TURKEY ECONOMIC REPORT

SOUND ECONOMIC REBOUND BUT PERSISTENT RISKS CHALLENGE THE OUTLOOK

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- Relative pick up in real economic activity
  Turkey's economy has shown resilience during past bouts of political instability, security drifts and global financial market volatility, owing largely to the country's solid public finances, its well regulated banking sector and its dynamic and diversified private business sector. Within this environment, the Turkish economy rebounded in 2017, with growth set to reach 5.1% as per the IMF on the back of a strong economic momentum in the first half of this year and a base effect in the third quarter from a 2016 low base amid the coup attempt. Growth has been domestic driven, thanks to a Credit Guarantee Fund-induced credit impulse, a fiscal stimulus that reflected in strong construction growth, higher exports amid strong Euro Area growth and a pick up in tourism.

- Widening current account deficit mostly led by surging trade deficit
  The rapid acceleration of domestic demand-driven output growth has widened the current account deficit by 27.1% in the first nine months of 2017, due to a surge in trade deficit by 31.7%. Turkish exports posted a 10.9% rise on a yearly basis, as the Turkish lira/US$ exchange rate has depreciated by circa 22% over the first nine months of 2017 relative to the previous year's same period, boosting export competitiveness. At the same time, Turkish imports reported a 15.5% year-on-year increase over the first nine months of 2017 to reach US$ 162.5 billion, following the rapid acceleration of domestic demand-driven output growth and the energy bill rising faster than the pick-up in energy prices.

- Rise in budget deficit, yet with persisting favorable debt dynamics
  Turkey's fiscal deficit widened relatively over the first ten months of 2017, mainly due to an increase in expenditures combined with a continued slowdown in non-tax and tax revenues, the latter being the main source of government revenue. However, the primary balance remained in surplus, spotting light on favorable debt dynamics. Central government revenues grew by 13.8% during the first ten months of 2017, while expenditures went up by 18.4%. As such, the central government deficit reached circa TL 31 billion over the first ten months of 2017 as compared to a deficit of TL 15 billion during the same period of 2016. That being said, the government debt stock is estimated to register 27.9% of GDP in 2017, one of the low debt ratios around the world.

- Aggressive monetary tightening amid elevated inflation
  Turkey's monetary conditions were marked in 2017 by extended losses in the value of the Turkish lira and a continuous elevated level of consumer price inflation. This prompted the Central Bank of Turkey to adopt an aggressive monetary tightening, while relying more heavily on the late liquidity window facility to meet system's funding requirement. It is worth mentioning that consumer price inflation reached a 14-year peak of 13.0% year-on-year in November 2017.

- Surging lending activity coupled with healthy deposit inflows amid buoyant economic performances
  Turkey's banking sector has had a good year in 2017, after withstanding currency-related pressures in the previous year and benefiting from a pick-up in economic activity throughout this year. In parallel, asset quality, liquidity and capitalization metrics have proven relatively resilient to recent shocks and continue to display adequate levels. Total assets grew by 16.0% in local currency terms in the first ten months of 2017 according to the latest official statistics available, or by 7.8% in US dollar terms, to reach the equivalent of US$ 838.9 billion at end-October 2017. The major driver of banks' surging activity proved to be none other than credit growth, as loans progressed by 17.9% in local currency terms between December 2016 and October 2017, or by 9.5% in US dollar terms over the period.

- Healthy price gains in Turkish equity and bond markets
  Turkish securities registered healthy price gains during the first eleven months of 2017, supported by tempting valuations and yields. Turkish stocks posted double-digit increases amid rising trading volumes, and Turkish bonds saw a price rebound, while Turkey's five-year CDS spreads witnessed decent contractions amid improved market perception of sovereign risks at large.

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

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Turkey's economy has shown resilience during past bouts of political instability, security drifts and global financial market volatility, owing largely to the country's solid public finances, its well regulated banking sector and its dynamic and diversified private business sector.

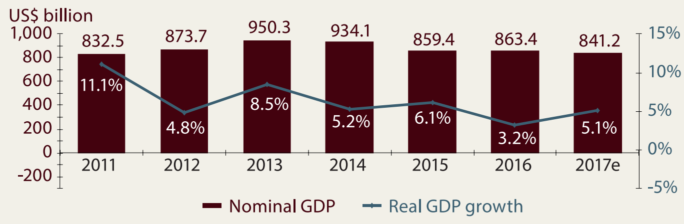
Within this environment, the Turkish economy rebounded in 2017, with growth set to reach 5.1% as per the IMF on the back of a strong economic momentum in the first half of this year and a base effect in the third quarter from a 2016 low base amid the coup attempt. Growth has been domestic driven, thanks to a Credit Guarantee Fund-induced credit impulse, a fiscal stimulus that reflected in strong construction growth and higher exports amid strong Euro Area growth and a pick up in tourism.

At the external sector level, the current account deficit rose by 27% year-on-year to reach US$ 31 billion in 9M 2017 driven by a widening trade deficit. While goods exported growth reached 11% year-on-year and imports growth reached 16% year-on-year, surging gold imports (three-fold increase) lead to a 32% year-on-year rise overall in the trade deficit. Meanwhile, tourism revenues increased by 28% year-on-year, reflecting rising tourist arrivals (+29% year-on-year). However, revenue per tourist in 9M 2017 was still 7% below the 2016 average and is unlikely to recover in the near term given the decline in tourist numbers from Europe with higher spending patterns. It is worth mentioning that portfolio inflows have provided the main source of financing for the current account deficit so far this year, leaving the lira exposed to a potential reversal of high risk appetite towards emerging markets assets.

At the public sector level, fiscal performance has somewhat weakened in 2017, driven by expansionary fiscal policy, but still remains sound on the overall. Higher government spending to stimulate domestic consumption was driven by an increase in the minimum wage and related subsidies, hiring in the education and health sectors, as well as higher security outlays. The government also granted a number of temporary tax reductions/exemptions and expanded investment incentives during the second half of 2016 and 2017 in an attempt to revive growth. Subsequently, the central government deficit is expected to report 3.2% of GDP in 2017, against 2.3% of GDP in 2016, with the primary surplus expected to be completely eroded against a net surplus of 0.7% of GDP in 2016.

