Bank Audi

TURKEY ECONOMIC REPORT

NOVEMBER 2021

TABLE OF CONTENTS

CONTACTS

Research

Dr. Marwan Barakat
(961-1) 977409
marwan.barakat@bankaudi.com.lb

Salma Saad Baba
(961-1) 977346
salma.baba@bankaudi.com.lb

Farah N. Nahlawi
(961-1) 959747
farah.nahlawi@bankaudi.com.lb

Zeina M. Labban
(961-1) 952426
zeina.labban@bankaudi.com.lb

Michele Sakha
(961-1) 977102
michele.sakha@bankaudi.com.lb

TURKEY'S PARADOX OF MONETARY VULNERABILITY AGAINST FISCAL STRENGTH

Real economy to recover by 9% this year

Outlining recovery from the harsh Pandemic year of 2020 with low base effects, Turkey's real GDP is set to grow by 9% in 2021 as per new IMF forecasts just released for Turkey. Both consumption and investment aggregates are on the upside this year. While the ratio of Investment to GDP is set to increase to 32.1% in 2021 as per IMF, real household spending in Turkey is to recover in 2021, growing by 6.0%. This follows an estimated contraction of 1.3% in 2020 due to the COVID-19 pandemic and the related restrictions.

Current account deficit position notably narrows down

The first nine months of 2021 witnessed a notable narrow down in the current account deficit on the back of the normalization in the global demand. Turkey's current account balance witnessed a retreat from a deficit of US$ 28.3 billion in 9M-2020 to a deficit of US$ 11.7 billion in 9M-2021, as rapid export growth and a decline in gold imports have mitigated the impact of rising commodity prices, including energy imports, accompanied by sizable inflows of financial account, mainly in the form of portfolio investment.

Narrowing fiscal deficit in 2021 on strong revenue growth amid robust economic rebound

Turkey's public finances posted a narrowing central government fiscal deficit over the first ten months of 2021, on the back of a strong revenue growth that has outpaced expenditures amid a robust post-pandemic economic recovery and a firm tax collection, while the country is on track to meet its reduced 2021 central government fiscal deficit target of 3.5% of GDP.

Banking sector continuing to fare well

Banking aggregates rose in Turkish Lira terms and contracted in US$ terms. Bank deposits fell slightly by 0.7% over the first nine-month period along with a 5.7% drop in loans. With respect to financial soundness indicators, they remain at comfortably satisfactory levels. The ratio of Non-Performing Loans to Total Cash Loans stands at 3.54% at end-September 2021. The Provisions for Non-Performing Loans as a percentage of Gross Non-Performing Loans amounts to 78.08%. The ratio of Regulatory Capital to Total Risk Weighted Assets reported 17.3%. As to profitability, banks annualized return on average assets registered 1.16% over the first nine months, while banks annualized return on average equity reported 12.72%, suggesting continuing decent earning power for Turkish banks.

Turkish Lira hits new depths amid soaring inflation rates and policy rate cuts

The year 2021 saw the Turkish Lira plummet to unprecedented lows and a shift to loose monetary policy starting September, while the Central Bank of Turkey's foreign currency reserves managed to recoup last year's losses, mainly helped by swap agreements and reserve requirement arrangements. In details, the Turkish Lira crashed to new record lows in 2021, crossing the TL/US$ 13 threshold by the closing of this report, mainly on growing concerns over the Central Bank of Turkey's consecutive policy rate cuts since September 2021 (from 19% to 15%) despite soaring inflation rates, and as the consumer confidence plunged to unprecedented low levels in November 2021.

A paradoxical case of monetary vulnerability against fiscal strengths

The recent policy rate reductions leave the Lira vulnerable to further dollarization, and it will be difficult to maintain such low real rates given the current inflation outlook. Therefore, global banks expect the policy rate to return to 18% by end-2022. Looking ahead, it is expected that the lira will continue to follow a depreciatory path amid a persisting current account deficit, high inflation and a gradual normalization of monetary policy in the US and the euro area, outlining a paradoxical case of monetary vulnerability against fiscal strength in Turkey.

Real economy set to continue recovering looking ahead

Looking forward, the real economy is set to continue recovering over the years ahead. The IMF forecasts real GDP growth at 3.3% in 2022 and at 3.3% in the 5-year period extending from the years 2022 to 2026 according to the World Economic Outlook issued in mid-October. In parallel, it forecasts inflation at 15.4% in 2022 and at an average of 13.1% in the 5-year period extending from the years 2022 to 2026. As to fiscal deficit, the Fund forecasts it at 5.6% of GDP in 2022, slightly raising debt to GDP to 37.9% at end-2022, while the current account deficit is set to decline to 1.6% of GDP in 2022 (A ratio of 1.8% on average over the next five years).

Bank Audi sal - Group Research Department - Bank Audi Plaza - Bab Idriss - PO Box 11-2560 - Lebanon - Tel: 961 1 994 000 - email: research@bankaudi.com.lb

Bank Audi

Outlining recovery from the harsh Pandemic year of 2020 with low base effects, Turkey's real GDP is set to grow by 9% in 2021 as per new IMF forecasts just released for Turkey. Both consumption and investment aggregates are on the upside this year. While the ratio of Investment to GDP is set to increase to 32.1% in 2021 as per IMF, real household spending in Turkey is to recover in 2021, growing by 6.0%. This follows an estimated contraction of 1.3% in 2020 due to the Covid-19 pandemic and the related restrictions. Turkish consumers still spend a very large share of their income on the three key sectors of essential goods: food and drinks (23.6%), housing and utilities (14.7%) and transport (15.6%), totaling up to 53.9% of total spending in 2021.

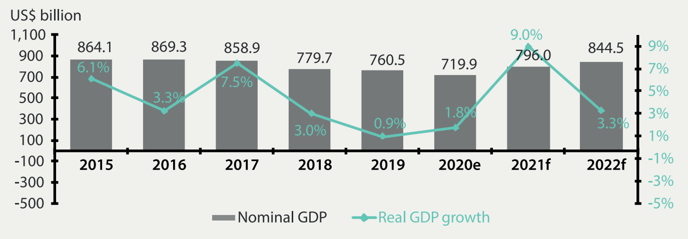
At the external level, the current account deficit has narrowed this year, with the full year deficit expected to reach 2.4% of GDP in 2021 as per IMF, from 5.2% in 2020, as tourism export receipts noticeably improve year-on-year in 2H21. Rapid export growth and a decline in gold imports have mitigated the impact of rising commodity prices, including energy imports. The number of foreigners visiting Turkey increased by 86% year-on-year to around 17.6 million in the first nine months of 2021 (up from 9.5 million in the first nine months of 2020), following the reopening of international borders in most countries.

