Rating Action: Moody's changes outlook on Turkiye to positive, affirms B3 ratings

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London, January 12, 2024 -- Moody's Investors Service (Moody's) has today changed the outlook on Government of Turkiye to positive from stable and affirmed at the same time the B3 long-term foreign- and domestic-currency issuer and the foreign-currency senior unsecured ratings. Concurrently, the foreign-currency backed senior unsecured rating of Hazine Mustesarligi Varlik Kiralama A.S. was also affirmed at B3. Hazine Mustesarligi Varlik Kiralama A.S. is a special purpose vehicle wholly owned by the Republic of Turkiye via which the Treasury issues sukuk certificates. Hazine Mustesarligi Varlik Kiralama A.S.'s outlook has changed to positive from stable.

The main driver of the outlook change to positive is the decisive change in economic policy, in particular the return to orthodox monetary policy, which, if maintained, materially improves the prospect for reducing Turkiye's major macroeconomic imbalances. While headline inflation is likely to rise further in the near term, there are signs that inflation dynamics are starting to turn, indicative of monetary policy regaining credibility and effectiveness. The monetary tightening also improves the prospects for a reduction of Turkiye's large external imbalance and for a rebuilding of the central bank's foreign-currency reserves, both of which would reduce the country's vulnerability to external shocks. Governance considerations are a key driver for this rating action.

The affirmation of the B3 ratings reflects on the one hand the large accumulated imbalances in the Turkish economy which will take time and policy consistency to be unwound, and on the other hand Turkiye's economic strengths, such as a comparatively high GDP per-capita and a dynamic and entrepreneurial private sector. Moreover, Turkiye's credit profile benefits from solid public finances and low public debt relative to peers.

Concurrently Moody's raised Turkiye's local-currency country ceiling to Ba3 from B1 previously. The three-notch gap between the local-currency ceiling and the sovereign rating reflects the prospect for declining external imbalances against the background of improving monetary policy effectiveness, as well as a relatively limited government footprint in the economy, balanced against still elevated domestic and geopolitical risks and some degree of policy unpredictability. The foreign-currency ceiling was raised to B2 from B3. The two-notch gap between the foreign-currency ceiling and the local-currency ceiling takes into consideration the continuing low level of foreign currency reserves while confidence in the local currency has not yet been fully restored. That said, the central bank has been actively removing many of the distortionary macroprudential measures that were put in place to constrain demand for hard currencies, and its foreign-currency reserves have been increasing steadily over the past months. Confidence in the domestic currency is gradually returning, as evidenced by the reduction in the size of the protected deposit scheme.

RATINGS RATIONALE

RATIONALE FOR CHANGING OUTLOOK TO POSITIVE FROM STABLE

IMPROVED PROSPECTS FOR SUSTAINABLY LOWER INFLATION AND REDUCED EXTERNAL VULNERABILITY

The key driver of the positive outlook is the marked change in monetary policy, which materially improves the prospects for bringing currently very high inflation rates down to more sustainable levels. Since June 2023, the Central Bank of Turkiye (CBRT) has hiked its key policy rate decisively by 34 percentage points to 42.5% currently, and has indicated some further tightening in the near term.

While annual inflation rates are currently very high – annual inflation was at 64.8% in December 2023 – and likely to rise further in the near term, inflation has started to moderate on a monthly basis, with the latest rates in October-December averaging 3.2% per month compared to over 9% in July and August and an average of 4.6% for the first nine months of last year. Moody's expects inflation to start moderating in the second half of this year but to remain high with inflation expected to be at around 45% by the end of the year.

The central bank has also started to gradually remove the many distortionary macroprudential measures implemented over the past two years, without a negative impact on financial stability. Depositors are shifting their savings back into Lira-denominated deposits at an accelerating pace, thereby reducing a large contingent liability for the CBRT and ultimately the government that stems from the creation of the protected deposit scheme, in which the CBRT compensates savers for excess Lira depreciation. Gold imports have started to trend down over the past few months, an indication of rising domestic confidence in the Turkish Lira.

Moreover, the significant monetary tightening improves the prospects for a reduction of Turkiye's large current-account deficit and for a rebalancing of growth away from excessive domestic demand, further supporting the disinflation efforts. There are first indications that consumer demand is slowing materially as a result of much higher lending rates (around 60% in late December 2023 compared to below 26% in March) and incentives to the banking sector to limit consumer credit growth. In the third quarter of 2023, private consumption dropped by 1.7% in real terms compared to the previous quarter while goods imports declined by 5.3% in nominal terms on average in the last three months of 2023.

