Bank Audi

TURKEY ECONOMIC REPORT

NOVEMBER 2022

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BUOYANT GROWTH RECOVERY THIS YEAR, BUT NET SLOWDOWN EXPECTED FOR THE YEAR AHEAD AMID CHALLENGING GLOBAL/DOMESTIC ENVIRONMENT

Buoyant recovery this year amid stimulative policies

Growth rebounded strongly from the initial impact of the pandemic, reflecting a dynamic private sector and stimulative policies. Turkey's economy expanded by 7.5% year-over-year in the first half of 2022 (latest available official figures), amid increasing indications of overheating. In the first half of 2022, according to official data, private consumption rose by 22% year-on-year in real terms, reflecting, among other things, households' preference to accumulate inventories of consumer durables and other merchandise as a hedge against inflation and exchange rate volatility. Private investment (particularly machinery and equipment investment) and consumption of durables have been major contributors to growth, despite the persistently high cost of borrowing and easing of fiscal support.

Current account deficit position widened significantly this year

This year has seen a wider gap in the current account deficit (US$ 39.7 billion) over the first eight months when compared with the corresponding period of year 2021, with the annual deficit forecast set at 5.5% of GDP this year (from 1.7% in full-year 2021). This came on the back of bigger goods account deficit, despite the increase in services account surplus due to travel item as per Central Bank of the Republic of Turkey. The government expects a bigger total trade deficit for 2022 mostly on the back of high global commodity prices and because of a slowdown in external demand in the second half-year.

Material weakening of public finance as budgetary pressures increase considerably

Turkey's public finances posted a rising central government fiscal deficit over the first nine months of 2022 when compared to the same period of the previous year, on the back of a higher wage and public-sector pension bill as well as earlier tax reductions which aimed to protect households from the full effect of high inflation, with central government fiscal deficit forecasted at 4.5% of GDP in 2022, as per Moody's assumptions. The central government debt stock reached TL 3,675 billion (or US$ 198 billion) as at end-September 2022, as per the latest figures released by the Ministry of Finance, recording a significant increase of 33.7% from TL 2,748 billion as at end-December 2021.

Turkish Lira spiraling downwards amid continuously loose monetary policy

The year 2022 saw the Turkish Lira spiraling downwards to hit new depths, while the Central Bank of Turkey maintained its loose monetary approach despite soaring inflation to more than two-decade highs. In details, the Turkish Lira crashed to new fresh lows in 2022, to reach TL/US$ 18.59 mid-November, compared to TL/US$ 13.32 at end-December 2021, down by circa 40%. With the Turkish Lira tumbling to its weakest level, the annual inflation rate accelerated to 85.5% in October 2022, up from 36.1% in December 2021.

Stable banking activity, yet with deteriorating asset quality

Banking aggregates almost stabilized YTD when expressed in US dollars. Banking activity, measured by total assets, slightly rose by 1.7% in US$ terms over the first nine months of 2022 to reach US$ 710 billion at end-September. Bank deposits expanded by 8.7% to US$ 437 billion over the same period, while loans contracted slightly by 0.1% to US$ 370 billion. Higher inflation in 2022 will be positive for banks' revenues, increasing gains from consumer price index-linked securities. However, this will likely be offset by increased provisioning needs and deeply negative real interest rates, which will weaken profitability in real terms. Also, bank asset quality could face further pressure because about 37% of loans were denominated in foreign currency, effectively making this debt more expensive to service as the lira depreciates.

Net slowdown expected for the year ahead amid challenging global/domestic environment

The global environment has become significantly more challenging, as financial conditions have tightened globally and Turkiye's main export markets in Europe face a slowdown in growth amid an energy crisis and continued supply chain challenges. While a gradual economic slowdown is expected in the second half of this year and into next year – the IMF forecasts Turkey's real GDP growth of 5.0% and 3.0% for 2022 and 2023 respectively, – the risk of a sharper slowdown is also material. A sharp slowdown would negatively impact the labour market, the strength of public finances and raise social and political risks. External refinancing options – important for the private sector as the main borrower abroad – might become more constrained if the economy slows sharply.

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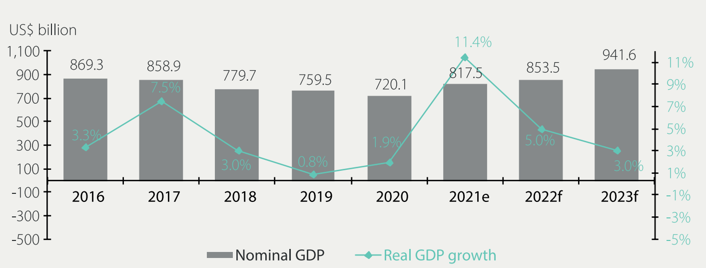
Growth rebounded strongly from the initial impact of the pandemic, reflecting a dynamic private sector and stimulative policies. Turkey's economy expanded by 7.5% year-over-year in the first half of 2022 (latest available official figures), amid increasing indications of overheating. In the first half of 2022, according to official data, private consumption rose by 22% year-on-year in real terms, reflecting, among other things, households' preference to accumulate inventories of consumer durables and other merchandise as a hedge against inflation and exchange rate volatility. Private investment (particularly machinery and equipment investment) and consumption of durables have been major contributors to growth, despite the persistently high cost of borrowing and easing of fiscal support.

At the external level, the current-account deficit has widened significantly, standing at US$ 39.7 billion in the first eight months of the year, compared to a deficit of US$ 12.8 billion over the same period a year earlier, with the strong increase in energy imports a key contributor. Moody's now expects a significantly wider current account deficit for the year, at close to 6% of GDP, compared to their expectation of a deficit of 1.7% of GDP prior to the Russian invasion of Ukraine. Exports rose by 17.0% in the first nine months of 2022 relative to the 2021 similar period. They moved from US$ 160.8 billion to US$ 188.2 billion respectively. The tourism season was particularly strong, which helped buoy demand and boosted foreign currency in the economy, contributing to stabilizing confidence.

In parallel, current reported inflation of 80% exceeds by far the 5% medium-term target. Besides energy, the continuing deprecation of the lira drives inflation. Loose monetary and fiscal policy settings, along with low net foreign currency reserve levels, underscore the Turkish lira's vulnerability to renewed volatility, with implications for financial stability and public finances. Ahead of 2023 Parliamentary and Presidential elections, Turkish monetary policymakers are prioritizing growth over financial and monetary stability. At the same time, authorities have introduced reserve and collateral requirements that appear to be aimed at suppressing foreign currency demand and lowering market interest rates, including government domestic yields to levels far below reported inflation. Since September 23, 2021, the CBRT has lowered its key reference rate by a cumulative 700 basis points. In the run-up to 2023 elections, broader fiscal risks are also on the rise as measured by the widening overall public deficit and the dollarization of the sovereign's on- and off-balance-sheet liabilities.