At the monetary level, Turkey's consumer price inflation rose to 17.6% year-on-year in October 2021, the highest rate since March 2019 and above the Central Bank's policy rate due to lira weakness. The Central Bank of Turkey lowered its one-week repo rate by 100 bps to 18% during its September meeting, by 200 bps to 16% during its October meeting, and by another 100 bps in its November meeting, sending the Lira to new record lows below 13 lira per dollar. In parallel, Central Bank reserves increased from US$ 50 billion at end-December 2020 to US$ 86 billion in October 2021.

At the fiscal level, there has been a 46% reduction in Central government budget balance amid a 34% rise in Central Government revenues, against a 22% increase in central government expenditures in the first ten months of the year. Turkey is on track to meet its reduced 2021 central government fiscal deficit target of 3.5% of GDP on the back of strong revenue performance and prudent spending. The general government deficit will narrow to 3.9% of GDP, well below the forecast of 5.8% of GDP for similarly rated peers, outlining the country's continuing fiscal strength amid low indebtedness ratios.

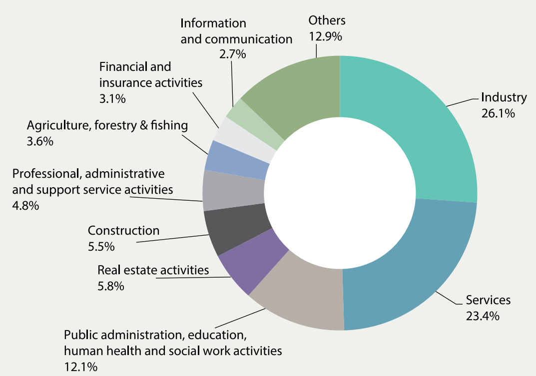
At the banking level, the banking system continues to demonstrate resilience to financial market stress. Banking sector activity, measured by total assets, fell slightly by 3.6% in US$ terms over the first nine months of 2021 to reach US$ 797 billion at end-September, while bank deposits fell by 0.7% to US$ 465 billion over the same period along with a 5.7% drop in loans to US$ 457 billion. Continuing high levels of deposit dollarization yet point to a lack of confidence of Turkish households and businesses in the effectiveness of monetary policy. With respect to profitability, banks annualized return on average assets reported 1.16% over the first nine months of 2021, while banks return on average equity reported 12.72% over the same period, suggesting continuing decent earning power for Turkish banks at large.

GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (H1 2021)



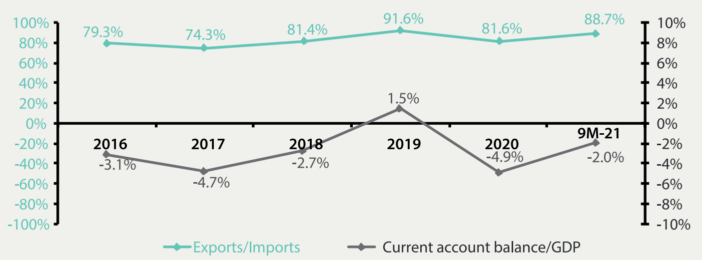
Sources: Central Bank of Turkey, Bank Audi's Group Research Department

Bank Audi

At the capital markets level, equity and fixed income markets performed unevenly. The BIST stock market price index rose by 3.1% over the first 10 months of 2021, with market capitalization reaching US$ 190 billion at end-October 2021, the equivalent of 23.9% of GDP. As to the fixed income markets, the CDS spread rose considerably over the first ten months moving from 304 basis points to 450 basis points outlining a deterioration of the market perception of sovereign risks at large.

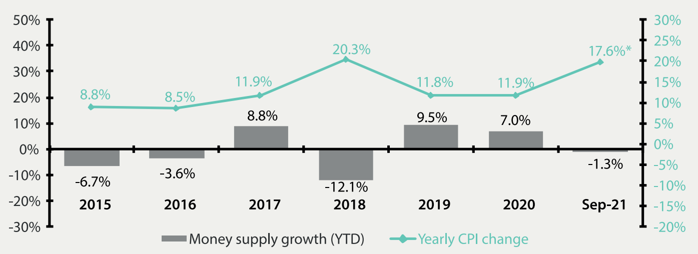
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economic, financial and monetary conditions looking ahead.

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

Bank Audi

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture

Primary sector continues its growth despite volatile conditions

The agriculture sector continued to grow this year. The sector reported a real growth of 4.7% in the first half of 2021, similar to its growth of 4.5% reported in the same period of the previous year. However, weather volatility conditions along with the COVID-19 pandemic remain sources of serious risk to the sector. In parallel, the share of the sector in the country's GDP stood at 3.6% in the first half of this year slightly lower than its share of 4.0% reported in the same period of last year.

At the level of crop production, the latter posted growth at all levels in 2020. Total cereals and other crops reported an amelioration of 10.8% to stand at 70,550 thousand tons in 2020. The growth in sugar beets production of 16.3% was significant. This comes along as consumption growth was weak earlier mainly due to the weak macroeconomic performance and the impact of the COVID-19 shocks. The recovery is expected to carry on uptrend in demand for sugar among other crops in the coming years. Production growth will be supported by improved farming techniques, greater investments to bolster productivity and increasing yields, as per Fitch Solutions.

At the level of total vegetables and other crops, production slightly edged up by 0.3%. Total fruits, nuts and spices crops reported an increase of 5.8% in 2020. This is backed up by the developing health consciousness, in addition to the fact that inflation will continue to keep a lid on meat and other food products consumption growth.

In terms of production, droughts continue to impose downside risks on grains output due to dry weather and a shortage of rainfall in key crop growing areas. Grains in large parts of Turkey are grown on unirrigated lands where yields are heavily reliant on adequate rainfall. Less than average rains during H1 2021 pose significant downside risks to the crop output in the upcoming harvest, as per Fitch Solutions.

In conclusion, Turkey's primary sector continued its growth this year, benefitting from the recovery of the tourism, hospitality and gastronomy sectors that came along as the lockdowns were lifted in June 2021. However, the sector continues to face the risks of a deteriorating monetary status, severe weather conditions and the residing COVID-19 pandemic.

