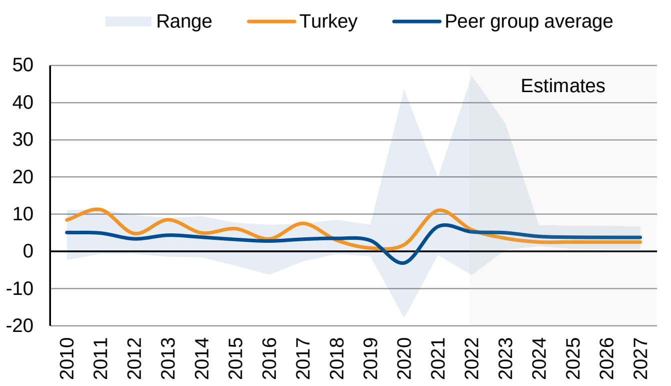
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Growth potential of the economy	Neutral	0	Strong growth potential, but constraints given increasingly frequent economic turbulences and current elevated inflation
	Monetary policy framework	Weak	-1/3	Monetary-policy 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 still-elevated unemployment (despite recent improvements)

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH forecasts

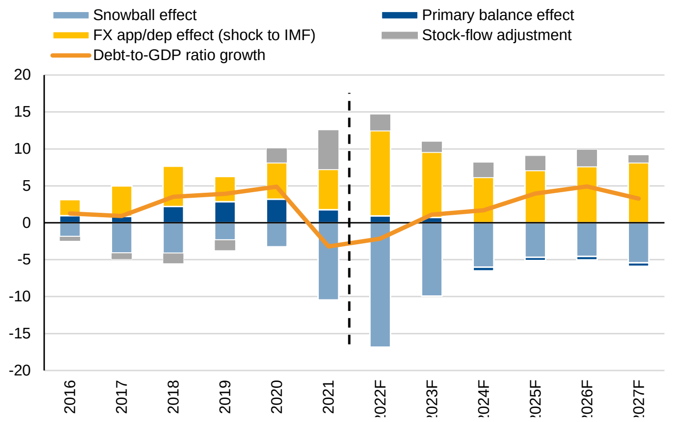
Public Finance Risks

- **Fiscal outlook:** In the year prior to the pandemic, Türkiye experienced a deterioration of the budget balance, seeing a general government deficit (IMF) of 4.7% of GDP during 2019. Due to stronger-than-expected tax revenue, the budget deficit stood at 5.1% 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 general government deficits of an average of 4% of GDP during 2022-2023, above the 2021 outcome of -3.3% of GDP. We view the lira savings scheme as gradually weakening one of Turkey's key credit strengths – the health of the sovereign balance sheet – to temporarily slow lira declines while retaining accommodative monetary policy settings.
- **Debt trajectory:** We view Turkey's comparatively moderate level of government debt as a credit strength. However, the public debt trajectory has deteriorated since the Covid-19 crisis due to lira depreciation and budget deficits, with debt rising to 39.5% of GDP in 2020 before an estimated 42% in 2021 (against 27.4% as of a 2015 low). We expect a gradual increase of the government debt ratio to 55% of GDP by 2027, despite the positive impact of inflation, driven by currency depreciation and continued budget deficits.
- **Market access and debt structure:** As of June 2022, central government total debt stock presented an average time to maturity of 5.5 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 June 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. 99% 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 75.7% of outstanding domestic debt alongside a further 4.2% 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 Türkiye's *Public Finance Risks*