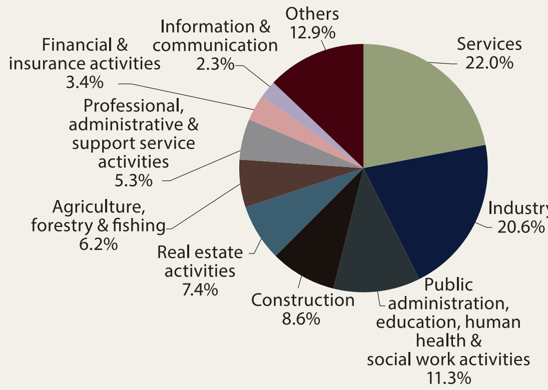
At the monetary level, faltering capital inflows put the lira under significant pressure in late 2016 and early 2017, fueling an acceleration in inflation that prompted the Central Bank of Turkey to tighten monetary policy after a prolonged period of loosening. Subsequently, inflation remained high and above the authorities target of 5%. The average consumer price inflation is expected to reach circa 10% in full-year 2017, buoyed by continued exchange rate volatility and higher food prices. To counter increasing inflation, the Central Bank has maintained its tight monetary policy by guiding banks towards more expensive interest rate channels and quantitative tightening. Meanwhile, official foreign assets remained

GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (9M 2017)



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

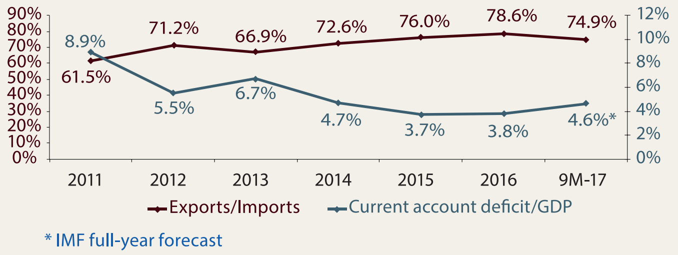
under pressure, further declining to US$ 104.9 billion in September 2017, which is considered relatively below prudential levels to absorb potential shocks.

At the banking sector level, the sector has proven resilient over the past years. Despite slight deterioration in assets quality, the banking sector's non-performing loans has remained contained, standing at 3.0% of total loans at end-October 2017 and comparing well with emerging markets, recently supported by the sales of problem loans, sound loan growth and regulatory forbearance measures. Capital adequacy is very sound, reflected by a comfortable capital adequacy ratio of 16.9% and a high core capital component equivalent to 14.0%. On the overall, Turkish banks remain well positioned to transition to IFRS 9.

At the capital markets level, a relatively good performance was observed in 2017 mirroring the overall economic rebound. The Stock market price index increased by 33.1% over the first 11 months of 2017 amid a decent trading volume, with the turnover ratio reporting a strong 197% of market capitalization. The surge in prices actually increased stock market capitalization to GDP from 20.2% at end-2016 to 24.0% at end-November 2017. At the fixed income level, a net contraction of 5-year CDS spreads by 71 bps was reported over the 11-month period, moving from 273 bps at end-2016 to 202 bps at end-November 2017 and reflecting an improved market perception of sovereign risks at large.

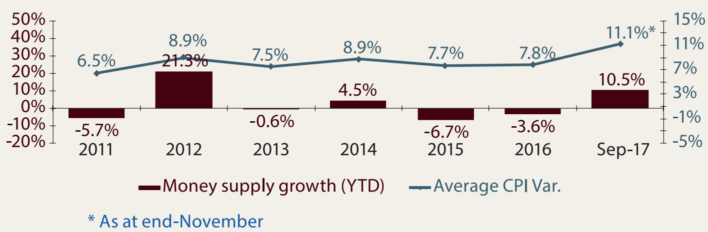
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economic, fiscal and monetary fundamentals looking ahead.

FOREIGN SECTOR INDICATORS



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

MONEY SUPPLY GROWTH AND INFLATION



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

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture Sector

Real growth in the primary sector supported by a growth in crop production

Turkey's agricultural sector grew at a faster pace during the first nine months of 2017, compared to the same period of 2016. The primary sector registered a real growth of 3.3% year-on-year in the aforementioned period of 2017. This compares to a decline of 3.4% posted in the same period of last year. However, the agriculture, forestry and fishing sector contributed by around 6.2% to Turkey's GDP compared to 6.5% in the first nine months of 2016. The share of the sector in the country's GDP is slightly decreasing as the sector is undergoing a period of transition, during which it will need to make some significant changes in order to remain competitive in an economy where industry and services are increasingly important.

Alongside, the country's crop production maintained an increasing trend in 2016, following its growth in 2015. According to the Turkish Statistical Institute, crop production of cereals and other crops rose by a yearly 0.4% in 2016. This came after an increase of 7.2% registered in 2015. Productions of vegetables grew by 2.4% in 2016, following a growth of 3.8% in the previous year and that of fruits, nuts and spices crops rose by an annual 6.4%, outpacing a growth of 4.0% in 2015.

In terms of exports, edible fruits and nuts took over a share of 2.0% of the country's total exports in the first three quarters of 2017, down from 2.3% in the same period of last year.

It is worth noting that Turkey's agricultural industry is largely fragmented, consisting of around 25,000 predominantly small, family-run enterprise. Currently, the sector's production is merely stable in both volume and value terms. However, new reforms, aimed at reducing State involvement and improving the sector's competitiveness, are expected to ultimately boost output and most likely result in significant sector consolidation.

These reforms started taking place since 2000 and include steps such as boosting Turkey's organic agricultural area in order to capitalize on growing international interest in this premium subsector. The process of agricultural reform is expected to be a long one, owing to the traditional practices still at large in the sector.

CROP PRODUCTION IN 2016 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share
Cereals	**35,281**	**54%**
o.w. Wheat	20,600	32%
o.w. Barley	6,700	10%
o.w. Maize	6,400	10%
Sugar beets	**19,593**	**30%**
Potatoes, dried legumineus	**4,750**	**7%**
Oil seeds	**3,481**	**5%**
Dry pulses	**1,080**	**2%**
Raw materials used in textiles	**756**	**1%**
Plants for perfumery, pharmacy	**103**	**0%**
Tobacco	**74**	**0%**
Total Cereals and other crops*	**65,118**	**100%**

* Excluding fodder crops

	Volume	Share
Vegetables	**24,955**	**82%**
o.w. Tomatoes	12,600	42%
o.w. Watermelon	3,929	13%
o.w. Cucumber	1,812	6%
o.w. Melon	1,854	6%
o.w. Pepper (green)	967	3%
Bulb and root vegetables	**3,400**	**11%**
o.w. Dry onion	2,121	7%
o.w. Carrots	555	2%
Other vegetables	**1,912**	**6%**
o.w. Leafy or edible stem vegetables	1,621	5%
Total Vegetables and other crops	**30,267**	**100%**

	Volume	Share
Fruits	**12,029**	**59%**
o.w. Citrus fruits	4,293	21%
o.w. Pome fruits	3,543	17%
o.w. Stone fruits	2,529	12%
o.w. Other fruits	1,664	9%
Grapes	**4,000**	**20%**
Olive production	**1,730**	**9%**
Tea production	**1,350**	**7%**
Nuts	**935**	**5%**
Spices crops	**278**	**1%**
Total Fruits, nuts and spices crops	**20,322**	**100%**

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

In conclusion, the sector, which benefits from Turkey's favorable geography and climate, maintained its real growth, in addition to growth in its crop production for the second consecutive period. Furthermore, the government made developments of the primary sector a priority, maintaining continued levels of investment.