CROP PRODUCTION IN 2020 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share		Volume	Share		Volume	Share
Cereals	**37,188**	**53%**	**Vegetables**	**25,373**	**81%**	**Fruits**	**14,844**	**63%**
o.w. Wheat	20,500	29%	o.w. Tomatoes	13,204	42%	o.w. Citrus fruits	4,349	18%
o.w. Barley	6,500	9%	o.w. Watermelon	3,492	11%	o.w. Pome fruits	5,057	21%
o.w. Maize	8,300	12%	o.w. Cucumber	1,886	6%	o.w. Stone fruits	3,005	13%
Sugar beets	**21,000**	**30%**	o.w. Melon	1,725	6%	o.w. Bananas, Kiwis, Avocado, Figs	1,128	5%
Potatoes, dried legumineus	**6,498**	**9%**	o.w. Pepper (green)	839	3%	o.w. Other fruits	1,306	6%
Oil seeds	**2,620**	**4%**	**Bulb and root vegetables**	**3,645**	**12%**	**Grapes**	**4,209**	**18%**
Dry pulses	**1,297**	**2%**	o.w. Dry onion	2,280	7%	**Olive production**	**1,317**	**6%**
Raw materials used in textiles	**1,774**	**3%**	o.w. Carrots	589	2%	**Tea production**	**1,418**	**6%**
Plants for perfumery, pharmacy	**97**	**0%**	**Other vegetables**	**2,178**	**7%**	**Nuts**	**1,483**	**6%**
Tobacco	**77**	**0%**	o.w. Leafy or edible stem vegetables	1,811	6%	**Spices crops**	**315**	**1%**
Total Cereals and other crops*	70,550	100%	Total Vegetables & other crops	31,197	100%	Total Fruits, nuts & spices crops	23,586	100%

**Excluding fodder crops*

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

Bank Audi

1.1.2. Industry

Turkey's industrial sector scales up its performance in the first half of 2021

Turkey's industrial sector reported growth in most of its branches in the first half of 2021, as recovery from the impact of the COVID-19 spread and consecutive lockdowns started to show. In real terms, the sector improved by 24.7% in the aforementioned period, following a retreat in the aforementioned period of last year. In nominal terms, the share of the sector in Turkey's GDP rose from 22.5% in the first half of 2020 to 26.1% in the corresponding period of this year.

On a similar note, Turkey's Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, improved by a yearly 18.7% during the first nine months of 2021, following a decline of 0.9% in the same period of last year, as per Turkstat. This highlights the improvement at the level of Turkish industrial production amidst an era of recovery from the pandemic and supported by an upside at the level of consumption and investment.

Looking at the breakdown of the sector, the manufacturing sector, which contributes by a nominal 22.1% to Turkey's GDP expanded by 26.2% year-on-year during H1 2021 following a contraction reported in the aforementioned period of 2020.

The Purchasing Managers' Index (PMI) for manufacturing stood at 52.1 during 10M 2021, up from 49.4 in 10M 2020, highlighting an expansion at the level of the sector, especially as most months reported values above the 50-mark. It is worth noting that a reading greater than 50 indicates growth of the sector, while a reading below 50 signals a contraction.

The country's construction sector, which contributes with a share of 5.5% to the country's GDP, reported an improvement of 3.2% year-on-year during the first half of 2021, versus a negative growth of 2.3% registered in the first half of 2020. This comes along as Turkey's favorable position as a transit market would ensure its long-term growth prospects, despite the fact that the country's economy continued vulnerability poses a risk to the construction sector's near-term growth potential. According to Fitch Solutions, the outlook for Turkish construction sector remains positive, with the prevailing interest of regional players supportive of the development of large-scale infrastructure.

In conclusion, Turkey's industrial sector reversed the negative performance of the previous years in the first half of this year, highlighting a recovery from the widespread pandemic in the previous year and challenging the economic instability that remains a material downside risk to the sector's growth.

VEHICLES PRODUCTION

(unit)	2018	2019	2020	20/19	10M-20	10M-21	10M/10M
Automobile	1,026,438	982,642	854,913	-13.0%	671,546	634,668	-5.5%
Pick-up	429,361	386,246	358,182	-7.3%	266,941	320,575	20.1%
Minibus	56,934	61,668	51,464	-16.5%	40,782	38,196	-6.3%
Tractor	37,686	23,899	38,103	59.4%	28,511	45,820	60.7%
Truck	25,529	19,003	23,126	21.7%	17,273	28,886	67.2%
Bus	8,541	9,212	7,893	-14.3%	6,541	4,440	-32.1%
Midibus	3,316	2,550	2,043	-19.9%	1,660	1,774	6.9%

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

Bank Audi

1.1.3. Trade and Services

Turkey's tertiary sector poised for a firm recovery

Turkey's trade and services sector showed signs of recovery, following its downturn due to the negative impact of the COVID-19 pandemic over the past year. In real terms, the sector witnessed an expansion of 12.5% in the first half of 2021 following a contraction of 3.4% in the first six months of 2020.

In nominal terms, Turkey's trade and services sector maintained its share of around 55% of the country's GDP in the first half of this year, nearly unchanged from its level in the same period of last year. The 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.

In a detailed look, Turkey's tourism sector posted a steady recovery this year. The number of foreigner arrivals reported a growth of 88.0% year-on-year in the first ten months of 2021, following a decline of 71.7% posted in 2020. The Turkish government's decision to open the international borders from early June 2020 resulted in the country being able to salvage a part of the holiday high season, with direct flights to key tourism locations. Tourism receipts also posted an amelioration of 106.9% in the first nine months of 2021, following a slump of 69.4% in the same period of 2020. It is worth noting that the country's attraction to Central and Western European visitors is a highly important factor behind development of tourism over the past two decades.

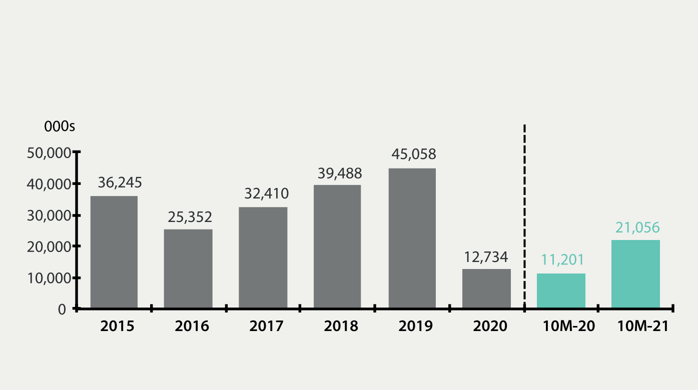
Increasing low-cost flight connections, a competitive currency and excellent tourism infrastructure across Istanbul, Antalya and the Mediterranean coast continue to offer excellent leisure and cultural tourism options across a range of budgets. While the COVID-19 pandemic caused a retreat in 2020, the industry is encountering a resilient comeback.