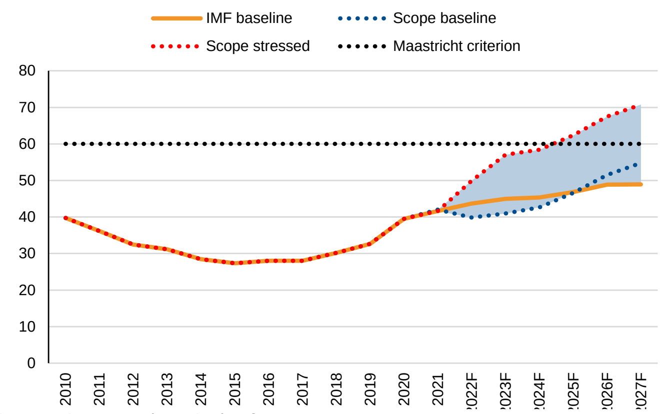
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Fiscal policy framework	Weak	-1/3	Sizeable deficits expected post-Covid crisis; linkage of fiscal compensation to lira losses set to weaken the strong sovereign balance sheet
	Debt sustainability	Weak	-1/3	Weakening 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 constrained 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 1.7% of GDP, as goods and tourism services exports recovered. However, the trade deficit sharply reversed over the first half of 2022 amid increases of energy as well as grain imports. We expect the current-account balance reversing sharply to a significant deficit of circa 7% of GDP in 2022 – driven by rise of global energy and commodity prices, and moderating to a deficit of 4% of GDP in 2023. Yet, as of June 2022 the current account balance - excluding the energy balance - posted a surplus of around USD 35bn in annualized terms supported by exports of goods and tourism services.

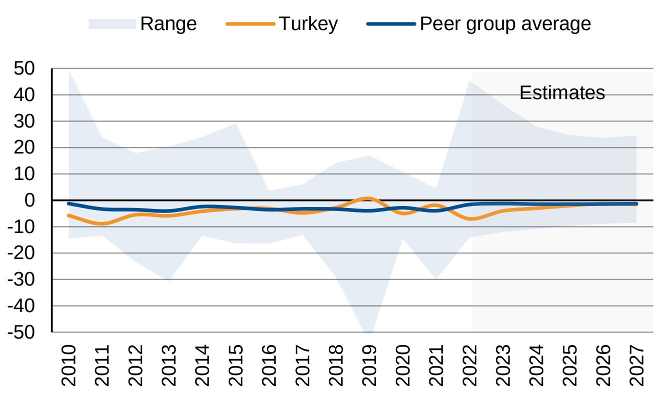
- **External position**: Türkiye's external debt amounted to 57% of GDP as of Q1 2022, dropping from a 2020 level of 60.4%. As far as the composition of external debt, 52.9% is owed by the private sector, 40.5% by the public sector and 6.6% by the central bank. The short-term external debt stock on remaining maturing basis amounted to USD 182.5bn as of June 2022. 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 -30% of GDP in Q1 2022, from -42.4% in Q1 2021, but will likely deteriorate over the coming quarters given higher current account deficits.

- **Resilience to short-term external shocks:** Gross official reserves (including gold) stand at USD 113.7bn as of 12 August 2022, moderately under a 19 November 2021 level of USD 128.5bn. While these reserves cover circa 62% of short-term external debt on remaining maturity basis (from late 2020 lows of 44%), 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 -60.1bn in July 2022, down from a level of USD 18.5bn as of year-end 2019 (and USD 56.2bn as of 2011 peaks).

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

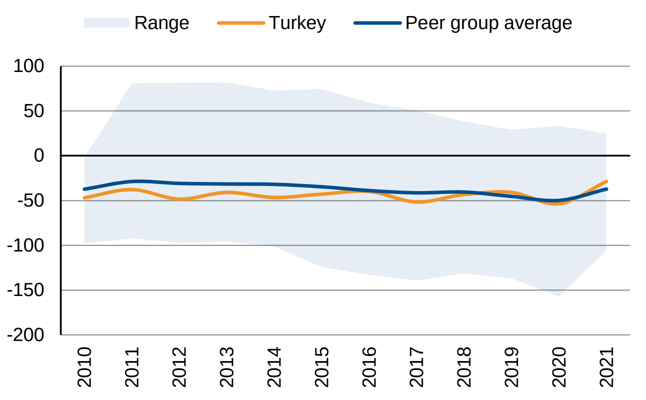
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Current account resilience	Weak	-1/3	Diversified exports; however, jump expected in 2022 current-account deficit amid exposure to elevated energy and commodity import prices
	External debt structure	Weak	-1/3	High short-term external debt; improving but highly negative 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