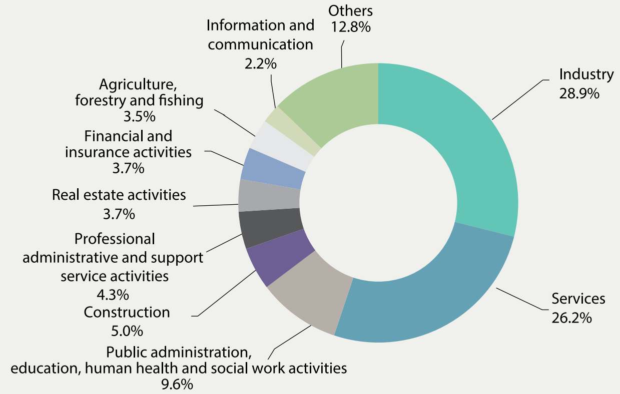
At the banking sector level, banking aggregates almost stabilized YTD when expressed in US dollars. Banking activity, measured by total assets, slightly rose by 1.7% in US$ terms over the first nine months of 2022 to reach US$ 710 billion at end-September. Bank deposits expanded by 8.7% to US$ 437 billion over the same period, while loans contracted slightly by 0.1% to US$ 370 billion. Higher inflation in 2022 will be positive for banks' revenues, increasing gains from consumer price index-linked securities. However, this will likely be offset by increased provisioning needs and deeply negative real interest rate, which will weaken profitability in real terms. Also, bank asset quality could face further pressure because about 37% of loans were denominated in foreign currency (as of mid-September 2022), effectively making this debt more expensive to service as the lira depreciates.

GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (H1 2022)



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

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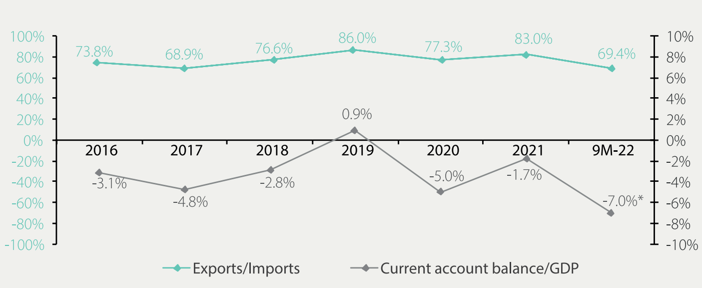
At the capital markets level, the stock market witnessed a flourishing performance this year, with a 114% rise in the BIST 100 price index, raising market capitalization from US$ 163.7 billion at end-2021 to US$ 239.8 billion at end-October 2022. As such, market capitalization to GDP moved from 20.0% to 28.1% respectively. The rise in prices was accompanied by a surge in trading volumes. The latter reported 1,241 billion shares in the first ten months of 2022, exceeding the total of full-year 2021 (1,203 billion shares). Paradoxically, the fixed income market witnessed further pressures, with the CDS spread, rising from 563 basis points at end-2021 to 661 basis points at end-October 2022 (against 304 basis points at end-2020).

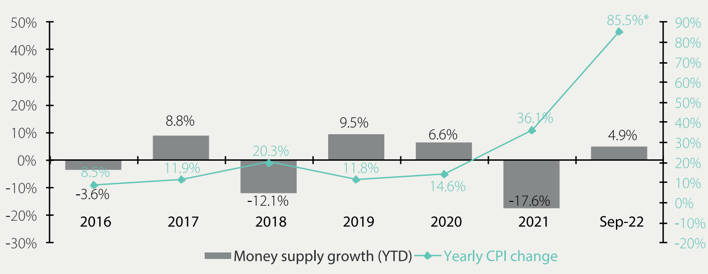
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economic, financial and monetary conditions looking ahead.

FOREIGN SECTOR INDICATORS



Sources: Central Bank of Turkey, IMF, Bank Audi'Group Research Department
**Eight months figures annualized as a percentage of GDP*

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

Turkey's primary sector takes a downturn this year

The agriculture sector entered into a contractionary mode this year amid higher food price inflation, fertilizer shortages, soaring input costs and aftershocks from COVID-19 and the Russia-Ukraine crisis. The sector reported a real contraction of 2.4% in the first half of 2022, after remaining stable in real terms in the same period of the previous year. In parallel, the share of the sector in the country's GDP edged slightly from 3.4% in the first half of 2021 to 3.5% in the same period of this year.

At the level of crop production, the latter traced a downward trajectory in 2021, sweeping away all gains registered over the previous year. Total cereals and other crops fell by 11.0% in 2021 after rising by 10.8% in 2020 to stand at 62,774 thousand tons.

A closer look at sub-categories shows that the largest contraction in 2021 was in dry pulses production (-18.7%), followed by Cereals with -14.3%, Sugar beets (-13.1%), potatoes (-5.3%), Tobacco (-4.6%) and plants for perfumery and pharmacy (-2.0%). The weak production is mainly associated with the drought experienced in the first half of 2021 in the Southern and Central Anatolian regions alongside with the heavy rain that occurred in July 2021, which have damaged soil conditions. This was exacerbated by a lower harvesting area and higher input costs (arising in part from the depreciation in the value of the Turkish lira), as per Fitch Solutions. In contrast, the growth in raw materials used in textiles was significant (+26.9%), followed by oil seeds with +15.5%.

Al the level of vegetables and other crops, production increased by 1.8% in 2021, following a 0.3% rise in the previous year. Total fruits, beverage and spices crops reported an annual rise of 5.5%, down from a growth of 5.8% in 2020. This is mainly explained by the country's growing health consciousness, and the reduced demand for meat and poultry due to high inflation, and as the general weakness in the economy continued to weigh on low and mid-income household spending.

While persistent droughts and poor water infrastructure remain a downside risk to production, growth in production is anticipated to bounce back in 2022 and 2023 provided that the outbreak of rice blast disease is brought under control and due to better seed technology and irrigation systems, and as the government may also extend its financial support to the sector in an effort to limit food price inflation, as per Fitch Solutions.