Occupancy across the country reached only 40.7% in the first seven months of 2021, up from 24.2% in the same period of the previous year, however still lower than what Turkish are accustomed to. Average daily rate for the same period climbed by 73.9% to TL 774 while revenue per available room rose by 116% to TL 314. At the same time, hotels in Istanbul have reported similar improvement in performance, with occupancy reaching 40.3% in the first seven months of 2021, compared to 13.5% in the same period of 2020. ADR increased 67% to TL 841 and RevPAR increased 89.6% to TL 339.

It is worth mentioning that, the Turkish government continues to support the tourism industry through various marketing campaigns and by investing in new transport infrastructure to facilitate arrivals.

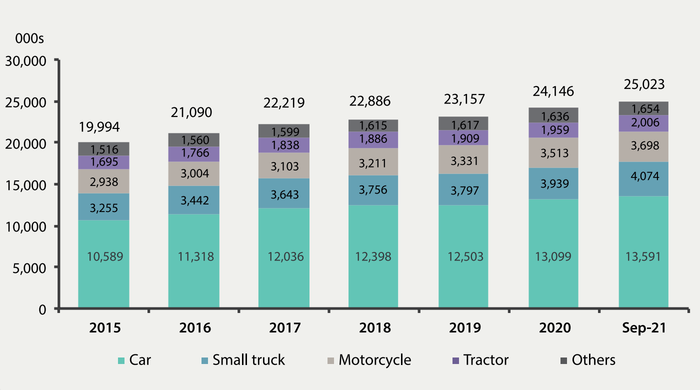
On a positive note, the economic optimism index in Turkey stood at 101.4 in October 2021, after it increased to 102.4 in September 2021 from 100.8 in August. Turkey's economic confidence index hit the highest level

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

Bank Audi

since April 2018 by increasing 1.6% month-on-month in September. The increase stemmed from rises in consumer, real sector, services and retail trade confidence indices, TurkStat data showed.

In conclusion, Turkey's tertiary sector revealed numerous signs of recovery throughout this year; however, continued growth is heavily dependent on an improved security environment and global developments at large.

1.2. EXTERNAL SECTOR

Current account deficit position notably narrows down

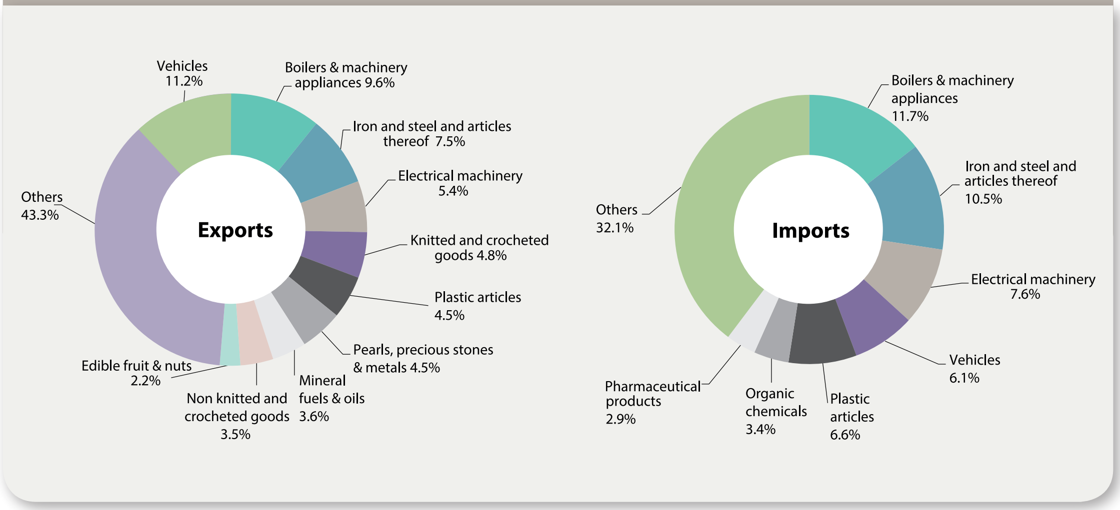
The first nine months of 2021 witnessed a notable narrow down in the current account deficit when compared with same period last year on the back of the normalization in the global demand. This improvement was due to two major drivers; the narrowing down in the gold trade deficit and the recovery in the services trade balance. It is worth noting that due to political pressure and economic imbalances, such as high inflation and volatility of foreign-currency market, the post pandemic recovery looks risky.

In details, Turkish exports reached US$ 161.0 billion over the first nine months of 2021, as per the latest Central Bank figures, posting a 35.9% increase on a yearly basis, following the gradual expansion of global economic activity. In parallel, the breakdown of domestic exports by commodity shows that the main exports over the first nine months of the year were vehicles (11.2% of total exports), boilers and machinery appliances (9.6%), iron and steel (7.5%), electrical machineries (5.4%), knitted and crocheted goods (4.8%) and plastic articles (4.5%). The geographic distribution of domestic exports indicates that 8.2% of total exports went to Germany, followed by the United States of America with 6.7% of the total, United Kingdom with 6.1%, Iraq with 5.0%, Italy with 4.9% of total domestic exports over the same period.

In parallel, Turkish imports reported a pickup of (+23.7%) over the first nine months of 2021 to reach US$ 193.3 billion, with global consumer demand witnessing an incline due to resuming business sentiments and therefore import demand at large. In parallel, the breakdown of domestic imports by commodity shows that the main imports over the first nine months of 2020 were mineral fuels and oils (16.3% of total imports), boilers and machinery appliances (11.7%), iron and steel (10.5%), electrical machinery (7.6%), plastic articles (6.6%), vehicles (6.1%) and organic chemicals (3.4%). The breakdown of imports by country of origin shows that most of the inward merchandise came from China with 12.4% of total imports, followed by Russia with 10.4%, Germany with 7.4%, USA with 6.1%, India with 3.9% of total imports over the same period.

Within this context, the cumulative trade deficit improved significantly by 30.8% over the first nine months of 2021 when compared to the same period of 2020 to reach US$ 20.3 billion. As such, Turkey's current account balance witnessed a narrowing from a deficit of US$ 28.3 billion in 9M-2020 to a deficit of US$

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-21)



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

Bank Audi

11.7 billion in 9M-2021, as rapid export growth and a decline in gold imports have mitigated the impact of rising commodity prices, including energy imports, accompanied by sizable inflows of financial account, mainly in the form of portfolio investment, extended into June and early September. In terms of tourism services exports, a marked increase was registered in tourist arrivals and receipts this summer, particularly due to the gradual opening up of the global travel amid softened lockdown restrictions worldwide with the number of foreigners visiting Turkey increasing by 86% year-on-year to around 17.6 million in the first nine months of 2021. Having said that, the year 2021 is expected to report a current account deficit of 2.4% of GDP, as per the IMF, highlighting a considerable narrowing down from last year's figure.