1.1.2. Industrial Sector

Secondary sector grows amidst further weakening in Turkish lira

Turkey's industrial sector remained on an expansionary path during the first nine months of 2017, amidst a further weakening in the Turkish lira and mounting diplomatic tensions. The country's industrial sector, which accounts for 20.6% of GDP, expanded by 9.5% year-on-year during the first nine months of 2017, compared to a growth rate of 3.6% recorded in the same period of 2016.

Turkey's industrial production accelerated at a faster-than-expected pace in September to the highest level in six-and-a-half years. It expanded by 10.4% year-over-year in September 2017, much faster than the 5.3% rise in August. The latest rate of increase was the steepest since March 2011, when production had grown by 11.5% year-on-year. Additionally, the average Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, rose by 5.6% year-on-year in the first three quarters of 2017, compared to 1.8% in the corresponding period of last year, as per Turkstat.

Moving on to the manufacturing sector, which is one of the most important components of Turkey's overall industrial sector and contributing to almost 17.5% of GDP, it managed to grow by 9.3% year-on-year during 9M 2017 against 3.1% in the same period of 2016. Reflecting sentiment among manufacturers, the Istanbul Chamber of Commerce Turkey PMI Manufacturing Index posted 52.9 points in November 2017, marginally up from October's 52.8 points. The latest reading marked the ninth consecutive month of growth in the Turkish manufacturing sector, the longest seen since 2014. It is worth noting that a reading greater than 50 indicates growth of the sector, while a reading below 50 signals a contraction.

This improvement in the manufacturing sector eased pressure on manufacturers' capacity and helped companies work through their outstanding businesses. The latest PMI report also revealed an increase in inflationary pressures on the sector driven by exchange rates.

As for Turkey's construction sector, which makes up 8.6% of GDP, it grew by 10.2% year-on-year during 9M 2017, compared to an expansion of 6.2% in the same period of 2016. The sustained growth in the construction sector can be attributed to a dynamic and increasing population base, alongside a vigorous rural-urban migration.

In conclusion, Turkey's industrial sector performed well so far in 2017, with the sector's real GDP growing year-on-year, industrial production rising, and the average industrial production index also increasing. The sector is expected to remain on a positive trend if the security situation remains intact, but it could also come under pressure in the case of a further depreciation in the exchange rate and further diplomatic tensions with the West.

VEHICLES PRODUCTION

(unit)	2012	2013	2014	2015	2016	H1-16	H1-17	H1/H1
Automobile	577,296	633,556	733,439	791,027	950,839	441,366	601,586	36.3%
Pick-up	426,633	410,558	357,889	468,933	461,838	250,787	224,152	-10.6%
Minibus	29,335	37,751	40,744	47,078	44,420	18,789	27,209	44.8%
Tractor	42,255	40,511	48,403	51,238	50,026	29,979	25,095	-16.3%
Truck	29,129	30,083	31,931	35,838	17,369	8,938	10,165	13.7%
Bus	6,427	8,374	6,442	8,789	8,084	4,425	4,591	3.8%
Midibus	4,158	5,197	5,324	7,131	3,332	1,636	1,455	-11.1%

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

1.1.3. Trade and Services Sector

Trade & services on growth trend after relative easing in political and security situation

Turkey's trade and services sector, which makes up close to 54% of GDP, managed to grow during the first nine months of this year. In fact, the sector witnessed an expansion of 7.3% in the first nine months of 2017, outpacing the growth rate of 2.7% 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.

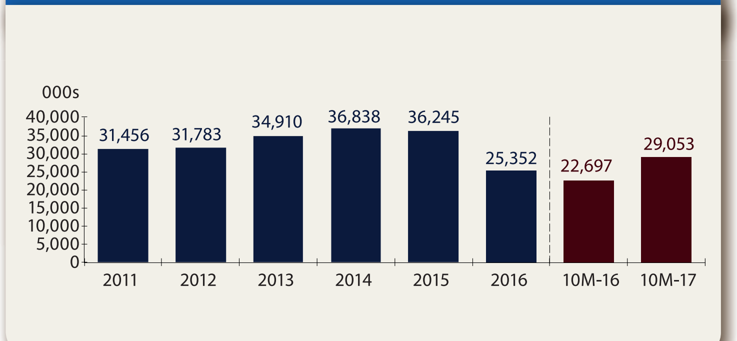
Further reflecting the improvement in the sector, Turkey's services confidence index reached 99.7 in November 2017, up by 2.9% from 96.8 in November 2016, with the index indicating an optimistic economic outlook when above 100 and a pessimistic one when below 100, as per data compiled by the Turkish 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.

Following a sharp decline in the number of visitors in 2016 in a year that included a series of terrorist attacks and a failed coup, Turkey's tourism industry recovered in 2017 with a continuous rise in the number of foreign tourists. The Culture and Tourism Ministry announced that around 29 million people visited Turkey in the first ten months of the year, an increase of 28% compared to 23 million in the same period last year. More specifically, the city of Antalya on the Mediterranean coast recorded the highest number of visitors with 9.25 million. Istanbul, the country's largest city by population, was second among all cities with border gates, with around 9 million visitors from abroad.

Russian tourists comprised the lion's share in the total number of foreign visitors, constituting 15.7% of the total and reaching 4.5 million visitors, according to statistics on foreign visitors' nationalities. They were followed by Germans which formed 11.5% of the total number of visitors and Iranians at 7.3% of the total.

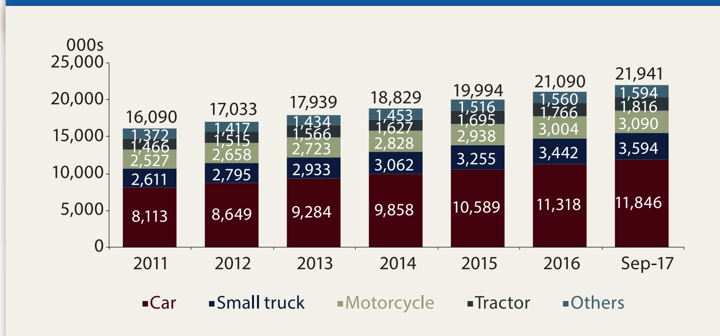
Therefore, the country used the year 2017 to recuperate from the unexpected political events in 2016, which contributed to a 52.2% hotel occupancy rate in October 2016. It is worth noting that the latter was the lowest recorded occupancy level in Turkey since 2001. The performance of Turkey's hotel industry rebounded in 2017, with hotel occupancy rates across Turkey rising by 12.5% year-on-year during the first seven months of the year, compared to the same period of 2016, but an 18.6% year-on-year decline was seen in average daily rates (ADRs), according to the Hotels Association of Turkey.