CROP PRODUCTION IN 2021 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share		Volume	Share		Volume	Share
Cereals	**31,870**	**51%**	**Vegetables**	**25,614**	**81%**	**Fruits**	**16,307**	**66%**
o.w. Wheat	17,650	28%	o.w. Tomatoes	13,095	41%	o.w. Citrus fruits	5,363	22%
o.w. Barley	5,750	9%	o.w. Watermelon	3,469	11%	o.w. Pome fruits	5,216	21%
o.w. Maize	6,750	11%	o.w. Cucumber	1,890	6%	o.w. Stone fruits	2,935	12%
Sugar beets	**18,250**	**29%**	o.w. Melon	1,639	5%	o.w. Bananas, Kiwis, Avocado, Figs	1,299	5%
Potatoes, dried legumineus	**6,156**	**10%**	o.w. Pepper (green)	1,065	3%	o.w. Other fruits	1,494	6%
Oil seeds	**3,026**	**5%**	**Bulb and root vegetables**	**3,875**	**12%**	**Grapes**	**3,670**	**15%**
Dry pulses	**1,054**	**2%**	o.w. Dry onion	2,500	8%	**Olive production**	**1,739**	**7%**
Raw materials used in textiles	**2,250**	**4%**	o.w. Carrots	590	2%	**Tea production**	**1,450**	**6%**
Plants for perfumery, pharmacy	**95**	**0%**	**Other vegetables**	**2,264**	**7%**	**Nuts**	**1,384**	**6%**
Tobacco	**73**	**0%**	o.w. Leafy or edible stem vegetables	1,863	6%	**Spices crops**	**332**	**1%**
Total Cereals and other crops*	**62,774**	**100%**	**Total Vegetables & other crops**	**31,753**	**100%**	**Total Fruits, nuts & spices crops**	**24,882**	**100%**

**Excluding fodder crops*

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

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Within this context, the Ministry of Agriculture and forestry unveiled that production quantities of cereals and other crops are expected to increase by 14.3% in 2022, while fruits, beverage and spices crops are estimated to grow by 3.8% when compared with the previous year. As to vegetables production, the latter is forecast to remain the same when compared with the previous year, according to the said Ministry.

1.1.2. Industry

Slowdown in Turkey's industrial sector in the first half of 2022

Turkey's industrial sector saw a softening of demand and a slowdown in activity during the first half of 2022 amid challenging global and domestic conditions. In nominal terms, the share of the sector in Turkey's GDP rose from 26.0% in the first half of 2021 to 28.9% during the same period of 2022. In real terms, the sector registered a slower growth over the first half of 2022, improving by 8.0% following a larger growth of 24.8% in the same period of 2021 stoked by a post-pandemic recovery.

Similarly, Turkey's Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, expanded by a yearly 7.8% during the first nine months of 2022 against a higher growth of 18.6% in the same period of last year, as per Turkstat.

While a loose monetary policy remains supportive for industrial production, the pace of growth of the latter has slowed in 2022, mainly due to a wider global economic slowdown and supply chain disruptions caused by the Russia-Ukraine war, which led to a lower foreign demand, in addition to challenging domestic economic conditions as an extended currency collapse and rising energy and raw material prices globally weighed on both input and output costs, reducing the local demand.

Looking at the breakdown of the sector, the manufacturing sector, which contributes to almost 23.9% of nominal GDP, expanded by 8.5% year-on-year during the first half of 2022 against a growth of 27.1% in the same period of last year.

The Purchasing Managers' Index (PMI) for manufacturing stood at 46.4 during the first 10 months of 2022, down from 51.20 in 2021 same year, slipping back below the 50-point line that separates expansion and contraction. Both new orders and production slowed as per the latest PMI survey data, while firms scaled back their purchasing activity and employment accordingly.

Turkey's construction sector, which makes up 5.0% of GDP, reported a yearly contraction of 9.4% in real terms during the first half of 2022, compared to an expansion of 4.1% in the first half of 2021. In fact, high costs of raw materials, disruptions of the supply chains, and currency weakness dented the industry's attractiveness for investment. However, the construction sector's long-term prospects remain strong, according to Fitch Solutions, amid Turkey's preference for large-scale infrastructure projects.

VEHICLES PRODUCTION

(unit)	2019	2020	2021	21/20	9M-21	9M-22	9M/9M
Automobile	982,642	854,913	782,212	-8.5%	570,031	571,454	0.2%
Pick-up	386,246	358,182	399,949	11.7%	286,286	316,507	10.6%
Minibus	61,668	51,464	46,878	-8.9%	33,981	36,376	7.0%
Tractor	23,899	38,103	55,503	45.7%	41,210	34,908	-15.3%
Truck	19,003	23,126	38,465	66.3%	24,696	32,404	31.2%
Bus	9,212	7,893	5,517	-30.1%	3,913	5,460	39.5%
Midibus	2,550	2,043	2,153	5.4%	1,554	2,269	46.0%

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

In conclusion, Turkey's industrial sector slowed down in 2022 after a strong post-pandemic recovery in the previous year, as a global economic downturn and challenging domestic economic conditions and a currency collapse to an all-time low, weighed on industrial activity at large.

1.1.3. Trade and Services

Turkey's tertiary sector poised for 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 previous year. In real terms, the sector witnessed an expansion of 12.8% in the first half of 2022, following a similar level of expansion in the first half of 2021 reaching around 12.5%, continuing in the same recovery pace after the pandemic that revealed a contraction of 3.4% in the respective phase of year 2020.

In nominal terms, Turkey's trade and services sector maintained a significant share of around 49.7% of the country's GDP in the first half of this year. Its level in the same period of last year yet constituted around 55% of the nominal GDP. The trade and services sector encompasses 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.

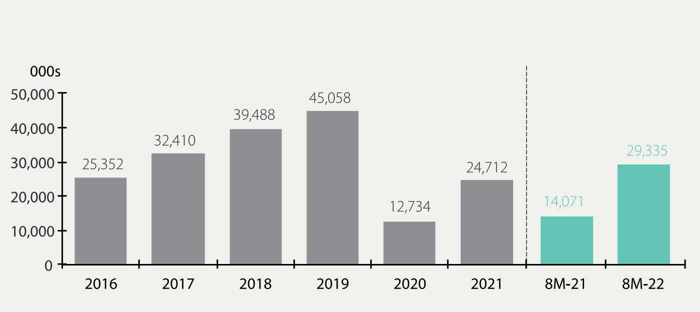
It is worth highlighting that tourism is a major part of the Turkish economy where the sector is set to constitute 11% of Turkey's GDP in 2023, according to the London-based World Travel & Tourism Council.

In a detailed look, Turkey's tourism sector posted a notable recovery this year. The number of foreigner arrivals reached 34.8 million, representing a growth of 55.8% year-on-year in the first nine months of 2022 against 17.6 million foreign arrivals during the respective period of previous year, as per data released by the Turkish Ministry of Culture and Tourism.