1.3. PUBLIC SECTOR

Narrowing fiscal deficit in 2021 on strong revenue growth amid robust economic rebound

Turkey's public finances posted a narrowing central government fiscal deficit over the first ten months of 2021 when compared to the same period of the previous year, on the back of a strong revenue growth that has outpaced expenditures amid a robust post-pandemic economic recovery and a firm tax collection, while the country is on track to meet its reduced 2021 central government fiscal deficit target of 3.5% of GDP.

In details, the central government budget revenues grew by a healthy 34.3% during the first ten months of 2021 when compared to the same period of 2020 to reach a total of TL 1,105 billion (or US$ 135 billion), mainly driven by a 34.5% year-on-year increase in general budget revenues to TL 1,075 billion, of which tax revenues rose by 38.0% to reach TL 905 billion. On another hand, general budget revenues showed that non-tax revenues such as enterprise and ownership revenues, grants and aids, capital revenues and interests, shares and fines and others expanded by 19.9% year-on-year over the covered period.

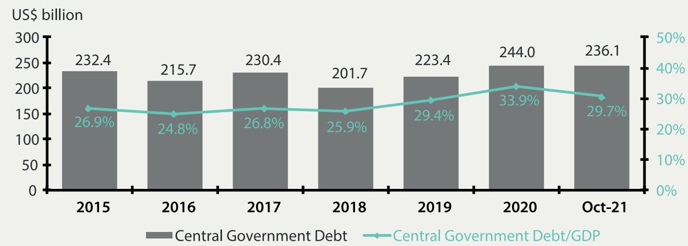
On the spending side, a growth of 22.3% in central government budget expenditures was recorded over the first ten months of 2021 compared to the same period of 2020, to reach TL 1,183 billion (or US$ 145 billion), mainly due to a 21.0% expansion in primary expenditures to reach TL 1,027 billion, and a 30.9% rise in interest expenditures to TL 157 billion. A breakdown of primary expenditures shows a 19.2% yearly increase in compensation of employees to reach TL 292 billion, current transfers went up by 17.0% year-on-year to reach TL 481 billion, of which Treasury aid grew by 0.6% to TL 239 billion and shares from revenues increased by 42.7% to TL 137 billion, and capital expenditures expanded by 30.7% to TL 77 billion over the same period. On another hand, interest expenditures showed a 25.9% increase in domestic interest

SELECTED PUBLIC FINANCE INDICATORS

TL billion	2019	2020	20/19	10M-20	10M-21	10M/10M
Central government budget revenues	**875.3**	**1,029.5**	**17.6%**	**822.2**	**1,104.6**	**34.3%**
o.w. Tax revenues	673.9	833.1	23.6%	655.3	904.5	38.0%
o.w. Non-tax revenues	201.4	196.4	-2.5%	166.8	200.0	19.9%
Central government budget expenditures	**1000.0**	**1,202.2**	**20.2%**	**967.7**	**1,183.1**	**22.3%**
o.w. Primary expenditures	900.1	1,068.3	18.7%	848.1	1,026.5	21.0%
o.w. Interest	99.9	134.0	34.0%	119.6	156.6	30.9%
Central government budget cash balance	**-125.6**	**-172.8**	**37.6%**	**-145.5**	**-78.5**	**-46.1%**

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

PUBLIC INDEBTEDNESS



Sources: Ministry of Finance, IMF, Bank Audi's Group Research Department payments during the first ten months of 2021 to TL 104 billion, as well as a 24.4% surge in foreign debt interest to TL 35 billion.

That being said, the central government budget deficit (on a cash basis) has contracted by 46.1% over the first ten months of 2021, reaching circa TL 79 billion (or US$ 10 billion) as compared to a deficit of TL 146 billion during the same period of 2020, thanks in part to post-pandemic economic recovery, rising income and consumption tax revenues. Within this context, the IMF expects the general government budget deficit to contract from 5.3% of GDP in 2020 to 4.9% of GDP in 2021.

Last but not least, the central government debt stock reached TL 2,269 billion (or US$ 236 billion) as at end-October 2021, or 29.7% of GDP, as per the latest figures released by the Ministry of Finance, recording a significant increase of 25.1% from TL 1,813 billion as at end-December 2020. This is mainly driven by an 13.6% rise in the domestic debt over the first ten months of 2021 to reach TL 1,205 billion at end-October (accounting for circa 53% of the total debt stock), and a 41.4% increase in the external debt over the covered period to reach TL 1,064 billion at end-October (accounting for the remaining 47%).

The currency composition of government debt shows that the foreign currency debt accounted for 60% of the total debt stock at end-October 2021, up from 39% at end-2017, in a sign of increased currency risk in recent years, as the government has increasingly issued FX-denominated government debt to domestic borrowers over the past few years. In fact, Turkish banks' FX-denominated government bond holdings rose from TL 5 million at end-December 2018 to TL 152 billion at end-September 2021, which raises the sensitivity of debt service payments to exchange rate movements.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Turkish Lira hits new depths amid soaring inflation rates and policy rate cuts

The year 2021 saw the Turkish Lira plummet to unprecedented lows and a shift to loose monetary policy starting September despite soaring inflation rates, while the Central Bank of Turkey's foreign currency reserves managed to recoup last year's losses, mainly helped by swap agreements and reserve requirement arrangements.

In details, the Turkish Lira crashed to new record lows in 2021, crossing the TL/US$ 13 threshold towards the end of November, mainly on growing concerns over the Central Bank of Turkey's policy rate cuts since September 2021 despite soaring inflation rates, and as the consumer confidence plunged to unprecedented low levels in November 2021. The free-fall of the Turkish Lira against the US dollar was exacerbated by higher-than-expected US inflation rate in October 2021, which has fueled bets over sooner-than-anticipated US Fed interest rate hikes. Accordingly, the Turkish Lira, which has initiated the year 2021 at TL/US$ 7.44, lost around 76% of its value against the US dollar so far this year, which makes it the worst performing currency in emerging markets in 2021.

Within this context, the Turkish Lira three-month realized (historical) volatility, which reflects the actual volatility derived from a time series of currency spot prices over a specific historic time horizon, averaged 19.4% over the first ten months of 2021 versus an average of 12.5% in 2020, noting that it has spiked to circa 34% over the March-May 2021 period following the dismissal of the Central Bank governor on March 20, which is its highest level since the October 2018 Khashoggi crisis.