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

Widening current account deficit mostly led by surging trade deficit

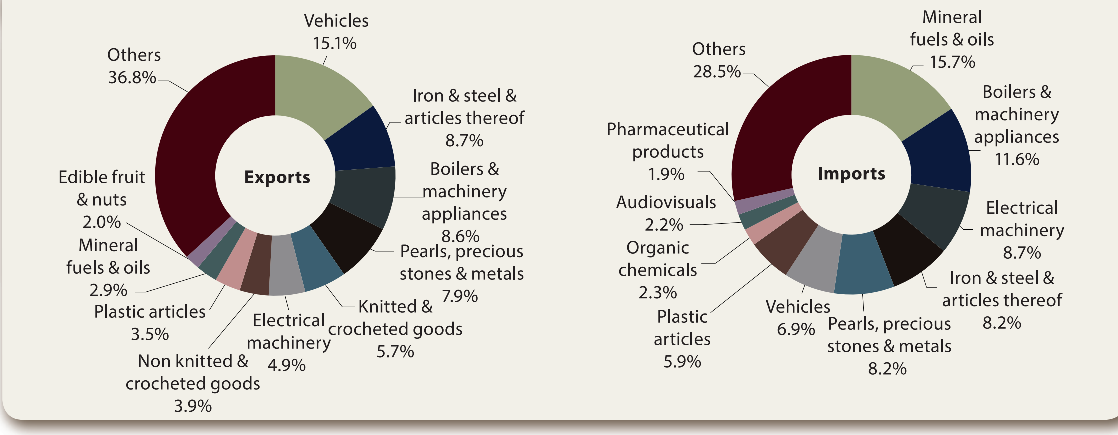
The rapid acceleration of domestic demand-driven output growth has widened the current account deficit by 27.1% in the first nine months of 2017, due to a surge in trade deficit by 31.7% during that period, as the demand driven pick-up in imports has become more evident in the third quarter of the year reflecting an overheating economy. However, the emergence of diplomatic tension between the US and Turkey in October, intensifying depreciation pressures on the lira during the previous couple of months, could limit this expansion in trade deficit by boosting export competitiveness and curbing import demand in the forthcoming period.

In details, Turkish exports reached US$ 121.7 billion in the first nine months of 2017, as per the latest Central Bank figures, posting a 10.9% rise on a yearly basis, as the Turkish lira/US$ exchange rate has depreciated by circa 22% over the first nine months of 2017 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 (15.1% of total exports), iron and steel (8.7%), boilers and machinery appliances (8.6%), pearls and precious metals (7.9%) and knitted and crocheted goods (5.7%). The geographic distribution of domestic exports indicates that 9.6% of total exports went to Germany, followed by UAE with 6.8% of the total, Iraq with 6.1%, United Kingdom with 6.1%, USA with 5.6%, and Italy with 5.3% of total domestic exports over the same period.

At the same time, Turkish imports reported a 15.5% year-on-year increase over the first nine months of 2017 to reach US$ 162.5 billion, led by a 29.4% surge in imports during the third quarter of the year, following the rapid acceleration of domestic demand-driven output growth and the energy bill rising faster than the pick-up in energy prices. In parallel, the breakdown of domestic imports by commodity shows that the main imports over the first nine months of 2017 were mineral fuels and oils (15.7% of total imports), boilers and machinery appliances (11.6%), electrical machinery (8.7%), iron and steel (8.2%), and pearls and precious metals (8.2%). The breakdown of imports by country of origin shows that most of the inward merchandise came from China with 10.2% of total imports, followed by Germany with 8.9%, Russia with 8.2%, USA with 5.3%, Italy with 4.8% and Iran with 3.5% of total imports over the same period.

Accordingly, the cumulative trade deficit went up by 31.7%, from US$ 30.9 billion over the first nine months of 2016 to US$ 40.8 billion over the first nine months of 2017. Turkish foreign trade activity posted a net increase in terms of volume, as the sum of exports and imports went up by 13.5% moving from US$ 250.5 billion in the first nine months of 2016 to US$ 284.2 billion in 2017. Consequently, the exports to imports coverage ratio reported 74.9% in the first nine months of 2017, from 78.0% a year earlier. As such, and despite the recovery in services balance, which is the second most important component of the current account, as a result of the hike in travel receipts by 28.2% (following a 29% rise in tourist arrivals during the same period), the current account deficit has expanded from US$ 24.5 billion in the first nine

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-17)



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

months of 2016 to US$ 31.1 billion in the first nine months of 2017. Having said that, the year 2017 is expected to report a higher current account deficit ratio of 4.6% of GDP when compared to 3.8% of GDP in 2016, as per the IMF.

Last but not least, the gap at the level of the current account has been more or less offset by a surplus in the financial account during this year. The latter has risen by 18.7% during the first nine months of 2017 to reach US$ 31.6 billion, driven by a hike in portfolio investments and other investments by 32%, while net foreign direct investments fell by 19% over the first nine months of 2017. As a result, the overall Turkish balance of payments registered in the first nine months' period a small deficit of US$ 0.5 billion, from a surplus of US$ 5.6 billion registered in the similar 2016 period.

1.3. PUBLIC SECTOR

Widening budget deficit, yet with persisting favorable debt dynamics

Turkey's fiscal deficit widened relatively over the first ten months of 2017, mainly due to an increase in expenditures combined with a continued slowdown in non-tax and tax revenues, the latter being the main source of government revenue. However, the primary balance remained in surplus, spotting light on favorable debt dynamics.

