22 September 2017

Public Finance

Republic of Turkey
Rating Report

Credit strengths

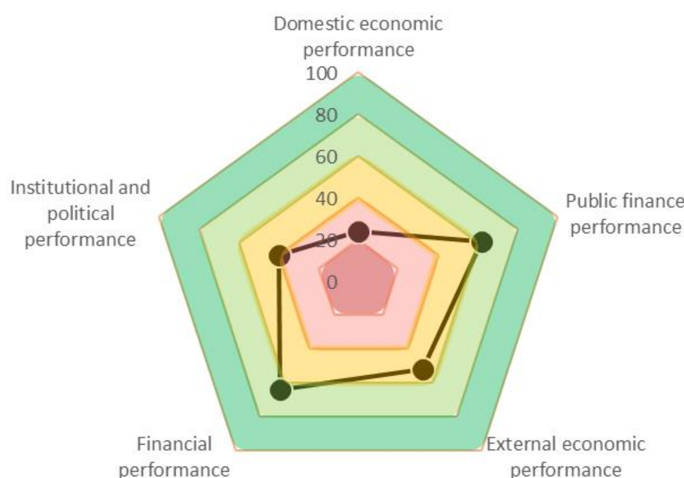
- Large, resilient economy
- Favourable demographics
- Sound public finances
- Sound, well-regulated banking sector

Credit weaknesses

- Private sector's considerable external financing needs
- Application of the rule of law
- Political and geopolitical uncertainties

Rating rationale and Outlook: Turkey's upgrade to BB+ is underpinned by the country's resilient economy, well-managed public finances with a moderate debt burden, the flexibility provided by a floating exchange rate regime and a sound banking system. The rating upgrade reflects Scope's assessment of Turkey's (1) improving economic prospects that proved resilient to event and financial shocks; (2) well managed public finances with a moderate debt burden and improving debt structure, reducing vulnerability to financial shocks; (3) effective economic policy actions that alleviated the economic downturn in 2016 with the sovereign and private sectors maintaining good external market access, and banking sector showing resilience. However, the ratings are constrained by large external financing needs, which expose the country to capital outflows, concerns on the application of the rule of law, and political and geopolitical uncertainties. The Stable Outlook reflects Scope's view that risks for the ratings are now broadly balanced.

Figure 1: Sovereign rating categories summary



Positive rating-change drivers

- Sustained and balanced growth
- Reduced reliance on capital inflows
- Institutional improvements
- Strengthened reserve adequacy
- Anchored price stability

Negative rating-change drivers

- A balance-of-payments crisis triggered by external shocks
- Sharp deterioration in GDP growth
- A significant political shock
- Deterioration in public finances

Ratings and outlook

Foreign currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

Local currency

Long-term issuer rating	BB+/Stable
Senior unsecured debt	BB+/Stable
Short-term issuer rating	S-3/Stable

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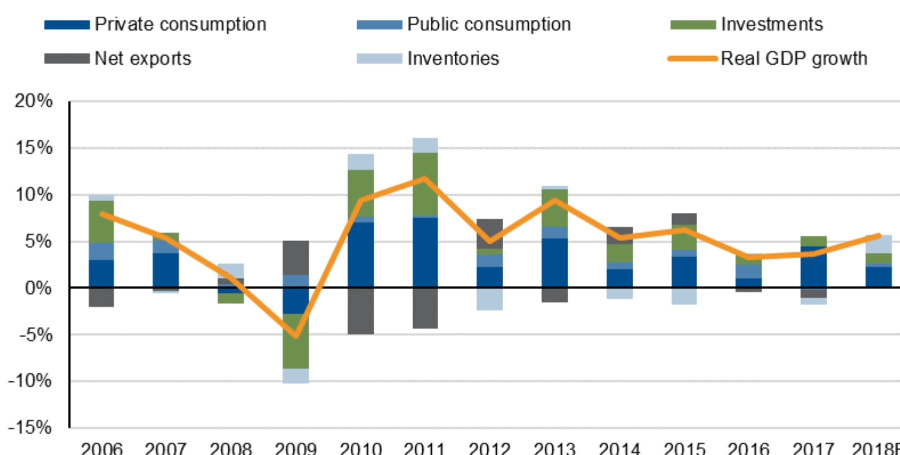
Bloomberg: SCOP

Domestic economic risk

The dynamism of the large, diversified Turkish economy is reflected by strong growth rates with an average annual real GDP growth of 7.4% from 2010 to 2015, supported by macroeconomic policies that have led to major improvements in the country's socio-economic profile. Turkey's economic catch-up phase since economic reforms following the financial crisis in 2001 has resulted in real per capita income increases of 50% while poverty was more than halved over that period. However, the transformation into an industry- and services-based economy is still ongoing with agriculture accounting for still one fifth of total employment.

Figure 2: Percentage point contribution to real GDP growth



Source: IMF, Calculations Scope Ratings AG

A series of shocks sharply slowed Turkey's real growth to 3.2% in 2016 from 6.1% in 2015[1], reflecting disruptions to the economy from the failed coup in July of last year. The slowdown was provoked by faltering foreign capital inflows amid heightened political stability risks and market expectations at the time that global liquidity would tighten; these expectations have since tempered. The failed coup damaged confidence in Turkey significantly, leading real GDP to decline by 2% in the third quarter of 2016. Foreign demand weakened last year, manifested in a sharp fall in the number of inward tourists to 25m in 2016 (down from 36m in 2015). This was partly due to sanctions imposed by Russia on charter flights to Turkey in response to the shooting down of a Russian fighter jet in late 2015, in addition to intensified global concerns about domestic security following a series of terrorist incidents.

A 'V'-shaped recovery has been gaining momentum in 2017. Half-year GDP data confirms that downside risks to growth have abated. Compared to previous periods, growth has spilled over to all main sectors, signalling a stable recovery, which is also supported by diminishing political uncertainties following the April referendum. Given strong GDP growth in the first half of 2017, and acknowledging a gradual and partial reversal of growth-supportive measures this year, Scope expects real GDP growth to accelerate to 5% in 2017, exceeding the 4.4% government target.

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[1] GDP growth was revised upward by an average of 2.7 percentage points over 2011–15 due to a methodological change to the compilation of GDP statistics. The key difference is that most of the sources of the accounting now come from records rather than surveys, improving the accuracy of the measurement of Turkish GDP.

