

TURKEY ECONOMIC REPORT

TURKEY ON A FAVORABLE MACRO TURNAROUND, THOUGH NOT COMPLETELY OUT OF THE WOODS YET

TABLE OF CONTENTS

Executive Summary	1
Introduction	2
Economic Conditions	4
Real Sector	4
External Sector	7
Public Sector	8
Financial Sector	9
Concluding Remarks	14

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- Real sector under pressure in 2019, yet with near term prospects on the upside**
While the Turkish economy has experienced crisis last year and suffered a downturn early this year, better-than-expected economic data recently released signal the country may be experiencing some turnaround. Fresh data also shows GDP grew by 1.2% in the second quarter, compared with the previous quarter, beating expectations and favored by government expenditures and export receipts, an improvement that apparently continued in the third quarter. Having said that, real GDP is expected to rebound in the remainder of the current year and grow by 3.0% next year.
- Turkey's current account balance recording its first surplus since 2002**
The Turkish economy has experienced major external adjustments over the past twelve months. In fact, the significant reduction in Turkey's external imbalances, combined with a sharp decline in import demand and a pick-up in exports, contributed to a shift in the current account balance from a deficit of US\$ 29.2 billion over the first nine months of 2018 to a surplus of US\$ 3.7 billion over the first nine months of 2019. This considerable shift in the current account balance over the period to its first surplus since 2002 was mainly attributable to a lower trade deficit and stronger services income, supported by a boost from tourism income in the peak summer months.
- Budget deficit continues to widen amid substantial fiscal stimulus**
Turkey's fiscal deficit continued to widen this year as the authorities have relied on fiscal stimulus to ride out Turkey's first recession in a decade and reverse the economic slump. In parallel, budget revenues have failed to keep pace after the government cut taxes while companies, suffering from the economic downturn this year, made fewer profits. As such, the budget deficit has expanded this year, to exceed the government's year-end target, despite the government bolstering revenue by drawing on tens of billions of Turkish liras from Central Bank profits and emergency reserves.
- Noticeable monetary policy easing amid cooling inflationary pressures**
Turkey's monetary conditions were marked in 2019 by cooling inflationary pressures, aggressive monetary policy easing aimed to bolster economic activity growth, a recovery in Turkish lira when compared to last year's record low levels, and a rebound in international reserves. Consumer Price Inflation descended into a single-digit territory this year, falling from 20.3% year-on-year in December 2018 to 8.6% year-on-year in October 2019, which is its lowest level since December 2016.
- Continued growth in banking activity indicators amid adequate financial standing**
The Turkish banking sector has had a somewhat better year in 2019 in relative terms amid a gradual return of confidence in the market translating into a deposit base increase. Measured by the total assets of banks operating in the country, banking sector activity grew by 10.5% in local currency terms in the first nine months of 2019, or 3.3% in US dollar terms, to reach the equivalent of US\$ 758.8 billion at end-September 2019. Deposits, accounting for 55% of total banks' balance sheet in Turkey, rose by 8.5% in US dollar terms over the first nine months of 2019 to reach the equivalent of US\$ 419.8 billion at end-September. Turkish banks have weathered the difficult environment rather well, continuing to collect deposits and displaying adequate liquidity and capitalization ratios. Banks continued to constitute provisions against asset quality risks which caused their profitability to decline in the current difficult conditions domestically.
- Long-term approach to policymaking apt to strengthen the confidence factor**
In brief, Turkey is now on a favorable turnaround though not out of the woods yet. Turkey's remarkable external adjustment, stronger than expected rebound, the recovery of the lira and the decline in inflation are widely recognized by market participants, overseas analysts and international observers. Finally, with the next parliamentary and presidential elections not due until mid-2023, the government is in a position to defuse domestic political tensions and take a more long-term approach to policymaking which is apt to strengthen investor confidence and favor sustainable economic growth ahead in the medium to long term.

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At the external level, Turkey has seen a rapid improvement in external balances and a drop in financing needs in recent months. Turkey's economy produced its first annual current account surplus in 17 years, as the decline in imports following its currency crisis wiped off a deficit that has long troubled investors. Turkey's current account was in surplus by 1% of GDP in the 12 months to October 2019, as per Central Bank data. Tourism provided a support to external balances, with the total number of tourists rising by 14.5% over the first nine months of 2019 relative to the same period last year.

At the fiscal level, the economy continues to benefit from favorable public finance dynamics, with a fiscal deficit remaining low (although trending up) at less than 3% of GDP and a public debt to GDP ratio under the 30% mark. While the recent fiscal stimulus has helped the economy recover, the unwinding of some of the measures taken are welcomed given recent economic strength. In the IMF's view, a neutral fiscal stance next year would still support growth, allowing automatic stabilizers to work, but further discretionary stimulus should be avoided to contain financing needs and preserve fiscal space.

On the monetary front, authorities are pushing for lower rates with the intent to bolster economic activity growth, and the Central Bank recently cut its key policy rate in July by 4.25% to 19.75% and cut it further in September and October to 14.0% amid benign outlook for inflation. The MPC statement expressed confidence in the near term disinflation trajectory and economic recovery, highlighting that despite weakness in investment demand, leading indicators point to a partial improvement in the sector diffusion of economic activity. Official data showed inflation reached 8.6% in October 2019, the lowest since end-2016, helped by the widening output gap.

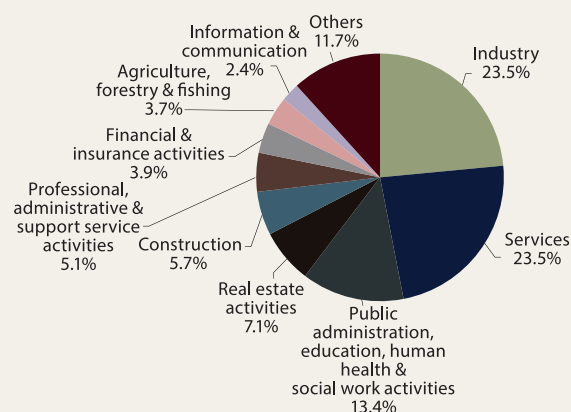
At the banking level, banking activity growth continued this year, fueled by deposits which rose by 9% in US dollar terms in the first nine months. The FX deposits to total deposits continued to rise, moving from 48.8% at end-December 2018 to 52.0% at end-September 2019, amid net conversions from domestic currency holdings to FX holdings. In parallel, the banks' net interest margin contracted from 2.92% in September 2018 to 2.74% in September 2019. Consequently, net banking sector profits over the first 9 months of 2019 were 12.5% lower in TL terms than the same period last year.

GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (H1 2019)

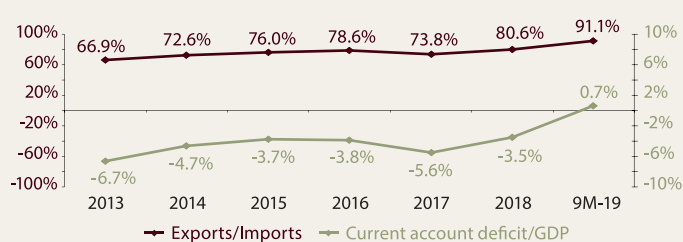


Sources: Central Bank of Turkey, Bank Audi's Group Research Department

With respect to capital markets, a net improvement was seen in 2019. Over the first ten months of the year, the BIST 100 price index rose by 8%, driving market capitalization up to US\$ 171 billion at end-October, against US\$ 151 billion at year-end 2018. Subsequently, the average Price to Earnings ratio on the Turkish bourse rose from its low of 9.12x at end-2018 to 10.16x in October 2019. In parallel, the 5-year CDS spreads, a measure of the market perception of sovereign risks, contracted from 362 basis points at end-2018 to 339 basis points at end-October 2019.

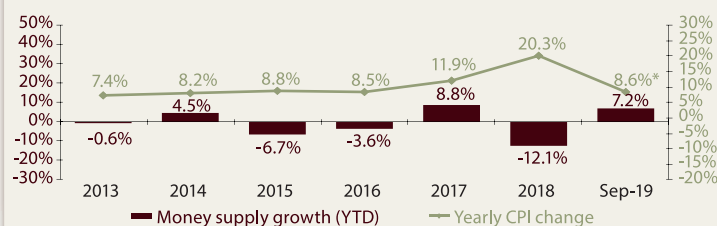
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economic, fiscal and monetary conditions looking ahead.

FOREIGN SECTOR INDICATORS



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

MONEY SUPPLY GROWTH AND INFLATION



* As at end-October

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

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture Sector

Growth in Turkey's primary sector speeds up

Turkey's agricultural sector grew at a faster speed in the first half of 2019, when compared to the same period of last year, reporting a growth of 2.7% up from a growth of 1.2% in the same period of last year. At the same time, the primary sector's share in the country's GDP reported an improvement from 3.3% in the first half of 2018 to 3.7% in the same period of this year.

At the level of the crop production last year, it registered a decrease following its growth in 2017. Crop production of cereals and other crops declined by a yearly 7.9% in 2018. This came after an increase of 4.7% registered in 2017. Production of vegetables contracted by 2.6% in 2018, following a rise of 1.9% in the previous year while that of fruits, nuts and spices crops rose by an annual 0.2%, down from a growth of 8.8% in 2017.

It is worth mentioning that Turkey has a significant place among the world's biggest cereal-producing countries and is one of the top six wheat exporters in the world. An estimated 38.5 million hectares of land are devoted to agricultural development in Turkey, with approximately a third of the country's workforce employed in the agricultural industry in some form.

At the external level, it is worth noting that edible fruits and nuts took over a share of 2.0% of the country's total exports in the first three quarters of 2019, nearly unchanged from its level in the same period of last year, as the country is geographically well placed to take advantage of trade opportunities in Europe and Asia.

It is worth noting that Turkey has one of the world's strongest agricultural sectors, owing to its favorable ecological conditions and diverse climate. It is among the world's leading exporters in almost all the major agricultural product sub-sectors. However, the sector is currently 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 of rising importance. New reforms, aimed at decreasing State involvement and improving the sector's competitiveness, are expected to boost output and most likely result in significant sector consolidation. Reforms of this kind have been ongoing since 2000 and include steps such as boosting Turkey's organic agricultural area, which is already the Mediterranean's largest, in order to capitalize on growing international interest in this premium sub-sector.

CROP PRODUCTION IN 2018 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share	Volume	Share	Volume	Share		
Cereals	34,409	55%	Vegetables	24,696	82%	Fruits	13,795	62%
o.w. Wheat	20,000	32%	o.w. Tomatoes	12,150	40%	o.w. Citrus fruits	4,770	22%
o.w. Barley	7,000	11%	o.w. Watermelon	4,031	13%	o.w. Pome fruits	4,343	20%
o.w. Maize	5,700	9%	o.w. Cucumber	1,848	6%	o.w. Stone fruits	2,695	12%
Sugar beets	17,436	28%	o.w. Melon	1,754	6%	o.w. Other fruits	1,986	9%
Potatoes, dried legumineus	4,550	7%	o.w. Pepper (green)	930	3%	Grapes	3,933	18%
Oil seeds	4,009	6%	Bulb and root vegetables	3,341	11%	Olive production	1,500	7%
Dry pulses	1,225	2%	o.w. Dry onion	1,931	6%	Tea production	1,500	7%
Raw materials used in textiles	977	2%	o.w. Carrots	643	2%	Nuts	1,134	5%
Plants for perfumery, pharmacy	109	0%	Other vegetables	1,996	7%	Spices crops	285	1%
Tobacco	75	0%	o.w. Leafy or edible stem vegetables	1,655	6%	Total Fruits, nuts and spices crops	22,147	100%
Total Cereals and other crops*	62,791	100%	Total Vegetables and other crops	30,033	100%			

* Excluding fodder crops

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

1.1.2. Industrial Sector

Turkey's industrial sector under pressure during the first half of 2019

Turkey's industrial sector came under pressure during the first half of 2019. The country's industrial sector, which accounts for 23.5% of GDP, contracted by 3.3% year-on-year during the first six months of 2019, compared to a growth rate of 6.1% recorded in the same period of 2018.