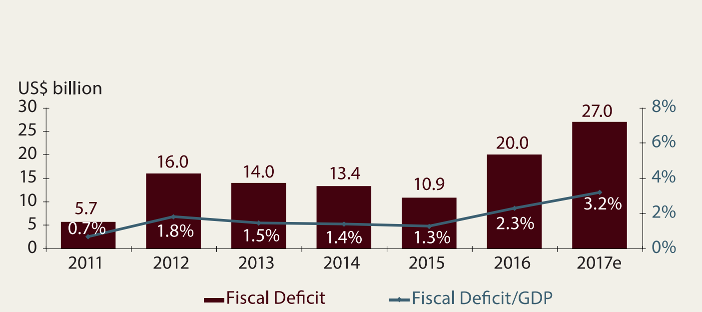
Central government revenues grew by 13.8% during the first ten months of 2017 to reach a total of TL 509 billion, mainly supported by a 13.9% year-on-year increase in general budget revenues to TL 491 billion, of which tax revenues that rose by 18.0% to reach TL 431 billion. Within this context, direct tax revenues rose by 19.1% during the first ten months of 2017 to reach TL 142 billion, while indirect tax revenues rose by 17.5% to reach TL 289 billion. General budget revenues showed that non-tax revenues such as capital revenues and enterprise and ownership revenues decreased by 24.5% and 19.7% respectively. Revenues of special budget agencies increased by 11.9% to reach TL 15 billion and revenues of regulatory and supervisory institutions rose by 7.5% to reach TL 4 billion.

Expenditures went up by 18.4% during the first ten months of 2017 to reach TL 544 billion, mainly due to a 19.0% expansion in primary expenditures to TL 494 billion, and a 12.4% rise in interest expenditures to TL 50 billion.

A breakdown of primary expenditures shows an 8.6% increase in compensation of employees to reach TL 137 billion and current transfers surged by 23.1% to reach TL 225 billion, of which Treasury aid increased by 26.6% to reach TL 123 billion, social security contributions rose by 9.6% to reach TL 22 billion and goods and services purchases increased by 22.0% to reach TL 46 billion.

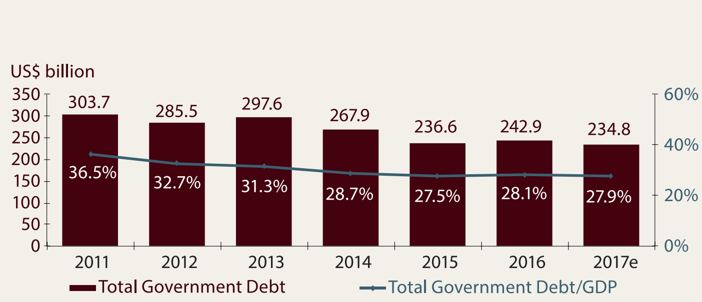
Interest expenditures showed a 12.4% increase during the first ten months of 2017 to TL 50 billion. A breakdown of interest expenditures showed a 7.8% increase in domestic interest expenditures to TL 35 billion as well as a 25.4% surge in foreign debt interest to TL 13.0 billion, and a 21.4% increase in interest of discount and short-term cash transactions to reach TL 2.1 billion.

FISCAL DEFICIT



Sources: IMF, Bank Audi's Group Research Department

PUBLIC INDEBTEDNESS



Sources: IMF, Bank Audi's Group Research Department

That being said, the central government deficit (on a cash basis) reached circa TL 31 billion over the first ten months of 2017 as compared to a deficit of TL 15 billion during the same period of 2016, mainly driven by a growth in primary expenditures, accounting for the majority of central government expenditures.

When excluding debt service, a primary surplus of TL 15 billion was recorded over the first ten months of 2017 as compared to a surplus of TL 32 billion over the corresponding period of 2016. According to the IMF, the general government budget deficit is projected to increase to 3.2% of GDP in full-year 2017, up from 2.3% in 2016.

In parallel, the central government debt stock reached TL 867 billion at end-October 2017 as per latest figures released by the Prime Ministry Undersecretariat of Treasury, up from TL 726 billion at the same date of 2016, and is split into TL 531 billion in domestic debt (accounting for circa 61% of the total) and TL 337 billion in external debt (accounting for the remaining 39%). The interest composition of the total debt stock shows that the fixed rate debt captured 73.6% of the total at end-October 2017, while the floating rate debt accounted for 12.6% of the total, and the CPI indexed debt 13.8% of it.

Besides, it is worth mentioning that 80.3% of domestic debt is held by residents, while 19.7% is held by non-residents. That being said, the government debt stock is estimated by the IMF to reach 27.9% of GDP in 2017, compared to 28.1% of GDP in 2016, one of the low debt ratios around the world.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Aggressive monetary tightening amid elevated inflation

Turkey's monetary conditions were marked in 2017 by extended losses in the value of the Turkish lira and a continuous elevated level of consumer price inflation. This prompted the Central Bank of Turkey to adopt an aggressive monetary tightening, while relying more heavily on the late liquidity window facility to meet system's funding requirement.

In details, consumer price inflation remained elevated during the first eleven months of 2017, averaging 11.1% year-on-year, while reaching a 14-year peak of 13.0% year-on-year in November 2017, mainly driven by the lagged spillovers of the Turkish lira depreciation, rising import prices and higher food prices, and the methodological change in the measurement of clothing prices. In addition to cost pressures, demand conditions have also stopped providing disinflationary support due to robust economic activity. Temporary VAT cuts and other measures, such as augmenting the Credit Guarantee Fund, which have stimulated private consumption and investment, have intensified underlying price pressures.

In response to the deteriorating inflation outlook, the Central Bank of Turkey delivered an aggressive monetary tightening over the year 2017. The one-week repo auctions have been suspended in 2017, the marginal funding rate has been gradually raised, and the late liquidity window lending rate has been lifted three times in January, March and April 2017 by a total 225 bps to reach 12.25%, noting that the latter became increasingly the primary source of funding. Also, banks' borrowing limits at the Central Bank of the Republic of Turkey Interbank Money Market for overnight transactions have been reduced to zero, effective November 22, 2017. Accordingly, the regulator cut lenders off from its 9.25% interbank overnight rate, which means that all financing would be delivered via the CBRT's late liquidity window at 12.25%. This lifts the effective borrowing cost for Turkish banks by 25 basis points, and puts it on par with the upper band of Turkey's main so-called interest-rate corridor.

Rising inflation, widening current account deficit, and expectations of higher US interest rates have intensified depreciation pressures on the Turkish lira. In fact, the Turkish lira has depreciated by 11% during the first eleven months of 2017, moving from TL/US$ 3.52 at end-2016 to TL/US$ 3.91 at end-November 2017. Citing the Turkish lira depreciation and the rising oil prices, the CBRT raised its inflation forecast to 9.8% from 8.7% for 2017 and to 7% from 6.4% for 2018.

In parallel, in an attempt to manage exchange rate risks, the CBRT launched on November 18, 2017 the Turkish lira-settled forward foreign exchange sale auctions, with the maximum total amount of foreign exchange sale position planned to be US$ 3 billion until end-2017. Auctioning non-deliverable forward contracts would allow companies with foreign currency liabilities to protect themselves by locking in exchange rates, noting that the contracts would be settled in liras, which means that the operation won't eat into the Central Bank's reserves.