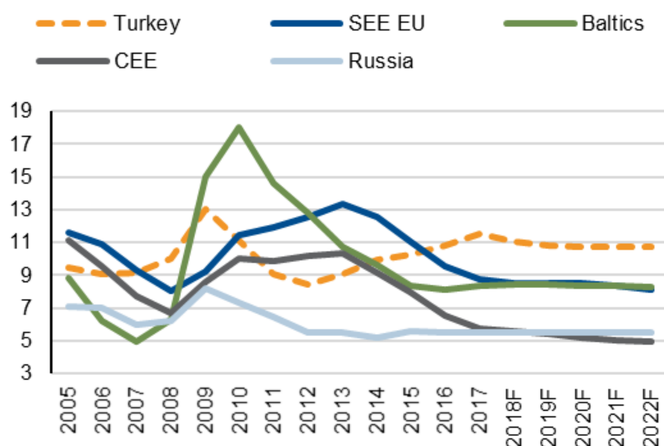
Monetary policy will likely be tightened in line with higher global interest rates, which would slow real growth to around 4% in 2018, while fiscal policy should remain broadly expansionary ahead of the election year 2019.

Solid private consumption growth in 2017 has been supported by fiscal stimulus measures, including the deferral of social security contribution payments made by companies until the end of this year alongside temporary VAT cuts. In addition, the government bolstered the existing credit guarantee fund by injecting TRY 25bn of capital in late 2016 to increase bank lending to small and medium-sized enterprises by TRY 250bn in 2017 (equivalent to around 15% of loans from Turkish banks in calendar year 2016). This move allows banks to transform part of their corporate loans into government-guaranteed assets with no capital requirements. Accelerating credit growth for consumer loans in the first half of 2017 via the credit guarantee fund has been an important factor contributing to the economic recovery.

Turkish exports also strengthened in the first half of 2017, benefitting from stronger demand from the euro area, improved price competitiveness on the back of the lira's depreciation and the lifting of Russian sanctions on charter flights to Turkey. These gains are, however, offset by the somewhat higher cost of imported energy and inputs for manufactured import-intensive exports. There has been a rebound in Russian tourism arrivals in 2017, but the tourism sector is likely to take several years to recover to its 2015 pre-crisis levels.

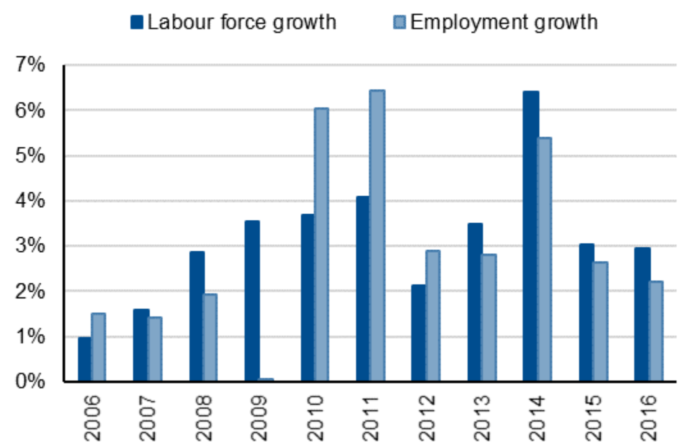
While the short-to-medium-term growth outlook is robust, Turkey's long-term economic growth potential faces considerable challenges related to the slowdown in the convergence process with advanced economies since 2008, making structural reforms necessary. Despite benign demographics and an increasing workforce size, weak job creation weighs on growth potential. Indeed, employment growth has not been sufficient to absorb the increasing labour force (despite recent Turkish gains in climbing the value chain), resulting in an elevated unemployment rate, especially amongst young workers. As of early 2017, the deterioration in the labour market has come to a halt and the unemployment rate has started to fall from a high level of 10.8% in 2016.

Figure 3: Unemployment rates



Source: IMF
SEE EU: Romania, Croatia, Bulgaria

Figure 4: Labour market developments



Source: Turkish Treasury

The rigidity of the labour market is hindering Turkey from making efficient use of its favourable demographics. Inflexible contract arrangements and employment protection rules, alongside more demanding labour market needs for productive workers and structural difficulties in the transition from education to employment, especially for women, are constraining factors for labour force participation. This situation has led to a rise in informal sector employment, affecting around one-third of the overall workforce.

Several policies have been implemented to address the lack of flexibility in the labour market, including the creation of a legal framework for private employment agencies, the inclusion of a flexible employment mechanism into the labour code, recognition of maternity rights and the introduction of new training and internship programmes. Scope has a positive assessment of the government's commitment to job creation with the launch of its large scale 'employment mobilisation campaign' aimed at creating 1.5m jobs by providing rebates on social security contributions.

Although investment rose sharply in the construction sector in the second quarter of 2017, also driven by new public-private partnership (PPP) projects, it remains weak in the machinery and equipment sector. According to the Ministry of Finance, the current VAT framework (with a standard rate of 18%, 1% for some agricultural foods, 8% on textile products, alongside some exemptions) is deterring investment in Turkey. Scope notes that the government is working on an alternative VAT scheme to relieve the tax burden for some strategic sectors. The government aims to announce the reform by 2018, not yet stating which sectors would see the larger tax cuts.

Another important concern is the government's response following last year's coup, in which civil servants were dismissed and individual persons jailed. This sequence weighed on investors' confidence. Political risks surrounding the Turkish transition to a presidential system are likely to continue to influence the business climate. The World Bank's 2017 Doing Business report ranked Turkey 69th out of 190 countries, with the country scoring particularly poorly on dealing with construction permits (102nd), the payment of taxes (128th) and starting a business (79th). The IMF's 2017 Article IV report on Turkey identified the restoration of business confidence and improvement in the investment climate as key priorities.

Continued inflationary pressures represent another factor weighing on investment. These issues stem from inherent lira depreciation pressures facilitated by structurally low domestic savings coupled with high investment requirements. Consumer price inflation reached a peak of 11.9% in April this year, driven by lira weakness. Since then, although inflation has started to recede, it has only done so marginally to 10.7% as of August, well above the 5% medium-term target. Scope expects the Turkish Central Bank (CBRT) to maintain high interest rates and continue to use the extraordinary late liquidity window facility as an active policy tool until a sizeable correction in inflation is achieved. This should include the target of positive real interest rates in order to anchor inflation expectations. 2017 year-end inflation is likely to remain high at about 10%.

