

## TURKEY ECONOMIC REPORT

### MACRO CONCERNS SHIFTING FROM CURRENCY WOES TO THE REAL ECONOMY

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- Turkish economy amid macro/monetary crisis in 2018**  
Seventeen years after the previous crisis of the beginning of the past decade, Turkey has experienced a significant economic/monetary shock in 2018. Long-standing external finance vulnerabilities have been exposed by tighter external financing conditions and exacerbated by deteriorating economic data, economic uncertainty and US sanctions, feeding into self-reinforcing concerns about the private sector's vulnerability to currency weakness. This has been manifested most clearly through a plunge in the Turkish lira and ensuing market pressures, leading to a prelude of a monetary crisis. The result was that the Turkish lira has declined by close to 60% relative to the US dollar, from 3.79 at the beginning of the year to reach a peak of 7.22 on August 12 to then appreciate to reach 5.25 by the closing of this report.
- Strong monetary tightening amid soaring inflation rates**  
Monetary conditions were marked by spiking Turkish lira volatility, dwindling international reserves and elevated levels of inflation (exceeding 25%), which prompted the Central Bank of Turkey to implement a strong monetary tightening to support price stability, while shifting to a simplified monetary policy that has involved abandoning a multi-rate framework and ensuring funding via a single rate. In parallel, Turkish securities registered noticeable price falls during the first eleven months of 2018. The BIST 100, which represents the 100 largest companies by market capitalization, registered a 17.3% drop during the first eleven months of 2018. Concurrently, the country's five-year CDS spreads expanded by 220 bps over the period, moving from 165 bps at end-2017 to 385 bps at end-November 2018, in a sign of a deterioration in market perception of sovereign risks at large.
- Adequate banks' capitalization and sound primary liquidity in the face of asset quality concerns and wholesale funding issues**  
The Turkish banking sector has had to face volatile and tough operating conditions domestically, with political pressures and tensions contributing to a currency crisis and taking a toll on investor sentiment and activity growth throughout part of the year. While the currency depreciation and domestic tensions have raised concerns over asset quality and funding metrics of banks operating in the country, it is to Turkish banks' luck that this is happening at a time when their financial buffers in terms of liquidity and capital adequacy, which have proven relatively resilient so far, are at their best (primary liquidity ratio of 29.3% and capital adequacy ratio of 18.2% at end-October 2018).
- Some differences and some similarities between the 2000-2001 crisis and the 2018 crisis**  
Regarding similarities, both crises revolved around exchange rate depreciation of almost similar magnitudes. Both the 2000-2001 crisis and the current crisis were partly triggered by growing external vulnerabilities amid a surging current account deficit to GDP ratio (from -0.4% in 1999 to -3.6% in 2000 and from -3.8% in 2016 to almost -5.6% in 2017). In addition, Central Bank reserves reported low reserve adequacy ratios during both crises (around 4 months of imports back then and today). As to differences, Turkey faced a banking crisis in 2000-2001 following risk accumulation in banks balance sheets prior to the crisis, erupting into acute losses in the banking system (ROE of -74.2% and -21.4%), with NPLs/Total loans reaching 18.6% at the time. Today, the sector is so far generating ROE of 15.1% and a NPL ratio of 3.5%. Overnight rates reached 80% during the previous crisis while they are still at 24% in this year's turmoil.
- Macro fears shifting from external imbalances and currency qualms to real sector concerns**  
Looking forward, the outlook doesn't look that dim, especially that external imbalances are starting to improve. The IMF forecasts the current account deficit to improve from 5.7% of GDP today to 1.4% of GDP in 2019. One of the main reasons of the improvement in the CAD is the slowdown in the real economy, which means less imports of goods and services. Real GDP growth is actually set to slow down to 3.5% in 2018 and 0.4% in 2019 before bouncing back in 2020. So the economy is rebalancing, with less output growth but better external imbalances amid sound public finances, which supports the outlook of the currency looking forward. In sum, macro fears have now shifted from the external imbalances and currency concerns to the real economy and sluggishness concerns at large.

The Turkey Economic Report can be accessed via internet at the following web address: <http://www.bankaudigroup.com>

The Turkish economy, which went this year into its worst monetary crisis since 2001 driving inflation to a 15-year record level in October, is starting to rebalance, with less output growth amid higher rates, but with noticeably better external imbalances post depreciation, which could provide the much needed support to the financial/monetary outlook looking forward.

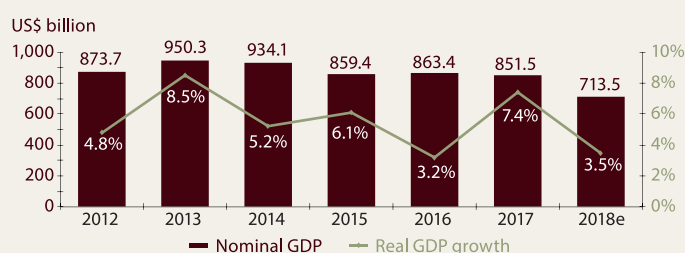
A backward look suggests that the significant currency depreciation of this summer was driven by four factors: (1) the escalation of tensions with the US and the announcement of tariffs on Turkish steel and aluminum, following sanctions against Turkish government officials; (2) a more hawkish outlook in term of interest rate hikes in the US which has generated a rising US dollar against the world currencies; (3) rising investor concerns related to a stronger grip on monetary policy post elections; (4) weak reserves adequacy with FX reserves at US\$ 79 billion at end-June (against US\$ 100 billion a year ago), equivalent to 30% of TL Money Supply, which is among the relatively weak ratios worldwide.

The result was that the Turkish lira has declined by close to 60% relative to the US dollar, from 3.79 at the beginning of the year to reach a peak of 7.24 on August 13 to then appreciate to reach 5.25 by the closing of this report. The lira's depreciation put additional upward pressure on Turkey's already high inflation rate which peaked at a 15-year high of 25% in October. Meanwhile, the yield on 10-year Turkish TL government bonds has risen from 11.5% to 16.2%, while the yield on 10-year USD Turkish government bonds has risen from 5.2% to 7.6%. Likewise, the stock market price index declined by 17.3% year-to-date. The CDS spreads have widened from 165 bps at the beginning of the year to a peak of 563 bps on August 13th and dropped back to 385 bps today.

In parallel, Turkey was subject to a series of rating downgrades. Fitch started in July by downgrading Turkish sovereign debt a notch to "BB" with a "negative" outlook, citing inflation and widening current account deficit. Moody's followed in August, downgrading the Government of Turkey's long-term issuer ratings to "Ba3" from "Ba2" and changed its rating outlook to "negative". Last but not least, S&P lowered its long-term foreign currency sovereign credit rating on Turkey to "B+" with a "stable" outlook.