With the Turkish Lira hitting new depths, the annual inflation rate ran close to 20% in October 2021, up from 14.6% in December 2020. Soaring inflation has been driven by supply side factors such as rise in food and import prices (especially in energy), supply constraints, an increase in administered prices and demand developments due to reopening effects.

Despite skyrocketing consumer prices, the Central Bank of Turkey slashed its one-week repo rate three times starting September 2021 by a total of 400 bps, following a 200 bps rate hike in March 2021, to reach 15% in November 2021 as compared to 17% at end-December 2020, thus driving the currency's real yield well below zero. The CBRT justified its policy rate cuts by noting that the tight stance in monetary policy adopted in March 2021 (when the one-week policy rate was raised by 200 bps to 19%), has had a higher than envisaged contractionary effect on commercial loan growth, and by referring to its analyses that decompose inflation pressures into "demand factors that monetary policy can influence, core inflation developments and supply shocks". Also, the overnight lending rate was cut from 18.50% at end-December 2020 to 16.50% at end-November 2021. The overnight borrowing rate was reduced from 15.50% to 13.50% over the covered period. The late liquidity window lending rate reached 19.5% at end-November 2021 as compared to 21.5% at end-December 2020.

In parallel, the CBRT's gross foreign exchange reserves have been rising over the year 2021, moving from US$ 50.0 billion at end-December 2020 to US$ 84.1 billion at end-October 2021, up by a significant 68%. The reserve increase is largely explained by currency swap agreements, reserve requirement arrangements, IMF funding, rediscount returns, and gold from ore. For instance, the CBRT raised the reserve requirement ratio for FX deposits/participation funds up to one-year maturity three times in 2021 by a total of 600 bps to reach 25% in October 2021. Also, the reserve requirement ratio for precious metal deposit accounts up to one-year maturity has been lifted twice this year by a total of 400 bps to reach 26% in October. Concurrently, Turkey's foreign currency coffers got a boost of US$ 6.4 billion thanks to the IMF's recent special drawing rights program.

Looking forward, supply-side transitory factors, deteriorating inflation expectations and prospects of a global monetary tightening leave limited room for further downward adjustments to the policy rate. This may suggest a major pause in the cutting cycle or even rate hikes to stabilize the Turkish Lira. Within this context, the Monetary Policy Committee said in November 2021 that it expects that the transitory effects of supply-side factors and other factors beyond monetary policy's control on price increases would persist through the first half of the year 2022, adding that it would consider to complete the use of the limited room implied by these factors in December 2021.

1.4.2. Banking Activity

Banking activity continuing to fare well

Though the year 2021 reported significant currency depreciation, the banking sector continues to fare well. Banking aggregates rose in Turkish Lira terms and contracted in US$ terms. Within this environment, banking sector activity, measured by total assets, fell slightly by 3.6% in USD terms over the first nine months of 2021 to reach US$ 797 billion at end-September, while bank deposits fell by 0.7% to US$ 465 billion over the same period along with a 5.7% drop in loans to US$ 457 billion and an 8.8% reduction in shareholders equity to US$ 74 billion. Continuing high levels of deposit dollarization yet point to a lack of confidence of Turkish households and businesses in the country's monetary outlook.

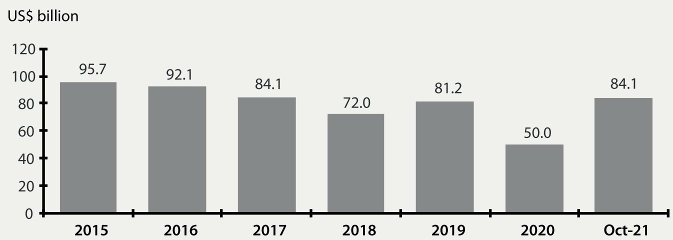
With respect to financial soundness indicators, they remain at comfortably satisfactory levels. The ratio of Non-Performing Loans to Total Cash Loans stands at 3.54% at end-September 2021. The Provisions for Non-Performing Loans as a percentage of Gross Non-Performing Loans amounts to 78.08%. The ratio of Regulatory Capital to Total Risk Weighted Assets reported 17.3% at the same date. As to profitability, banks annualized return on average assets registered 1.16% over the first nine months of 2021, while banks annualized return on average equity reported 12.72% over the same period, suggesting continuing decent

MONETARY SITUATION

Flows in US$ million	2016	2017	2018	2019	2020	9M-21
Net foreign assets	**10,473**	**-8,997**	**20,424**	**32,155**	**-20,453**	**31,959**
Foreign assets	7,474	6,460	-293	13,508	-18,361	35,453
Foreign liabilities	2,999	-15,457	20,717	18,647	-2,092	-3,495
Domestic Assets	**-30,342**	**56,061**	**-91,277**	**16,690**	**89,925**	**-28,802**
Claims on private sector	-20,144	53,713	-96,260	-1,753	32,897	-29,910
Claims on public sector	-10,070	36	8,038	17,632	56,014	870
Claims on non-bank financial institutions	-128	2,311	-3,056	812	1,014	238
Total Money Supply	**-19,869**	**47,064**	**-70,853**	**48,845**	**39,515**	**-7,660**
Money Supply (M1)	2,276	1,522	-23,310	11,055	-1,589	3,151
Quasi-Money	-13,655	28,670	-42,816	39,284	33,917	1,098
Other Items (Net)	-8,490	16,872	-4,727	-1,494	7,186	-11,910

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

earning power for Turkish banks at large.

The banking system actually continues to demonstrate resilience to financial market stress, although risks to banks' Standalone Credit Profiles remain significant according to Fitch. The relative stickiness of deposits during periods of stress in recent years is a supportive factor for the rating. In addition, the banking sector's available foreign-currency liquidity is sufficient to meet its short-term foreign currency debt, in particular when adjusting the latter for more stable sources of funding.

With respect to the banks' asset quality, it faces pressure due to operating environment volatility, significant foreign currency (FC) lending, high lira interest rates and exposures to high-risk sectors, such as construction and real estate, energy and tourism. Stage 2 loans are significant and include several large single-name exposures from restructured energy project finance loans and construction loans. However, reserve coverage of problematic loans is generally adequate, partly due to the frontloading of pandemic-related provisions in 2020. The extent of asset-quality weakening will depend on the pace of Turkey's economic recovery, potential further market volatility and seasoning risks as per Fitch. Regulatory forbearance on loan classification is being phased out from end-3Q21 but Fitch expects this to have a modest impact on reported asset-quality metrics.

