Bank Audi

TURKEY ECONOMIC REPORT

DECEMBER 2020

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A DIFFICULT CYCLE EXACERBATING GROWTH, EXTERNAL & MONETARY CHALLENGES DESPITE NET REAL SECTOR RECOVERY IN THE SECOND HALF-YEAR

A tough year for Turkey despite relative real sector recovery since the third quarter

The year 2020 has been a tough year for Turkey amid negative real output growth, worsening external vulnerabilities, eroding fiscal buffers and rising financial risks amid a partial depletion of foreign exchange reserves, negative real interest rates, and a sizeable current account deficit, partly fueled by a strong credit stimulus. In its World Economic Outlook issued in mid-October, the IMF has forecasted real GDP growth at -5%, mainly driven by the first half real sector weaknesses, bearing in mind that conditions improved in the second half-year as witnessed by the partial recovery of a number of real sector indicators since the third quarter, such as capacity utilization, industrial output, manufacturing PMI and cars sales.

Current account swinging back into deficit in 2020

The increasing current account imbalance amid currency pressures have raised Turkey's overall external vulnerability in 2020. In fact, the current account deficit reappeared noticeably between March and August this year, through mainly a considerable deterioration in trade deficit, on the back of the collapse in global demand, which took a toll on Turkey's merchandise trade, along with a net contraction in tourism receipts amid ongoing global mobility restrictions as a result of COVID-19. As such, the current account balance is likely to post a deficit of 3.7% of GDP in 2020, against a surplus of 1.5% of GDP in 2019.

Fiscal imbalances growing amid pandemic challenges

Turkey's fiscal imbalances, financed mostly through domestic borrowing, have grown rapidly between March and September this year when the effects of the pandemic peaked. That being said, the central government budget deficit (on a cash basis) has increased by 39.9% over the first ten months of 2020, reflecting sluggish economic activity and moderate counter-cyclical fiscal measures. Within this context, the general government budget deficit to GDP is projected to exceed 7% in full-year 2020, the highest since 2003, up from 5.6% in 2019.

Currency depreciation amid dwindling FX reserves prompting a reversal of monetary policy

The year 2020 was an erratic year for Turkey's monetary sector, as it saw a sharp fall in the Turkish lira against the US dollar, dwindling foreign currency reserves and stubbornly high inflation rates. This required a major shift into a contractionary monetary stance starting September 2020 and prompted the Turkish government to form a new economic growth strategy and start a new era for the improvement of the country's investment climate. Following five consecutive rate cuts delivered over the first five months of 2020, the Central Bank one-week repo rate was raised in September and November 2020 by a total of 675 bps to reach 15.0%, versus 12.0% at end-December 2019.

Comfortable capital buffers at banks to weather arising financial risks

Turkish banks witnessed an expansion in activity in the first nine months of 2020, on the back of higher liquidity channeled towards more lending amid supportive measures on behalf of Turkish authorities in the face of the COVID-19 pandemic. While currency depreciation and other macroeconomic induced challenges are major downside risks to the domestic banking sector, Turkish banking institutions maintain adequate financial standing and comfortable capital buffers on the overall to weather the difficult operating conditions. Measured by the aggregated assets of banks operating in the country, total sector activity grew by 33.7% in local currency terms and by 2.5% when expressed in US dollar terms in this year's first nine months.

Recovery expected in 2021, though subject to downside risks

Looking forward, following the 2020 net contraction in real output, The Turkish economy is expected to grow by 5% in 2021 according to the IMF projections in its Global Economic Outlook published mid-October, due mainly to a low base effect. That said, the biggest downside risk to such a forecast stems from the uncertainties related to the Pandemic in addition to FX volatility.

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The year 2020 has been a tough year for Turkey amid negative real output growth, worsening external vulnerabilities, eroding fiscal buffers and increasing financial risks amid a partial depletion of foreign exchange reserves and a sizeable current account deficit, partly fueled by a strong credit stimulus. In its World Economic Outlook issued in mid-October, the IMF has forecasted real GDP growth at -5%, mainly driven by the first half real sector weaknesses, bearing in mind that conditions improved in the second half-year.

As a matter of fact, having entered a sort of a normalization process, Turkey's real sector has shown that it has partly recovered from the negative fallout of the pandemic, achieving an increase in its foreign sales by 6% on an annual basis in September, the highest export figure of the year 2020. Industrial output figures recently published were the latest data point to confirm that Q3 saw a sound rebound in economic activity, on the back of a highly accommodative policy backdrop. Industrial production rose by 8.1% year-on-year in September, and by 7.7% year-on-year in Q3, following a 16.8% contraction in Q2, when disruptions to activity as a result of COVID-19 were the most acute. Other production-side indicators such as capacity utilization and the manufacturing PMI also registered improvement. Some data series saw historic highs, with car sales rising by 178% year-on-year in Q3 2020, and home sales up by 49% year-on-year.

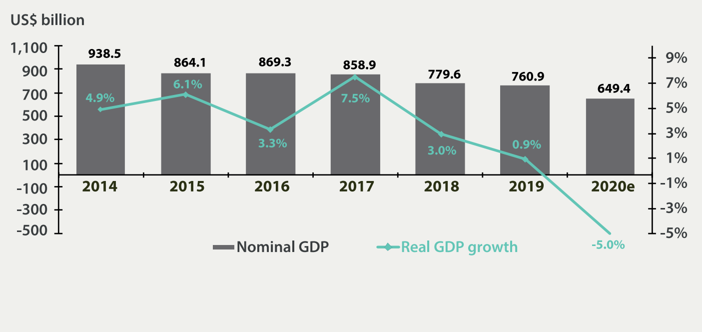
The biggest driver of the strong recovery in the third quarter of the current year was strong lending activity that reported its highest annual growth figure since September 2011. The recent increase in lending growth was driven by the combination of ultra-low interest rates, in nominal terms and more importantly in real terms, and the regulations disincentivizing low loan growth.

At the external level, despite a competitive exchange rate, subdued oil prices and soft domestic demand, it is believed that the current account balance is on track to swing into a deficit of about 3.7% of GDP this year from a surplus of 1.5% of GDP in 2019. Such a deterioration in the current account balance actually comes amid weak tourism revenues and strong gold imports.

At the fiscal level, a net deterioration in public finances was witnessed this year. As the growth in budget expenditures outpaced that of budget revenues (respectively 18.0% and 14.3% over the first ten months of the year), budget deficit rose by 39.9% between the two periods, likely to exceed 7% of GDP this year. Subsequently, this has fueled a rise in public debt ratios which moved from 29.4% of GDP at end-2019 to 34.7% of GDP at end-October, though the latter remains moderate by emerging markets standards.

