MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Turkiye's ratings to B3, changes outlook to stable

12 Aug 2022

London, August 12, 2022 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Turkiye's long-term foreign- and domestic-currency issuer and the foreign-currency senior unsecured ratings to B3 from B2.The foreign-currency senior unsecured shelf rating was downgraded to (P)B3 from (P)B2. Concurrently, the foreign-currency backed senior unsecured rating of Hazine Mustesarligi Varlik Kiralama A.S., a special purpose vehicle wholly owned by the Republic of Turkiye from which the Treasury issues sukuk certificates, was also downgraded to B3 from B2. The outlook is changed to stable from negative for both issuers.

The downgrade to B3 reflects the following key drivers:

1. Rising pressures on Turkiye's balance of payments with risks of a further depletion of foreign-currency reserves. Turkiye's current account deficit will likely exceed earlier expectations by a wide margin, raising external financing needs at a time of tightening financial conditions globally;

2. The authorities are having to resort to increasingly unorthodox measures in an attempt to stabilize the currency and restore foreign-currency buffers. Inflation has risen to its highest levels for over two decades and will likely trend higher in the coming months, on the back of surging energy and food prices and also reflecting the unwillingness of the Central Bank of Turkiye (CBRT) to raise its policy rate. In Moody's view, it is unlikely that the increasingly complex set of regulatory, fiscal and macroprudential measures will be effective in restoring some degree of macroeconomic stability. Moody's considers this a Governance driver under its ESG framework.

The stable outlook reflects Moody's view that the risks at the B3 level are balanced. While the authorities' highly unorthodox economic policies will likely exacerbate the current economic imbalances, the sovereign has relatively low external debt and moderate refinancing needs for the remainder of the year and next year.

Concurrently Moody's lowered Turkiye's local-currency country ceiling to B1 from Ba3 previously. The two-notch gap between the local-currency ceiling and the sovereign rating mainly balances a relatively limited government footprint in the economy with unpredictable institutions and government actions, elevated domestic and geopolitical political risks and significant external imbalances. The foreign-currency ceiling was lowered to B3 from B2. The two-notch gap between the foreign-currency ceiling and the local-currency ceiling mainly reflects weak policy effectiveness as well as the low level of foreign currency reserves, which leads to elevated transfer and convertibility risks.

RATINGS RATIONALE

RATIONALE FOR RATINGS DOWNGRADE TO B3

FIRST DRIVER: RISING PRESSURES ON THE BALANCE OF PAYMENTS

Turkiye's external position is under greater than expected pressure, mainly as a result of surging energy prices, which are pushing up already high inflation and raising external financing needs. The country's current account deficit will likely be close to 6% of GDP this year, more than three times larger than expected before Russia's invasion of Ukraine (Caa3 negative) on 24 February, and much higher than last year's deficit of 1.7% of GDP.

Declining foreign-currency reserves are a further pressure point. While strong tourism and goods export performance provide important foreign-currency revenues, those inflows will start to slow in the autumn months, while net energy imports will likely remain very high. At that point, Moody's expects pressure on the exchange rate and the CBRT's foreign-currency buffer to increase again. Hard-currency reserves have recently risen to $67.7 billion as of early August (excluding gold reserves valued at $40.8 billion), helped by a large inflow linked to a large energy project. But reserves have been declining for most of the year although the introduction of the deposit protection scheme, intended to incentivize depositors to shift into lira-denominated deposits and away from hard-currency deposits, and the requirement for exporters to convert 40% of their export earnings into lira with the CBRT, should have led to materially stronger reserve buffers. Excluding borrowed reserves in the form of swaps with banks and banks' reserve requirements net reserves are negative to the tune of $50 billion.

External financing needs are large at around $250 billion or 34% of GDP this year, of which half is short-term debt that has typically been rolled over such as trade credit or is in the form of stable non-resident deposits in the banking system. Moody's estimates confidence-sensitive external refinancing needs at around $128 billion or 17% of GDP, primarily owed by the private sector. In contrast, the government has only one external bond maturity left in September for $2.5 billion plus interest and loan repayments of a further $3.2 billion from July-December, which could be covered out of its foreign-currency deposits at the CBRT of around $11 billion in case of tighter financing conditions.

SECOND DRIVER: INCREASINGLY UNORTHODOX MEASURES ARE UNLIKELY TO RESTORE MACROECONOMIC STABILITY

Inflation has accelerated to 79.6% in July, compared to below 20% in October last year and is now among the highest levels reported globally. The Turkish lira has lost around 30% of its value against the US dollar this year, following a depreciation of around 45% over the last two months of 2021, which was triggered by a series of CBRT interest rate cuts. The currency remains under pressure, which points to continuing high inflation in the coming months. According to Moody's latest forecasts, consumer price inflation will still stand at close to 70% at year-end.

The authorities have taken a series of measures since the start of the year, with the aim to stabilise the currency, rebuild the central bank's low foreign-currency reserve buffer and more recently engineer a "soft" landing of the economy by reigning in credit growth. New measures have been announced ever more frequently and have become increasingly unorthodox, such as the requirement for exporters to convert 40% of their export earnings into lira with the CBRT and the prohibition for banks to extend credit to firms holding material foreign-currency assets. So far, the measures have not been successful in stabilising the currency and materially raising the CBRT's foreign-exchange buffers. Other measures focus on directing credit to specific sectors and activities, such as exporting companies and loans for investment, rather than consumption. There are early signs of a slowdown in credit growth. Also, bank lending rates have risen to over 30% in recent weeks, significantly above the CBRT's policy rate at 14%, which should help to dampen demand for credit.