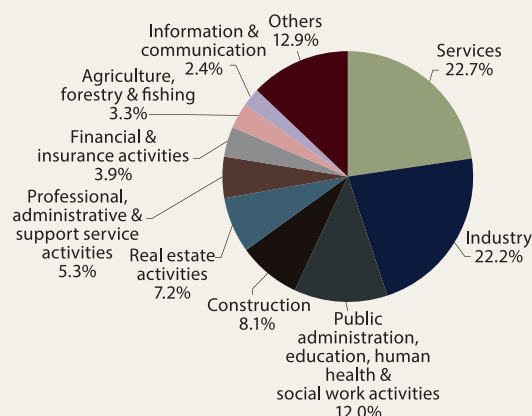
As a response to market pressures, Turkish authorities restricted the short selling on Turkish lira. They limited FX swap transactions of local banks with non-residents. The total stock of FX swaps cannot exceed 50% of banks' equity. The Central Bank has reduced reserve requirements for both lira and FX-denominated liabilities. For lira liabilities, reserve requirements have been cut by 250 bps and by 400 bps on FX liabilities. The Central Bank of Turkey increased its benchmark interest rate in September to 24%, a hike of 625 basis points from the previous rate of 17.75%. The rate hike came alongside a pledge by the Bank to enact strong monetary tightening in order to support price stability amid widening economic turbulence.

### GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

### BREAKDOWN OF GDP BY SECTOR (H1 2018)



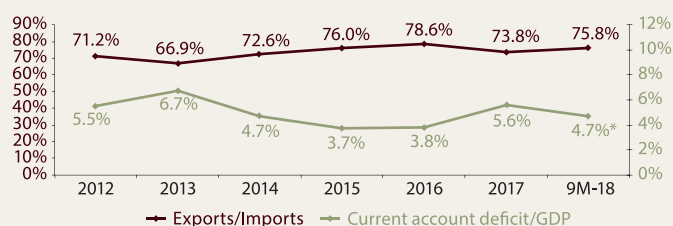
Sources: Central Bank of Turkey, Bank Audi's Group Research Department

In terms of economic strategy, Turkish policymakers have been facing three options to stabilize the currency: (1) through “conventional” means – i.e., a combination of monetary and fiscal measures; (2) seeking external assistance, most likely from the IMF; or (3) imposing capital controls. They have shown a preference for the first option. The authorities have so far rejected the possibility of external assistance. The imposition of formal capital controls has the least chance of success given the economy’s ongoing need for foreign inflows to fund its current account deficit. Looking back in this cycle, lira depreciation pressures have not been due to capital outflows; rather it seems to have been the inadequacy of capital inflows to plug the current account gap that has caused depreciation. In this context, imposing capital controls would be counterproductive, as it would hurt the capital inflows outlook and exacerbate the depreciation pressures.

On the positive side, the Turkish economy is supported by strong fiscal fundamentals with a public debt ratio of 26% and a public deficit ratio of 4.0%. It’s true that the current account deficit in Turkey has widened from 3.8% of GDP in 2016 to 5.4% in 2018 but the CAD outlook is on a gradually improving trend post depreciation and economic slowdown.

The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to a comparison between the 2000-2001 crisis and the 2018 crisis and the near term outlook of the Turkish economic, fiscal and monetary conditions looking ahead.

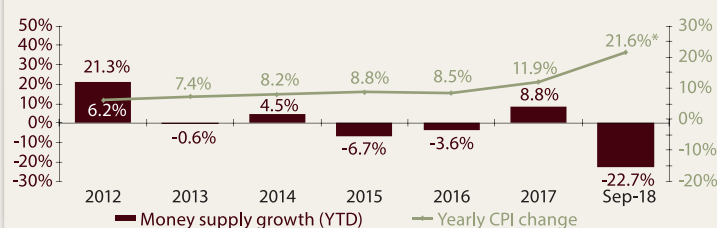
## FOREIGN SECTOR INDICATORS



\* Turkey's new economic program target for full-year 2018

Sources: Central Bank of Turkey, IMF, Bank Audi's Group Research Department

## MONEY SUPPLY GROWTH AND INFLATION



\* As at end-November

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

## 1. ECONOMIC CONDITIONS

### 1.1. REAL SECTOR

#### 1.1.1. Agriculture Sector

*Primary sector continues to grow though at a much slower pace*

The activity in the country's primary sector grew at a slower pace in the first half of 2018, when compared to the same period of last year, with the share of Turkey's agriculture, forestry and fishing sector registering a decline as well. The sector posted a real growth of 1.2% year-on-year in the aforementioned period of 2018. This compares to a rise of 6.3% registered in the same period of last year. Moreover, the share of the sector in the country's GDP reported a decline from 3.7% in the first half of 2017 to 3.3% in the first half of the current year.

However, the country's crop production continued to register a positive trend following its growth in 2016. Crop production of cereals and other crops rose by a yearly 4.7% in 2017. This came after an increase of 0.4% registered in 2016. Production of vegetables expanded by 1.9% in 2017, following a rise of 2.4% in the previous year and that of fruits, nuts and spices crops rose by an annual 8.8%, speeding up from a growth of 6.4% in 2016. In this context, the country is planning to implement a new subsidy allocation system for agricultural products to diversify local production, increase productivity and reduce the planted area of water-intensive crops such as rice and soybeans in drought-prone areas.

On the downside, the sector is dependent on government subsidies, which keep prices for some key commodities artificially high. Under the National Agriculture Project, which is set to be introduced soon, this trend would be extended. Moreover, small-scale farms' production growth and efficiency is being hampered by the country's high cost of machinery, as per BMI.

At the external level, it is worth noting that edible fruits and nuts took over a share of 2.1% of the country's total exports in the first three quarters of 2018, edging up slightly from 2.0% in the same period of last year, as the country is geographically well placed to take advantage of trade opportunities in Europe and Asia.

Finally, the increased acreage and sufficient rainfall continue to help Turkey's agricultural sector, which maintained its growth over the past period even if at a slower pace from the previous year.

#### CROP PRODUCTION IN 2017 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share	Volume	Share	Volume	Share		
<b>Cereals</b>	<b>36,133</b>	<b>53%</b>	<b>Vegetables</b>	<b>25,431</b>	<b>82%</b>	<b>Fruits</b>	<b>13,164</b>	<b>60%</b>
o.w. Wheat	21,500	32%	o.w. Tomatoes	12,750	41%	o.w. Citrus fruits	4,770	22%
o.w. Barley	7,100	10%	o.w. Watermelon	4,011	13%	o.w. Pome fruits	3,729	17%
o.w. Maize	5,900	9%	o.w. Cucumber	1,828	6%	o.w. Stone fruits	2,894	13%
<b>Sugar beets</b>	<b>21,149</b>	<b>31%</b>	o.w. Melon	1,813	6%	o.w. Other fruits	1,772	8%
<b>Potatoes, dried legumineus</b>	<b>4,800</b>	<b>7%</b>	o.w. Pepper (green)	945	3%	<b>Grapes</b>	<b>4,200</b>	<b>19%</b>
<b>Oil seeds</b>	<b>3,883</b>	<b>6%</b>	<b>Bulb and root vegetables</b>	<b>3,426</b>	<b>11%</b>	<b>Olive production</b>	<b>2,100</b>	<b>9%</b>
<b>Dry pulses</b>	<b>1,164</b>	<b>2%</b>	o.w. Dry onion	2,132	7%	<b>Tea production</b>	<b>1,300</b>	<b>6%</b>
<b>Raw materials used in textiles</b>	<b>882</b>	<b>1%</b>	o.w. Carrots	570	2%	<b>Nuts</b>	<b>1,116</b>	<b>5%</b>
<b>Tobacco</b>	<b>94</b>	<b>0%</b>	<b>Other vegetables</b>	<b>1,969</b>	<b>6%</b>	<b>Spices crops</b>	<b>229</b>	<b>1%</b>
<b>Plants for perfumery, pharmacy</b>	<b>92</b>	<b>0%</b>	o.w. Leafy or edible stem vegetables	1,662	5%	<b>Total Fruits, nuts and spices crops</b>	<b>22,109</b>	<b>100%</b>
<b>Total Cereals and other crops*</b>	<b>68,197</b>	<b>100%</b>	<b>Total Vegetables and other crops</b>	<b>30,826</b>	<b>100%</b>			

\* Excluding fodder crops

Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

### 1.1.2. Industrial Sector

#### *Industrial sector witnesses mixed performances, tilted to the downside*

The country's industrial sector weakened during the first half of 2018, amidst a further depreciation of the Turkish lira. Turkey's industrial sector, which accounts for 22.2% of GDP, grew by 6.2% year-on-year during the first six months of 2018, compared to a growth rate of 6.0% recorded in the same period of 2017.