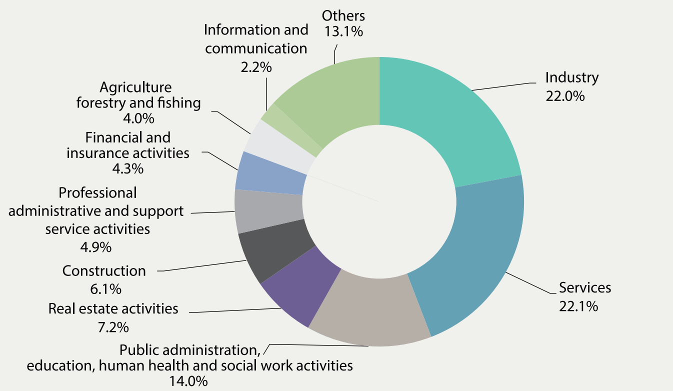
At the monetary level, the year 2020 has witnessed a significant depreciation of the national currency along with a drop in Central Bank's FX reserves amid intervention on the foreign exchange market. FX reserves dropped from US$ 81.2 billion at end-December 2019 to US$ 42.3 billion at end-October 2020. The year-to-date FX interventions by the Central Bank are actually estimated at US$ 101 billion, calculated as the difference between the actual and expected changes in net foreign assets of the TCMB. Having said that, if banks' required reserves for TL and FX liabilities are netted out, net foreign-exchange reserves are now slightly negative.

GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (H1 2020)



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

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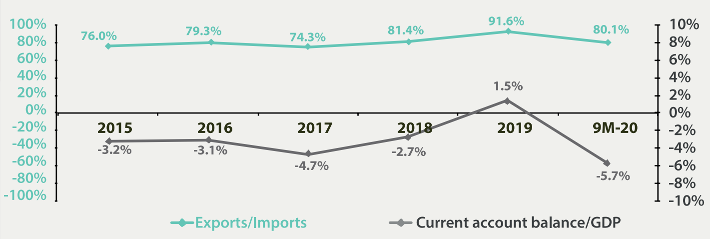
At the banking sector level, banking activity, measured by total assets, grew by 33.7% in local currency terms over the first nine months of 2020 (or by 2.5% in US dollar terms). In parallel, bank deposits rose by 34.2% in local currency terms (or by 2.9% in US dollar terms) over the same period. With respect to the currency structure, the FX deposits to total deposits rose moved from 51.0% at end-December 2019 to 54.3% at end-September 2020 amid net conversions to foreign currencies. With respect to bank profitability, while net bank profits declined by 5.9% in US$ terms, they grew by 28.8% in local currency terms over the first nine months of 2020. Finally, strong lending growth together with increased credit losses, lower operating revenue, and the weak Turkish lira are believed to weigh on banks' capitalization despite comfortable capital buffers.

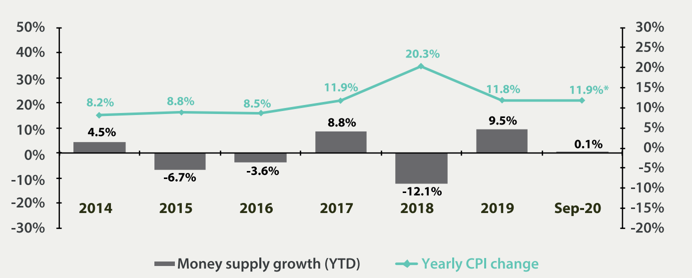
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economic, financial and monetary conditions looking ahead.

FOREIGN SECTOR INDICATORS



Sources: 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

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1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture

Primary sector grows at a slower pace this year

Despite the spread of the Coronavirus which took its toll on the real sector in Turkey, the primary sector maintained its positive growth though at a slower pace. The sector reported a real growth of 3.5% in the first half of 2020, down from 4.4% in the same period of last year. In parallel, the share of the sector in the country's GDP reported an improvement from 3.7% in the first half of 2019 to 4.0% in the same period of this year.

It is worth noting that grains production is often dampened by severe seasonal droughts across large parts of Turkey. However, corn and barley made good recoveries over the past two seasons whereas wheat had a lower performance. In this context, the government maintains its heavy investments in irrigation projects to help serve the sector.

The severity of the COVID-19 pressured businesses and domestic consumption. In this context, economic units that support food consumption faced severe challenges this year owing to the pandemic. The tourism, hospitality and gastronomy sectors are apt to face a sharp fall in revenues and hence food consumption and the primary sector will be directly impacted, as per Fitch Solutions.

At the external level, it is worth noting that edible fruits and nuts took over a share of 2.7% of the country's total exports in the first three quarters of 2020, up from 2.0% in the same period of last year. This is backed up by Turkey's favorable geography and good location for trading with Asia, Europe and the Middle East. The country is one of the major exporters in almost all the major agricultural product sub-sectors.

In sum, the COVID-19 related overall slowdown is putting adverse pressure on the sector slowing down its growth, as food consumption in the tourism and hospitality sector and shocks could extend amid slowing down household incomes and spending patterns driven by the pandemic.

CROP PRODUCTION IN 2019 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share		Volume	Share		Volume	Share
Cereals	**34,402**	**54%**	**Vegetables**	**25,362**	**82%**	**Fruits**	**13,645**	**61%**
o.w. Wheat	19,000	30%	o.w. Tomatoes	12,842	41%	o.w. Citrus fruits	4,301	19%
o.w. Barley	7,600	12%	o.w. Watermelon	3,871	12%	o.w. Pome fruits	4,351	20%
o.w. Maize	6,000	9%	o.w. Cucumber	1,917	6%	o.w. Stone fruits	2,874	13%
Sugar beets	**18,054**	**28%**	o.w. Melon	1,777	6%	o.w. Bananas, Kiwis, Avocado, Figs	926	4%
Potatoes, dried legumineus	**4,980**	**8%**	o.w. Pepper (green)	902	3%	o.w. Other fruits	1,192	5%
Oil seeds	**3,985**	**6%**	**Bulb and root vegetables**	**3,621**	**12%**	**Grapes**	**4,100**	**18%**
Dry pulses	**1,230**	**2%**	o.w. Dry onion	2,200	7%	**Olive production**	**1,525**	**7%**
Raw materials used in textiles	**814**	**1%**	o.w. Carrots	664	2%	**Tea production**	**1,407**	**6%**
Plants for perfumery, pharmacy	**112**	**0%**	**Other vegetables**	**2,106**	**7%**	**Nuts**	**1,309**	**6%**
Tobacco	**68**	**0%**	o.w. Leafy or edible stem vegetables	1,742	6%	**Spices crops**	**307**	**1%**
Total Cereals and other crops*	**63,646**	**100%**	**Total Vegetables & other crops**	**31,090**	**100%**	**Total Fruits, nuts & spices crops**	**22,293**	**100%**

**Excluding fodder crops*

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

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1.1.2. Industry

Growth in Turkey's industrial sector remains at the negative end

Turkey's industrial sector continued to report a negative performance in the first half of 2020, as spread of the Coronavirus in the first quarter of this year in the country put pressure on the performance of the sector.

