12-I-027
June 28, 2012

# JCR Affirmed FC/LC Ratings on Turkey and Revised LC Rating Outlook to Positive

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

*Rationale*

The Turkish economy which weathered the impact of the global financial crisis without any financial support from the IMF achieved a high economic growth from 2010 to 2011. However, as the current account deficit expanded sharply amid the recovery of domestic demand, the problem of its structural weakness in the external balance came to the fore again. With the economy slowing down since the third quarter of 2011, the current account deficit turned decreasing on a y-o-y basis from late 2011. A prudent fiscal policy and flexible monetary policy aimed to manage both of domestic demand and international capital flows is certainly creditable about the turn. However, it is premature to judge if the dilemma of economic growth and the external balance is finally overcome yet. Future developments of the problem need to be watched. On the other hand, thanks to the structural reforms carried out by the government since its standby arrangement with the IMF as well as other efforts made by the government, the country's fiscal position has significantly improved as compared to early in the 2000's. The country's banking sector which has assumed an important role in financing the government's debt has maintained its stability despite the European debt crisis in 2011. Considering these factors positively, JCR has revised the outlook of the local currency rating to positive from stable. It has, however, affirmed the foreign currency rating as the economy's dependence on external finance is hardly without concern under the on-going European debt crisis. JCR will see the possible impact of the crisis and the Turkish fiscal and economic performance under the growing prospect of deterioration in the world economy.

### (1) Macroeconomic situation

The Turkish economy made a V-shaped recovery from the impact of the global financial crisis, posting annual average growth rates higher than 8% from 2010 to 2011. However, the current account deficit expanded again on a quarterly basis amid the recovery of domestic demand, necessitating the government to take steps to avoid an economic overheating. Due partly to the sustained fiscal discipline and tightened monetary policies, the economy slowed down to 5.2% in the fourth quarter of 2011 after peaking out at 11.9% in the first quarter of the year. The growth rate is expected to keep decelerating in 2012 as domestic demand will weaken. Meanwhile, amid the growing uncertainty over the prospect of the world economy centering on the European and U.S. economies, future developments and their possible impact on the Turkish economy need to be closely watched.

### (2) Fiscal position and financial system

The government's fiscal position has significantly improved as compared with the one during the country's economic crisis in 2001. Much of the improvement came from the structural reforms and other efforts the government made under its standby arrangement with the IMF and thereafter as well as its adherence to fiscal discipline. The inflation rate that had exceeded 100% in 1994 fell to a single digit in 2004. This helped to slash the interest expenses/revenue ratio from 70.3% in 2001 to 14.3% (on an estimated basis) in 2011. The government's fiscal deficit to GDP ratio declined to 1.3% in 2011 on estimated basis from 3.6% in 2010. The public debt/GDP ratio decreased largely in the 2000's backed by the reduction of a fiscal deficit as well as an economic growth, declining to 39.4% at the end of 2011.

The stability of the financial system has also been enhanced through reforms by the government. The banking sector's nonperforming loan ratio declined to 2.6% at the end of 2011 from 17.0% at the end of January 2003. Although its capital adequacy ratio had been on the decrease due to an expansion of loan assets, it remained high at 16.5% at the end of 2011. These indicate the stability of the banking system has basically been maintained. However, Turkish banks' foreign currency borrowings from foreign banks in the meantime have kept increasing in tandem with the expansion of their loan assets. Future developments of the European debt crisis and their possible impact on those borrowings need to be seen.

### (3) External Balance

One of the concerns for the Turkish economy in recent years has been its increasing current account deficit resulting mainly from bigger trade deficits against the backdrop of a structural saving-investment gap. In 2011, the current account deficit widened to USD77.2 billion or 10% of GDP from USD46.6 billion (6.4% of GDP) due mainly to increased imports brought by the economic recovery. However, the trade deficit turned reducing due mainly to decreased imports, allowing the current account deficit to shrink to USD21.2 billion in the first four months of 2012 from USD29.3 billion a year earlier. The current account problem appears to be heading for settlement. However, concerns remain that imports will swell as the economy recovers, sending a current account deficit to expand once again. The downtrend of the foreign exchange reserves since the second half of 2011 narrowly came to a halt in early 2012. However, the reserves totaling USD80.1 billion at the end of March 2012 were still smaller than the country's short-term external debt that stood at USD83.8 billion at the end of 2011. The possibility of any significant improvement on the country's foreign currency liquidity position in the near future is yet to be seen. JCR will keep watch on the effect of policy measures to improve the external balance problem including investment incentives to expand intermediate goods production.

Shingo Muraoka, Chief Analyst
Yoshihiko Tamura, Chief Analyst

*Rating*

Issuer: Republic of Turkey

<Affirmation>

| Issues | Rating | Outlook |
|---|---|---|
| FC (Foreign Currency Long-Term Senior Debts) | BB | Stable |

<Outlook Change>

| Issues | Rating | Outlook |
|---|---|---|
| LC (Local Currency Long-Term Senior Debts) | BB | To Positive from Stable |

Outline of methodology for determination of the credit ratings is shown as "Sovereign and Public Sector Entities" (February 10, 2009) in the Rating Policies on JCR's home page (http://www.jcr.co.jp).

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026