In an environment where the Turkish lira depreciated to historic lows, the country's retail sales volume and industrial production data were among the most concrete indicators reflecting the performance of the industrial sector. According to the Turkish Statistical Institute (Turkstat), calendar-adjusted retail sales volumes contracted by 3.4% year-on-year in September 2018, and the calendar-adjusted industrial production index fell by 2.7% year-on-year.

On the other hand, Turkey's Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, rose by 5.0% year-on-year during the first nine months of 2018, compared to a growth rate of 8.3% in the corresponding period of last year, as per Turkstat. The latter is partly attributable to increasing export demand, as the depreciation of the Turkish lira against the US dollar boosted export competitiveness. It is worth noting that the Industrial Production Index measures the evolution of the Turkish economy, alongside reflecting the consequences of economic and political decisions in the short term.

Moving on to the manufacturing sector, which is one of the most important components of Turkey's industrial sector and contributing to almost 19.1% of GDP, it managed to grow by 6.6% year-on-year during H1 2018 against 5.8% in the same period of 2017. Reflecting sentiment among manufacturers, Turkey's Purchasing Managers' Index (PMI) for the manufacturing sector posted 44.7 in November, up for a second successive month and climbing from October's index value of 44.3. It is worth noting that a reading greater than 50 indicates growth of the sector, while a reading below 50 signals a contraction.

However, recent data from the Central Bank indicates that capacity utilization in manufacturing fell to a record low of 75.8% in September 2018, after a slight pick-up to 77.6% in August. Capacity utilization declined for all categories of goods in September.

As for Turkey's construction sector, which makes up 8.1% of GDP, it grew by 3.3% year-on-year during the first half of 2018, compared to an expansion of 5.1% in the same period of 2017. In contrast, the number of new building permits given by councils dropped by 41.4% year-on-year during the first nine months of 2018. Turkey's construction sector has been negatively impacted by the lira's depreciation, with the latter adversely impacting activity in the private non-residential building sector and leading to higher input costs. Moreover, the country's infrastructure projects, which utilize external financing but generate revenues in lira, would face significant risks of project viability undermined in the new currency environment, as per Fitch.

To sum things up, Turkey's industrial sector witnessed a rather negative performance so far in 2018. Despite the sector's real GDP growing year-on-year, the industrial sector was negatively impacted by

#### VEHICLES PRODUCTION

(unit)	2014	2015	2016	2017	17/16	10M-17	10M-18	10M/10M
Automobile	733,439	791,027	950,839	1,120,860	17.9%	941,380	858,615	-8.8%
Pick-up	357,889	468,933	461,838	462,389	0.1%	365,961	361,454	-1.2%
Minibus	40,744	47,078	44,420	55,036	23.9%	45,223	45,636	0.9%
Tractor	48,403	51,238	50,026	53,841	7.6%	43,916	34,444	-21.6%
Truck	31,931	35,838	17,369	23,499	35.3%	17,787	22,652	27.4%
Bus	6,442	8,789	8,084	8,168	1.0%	7,022	6,948	-1.1%
Midibus	5,324	7,131	3,332	3,732	12.0%	2,772	2,946	6.3%

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

weak retail sales volume and industrial production growth. The weakening of the Turkish lira has had a double-edged sword impact on the industrial sector, supporting its export competitiveness on the one hand while putting strains on the construction sector at the same time. Looking forward, the sector's performance is tied to domestic political stability, a steady Turkish lira, and a faster economic recovery in Europe.

### 1.1.3. Trade and Services Sector

*Tertiary sector remains on growth trend supported by weaker currency*

The country's trade and services sector, which constitutes around 55% of GDP, remained on a growth trend during the first half of 2018. Supported by a weaker Turkish lira, the sector witnessed an expansion of 20.9% in the first six months of 2018, outpacing the growth rate of 15.4% attained during same period of last year.

It is worth noting that the trade and services sector includes wholesale trade, information and communication, financial and insurance activities, real estate activities, professional, administrative and support service activities, public administration, education, human health and social work activities, and other service activities.

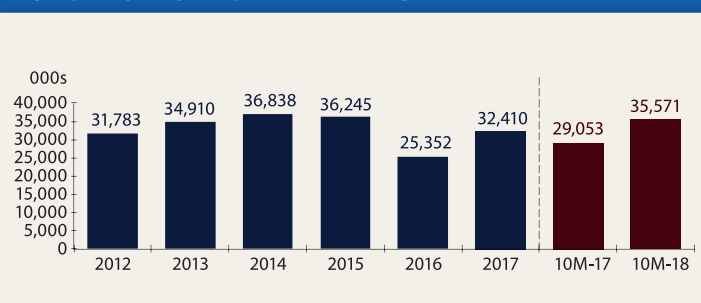
Turkey's services confidence index reached 79.8 in November 2018, down by 19.9% from 99.7 in November 2017. Nonetheless, it rose from 75.7 in October 2018 and was above levels seen in September. The index indicates an optimistic economic outlook when above 100 and a pessimistic one when below 100, as per data compiled by the Turkish Statistical Institute. The index tracks business sentiment within the services industries, with the results based on a survey conducted among a representative sample of businesses in the services sector.

Supported by a notable depreciation in its local currency, Turkey's tourism industry performed strongly in 2018 with a significant rise in the number of foreign tourists. The Culture and Tourism Ministry announced that nearly 35.6 million foreigners visited Turkey in the first ten months of 2018, a 22.4% increase compared to 29.1 million in the same period of last year. The Mediterranean resort city of Antalya was the top destination in the country with 12 million foreign visitors during 10M 2018, accounting for 33.7% of all foreign visitors. Istanbul, Turkey's capital, was the second among all cities with 11.3 million foreign visitors.

Forming a breakdown of tourists by nationality, Russia led the way of total visitors with 5.26 million tourists in the first nine months of this year, recording a 16.1% year-on-year increase. It was followed by Germany with 4.16 million visitors and the UK with 2.16 million visitors.