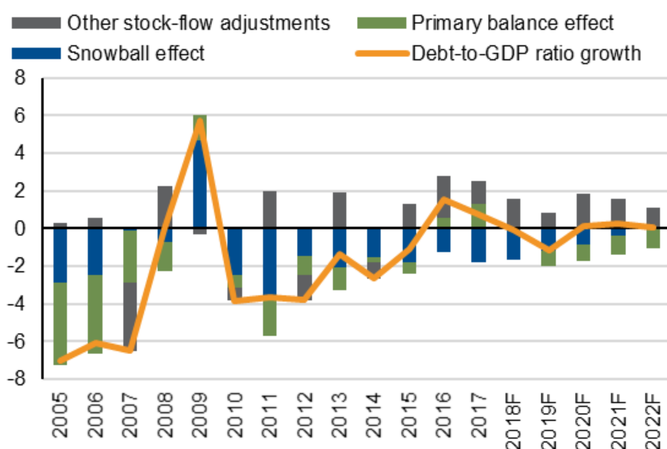
Public finance risk

Turkey made significant progress to its fiscal management, both quantitatively and qualitatively. Successful fiscal consolidation efforts reduced public debt to GDP from 44% in 2009 to 29% in 2016 while Turkey maintained primary surpluses averaging 0.7% of GDP from 2010 to 2016, demonstrating strong fiscal discipline over an extended period. Turkey's budget consolidation process was underpinned by reforms aimed at strengthening its fiscal framework, including the implementation of a rolling three-year budgeting system and internal budgetary rules.

In 2016, the fiscal deficit widened to 2.3% of GDP from 1.2% in 2015, parallel with a worsening in the primary balance (which decreased from a surplus of 0.6% of GDP in 2015 to a deficit of 0.6% in 2016), reflecting the hiring of new employees in the education and health sectors, increased security spending and subsidies to raise the minimum wage. For 2017, Scope expects the headline and primary deficits to rise moderately, driven by expansionary fiscal policies geared towards stimulating domestic demand and employment growth. Going forward, it is Scope's view that the budget deficit will remain elevated at 3% of GDP ahead of the 2019 elections, before gradually shrinking below 2% in 2020.

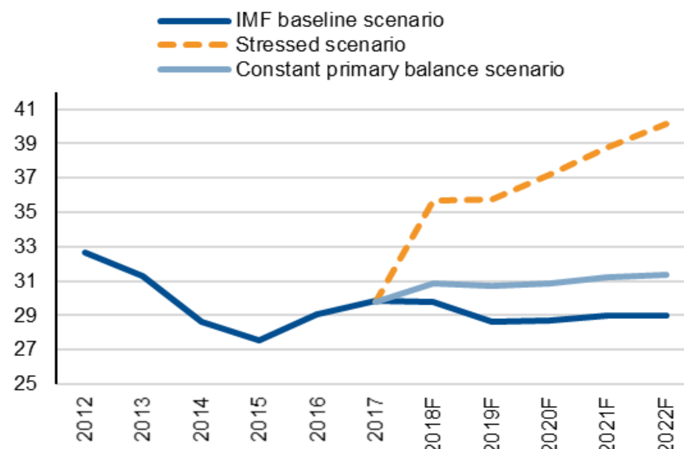
Scope stressed the underlying fiscal performance assumptions for the government debt-to-GDP projections from the IMF (World Economic Outlook April 2017) with a hypothetical constant primary balance scenario (with the 2016 primary balance assumed to remain constant). Scope also implemented a 'stressed scenario' in which the underlying IMF assumptions underwent combined financial and economic shocks, including the assumption of a combination of lower economic growth, higher interest payments, fiscal loosening and a balance-of-payment shock over the forecast period to 2022 (Figure 6).

Figure 5: Contribution to gov't debt changes, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 6: Government debt, % of GDP



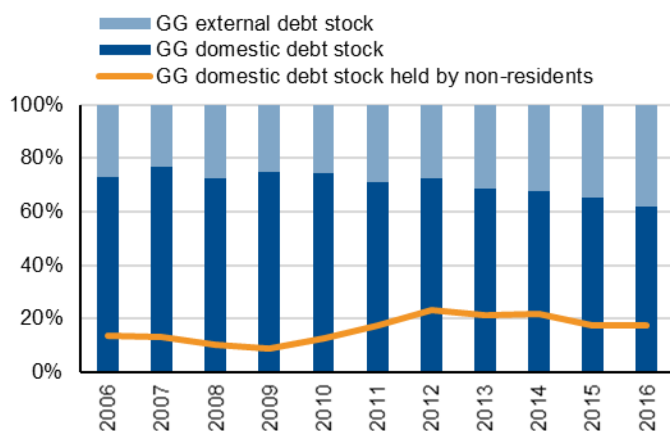
Source: Calculations Scope Ratings AG

Turkey benefits from a low stock of debt with a moderate share denominated in a foreign currency (accounting for 38% of total public debt in 2016), sound budgetary performance and resilient GDP growth. Scope considers Turkey's public-debt dynamics to be robust. According to Scope's public debt sustainability analysis, the key risk to Turkey's debt sustainability is a scenario of protracted weak GDP growth.

Turkey's public-debt dynamics are particularly resilient to external financial shocks. This resilience is reflected in a modest sensitivity to exchange rate and global interest rate changes, thanks to an improving share of the country's debt that is externally sourced (which is equivalent to a modest 10% of GDP). In recent years, prudent debt

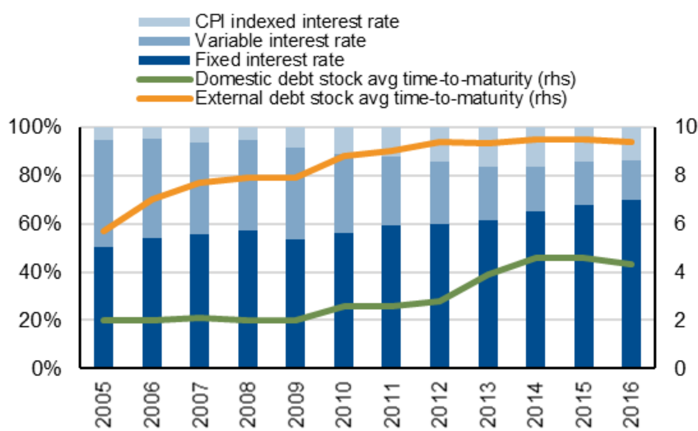
management has led to improvements in the debt profile, including the successful lengthening of the average time to maturity of external public debt to 9.4 years in 2016. Moreover, the share of fixed interest rate debt in total debt increased from 54% in 2005 to 70% in 2016 (and in external public debt from 58% in 2006 to 86% in 2016). This favourable composition of Turkey's public external debt provides an adequate buffer against global liquidity tightening and exchange rates fluctuations. Refinancing risks remain moderate, in view of overall low financing needs that were reduced from 12.6% of GDP in 2011 to 5.4% in 2016.