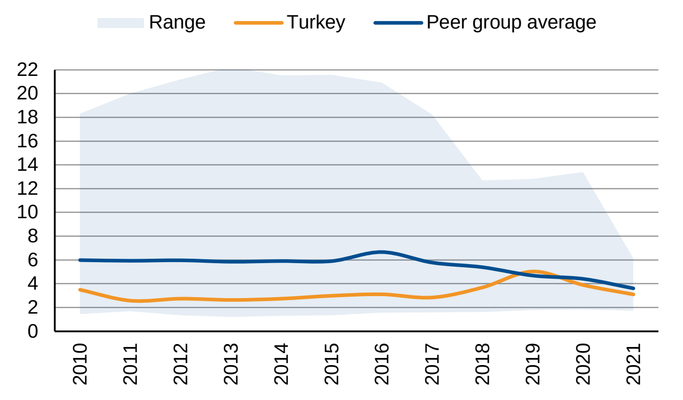
Financial Stability Risks

- **Banking sector:** The Turkish banking sector remains resilient on aggregate: credit growth of state-owned banks remained robust during the first half of 2022. Tier 1 capital adequacy of the banking system, while recently reinforced, had declined to 15% of risk-weighted assets as of Q4 2021 from 15.7% as of Q4 2020 – amid depreciation of lira and associated effects on the lira-equivalent value of foreign-currency loans. Due to a discrepancy between the share of banking deposits and funding in foreign currency (ca. 55% as of August 19) and that of loans in foreign currency (ca. 35% as of August 19), periods of FX sell-off increasingly disproportionately affect financial-system liabilities and capital cushions. Türkiye'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 2.5% of aggregate loans as of June 2022, after reaching highs of 5.4% 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 debt of only 14% of GDP as of Q1 2022 (down 1.2pps compared against the previous quarter). Non-financial corporates (NFC) experienced an increase in indebtedness levels during the pandemic crisis, on the back of low-cost funding opportunities. NFC debt as a share of GDP started to drop mid-2021 to 65% by Q3 2021 before rising to 73% in Q1 2022.
- **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. The house price-to-rent ratio remains moderately higher than the OECD average, signalling no significant risk of extreme overvaluation. Non-financial corporates' net FX debt position was reduced to USD 106bn as of May, 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 Türkiye's *Financial Stability Risks*

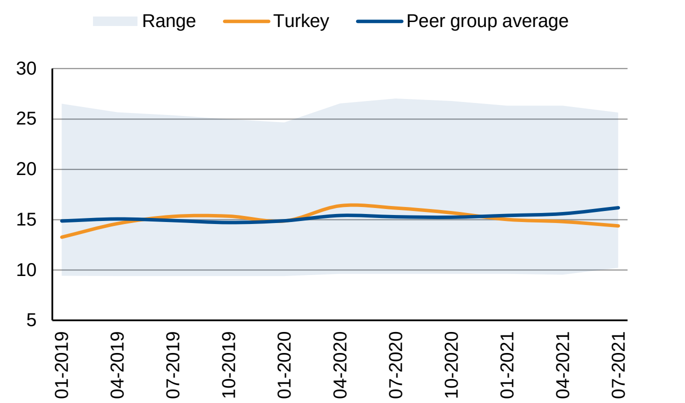
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Banking sector performance	Neutral	0	Resilient banking system able to provide significant liquidity to sovereign, low NPLs, FX sell-off periods impair capital ratios
	Banking sector oversight	Weak	-1/3	Banking system 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

