14-I-0028
July 11, 2014

JCR Affirmed BBB-/BBB- (FC/LC) Ratings on Turkey

Japan Credit Rating Agency, Ltd. (JCR) announces the following credit ratings.

Rationale

(1) The ratings on the Republic of Turkey are supported by: (a) its fairly developed economy whose GDP per capita exceeds USD10,000, (b) the largest economic size in the Middle East generated by a 77 million population, and (c) its sound public, banking and household sectors that provide buffers against shocks as underpinned by a prudent fiscal policy and strict banking supervision. On the other hand, the ratings are constrained by (i) macroeconomic imbalances as exemplified by its low saving ratio and chronic current account deficit, and (ii) heavy dependence on the international financial markets to fill its large external financing needs. The outlook of the ratings is stable. The Turkish economy has since May 2013 experienced considerable stresses in the form of a sharp decline in net inward capital inflows amid speculation of the normalization of the US unconventional monetary policy and the political unrest at home. The authorities have responded by allowing the country's currency to depreciate and, in January 2014, significantly raising the one-week repo rate, its policy interest rate, from 4.5% to 10.0%. As a result, the access to the international financial markets has been maintained. Also, despite the severe stresses, its public, banking and household sectors' soundness has been kept intact. That said, Turkey has a large short-term external debt, which was equivalent to 61% of annual exports and 87% of the foreign reserves in 2013, making it inevitable to ensure sustained access to the international financial markets. The Turkish economy will remain susceptible to exogenous factors such as economic and monetary conditions in the advanced economies and the political and social stability at home. Under such circumstances, adjustment of macroeconomic imbalances would be essential to maintain or improve its credit standing. In the first quarter of 2014, a current account deficit narrowed to slightly more than 6% of GDP, while real GDP growth kept at more than 4%, as growth of bank lending, private consumption and investment decelerated and exports picked up thanks to the economic recovery in Europe and the currency depreciation. Nevertheless, in order to structurally improve the macroeconomic imbalances, Turkey needs to tackle fundamental challenges such as (i) its low saving rate (12.6% in 2013), (ii) chronically high inflation rate (9.2% year-on-year in June 2014 in CPI terms), and (iii) heavy dependence on intermediate goods imports, of which the authorities are aware. They have made efforts to secure macroeconomic stability by keeping relatively tight fiscal and monetary policies, using a wide range of macro-prudential measures, and maintaining and accumulating the foreign exchange reserves. The authorities have also embarked on structural measures such as increasing the saving ratio, restraining energy imports, enhancing domestic industries' productivity, improving the investment and business climate, and developing the domestic financial and capital markets. As the presidential and general elections are scheduled in 2014-15, JCR will monitor the consistency of those policies, their progress, and the investor confidence, and will reflect them on the ratings in a timely manner.

(2) Located at the junction of Europe and Asia, Turkey is a regional power in the Middle East, having the land size of 781,000 km^2 (about twice the size of Japan) and the population of 77 million. It is a member of the Organization for Economic Cooperation and Development (OECD) and the North Atlantic Treaty Organization (NATO). Also, Turkey is a candidate country for EU membership. While the majority of its population is Muslim, it has been adhering to the principle of secularism cherishing the concept of the separation of politics and religion since the founding of the Republic of Turkey in 1923. The Justice and Development Party (AKP) has been in power since 2002. The administration's stability is generally high while persistent criticisms exist against its policies and governance style as its reign exceeds more than 10 years, which have sporadically led to high political and social tensions. The next presidential election and the general elections of the unicameral Grand National Assembly are slated for August 2014 and by June 2015, respectively.

(3) The country's GDP totaled USD0.8 trillion (or approximately JPY80 trillion), the largest in the Middle East, and its GDP per capita was USD10,782 in 2013. The population expanded 1.4% per year (2009-2013) and real GDP annually grew an average 4.9% for the last 10 years (2004-2013). Exports and imports sized 26% and 33% of GDP in 2013, relatively low as compared to East Asian and European countries. The gross national saving rate remained low at 12.6% in 2013, way