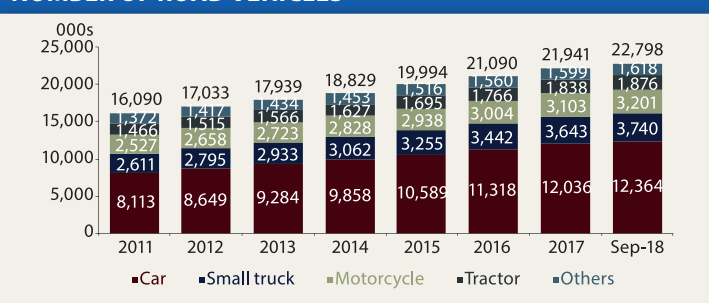
As for the hospitality sector, hotels in Turkey enjoyed substantial increases in occupancy rates during the first seven months of the year, driven by the rise in foreign arrivals, as per a report from the Hotels Association of Turkey (TÜROB). As a matter of fact, hotel occupancy rates across Turkey rose by 15.7% year-on-year to reach 64.8% during the aforementioned period. Average daily revenue (ADR) also rose to € 69, up by 25.2% year-on-year. Thus, Turkey reached the highest increase in terms of both hotel occupancy rates and ADR among all European destinations in the January-July period.

#### NUMBER OF FOREIGNER ARRIVALS



Sources: Ministry of Tourism and Culture, Bank Audi's Group Research Department

#### NUMBER OF ROAD VEHICLES



Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

## 1.2. EXTERNAL SECTOR

*Turkey's external imbalances showing noticeable improvement post-currency crisis*

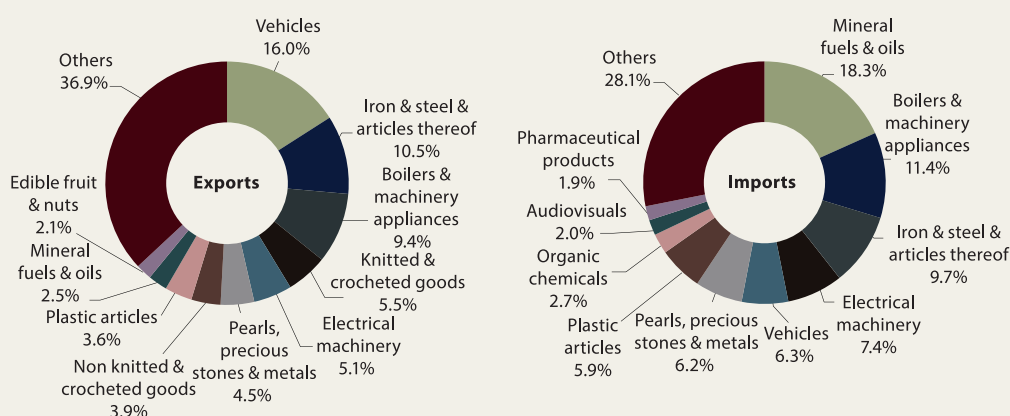
Given the ongoing loss of momentum in the Turkish economy along with a weakened local currency, Turkey's external imbalances witnessed a tangible improvement this year, as exports remained supported by the ongoing strength in external demand and increasing price competitiveness from the Turkish lira's depreciation on the one hand, while the significant softening in domestic demand continued to curb imports on another hand. As such, Turkey's current account balance recorded, over the first nine months of the year, the first drop in its deficit in three years, and reported since the currency crisis in summer, the largest surplus in its history during August and September 2018. This considerable shift in the current account balance from a deficit to a surplus during that period was mainly attributable to a lower trade deficit and stronger services income, supported by an ongoing boom in tourism activity.

In details, Turkish exports reached US\$ 128.2 billion in the first nine months of 2018, as per the latest Central Bank figures, posting a 5.4% rise on a yearly basis (growing by a yearly 20.4% in September), as the Turkish lira/US\$ exchange rate has depreciated by circa 24% over the first nine months of 2018 relative to the previous year's same period, boosting export competitiveness. In parallel, the breakdown of domestic exports by commodity shows that the main exports over the first nine months of the year were vehicles (16.0% of total exports), iron and steel (10.5%), boilers and machinery appliances (9.4%), knitted and crocheted goods (5.5%), electrical machineries (5.1%) and pearls and precious metals (4.5%). The geographic distribution of domestic exports indicates that 9.8% of total exports went to Germany, followed by the United Kingdom with 6.6% of the total, Italy with 5.8%, USA with 4.9%, Iraq with 4.8%, and Spain with 4.7% of total domestic exports over the same period.

At the same time, Turkish imports reported a moderate 4.0% year-on-year increase over the first nine months of 2018 to reach US\$ 169.1 billion (declining by a yearly 17.4% in September), when compared to a 15.6% yearly rise in imports during the first nine months of 2017. In parallel, the breakdown of domestic imports by commodity shows that the main imports over the first nine months of 2018 were mineral fuels and oils (18.3% of total imports), boilers and machinery appliances (11.4%), iron and steel (9.7%), electrical machinery (7.4%), vehicles (6.3%) and pearls and precious metals (6.2%). The breakdown of imports by country of origin shows that most of the inward merchandise came from China with 9.6% of total imports, followed by Russia with 9.5%, Germany with 8.9%, USA with 5.4%, Italy with 4.5% and United Kingdom with 3.5% of total imports over the same period.

Within this context, the cumulative trade deficit went down slightly by 0.1% over the first nine months of 2018 compared to the same period of 2017 (following a 32.4% surge a year ago) to reach US\$ 40.9 billion, while the combined trade deficit in August and September 2018 was slashed by 78.7% compared to the same period of 2017. In parallel, services balance, which is the second most important component of the current account, reported a hike of 21.8% during the first nine months of 2018, supported by an ongoing

### BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-18)



Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

recovery in tourism sector raising travel and touristic receipts by 13.9% over the same period. As such, the cumulative current account deficit dropped, for the first time in three years, from US\$ 31.3 billion in the first nine months of 2017 to US\$ 30.0 billion in the first nine months of 2018, a drop of 4.2% between the two periods. Moreover, it is worth mentioning that the current account balance recorded a historical combined surplus of US\$ 3.7 billion in August and September 2018, compared to a deficit of US\$ 5.4 billion over the previous year's same period, and is expected to report another record surplus in October as per the Minister of Finance. Having said that, the country's new economic program, announced in September, is targeting a current account deficit to GDP ratio of 4.7% in 2018, from 5.6% in 2017.

### 1.3. PUBLIC SECTOR

#### *Strong public spending doubling the budget deficit over the first ten months of 2018*

Despite healthy public revenues generation, Turkey's budget deficit reported a relative deterioration over the first ten months of 2018 with a spike in both primary and interest expenditures, amid higher government spending on defense, security, infrastructure, public employment and social benefits.

In details, the central government budget revenues grew by a healthy 19.5% during the first ten months of 2018 to reach a total of TL 609 billion (or US\$ 133 billion), mainly supported by a 19.6% year-on-year increase in general budget revenues to TL 587 billion, of which tax revenues that rose by 17.9% to reach TL 508 billion, as released by the Ministry of Finance. This robust revenue generation was attributable to a strong economic activity mainly in the first half of the year (although there have been recent signs of moderation in September and October) supporting tax revenues, in addition to the impact of the lira's depreciation on import VAT and the increase in the corporate tax rate by 2% with a series of other tax rises. Within this context, direct tax revenues rose by 27.2% during the first ten months of 2018 to reach TL 181 billion, while indirect tax revenues rose by 13.2% to reach TL 327 billion. On another hand, general budget revenues showed that non-tax revenues such as enterprise and ownership revenues, grants and aids, capital revenues and interests, shares and fines and others rose by 29% over the same period.