Figure 7: Debt stock composition, % of total public debt



Source: Turkish Treasury

Figure 8: Debt stock interest rate & maturity composition



Source: Turkish Treasury

The upward trajectory in the debt-to-GDP ratio to roughly 30% of GDP in 2017 is due to expansionary fiscal policies. In 2018, the government's fiscal stance is likely to remain accommodative to the economy, ahead of general elections in 2019, before reversing over the medium-term. However, even considering a major growth shock and a crystallisation of contingent liabilities (estimated at around 4% of GDP) from PPPs and state-owned banks, Scope does not expect the debt-to-GDP ratio to increase to over 45% of GDP over the forecast period to 2022. Contingent liabilities are rising from a low level and are unlikely to materially affect public finances. The Turkish PPP portfolio, mostly reflecting transportation infrastructure projects and partnerships in the socially-sensitive health and education sectors, comprised 211 projects amounting to USD 53bn in 2016.

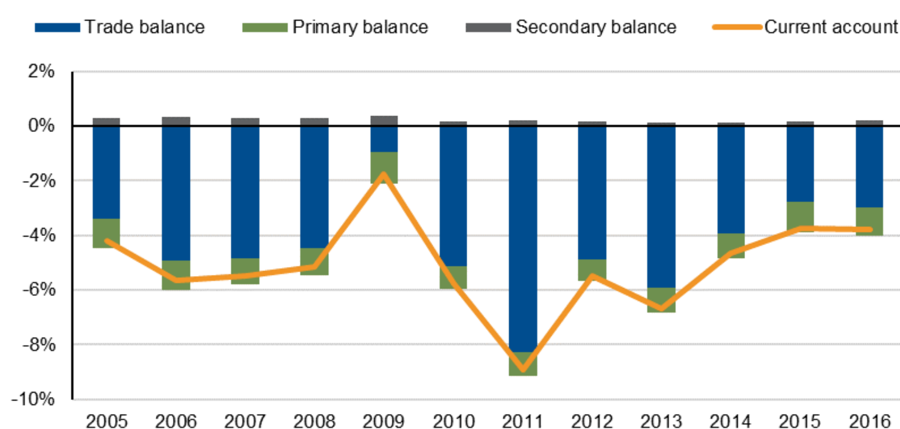
External economic risk

Turkey's current account has been persistently in deficit, reflecting reliance on the import of energy, the high import-intensity of Turkish manufactured export goods and elevated funding needs for investment in the face of meagre domestic savings. However, the current account deficit has dropped since peaking at 9% of GDP in 2011, remaining broadly unchanged from a year earlier at an elevated 3.8% of GDP in 2016 (or USD 32bn).

Excluding energy imports, Turkey's current account was fairly balanced in 2016. Nevertheless, the trade deficit reduction generated by lower oil prices and energy imports was offset by a deteriorating surplus in services caused by low tourism revenues in 2016. The higher cost of imported energy in 2017 and increasing domestic demand will probably stabilise the current account deficit at around 4-5% of GDP in 2017 and 2018, offsetting the recent rebound in tourism arrivals and stronger demand in European Union (EU) countries.

The coverage of current account deficits through volatile sources of capital inflows was insufficient in 2016, which weighed on Turkey's modest international reserves. Turkey remains vulnerable to external shocks in view of its reliance on non-resident investor sentiment, given a low but improving coverage of the current account deficit through long-term, stable foreign direct investments. Capital outflows placed the lira under intense pressure in late 2016 and early 2017, fuelling an acceleration in inflation that prompted the Central Bank of Turkey to start tightening monetary policy in November 2016 after a prolonged period of loosening. The lira has since stabilised after January 2017, but it remains vulnerable to sudden shifts in investor sentiment, potentially propelled through shifting market expectations on global interest rates.

Figure 9: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

Net foreign direct investments into Turkey of 1.1% of GDP in 2016 remains low compared with a current account deficit of 3.8% of GDP. Real estate investments, which are important form of inward investment, particularly for the construction sector, have been on an increasing trend since 2013 on the back of changes to the law facilitating the acquisition of Turkish real estate by foreigners.

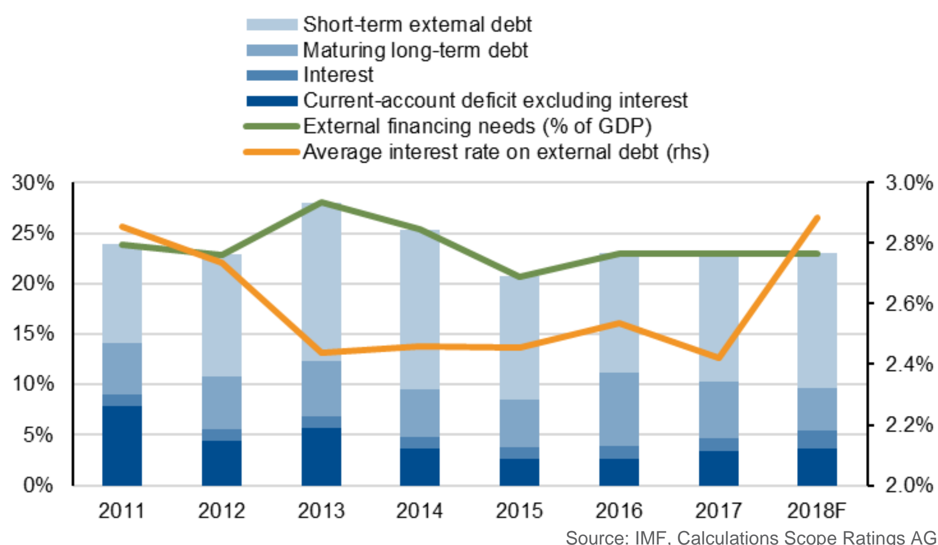
Portfolio investors reduced their exposure to Turkish assets in 2016, reflecting capital reversals associated with Turkish political and security risks. Net portfolio flows bounced back in 2017 and have gradually strengthened since the beginning of this year. However, despite a large amount of portfolio flows to emerging economies in 2017, caused by market expectations that the US Federal Reserve will extend its normalisation of monetary policy over a longer horizon, a relatively small share of these portfolio flows have gone to Turkey. In January-February 2017, portfolio inflows mostly went into the domestic stock market, whereas since March, both stock and bond markets have seen more robust inflows than in previous years.

