

06 SEP 2024

Fitch Upgrades Turkiye to 'BB-'; Outlook Stable

Fitch Ratings - London - 06 Sep 2024: Fitch Ratings has upgraded Turkiye's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'BB-' from 'B+'. The Outlook is Stable.

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

Key Rating Drivers

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

High

Improved External Buffers: Reduced financial dollarisation and FX demand, capital inflows and increased access to external borrowing have lifted reserves to USD149 billion with net reserves at USD41 billion. Reserve composition has strengthened as the net foreign asset position of the central bank has improved from a low of minus USD75 billion in early April to a positive USD6 billion (excluding FX swaps with other central banks) at end-August due to a reduction in FX swaps with local banks.

Positive real interest rates, low current account deficits and the orderly and gradual decline in FX-protected deposits will likely support the durability of the improvement in external buffers. We forecast reserves to increase to USD158 billion at end-2024 and USD165 billion by end-2025, which will maintain reserve coverage at 4.7 months of current external payments, broadly in line with the 'BB' median.

Reduced Contingent FX Liabilities: Improved depreciation expectations and attractive lira deposit real rates led to a decline in financial dollarisation after the March local elections and in FX-protected deposits. The latter have declined by two-thirds to USD46 billion from a USD138 billion peak in August 2023. With a more comfortable external liquidity buffers, authorities have accelerated the pace of this instrument's unwinding, although this has led to a partial reversal of the dollarisation trend. FX deposits stood at 37% in August (43% at end-March) or 45% when including FX-protected deposits (58% in March).

Medium

Expectation of Consistent Policy Mix: The Central Bank of the Republic of Turkiye hiked its policy rate by 500bp to 50% in March and has strengthened policy transmission through higher reserve requirements, deposit auctions and measures to limit the pace of local- and foreign-currency credit growth. The monetary tightening has led to the lira's real appreciation, which is important for the authorities' disinflation strategy.

Fitch has greater confidence that the maintenance of a tight monetary policy stance (with an easing cycle starting in early 2025) combined with projected fiscal consolidation and prudent minimum wage adjustments will support a significant decline in inflation, and help maintain improved external liquidity buffers, low current account deficits and reduced dollarisation.

Lower, but Still Elevated Inflation: We expect inflation to finish 2024 at 43%, resulting in average inflation of 59.5% for the year; average inflation will then decline to 31% in 2025 (21% at end-2025), the highest in the 'BB'

rating category. Given the still high projected level of inflation, the premature easing of monetary policy or the abandonment of the current policy direction, which is not our base case, could reignite inflationary pressures and consequently macro-financial stability and balance of payments risks.

Lower Current Account Deficits: After more than halving yoy to 1.9% of GDP in 2024, we forecast Turkiye's current account deficit to remain low, averaging 1.7% in 2025-2026, below the projected 2.4% deficit 'BB' median. This is due to a tight policy mix, improved export demand derived from the recovery in the eurozone, continued growth in tourism receipts and lower gold and consumer imports. Total external debt maturing over the next 12 months was USD237 billion at end-June, leaving Turkiye vulnerable to changes in investor sentiment. Nevertheless, the sovereign and private sector have a record of resilience in access to external financing.

Turkiye's 'BB-' IDRs also reflect the following key rating drivers:

Fiscal Consolidation: We expect the central government deficit to ease slightly to 5% of GDP in 2024 (5.2% in 2023), thus outperforming the budgeted 6.4%. In 2025, we forecast the central government deficit to decline markedly to 3.1% of GDP and further to 2.8% in 2026. Fiscal consolidation will be supported by a decline in spending related to earthquake reconstruction (planned to drop from 2.6% of GDP in 2024 to 0.9% in 2025), increased expenditure discipline, the gradual reduction in electricity and gas subsidies, and tax revenue measures seeking to improve collection and reduce informality.