Tourism receipts also posted an amelioration of 196.5% in the first half of 2022 against first half of 2021, following an increase of 17.2% in the same half of 2021/2020. It is worth noting that Turkey's international tourism receipts will grow by a projected 36.1% year-on-year in 2022 to US$ 36.7 bn, as forecasted by Fitch.

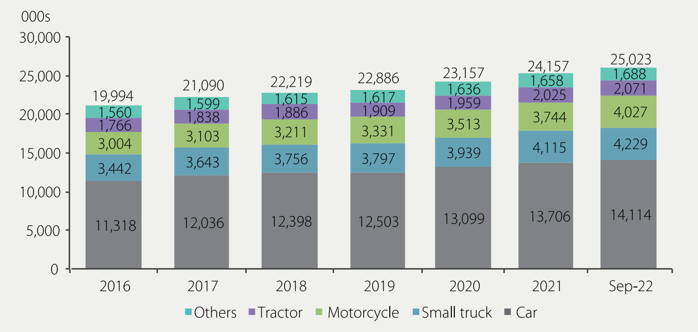
Increasing low-cost flight connections, a competitive currency and sound tourism infrastructure across Istanbul, Antalya and the Mediterranean coast continue to offer excellent leisure and cultural tourism options across a range of budgets. In addition, the notable Turkish government's decision to open the international borders from early June 2020 resulted in the country encountering a resilient industry comeback, with direct flights to Istanbul, Antalya, Bodrum, Izmir and Dalaman from the UK, Russia, Kazakhstan and Ukraine.

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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Despite the Russia-Ukraine conflict and its sanctions consequences, Russian tourists still represent a key source of arrivals for Turkey constituting around 16% of total foreign arrivals in September 2022.

It is worth mentioning that over the July-October period, major hotel groups across Bodrum, Belek, Göcek, Dalaman and Marmaris reported high occupancy, suggesting that limited pent-up demand potential was being unlocked, as per Fitch.

The hotel occupancy rate hit a high of 70% in the first seven months of 2022, noting that in July 2019, when the COVID-19 pandemic had not yet hit the global travel and tourism industries, the occupancy rate at Turkish hotels was 75.6%.

In the first seven months of the year, more than 8.5 million tourists visited Istanbul. In the whole of 2021, the city welcomed 9 million tourists. In Antalya, the hotel occupancy rate rose by 38% year-on-year to 59.8% over the first seven months of the year. Moreover, the hotel occupancy rate in Anatolian provinces increased by 28% to reach 51.2% over the same mentioned period, as per TÜROB.

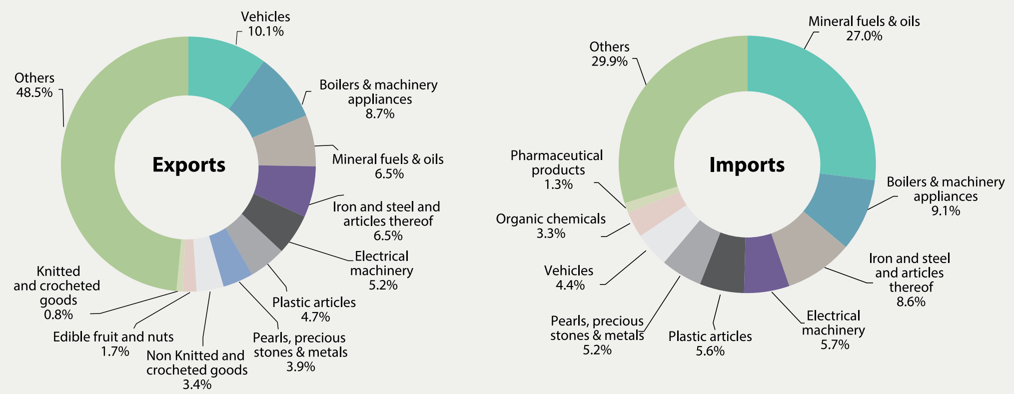
Finally, the economic confidence index in Turkey rose to 97.1 in October of 2022, up from 94.3 in the previous month. It was the highest reading since February as confidence improved in all sectors: service providers (119.3 vs.118.2 in September), retailers (119.4 vs. 115.9), consumers (76.2 vs 72.4), and constructors (90.5 vs. 88.1) and manufacturers (102 vs. 100.2), TurkStat data revealed.

1.2. EXTERNAL SECTOR

Current account deficit position widened significantly this year

This year has seen a wider gap in the current account deficit (US$ 39.7 billion) over the first eight months of 2022 when compared with last year's corresponding period, after witnessing a narrowed deficit gap in 2021. This came on the back of bigger goods account deficit, despite the increase in services account surplus due to travel item as per Central Bank of the Republic of Turkey. The government expects a bigger total trade deficit for 2022 mostly on the back of high global commodity prices and because of a slowdown in external demand in H2. It is worth noting that the government's focus on maintaining high growth feeds FX demand, depreciation pressures on the Turkish Lira, decline in international reserves and spiraling inflation and discourages capital inflows to fund the higher current account deficit.

BREAKDOWN OF EXPORTS AND IMPORTS BY MAIN COMMODITIES (9M-22)



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

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In details, Turkish exports reached US$ 188.2 billion over the first nine months of 2022, representing an increase of 17.0% year-on-year as per the Turkish Statistical Institute and the Ministry of Trade, 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 (10.1% of total exports), boilers and machinery appliances (8.7%), iron and steel (6.5%), electrical machineries (5.2%), plastic articles (4.7%), and knitted and crocheted goods (0.8%). The geographic distribution of domestic exports indicates that 8.4% of total exports went to Germany, followed by the United States of America with 6.8% of the total, Iraq with 5.3%, United Kingdom with 5.2%, Italy with 4.9% of total domestic exports over the same period.

In parallel, Turkish imports reported a rise of +40.4% over the first nine months of 2022 when compared to the same period of 2021, to reach US$ 271.2 billion, as global consumer demand witnessed an incline due to resuming business sentiment 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 2022 were mineral fuels and oils (27.0% of total imports), followed by boilers and machinery appliances (9.1%), iron and steel (8.6%), electrical machinery (5.7%), plastic articles (5.6%), precious stones (5.2%), vehicles (4.4%) and organic chemicals (3.3%). The breakdown of imports by country of origin shows that most of the inward merchandise came from Russia with 16.5% of the totals, followed by China with 11.7%, Germany with 6.4%, USA with 4.4%, Italy with 3.8% and India with 3.1% of total imports over the same period.