In real terms, the sector retreated by 5.6% in the aforementioned period, compared to a drop of 3.3% in the same period of last year. In nominal terms, the share of the sector in Turkey's GDP edged down from 23.5% in the first half of 2019 to 22.0% in the corresponding period of this year.

Similarly, Turkey's Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, fell by 0.9% year-on-year during the first nine months of 2020, following a decline of 2.8% in the corresponding period of last year, as per Turkstat. It is worth noting that the third quarter of this year weighed positively on the index as the Turkish industrial production continued to recover, keeping up the pace of an economic improvement as the Coronavirus outbreak starts to normalize in the country.

Looking at the breakdown of the sector, the manufacturing sector, which is one of the major contributors to Turkey's industrial sector contracted by 6.3% year-on-year during H1 2020 against 6.2% in the same period of last year. However, the Turkish manufacturing activity which slowed down in the first two months following the spread of the pandemic in Turkey posted an expansion between June and October. The Purchasing Managers' Index (PMI) for manufacturing stood at 49.8 during 10M 2020, up from 47.2 in 10M 2019. On a positive note, the PMI averaged 54.4 in the period between June and October. This value suggests a solid improvement in the health of the sector. 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 reported a negative growth of 2.3% year-on-year during the first half of 2020, compared to a contraction of 10.2% in the same period of last year. The sector was highly impacted by liquidity issues and economic uncertainty which put pressure on overall demand. Furthermore, the significant slump in the value of the Turkish lira and high inflation are dragging on trade growth. In this context, a slowdown in activity is expected throughout 2020 as most investments for the sector this year were halted.

In conclusion, Turkey's industrial sector continued to encounter a negative growth performance throughout 2020, as the spread of the Coronavirus pandemic along with the high inflation and depreciation of the local currency were of noticeable negative impact.

VEHICLES PRODUCTION

(unit)	2017	2018	2019	19/18	10M-19	10M-20	10M/10M
Automobile	1,120,860	1,026,438	982,642	-4.3%	794,156	671,546	-15.4%
Pick-up	462,389	429,361	386,246	-10.0%	319,349	266,941	-16.4%
Minibus	55,036	56,934	61,668	8.3%	50,008	40,782	-18.4%
Tractor	53,841	37,686	23,899	-36.6%	19,134	28,511	49.0%
Truck	23,499	25,529	19,003	-25.6%	16,306	17,273	5.9%
Bus	8,168	8,541	9,212	7.9%	7,764	6,541	-15.8%
Midibus	3,732	3,316	2,550	-23.1%	2,012	1,660	-17.5%

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

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1.1.3. Trade and Services

Tertiary sector takes a hit due to Coronavirus outbreak

Turkey's tertiary sector was significantly impacted by the spread of the Coronavirus pandemic as its outbreak negatively impacted the various components of the sector, especially tourism which encountered a reduced global demand.

In real terms, the sector witnessed a contraction of 7.1% in the first half of 2020 following an expansion of 0.3% in the first six months of 2019.

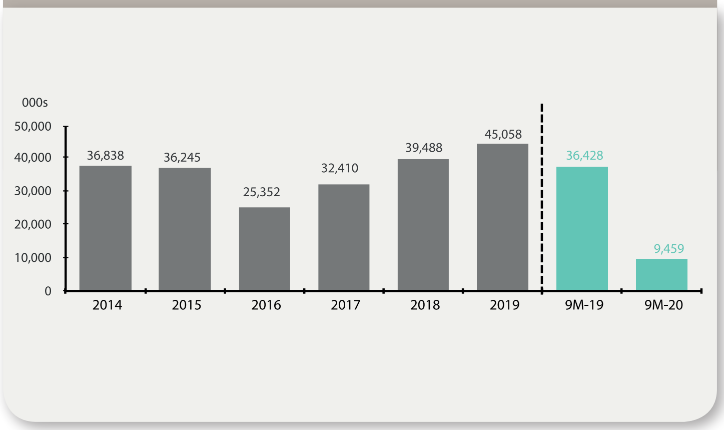
In nominal terms, Turkey's trade and services sector continued to maintain a share of nearly 55% of the country's GDP in the first half of this year, nearly unchanged from its level in the same period of last year. The sector includes wholesale trade, information and communication, financial and insurance 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 look at the components of the tertiary sector, Turkey's tourism sector will witness a sharp downtrend in 2020 due to the ongoing COVID-19 pandemic. The closure of the Turkish international airport from early March 2020 to June weighed negatively on the sector's performance. The pandemic depressed 2020 arrivals to Turkey and derailed tourism recovery. The number of arriving foreigners retreated by 72.5% year-on-year in the first ten months of 2020, according to the Turkish Hotel Association (TUROB). TurkStat said tourism income totaled US$ 8.1 billion in the first three quarters of 2020 down by a yearly 69.4% from US 26.6 billion in the first nine months of 2019. It is worth noting that the Turkish government is actively working on the development of policies in order to deal with COVID-19 and regain trust among prospective tourists. The Ministry of Tourism stated in the second quarter of this year that a new tourism health certification system was being developed to promote the health and safety precautions across the sector.

At the level of hospitality, the hotel occupancy rate across Turkey was 35.4% in the first nine months of 2020, down by 47.8% from the same period of last year, as per TUROB. The average daily rate (ADR) for rooms dropped by an annual 9% over the same period to US$ 84, while revenue per available room (RevPAR) was down by 52.5%. Furthermore, several hotels in Turkey temporarily shut down due to the pandemic.

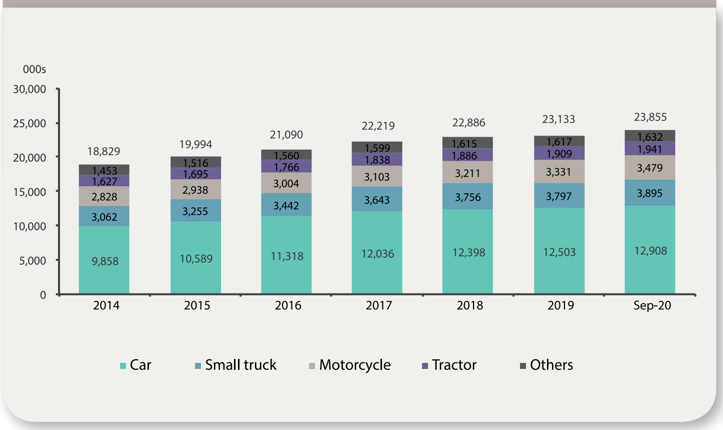
Looking at a different component suggesting sort of a recovery, the economic optimism index in Turkey increased to 92.8 in October of 2020 from 88.5 in September. The index continued to recover from a record low of 51.3 reported in April when the coronavirus pandemic started. It is noteworthy that improvements were seen in confidence in the real sector, services, retail trade and construction confidence indices. However, the index remains below the 94.3 level a year earlier and the 97.5 level reached in February, before the Coronavirus hit.