The country's industrial production data was among the most concrete indicators reflecting the performance of the industrial sector. Turkey's Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, fell by 2.8% year-on-year during the first nine months of 2019, compared to a growth rate of 4.6% in the corresponding period of last year, as per Turkstat. 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 20.1% of GDP, it contracted by 3.8% year-on-year during H1 2019 against 6.2% in the same period of 2018. Turkish manufacturing activity remained in contractionary mode during the first ten months of 2019 due to a slowdown in new orders, even while employment increased. The Purchasing Managers' Index (PMI) for manufacturing declined slightly to 47.2 during 10M 2019, down from 48.8 in 10M 2018, slipping back below the 50-point line that separates expansion from contraction. It is worth noting that a reading greater than 50 indicates growth of the sector, while a reading below 50 signals a contraction.

Manufacturing yet seems to gain some ground in the second half-year. Recent data showed that Turkey's manufacturing industry used 77.2% of its capacity in November, its highest level in the last 15 months, the country's Central Bank reported.

As for Turkey's construction sector, which makes up 5.7% of GDP, it witnessed a negative growth by 11.2% year-on-year during the first half of 2019, compared to an expansion of 3.8% in the same period 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.

To sum things up, Turkey's industrial sector witnessed a rather adverse performance in the early months of 2019 to slightly improve in recent months. The sector's real GDP still contracted year-on-year, and the industrial sector was negatively impacted by feeble 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.

VEHICLES PRODUCTION

(unit)	2015	2016	2017	2018	18/17	10M-18	10M-19	10M/10M
Automobile	791,027	950,839	1,120,860	1,026,438	-8.4%	858,615	794,156	-7.5%
Pick-up	468,933	461,838	462,389	429,361	-7.1%	361,454	319,349	-11.6%
Minibus	47,078	44,420	55,036	56,934	3.4%	45,636	50,008	9.6%
Tractor	51,238	50,026	53,841	37,686	-30.0%	34,444	19,134	-44.4%
Truck	35,838	17,369	23,499	25,529	8.6%	22,652	16,306	-28.0%
Bus	8,789	8,084	8,168	8,541	4.6%	6,948	7,764	11.7%
Midibus	7,131	3,332	3,732	3,316	-11.1%	2,946	2,012	-31.7%

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

1.1.3. Trade and Services Sector

Tertiary sector on a slight growth path

Turkey's trade and services sector, which constitutes around 55.4% of GDP, remained on a growth trend during the first half of 2019. Supported by a relatively weak Turkish lira, the sector witnessed a positive expansion of 0.3% in the first six months of 2019.

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.

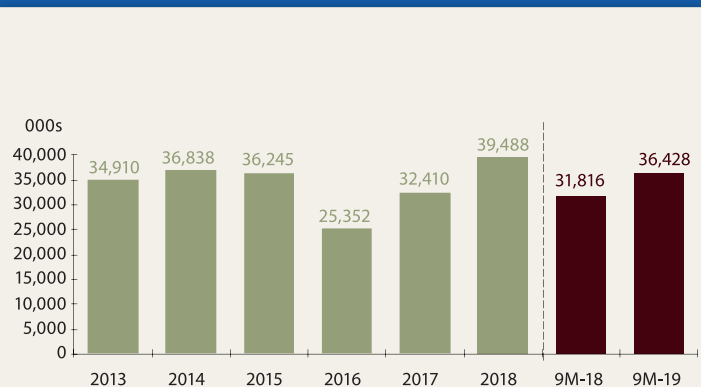
Turkey's services confidence index reached an average of 85 in the first 11 months of 2019, down from 91 in the same period of 2018 and contracting by 6.6% year-on-year. The index indicates an optimistic economic outlook when above 100 and a pessimistic one when below 100, as per data compiled by the 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 relatively weaker local currency, Turkey's tourism industry performed strongly in 2019 with a significant rise in the number of foreign tourists. The country welcomed some 36.4 million visitors during the first nine months of 2019, a 14.5% rise on a yearly basis.

It is worth noting that 85.3% of tourists were foreign and 14.7% Turkish citizens living abroad. TurkStat said visitors' average expenditures were US\$ 649 per capita, as foreign visitors spent US\$ 623 per capita and Turkish citizens spent US\$ 789 per capita.

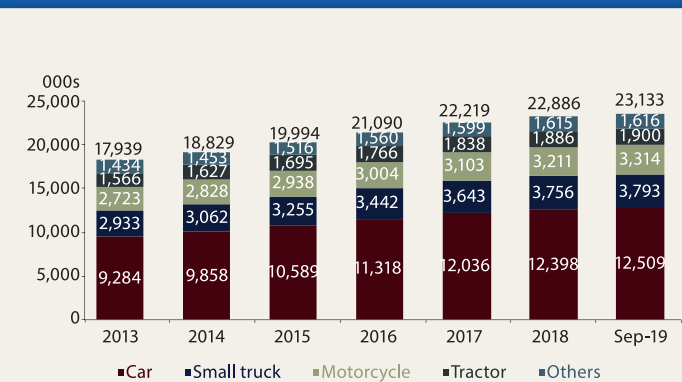
As for the hospitality sector, hotel occupancy rates across Turkey increased by 1.1% year-on-year to 63.8% in the first half of the current year, according to the Turkish Hotel Association (TUROB). Moreover, average daily rate for rooms rose by 7.7% to € 69.8 during the aforementioned period. Revenue per available room across Turkey stood at € 44.5 in the first six months, up by 8.9% from the same period of last year, indicating an improved performance of the hospitality sector at large.

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 current account balance recording its first surplus since 2002