Within this context, the cumulative trade deficit surged by 156.3% over the first nine months of 2022 when compared to the same period of 2021 to reach US$ 83.1 billion. As such, Turkey's current account, non-monetary gold and energy foreign trade, witnessed a wider deficit of US$ 39.7 billion in 8M-2022 compared to a deficit of US$ 10.9 billion in 8M-2021, despite a recovery in tourism. Higher energy prices and weaker external demand will result in a current account deficit for about 5.5% of GDP in 2022, as per S&P.

1.3. PUBLIC SECTOR

Material weakening of public finance as budgetary pressures increase considerably

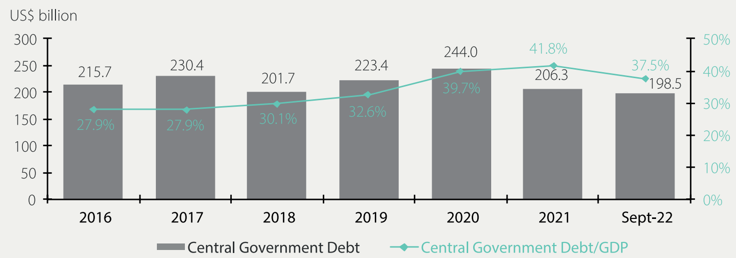
Turkey's public finances posted a rising central government fiscal deficit over the first nine months of 2022 when compared to the same period of the previous year, on the back of a higher wage and public-sector pension bill as well as earlier tax reductions which aimed to protect households from the full effect of high inflation, with central government fiscal deficit forecasted at 4.5% of GDP in 2022, as per Moody's assumptions.

SELECTED PUBLIC FINANCE INDICATORS

TL billion	2020	2021	21/20	9M-21	9M-22	9M/9M
Central government budget revenues	**1,029.5**	**1,407.4**	**36.7%**	**990.56**	**1,975.26**	**99.4%**
o.w. Tax revenues	833.1	1,164.8	39.8%	808.4	1,648.0	103.8%
o.w. Non-tax revenues	196.4	242.6	23.5%	182.1	327.3	79.7%
Central government budget expenditures	**1,202.2**	**1,599.64**	**33.1%**	**1,051.6**	**2,020.8**	**92.2%**
o.w. Primary expenditures	1,068.3	1,418.8	32.8%	909.4	1,813.6	99.4%
o.w. Interest	134.0	180.9	35.0%	142.3	207.1	45.6%
Central government budget cash balance	**-171.5**	**-130.0**	**-24.2%**	**-66.0**	**-67.8**	**2.7%**

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

PUBLIC INDEBTEDNESS



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

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In details, the central government budget revenues witnessed a hike in growth of 99.4% during the first nine months of 2022 when compared to the same period of 2021 to reach a total of TL 1,975 billion (or US$ 124.1 billion), mainly driven by a 100.4% year-on-year increase in general budget revenues to TL 1,932 billion, of which tax revenues rose by 103.8% to reach TL 1,648 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 79.7% year-on-year over the covered period.

On the spending side, a growth of 92.2% in central government budget expenditures was recorded over the first nine months of 2022 compared to the same period of 2021, to reach TL 2,021 billion (US$ 127.0 billion), mainly due to a 99.4% expansion in primary expenditures to reach TL 1,814 billion, and a 45.6% rise in interest expenditures to TL 207 billion. A breakdown of primary expenditures shows a 69.5% yearly increase in compensation of employees to reach TL 441 billion, good and services purchases revealed a rise of 120.4% (TL 149 billion), current transfers went up by 89.3% year-on-year to reach TL 829 billion, of which Treasury aid grew by 53.9% to TL 337 billion and shares from revenues increased by 102.8% to TL 249 billion, and capital expenditures expanded by 97.5% to TL 128 billion over the same period. On another hand, interest expenditures showed a 23.5% increase in domestic interest payments during the first nine months of 2022 to TL 118 billion, as well as a 108.4% surge in foreign debt interest to TL 63 billion.

That being said, the central government budget deficit (on a cash basis) has increased by 2.7% over the first nine months of 2022, reaching circa TL 68 billion (US$ 3.7 billion) as compared to a deficit of TL 66 billion during the same period of 2021.

Last but not least, the central government debt stock reached TL 3,675 billion (or US$ 198 billion) as at end-September 2022, as per the latest figures released by the Ministry of Finance, recording a significant increase of 33.7% from TL 2,181 billion as at end-September 2021. This is mainly driven by a 94.7% rise in the external debt over the first nine months of 2022 to reach TL 1,936 billion at end-September (accounting for circa 53% of the total debt stock), and a 46.5% increase in the domestic debt over the covered period to reach TL 1,738 billion at end-September (accounting for the remaining 47%). The general government debt is estimated at around 37% of GDP in 2022 compared to 42% of GDP in 2021, according to Moody's.

The currency composition of government debt shows that the foreign currency debt accounted for 65.7% of the total debt stock at end-September 2022, up from 39.0% 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.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Turkish Lira spiraling downwards amid continuously loose monetary policy

The year 2022 saw the Turkish Lira spiraling downwards to hit new depths, while the Central Bank of Turkey maintained its loose monetary approach despite soaring inflation to more than two-decade highs.

In details, the Turkish Lira crashed to new fresh lows in 2022, crossing the TL/US$ 18 threshold starting August 18 to reach TL/US$ 18.59 mid-November, compared to TL/US$ 13.32 at end-December 2021, down by 39.6%. The currency collapse came within the context of the Central Bank of Turkey's continuous commitment to a loose monetary policy despite runaway inflation, and as a stronger US dollar fueled by an aggressive US Fed monetary tightening approach continued to pull funds from emerging markets. That being said, it is worth noting that the discrepancy between loose Turkish monetary policy and massive tightening seen across the globe to tame raging inflation let the Turkish lira be one of the worst emerging-market currencies this year.

As to currency volatility, the Turkish Lira three-month realized or historical volatility, which reflects the actual volatility derived from a time series of currency spot prices over a specific historic time horizon, slowed to 14.91% mid-November 2022, down from a peak level of 60.98% late December 2021, as pressures on the lira were relieved by FX interventions and a new "FX-protected" deposit scheme.

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With the Turkish Lira tumbling to its weakest level, the annual inflation rate accelerated to 85.5% in October 2022, up from 36.1% in December 2021. Skyrocketing consumer prices have been driven by the lagged and indirect effects of rising energy costs resulting from geopolitical developments, effects of pricing formations that are not supported by economic fundamentals, in addition to strong negative supply shocks caused by the rise in global energy, food and agricultural commodity prices.