In its last Article IV report, the IMF called for further reining in and refocusing state-owned bank credit growth, as well as carefully monitoring bank foreign exchange liabilities. They encouraged gradually reversing regulatory flexibility and loan deferrals as the pandemic recedes. Most IMF Directors agreed that, once the pandemic fades, a third-party asset quality review would help in better understanding underlying bank health. Additional reforms to strengthen regulatory, resolution and AML/CFT frameworks would also help financial stability at large.

1.4.3. Equity and Bond Markets

Extended price gains in Turkish stocks on attractive valuations, Turkish bonds on the decline tracking global sell-off mood

Turkish stocks remained on the rise in 2021, mainly driven by attractive valuations relative to emerging market peers and due to a post-pandemic recovery. In contrast, Turkish bonds dipped into the red in 2021, mainly tracking US Treasuries move and a global sell-off mood, on prospects of monetary policy tightening by the world's leading Central Banks and as a relentless surge in oil prices and strong commodity price gains fueled worries about elevated inflation in global economies.

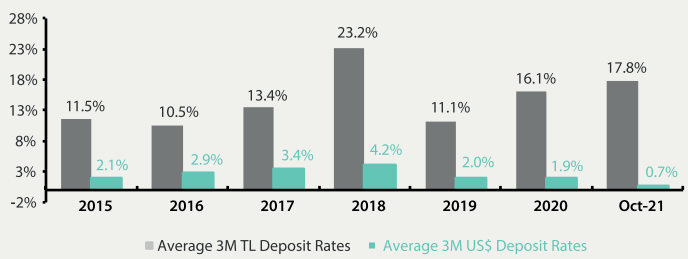
In details, Borsa Istanbul continued to follow an upward trajectory over the first ten months of 2021, mainly helped by attractive market pricing ratios, as Turkish stocks traded at a P/E of 8.6 times in October 2020 versus a P/E of 18.6 times at end-2020. Also, a post-pandemic recovery, a revival of business activity after closures, a renewed demand and a supply squeeze gave a boost to industrial companies, while some exporters sought

BANKING SECTOR INDICATORS

in US$ billion	2016	2017	2018	2019	2020	Sep-21
Banking Aggregates						
Assets	778.3	862.7	734.8	758.0	826.5	796.7
Deposits	414.7	453.4	387.1	433.6	467.8	464.6
Loans	494.5	555.8	455.1	448.4	484.1	456.6
Shareholders' equity	85.4	95.0	80.1	83.0	81.1	74.0
YTD Growth rates						
Assets	-4.3%	10.8%	-14.8%	3.2%	9.0%	-3.6%
Deposits	-3.5%	9.4%	-14.6%	12.0%	7.9%	-0.7%
Loans	-3.5%	12.4%	-18.1%	-1.5%	8.0%	-5.7%
Shareholders' equity	-5.6%	11.2%	-15.7%	3.6%	-2.3%	-8.8%

Sources: Banking Regulation and Supervision Agency (BRSA), Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



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

Bank Audi

to reap the benefits of a weaker Turkish Lira against major foreign currencies, and some local market players opted to add Turkish equities to their holdings to hedge against a double-digit inflation.

That being said, the BIST 100, which represents the 100 largest companies by market capitalization, reached 1,522.04 at end-October 2021, which marks a rise of 3.1% over the first ten months of the year. The Borsa Istanbul gauge continued to follow a strong winning streak over the month of November 2021, hitting fresh all-time highs after valuation discount to emerging-market peers approached the near-record low levels seen earlier this year (Turkish stocks trading at 56% discount to average emerging-market valuations), while also fueled by a strong price rally in the Borsa Istanbul Banks Index following a bid by a Spanish bank (Banco Bilbao Vizcaya Argentaria) for the rest of its Turkish unit.

The total number of traded companies on the Borsa Istanbul markets rose from 415 companies at end-December 2020 to 457 companies at end-October 2021. Despite equity price gains and new listings on Borsa Istanbul over the first ten months of 2021, the market capitalization contracted significantly by 20.9%, moving from US$ 240.3 billion at end-December 2020 to US$ 190.0 billion at end-October 2021. This can be explained by the currency depreciation, as the TL/US$ exchange rate moved from TL/US$ 7.43 at end-2020 to TL/US$ 9.61 at end-October 2021. The total number of contracts reached 551.8 million during the first ten months of 2021, up from 522.7 million during the corresponding period of 2020. The total trading value reached US$ 694.3 billion during the first ten months of 2021 and compared similarly to US$ 694.7 billion during the first ten months of 2020. Accordingly, the turnover ratio, measured by the annualized total trading value to market capitalization, reached 438.4% during the first ten months of 2021, up from 384.9% in 2020.

At the level of the bond market, Turkish bonds came under downward price pressures over the year 2021, mainly tracking declines in US Treasuries and a global sell-off mood on prospects of tightening global monetary policies and as an energy crunch and a relentless surge in oil prices fueled concerns about elevated inflation in global economies.

Accordingly, the yield on 10-year US dollar Turkish government bonds rose from 5.4% at end-2020 to 6.9% at end-October 2021. Concurrently, the 10-year Turkish Lira Benchmark bond index yield increased from 12.9% at end-2020 to 20.0% at end-October 2021. Within this context, it is worth mentioning that non-resident investors were net sellers of Turkish bonds over the first ten months of the year 2021, as reflected by a US$ 927 million contraction in their holdings, moving from US$ 6.4 billion at end-2020 to US$ 5.5 billion at end-October 2021.

A closer look at Turkish bonds shows that sovereigns maturing in 2026, 2031 and 2041 registered price contractions of 7.0 pts, 11.25 pts and 13.13 pts respectively over the first ten months of 2021. As to papers issued by financial institutions, QNB Finansbank'24 posted price decreases of 2.23 pts over the first ten months of 2021. Akbank'25 closed down by 2.63 pts. Yapi Ve Kredi Bankasi'24 recorded price declines of 1.13 pt. Garanti Bank'23 saw price falls of 0.63 pt. As to the cost of insuring debt, Turkey's five-year CDS spread expanded by 145 bps over the first ten months of 2021 to reach 450 bps at end-October. This followed a 24 bps expansion in 2020.

Regarding new issues, Turkey raised US$ 3.5 billion in January 2021 through the sale of US$ 1.75 billion five-year bonds at a coupon rate of 4.750% and US$ 1.75 billion 10-year bonds at a coupon of 5.875%. Also, Turkey raised US$ 2.25 billion in September 2021 from the sale of US$ 1.5 billion 12-year bonds at a coupon of 6.50% and a US$ 750 million tap of bonds maturing in October 2028 at a coupon of 6.125%. Concurrently, Turkey raised € 1.5 billion in July 2021 from the sale of six-year bonds at a coupon of 4.375%.