Also, the CBRT reduced the amount of foreign currency lenders can park as reserves with the regulator and introduced a measure allowing exporters to repay as much as US$ 5 billion of foreign currency loans due through February 1, 2018 in liras at favorable rates, in an attempt to free up access to foreign currency and shore up the Turkish lira.

Given the weakening Turkish lira and the increased political tensions between the US and Turkey, the CBRT's gross foreign exchange reserves reversed towards the end of November the upward trajectory that was traced over the first ten months of 2017 (+4.6%), registering around US$ 6 billion drop during the month of November 2017 to reach US$ 90.0 billion, as compared to US$ 92.1 billion at end-2016, down by 2.4%.

Looking forward, the CBRT is expected to keep its monetary policy tight in order to dampen inflationary pressures and prevent further depreciation of the lira amid political volatility and expectations of higher US interest rates and Fed balance sheet tapering. To this purpose, the CBRT may use a mix of interest-rate rises, macroprudential measures and other policies in the period ahead.

1.4.2. Banking Activity

Surging lending activity coupled with healthy deposit inflows amid buoyant economic performances

Turkey's banking sector has had a good year in 2017, after withstanding currency-related pressures in the previous year (and to a much lesser extent this year) and benefiting from a pick-up in economic activity throughout this year. In parallel, asset quality, liquidity and capitalization metrics have proven relatively resilient to recent shocks and continue to display adequate levels, further cementing the Turkish banking sector financial standing. Measured by the aggregated assets of banks operating in Turkey, banking activity grew by 16.0% in local currency terms in the first ten months of 2017 according to the latest official statistics available, or by 7.8% in US dollar terms, to reach the equivalent of US$ 838.9 billion at end-October 2017.

The major driver of banks' surging activity proved to be none other than credit growth. As a matter of fact, lending activity turned out to be the most important contributor to balance sheet growth over the covered period. Loans progressed by 17.9% in local currency terms between December 2016 and October 2017, or by 9.5% in US dollar terms, to reach the equivalent of US$ 541.7 billion at end-October 2017.

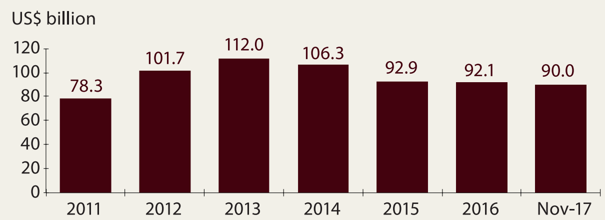
Going further into details, Turkish lira loans contributed the most to lending activity growth in the country this year, accounting for 76% of the total increase in the first ten months, leaving a quarter of total growth

MONETARY SITUATION

Flows in US$ million	2011	2012	2013	2014	2015	2016	9M-17
Net foreign assets	**-2,341**	**6,649**	**-25,739**	**-16,026**	**-4,681**	**10,473**	**-6,346**
Foreign assets	7,123	28,861	11,888	-4,318	-13,448	7,474	6,434
Foreign liabilities	-9,464	-22,211	-37,626	-11,708	8,767	2,999	-12,780
Domestic Assets	**-26,520**	**94,369**	**22,228**	**41,881**	**-35,585**	**-30,342**	**62,630**
Claims on private sector	26,540	91,188	46,689	44,265	-21,705	-20,144	65,092
Claims on public sector	-49,055	-563	-24,558	-3,997	-12,765	-10,070	-3,470
Claims on non-bank financial institutions	-4,005	3,744	97	1,614	-1,115	-128	1,007
Total Money Supply	**-28,861**	**101,018**	**-3,533**	**25,878**	**-40,266**	**-19,869**	**56,283**
Money Supply (M1)	-6,572	10,383	6,080	2,301	-5,155	2,276	5,156
Quasi-Money	-17,745	61,002	-4,927	11,254	-28,822	-13,655	34,759
Other Items (Net)	-4,544	29,633	-4,686	12,323	-6,289	-8,490	16,368

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

to foreign currency denominated loans. The solid rise in lending volumes was driven by the introduction of the government's TL 250 billion credit guarantee fund, which seeks to help SMEs secure loans. Loans covered by the fund are guaranteed up to a 7% non-performance level but the guarantee would stop if that level came to be exceeded, which should deter banking institutions from loosening noticeably their underwriting standards. SME loans progressed by 20.1% in local currency terms over the covered period of 2017, while consumer lending rose by 13.8% over the same period. It is also worth noting that credit growth was revived this year partly due to some relaxation of consumer lending terms.

Recently, the Central Bank noted that credit growth converged to its historical average in the third quarter and stabilized at these levels as a result of the normalization in loan demand and the fund approaching its limit. Over the ten-month period, wholesale and retail trade, manufacturing and construction respectively were the biggest gainers in terms of credit volumes.

Turkish banks largely used additional liquidity at hand in the form of deposits to fund new credit waves, with total deposits at banks in the country growing by 16.0% in local currency terms in the first ten months, or by 7.7% in US dollar terms, to reach the equivalent of US$ 446.6 billion at end-October 2017.

Both deposits in local currency and in foreign currencies rose over the covered period, but with an advantage to the latter (54% of total growth versus 46% for Turkish lira funds). In particular, term deposits accounted for close to 80% of deposit growth, noting that resident deposits accounted for the bulk of deposit growth on the overall.

The swift increase in FX deposits and acceleration in local currency loans urged banks to seek additional lira funding in international markets through currency swaps. Generally speaking, large FX positions generated by banks' funding strategy are closed through derivatives transacted with foreign counterparties, mostly through cross-currency and interest rate swaps. Hedging allows banks to lower FX market risks, although cross-currency swaps are usually short-term, which in turn increases re-pricing risks.

In parallel with deposits, banks have been funding loans through wholesale markets in recent years, given strong loan demand relative to deposit growth. The usually short-term nature of such wholesale borrowing yet raises some refinancing risks, noting that this funding is also sensitive to domestic macro risks perception by markets. Consequently to loan growth outstripping deposit growth, banking sector liquidity is being pressured. We note that the loan-to-deposit ratio is high by emerging market standards at 121.3% at end-October 2017, against 119.3% at end-2016 and levels below the 100% mark a few years ago.