Despite scorching inflation, the Central Bank of Turkey slashed its one-week repo rate three times over the August-October 2022 period by a total of 350 bps, after it had kept rates on hold at 14.0% since end-2021, to reach 10.50% in October 2022. Within this context, the Central Bank of Turkey emphasized that it is critically important that financial conditions remain supportive to preserve the growth momentum in industrial production and the positive trend in employment in a period of increasing uncertainties regarding global growth as well as further escalation of geopolitical risks. Concomitantly, the overnight lending rate was cut from 15.50% at end-December 2021 to 12% at end-October 2022. The overnight borrowing rate was reduced from 12.50% to 9% over the covered period. The late liquidity window lending rate reached 15.0% at end-October 2022 as compared to 18.50% at end-December 2021.

In parallel, the CBRT's gross foreign exchange reserves ticked upward this year, moving from US$ 72.6 billion at end-2021 to US$ 74.8 billion at end-October 2022. The reserve increase is mainly explained by currency swap agreements, currency reserve requirements and money transfers from Russia for the construction of a nuclear power plant.

Finally, it is worth mentioning that Turkey's Central Bank has recently put the finishing touches to a reserve-management system that has helped stabilizing the lira currency ahead of elections in 2023. The policy, adopted in the wake of a historic currency crash, relies largely on foreign funds obtained from export revenues, foreign homebuyers and other sources to balance the market's supply and demand. In the coming period, the IMF recommends early policy rate hikes accompanied by moves to strengthen the Central Bank's independence. Such moves, according to the Fund, would help reduce inflation more durably and allow reserve buffers to be rebuilt over time.

1.4.2. Banking Activity

Stable banking activity, yet with deteriorating asset quality

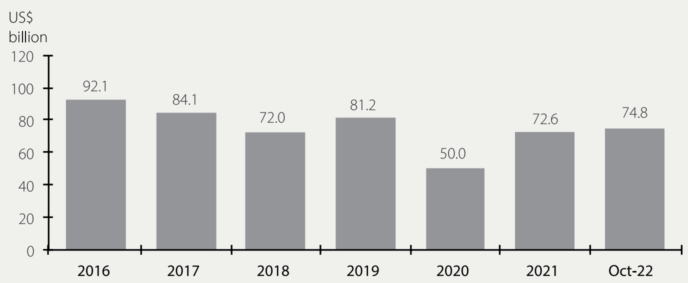
At the banking sector level, banking aggregates almost stabilized YTD when expressed in US dollars. Banking activity, measured by total assets, slightly rose by 1.7% in US$ terms over the first nine months of 2022 to reach US$ 710 billion at end-September. Bank deposits expanded by 8.7% to US$ 437 billion over the same period, while loans contracted slightly by 0.1% to US$ 370 billion. Higher inflation in 2022 will be positive for banks' revenues, increasing gains from consumer price index-linked securities. However, this will likely be offset by increased provisioning needs and deeply negative real interest rates, which will weaken profitability in real terms. Also, bank asset quality could face further pressure because about 37% of loans were denominated in foreign currency (as of mid-September 2022), effectively making this debt

MONETARY SITUATION

Flows in US$ million	2016	2017	2018	2019	2020	2021	9M-22
Net foreign assets	**10,473**	**-8,997**	**20,424**	**32,155**	**-20,152**	**32,772**	**4,670**
Foreign assets	7,474	6,460	-293	13,508	-18,067	24,265	4,444
Foreign liabilities	2,999	-15,457	20,717	18,647	-2,085	8,507	226
Domestic Assets	**-30,472**	**56,129**	**-93,550**	**16,749**	**57,075**	**-137,711**	**19,555**
Claims on private sector	-20,274	53,758	-96,429	-1,738	32,940	-117,296	-2,225
Claims on public sector	-10,070	61	5,935	17,675	23,120	-18,404	20,305
Claims on non-bank financial institutions	-128	2,311	-3,056	812	1,014	-2,011	1,475
Total Money Supply	**-19,869**	**47,064**	**-70,853**	**46,570**	**36,923**	**-104,938**	**24,225**
Money Supply (M1)	2,276	1,522	-23,310	11,055	-1,592	-14,172	5,596
Quasi-Money	-13,655	28,670	-42,816	39,129	33,913	-56,260	15,786
Other Items (Net)	-8,490	16,872	-4,727	-3,615	4,602	-34,506	2,843

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

more expensive to service as the lira depreciates.

In its Bank System Outlook this year, Moody's expects Turkish banks' asset quality to deteriorate in 2022 as slowing growth and very high inflation weigh on borrowers' repayment capacity. They also expect a lingering impact from the pandemic related economic slowdown, principally affecting lenders with high exposure to small and medium sized businesses and the construction, tourism, real estate and energy sectors. In 2021, problem loans fell to 3.7% of total loans from 4.5% in 2020, while Stage 2 loans under the IFRS 9 accounting standard - those where credit risk has increased but which continue to perform - increased by 100 bps to 11.8%. The decline in the problem loan ratio reflected a combination of lending growth and a rise in the value of foreign currency loans in local currency terms.

Moody's also expects exchange rate volatility and aggressive credit growth to keep Turkish banks' capital under pressure. The sector's aggregate capital adequacy ratio (CAR), including regulatory forbearance was 18.4% of risk-weighted assets (RWAs) at the end of 2021, down from 18.7% in 2020. The deterioration removing the benefit of regulatory forbearance was significant reflecting currency depreciation of 44% against the US dollar and loan growth of 37%. Stripping out regulatory forbearance lowers the capital adequacy ratio by 300 basis points. During the outlook period, pressure on Turkish banks' capital will be partly offset by profit retention. Capital levels of the State-owned banks has also been supported by injections from the government to promote lending growth. Such injections have replenished State-owned banks capital buffers following weakening of Turkish Lira combined with domestic currency loan growth.

Profitability will be broadly stable. Higher lending rates and income from inflation-linked investments will drive continued growth in interest income, partly offset by moderately higher deposit costs. Operating costs will also rise as a result of high inflation, while asset quality deterioration will push up provisioning expenses. Overall, Moody's expects net income to tangible assets to remain on average around the 2021 level of 1%. The performance of State and private banks is diverging, with profitability falling at State banks as high volumes of low rate loans originated during the pandemic squeeze net interest income.