The higher cost of foreign borrowing has forced the private sector to shorten the maturity of new borrowings. Net long-term foreign borrowing shrank by more than 50% to USD 16bn in 2016. This was particularly true in the banking sector, which made use of foreign-exchange deposits under the central bank's Reserve Option Mechanism, allowing them to hold up to 60% of required reserve requirements for lira liabilities in foreign-exchange and 30% in gold.

External financing needs remained elevated at 23% of GDP in 2016. Nearly 85% of external financing needs were attributable to maturing external debt in 2016, mainly reflecting rollover requirements in the corporate and banking sectors. Going forward,

Scope expects similarly high levels of external financing needs amounting to 23% of GDP in 2017 and 2018 with a broadly unchanged composition.

Figure 10: Composition of external financing needs



Source: IMF, Calculations Scope Ratings AG

Substantial external financing needs for the private sector make Turkey vulnerable to changes in global market conditions, particularly to protracted reversals in capital flows. However, external debt servicing costs are low and in line with benign global financing conditions. Turkey's external financing needs have been comfortably met thanks to ample global liquidity. Turkey's net international investment position widened to about -56% of GDP at the end of 2016, mainly due to debt accumulation at the beginning of the year. Gross external debt reached a still moderate 47.3% of GDP in 2016.

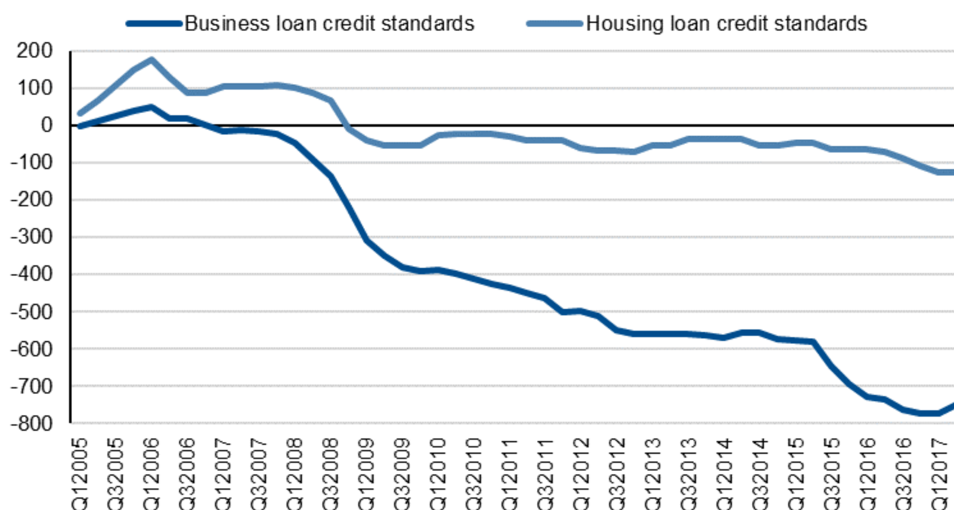
The adequacy of Turkey's international reserves is low compared with peers and on a deteriorating trend since the failed coup in the summer of 2016. In Q1 2017, gross international reserves dropped by USD 0.6bn quarter-on-quarter to USD 105.7bn. Bank reserves decreased by USD 0.5bn to USD 23bn. The short-term external debt stock, increased by 2.4% quarter-on-quarter to USD 163.7bn in Q1 2017. As a result, the ratio of total international reserves to short-term external debt stood at 78.6%, and 90.1% excluding branches and affiliates abroad.

Financial stability risk

The Turkish banking sector remained resilient to the domestic shocks of 2016, thanks to its strong capital structure, asset quality and liquidity buffers, underpinned by supportive measures from the government and macroprudential changes. The tendency within the banking sector to roll-over short-term external debt with long-term resources in 2016 continued in Q1 2017, implying no significant change in access to external resources. As banks are required to hold FX reserves at the central bank, this provides room for manoeuvre to cover FX liquidity shocks under most negative scenarios within a one-year period. In addition, liquidity coverage ratios, which show how well banks can meet 30-day net cash outflows through highly-liquid assets, are well above the legal requirements.

Recently strengthened credit growth has been supported by government policies and macroprudential measures towards supporting the financing of the corporate sector and arrangements made with regards to the cost, collateral requirements and maturity conditions of loans.

Figure 12: Credit standards (+ = relaxation; - = tightening)



Source: Central Bank of Turkey

Macroprudential policies for consumer loans, which had been strictly implemented, were loosened to some extent at FYE 2016. The average maturity of general-purpose and housing loans lengthened due to an increase in the maturity cap from three years to four and the loan-to-value ratio for housing loans was raised from 75% to 80%. According to the regulations in force, households cannot borrow in forex or at variable interest rates (except for housing loans). Consequently, household liabilities do not bear any market risk arising from exchange rate or interest rate developments.

The upward trend in banking sector profitability observed in 2016 has continued into 2017. The recovery in lending appetites, improvement in net interest income alongside measures to minimise non-interest expenses have contributed to the profitability of the sector. Profitability is likely to remain strong because of the accelerated loan volume and rising interest and commission income (and, as such, positive contribution from net interest margins). The capital structure of the banking sector remains strong.

As of March 2017, the banking sector's capital adequacy ratio was 16%, well above the regulatory requirement of 8% and target ratio of 12%, constituting adequate buffers to cover possible negative shocks. The leverage effect driven by the recovery in credit volumes and increase in risk-weighted assets triggered by exchange rate effects on foreign-currency assets slightly reduced capital adequacy in the second half of 2016, although ratios remained above requirements. The rapid rise in the capital adequacy ratio at the beginning of 2017 has been supported by the stability in the exchange rate, upward trend in profitability and macroprudential changes to the calculation of risk weights.