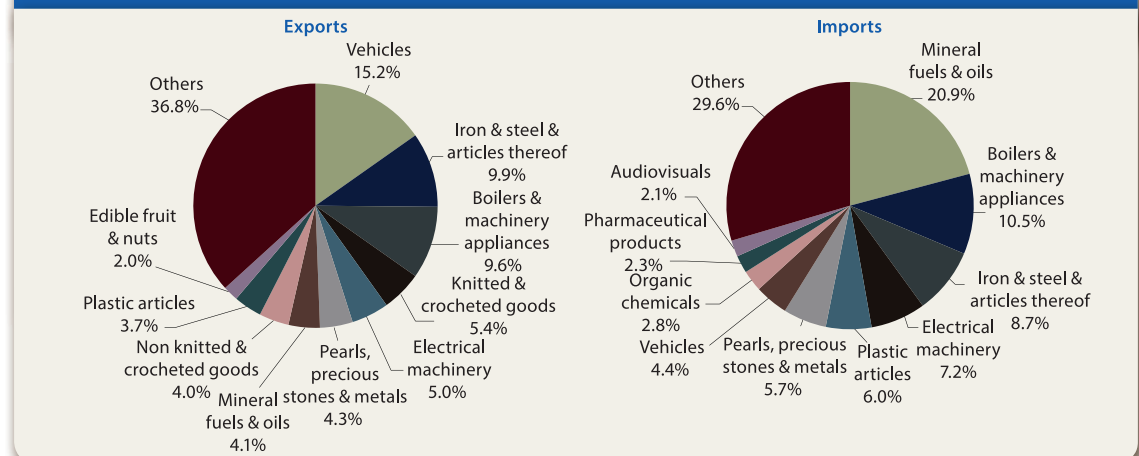
The Turkish economy has experienced major external adjustments over the past twelve months. In fact, the significant reduction in Turkey's external imbalances, combined with a sharp decline in import demand and a pick-up in exports, contributed to a shift in the current account balance from a deficit of US\$ 29.2 billion over the first nine months of 2018 to a surplus of US\$ 3.7 billion over the first nine months of 2019. This considerable shift in the current account balance over the period to its first surplus since 2002 was mainly attributable to a lower trade deficit and stronger services income, supported by a boost from tourism income in the peak summer months.

In details, Turkish exports reached US\$ 134.0 billion over the first nine months of 2019, as per the latest Central Bank figures, posting a 4.6% rise on a yearly basis, on the back of the Turkish lira/US\$ exchange rate depreciating by circa 26% over the first nine months of 2019 relative to the previous year's same period, boosting somehow 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 (15.2% of total exports), iron and steel (9.9%), boilers and machinery appliances (9.6%), knitted and crocheted goods (5.4%), electrical machineries (5.0%) and pearls and precious metals (4.3%). The geographic distribution of domestic exports indicates that 9.1% of total exports went to Germany, followed by the United Kingdom with 6.5% of the total, Italy with 5.4%, Iraq with 5.0%, USA with 4.7%, and Spain with 4.6% of total domestic exports over the same period.

In parallel, Turkish imports reported a drop of 13.1% over the first nine months of 2019 to reach US\$ 147.1 billion, when compared to a 4.1% yearly rise in imports during the first nine months of 2018, as weak consumer demand continued to curb imports at large. In parallel, the breakdown of domestic imports by commodity shows that the main imports over the first nine months of 2019 were mineral fuels and oils (20.9% of total imports), boilers and machinery appliances (10.5%), iron and steel (8.7%), electrical machinery (7.2%), plastic articles (6.0%), pearls and precious metals (5.7%) and vehicles (4.4%). The breakdown of imports by country of origin shows that most of the inward merchandise came from Russia with 11.1% of total imports, followed by China with 8.9%, Germany with 8.7%, USA with 5.7%, Italy with 4.2% and India with 3.3% of total imports over the same period.

Within this context, the cumulative trade deficit went down significantly by 68.1% over the first nine months of 2019 compared to the same period of 2018 (following a relative stagnation a year ago) to reach US\$ 13.1 billion. In parallel, services balance, which is the second most important component of the current account, reported a hike of 24.8% during the first nine months of 2019, supported by an ongoing recovery in tourism sector raising travel and touristic receipts by 16.7% over the same period. Moreover, it is worth mentioning that the current account balance recorded a historical combined surplus of US\$ 6.4 billion in the third quarter of 2019, compared to a surplus of US\$ 1.8 billion over the previous year's same

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-19)



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

period. Having said that, the year 2019 is expected to report a tiny current account deficit ratio of 0.6% of GDP when compared to a deficit of 3.5% of GDP in 2018, as per the IMF.

1.3. PUBLIC SECTOR

Budget deficit continues to widen amid substantial fiscal stimulus

Turkey's fiscal deficit continued to widen this year as the authorities have relied on fiscal stimulus to ride out Turkey's first recession in a decade and reverse the economic slump. In parallel, budget revenues have failed to keep pace after the government cut taxes while companies, suffering from the economic downturn this year, made fewer profits. As such, the budget deficit has expanded this year, to exceed the government's year-end target, despite the government bolstering revenue by drawing on tens of billions of Turkish liras from Central Bank profits and emergency reserves.

In details, the central government budget revenues grew by 18.1% during the first ten months of 2019 to reach a total of TL 719 billion (or US\$ 127 billion), mainly supported by an 18.7% year-on-year increase in general budget revenues to TL 697 billion, of which tax revenues that rose moderately by 6.3% to reach TL 540 billion, as they were hit by the deep economic slowdown in 2019. 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 significantly over the same period amid very strong non-recurring revenue growth this year, most notably a profit and liquidity transfer from the Central Bank to the Treasury worth more than TL 75 billion.

Within this context, the Turkish Parliament ratified in November new laws on tax regulation including higher rates for high earners and hotel accommodation, as well as new taxes on digital services. The law proposes new taxes namely a valuable house tax and accommodation tax. The regulation includes a new tax bracket of 40%, from the previous 35%, for those earning more than TL 500,000 annually, according to the final text of the regulation. Houses that cost more than TL 5 million will be subject to a valuable residence tax. The regulation also sees a 7.5% tax on all manners of digital advertisements and services content.

On the spending side, a strong growth of 22.2% in central government budget expenditures was recorded over the first ten months of 2019 compared to the same period of 2018, to reach TL 820 billion (or US\$

SELECTED PUBLIC FINANCE INDICATORS

TL billion	2015	2016	2017	2018	18/17	10M-18	10M-19	10M/10M
Central government budget revenues	482.8	554.1	630.5	757.8	20.2%	609.0	719.2	18.1%
o.w. Tax revenues	407.8	459.0	536.6	621.3	15.8%	507.9	539.9	6.3%
o.w. Non-tax revenues	75.0	95.1	93.9	136.5	45.4%	101.1	179.3	77.4%
Central government budget expenditures	506.3	584.1	678.3	830.4	22.4%	671.1	819.9	22.2%
o.w. Primary expenditures	453.3	533.8	621.6	756.5	21.7%	606.4	731.6	20.6%
o.w. Interest	53.0	50.2	56.7	74.0	30.4%	64.6	88.3	36.6%
Central government budget cash balance	-19.5	-37.0	-54.8	-88.3	61.0%	-62.8	-100.7	60.5%
Central government budget cash balance/GDP	-0.8%	-1.4%	-1.8%	-2.4%	-0.6%	-2.0%	-2.8%	-0.8%

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

PUBLIC INDEBTEDNESS



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

145 billion), mainly due to a 20.6% expansion in primary expenditures to TL 732 billion, and a 36.6% rise in interest expenditures to TL 88 billion. A breakdown of primary expenditures shows that compensation of employees increased by 25.2% to reach TL 211 billion, current transfers went up by 25.6% to reach TL 336 billion, of which Treasury aid increased by 38.4% to reach TL 189 billion, social security contributions surged by 28.2% to TL 36 billion, while social transfers surged by 49.8% to reach TL 16 billion over the same period. On another hand, interest expenditures showed a 48.1% increase in domestic interest payments during the first ten months of 2019 to TL 63 billion, as well as a 25.0% surge in foreign debt interest to TL 21 billion.