Turkish banks rely on short-term capital market borrowing in foreign currency. However, they have over past few years reduced their market funding needs and improved their liquidity position, particularly in foreign currency. The loan-to-deposit ratio improved markedly to 91% as of December 2021 from 103% a year earlier, continuing a trend that began in 2017. The regulatory liquidity coverage ratio (LCR) increased to an adequate 173% in 2021 from 153% at year-end 2020, with foreign currency liquidity surpassing overall liquidity. At the same time, the deposit dollarization rate increased to 65% of total deposits as of December 2021 from 55% a year earlier. Deposit dollarization moderated to 59% early 2022 following the introduction of a foreign exchange-indexed local currency deposit scheme. Loan growth is expected to remain strong given high inflation and currency volatility, putting modest pressure on banks' funding profile.

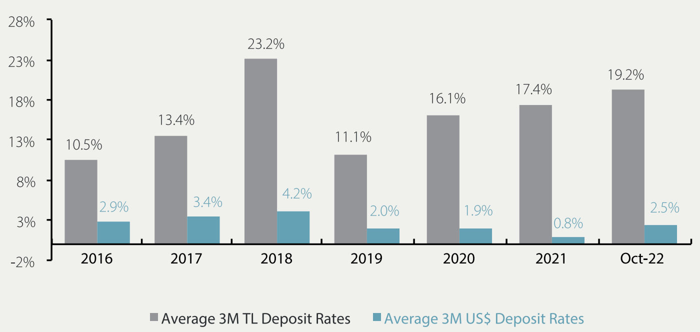
The government is willing to support banks, but its capacity is limited. Banks are the key driver of economic growth in Turkey, but the government's capacity to support them in a crisis is limited, as indicated by the sovereign's B2 debt rating which has a negative outlook as per Moody's. Government support measures

BANKING SECTOR INDICATORS

in US$ billion	2016	2017	2018	2019	2020	2021	Sep-22
Banking Aggregates							
Assets	778.3	862.7	734.8	758.0	826.5	697.7	709.7
Deposits	414.7	453.4	387.1	433.6	467.8	401.6	436.5
Loans	494.5	555.8	455.1	448.4	484.1	370.9	370.4
Shareholders' equity	85.4	95.0	80.1	83.0	81.1	54.1	64.4
YTD Growth rates							
Assets	-4.3%	10.8%	-14.8%	3.2%	9.0%	-15.6%	1.7%
Deposits	-3.5%	9.4%	-14.6%	12.0%	7.9%	-14.1%	8.7%
Loans	-3.5%	12.4%	-18.1%	-1.5%	8.0%	-23.4%	-0.1%
Shareholders' equity	-5.6%	11.2%	-15.7%	3.6%	-2.3%	-33.3%	18.9%

Sources: BDDK, 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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have partly shielded the Turkish economy and banking sector from the negative consequences of the coronavirus outbreak, but have also contributed to macroeconomic challenges and asset quality risks.

1.4.3. Equity and Bond Markets

Noticeable Turkish equity price rally in 2022 on inflation hedge, bonds plunging deeper into red tracking US Treasuries move

Turkish stocks registered a strong price rally over the year 2022, bucking global and emerging equity weakness stoked by tighter global financial conditions and mounting global recession fears, as local market players flocked to Turkish equities to hedge against rampant inflation and large real negative interest rates in the midst of continuous policy rate cuts. In contrast, Turkish bonds dipped further into the red in 2022, mainly tracking US Treasuries move in a global monetary tightening environment.

In details, Borsa Istanbul followed a strong winning streak over the first ten months of 2022, mainly as local investors sought to add Turkish stocks to their holdings as an inflation hedge, and given some upbeat corporate earnings, and appealing market valuations as Turkish stocks traded at a P/E of 7.4 times in October 2022 versus a P/E of 9.2 times at end-2021.That being said, the TL-denominated BIST 100, which represents the 100 largest companies by market capitalization, hit an all-time-high of 3,978.96 at end-October 2022, which marks a significant increase of 114.2% over the first ten months of the year.

The total number of traded companies on the Borsa Istanbul markets rose from 469 companies at end-December 2021 to 503 companies at end-October 2022. On the back of new listings and as equity prices more than doubled, outpacing the 40% currency collapse over the first ten months of 2022, the market capitalization expanded significantly by 46.5% in US dollar terms, moving from US$ 163.7 billion at end-December 2021 to US$ 239.8 billion at end-October 2022.

Concurrently, the total number of contracts reached 700.1 million during the first ten months of 2022, up from 551.8 million during the corresponding period of 2021. The total trading value reached US$ 708.2 billion during the first ten months of 2022 and compared to US$ 694.3 billion during the first ten months of 2021. Accordingly, the turnover ratio, measured by the annualized total trading value to market capitalization, reached 354.3% over the first ten months of 2022, down from 438.4% during the corresponding period of 2021.

At the level of the bond market, Turkish bonds plunged deeper into the red over the year 2022 amid a wide sell-off mood, mainly tracking US Treasuries move as the US Federal Reserve embarked into an aggressive monetary tightening approach since March 2022 to fight multi-decade high inflation, while also weighed by credit rating cuts by international rating agencies.

The yield on 10-year US dollar Turkish government bonds followed an upward streak over the first ten months of 2022, rising from 7.6% at end-2021 to 10.4% at end-October 2022. Non-resident investors were heavy net sellers of Turkish bonds over the first ten months of the year, with their holdings slashed by more than half, moving from US$ 3.5 billion at end-2021 to US$ 1.2 billion at end-October 2022.

A closer look at Turkish bonds shows that sovereigns maturing in 2024, 2027, 2031 and 2041 registered price contractions of 1.01 pt, 6.71 pts, 12.75 pts and 18.50 pts respectively over the first ten months of 2022. As to papers issued by financial institutions, QNB Finansbank'24 posted price decreases of 1.55 pt over the first ten months of 2022. Akbank'25 closed down by 2.38 pts. Yapi Ve Kredi Bankasi'24 recorded price declines of 1.69 pt. As to the cost of insuring debt, Turkey's five-year CDS spread expanded by 101 bps over the first ten months of 2022 to reach 665 bps at end-October. This followed a larger expansion of 258 bps in 2021.