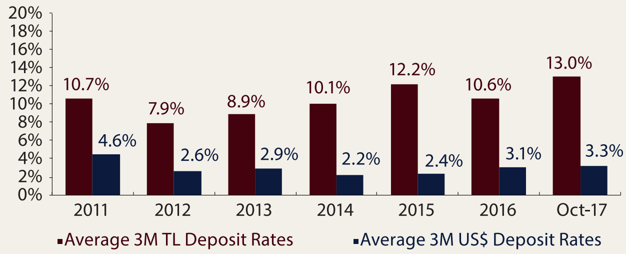
Nonetheless, banks still hold enough readily available liquidity at hand should the need arise. The ratio of core liquidity to total deposits stood at a decent 21.5% at end-October 2017 (we measure core liquidity as the sum of cash and receivables from the Central Bank and required reserves), which is pretty much in line with global averages. The core liquidity levels were favored by an increase in the amount of required reserves over the covered period.

BANKING SECTOR INDICATORS

in US$ billion	2011	2012	2013	2014	2015	2016	Oct-17
Banking Activity							
Assets	648.1	773.4	814.4	859.8	813.4	778.3	838.9
Deposits	370.3	435.7	444.6	454.3	429.8	414.7	446.6
Credit facilities	363.5	448.4	492.4	535.5	512.3	494.5	541.7
Shareholders' equity	76.9	102.6	91.1	99.9	90.5	85.4	92.3
YTD Growth rates							
Assets	-1.3%	19.3%	5.3%	5.6%	-5.4%	-4.3%	7.8%
Deposits	-8.0%	17.7%	2.0%	2.2%	-5.4%	-3.5%	7.7%
Credit Facilities	5.9%	23.4%	9.8%	8.8%	-4.3%	-3.5%	9.5%
Shareholders' equity	-12.3%	33.4%	-11.2%	9.7%	-9.4%	-5.6%	8.1%

Sources: BRSA, Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



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

The rising lending quality did not come at the expense of asset quality as reflected by NPL metrics. The non-performing loans to total cash loans ratio reached 3.0% at end-October 2017, against a slightly higher 3.2% at end-2016. This compares well to emerging market peers and reflects asset quality resilience supported by high loan growth, some sales of problem loans by privately owned banks, and regulatory forbearance measures. Turkish authorities have encouraged banking institutions to restructure payment schedules and let companies repay FX loans in local currency at a favorable FX rate. Furthermore, the Central Bank recently declared that the sector preserves its sound asset quality owing to the pick-up in economic activity, TL credit growth and the positive course in NPL collection. Also, provisioning coverage strengthened further to reach close to 80% at end-October.

Having said that, Turkish banks also benefit from solid capital buffers that enable to absorb loan losses just in case these were to occur. Banks are well capitalized, as mirrored by a comfortable capital adequacy ratio of 16.9% at end-October and a high core capital component equivalent to 14.0%. The increase in subordinated debt issuance and the favorable outlook in profitability, along with accommodative regulatory reliefs, provided significant support to banks' regulatory capital. Also, some banks strengthened their capital by exchanging their subordinated debt for new issuances that are compatible with Basel III, as per the Central Bank.

Last but not least, the surge in lending activity gave a boost to banks' revenues, with a double-digit rise in net interest income (favoring a slight rise in NIMs) and a healthy growth in non-interest income amid solid economic performances well outpacing a more contained increase in operating expenses. This lead to a 28.3% yearly progression in banks' bottom line in local currency terms (+5.1% in US dollar terms) in the first ten months of 2017. Subsequently, return ratios rose to 1.68% for ROAA and 16.1% for ROAE when annualizing first ten months figures. As such, the Turkish banking sector displayed strong profitability metrics despite a limited decline as of the second quarter due to the loss of the one-off income effect seen last year and the cost of swap transactions conducted to meet the local currency loan demand.

1.4.3. Equity and Bond Markets

Healthy price gains in Turkish equity and bond markets

Turkish securities registered healthy price gains during the first eleven months of 2017, supported by tempting valuations and yields. Turkish stocks posted double-digit increases amid rising trading volumes, and Turkish bonds saw a price rebound, while Turkey's five-year CDS spreads witnessed decent contractions amid improved market perception of sovereign risks at large.

In details, Borsa Istanbul reported a strong price rally during the first eleven months of 2017, fueled by support from a State-backed corporate loan fund aimed to facilitate and stimulate lending to businesses, a stronger-than-expected economic growth, tempting valuations and a global demand for higher-yielding emerging market stocks. The BIST 100, which represents the 100 largest companies by market capitalization, registered a 33.1% growth during the first eleven months of 2017, which is its largest increase since 2012, to close at 103,984 at end-November 2017. This occurred at a time when the spread between the price-to-estimated earnings valuation between BIST 100 Index and MSCI Emerging Markets Index widened to its highest level since 2009. For instance, the BIST 100 Index is currently trading at a P/E of 9.16 times as compared to a multiple of 15.44 times for MSCI Emerging Markets Index, as per Bloomberg figures, which sheds light on the attractiveness of Turkish stocks.

The market capitalization surged from US$ 174.5 billion at end-2016 to US$ 202.4 billion at end-November 2017, up by 16.0%. The total number of contracts reached 141.9 million during the first eleven months of 2017, up from 99.5 million during the corresponding period of 2016. The total trading value increased from US$ 316.7 billion during the first eleven months of 2016 to US$ 366.1 billion during the corresponding period of 2017, moving up by 15.6%. The turnover ratio, measured by the annualized total trading value to market capitalization, reached 197.3% during the first eleven months of 2017, down from 205.2% during the corresponding period of 2016.

At the level of the bond market, Turkish bonds were on foreign market players' radar screen during the year 2017, given their attractive yields relative to peers. The Turkish lira-denominated bonds ranked among top yielding debt papers in emerging markets following Argentina and Nigeria. The 10-year

Turkish lira Benchmark bond index yield reached 12.36% at end-November 2017, up from 11.39% at end-2016. Within this context, non-resident investors were net buyers of Turkish bonds over the first eleven months of the year 2017. This was reflected by a US$ 2.3 billion increase in their holdings, moving from US$ 26.7 billion at end-2016 to US$ 29.0 billion towards the end of November 2017. This compared to a US$ 5.0 billion contraction in their holdings in 2016.

By looking at individual debt papers, sovereigns maturing in 2021, 2026, 2036 and 2045 registered price gains ranging between 1.81 pt and 5.28 pts during the first eleven months of 2017. Also, papers issued by financial institutions were on the rise. Akbank'25 was up by 5.18 pts. Isbank'21 closed up by 3.76 pts. Prices of Halkbank'25 rose by 3.50 pts. Yapibank'26 posted price gains of 2.92 pts. As to the cost of insuring debt in Turkey, the country's five-year CDS spreads contracted by 71 bps over the first eleven months of 2017, moving from 273 bps at end-2016 to 202 bps at end-November 2017, in a sign of an improved market perception of sovereign risks at large.