On the spending side, an across-the-board increase in all items have contributed to a strong 23.3% year-on-year rise in central government budget expenditures over the first ten months of 2018 to reach TL 671 billion (or US\$ 147 billion), mainly due to a 22.7% expansion in primary expenditures to TL 606 billion,

#### SELECTED PUBLIC FINANCE INDICATORS

TL billion	2014	2015	2016	2017	17/16	10M-17	10M-18	10M/10M
<b>Central government budget revenues</b>	<b>425.4</b>	<b>482.8</b>	<b>554.1</b>	<b>630.5</b>	<b>13.8%</b>	<b>509.4</b>	<b>609.0</b>	<b>19.5%</b>
o.w. Tax revenues	352.5	407.8	459.0	536.6	16.9%	430.9	507.9	17.9%
o.w. Non-tax revenues	72.9	75.0	95.1	93.9	-1.3%	78.5	101.1	28.7%
<b>Central government budget expenditures</b>	<b>448.8</b>	<b>506.3</b>	<b>584.1</b>	<b>678.3</b>	<b>16.1%</b>	<b>544.4</b>	<b>671.1</b>	<b>23.3%</b>
o.w. Primary expenditures	398.8	453.3	533.8	621.6	16.4%	494.3	606.4	22.7%
o.w. Interest	49.9	53.0	50.2	56.7	12.9%	50.1	64.6	29.0%
<b>Central government budget cash balance</b>	<b>-21.0</b>	<b>-19.5</b>	<b>-37.0</b>	<b>-53.9</b>	<b>45.6%</b>	<b>-30.7</b>	<b>-62.8</b>	<b>104.4%</b>

Sources: Ministry of Finance, Bank Audi's Group Research Department

#### PUBLIC INDEBTEDNESS



Sources: Ministry of Finance, IMF, Bank Audi's Group Research Department

and a 29.0% rise in interest expenditures to TL 65 billion. A breakdown of primary expenditures shows a 23.0% increase in compensation of employees to reach TL 168 billion, current transfers went up by 19.0% to reach TL 268 billion, of which Treasury aid increased by 10.7% to reach TL 136 billion, social transfers, subsidies and other contributions and transfers to households surged by 28.0% to reach TL 46 billion over the same period, while social security contributions surged by 24.0% to TL 28 billion. On the other hand, interest expenditures showed a 21.5% increase in domestic interest payments during the first ten months of 2018 to TL 43 billion, as well as a 31.3% surge in foreign debt interest to TL 17 billion, and a 140.1% increase in interest of discount and short-term cash transactions to reach TL 5 billion.

That being said, the central government budget deficit (on a cash basis) has doubled over the first ten months of 2018, reaching circa TL 63 billion (or US\$ 13.7 billion) as compared to a deficit of TL 31 billion during the same period of 2017, mainly driven by a growth in primary expenditures, accounting for 90% of central government expenditures. When excluding interest payments, a small primary surplus of TL 3 billion was recorded over the first ten months of 2018 as compared to a surplus of TL 15 billion over the corresponding period of 2017. Within this context, the general government budget deficit is projected to increase to 4.0% of GDP in full-year 2018, up from 2.3% in 2017, as per the IMF. Accordingly, the budget outcome calls for fiscal prudence in the period ahead as budget spending will be controlled more effectively, as signaled by the Minister of Finance.

Last but not least, the central government debt stock reached TL 1,083 billion (or US\$ 194 billion) as at end-October 2018 as per the latest figures released by the Ministry of Finance, up from TL 868 billion during the same month of 2017, and which is split into TL 590 billion in domestic debt (accounting for circa 54% of the total) and TL 494 billion in external debt (accounting for the remaining 46%).

## 1.4. FINANCIAL SECTOR

### 1.4.1. Monetary Situation

#### *Strong monetary tightening amid falling Turkish lira and soaring inflation rates*

The year 2018 was a tough year for Turkey, with monetary conditions marked by spiking Turkish lira's volatility, dwindling international reserves and elevated levels of inflation, which prompted the Central Bank of Turkey to continue to implement a strong monetary tightening to support price stability, while shifting to a simplified monetary policy that has involved abandoning a multi-rate framework and ensuring funding via a single rate.

In details, the Turkish lira plunged by 37% over the first eleven months of 2018, hitting a record low level at the closing of August 13, 2018, before starting to recover gradually in October and November, mainly on eased US-Turkey trade tensions and due to an oil price collapse that has left a positive impact on the currency in the oil importing country.

The Turkish lira moved from TL/US\$ 3.80 at end-December 2017 to TL/US\$ 5.19 at end-November 2018, amid a sustained gradual US monetary policy tightening and a stronger US dollar that stoked a wide currency sell-off in emerging markets at large, and in Turkey specifically given its current account deficit and its large stock of US dollar-denominated government debt (46% of the total debt). The Turkish lira depreciation was also exacerbated by elevated US-Turkey trade disputes, as the US placed trade sanctions on some Turkish products, namely steel and aluminum, before starting to ease ties with Turkey in October 2018.

The exchange rate weakness quickly feeds through into inflation. Consumer prices surged by 16.0% on average during the first eleven months of 2018, reaching a 15-year high level of 25.2% year-on-year in October 2018, mainly driven by the lagged spillovers of the Turkish lira depreciation, rising import prices, and as the Turkish government stimulated the economy with tax cuts and loan incentives, raising fears of economic overheating. Within this context, the IMF forecasts inflation at 15.0% in 2018, factoring in the pass-through to the CPI basket from spiraling Turkish lira depreciation.

In an attempt to contain soaring inflation rates, the Central Bank of Turkey followed an aggressive monetary policy tightening over the year 2018. The Central Bank raised its one-week repo rate three

times so far this year by a total of 16%, moving from 8.0% at end-2017 to a current 24.0%. Also, the CBRT lifted the overnight lending rate three times by a total of 16.25% to reach 25.50% at present. Similarly, the overnight borrowing rate was raised three times by a total of 15.25%, moving from 7.25% at end-2017 to 22.50% currently. As to the late liquidity window lending rate, it was lifted five times so far this year, moving from 12.75% at end-2017 to 27.00% currently.

Within this context, it is worth mentioning that the CBRT has completed in late-May 2018 the process of simplifying its monetary policy after two years of work, a process that involved the shift from the wide "interest rate corridor" to a "single interest rate policy" in the aim of enhancing the predictability of monetary policy and strengthening the transmission mechanism, as per the CBRT. Accordingly, the CBRT set the one-week repo rate as its policy rate, and said that the overnight lending and borrowing rates should be placed equidistant at 150 basis points above and below the benchmark rate, respectively.

Also in response to market pressures, the CBRT has cut in August 2018 lira reserve requirement ratios by 250 bps for all maturity brackets and lowered reserve requirement ratios for non-core FX liabilities by 400 bps for up to three-year maturities, a move that aimed at curbing Turkish lira's plunge, supporting effective functioning of financial markets and the flexibility of banks in their liquidity management.

Under these conditions, the CBRT's gross foreign exchange reserves continued to follow a downward trajectory over the first ten months of the year 2018, falling by 19.6% to reach US\$ 67.6 billion at end-October 2018, down from US\$ 84.1 billion at end-2017, as the Central Bank continued to draw on its international buffers to defend a dwindling Turkish lira in a wide currency sell-off environment, and to finance the country's current account deficit.

Looking forward, with price increases continuing to pose upside risks on the inflation outlook, the CBRT is set to maintain a tight stance in monetary policy until inflation outlook starts displaying a significant improvement.