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

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Turkey's services confidence index reached an average of 87 in the first ten months of 2020, up from 84 in the same period of 2019 and expanding by 3.2% 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. The index was hardly hit in the second quarter following the spread of the Coronavirus in Turkey, however it went back to increase starting July 2020.

Still, it is clear that the trade and services sector, which is more vulnerable than others to any external shock, was one of the significantly affected real sectors in Turkey this year. The weight of the pandemic and the political instability in the region lead to shifting the growth of the past year into a net contraction in 2020, despite the relative recovery since the third quarter.

1.2. EXTERNAL SECTOR

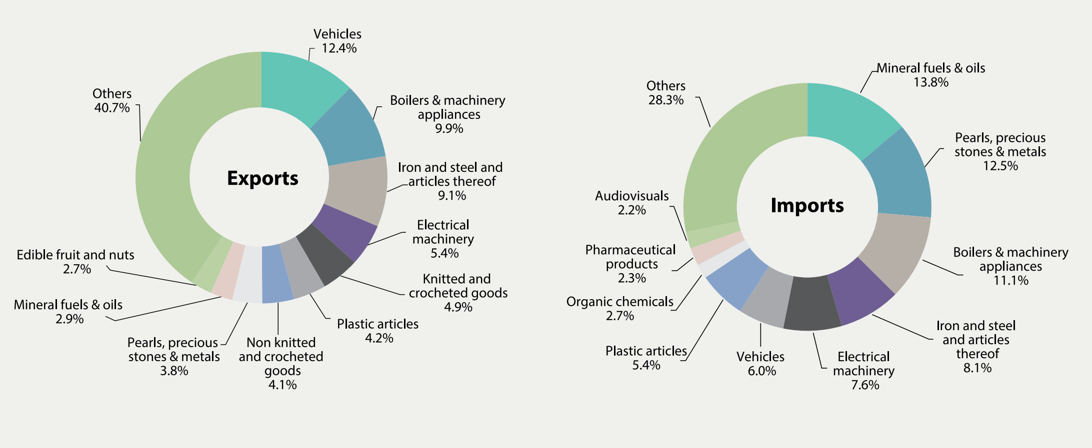
Current account swinging back into deficit

In 2020, the increasing current account imbalances amid declining foreign exchange reserves and currency pressures have raised Turkey's overall external vulnerability. In fact, the current account deficit reappeared noticeably between March and August this year, through mainly a considerable deterioration in trade deficit, on the back of the collapse in global demand, which took a toll on Turkey's merchandise trade, along with a net contraction in tourism receipts amid ongoing global mobility restrictions as a result of COVID-19. As such, the current account balance shifted into deficit over the first nine months of this year, from its first surplus since 2002.

In details, Turkish exports reached US$ 117.6 billion over the first nine months of 2020, as per the latest Central Bank figures, posting a 12.4% drop on a yearly basis, following the COVID-19-related slump in 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 (12.4% of total exports), boilers and machinery appliances (9.9%), iron and steel (9.1%), electrical machineries (5.4%), knitted and crocheted goods (4.9%) and plastic articles (4.2%). The geographic distribution of domestic exports indicates that 9.5% of total exports went to Germany, followed by the United Kingdom with 6.4% of the total, USA with 6.1%, Iraq with 5.3%, Italy with 4.7%, France with 4.2% and Spain with 4.0% of total domestic exports over the same period.

In parallel, Turkish imports, despite higher gold imports, reported a relative stagnation (+0.9%) over the first nine months of 2020 to reach US$ 146.9 billion, as weak global consumer demand continued to curb business sentiment and therefore import demand at large. In parallel, the breakdown of domestic imports

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-20)



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

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by commodity shows that the main imports over the first nine months of 2020 were mineral fuels and oils (13.8% of total imports), pearls and precious metals (12.5%), boilers and machinery appliances (11.1%), iron and steel (8.1%), electrical machinery (7.6%), vehicles (6.0%) and plastic articles (5.4%). The breakdown of imports by country of origin shows that most of the inward merchandise came from China with 10.5% of total imports, followed by Germany with 9.4%, Russia with 8.2%, USA with 5.6%, Iraq with 4.2%, Italy with 4.0% and Switzerland with 2.9% of total imports over the same period.

Within this context, the cumulative trade deficit went up considerably by 159.0% over the first nine months of 2020 when compared to the same period of 2019 (following a significant contraction of 72.8% a year ago) to reach US$ 29.3 billion. As such, Turkey witnessed a tangible deterioration in its current account balance, shifting from a surplus of US$ 8.1 billion in 9M 2019 to a deficit of US$ 28.0 billion in 9M 2020 (the highest since 2009), accompanied by sizable outflows of non-resident capital, mainly in the form of portfolio investment, extended into August and early September. In terms of tourism services exports, a marked decrease was registered in tourist arrivals and receipts this summer, particularly due to COVID-19 travel restrictions in important tourist source countries. Having said that, the year 2020 is expected to report a current account deficit of 3.7% of GDP, as per the IMF.

1.3. PUBLIC SECTOR

Fiscal imbalances growing rapidly in 2020

Turkey's fiscal imbalances, financed mostly through domestic borrowing, have grown rapidly between March and September this year when the effects of the pandemic peaked. In fact, the weak economic growth performance and fiscal measures to manage the economic effects of the coronavirus had a meaningful impact on the fiscal deficit in 2020, as most of the moderate government's direct fiscal response to the coronavirus shock (totaling close to 2% of GDP) came in the form of tax deferrals, subsidized lending through public banks or the unemployment insurance facility.

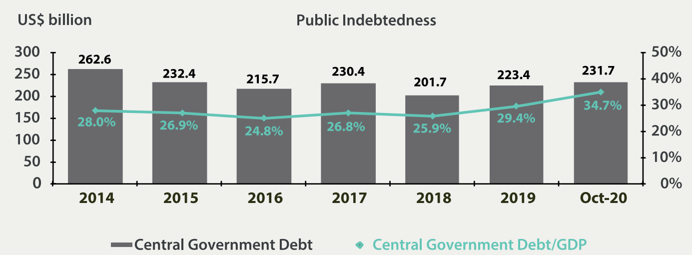
In details, the central government budget revenues grew by a healthy 14.3% during the first ten months of 2020 to reach a total of TL 822 billion (or US$ 121 billion), mainly supported by a 14.8% year-on-year increase in general budget revenues to TL 800 billion, of which tax revenues that rose by 21.4% to reach TL 655 billion, as the tangible drop in tax revenues mainly between March and June came in parallel with the impact of the ratification of new laws on tax regulation in November 2019 including higher rates for high earners and hotel accommodation, as well as new taxes on digital services. On another hand, general

SELECTED PUBLIC FINANCE INDICATORS

TL billion	2017	2018	2019	19/18	10M-19	10M-20	10M/10M
Central government budget revenues	**630.5**	**758.0**	**875.8**	**15.5%**	**719.2**	**822.2**	**14.3%**
o.w. Tax revenues	536.6	621.5	673.3	8.3%	539.9	655.3	21.4%
o.w. Non-tax revenues	93.9	136.5	202.5	48.4%	179.3	166.8	-7.0%
Central government budget expenditures	**678.3**	**830.8**	**999.5**	**20.3%**	**819.9**	**967.7**	**18.0%**
o.w. Primary expenditures	621.6	756.8	899.5	18.9%	731.6	848.1	15.9%
o.w. Interest	56.7	74.0	99.9	35.1%	88.3	119.6	35.4%
Central government budget cash balance	**-54.8**	**-88.5**	**-124.6**	**40.8%**	**-104.1**	**-145.6**	**39.9%**

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

PUBLIC INDEBTEDNESS



Sources: Ministry of Finance, IMF, Bank Audi's Group Research Department 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 declined by 7.0% over the same period.