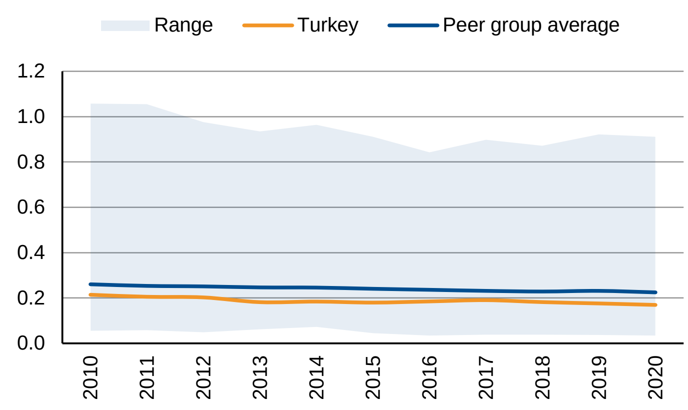
ESG Risks

- **Environment:** Exposure to climate-related and extreme weather events has increased over the last two decades, with a pronounced 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 Türkiye 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 (83.4%) with only 16.5% of aggregate energy supply from renewables. Türkiye 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 favourable 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 reducing absolute poverty levels and improving educational outcomes.
- **Governance**: In our view, the economic challenges will likely interact over a forthcoming period with institutional challenges ahead of scheduled 2023 presidential and parliamentary elections. Recent polls indicate that the President Recep Tayyip Erdoğan lags significantly behind potential presidential candidates of the main opposition Republican People's Party. The risk of heightened domestic political tensions in the context of the forthcoming elections adversely affects the credit outlook. Finally, geopolitical developments, including risk of a deterioration in security conditions and international relations, pose a downside risk. However, the Russia-Ukraine war, while posing risk for further financial-market spill-over, might also present Turkey an opportunity for increasing its strategic importance to the West.

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

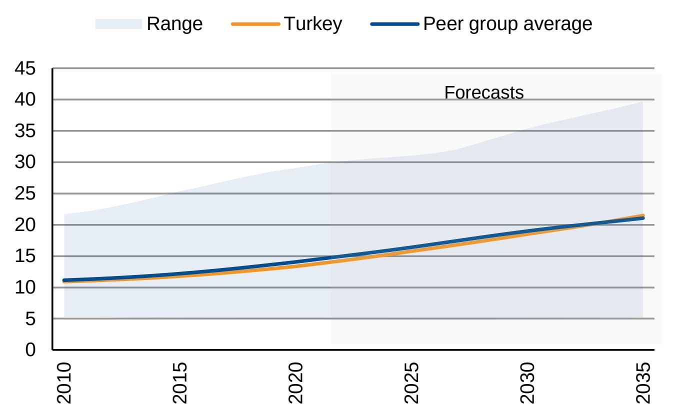
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental risks	Neutral	0	Exposure to natural disasters; improvement in certain areas on environmental management but deterioration in other facets
	Social risks	Neutral	0	Moderating but still positive demographic 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, risk of domestic political tensions surrounding forthcoming electoral period