That being said, the central government budget deficit (on a cash basis) has surged by 60.5% over the first ten months of 2019, reaching circa TL 101 billion (or US\$ 18 billion) as compared to a deficit of TL 63 billion during the same period of 2018, reflecting weak economic activity and counter-cyclical fiscal measures. Within this context, the general government budget deficit is projected to exceed 3% of GDP in full-year 2019, for the first time since 2010, up from 2.4% in 2018. Given the recent dynamics, the government's 2020 budget deficit target is 2.9% of GDP, as it is built on three key assumptions: a sharp slowdown in the pace of primary expenditure growth, reduced reliance on one-off revenues and a corresponding acceleration in tax revenue growth.

Last but not least, the central government debt stock reached TL 1,261 billion (or US\$ 221 billion) as at end-October 2019, or 29.5% of GDP, as per the latest figures released by the Ministry of Finance, up from TL 1,084 billion as at end-October 2018, and which is split into TL 713 billion in domestic debt (accounting for circa 57% of the total) and TL 548 billion in external debt (accounting for the remaining 43%).

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Noticeable monetary policy easing amid cooling inflationary pressures

Turkey's monetary conditions were marked in 2019 by cooling inflationary pressures, aggressive monetary policy easing aimed to bolster economic activity growth, a recovery in Turkish lira when compared to last year's record low levels, and a rebound in international reserves, mainly helped by the use of unconventional mechanism to address the financial system's local currency shortage.

In details, the Turkish lira recovered in 2019 from record low levels of TL/US\$ 6.90 seen on August 13, 2018, and held up well despite large interest rate cuts applied since July 2019, to reach TL/US\$ 5.71 at end-October 2019 versus TL/US\$ 5.29 at end-2018. The mild depreciation in the Turkish lira against the US dollar over the first ten months of 2019 (down by 8.0%) followed sharp falls in 2018, and mainly reflects political uncertainty on the local front, heightened geopolitical risks and lingering US-China trade tensions.

Consumer price inflation eased significantly since end-2018, mainly due to positive base effects, subdued consumer demand and lower average oil prices amid lingering US-China trade tensions and a slower global economic growth. Consumer Price Inflation descended into a single-digit territory this year, falling from 20.3% year-on-year in December 2018 to 8.6% year-on-year in October 2019, which is its lowest level since December 2016. Within this context, the IMF expects the inflation rate to average 15.7% in 2019, which remains far above CBRT's official target of 5%.

On the back of cooling inflationary pressures and in a bid to revive a slowing domestic economy, the Central Bank of Turkey followed an aggressive monetary policy easing during the second half of the year 2019 under the leadership of a new Central Bank Governor. In fact, starting July 2019, the CBRT has slashed its key policy rates three times by a total of 1,000 bps over the short span of three consecutive Monetary Policy Committee meetings. The one-week repo rate was cut from 24.0% at end-December 2018 to 14.0% at end-October 2019. The overnight lending rate was reduced from 25.50% at end-December 2018 to 15.50% at present. The overnight borrowing rate was slashed from 22.50% at end-December 2018 to 12.50% currently. Also, the CBRT cut the late liquidity window lending rate from 27.00% at end-December 2018 to 17.0% currently.

The CBRT's gross foreign exchange reserves grew by 9.1% during the first ten months of 2019, the equivalent of US\$ 6.5 billion, to reach US\$ 78.5 billion at end-October 2019, mainly supported by the CBRT's recently-created swap facility. The CBRT has been providing the financial market with Turkish lira through Istanbul Stock Exchange via swaps (taking US dollars from Turkish financial companies in exchange for Turkish lira), rather than using short-term repurchase agreements offered through its own facilities, while signaling that the outstanding value of the stock exchange swaps market hovered around US\$ 12 billion.

Looking forward, lower inflationary pressures and the introduction of macro-prudential measures (linking reserve requirement to loan growth rates above 10%) are set to provide the Central Bank of Turkey with more room to pursue its accommodative monetary policy.

1.4.2. Banking Activity

Continued growth in banking activity indicators amid adequate financial standing

The Turkish banking sector has had a somewhat better year in 2019 in relative terms amid a slight currency depreciation compared to the sharp movements of the previous year, and a gradual return of confidence in the market translating into a deposit base increase. Measured by the total assets of banks operating in the country, banking sector activity grew by 10.5% in local currency terms in the first nine months of 2019, or 3.3% in US dollar terms, to reach the equivalent of US\$ 758.8 billion at end-September 2019, according to the most recent Banking Regulation and Supervision Agency statistics.

This year's rise in banking activity was mostly fueled by a growth in banks' main source of funding, i.e. deposits. The latter, accounting for 55% of total banks' balance sheet in Turkey, rose by 8.5% in US dollar terms over the first nine months of 2019 to reach the equivalent of US\$ 419.8 billion at end-September 2019, noting that core customer deposits account for the bulk of the Turkish banking sector.

The increase in the banks' deposit base so far this year is almost equally attributed to demand and term deposits, which accounted for respectively 57% and 43% of the total increase in deposits over the covered period of 2019. It is worth noting that the resident sector accounted for practically all the growth in the deposit base this year, and the non-resident sector saw a slight uptick in its deposits at banks operating in the country. Also, the deposit dollarization ratio edged up, from 48.8% at end-December 2018 to 52.0% at end-September 2019, within the context of net conversions in favor of foreign currencies over the covered period.