Regarding new issues, Turkey tapped international debt markets three times this year, raising a total of US$ 6.5 billion. First, Turkey raised US$ 3 billion in February 2022 through the sale of Islamic bonds at a yield of 7.25%. Also, Turkey raised US$ 2.0 billion in March 2022 from the sale of bond maturing in 2027 at coupon of 8.60%. Turkey returned to international bond markets on November 15, 2022 after the risk premium on the nation's dollar debt fell to a one-year low. In fact, JP Morgan EMBIG Diversified Turkey Sovereign Spread, which reveals the risk premium on Turkish debt, reached 471 bps mid-November 2022 after peaking at 791 bps mid-July 2022, mainly as the wider mood for emerging-market nations has improved, with Morgan

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Stanley calling a bottom for their currencies. In details, Turkey raised US$ 1.5 billion through the sale of bonds maturing in January 2028 at a coupon of 9.875%, noting that Turkey is leading a rally in high-yield emerging markets. The bond sale was more than three times oversubscribed.

As to credit rating changes, Fitch Ratings downgraded in July 2022 Turkey's long-term foreign currency Issuer Default Rating to "B" from "B+", with a "negative" outlook, citing spiraling Inflation, monetary policies increasing macro and external risks, higher financing needs and limited inflows, high financial dollarization and as international reserves remain under pressure.

Also, Moody's downgraded in August 2022 the Government of Turkey's long-term foreign- and domestic-currency issuer and the foreign-currency senior unsecured ratings to "B3" from "B2", and changed the outlook to "stable" from "negative", citing rising pressures on Turkey's balance of payments, unorthodox measures aimed to stabilize the currency and restore foreign-currency buffers and soaring Inflation to its highest levels for over two decades.

Finally, Standard and Poor's S&P Global Ratings lowered its unsolicited long-term sovereign credit ratings on Turkey to "B" from "B+", with a "stable" outlook. The "stable" outlook reflects, as per S&P, balanced risks to Turkey's creditworthiness: the central government's remaining fiscal space against still-notable balance of payments vulnerabilities, contingent liabilities from State banks and public enterprises, and unpredictable policy settings.

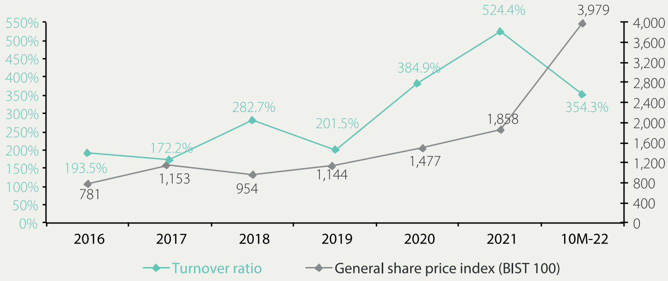
All in all, Morgan Stanley sees that Turkish bonds are now looking too costly after recently leading a rally in high-yield emerging markets, while retaining a "dislike" stance as risk/reward seen as clearly not favorable. Morgan Stanley noted that 10-year yields currently trade at a six-month z-score at nearly two standard deviations below the mean, which is near multi-year lows and compares unfavorably with similarly-rated peers. Meanwhile there are risks from monetary policy, next year's elections and the potential for more bond sales, as per Morgan Stanley.

SELECTED STOCK MARKET INDICATORS

	2017	2018	2019	2020	2021	10M-22
Market capitalization (in US$ billion)	233.4	150.5	186.7	240.3	163.7	239.8
Market capitalization/GDP	27.2%	19.3%	24.6%	33.4%	20.0%	28.1%
Trading value (in US$ billion)	401.9	425.5	376.1	924.7	858.7	708.2
Traded volume (in millions)	356,578	436,596	548,083	1,511,484	1,203,335	1,241,654
Number of contracts (000s)	157,749	230,789	264,516	670,982	691,301	700,110
Change in share BIST 100 price index	47.6%	-17.3%	19.9%	29.1%	25.8%	114.2%
Price/Earnings ratio (times)	11.58	9.12	10.72	18.64	9.17	7.44
Dividend Yield (%)	2.05	3.28	2.35	0.83	2.39	1.79
CDS spread (bps)	165	362	280	304	563	661

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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CONCLUSION

The global environment has become significantly more challenging, as financial conditions have tightened globally and Turkey's main export markets in Europe face a slowdown in growth amid an energy crisis and continued supply chain challenges. While a gradual economic slowdown is expected in the second half of this year and into next year – the IMF forecasts Turkey's real GDP growth of 5.0% and 3.0% for 2022 and 2023 respectively, the risk of a sharper slowdown is also material. A sharp slowdown would negatively impact the labor market, the strength of public finances and raise social and political risks. External refinancing options – important for the private sector as the main borrower abroad – might become more constrained if the economy slows sharply.

At the external level, Turkey's external position is under greater than expected pressure, mainly as a result of surging energy prices, which are pushing up already high inflation and raising external financing needs. The country's current account deficit will likely be close to 6% of GDP this year, more than three times larger than expected before Russia's invasion of Ukraine on February 24, and much higher than last year's deficit of 1.7% of GDP. Declining foreign-currency reserves are a further pressure point. While strong tourism and goods export performance provide important foreign-currency revenues, those inflows will start to slow in the autumn months, while net energy imports will likely remain very high.

At the fiscal level, a material weakening of Turkey's public finances is expected this year. While public finances have remained solid in the first half of the year, supported by a doubling of government revenues as a result of high inflation, budgetary pressures will likely increase materially in the latter months of the year. The IMF expects a budget deficit of around 4.2% of GDP in 2022 (5.6% in 2023), also reflecting the slowdown in the economy, a higher wage and public-sector pension bill as well as earlier tax reductions according to Moody's.

At the monetary level, inflation is expected at 73.5% at year-end 2022 as per IMF (36.9% for end-2023 with the help of base effects). According to its new Medium Term Economic Program released on September 4, the government now expects a year-end inflation of +65.0% yoy (previously +9.8% yoy). Following the Program, the TCMB in its fourth and last inflation report for the year raised its own year-end inflation forecast from +60.4% yoy to +65.2% yoy.

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 are probably the large and diversified middle-income economy with favorable demographics, the moderate public debt burden, the banking sector's good track record of managing currency volatility, the fairly diversified goods export structure, 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 unpredictable policymaking that exposes Turkiye to currency stress and high inflation, the material erosion of institutional and governance strength over past several years, the ongoing turbulent geopolitical environment and rising security risks, and the deterioration of institutional quality in recent years.

Finally, to address Turkey's challenges, the IMF recommended early policy rate hikes accompanied by moves to strengthen the central bank's independence. Such moves would help reduce inflation more durably and allow reserve buffers to be rebuilt over time. Tight fiscal policy would also help, given rising fiscal risks and high inflation, with provision made for targeted assistance to the vulnerable. If these policies were implemented and as disinflation takes hold, macroprudential and regulatory measures, including FX-protected deposits, should be phased out carefully, so that the State plays a smaller role in financial markets and in credit allocation at large.