#### 1.4.2. Banking Activity

*Healthy capitalization and adequate primary liquidity in the face of rising asset quality and wholesale funding concerns*

The Turkish banking sector has had to face volatile and tough operating conditions domestically, with political pressures and tensions contributing to a currency crisis and taking a toll on investor sentiment and activity growth throughout part of the year. Today, the overall conditions somewhat ameliorated with an easing of such pressures and some positive signals emerging that succeeded in offering a relatively more stable environment for banks.

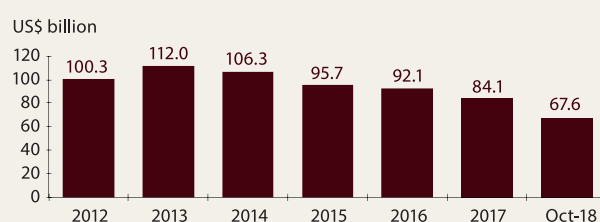
Over the first ten months of this year and according to the latest official statistics, the Turkish banking sector witnessed relatively mild activity growth. 55% of the balance sheets of banks are denominated in

#### MONETARY SITUATION

Flows in US\$ million	2011	2012	2013	2014	2015	2016	2017	9M-18
<b>Net foreign assets</b>	<b>-2,341</b>	<b>6,649</b>	<b>-25,739</b>	<b>-16,026</b>	<b>-4,681</b>	<b>10,473</b>	<b>-8,997</b>	<b>5,118</b>
Foreign assets	7,123	28,861	11,888	-4,318	-13,448	7,474	6,460	1,300
Foreign liabilities	-9,464	-22,211	-37,626	-11,708	8,767	2,999	-15,457	3,818
<b>Domestic Assets</b>	<b>-26,520</b>	<b>94,369</b>	<b>22,228</b>	<b>41,881</b>	<b>-35,585</b>	<b>-30,342</b>	<b>56,061</b>	<b>-138,109</b>
Claims on private sector	26,540	91,188	46,689	44,265	-21,705	-20,144	53,713	-122,683
Claims on public sector	-49,055	-563	-24,558	-3,997	-12,765	-10,070	36	-10,787
Claims on non-bank financial institutions	-4,005	3,744	97	1,614	-1,115	-128	2,311	-4,639
<b>Total Money Supply</b>	<b>-28,861</b>	<b>101,018</b>	<b>-3,533</b>	<b>25,878</b>	<b>-40,266</b>	<b>-19,869</b>	<b>47,064</b>	<b>-132,991</b>
Money Supply (M1)	-6,572	10,383	6,080	2,301	-5,155	2,276	1,522	-24,956
Quasi-Money	-17,745	61,002	-4,927	11,254	-28,822	-13,655	28,670	-78,610
Other Items (Net)	-4,544	29,633	-4,686	12,323	-6,289	-8,490	16,872	-29,425

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

#### CENTRAL BANK RESERVES



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

local currency and the remainder is in foreign currencies, and the TL side expressed in local currency grew by 9.8% while the FC side expressed in US dollar terms contracted by 2.7%. Obviously when expressing the total balance sheets in TL, the sector activity cross-currencies shows a significant growth of 22.5% but this is due to the 47% depreciation of the lira between December 2017 and October 2018 and which inflates the FX balance sheet total expressed in liras.

On the funding side of banks' balance sheets, total deposits, a major activity driver accounting for more than half of total size of the banking sector, witnessed a similar trend in the first ten months of this year. A closer look shows that Turkish lira deposits (expressed in TL) rose by 8.2% in the covered period mostly due to higher term deposits, while FX deposits (expressed in US\$) contracted by 7.4%.

The adverse conditions Turkey has witnessed in 2018 not only affected deposit growth but also raised some concerns about refinancing risks for banks. In fact, the country's low gross domestic savings rate (around a quarter of GDP) means local currency denominated deposits have grown more slowly than lending over the past few years. This encouraged banks to resort to market funding (more than a quarter of total balance sheets and of which a sizable chunk is short-term) that is more volatile and subject to swings in investor sentiment, noting that the risk of the latter has increased lately. Should foreign market funding take a hit, then banks would restrict lending and that might have some spillovers on their activity growth. While risks are not yet behind Turkey, the improved in domestic conditions favored an amelioration of market access, with several banks refinancing their debt with high rollover rates albeit at a higher premium.

On the asset utilization side, and after the significant expansion of State loan guarantees and the relaxation of macro prudential measures triggered an acceleration in credit growth last year, lending activity growth moderated and banks' risk appetite diminished this year. TL loans expressed in local currency rose by 3.6% in 10M2018 while FX loans expressed in US\$ inched down by a mere 0.5%. But since close to 60% of loans are in the local currency, and interest rates surged especially in TL, refinancing the existing stock of loans denominated in liras would become challenging, thereby implying weaker TL lending prospects in the near term at least.

While banking sector liquidity pressures eased in relative terms as lending growth slowed down (loan-to-deposit ratio is yet high by emerging market standards at 119.5% at end-October 2018, against a slightly higher 122.6% at end-2017 and levels below the 100% mark a few years ago), banks continue to benefit from sufficient readily available liquidity at hand should the need arise. The ratio of primary liquidity to total deposits, which we measure as the sum of cash and receivables from the banking system and required reserves to total deposits, was further reinforced as banks have raised their inter-bank deposits cross-currencies and at the CBRT and cash levels in FX. The primary liquidity ratio stood at a decent 29.3% at end-October 2018, which is quite favorable relative to international benchmarks.

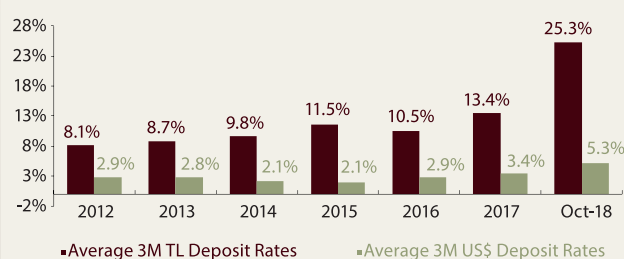
Even though banks' loan books are well diversified in general, perhaps the most pressing concern is the asset quality of the corporate sector, as lira volatility has affected Turkish borrowers' capacity to honor their FX dues, which led to a rise in restructured loans. The corporate sector FX borrowing risk arises when companies are not hedged with FX revenues or derivatives in the market. Authorities introduced earlier

#### BANKING SECTOR INDICATORS

in US\$ billion	2011	2012	2013	2014	2015	2016	2017	Oct-18
<b>Banking Activity</b>								
Assets	648.1	773.4	814.4	859.8	813.4	778.3	862.7	720.2
Deposits	370.3	435.7	444.6	454.3	429.8	414.7	453.4	372.0
Credit facilities	363.5	448.4	492.4	535.5	512.3	494.5	555.8	444.5
Shareholders' equity	76.9	102.6	91.1	99.9	90.5	85.4	95.0	74.0
<b>YTD Growth rates</b>								
Assets	-1.3%	19.3%	5.3%	5.6%	-5.4%	-4.3%	10.8%	-16.5%
Deposits	-8.0%	17.7%	2.0%	2.2%	-5.4%	-3.5%	9.4%	-18.0%
Credit Facilities	5.9%	23.4%	9.8%	8.8%	-4.3%	-3.5%	12.4%	-20.0%
Shareholders' equity	-12.3%	33.4%	-11.2%	9.7%	-9.4%	-5.6%	11.2%	-22.1%

Sources: BRSA, Bank Audi's Group Research Department

#### BANKING SECTOR DEPOSIT RATES



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

this year measures to limit FX borrowing (notably by distinguishing between entities with and without FX earnings for loans), the latest of which is a decree published in the third quarter. The latter requires contracts between two local entities to be denominated in liras (except for cases specified by the Ministry of Treasury and Finance) and that should help reduce vulnerabilities in this regard.