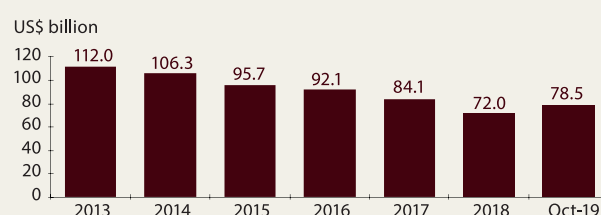
While banks continue to rely on deposits to fund their activities, their higher reliance on short-term external debt relative to peers exposes them to swings in investor sentiment in global credit markets and structurally raises some refinancing risks for the sector. Another type of risk lies in the on-balance sheet FX open positions, which banks usually close through off-balance sheet swap operations. While banks have been reimbursing FX debt, the deposit dollarization ratio is now just above the 50% mark. FX loans have

MONETARY SITUATION

Flows in US\$ million	2012	2013	2014	2015	2016	2017	2018	9M-19
Net foreign assets	6,649	-25,739	-16,026	-4,681	10,473	-8,997	20,424	25,042
Foreign assets	28,861	11,888	-4,318	-13,448	7,474	6,460	-293	10,980
Foreign liabilities	-22,211	-37,626	-11,708	8,767	2,999	-15,457	20,717	14,062
Domestic Assets	94,369	22,228	41,881	-35,585	-30,342	56,061	-91,277	11,742
Claims on private sector	91,188	46,689	44,265	-21,705	-20,144	53,713	-96,260	-625
Claims on public sector	-563	-24,558	-3,997	-12,765	-10,070	36	8,038	10,989
Claims on non-bank financial institutions	3,744	97	1,614	-1,115	-128	2,311	-3,056	1,378
Total Money Supply	101,018	-3,533	25,878	-40,266	-19,869	47,064	-70,853	36,785
Money Supply (M1)	10,383	6,080	2,301	-5,155	2,276	1,522	-23,310	6,926
Quasi-Money	61,002	-4,927	11,254	-28,822	-13,655	28,670	-42,816	32,903
Other Items (Net)	29,633	-4,686	12,323	-6,289	-8,490	16,872	-4,727	-3,044

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

been declining on the other hand. Anyhow, banks' long position in foreign exchange swaps allow them to manage FX risk.

On the asset utilization side, despite State-driven policies to attempt to reinvigorate lending activity growth, private banks have significantly cut back on credit. They are in fact more cautious in a still weak economic and high albeit declining interest rate environment to avoid further deterioration in asset quality. On an aggregated basis, the lending portfolio of the Turkish banking sector almost stood still in the first nine months of this year, noting that TL loans in local currency terms edged up while FX loans in US dollar terms contracted.

Having said that, banking sector liquidity pressures continued to ease in relative terms as lending activity somewhat stagnated while the deposit base witnessed a healthy increase this year, translating into a declining albeit still high by emerging market standards loan-to-deposit ratio of 107.1% at end-September 2019 (117.6% at end-December 2018). This ratio has been seeing some rebalancing since the summer of 2018. Moreover, Turkish 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, stood at an adequate 26.5% at end-September 2019, pretty much in line with international averages.

On another note, the most recent Central Bank released financial stability report earlier this year mentions that the banking sector remains resilient to short-term liquidity shocks. Liquidity coverage ratios that measure the capacity of high-quality liquid assets on banks' balance sheets to offset net cash outflows over a 30-day period are well above the legal limits of 100% and 80% for total and FX assets, respectively. These have been implemented at the start of the year and coincide with Basle III minimum ratios, as per the Central Bank.

Asset quality in the banking sector remains decent, though deteriorating recently owing to corporate debt challenges. The non-performing loans to total cash loans ratio stood at 4.96% at end-September 2019, rising from 3.87% at end-December 2018. Also indicating asset quality stress is the rising share of Stage 2 loans, which are classified as having elevated credit risk. Part of the latter increase mirrors the introduction of IFRS accounting norms designed to report more accurately risky assets.

According to the latest World Bank report on Turkey, an ongoing challenge is the absence of implementation guidelines for this new regulation, which has created inconsistencies in the categorization of distressed assets across banks. Turkish authorities have committed to addressing the lower asset quality, though the accumulated impact of the 2018 fragilities are projected to sustain pressure on asset quality metrics, as per the same source which added that a BRSA statement mentioned that NPLs are projected to rise to more than 6% after the reclassification of loans mandated by the regulator.

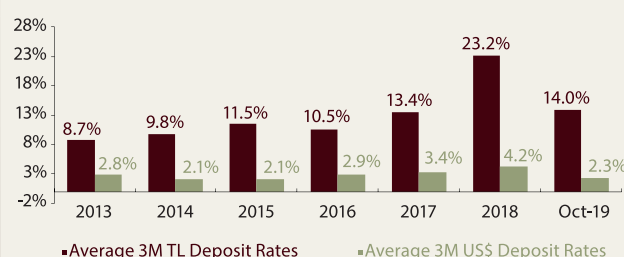
It is worth mentioning that NPLs remain more or less contained so far owing to the sale of problem loans by private banks, rapid loan growth in the past couple of years, the Credit Guarantee Fund of the government that guarantees the bulk of SME loans, in addition to regulatory forbearance measures.

BANKING SECTOR INDICATORS

in US\$ billion	2012	2013	2014	2015	2016	2017	2018	Sep-19
Banking Activity								
Assets	773.4	814.4	859.8	813.4	778.3	862.7	734.8	758.8
Deposits	435.7	444.6	454.3	429.8	414.7	453.4	387.1	419.8
Credit facilities	448.4	492.4	535.5	512.3	494.5	555.8	455.1	449.8
Shareholders' equity	102.6	91.1	99.9	90.5	85.4	95.0	80.1	82.7
YTD Growth rates								
Assets	19.3%	5.3%	5.6%	-5.4%	-4.3%	10.8%	-14.8%	3.3%
Deposits	17.7%	2.0%	2.2%	-5.4%	-3.5%	9.4%	-14.6%	8.5%
Credit Facilities	23.4%	9.8%	8.8%	-4.3%	-3.5%	12.4%	-18.1%	-1.2%
Shareholders' equity	33.4%	-11.2%	9.7%	-9.4%	-5.6%	11.2%	-15.7%	3.3%

Sources: BRSA, Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



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

Having said that, NPLs remain adequately provisioned, with the provisioning coverage ratio at 65.6% at end-September 2019.