Heightened economic and exchange rate volatility in 2016 caused non-performing loans (NPLs) to increase by 22% in nominal terms against a 17% rise in total loans, leading to a slight increase in the NPL ratio from 3.1% in 2015 to 3.2% in 2016. In March 2017, most NPLs comprised of consumer loans (NPL ratio of 4.5%) while most corporate NPLs (2.9%) were owed by small- and medium-sized enterprises (SMEs). The NPL ratio in foreign exchange loans, generated from quarterly independent audit reports of the 10 banks with the largest FX loan volumes, was quite low at 1.5% at end-2016. Moreover, Scope notes that the effect of exchange rate movements and loan growth developments on FX loan NPLs is rather limited, and the ratio stayed within a band of 1% to 1.5% even in periods of elevated exchange rate volatility. The recent flattening of FX loan NPLs confirms a degree of resilience of the Turkish corporate sector to exchange rate risks.

Effective measures taken by the public sector have made it easier for firms, especially SMEs, to access financing. Corporate loans, backed by the loan guarantees provided by the credit guarantee fund, have also risen sharply since March. Overall, the significant lengthening in the maturities of forex credits in 2016, and the low level of the NPL ratio in forex loans, mitigate the foreign exchange risks for companies. Of the total forex debt, 83% is concentrated in 2,000 companies (of nearly 30,000 firms with outstanding forex loans). In this context, the central bank plans to strengthen the supervisory infrastructure for companies' foreign exchange risks with a systemic data monitoring system, which is currently in the process of being completed.

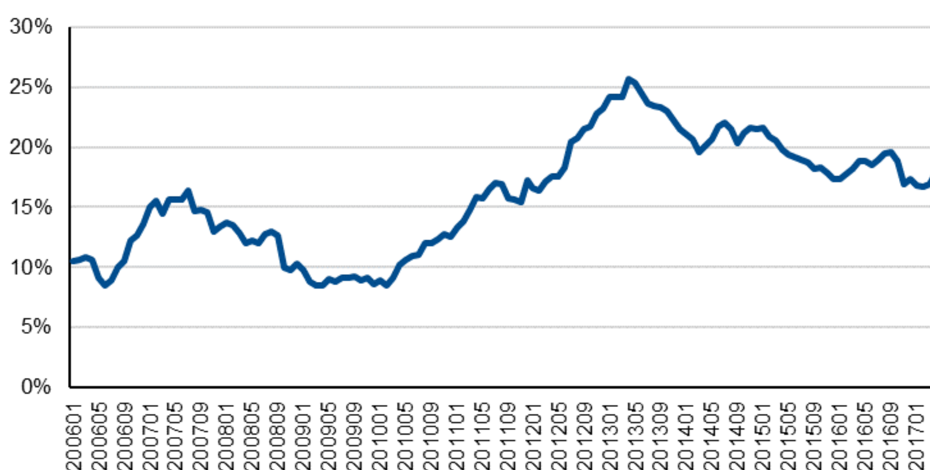
Institutional and political risk

The domestic political environment remains a key constraint to Turkey's credit rating. Turkey's political system is based on parliamentary representative democracy within a multiparty parliamentary and presidential system. Elections in 2015 resulted in the Justice and Development Party, President Recep Tayyip Erdoğan's party, regaining a parliamentary majority (with 317 of 550 seats in the Grand National Assembly).

The Grand National Assembly's presidential reform, submitted to and ratified by a referendum in April 2017, will strengthen the powers of the president in Turkey, confirming an evolution of the political system towards an executive presidency. By enabling the president to enact certain laws by decree, declare emergency rule, dismiss parliament, and appoint ministers and top state officials, the executive presidency will bolster the role of the president in policy-setting and governance. These reforms are expected to become effective in 2019, coinciding with the next presidential and general elections. Given his popularity, it is likely that President Erdogan will win the presidential election and remain in office (the maximum permitted length of office being two five-year terms, i.e. up to 2029).

The political crisis in July 2016 resulted in markedly lowered investor confidence in Turkish assets, as reflected by reversals in foreign investors' holdings of Turkish local-currency-denominated debt.

Figure 13: Percentage of domestic debt held by non-residents

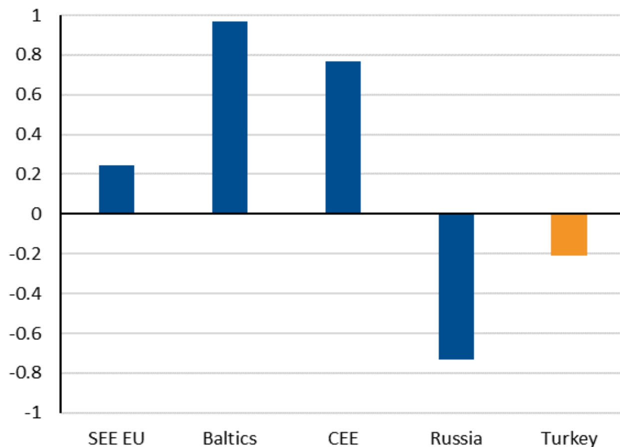


Source: Turkish Treasury

Turkey's institutional strength has weakened in the wake of the failed military coup following extensive dismissals and arrests of judges, academics and civil servants. Indeed, Turkey's governance indicators show a declining trend in the rule of law, which will be further exacerbated by the government's push to establish a presidential system.

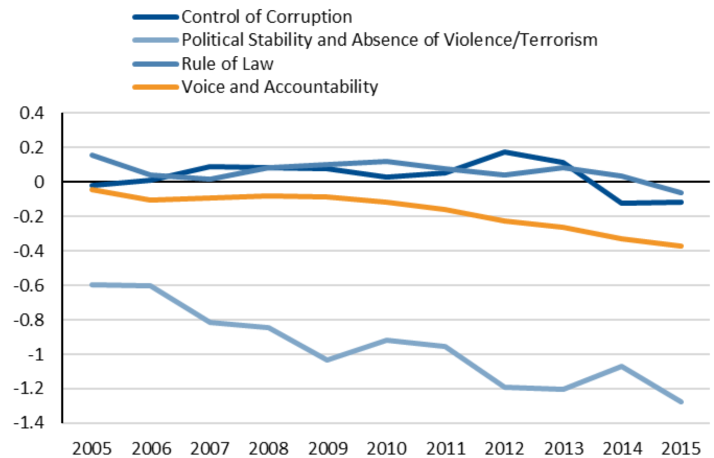
However, political uncertainties have somewhat declined after the conclusion of the constitutional referendum in April 2017.