Meanwhile, the latest official data on Turkish banks' financial standing shows that asset quality slightly deteriorated over the course of 2018 but remains so far acceptable. The non-performing loans to total loans ratio moved from 3.0% at end-2017 to 3.5% at end-October 2018 while NPLs remain adequately covered up to 70% (79% at end-2017). Having said that, the IMF said in its latest report on Turkey earlier this year that a broader definition of impaired loans (including restructured credits, watch list loans and NPLs sold to third parties) amounted to close to 8% of all loans, signaling emerging loan quality weakness. It is yet worth noting that this compares to a NPL/Total loans ratio in the 7%-8% range for emerging and global markets.

Such a rise in asset quality pressures is seen as offset by banks' large capital buffers, noting that their capitalization levels remain high. So far this year, banks operating in Turkey saw a rise in both core capital and supplementary capital, leading to a further strengthening of their capital adequacy ratio from 16.9% at end-2017 to 18.2% at end-October 2018 (core capital adequacy at 14.5%), above minimum requirements and comparing favorable to international averages. In recent times, solid retained earnings, lower risk weights on Credit Guarantee Fund-backed loans and more relaxed macro prudential measures helped offset the adverse spillovers of FX rate movements, and banks strengthened capital levels through Tier 2 bond issuances.

This is important all the more so capitalization is generally not immune from lira depreciation since capital is largely labeled in domestic currency while risk-weighted assets have a significant FX portion, and from mark-to-market losses on securities issued by the government. In this respect, it is worth noting that this summer the sector regulator introduced measures that eliminated mark-to-market losses from TL depreciation and higher rates on capital. The regulator said it suspended mark-to-market calculations on capital adequacy ratios until prices of securities normalize. Authorities also lowered the amount commercial banks must park with the regulator and eased rules that govern how they manage their lira and FX liquidity, vowing to take all necessary measures to maintain financial stability.

Last but not least, slower lending growth, higher costs of domestic funds and increasing loan-loss provisions would to a certain extent erode banking sector profitability which would decline from currently high levels, though high NPL coverage constitutes a sound buffer to protect bottom lines. The latest figures point to a low double-digit growth in banking sector profits (expressed in TL) on the back of higher interest and non-interest income on a yearly basis in 10M2018 offsetting a relatively contained rise in staff expenses, higher provisions and especially foreign currency losses. Sector-wide annualized ROAA and ROAE stood at 1.48% and 15.1% in 10M2018.

All in all, it is true that the currency depreciation and domestic tensions have weighed on banks' activity growth and are causing pressure on asset quality and funding metrics of banks operating in the country. But it is also to Turkish banks' luck that this is happening at a time when their financial buffers in terms of liquidity and capital adequacy, which have proven relatively resilient so far, are at their best.

### 1.4.3. Equity and Bond Markets

#### *Price falls across Turkish equity and bond markets amid increased currency volatility*

Turkish securities registered noticeable price falls during the first eleven months of 2018, amid a free-falling Turkish lira, a widespread sell-off mood in emerging markets, increased US-Turkey tensions, and lingering concerns over a global economic slowdown. Turkish stocks posted double-digit price falls despite attractive valuations, and Turkish bonds traced a downward trajectory. Concurrently, Turkey's five-year CDS spreads witnessed significant expansions amid reduced market perception of sovereign risks at large.

In details, Borsa Istanbul saw double-digit price falls during the first eleven months of 2018, amid a plummeting Turkish lira that has fueled contagion fears in emerging markets and reduced risk appetite,

and due to Turkey's diplomatic and trade spats with the US, and lingering concerns over a global economic slowdown amid escalating US-China trade disputes. The BIST 100, which represents the 100 largest companies by market capitalization, registered a 17.3% drop during the first eleven months of 2018 to close at 95,416.03 at end-November 2018. This occurred despite upward price corrections observed in Borsa Istanbul over the month of November (+5.8% month-on-month), as a decent demand for Turkish stocks emerged within the context of relatively eased US-Turkey tensions and a recovery in Turkish lira against the US dollar, while also supported by relatively attractive market pricing ratios, as Turkish stocks traded at a P/E of 8.95 times at end-November 2018 as compared to a P/E of 11.58 times at end-2017.

Under these conditions, the market capitalization fell from US\$ 233.4 billion at end-2017 to US\$ 152.4 billion at end-November 2018, down by 34.7%. The total number of contracts reached 221.1 million during the first eleven months of 2018, up from 141.9 million during the corresponding period of 2017. The total trading value increased from US\$ 366.1 billion during the first eleven months of 2017 to US\$ 403.9 billion during the corresponding period of 2018, moving up by 10.3%. That being said, the turnover ratio, measured by the annualized total trading value to market capitalization, reached 289.1% during the first eleven months of 2018, up from 197.3% during the corresponding period of 2017.

At the level of the bond market, Turkish bonds came under downward price pressures over the year 2018 amid a falling Turkish lira and soaring inflation rates that have prompted the CBRT to raise key interest rates, and following credit rating downgrades by international rating agencies, while also tracking US Treasuries declines after the US Federal Reserve raised its benchmark interest rate for three times so far this year.

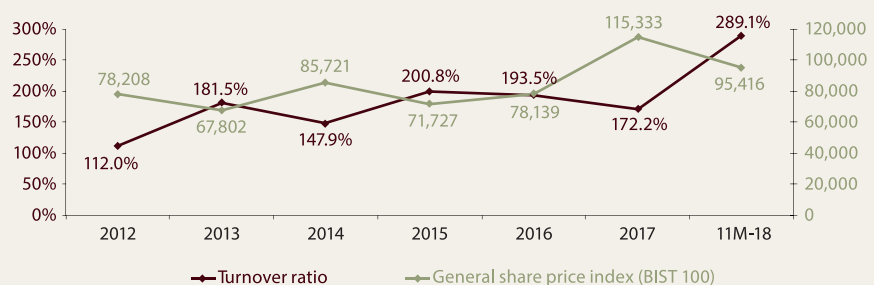
The 10-year Turkish lira Benchmark bond index yield reached 16.8% at end-November 2018, up from 11.7% at end-2017. Concurrently, the yield on 10-year USD Turkish government bonds rose from 5.6% at end-2017 to 7.6% at end-November 2018. Within this context, it is worth mentioning that non-resident investors were net sellers of Turkish bonds over the first eleven months of the year 2018. This was reflected by a US\$ 12.5 billion contraction in their holdings, moving from US\$ 30.9 billion at end-2017 to US\$ 18.5 billion towards the end of November 2018. This compared to a US\$ 4.2 billion expansion in their holdings over the year 2017.

