

08 MAR 2024

Fitch Upgrades Turkiye to 'B+'; Outlook Positive

Fitch Ratings - London - 08 Mar 2024: Fitch Ratings has upgraded Turkiye's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'B+' from 'B'. The Outlook is Positive.

A full list of rating actions is at the end of this rating action commentary.

Key Rating Drivers

The upgrade of Turkiye's IDR and the Positive Outlook reflects the following key rating drivers and their relative weights:

High

Stronger Policies, Reduced Vulnerabilities: The upgrade reflects increased confidence in the durability and effectiveness of policies implemented since the pivot in June 2023, including greater-than-expected frontloading of monetary policy tightening, in reducing macroeconomic and external vulnerabilities. Inflation expectations have eased and external liquidity risks have moderated, reflected by more favourable external financing conditions, higher reserves, lower FX-protected deposits and a narrowing current account deficit.

The Positive Outlook reflects Fitch's expectation that Turkiye's overall macroeconomic policy stance should be consistent with a significant decline in inflation (albeit inflation will likely remain significantly higher than rating peers), as well as a continued reduction in external vulnerabilities in terms of lower current account deficits and stronger liquidity buffers.

Reduced External Liquidity Risks: International reserves stood at USD131 billion at the beginning of March, USD32 billion higher than June 2023. Reserves declined in the first two months of the year, but in Fitch's view the decline is temporary and reflects reduced portfolio inflows, maturing FX-protected deposits, winter-related seasonality in external payments and some election-related uncertainty. The structure of reserves remains weak, as the central bank's net foreign asset position (minus FX swaps) remains negative, at minus USD62 billion in early March, although this is an improvement from minus USD76 billion in June.

We expect that lower current account deficits, sustained improvement in external financing conditions and some portfolio inflows will lift international reserves to USD148 billion at end-2024 and USD159 billion by end-2025, raising reserve coverage to 4.5 months of current external payments, above the 3.7 months projected for 'B' peers. FX-protected deposits, which we view as a contingent claim on international reserves, declined to USD77 billion at end-February from USD130 billion at the end of August.

Policy Shift Makes Progress: The central bank has tightened monetary conditions through a combination of larger-than-expected interest rate hikes to 45% (3650bp since June), absorption of excess liquidity through reserve requirements and deposit auctions, and targeted credit policies. Inflation expectations have eased, and overall credit growth has slowed, but it remains high for household loans. FX and FX-protected deposits declined to 56% of total deposits at end-February 2024 (down 13pp since June 2023), driven by lower FX-protected deposits.

Any premature easing of monetary policy or additional stimulus in terms of income or fiscal policy, although not expected, would undermine the benign effects of the policy adjustment given the high level of inflation and inflation expectations, and weakened monetary policy transmission mechanisms

Inflation Declines, but Remains High: We forecast inflation to average 58% in 2024 and finish the year at 40%, above the central bank's intermediate target of 36%. Fitch's base case assumes that a tight monetary policy stance in combination with strengthened consistency of fiscal, income and credit policies will bring inflation down to 29% in 2025, still multiples of the projected 'B' and 'BB' medians.

Medium

Lower Current Account Deficits: As subdued external demand will dampen exports, the majority of the external deficit correction will come from lower consumer and gold imports due to slower domestic demand and the expected continuation of the policy rebalancing process. We forecast the current account deficit to fall to 2.6% of GDP in 2024, from 4.2% of GDP in 2023, while recovery in Turkiye's main trading partners, continued growth in tourism receipts and a relatively tight policy stance will lead the deficit to decline further to 2.2% of GDP in 2025, below the 2.6% projected for the 'B' median.

Total external debt maturing over the next 12 months was USD226 billion at end-2023, leaving Turkiye vulnerable to changes in investor sentiment. There is a record of resilience in access to external financing for the sovereign and private sector.

Turkiye's 'B+' IDRs also reflect the following key rating drivers:

Wider Deficits, Low Debt: The central government budget deficit rose to 5.2% of GDP, the largest since 2009, but below the 6.4% budgeted projection. As earthquake-related spending reached an estimated 3.6% of GDP in 2023, the government comfortably met its objective to maintain an underlying central government deficit (without accounting for earthquake reconstruction costs) below 3% of GDP. We forecast that the central government budget deficit will remain roughly stable in GDP terms at 5.2%, as we expect that year to be the main year for earthquake reconstruction (projected at 2.6% of GDP), before declining sharply to 3% of GDP in 2025 as reconstruction costs fade.