Figure 14: Average World Bank Governance Indicators



Source: World Bank

Figure 15: World Bank Governance Indicators for Turkey



Source: World Bank

The possibility of an escalation in regional crises in Iraq and Syria constitutes an additional downside risk. International relations with Turkey's traditional Western allies have become more strained, resulting in lagged negotiations related to the current Customs Union agreement between the European Union and Turkey. However, cooperation between the EU and Turkey will be maintained owing to Turkey's strategically-important location, as reflected in the 2015 refugee deal. Scope believes that Turkey's transformation to a presidential system will continue to impact the business climate before implementation in 2019, thus making measures to restore and improve the investment climate a key priority for the government.

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative 'BB' ('bb') rating range for the Republic of Turkey. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For the Republic of Turkey, the following relative credit strengths have been identified: 1) growth potential of the economy, 2) economic policy framework, 3) fiscal performance, 4) public debt sustainability, 5) market access and funding sources, 6) financial sector performance, 7) financial sector oversight and governance. The relative credit weaknesses signalled are: 1) current account vulnerabilities, 2) vulnerability to short-term shocks, 3) recent events and policy decisions, 4) geo-political risk. Combined relative credit strengths and weaknesses generate an upward adjustment and signal a sovereign rating of BB+ for Turkey. A rating committee discussed and confirmed these results.

Rating overview	
CVS category rating range	bb
QS adjustment	BB+
Final rating	BB+

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign versus local-currency ratings

As reflected by the considerable external financing needs of the private sector, Turkey remains reliant on external capital markets. Furthermore, Turkey has an established history of open capital accounts and local-currency debt issuance that does not provide for a rating bias in favour of either local-currency or foreign-currency debt. Therefore, Scope sees no evidence that Turkey would differentiate among any of its contractual debt obligations based on currency denomination. This is further corroborated by the recent history of sovereign defaults, which does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bb**
QS adjustment	**BB+**
Final rating	**BB+**

QS

Maximum adjustment = 3 notches

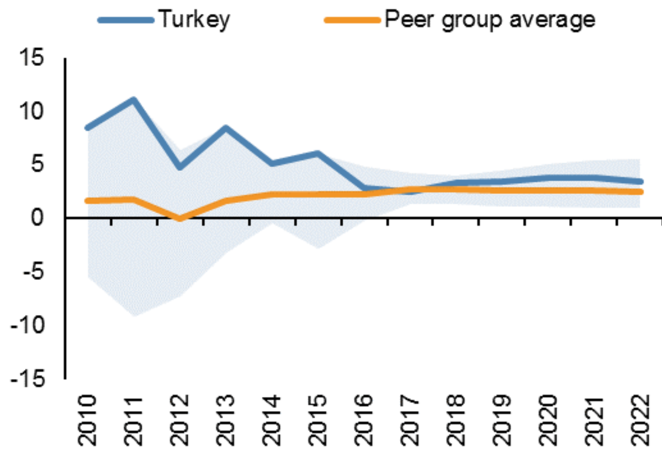
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	● Strong outlook, good growth potential	○ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	● Good	○ Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	● Strong performance	○ Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	● Strong sustainability	○ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	● Very good access	○ Neutral	○ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	○ Good resilience	○ Neutral	● Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Financial sector performance	○ Excellent	● Good	○ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	● Good	○ Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings AG

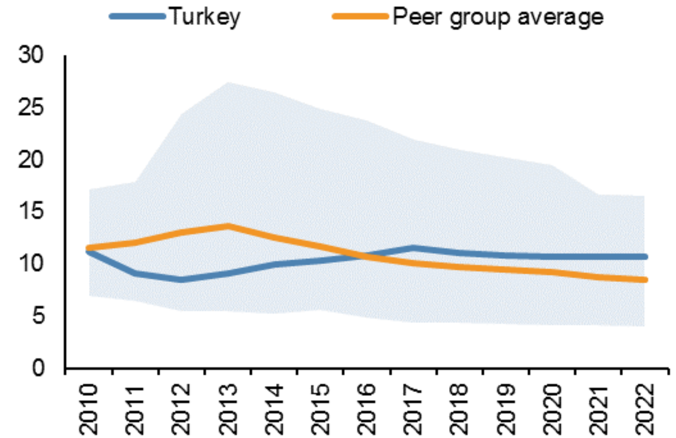
III. Appendix: Peer comparison

Figure 16: Real GDP growth



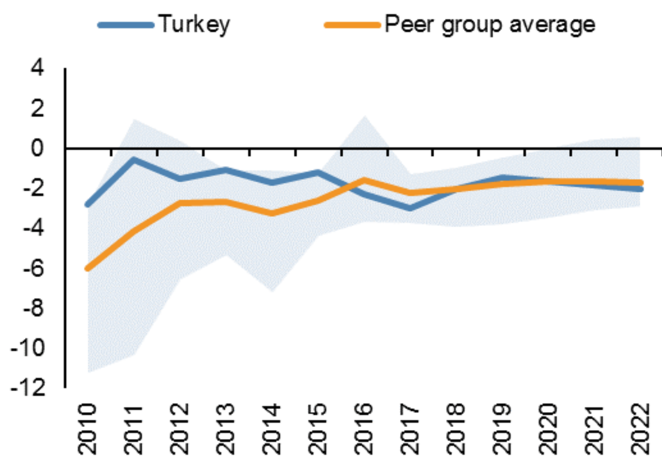
Source: IMF, Calculations Scope Ratings AG

Figure 17: Unemployment rate, % of total labour force



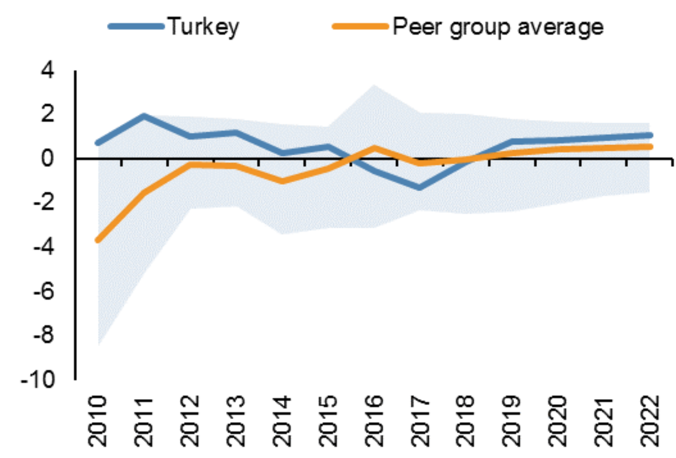
Source: IMF, Calculations Scope Ratings AG