On the spending side, a strong growth of 18.0% in central government budget expenditures was recorded over the first ten months of 2020 compared to the same period of 2019, to reach TL 968 billion (or US$ 142 billion), mainly due to a 15.9% expansion in primary expenditures to TL 848 billion, and a 35.4% rise in interest expenditures to TL 120 billion. A breakdown of primary expenditures shows a 16.2% increase in compensation of employees to reach TL 245 billion, current transfers went up by 22.3% to reach TL 411 billion, of which Treasury aid increased by 25.8% to reach TL 237 billion, social security contributions went up by 12.4% to TL 40 billion, while social transfers increased by 15.8% to reach TL 19 billion over the same period. On another hand, interest expenditures showed a 31.1% increase in domestic interest payments during the first ten months of 2020 to TL 83 billion, as well as a 29.7% surge in foreign debt interest to TL 28 billion.

That being said, the central government budget deficit (on a cash basis) has increased by 39.9% over the first ten months of 2020, reaching circa TL 146 billion (or US$ 21 billion) as compared to a deficit of TL 104 billion during the same period of 2019, reflecting sluggish economic activity and moderate counter-cyclical fiscal measures. Within this context, the general government budget deficit is projected to exceed 7% of GDP in full-year 2020, the highest since 2003, up from 5.6% in 2019 as per the IMF.

Last but not least, the central government debt stock reached TL 1,934 billion (or US$ 232 billion) as at end-October 2020, or 34.7% of GDP, as per the latest figures released by the Ministry of Finance, recording a considerable increase by 45.6% from TL 1,329 billion as at end-December 2019, and which is split into TL 1,108 billion in domestic debt (accounting for circa 57% of the total) and TL 826 billion in external debt (accounting for the remaining 43%). It is worth mentioning that the currency composition of government debt has weakened in recent years. Foreign currency debt as a share of total debt increased to 43% today, up from 39% at end-2017, as the government has increasingly issued FX-denominated government debt to domestic borrowers (particularly the banking sector), which raises the sensitivity of debt service payments to exchange rate movements.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Currency depreciation amid dwindling FX reserves prompting a reversal of monetary policy

The year 2020 was an erratic year for Turkey's monetary sector, as it saw a sharp fall in the Turkish lira against the US dollar, dwindling foreign currency reserves and stubbornly high inflation rates. This required a major shift into a contractionary monetary stance starting September 2020 and prompted the Turkish government to form a new economic growth strategy and start a new era for the improvement of the country's investment climate.

In details, the Turkish lira was in free fall against the US dollar over the year 2020, amid widening current account deficit, dwindling foreign currency reserves and lingering geopolitical tensions. Its nosedive has accelerated after the Central Bank of Turkey unexpectedly decided on October 22, 2020 to keep its policy rate (the one-week repo auction rate) unchanged. This brought the TL/US$ exchange rate to an unprecedented low level of TL/US$ 8.53 on November 6, 2020 as compared to TL/US$ 5.95 at end-December 2019, marking a 43% loss in the Turkish lira against the US dollar, which makes it the worst performing currency in emerging markets.

However, the Turkish lira started partially recovering from its lows following the pledge to form a new economic growth strategy based on stability, lower inflation and international investment, in addition to the CBRT's decision on November 19, 2020 to raise its policy rate by 475 bps, in line with forecasts, to support the Turkish lira and contain inflationary pressures. This sparked an upward correction in the Turkish lira against the US dollar, with the exchange rate hovering around TL/US$ 7.83 at end-November 2020.

Amid a sharp fall in the Turkish lira against the US dollar in 2020 and as a result of a fast domestic economic recovery during the third quarter of 2020 with strong credit momentum curbing demand-side disinflationary effects, and given the pandemic-related supply-side inflationary effects, inflation followed a higher-than-envisaged path in October 2020, hitting 11.89% year-on-year.

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Under these conditions, the CBRT decided on November 19, 2020 to reinforce the tightening steps taken in September 2020 in order to ensure price stability and contain risks to the inflation outlook. This marked a major shift from the aggressive monetary easing policy launched in July 2019 to a contractionary policy aimed to support the Turkish lira and contain inflation expectations. In fact, following five consecutive rate cuts delivered over the first five months of 2020, the one-week repo rate was raised in September and November 2020 by a total of 675 bps to reach 15.0% at end-November 2020 versus 12.0% at end-December 2019. Also, the overnight lending rate was raised to 16.50% as compared to 13.50% at end-December 2019. The overnight borrowing rate was lifted to 13.50% in November 2020 against 10.50% at end-December 2019. The late liquidity window lending reached 19.50% at end-November 2020 as compared to 15.0% at end-December 2019.

In parallel, the CBRT's gross foreign exchange reserves have been dwindling over the year 2020, moving from US$ 81.2 billion at end-December 2019 to US$ 42.3 billion at end-October 2020, down by a significant 48%, amid a shift in Turkey's current account balance to a deficit, sizeable outflows from assets like local government bonds and equities, and residents' strong FX demand which required large currency interventions from the Central Bank to defend the lira. This is despite a US$ 10 billion increase in the swap line with Qatar in May 2020.

Looking forward, the Turkish monetary authorities would continue to take into account all factors affecting inflation to ensure price stability, while maintaining tight monetary conditions until a persistent drop in inflation is achieved.

1.4.2. Banking Activity

Comfortable capital buffers to weather arising financial risks

Turkish banks witnessed an expansion in activity in the first nine months of 2020, on the back of higher liquidity channeled towards more lending amid supportive measures on behalf of Turkish authorities in the face of the COVID-19 pandemic. While currency depreciation and other macroeconomic induced challenges are major downside risks to the domestic banking sector, Turkish banking institutions maintain adequate financial standing on the overall to weather the difficult operating conditions. Measured by the aggregated assets of banks operating in the country, total sector activity grew by 33.7% in local currency terms and by 2.5% when expressed in US dollar terms in this year's first nine months (due to the marked currency depreciation between December 2019 and September 2020).