As to credit rating changes, Fitch cut in January 2017 its rating for Turkey from "BBB-" to "BB+", with a "stable" outlook, citing political and security developments that have undermined economic performance and institutional independence. This followed a rating cut by Moody's in September 2016 from "Baa3" to "Ba1" with a "stable" outlook.

In parallel, Capital Intelligence Ratings affirmed in November 2017 Turkey's long-term foreign currency and local currency ratings at "BB+", with "negative" outlook. The ratings and the outlook reflect persistently, as per CI, high external financing needs and continued reliance on external capital inflows that are sensitive to changes in investor sentiment; CI's expectation of weaker institutional strength following the move to an executive presidency; continued reliance on fiscal policy to stimulate the economy and trigger higher domestic consumption; and high geopolitical risk in addition to ongoing tensions with some key EU member states which could adversely affect foreign capital inflows, as per CI.

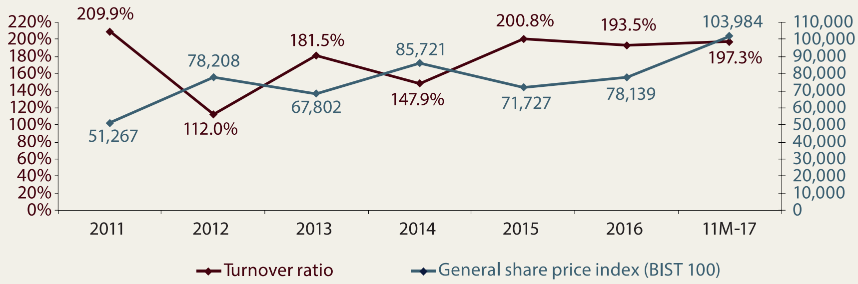
Finally, regarding new issues, Turkey raised US$ 6.75 billion during the first eleven months of 2017 through the sale of a US$ 3.25 billion Eurobond maturing in 2027 at a coupon of 6.0% and a US$ 3.5 billion Eurobond maturing in 2047 at a coupon of 5.75%.

SELECTED STOCK MARKET INDICATORS

	2011	2012	2013	2014	2015	2016	11M-17
Market capitalization (in US$ billion)	201.9	311.2	237.6	269.8	190.2	174.5	202.4
Market capitalization/GDP	24.3%	37.2%	25.0%	28.9%	22.1%	20.2%	24.0%
Trading value (in US$ billion)	423.9	348.6	431.3	399.1	381.7	337.7	366.1
Traded volume (in millions)	202,149	174,290	198,858	207,100	214,061	234,483	325,388
Number of contracts (000s)	102,855	79,808	80,298	83,640	97,300	110,038	141,945
Change in BIST 100 price index	-22.3%	52.6%	-13.3%	26.4%	-16.3%	8.9%	33.1%
Price/Earnings ratio	11.88	12.51	10.22	14.38	14.00	10.24	10.51
Dividend Yield (%)	2.57	1.73	2.27	1.54	2.84	2.27	2.26

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

STOCK MARKET PERFORMANCE



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

2. CONCLUDING REMARKS

Looking ahead, absent of a policy stimulus or a positive external shock, growth will likely slow down in 2018. The Turkish economy is indeed unlikely to see this year's pace of growth maintained into 2018. There are 3 issues that could cloud the economic outlook in 2018: (1) The expected global liquidity fluctuations within the context of aggressive monetary tightening in the US, (2) the risk of intensifying domestic political instability ahead of the 2019 presidential elections and (3) the uncertainty about the direction of economic policy as authorities' stimulus measures are withdrawn. Within this context, the IMF expects real GDP growth to slow down from 5.1% in 2017 to 3.5% in 2018

In the medium term, real output growth is expected to average 5.5% in 2018-2020 according to official forecasts. However, risks to economic growth prospects remain pronounced as above-target inflation, high – though declining – unemployment, continued depreciation of the lira and unfavorable geopolitical conditions continue to weigh on private consumption, while relatively unsettled global economic conditions hinder a speedier recovery in net trade. It is within this context that the IMF foresees lower average growth of 3.5% over the same period. Uncertainty about the direction of Turkey's economic policy continues to cloud the country's medium term outlook. The current direction of policy appears to be towards a difficult balancing act between fiscal loosening and tight monetary policy while encouraging banks to lend to households and businesses.

At the fiscal level, fiscal policy might be adjusted to support investor confidence and prevent a surge in domestic demand from causing an unsustainable widening of the current account deficit. The budget deficit is expected to average 2.4% of GDP in 2018-2019. But the general government debt will remain manageable at around 28% of GDP, bearing in mind that the government aims to bring it down to 25% of GDP in 2019. Nonetheless, risks to the outlook remain noticeable as expansionary fiscal policy, which is not expected to be phased out before 2020, could partly erode the government's fiscal space.

At the monetary level, inflation is expected to slow down to 8% in 2018, provided that the Turkish lira's nominal basket exchange rate remains broadly stable around current levels. The decline expected in headline inflation in 2018 might pave the way for the MPC to reduce the marginal rate at which it provides funding to the market. This could either be achieved through a cut in the late liquidity window rate, or by a return to the corridor mechanism and a hike in the Central Bank's overnight lending rate, unless the Central Bank chooses to normalize its framework in 2018. If the lira depreciates sharply again, an abrupt tightening of policy, which could strangle Turkey's economic recovery, may be necessary to halt the slide.

When trying to assess the Turkish prospects looking ahead, it is important to look at the positive and negative drivers to the outlook. At the level of positive drivers, we mention the diversified economy with good medium-term growth potential, the favorable government debt dynamics and maturity structure, the manageable external debt levels and the improving trade links beyond the country's traditional European markets. At the level of negative drivers, we mention the moderate international reserve adequacy and vulnerability to external shocks, the political and institutional vulnerabilities and high geopolitical risk factors, the persistently high inflation rate and the low national savings rates.

Having said that, strengths exceed weaknesses and opportunities outpace risks at the horizon. Still, institutional strength is a pre-requisite to tackle these challenges, as highlighted by this year's IMF Article IV Consultation mission report. Stronger macro-financial policies are necessary to bring down stubbornly high inflation and reduce external vulnerabilities. Avoiding an excessive slowdown is essential in the short run. In the medium-term, rebuilding buffers and tackling structural weaknesses is important. Policies should aim at improving the investment climate and ensuring adequate public institutional capacity. Further steps are needed to boost the internal and external competitiveness of the formal economy, including keeping future minimum wage increases in check and addressing labor market rigidities at large.

DISCLAIMER

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