The IMF advised that further steps to clean up bank and corporate balance sheets would support financial stability and stronger and more resilient growth in the medium term. Banks' impairment and restructuring practices should be reviewed to support loan repayments in a durable and sustainable manner, as per the IMF, which advised to limit actions to support lending activity growth, including through State banks and the Credit Guarantee Fund, and to ensure that resulting credit is only provided to viable borrowers.

Anyhow, even though NPLs increased lately, Turkish banks continue to have capital adequacy ratios within prudential thresholds. Banks continued to boost their capitalization, as shareholders' equity rose by 3.3% in US dollar terms over the first nine months of 2019, to reach the equivalent of US\$ 82.7 billion. Total sector capital adequacy ratio increased from 17.3% at end-December 2018 to 18.4% at end-September 2019, comfortably above minimum regulatory requirements and shielding banks from potential pressures on their capital base.

Last but not least, the difficult operating conditions that banks have gone through have pressured their bottom lines. The stagnation in lending activity amid economic rebalancing, coupled with weaker economic performance spillovers on banks' fee income generation capacity, and more importantly the rise in provisions for NPLs, contributed to a decline in banks' net profits of 12.5% on a yearly basis in the first nine months of 2019 (expressed in TL terms).

As such, Turkish banks have weathered the difficult environment rather well, continuing to collect deposits and displaying adequate liquidity and capitalization ratios. Banks continued to constitute provisions against asset quality risks which caused their profitability to decline in the current difficult conditions domestically.

1.4.3. Equity and Bond Markets

Price rebounds in Turkish securities in 2019 on improved economic conditions

Turkish securities saw price rebounds over the first ten months of 2019, mainly supported by a rapid improvement in the country's external balances, better-than-expected economic data and recent interest rate cuts. Turkish stocks registered decent price gains in 2019 following double-digit price falls in the previous year. Concurrently, Turkish bonds traced an upward trajectory, mainly helped by the yield advantage of emerging market bonds over their counterparts, while also tracking rises in US Treasuries. As to the cost of insuring debt, Turkey's five-year CDS spreads contracted moderately over the first ten months of 2019 amid improved market perception of sovereign risks at large, following significant expansions in the previous year.

In details, Borsa Istanbul saw a price recovery during the first ten months of 2019, as Turkey's remarkable external adjustment, better-than-expected economic growth and a recovery in the Turkish lira relative to record low levels seen in 2018 provided a relief to the stock market. The BIST 100, which represents the 100 largest companies by market capitalization, grew by 7.9% during the first ten months of 2019 to close at 98,468.52 at end-October 2019. This took place despite downward price pressures observed over the month of October (-6.2% month-on-month) due to heightened geopolitical tensions.

That being said, the market capitalization rose from US\$ 150.5 billion at end-2018 to US\$ 171.1 billion at end-October 2019, up by 13.7%. The total number of contracts reached 202.0 million during the first ten months of 2019, up from 198.4 million during the corresponding period of 2018. The total trading value fell from US\$ 372.8 billion during the first ten months of 2018 to US\$ 288.2 billion during the corresponding period of 2019, contracting by 22.7%. Accordingly, the turnover ratio, measured by the annualized total trading value to market capitalization, reached 202.1% during the first ten months of 2019, down from 334.5% during the corresponding period of 2018.

At the level of the bond market, Turkish bonds traced an upward trajectory over the first ten months of 2019, mainly supported by improved investor sentiment following better-than-expected economic data, and given the yield advantage of emerging market bonds over their developed counterparts, with the

extra yields offered by emerging markets over developed nations held at 302 bps in October 2019 (rising almost five-fold since 2013), while also tracking US Treasuries move on dovish US Federal Reserve stance.

That being said, the yield on 10-year US dollar Turkish government bonds declined from 7.1% at end-2018 to 6.6% at end-October 2019. Concurrently, the 10-year Turkish lira Benchmark bond index yield reached 12.84% at end-October 2019, down from 16.42% at end-2018. Within this context, it is worth mentioning that the net demand for Turkish bonds did not originate from non-resident investors, as the latter were net sellers of Turkish bonds over the first ten months of the year 2019, as reflected by a US\$ 2.8 billion contraction in their holdings, moving from US\$ 18.3 billion at end-2018 to US\$ 15.5 billion towards the end of October 2019. This compared to a much wider contraction in their holdings of US\$ 12.6 billion over the year 2018.

With activity tilted to the upside on the Turkish fixed income market, sovereigns maturing in 2021, 2036 and 2045 closed up by 2.16 pts, 4.69 pts and 3.19 pts respectively during the first ten months of 2019. Amongst financials, prices of Halkbank'21 expanded by 7.43 pts. Yapibank'26 posted price rises of 9.55 pts. Akbank'25 closed up by 7.84 pts. Prices of Garanti Bank'23 grew by 7.0 pts. Export Credit Bank of Turkey'24 traded up by 7.19 pts.

Regarding new issues, Turkey raised this year US\$ 7.75 billion through the sale of US\$ 2.5 billion senior unsecured bonds maturing in November 2024 at a coupon rate of 5.60%, US\$ 2.25 billion senior unsecured bonds maturing in August 2024 at a coupon rate of 6.35% and US\$ 3 billion senior unsecured bonds maturing in April 2029 at a coupon rate of 7.625%. Also, Turkey raised this year € 1.25 billion through the sale of senior unsecured bonds maturing in March 2025 at a coupon rate of 4.625%.

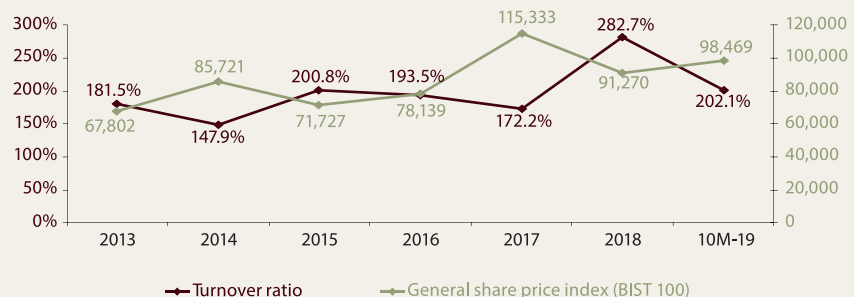
As to the cost of insuring debt in Turkey, the country's five-year CDS spreads contracted by 23 bps over the first ten months of 2019, moving from 362 bps at end-2018 to 339 bps at end-October 2019, in a sign of improved market perception of sovereign risks at large. This followed a 197 bps expansion in 2018.