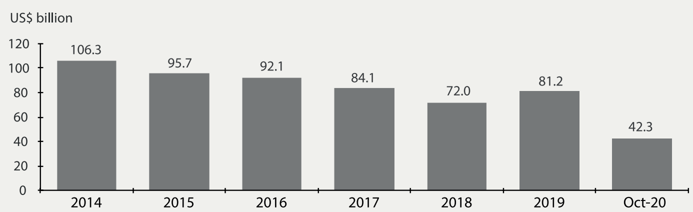
On the funding side, Turkish banks benefited from increased liquidity in the form of customer deposits, both in local currency as spending was curbed amid the ongoing COVID-19 pandemic and in foreign currency terms as currency fears favored some conversions into FC deposits. Deposits at Turkish banks surged by 34.2% in the first nine months of this year when expressed in local currency terms, or by 2.9% when expressed in US dollar terms. In details, Turkish lira-denominated deposits rose by 25.1% in the first nine months of 2020, and FC deposits expressed in US dollar terms progressed by 9.6% amid a marked currency depreciation over the covered period. As such, the deposit dollarization ratio rose to reach 54.3% at end-September 2020, against 51.0% at end-December 2019.

MONETARY SITUATION

Flows in US$ million	2014	2015	2016	2017	2018	2019	9M-20
Net foreign assets	**-16,026**	**-4,681**	**10,473**	**-8,997**	**20,424**	**32,155**	**-26,368**
Foreign assets	-4,318	-13,448	7,474	6,460	-293	13,508	-25,270
Foreign liabilities	-11,708	8,767	2,999	-15,457	20,717	18,647	-1,098
Domestic Assets	**41,881**	**-35,585**	**-30,342**	**56,061**	**-91,277**	**16,690**	**27,109**
Claims on private sector	44,265	-21,705	-20,144	53,713	-96,260	-1,753	11,200
Claims on public sector	-3,997	-12,765	-10,070	36	8,038	17,632	16,764
Claims on non-bank financial institutions	1,614	-1,115	-128	2,311	-3,056	812	-855
Total Money Supply	**25,878**	**-40,266**	**-19,869**	**47,064**	**-70,853**	**48,845**	**741**
Money Supply (M1)	2,301	-5,155	2,276	1,522	-23,310	11,055	4,467
Quasi-Money	11,254	-28,822	-13,655	28,670	-42,816	39,284	4,553
Other Items (Net)	12,323	-6,289	-8,490	16,872	-4,727	-1,494	-8,279

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

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The share of deposits in the funding mix increased when looking at flows during the first nine months of this year. Deposits are less volatile by nature than foreign market funding, which are subject to swings in investor sentiment and global credit market conditions and usually augment refinancing risks for the banking sector.

However, a glance at the breakdown of those deposits by maturity shows that the bulk of the increase consisted of short-term deposits. In a way, this exacerbates the structural maturity mismatches on Turkish banks' balance sheets. This increases the difficulty for banks of purchasing liquid assets to cover short-term liabilities when market conditions deteriorate (noting that at the same time borrowing costs tend to rise in such conditions).

On the asset utilization side, the single largest contributor to sector activity growth proved to be loans, especially as authorities encouraged banks to boost credit to the domestic economy. According to the BRSA statistics covering the first nine months of this year, loans extended by Turkish banks progressed by 33.9% in local currency terms, the equivalent of 2.6% when expressed in US dollar terms. In fact, loan growth rose swiftly within the context of rising liquidity in local currency (in the form of TL deposits), decreasing financing costs and sector regulator measures aimed at encouraging banks to lend to the private sector economy.

The breakdown of new loans by sector shows that close to a quarter of banks' lending activity growth in volumes went to the manufacturing sector with a 24% share, followed by retail loans (individual credit) with a 13% share, wholesale and retail trade with a 12% share, retail housing loans with 9% and transport, storage and communication with close to 8% of the total growth in new loans over the covered period of this year.

Turkish authorities introduced financial and macro prudential measures to channel liquidity to struggling enterprises through banks. These include the extension to the Credit Guarantee Fund for SME lending through risk sharing and the easing of macro-prudential regulations to boost lending activity growth such as a rise in the loan-to-value ratio for mortgages and the introduction of the Asset Ratio until recently. The latter was designed to accelerate the flow of funding to the domestic economy, thus mitigating the COVID-19 pandemic's adverse spillovers. The Asset Ratio was calculated as the sum of loans and 75% of securities and 50% of Central Bank swap balances to the sum of all Turkish lira deposits and 125% of foreign currency deposits. The regulator had said that as of October 2020, it should not fall below 90% for deposit banks and below 70% for participation banks as a monthly average. But upon the finalization of this report, authorities said they will repeal the asset ratio rule from December 31, 2020 as a continuation of the normalization steps. This is viewed as a further step toward mainstream economic management by canceling a measure that compelled lenders to extend loans and purchase government debt.

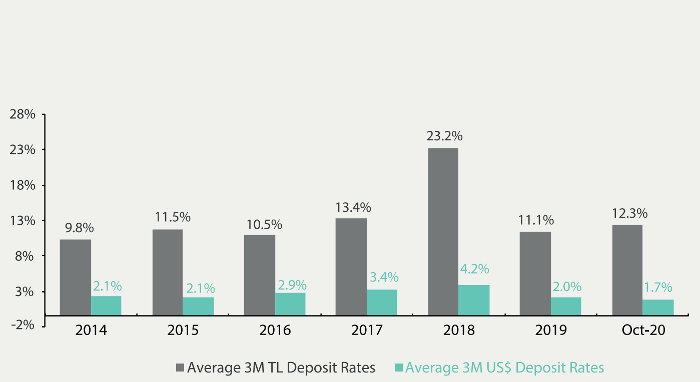
The Turkish banking sector remains resilient to short-term liquidity shocks, ascertains the sector regulator. The minimum legal limits of the liquidity coverage ratio, measuring the capacity of high quality liquid assets on banks' balance sheets to offset net cash outflows over a 30-day period, stand at 100% and 80% respectively for total and foreign currency assets, as of January 2019. Those ratios are, according to the latest BRSA financial stability report, well above the regulatory minimum limits.

BANKING SECTOR INDICATORS

in US$ billion	2014	2015	2016	2017	2018	2019	Sep-20
Banking Activity							
Assets	859.8	813.4	778.3	862.7	734.8	758.0	776.7
Deposits	454.3	429.8	414.7	453.4	387.1	433.6	446.1
Loans	535.5	512.3	494.5	555.8	455.1	448.4	460.1
Shareholders' equity	99.9	90.5	85.4	95.0	80.1	83.0	73.6
YTD Growth rates							
Assets	5.6%	-5.4%	-4.3%	10.8%	-14.8%	3.2%	2.5%
Deposits	2.2%	-5.4%	-3.5%	9.4%	-14.6%	12.0%	2.9%
Loans	8.8%	-4.3%	-3.5%	12.4%	-18.1%	-1.5%	2.6%
Shareholders' equity	9.7%	-9.4%	-5.6%	11.2%	-15.7%	3.6%	-11.3%

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

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Moreover, the primary liquidity ratio in the banking sector, which we measure as the sum of cash, receivables and required reserves as a percentage of total deposits, stood at a fairly decent 22.7% at end-September 2020. The ratio was at a slightly higher 25.1% at year-end 2019. During the covered period of this year, strong deposit growth was more or less offset by an increase in banks' primary liquidity across all its components. As such, banks operating in the country have enough buffers against FX liquidity shocks in general, barring a severe withdrawal of foreign currency deposits as would be the case for any bank globally.