### SELECTED STOCK MARKET INDICATORS

	2011	2012	2013	2014	2015	2016	2017	11M-18
Market capitalization (in US\$ billion)	201.9	311.2	237.6	269.8	190.2	174.5	233.4	152.4
Market capitalization/GDP	24.3%	37.2%	25.0%	28.9%	22.1%	20.2%	27.4%	21.0%
Trading value (in US\$ billion)	423.9	348.6	431.3	399.1	381.7	337.7	401.9	403.9
Traded volume (in millions)	202,149	174,290	198,858	207,100	214,061	234,483	356,578	402,320
Number of contracts (000s)	102,855	79,808	80,298	83,640	97,300	110,038	157,749	221,135
Change in BIST 100 price index	-22.3%	52.6%	-13.3%	26.4%	-16.3%	8.9%	47.6%	-17.3%
Price/Earnings ratio	11.88	12.51	10.22	14.38	14.00	10.24	11.58	8.95
Dividend Yield (%)	2.57	1.73	2.27	1.54	2.84	2.27	2.05	3.34

Sources: Borsa Istanbul, Bank Audi's Group Research Department

### STOCK MARKET PERFORMANCE



Sources: Borsa Istanbul, Bank Audi's Group Research Department

With activity skewed to the sell side on the Turkish fixed income market, sovereigns maturing in 2021 closed down by 7.66 pts during the first eleven months of 2018. Turkey'26 and '27 saw price falls of 14.38 pts and 17.0 pts respectively. Longer-term sovereigns maturing in 2036 and 2045 posted more significant price drops of 23.90 pts each. Amongst financials, prices of Halkbank'21 fell by 11.63 pts. Yapibank'26 posted price contractions of 16.87 pts. As to the cost of insuring debt in Turkey, the country's five-year CDS spreads expanded by 220 bps over the first eleven months of 2018, moving from 165 bps at end-2017 to 385 bps at end-November 2018, in a sign of a deterioration in market perception of sovereign risks at large. This followed a 108 bps contraction in 2017.

As to credit rating changes, Fitch downgraded in July 2018 Turkey's long-term foreign currency Issuer Default Rating to "BB" from "BB+", with "negative" outlook, citing downside risks to macroeconomic stability that have intensified owing to the widening in the current account deficit, more challenging global external financing environment, jump in inflation and the impact of the plunge in the exchange rate on the private sector, which has significant foreign currency-denominated debt.

In parallel, Standard & Poor's lowered in August 2018 its unsolicited long-term foreign currency sovereign credit rating on Turkey to "B+" from "BB-" and its unsolicited long-term local currency sovereign credit rating to "BB-" from "BB", with "stable" outlook. The downgrade reflects S&P's expectation that the volatility of the Turkish lira and the resulting projected sharp balance of payments adjustment would undermine Turkey's economy. Also, Moody's downgraded in August 2018 Turkey's long-term issuer ratings to "Ba3" from "Ba2" and changed its rating outlook to "negative".

Finally, regarding new issues, Turkey raised US\$ 6.0 billion during the first eleven months of 2018 through the sale of a five-year US\$ 2.0 billion Eurobond in October 2018 at a coupon of 7.25%, a ten-year US\$ 2.0 billion Eurobond in April 2018 at a coupon of 6.125%, and a 10-year US\$ 2.0 billion Eurobond in January 2018 at a coupon of 5.125%. Turkey also raised € 1.5 billion in November 2018 through the sale of a Eurobond maturing in February 2026 at a coupon of 5.20%.

Looking forward, a sustained recovery in Turkish lira, along with expectations of a US-China trade truce, and a more dovish stance from the US Federal Reserve could leave a positive impact on Turkish securities, with equity and bond markets currently starting to witness some price recovery

## 2. CONCLUDING REMARKS

Seventeen years after the previous crisis of the beginning of the past decade, Turkey has experienced a significant economic/monetary shock in 2018. Long-standing external finance vulnerabilities have been exposed by tighter external financing conditions and exacerbated by deteriorating economic data, economic uncertainty and US sanctions, feeding into self-reinforcing concerns about the private sector's vulnerability to currency weakness. This has been manifested most clearly through a plunge in the Turkish lira and ensuing market pressures, leading to a prelude of a monetary crisis.

Our in-depth comparative analysis suggests that there are some differences and some similarities between the 2000-2001 crisis and the 2018 crisis. Regarding similarities, both crises revolved around exchange rate depreciation of almost similar magnitudes. Both the 2000-2001 crisis and the current crisis were partly triggered by growing external vulnerabilities amid a surging current account deficit to GDP ratio (from -0.4% in 1999 to -3.6% in 2000 and from -3.8% in 2016 to almost -5.6% in 2017). In addition, Central Bank reserves reported low reserve adequacy ratios during both crises (around 4 months of imports back then and today). With respect to stock market valuations, the average P/BV of the Top four listed banks fell by 72% during the previous crisis to reach 1.6 times. Likewise, it declined by 46% in the current turmoil to reach 0.48 times today.

As to differences, Turkey faced a banking crisis in 2000-2001 following risk accumulation in banks balance sheets prior to the crisis, erupting into acute losses in the banking system (ROE of -74.2% and -21.4%), with NPLs/Total loans reaching 18.6% at the time. Today, the sector is so far generating ROE of 15.1% and a NPL ratio of 3.5%. Overnight rates reached 80% during the previous crisis while they are still at 24% in this year's turmoil.

Also, Turkey had a troubled fiscal situation in the previous crisis unlike current conditions, with a fiscal deficit/GDP of 11.8% back then. Today, Turkey's fiscal deficit to GDP ratio stands at 4.0%. Debt to GDP used to be at 76.1% in 2001 (as the high public sector borrowing requirement was mainly financed by issuing domestic debt), while the debt ratio stands at a mere 26.3% today. At the real sector level, Turkey went into a depression in 2001 as a result of the crisis, with real GDP growth displaying -6%. In 2018, real growth, though considerably slowing down, is still forecasted at a positive rate despite the recent turmoil.

Looking forward, while inflation has risen to 25% this October (highest since 2003) following the acute currency crisis in summer, the outlook doesn't look that dim, especially that external imbalances are starting to improve with a rise in the exports of goods and services and a decrease in the imports of goods and services. The IMF forecasts the current account deficit to improve from 5.7% of GDP today to 1.4% of GDP in 2019. One of the main reasons of the improvement in the CAD is the slowdown in the real economy, which means less imports of goods and services. Real GDP growth is actually set to slow down to 3.5% in 2018 and 0.4% in 2019 before bouncing back in 2020. So the economy is rebalancing, with less output growth but better external imbalances, which supports the outlook of the currency looking forward. What supports the currency as well is the competitive public finance conditions. Turkey's public debt of 26% of GDP compares with a global average of 83%. Turkey's budget deficit to GDP ratio is within the quadrant of sound ratios worldwide.

This actually augurs well for the Turkish lira. After having reached a peak of 7.24 on August 13th, the Turkish lira appreciated to 5.3 by the closing of this report, as Turkey's economy slows and exports gain strength, improving the country's balance of payments outlook. The IIF says that the fair value of the Turkish lira is somewhere between 5.0 and 5.5. The consensus forecast of global banks puts it at 6.0 in 2020, as inflation should abate, interest rates are set to remain high and external imbalances would improve. In sum, macro fears have now shifted from the external imbalances and currency concerns to the real economy and sluggishness concerns at large.

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