We estimate that general government debt declined to 30.4% of GDP in 2023, as high nominal GDP growth and negative real government yields in the domestic market outweighed higher borrowing and significant lira depreciation. We forecast debt to remain relatively stable, but interest payments to increase (10.3% of government revenues in 2025), as the share of debt subject to interest rate re-fixing within 12 months is high at 54%. Despite increased issuance of local-currency debt and repayment of

foreign-currency debt issued in the local market, the share of foreign-currency denominated debt remained high at 64% in 2023.

Growth to Slow Down: Growth was resilient at 4.5% in 2023, but we expect that a tighter policy mix weighing more forcefully on domestic demand and private consumption after 1Q24, combined with relatively weak external demand, will result in growth slowing to 2.8% in 2024. Growth could then pick up slightly to 3.1% in 2025 on improved growth prospects for Turkiye's main trading partners.

Local Elections, Geopolitics: Our base case assumes that the outcome of the local elections in March will not lead to a policy reversal. Governance indicators, as measured by the World Bank, have weakened continuously over the past decade and represent a weakness relative to 'B' and 'BB' peers. The volatile regional environment and the efforts to maintain an active and independent foreign policy bring geopolitical challenges, but these are not expected to affect the rating in the near term.

ESG - Governance: Turkiye has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Turkiye has a medium WBGI ranking at the 33rd percentile reflecting a moderate level of rights for participation in the political process, moderate but deteriorating institutional capacity due to increased centralisation of power in the office of the president and weakened checks and balances, uneven application of the rule of law and a moderate level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-Macro: Failure to maintain a policy mix consistent with reducing risks to macroeconomic and financial stability, including through a significant decline in inflation.

-External Finances: Failure to improve the level and composition of international reserves, for example, as a result of reduced market confidence in the commitment to consistent macroeconomic policies.

-Structural Features: Deterioration of the domestic political or security situation or international relations that affects the economy and external finances.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-Macro: Evidence of sustained progress in Turkiye's disinflation process and greater confidence that the current policy normalisation and rebalancing process will lead to a sustained decline in inflation.

-External Finances: Sustained strengthening in external buffers, for example due to increased capital inflows, which in turn leads to improvements in the level and composition of international reserves and reduced dollarisation.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Turkiye a score equivalent to a rating of 'BB-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM score to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

The removal of the -1 notch for Macro reflects Fitch's view that the effects of previously weak monetary policy relative to 'B' peers, including political interference, in recent years is being captured in the high inflation figures feeding into the SRM, and our forward-looking assessment that the current macroeconomic policy direction will lead to lower inflation and reduced macroeconomic and financial stability risks.

- External Finances: -1 notch, to reflect a very high gross external financing requirement, low international liquidity ratio, a weak central bank net foreign asset position, and risks of renewed balance of payments pressures in the event of changes in investor sentiment.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

Country Ceiling

The Country Ceiling for Turkiye is 'B+', in line with the LT FC IDR. This reflects no material constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of '0' notches above the IDR. Fitch's rating committee did not apply a qualitative adjustment to the model result.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Turkiye has an ESG Relevance Score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Turkiye has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Turkiye has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and

are therefore highly relevant to the rating and are a key rating driver with a high weight. As Turkiye has a percentile rank below 50 for the respective Governance Indicators, this has a negative impact on the credit profile.

Turkiye has an ESG Relevance Score of '4' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Turkiye has a percentile rank 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Turkiye has an ESG Relevance Score of '4' for International Relations and Trade, as Turkiye faces the risk of renewed balance of payments pressures in the event of changes in investor sentiment given the high external financing requirements., which has a negative impact on the credit profile, is relevant to the rating and a rating driver.

Turkiye has an ESG Relevance Score of '4+' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Turkiye, as for all sovereigns. As Turkiye has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Turkiye	LT IDR	B+ 	Upgrade	B 
	ST IDR	B	Affirmed	B
	LC LT IDR	B+ 	Upgrade	B 
	LC ST IDR	B	Affirmed	B
	Country Ceiling	B+	Upgrade	B
	• senior LT unsecured	B+	Upgrade	B
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	• senior LT unsecured	B+	Upgrade	B

RATINGS KEY OUTLOOK WATCH

POSITIVE



NEGATIVE



RATINGS KEY OUTLOOK WATCH

EVOLVING



STABLE



Applicable Criteria

[Country Ceiling Criteria \(pub.24 Jul 2023\)](#)

[Sovereign Rating Criteria \(pub.06 Apr 2023\) \(including rating assumption sensitivity\)](#)

[Sukuk Rating Criteria \(pub.13 Jun 2022\)](#)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v2.0.1 [\(1\)](#)

Debt Dynamics Model, v1.3.2 [\(1\)](#)

Macro-Prudential Indicator Model, v1.5.0 [\(1\)](#)

Sovereign Rating Model, v3.14.1 [\(1\)](#)

Additional Disclosures

[Solicitation Status](#)

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