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## **IIRA's Ratings on the Sovereign of Turkey revisited, with revision in growth assumptions, expected sharp fall in tourism inflows and falling reserves**

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**Manama, June 19, 2020**—In its most recent rating action in February 2020, IIRA had maintained the long term and short term foreign currency ratings of Republic of Turkey ('Turkey' or 'the Country') at 'BBB-/A3' (Triple B Minus / Single A Three) and local currency ratings at 'BBB/A3' (Triple B/ Single A Three), on the international scale and improved the outlook to 'Stable'. IIRA had further noted that among other factors, the assigned ratings may be viewed to be under downward pressure in case of any external shock adversely affecting economic recovery. The Covid-19 pandemic has triggered a high impact shock to global markets, with unavoidable consequences for emerging economies including Turkey. IIRA notes that the GDP will maintain its below potential growth for the third year in a row, contrary to our earlier expectation of economic recovery in the current year. Continued below par growth will further exacerbate the already high levels of unemployment and weigh negatively on budget dynamics, given the extent of fiscal intervention necessitated by the prevailing health crisis, coupled with weaker tax collection. Pressure on the external account has precipitated a fall in CBRT's reserves in recent months. As a result, Turkish Lira has depreciated by double digits against USD which poses risks via increasing debt burden of firms in local currency terms, and hence pressure on asset quality profiles of the banking system.

Turkey appears to have averted the worst of the pandemic with a relatively low fatality rate observed, despite having recorded a sharp surge in case numbers in a short period of time. Turkey's relatively effective performance in combating the crisis is attributable to a strong health care system, favorable demographics and lockdown measures taken to protect vulnerable segments of the population. Starting from June 1<sup>st</sup> most of the restrictive measures have been lifted, with intercity traffic resuming and businesses reopened.

In the first quarter of 2020, Turkey's economic activity was buoyant at 4.5%, supported by strong credit growth. However, with the spread of COVID-19, trade and tourism has subsequently fallen sharply. As such, IIRA's earlier expectations of 4% growth for 2020 are unlikely to materialize and our current year forecasts have been revised down to a 1.0% contraction, assuming gradual pick up of the economy in the third quarter of 2020 while remaining below capacity, and muted, if any recovery in tourism. Leading indicators suggest that the economic activity bottomed out in the first half of May, following steps taken towards partial normalization. On the other hand, we expect our 4% growth estimate for this year to be pushed forward to 2021, with further upside potential, as pent up demand of the 2018-2020 period, along with normalization of tourism, factor in the aggregate demand composition. Downside risks persist in the form of a looming threat to subsequent waves of the pandemic, moderated by expectations of treatment protocol development to reduce associated health risks.

The scale of the macroeconomic shock will have an all-round impact on economic activity. Support measures taken by the government aim at business continuity for firms and addressing the needs of the

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most vulnerable segments of the society; these are equivalent to around 5% of GDP. The additional burden of fiscal support measures, along with the weaker tax collection and the absence of one-off revenue items should lead to significant increase in budget deficit. In the first four months of 2020, budget deficit grew by 33.6% to TL72.8bn. Meanwhile deterioration was much more significant in April, whereby COVID-19 measures were fully effective with monthly budget deficit surging 135.8% to TL43.2mn. High fiscal dependence on indirect taxes continues to be a challenge for the economy as weaker economic activity reduces value added tax and special consumption tax collection, weighing negatively on fiscal balances. Our concerns regarding the expected deterioration of fiscal balances in 2020 are moderated by our assessment of their efficiency in absorbing the spillovers of the economic shock and easing of stress in 2021. Meanwhile, IIRA's outstanding rating is supported by the relatively low levels of government debt to GDP of Turkey.

Pressure on trade deficit is expected to be compounded with the inevitable underperformance of the tourism sector. Exports are expected to dip with Europe as a major export destination, continuing to struggle economically. Deterioration in the current account balance was marked in the first four months of the ongoing year as exports contracted 14% YoY and imports increased 1.1%. Nevertheless, IIRA expects moderation to monthly current account balance as reduction in energy import bill materializes; USD10 drop in per barrel oil prices lowers the deficit by around USD5.3bn on an annual basis. Recent tariffs imposed are also aimed at reducing imports.

Further, with the loss of funds from emerging countries to reserve currencies, amidst the 'flight to quality' following the spread of the pandemic, Turkey's financial account posted deficit as well, precipitating a marked decline in CBRT's gross reserves in recent months. With the share of foreign ownership in TL denominated government debt securities dipping at historically low levels hints that further outflows would be at lower scale. Meanwhile, concerns over the reserve adequacy for the short to medium term, persist with CBRT reserves covering around 55% of short-term external debt. However, banking sector debt constitutes around 45% of this and in the months of April and May, several Turkish Banks rolled over their syndicated financings, with a roll-over ratio between 80%-85%, indicating no significant constraints in renewing FCY funding lines.

On a positive note, the outlook for inflation has eased, which led to successive rate cuts bringing the policy rate to 8.25% in May 2020 which should support economic activity in ensuing quarters. Consumer Price Inflation stood at 10.9% as of April 2020, and is projected to decline further in the 8%-9% range by the end of the year, as aggregate demand conditions are expected to remain disinflationary, further weighed down by the sharp reduction in commodity prices, offsetting the impact of a depreciating currency.

In the first quarter of the ongoing year, banking sector registered relatively high volume growth which in the absence of sizable new NPLs resulted in 40bps decline in aggregate NPL ratio to 5.0%. We nevertheless expect non-performance to increase in later quarters, in the wake of the prevailing

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economic situation. Overall, the banking sector indicators point to adequate buffers. However, notable depreciation of the currency as already witnessed year to date will have adverse effects, given the high levels of FCY debts in non-financial private firms, in turn translating into repercussions for banks in terms of asset quality and on the capital front in the medium term. The Central Bank took measures to improve the liquidity of the banking sector and enhanced credit facilities for exporters. Doubling of the credit guarantee fund shall allow the banks to provide funding to the companies in the present situation.

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