As a result, the current-account deficit has started to narrow, from $60.3 billion (equivalent to 5.6% of estimated 2023 GDP) on a twelve-month rolling basis at the peak in May 2023 to $49.6 billion (4.6% of GDP) in the twelve months to November. Moody's expects the reduction in the external deficit to accelerate further in 2024, with a full-year deficit below $40 billion (3.3% of GDP), more than a full percentage points of GDP lower than the estimated 2023 deficit. The central bank's foreign currency reserves - an important metric for vulnerability to external shocks – have risen by $36 billion to $85 billion and by close to $16 billion on a net basis (subtracting banks' reserve requirements and CBRT swaps with domestic banks) as of late December since the low point in May 2023.

The positive outlook also reflects Moody's assessment that the risk of a reversal back to the previous unorthodox

policy stance is lower than it has been in the past. The central bank's building track record of tightening is evidence that it has a mandate to bring inflation down, with President Erdogan publicly endorsing the current policy stance. Beyond the municipal elections scheduled for 30 March, there is a lengthy period of around four years without elections, which should give policymakers time to pursue disinflation, even if it comes at the cost of a period of below-trend economic growth.

RATIONALE FOR AFFIRMING THE B3 RATINGS

The affirmation of the B3 ratings balances Turkiye's credit weaknesses and strengths.

With respect to the former, the affirmation reflects a track record of institutional weakening over many years which the change in policy stance during 2023 does not yet erase. In addition, the accumulated imbalances in the Turkish economy are large and will take time to be unwound, while tight policies are likely to remain in place irrespective of a potential significant growth slowdown. Inflation expectations are high and backward-looking in Turkiye and the full impact of the significant monetary tightening is yet to be seen.

The monetary and credit tightening underway will undoubtedly slow the pace of economic growth in the country over the coming months. Fiscal policy has turned more expansionary, partly as a result of the need for reconstruction after the February 2023 earthquake, and the central bank has also recently announced new measures to support exporters in the face of the need for real exchange rate appreciation. Moody's expects that both of these will provide some support to the economy but the risk of a sharper-than-intended slowdown remains. In Moody's view, signs of a very sharp growth slowdown would increase the risk of another policy reversal, back to the previous unorthodox and credit-negative policies.

These credit weaknesses are balanced by Turkiye's economic strengths, such as a comparatively high level of wealth a dynamic private sector, solid public finances and relatively low government debt, standing at an estimated 33% of GDP in 2023.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Turkiye's ESG credit impact score at CIS-4 reflects an overall negative impact of ESG factors, in particular still weak governance. Turkiye also has material exposure to a number of environmental and social risks, which are mitigated to some extent by reasonably strong balance sheets of the sovereign, banks and corporates.

Turkiye has moderate exposure to environmental risks (E-3) across a range of categories, such as carbon transition, water supply, natural capital, and waste and pollution. The country is vulnerable to water stress and it has experienced reductions in winter precipitation in the western part of the country over the past half century, which can have an impac on the quantity and quality of water in Turkiye's rivers, which are an important source of drinking water, irrigation, and power generation. Carbon transition risks are also material and reflect a relatively high share of coal and gas-fired energy generation.

Exposure to social risks is similarly moderate (S-3). While Turkiye's young population supports its demographic profile, youth unemployment is high, labour force participation is low and informality is widespread. High inflation has eroded

living standards, adding to social risks. The overall provision of basic services such as safe drinking water and sanitation services to the population is uneven across the country and weaker than in many other OECD countries.

Governance risks are more elevated (G-4) and reflect the track record of at times unpredictable policymaking. The score was recently changed from the weaker G-5 level, acknowledging the material change in monetary policy and the expectation that it will lead to improving monetary and macroeconomic policy effectiveness.

GDP per capita (PPP basis, US$): 39,314 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 5.5% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 64.3% (2022)

Gen. Gov. Financial Balance/GDP: -0.8% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: -5.4% (2022) (also known as External Balance)

External debt/GDP: 50.6% (2022)

Economic resiliency: ba1

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 09 January 2024, a rating committee was called to discuss the rating of the Turkiye, Government of. The main points raised during the discussion were: The issuer's institutions and governance strength, have increased. The issuer's governance and/or management, have increased. Other views raised included: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Moody's would likely upgrade Turkiye's ratings if the current monetary policy stance was maintained beyond the upcoming municipal elections and through emerging evidence of a growth slowdown, raising confidence that inflation will start to slow in the second half of the year and that macroeconomic imbalances are being durably reduced.

Other positive indications that the new policy direction yields tangible results would include durably lower imports, in particular of consumer goods and a further orderly switch to Lira-denominated deposits. Stability in the exchange rate combined with stronger capital inflows that would allow a faster-than-expected replenishment of the central bank's foreign-currency reserves would also be positive.

Conversely, given the positive outlook a negative rating action is unlikely. However, Moody's would return the outlook back to stable if there were indications that the authorities returned to the previous policy of prioritising economic growth in an unsustainable manner, at the expense of bringing inflation down. A push for strong credit growth or further wage hikes that would prolong the period of very high inflation and reduce the possibility of disinflation could be such indications.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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At least one ESG consideration was material to the credit rating action(s) announced and described above. Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found

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