At the level of credit rating changes, Fitch Ratings affirmed in August 2021 Turkey's long-term foreign currency Issuer Default Rating at "BB-" with a "stable" outlook. Turkey's ratings reflect, according to Fitch, weak monetary policy credibility, high inflation, low external liquidity in the context of high financing requirements and geopolitical risks. The "stable" outlook balances elevated policy uncertainty due to rising inflation, lack of Central Bank independence and the potential for de-stabilizing stimulus ahead general elections due by 2023 against an easing of near-term external financing pressures due to a narrowing

Bank Audi

current account deficit, moderately higher international reserves, and banks and corporates' uninterrupted access to sufficient external finance to roll-over large debt payments, as per Fitch.

In parallel, S&P Global Ratings affirmed in October 2021 its unsolicited "B+/B" long-term and short-term foreign currency sovereign credit ratings on Turkey and its unsolicited "BB-/B" long-term and short-term local currency sovereign credit ratings, with a "stable" outlook. The "stable" outlook considers the lingering risks from Turkey's economic imbalances over the next 12 months. These are partly offset by the resilience of Turkey's private sector and the manageable stock of net general government debt, which leaves room for a fiscal policy response, should one be required, as per S&P.

Looking forward, weak monetary outlook, the uncertainty about the Turkish Lira and an increased risk perception may spur further foreign outflows from the Turkish debt market.

CONCLUSION

In sum, The Turkish economy rebounded briskly from a pandemic-related downturn last year, and has continued to expand in 2021. In real terms, output had already exceeded the pre-pandemic peak in the third quarter of 2020, and now stands 8.4% above the pre-pandemic level attained in the first quarter of 2020. Turkey has witnessed improved fiscal balances, primarily driven by cyclical factors and high inflation. Turkey's external balance has also improved, thanks to a sizeable increase in its gross reserves. However, this overstates the improvement in Turkey's external balances, as the rise in net reserves has been much more modest.

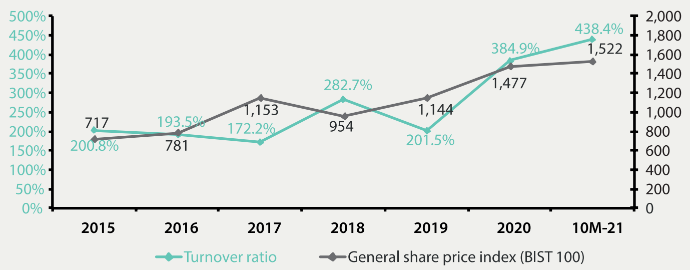
Looking forward, the economy is set to continue recovering over the years ahead. The IMF forecasts real GDP growth at 3.3% in 2022 and at 3.3% in the 5-year period extending from the years 2022 to 2026 according to the World Economic Outlook issued in mid-October. In parallel, it forecasts inflation at 15.4% in 2022 and at an average of 13.1% in the 5-year period extending from the years 2022 to 2026. As to fiscal

SELECTED STOCK MARKET INDICATORS

	2016	2017	2018	2019	2020	10M-21
Market capitalization (in US$ billion)	174.5	233.4	150.5	186.7	240.3	190.0
Market capitalization/GDP	20.1%	27.2%	19.3%	24.5%	33.4%	23.9%
Trading value (in US$ billion)	337.7	401.9	425.5	376.1	924.7	694.3
Traded volume (in millions)	234,483	356,578	436,596	548,083	1,511,484	923,762
Number of contracts (000s)	110,038	157,749	230,789	264,516	670,982	551,777
Change in share BIST 100 price index	8.9%	47.6%	-17.3%	19.9%	29.1%	3.1%
Price/Earnings ratio (times)	10.24	11.58	9.12	10.72	18.64	8.55
Dividend Yield (%)	2.27	2.05	3.28	2.35	0.83	2.7
CDS spread (bps)	273	165	362	280	304	450

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

STOCK MARKET PERFORMANCE



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

Bank Audi

deficit, the Fund forecasts it at 5.6% of GDP in 2022, slightly raising debt to GDP to 37.9% at end-2022 (41.1% at end-2026).

With respect to the external sector, the IMF forecasts the current account deficit to decline to 1.6% of GDP in 2022 (A ratio of 1.8% on average over the next five years). The current account deficit is actually set to narrow sharply as the economy begins to rebalance. Attracting sufficient capital inflows to cover the deficit, as well as to service foreign debt without further damaging the inadequate levels of foreign-exchange reserves, will require a continuation of more cautious economic and foreign policies as per the Economist Intelligence Unit.

At the monetary policy level, reflecting the authorities' preferences for low rates, the TCMB cut rates noticeably in the past couple of months. However, these rate reductions leave the Lira vulnerable to further dollarization, and it will be difficult to maintain such low real rates given the current inflation outlook. Therefore, global banks expect the policy rate to return to 18% by end-2022. Looking ahead, it is expected that the lira will continue to follow a depreciatory path amid a persisting current account deficit, high inflation and a gradual normalization of monetary policy in the US and the euro area, outlining a paradoxical case of monetary vulnerability against fiscal strength in Turkey.

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 moderate fiscal deficit and general government debt and the favorable maturity structure of external government debt, the fairly diversified goods export structure within the context of a dense widely diversified domestic economy, in addition to the stronger growth performance and structural indicators, such as GDP per capita and Human Development, relative to rating peers.

Yet, a number of risk factors continue to dominate the near term outlook. Among these, we mention the monetary uncertainties, high inflation, low external liquidity in the context of high financing requirements and geopolitical risks. In addition, Turkey suffers from the large short-term external debt rollover needs and low external buffers, the elevated financial stability risks and associated contingent liabilities, the high policy risk and the deterioration of institutional quality in recent years.

Finally, in its 2021 Article IV Consultation Report with Turkey, the IMF underscored the importance of strongly committing to, and delivering, a firm monetary policy stance to bring inflation towards target. They welcomed the shift in that direction and encouraged a further timely and well-calibrated tightening if inflation expectations increase further. The IMF also emphasized the importance of strengthening central bank independence, rebuilding high-quality reserves, further simplifying the operational framework, and improving policy communication. The IMF also encouraged further steps to strengthen debt management, better monitor quasi-fiscal operations and extra budgetary institutions, and enhance fiscal transparency more broadly. The Fund also called for focused structural reforms to minimize long-term adverse effects of the pandemic through focusing on female labor force participation and youth employment, increasing labor market flexibility, and ensuring that viable but temporarily insolvent firms are restructured while winding down unviable firms at large.