Figure 18: General government balance, % of GDP



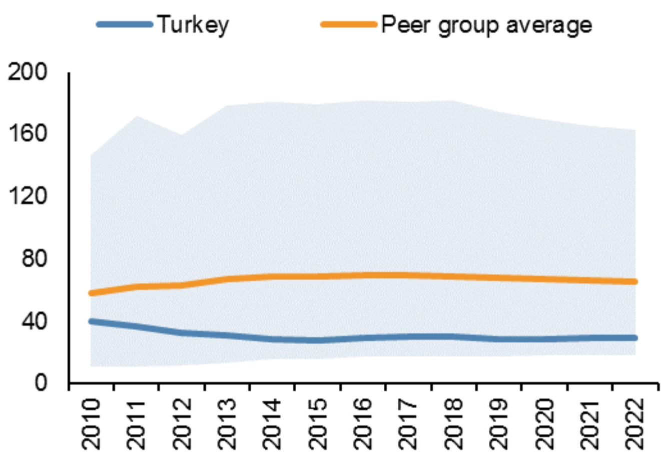
Source: IMF, Calculations Scope Ratings AG

Figure 19: General government primary balance, % of GDP



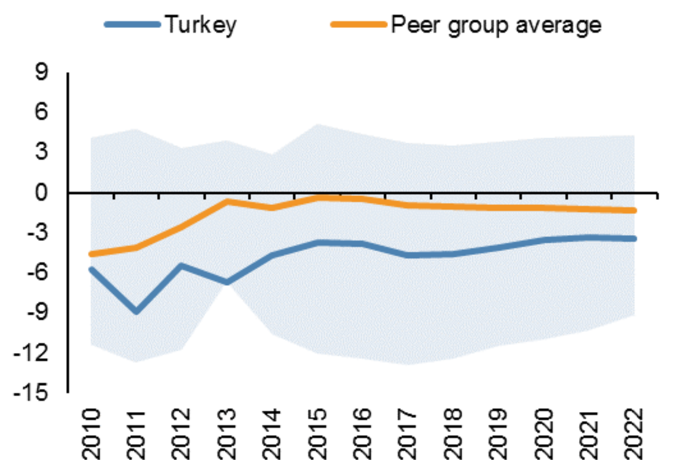
Source: IMF, Calculations Scope Ratings AG

Figure 20: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 21: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (TRY bn)	1,570	1,810	2,044	2,338	2,591	2,917	3,290
Population ('000s)	74,570	75,787	77,031	78,271	79,512	80,745	81,917
GDP-per-capita PPP (USD)	20,640	22,311	23,111	24,054	24,244	-	-
GDP per capita (TRY)	20,755	23,605	26,314	29,686	32,457	36,113	40,333
Real GDP growth, % change	4.8	8.5	5.2	6.1	2.9	5.0	4.0
GDP growth volatility (10-year rolling SD)	4.7	4.8	4.6	4.4	4.5	4.5	4.4
CPI, % change	8.9	7.5	8.9	7.7	7.8	10.1	9.1
Unemployment rate (%)	8.4	9.0	9.9	10.3	10.8	11.5	11.0
Investment (% of GDP)	28.3	29.8	29.0	28.3	28.7	29.5	29.6
Gross national savings (% of GDP)	22.8	23.2	24.4	24.7	24.9	24.8	25.0
Public finances							
Net lending/borrowing (% of GDP)	-1.5	-1.1	-1.7	-1.2	-2.3	-3.0	-2.0
Primary net lending/borrowing (% of GDP)	1.0	1.2	0.3	0.6	-0.6	-1.3	-0.1
Revenue (% of GDP)	31.6	32.2	30.5	30.9	31.2	30.6	31.4
Expenditure (% of GDP)	33.1	33.3	32.2	32.1	33.5	33.6	33.5
Net interest payments (% of GDP)	2.5	2.3	2.0	1.8	1.7	1.7	1.9
Net interest payments (% of revenue)	8.0	7.1	6.4	5.7	5.5	5.5	6.1
Gross debt (% of GDP)	32.6	31.3	28.7	27.6	29.1	29.8	29.8
Net debt (% of GDP)	25.1	23.7	21.6	20.3	22.2	23.5	24.0
Gross debt (% of revenue)	103.4	97.3	93.9	89.2	93.2	97.6	94.6
External vulnerability							
Gross external debt (% of GDP)	38.9	41.1	43.0	46.2	47.3	-	-
Net external debt (% of GDP)	21.8	24.2	26.1	29.3	29.5	-	-
Current-account balance (% of GDP)	-5.5	-6.7	-4.7	-3.7	-3.8	-4.7	-4.6
Trade balance [FOB] (% of GDP)	-9.5	-10.6	-9.1	-7.4	-6.5	-	-
Net direct investment (% of GDP)	-1.09	-0.98	-0.62	-1.45	-1.07	-	-
Official forex reserves (EOP, USD m)	98,270.2	109,279.8	105,344.8	91,431.0	90,609.9	-	-
REER, % change	0.0	0.0	-0.1	0.0	0.0	-	-
Nominal exchange rate (EOP, TRY/USD)	1.8	2.1	2.3	2.9	3.5	-	-
Financial stability							
Non-performing loans (% of total loans)	2.7	2.6	2.7	3.0	-	-	-
Tier 1 ratio (%)	15.1	13.0	13.9	13.2	-	-	-
Private debt (% of GDP)	134.6	147.6	151.3	160.4	-	-	-
Domestic Credit-to-GDP gap (%)	9.7	13.2	10.7	9.8	8.8	-	-

Source: IMF, European Commission, European Central Bank, TURKSTAT, Central Bank of the Republic of Turkey, World Bank, BIS, OECD, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by Jakob Suwalski, Lead Analyst.

Person responsible for approval of the rating: Dr Stefan Bund, Chief Analytical Officer.

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The subscription ratings/outlooks were last updated on 05.05.2017.

The senior unsecured debt ratings as well as the short term issuer ratings were assigned by Scope for the first time.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the Republic of Turkey are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

The main points discussed by the rating committee were: i) growth potential of the economy, ii) economic policy framework, iii) fiscal performance, iv) public debt sustainability, v) current account vulnerabilities, vi) external debt sustainability, vii) vulnerability to short-term shocks, viii) market access and funding sources, ix) macro-financial vulnerabilities, x) peers consideration.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: Ministry of Finance of the Republic of Turkey, Central Bank of the Republic of Turkey, TURKSTAT, European Commission, IMF, OECD, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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