Another measure of liquidity for the sector, perhaps more of a long-term liquidity indicator, is the loan-to-deposit ratio, showing the extent to which loans are financed by deposits. The loan-to-deposit ratio rebalancing that took place as of last year is continuing as deposit growth proved to be even stronger than lending activity growth in Turkey. As a result, the loan-to-deposit ratio based on banks' aggregated balance sheet stood at 103% at end-September 2020, thus inching closer to the 100% threshold.

A further indicator of liquidity that is being monitor by the sector regulator is the ratio of loans to the sum of deposits and other stable funds (L/D+). This ratio serves as a more comprehensive means of measuring the liquidity outlook for banks and covers deposits in addition to other stable funds, and came in at close to 76% in March 2020 as per the latest BRSA financial stability report. The BRSA said that the acceleration in TL loans was funded by higher deposits, equities and long-term TL-denominated issuances.

Having said that, the expansion in credit across Turkish banks in the covered period does not seem to have come at the expense of asset quality, at least not yet. As a matter of fact, the non-performing loans to total cash loans ratio inched down from 5.4% at end-December 2019 to 4.1% at end-September 2020. After rising as a result of the lagged effects of the weakening of economic activity on banks' balance sheets, the NPL ratio has been on the decline lately. This occurred within the context of the short-lived economic upturn in late 2019/early 2020 (i.e. prior to the COVID-19 pandemic), swift rise in lending activity, restructuring of some stage 2 loans and COVID-19 induced regulatory forbearance measures. The BRSA said that actions taken by banks and Turkish authorities in response to weaker income and cash flows of households and companies contained the pandemic spillovers on banks' asset quality metrics.

Credit risks actually stem from the stock of foreign currency-denominated lending to Turkish borrowers, which are being pressured as the depreciating local currency is straining their FX debt service capacity. Nonetheless, Turkish banks have ameliorated their provisioning coverage ratio. Provisions for NPLs are now at 74.2% of gross NPLs, against a markedly lower 65.1% at end-December 2019.

In parallel, Turkish banks maintain adequate buffers against potential pressures on their capital base. The sector-wide capital adequacy ratio attained 19.4% at end-September 2020, rising from 18.4% at end-December 2019. This remains comfortable above the local regulatory minimum target of 12%. This also comes as the regulator has introduced forbearance measures fixing the FX rate and securities valuation to provide greater capital headroom, and as the local sovereign wealth fund has injected the equivalent of around US$ 3 billion worth of capital in the three large State banks. It is worth noting that the bulk of banks' equity consists of core capital, with the core capital adequacy ratio at 14.8% at end-September 2020.

Last but not least, Turkish banks somewhat benefited from interest rate cuts noting that deposits reprice faster than loans, which to some extent offset rising loan loss provisions and lead to an increase in net profits of the sector when expressed in TL. The net interest margin expanded from 2.74% in 9M2019 to 3.14% in 9M2020. Banks' net profits rose by 28.8% on a yearly basis (in local currency terms) in the first nine months of 2020. Yet when expressed in US dollar terms, bottom lines reported a 5.9% decline due to a net loss on the FX side of the income statement owing to FX losses and higher provisions.

All in all, authorities' credit supportive steps and regulatory forbearance measures should contribute to containing pandemic-related damage, but outsized credit activity growth in a year of unprecedented challenges worldwide might translate into future asset quality pressures and add to non-negligible external debt roller needs and large structural mismatch on balance sheets and create upward pressure on financial stability risks. Nonetheless, Turkish banks maintain comfortable capital buffers to weather credit, operational and market risks at large.

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1.4.3. Equity and Bond Markets

Price rebound in Turkish securities following November's pledges of market-friendly policies

The month of November 2020 tipped the scales in Turkey's capital markets, following pledges of a market-friendly approach to the economy that would enable an improved investment climate. This triggered a strong price rebound in Turkish securities, which allowed them to end the first eleven months of 2020 on a positive note. As to the cost of insuring debt, November's contractions resulted into reduced year-to-date expansions in Turkey's five-year CDS spreads.

In details, after contracting by 2.8% over the first ten months of 2020 amid sizeable outflows of non-resident capital, Borsa Istanbul registered a strong price rebound over the month of November, mainly on improved investor sentiment after the Turkish President vowed on November 11, 2020 to open a new era to improve investment environment in the country and support the economy with market-friendly policies. The strong price rally in Turkish equities over the month of November 2020 also tracked global equity strength, mainly on US election outcome relief and optimism of a breakthrough in the race to develop a COVID-19 vaccine, which boosted hopes of a potential global economic recovery. That being said, the BIST 100, which represents the 100 largest companies by market capitalization, reached 1,283.58 at end-November 2020, sweeping all losses incurred over the first ten months of 2020, and resulting into significant year-to-date price gains of 12.2%.

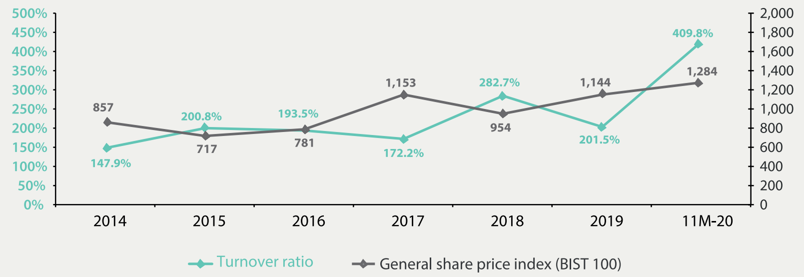
Accordingly, the market capitalization rose from US$ 186.7 billion at end-2019 to US$ 214.6 billion at end-November 2020, up by 15.0%. The total number of contracts reached 592.9 million during the first eleven months of 2020, up from 230.4 million during the corresponding period of 2019. The total trading value more-than-doubled year-on-year, moving from US$ 328.6 billion during the first eleven months of 2019 to US$ 806.2 billion during the first eleven months of 2020. Accordingly, the turnover ratio, measured by the annualized total trading value to market capitalization, reached 409.8% during the first eleven months of 2020, up from 192.8% during the corresponding period of 2019.

