IIRA Affirms Ratings of Sovereign of Turkey with a change in 'Outlook'

Manama, June 11, 2021– The Islamic International Rating Agency (IIRA) has maintained the long term and short term foreign currency ratings of Republic of Turkey ('Turkey' or 'the Country') at 'BBB- / A3' (Triple B Minus / Single A Three) and local currency ratings at 'BBB/A3' (Triple B/ Single A Three). Meanwhile, the outlook on the ratings has been revised to 'Negative' from 'Stable'. National Scale ratings have been kept at 'AAA (tr)/ A1+ (tr)' (Triple A/ Single A One Plus).

The credit ratings of Turkey are underpinned by the size and level of diversification in the economy, strong private sector, sound public finance position and a resilient banking sector. Risks stem from persistent inflation, recent weakness in the balance of payments position, rising external debt levels and lower reserves, albeit having risen by USD 12bn since October 2020.

With a strong credit push driving domestic demand, the Turkish economy was able to post growth of 1.8% in 2020. IIRA forecasts Turkey to register GDP growth rate of at least 5% for the full year 2021, with upward potential of up to 6%. Key downside risks stem from prolonged effects of Covid-19 on economic activity and the vaccination drive being slower or less effective than expected. We note the recent procurement of 120mn doses of the vaccine, being the first part of a total 270mn doses acquisition deal (likely to be sufficient in view of a population of around 84mn), positively. On the upside, expected improvement in tourism with prospective acceleration of vaccination campaign from June, and continuation of positive trends in exports, support growth prospects for the current year. Growth is likely to decelerate next year as base effect dissipates, however, strengthening of external position is expected to allow growth in the year 2022, to persist close to its potential of about 4%.

Fiscal discipline has been a strong pillar of the economy since the early 2000s; prudence on the budget front is evident with the budget deficit to GDP ratio maintained below 3% and leaving the primary balance in surplus even in relatively weaker years. More recently, revenues have been supported by one-off streams as well as adjustments to indirect taxes. In 2020, the burden arising from fiscal support measures along with absence of one-off revenue sources caused the deficit to widen to 3.4% of GDP (2019: 2.9%), while remaining favorable vis-a-vis emerging market peers. Revenue performance has remained favorable so far in 2021, supported by increased indirect tax generated on the back of rising domestic demand. As such government target deficit of 3.5% for the year, appears achievable. We may see fiscal consolidation following normalization of the economy in and beyond 2022.

Containing inflation has been a core challenge faced by the Turkish economy. Annual Consumer Price Index (CPI) has been consistently above the Central Bank of Turkey (CBT) target of 5% and has remained in double digits since 2017. Year-on-year Consumer Price Index (CPI) was recorded at 11.8% in December 2019 and 14.6% in December 2020. The Turkish Lira also depreciated by almost 20% against the USD in 2020, feeding into domestic inflation. The Central Bank has forecasted 2021 inflation to close at 12.2%. Recent depreciation of Turkish Lira coupled with elevated international commodity prices and supply constraints in some sectors pose risks to headline inflation. IIRA expects CPI to close the year at around 15%.

In a recent statement, the Central Bank asserted its policy stance on the continuity of price stability-focused monetary policy framework. As such, predictability and direction of future monetary policy have strong implications for the ratings.

In the wake of the COVID-19 pandemic, weaker global economic activity along with travel bans by many countries substantially impacted exports and tourism in 2020. Turkey's current account deficit widened considerably given a surge in gold imports. For 2021, IIRA expects current account deficit to narrow to 3.5% from 5.1% in 2020 despite notable increase in oil prices. Meaningful improvement depends on realization of expectations regarding continued tight monetary policy and its impact on consumer loans and hence imports, normalization of gold imports supported by recent legislative measures, and improvement in tourism revenues.

Turkey's external financing position poses some concern in view of higher external debt to GDP, shortened maturity profile, and declining coverage of short term debt by international reserves. The proportion of short term debt increased to 30.8% in 2020 while reserve coverage of short term external debt dropped significantly to 67.4%. While debt roll-over ratios remain comfortable, the relatively high external refinancing needs, leave the country vulnerable to investor sentiment.

The banking sector in Turkey has continued to depict resilience with a Capital Adequacy Ratio of 18.7% at end-2020. While recognition of non-performing loans has been delayed due to regulatory forbearance, which is valid until end-H1'21, the sector has continued to create additional provisioning buffers. Given that sizeable loan growth has been witnessed over the last year, IIRA will continue to monitor developing asset quality indicators.

Ratings have been placed on a negative outlook given the exacerbation in imbalances arising in large part due to the stress inflicted by the pandemic. Ratings may be downgraded if:

a) Material deviation from CBT's inflation estimates by the end of the current year,
b) Premature monetary easing or deviation from a strict inflation targeting monetary policy direction,
c) Deterioration in current account balances vis-à-vis expected improvement as highlighted in this release,
d) Deterioration in international reserve coverage of short-term external debt.

Outlook may be revised to 'Stable' in case of:

a) Positive decoupling from estimates laid down in this document with regards to current account and fiscal balance,
b) Meeting inflation estimates as stated in Central Bank's Inflation Report,
c) Notable improvement in international reserve coverage of debt.

For further information on this rating announcement, please contact IIRA at iira@iirating.com