Low Government Debt: We project that general government debt will continue to decline to 27.3% of GDP (29.6% in 2023), less than half the projected 55.2% 'BB' median, driven by still high nominal GDP growth, the real appreciation of the lira and moderate primary deficits. We forecast interest payments-to-revenue to continue to increase, reaching 9.5% in 2025, slightly below the 10.1% median. The share of domestic debt subject to interest rate re-fixing within 12 months has declined but is high at 47%, while the share of foreign-currency-denominated debt declined to 59.8% in June from 64.2% at end-2024.

Macroeconomic Policy Risks: Our baseline is that the current economic programme maintains support from the political leadership. Nevertheless, the risk of policy reversals remains present, in Fitch's view, given Turkiye's recent history, the strong belief, at the highest political levels, in low interest rates, and the potential resistance from vested interests and lobby groups.

Weaker Governance: Governance indicators, as measured by the World Bank, have deteriorated continuously over the past decade and represent a weakness relative to 'B' and 'BB' peers. Relations with the US and EU have improved, but the volatile regional environment (including the Gaza and Ukraine wars) and the efforts to maintain an active and independent foreign policy bring geopolitical challenges. We do not expect these to affect the rating in the near term.

Growth, Credit Slowdown: After strong 1Q24 on the back pre-electoral stimulus, economic activity has decelerated markedly. We forecast growth to slow to 3.5% in 2024 and remain subdued at 2.8% in 2025, as we expect the continuation of a tight monetary policy stance combined with significant fiscal consolidation yoy and minimum wage increase more aligned with the objective of reducing inflation will continue cooling domestic demand. The EU's projected gradual recovery will support net exports.

MPI Score of '3': Given the highly accommodative policy stance pre-June 2023, Fitch assigned a Macro-Prudential Indicator (MPI) Score of '3' to Turkiye, indicating high vulnerability due to rapid credit and house price growth in recent years. Both have decelerated since the start of the rebalancing process.

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: Premature policy easing or a return to an unconventional policy mix that reignite inflationary pressures and risks to macroeconomic and financial stability.

-External: A rapid decline in international reserves or a significant deterioration in reserves' composition, for example, due to a wider current account deficit and/or reduced market confidence.

-Structural: 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: Sustained decline in inflation that reduces the gap with rating peers underpinned by the rebuilding of monetary policy credibility.

-External: Significant strengthening of the sovereign's external buffers, especially if combined with a sustained reduction in external financing requirements.

-Structural: Implementation of reforms that contribute to rebuilding institutional strength and governance.

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:

- Macro: -1 notch, to reflect weak monetary policy relative to 'BB' peers due to a track record of political interference, and the risk that lower but still high inflation could reignite macro financial and balance of payments pressures in the event of policy mistakes or reversal.

- The removal of the -1 notch for External Finances reflects Turkiye's track record of access to external financing, even in periods of high policy uncertainty, which partly mitigates risk related to very high gross external financing requirements; and the rapid improvement in the level and composition of international reserves, including the central bank's net foreign asset position.

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 'BB-', 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 below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

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 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 | BB-  | Upgrade | B+  |
| | ST IDR | B | Affirmed | B |
| | LC LT IDR | BB-  | Upgrade | B+  |
| | LC ST IDR | B | Affirmed | B |
| | Country Ceiling | BB- | Upgrade | B+ |
| • senior unsecured | LT | BB- | Upgrade | B+ |
| • Senior Unsecured-Local currency | LT | BB- | Upgrade | B+ |
| Hazine Mustesarligi Varlik Kiralama Anonim Sirketi | | | | |
| • senior unsecured | LT | BB- | Upgrade | B+ |

RATINGS KEY OUTLOOK WATCH

| | | |
|-----------------|---|---|
| POSITIVE |  |  |
| NEGATIVE |  |  |
| 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, v2.0.2 \(1\)](#)

[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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Hazine Mustesarligi Varlik Kiralama Anonim Sirketi UK Issued, EU Endorsed

Turkiye UK Issued, EU Endorsed

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