CO_2 emissions per GDP, $mtCO_2e$



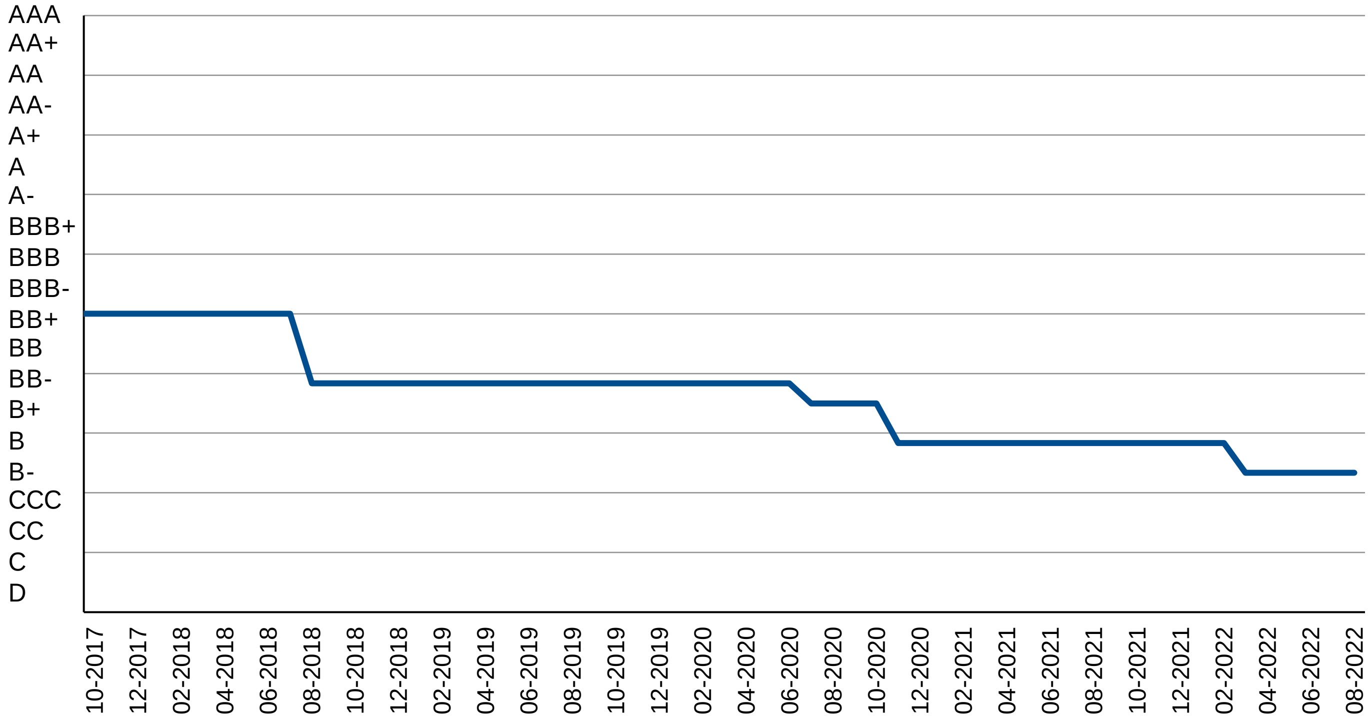
Source: European Commission, Scope Ratings GmbH

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*
Serbia
Georgia

*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	2021	2022E	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	10.9	10.6	9.5	9.1	8.6	9.5	8.1	8.2
Nominal GDP, USD bn	869.3	858.9	779.7	760.5	719.9	806.8	692.4	714.3
Real growth, %[1]	3.3	7.5	3.0	0.9	1.8	11.0	5.8	3.5
CPI inflation, %[1]	7.8	11.1	16.2	15.5	12.3	19.4	64.0	45.6
Unemployment rate, %[1]	10.9	10.9	10.9	13.7	13.1	12.0	11.0	11.8
Public Finance Risk								
Public debt, % of GDP[1]	28.0	28.0	30.2	32.7	39.5	42.0	40.0	41.0
Interest payment, % of government revenue	4.2	4.3	4.9	6.1	6.5	6.2	10.0	11.0
Primary balance, % of GDP[1]	-1.0	-0.9	-2.2	-2.9	-3.2	-1.8	-1.0	-1.0
External Economic Risk								
Current-account balance, % of GDP[1]	-3.1	-4.8	-2.8	0.7	-5.0	-1.7	-7.0	-4.0
Total reserves, months of imports	5.4	4.8	4.2	5.1	4.6	4.3	-	-
NIIP, % of GDP	-39.9	-51.5	-42.9	-40.9	-53.9	-31.4	-	-
Financial Stability Risk								
NPL ratio, % of total loans	3.1	2.8	3.7	5.0	3.9	3.0	-	-
Tier 1 ratio, % of risk-weighted assets	13.1	14.1	14.0	15.3	15.7	15.0	-	-
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	8.5	8.3	8.4	8.9	-	-	-	-
Labour-force participation rate, %	57.0	58.0	58.5	58.5	54.9	57.2	-	-
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] 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 26 August 2022	733

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