SELECTED STOCK MARKET INDICATORS

	2012	2013	2014	2015	2016	2017	2018	10M-19
Market capitalization (in US\$ billion)	311.2	237.6	269.8	190.2	174.5	233.4	150.5	171.1
Market capitalization/GDP	37.2%	25.0%	28.9%	22.1%	20.2%	27.4%	19.5%	22.9%
Trading value (in US\$ billion)	348.6	431.3	399.1	381.7	337.7	401.9	425.5	288.2
Traded volume (in millions)	174,290	198,858	207,100	214,061	234,483	356,578	436,596	405,854
Number of contracts (000s)	79,808	80,298	83,640	97,300	110,038	157,749	230,789	202,005
Change in BIST 100 price index	52.6%	-13.3%	26.4%	-16.3%	8.9%	47.6%	-20.9%	7.9%
Price/Earnings ratio	12.51	10.22	14.38	14.00	10.24	11.58	9.12	10.16
Dividend Yield (%)	1.73	2.27	1.54	2.84	2.27	2.05	3.28	2.61
CDS spreads (bps)	131	244	183	273	273	165	362	339

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

STOCK MARKET PERFORMANCE



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

At the level of credit rating changes, Fitch revised on November 1, 2019 the outlook on Turkey's long-term FC Issuer Default Rating to "stable" from "negative", and affirmed the IDR at "BB-". Fitch said that Turkey has continued to make progress in rebalancing and stabilizing its economy, the current account balance has improved, FX reserves have edged up, economic growth has continued, inflation has fallen and the lira has held up despite large cuts in interest rates, buoyed by more supportive global financing conditions and the recent US announcement on removal of Syria-related sanctions.

Standard & Poor's affirmed in August 2019 its unsolicited long-term foreign currency sovereign credit rating on Turkey at "B+" and its unsolicited long-term local currency sovereign credit rating at "BB-" with is "stable" outlook. The "stable" outlook reflects S&P's baseline forecast that, despite the absence of a coordinated and proactive policy response, the Turkish economy and banking system would navigate existing challenges over the next year, helped by the US Federal Reserve's looser monetary policy.

In parallel, Moody's downgraded in June 2019 Turkey's long-term issuer ratings to "B1" from "Ba3" and maintained the "negative" outlook. The downgrade reflects Moody's view that the risk of a balance of payments crisis continues to rise, and with it the risk of a government default. The "B1" rating balances these risks against the country's fundamental credit strengths, particularly its large, diversified economy and still moderate levels of government indebtedness, as per Moody's.

Looking forward, should macroeconomic visibility improve and geopolitical risks subside, there would be ample room for investors to raise their exposure to Turkish assets, with Turkish local assets given the opportunity to outperform in the near term amid easier global liquidity conditions and further declines in domestic inflation.

2. CONCLUDING REMARKS

Turkey is now on a favorable turnaround though not out of the woods yet. Turkey's remarkable external adjustment, stronger than expected rebound, the recovery of the lira and the decline in inflation are widely recognized by market participants, overseas analysts and international observers.

There has been a quite favorable concluding statement issued by the IMF in September as a result of the Article IV mission to Turkey. According to the Fund, growth has rebounded, aided by policy stimulus and favorable market conditions, following the sharp lira depreciation and associated recession in late-2018. Turkey yet remains susceptible to external and domestic risks and prospects for strong, sustainable, medium-term growth look challenging without further reforms. Current positive market sentiment provides a good opportunity to enact a set of reforms that would address vulnerabilities, strengthen policy credibility, and set the economy on a higher and more sustainable growth path.

Looking forward, population and employment growth, rising real wages, credit growth, government spending, continued capital investment, tourism inflows and increased goods exports will all drive growth at the real sector level. The IMF forecasts real GDP growth at 3.5% over the next five years suggesting economic growth will be pushed consistently above potential growth.

At the monetary level, there is room for 1-3% more policy space given global monetary easing. The Central Bank of Turkey is committed to a sustained disinflation process that will help reduce sovereign risk, lower long-term interest rates and support a stronger economic recovery. While the Central Bank will continue to overshoot its inflation target of 5%, gradual cuts are expected alongside moderating inflation. It is expected that base effects, lower average oil prices, subdued consumer demand and the emergence of spare capacity in the economy should cause inflation to moderate further. At the exchange level, while volatility is expected to continue, reduced downward-value directionality for the lira is expected as well.

If we were to assess the Turkish outlook looking forward, we need to look at a number of strengths but also some risk drivers. Starting with positive points, the most important is probably the noticeable drop in current account deficit, which used to be the main vulnerability of the Turkish economy. The lira's depreciation against the US dollar, and the Euro, depressed imports and boosted export competitiveness along with the balance of services, which helped reduce external imbalances.

In parallel, at the fiscal level, public finances have been one of the economy's most reassuring aspects, with a fiscal deficit remaining low (although trending up) at less than 3% of GDP (0.3% of primary deficit to GDP ratio) and a public debt to GDP ratio under the 30% mark, well below ratios witnessed in emerging markets at large. Low deficit and debt ratios reflect the positive impact of past cautious fiscal policy.

Yet, a number of risk factors continue to dominate the near term outlook. Potential US sanctions are still looming large. Elsewhere, tensions with the EU over gas drilling off Cyprus may be exacerbated by concerns about controlling the flow of Syrian refugees. Also, potential pressures to loosen monetary policy stance should keep the balance of risks to a relative downside. In addition, a weak labor market, the need to repair corporate balance sheets and discretion in the conduct of economic policies are likely to weigh on consumption and investment. Concurrently, external financing needs are still high, macro-financial vulnerabilities remain and overall confidence in the economy is still relatively weak.

Finally, to end on a relatively positive note, with the next parliamentary and presidential elections not due until mid-2023, the government is in a position to defuse domestic political tensions and take a more long-term approach to policymaking which is apt to strengthen investor confidence and favor sustainable economic growth ahead in the medium to long term.

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