below its gross domestic investment rate at 20.3%, causing its chronic current account deficit. The current account deficit has been financed by capital inflows from abroad. Both nonresident portfolio investment in government bonds and external borrowing by domestic financial institutions swelled amid the global monetary ease in the post-Lehman shock period. At the end of 2013, the outstanding balance of external debt was equivalent to 185% of annual goods & services exports and 263% of the foreign reserves, respectively. Also, the combined total of principal and interest payments on external debt in 2013 and the outstanding short-term external debt at the end of the previous year reached 74% of exports and 105% of foreign reserves. Such large non-residents' inward portfolio and other investments has dropped drastically since May 2013 when speculation surfaced that the US unconventional monetary policy might be normalized. Fueled by the domestic political turmoil, both inward portfolio and other investments registered a net outflow in January 2014. To cope with such stresses, the authorities have allowed the currency to depreciate (by 30% between May 2013 and January 2014) and sharply tightened its monetary policy (by raising the one-week repo rate from 4.5% to 10.0% in January 2014) while keeping the foreign exchange reserves at around USD140 billion. Nonresident inward portfolio and other investments have returned to a net inflow by now. In addition, in a bid to augment the resilience to external vulnerability, the authorities have embarked on adding up the foreign reserves by acquiring the foreign currencies repaid to the Export Credit Bank of Turkey (Turk Eximbank).

(4) In recent years, the Turkish banking system accelerated lending amid the monetary ease both at home and abroad in the post-Lehman shock period. The banking sector's loan outstanding soared from 41% of GDP at the end of 2009 to 67% at the end of 2013. During the same period, the deposit outstanding rose only from 54% of GDP to 61%, with the banks' external borrowing swelling from USD54.2 billion to USD153.9 billion (equivalent to 19% of GDP). As a result, the banking sector's loan-to-deposit ratio climbed from 80% at the end of 2009 to 114% at the end of 2013. That said, the banking system is under the rigorous supervision by the authorities and exhibits little signs of concerns as its capital adequacy ratio (CAR) stood at 15.3% in 2013, nonperforming loan ratio at 2.7% and 0.7% in gross and net terms, ROA at 1.6%, net interest margin (NIM) at 3.7% and liquidity ratio (liquid assets up to three months divided by liquid liabilities up to three months) at 109%. While their foreign currency borrowing is increasing, their net open FX position is contained at around 1% of total equity through active use of currency swaps. Household debt stood at as low as 24% of GDP at the end of 2013. Households are not allowed to borrow in foreign currency. Corporate lending in foreign currency is practically limited to large enterprises given the regulatory floor set at more than USD5 million. As such, the impact of foreign exchange fluctuations on the banking system is contained minimum. In fact, despite having the severe stresses since May 2013, Turkey's resilient banking sector remains sound. At the end of April 2014, its CAR and nonperforming loan ratio (gross) stood at 16.1% and 2.8%. The system's loan growth has started to decline after the sharp interest hike in January 2014, which slowed from 35% year-on-year at the end of January 2014 to 28% at the end of April 2014.

(5) On the fiscal front, the government increased its expenditures in 2009-2010 to underpin the flagging economy after the Lehman shock while keeping the primary balance in surplus. Between 2011 and 2013, it improved the primary balance mainly on increased tax revenues. The year 2013 registered a central government primary surplus equivalent to 2.0% of GDP and an overall budget deficit equivalent to 1.2% of GDP. The sustained primary surplus put the public debt (EU defined general government debt) in a gradually declining path to reach 36% of GDP at the end of 2013. The government's medium-term fiscal plan for 2014-16 aims to cut the public debt to 30% of GDP by the end of 2016 by retaining an annual primary surplus equivalent to 1.1-1.3% of GDP. Pressure for increasing spending may mount as the country draws closer to the presidential and general elections in 2014-15. However, JCR holds that it would be unlikely for the government to manage its public finance in a way to largely deviate from the budget targets, given that the fiscal discipline is one of the main pillars to support the investor confidence, a crucial factor for the country's economic stability.

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Rating

Issuer: Republic of Turkey

<Affirmation>

	Rating	Outlook
FC (Foreign Currency Long-Term Issuer Rating)	BBB-	Stable
LC (Local Currency Long-Term Issuer Rating)	BBB-	Stable

Rating Assignment Date: July 8, 2014

The criteria used for identifying matters which serve as assumptions for the assessment of the credit status, and the criteria used for setting of grades indicating the results of the assessments of the credit status are published as "Types of Credit Ratings and Definitions of Rating Symbols" (January 6, 2014) in Rating Policies on JCR's website (http://www.jcr.co.jp/english/).

Outline of methodology for determination of the credit rating is shown as "Sovereign and Public Sector Entities" (March 29, 2013) in Rating Policies on JCR's website (http://www.jcr.co.jp/english/).

The aforementioned credit ratings are unsolicited. Except in cases of a credit rating for a sovereign, JCR indicates affix "p" after a rating symbol to distinguish it from a rating with solicitation. The undisclosed information, which has material influence on the credit rating, was obtained from the rating stakeholder.

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