However, in Moody's view it is unlikely that the increasingly complex set of regulatory and macroprudential measures will be effective in restoring some degree of macroeconomic stability and sustainably help to bring down inflation. While Moody's expects a gradual economic slowdown in the second half of this year and into next year – the rating agency forecasts real GDP growth of 4.5% and 2% for 2022 and 2023 respectively, the risk of a sharper slowdown is material. The global environment has become significantly more challenging, as financial conditions have tightened globally and Turkiye's main export markets in Europe face a slowdown in growth amid an energy crisis and continued supply chain challenges. A sharp slowdown would negatively impact the labour market, the strength of public finances and raise social and political risks. External refinancing options – important for the private sector as the main borrower abroad – might become more constrained if the economy slows sharply. At the same time, it is unclear whether there is political acceptance that the Turkish economy will need to slow down, in particular in light of the approaching elections, which will have to be held by June 2023 at the latest.

Moody's expects a material weakening of Turkiye's public finances this year. While public finances have remained solid in the first half of the year, supported by a doubling of government revenues as a result of high inflation, budgetary pressures will likely increase materially in the latter months of the year. The cost to the Treasury of the deposit protection scheme is rising, with Moody's estimating the full-year cost at around 2.2% of GDP, on the basis of the rating agency's exchange rate forecasts. As of June, the Treasury has paid out 0.3% of GDP. Similarly, the cost of inflation-indexed debt which is mostly held by domestic banks has risen substantially, and Moody's estimates that high inflation will add around 1.2% of GDP in interest payments this year compared to 2021. The rating agency expects a budget deficit of around 4.5% of GDP, also reflecting the slowdown in the economy, a higher wage and public-sector pension bill as well as earlier tax reductions. Debt affordability is deteriorating rapidly, with the ratio of interest payments to revenue expected to rise to 10.2% this year, the highest level since 2010, and further in the coming years.

RATIONALE FOR STABLE OUTLOOK

The outlook on the B3 rating is stable, mainly reflecting Moody's view that at this rating level Turkiye's credit challenges are fully incorporated. Despite the expected increase in the budget deficit, the government's debt burden will remain moderate compared to peers at below 40% of GDP (general government level) this year. The central government's external debt stock is low at less than 20% of GDP. While the government's debt is highly exposed to currency depreciation – around 67% of the central government's outstanding debt stock is linked to or denominated in foreign currencies as of June 2022 – still strong nominal GDP growth should continue to compensate to a large extent for currency deprecation. Despite last year's large depreciation, the debt ratio increased by just 2.4 percentage points of GDP. The government borrows predominantly domestically, where its borrowing costs are deeply negative in real terms, and more than three quarters of the debt is held by resident banks. Foreign investors hold just 1% of domestically issued debt as of June, which limits the impact of a further loss of foreign investor confidence.

Banks and corporates – the main borrowers abroad – have been able to roll over maturing debt during previous periods of financial stress and have not encountered any difficulties so far this year and have well-hedged foreign-currency positions, which provides a cushion against future episodes of financial stress.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Turkiye's ESG credit impact score is highly negative (CIS-4), reflecting material exposure to a number of environmental and social risks and a weak institutional environment.

Turkiye's environmental issuer profile score is moderately negative (E-3), reflecting exposure to environmental risks across a range of categories, such as water supply, natural capital, and waste and pollution. Turkiye 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 impact on the quantity and quality of water in the country's rivers, which are an important source of drinking water, irrigation, and power generation.

Turkiye's social IPS is also moderately negative (S-3). While the country's young population supports its demographic profile, youth unemployment is high, labour force participation is low and informality is widespread. High inflation is eroding living standards, with 15% of the population at-risk of poverty in 2020, 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.

Turkiye's institutions and governance profile has deteriorated steadily in recent years and has been a key driver of successive downgrades to the sovereign's rating. This is captured by a highly negative governance IPS (G-4).

The publication of this rating action deviates from the previously scheduled release dates in the UK sovereign calendar published on https://ratings.moodys.com. This action was prompted by heightened macroeconomic risks following very high and still increasing inflation numbers in the first half of 2022, and comes against the backdrop of a much more challenging external environment given an expected economic slowdown in key trading partners and tighter global financing conditions.

GDP per capita (PPP basis, US$): 34,755 (2021) (also known as Per Capita Income)

Real GDP growth (% change): 11% (2021) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 36.1% (2021)

Gen. Gov. Financial Balance/GDP: -3.4% (2021) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.7% (2021) (also known as External Balance)

External debt/GDP: 54.4% (2021)

Economic resiliency: ba1

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

On 09 August 2022, 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 economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance 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, in particular political event risk, has materially changed.

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

FACTORS THAT COULD LEAD TO AN UPGRADE

The ratings could be upgraded if Turkiye's policymakers refocused on reducing inflation through decisive and clear monetary policy actions that restored confidence in the CBRT. A sustained reduction in the external imbalance would also be positive for the rating, if it was the result of an improvement in Turkiye's external competitiveness and economic resilience.

FACTORS THAT COULD LEAD TO A DOWNGRADE

The ratings would likely be downgraded further if the authorities resorted to ever more coercive policy measures that raise the risk of a banking crisis or payment defaults by large corporations. A further material deterioration in the external balance would also be negative, as would evidence that inflation remains persistently high, implying a further increase in social risks. Furthermore, a severe political crisis following the next elections that brought on acute economic and financial disruptions would also be credit negative. Expectations that government debt would rise materially, with a related deterioration in debt affordability, would also put downward pressure on the rating.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://ratings.moodys.com/api/rmc-documents/63168 . 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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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on https://ratings.moodys.com.

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