SELECTED STOCK MARKET INDICATORS

	2015	2016	2017	2018	2019	11M-20
Market capitalization (in US$ billion)	190.2	174.5	233.4	150.5	186.7	214.6
Market capitalization/GDP	22.0%	20.1%	27.2%	19.3%	24.5%	32.6%
Trading value (in US$ billion)	381.7	337.7	401.9	425.5	376.1	806.2
Traded volume (in millions)	214,061	234,483	356,578	436,596	548,083	1,343,838
Number of contracts (000s)	97,300	110,038	157,749	230,789	264,516	592,919
Change in share BIST 100 price index	-16.3%	8.9%	47.6%	-17.3%	19.9%	12.2%
Price/Earnings ratio (times)	14.00	10.24	11.58	9.12	10.72	18.23
Dividend Yield (%)	2.84	2.27	2.05	3.28	2.35	0.78
CDS spread (bps)	273	273	165	362	282	386

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

STOCK MARKET PERFORMANCE



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

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At the level of the bond market, Turkish bonds reversed in November 2020 the downward trajectory that was prevailing over the first ten months of 2020, as a shift to a more orthodox policy set-up swiftly reversed the ongoing risk-off sentiment for Turkish assets into a search-for-yield sentiment, triggering sizable inflows of capital, while also tracking gains in emerging debt markets on US Presidential election outcome relief and COVID-19 vaccine optimism.

Accordingly, the yield on 10-year US dollar Turkish government bonds, which hit 7.2% at end-October 2020, fell to 5.7% at end-November 2020. This compared to 6.13% at end-2019. Concurrently, the 10-year Turkish Lira Benchmark bond index yield declined from 14.45% at end-October 2020 to 12.29% at end-November 2020, and compared to 12.21% at end-2019. Within this context, it is worth mentioning that non-resident investors were net sellers of Turkish bonds over the first eleven months of the year 2020, as reflected by a US$ 9.3 billion contraction in their holdings, moving from US$ 15.4 billion at end-2019 to US$ 6.1 billion towards the end of November 2020, noting that non-resident investors added to their holdings during the month of November .

Following an across-the-board monthly price rally in November 2020, some Turkish sovereigns and papers issued by financial institutions managed to end the first eleven months of 2020 with price gains. For instance, sovereigns maturing in March 2023 posted price rises of 1.71 pt during the first eleven months of 2020. Turkey'40 closed up by 0.82 pt. Amongst financials, Yapibank'26 posted price increases of 0.28 pt. Akbank'27 closed up by 0.04 pt. Garanti Bank'27 registered price expansions of 1.15 pt.

Concurrently, the cost of insuring debt in Turkey saw significant monthly contractions of 173 bps in November 2020 to reach 386 bps. This helped reducing expansions in the country's five-year CDS spreads from 277 bps over the first ten months of 2020 to 104 bps over the first eleven months of the year.

Regarding new issues, Turkey raised US$ 8.75 billion this year through the sale of US$ 2.0 billion senior unsecured bonds maturing in 2025 at a coupon of 4.25%, US$ 2.0 billion senior unsecured bonds maturing in 2030 at a coupon of 5.25%, US$ 2.5 billion senior unsecured bonds maturing in 2025 at a coupon of 6.375% and US$ 2.25 billion senior unsecured bonds maturing in 2031 at a coupon of 5.95%.

At the level of credit rating changes, Standard and Poor's affirmed in July 2020 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 a "stable" outlook. The "stable" outlook balances, according to S&P, the lingering downside economic risks stemming from the pandemic over the next 12 months against the resilience of Turkey's private sector, and the still-contained stock of net general government debt.

Fitch revised in August 2020 the outlook on Turkey's long-term Issuer Default Ratings to "negative" from "stable" and affirmed the IDRs at "BB-". The revision of the outlook reflects, according to Fitch, a depletion of foreign exchange reserves, weak monetary policy credibility, negative real interest rates, and a sizeable current account deficit partly fueled by a strong credit stimulus, which have exacerbated external financing risks.

In parallel, Moody's downgraded in September 2020 Turkey's issuer and senior unsecured debt ratings to "B2" from "B1" and downgraded its senior unsecured shelf rating to "(P)B2" from "(P)B1", with a "negative" outlook, citing Turkey's external vulnerabilities, which are increasingly likely to crystallize in a balance of payments crisis, and the country's eroding fiscal buffers.

Looking forward, an embark into structural reforms to improve the investment environment and increase the depth of the financial markets could, if firmly materializing, send positive messages to the investment community, allowing the country's risk premium to contract further in international markets.

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CONCLUSION

Looking forward, following the 2020 net contraction in real output, the Turkish economy is expected to grow by 5% in 2021 according to the IMF projections in its World Economic Outlook published mid-October, due mainly to a low base effect. That said, the biggest downside risk to such a forecast stems from the uncertainties related to the Pandemic in addition to FX volatility.

At the monetary level, the lira is not likely to recover its registered losses for a number of reasons. Given a net negative reserve position, there is a chance that the Central Bank starts intervening in FX. The recovery in the lira can give another boost to imports, in which case a stronger local currency may not be desirable to the authorities. In addition, geopolitical risks and risks from the second wave of COVID (especially from European lockdowns impacting Turkish exports) remain.

With respect to the external sector, external imbalances for Turkey remain an important source of vulnerability. Though short-term external debt repayment obligations seem manageable, increasing current account imbalances, declining foreign exchange reserves, and currency pressures raise Turkey's overall external vulnerability.

The significant accumulation of external vulnerabilities means that Turkey's current choices in terms of monetary and fiscal policies to reverse previous trends are likely to prove ultimately detrimental to growth and financial stability. And given the country's track record over the past five years, there is significant uncertainty regarding the willingness of the authorities to change course and implement policies that would sustainably address the country's credit challenges and steer the economy away from a more credit-negative path.

Another challenge is to prevent the current health induced economic shock to undermine financial stability. While a swift policy response is welcome and necessary, over extension of forbearance measures may be pushing the authorities deep into uncharted territory, with possible unintended effects over financial stability. Prudence in regulatory and supervisory responses should prevail in order to avoid financial stress at a later stage that would amplify the current impact of the COVID shock. Linked to this, Turkey's efforts to implement structural reforms and to increase productivity should gain traction. A key element to this is the deepening of its financial system and enhancing its resilience, including through greater access to long-term finance.

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 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 observed relative recovery of Turkey's private sector over the second half-year.

Yet, a number of risk factors continue to dominate the near term outlook. Among these, we mention the sluggish economic growth on the back of COVID-19, 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, the depletion of foreign exchange reserves and the sizeable current account deficit partly fuelled by a strong credit stimulus,

Finally, Turkey will need to transition from policies focused on short-term economic relief to building resilience and accelerating recovery, as well portrayed by the recent World Bank report on Turkey. Among priorities in this regard going forward is monetary discipline, essential to anchor economic expectations and restore investor confidence; the absence of this may fuel a vicious cycle of capital outflows, currency pressures, erosion of external buffers, price pressures and back around again. Turkey can on the other hand afford to maintain responsive and flexible fiscal policy to manage the difficult recovery ahead, ensuring that short-term responses are consistent with fiscal sustainability at large.

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