Four Reasons Why Russia Is Investment Grade and Turkey Is Not

In Scope's 2018 Public Finance Outlook, we identified an investment grade (IG) compared with a non-investment grade (non-IG) rating disparity between Russia (BBB-/Stable) and Turkey (BB+/Stable) as an important theme in 2018. In this special comment, Scope introduces four core arguments for this stronger view on Russia's sovereign creditworthiness. In addition, we note two areas where Turkey's credit profile has an advantage over Russia's.

Scope's October 2017 upgrade of Russia's long-term ratings to investment grade reflected the nation's strengthened macroeconomic framework and greater resilience to external shocks, which enhance the economy's defences against risks including lower oil prices and international sanctions. This resilience is shown in higher foreign-exchange reserve adequacy, robust current-account surpluses since 1999, a higher degree of economic self-sufficiency, and a strong net external-creditor position.

By comparison, Scope's ratings on Turkey are one notch below investment grade, reflecting a higher vulnerability to adverse shocks. Despite positive dynamics at work, especially with relation to the near-term growth outlook, Turkey's weaknesses are present in the event of adverse terms of trade shocks, declines in external liquidity buffers, and/or negative evolution in the political environment.

In Scope's Public Finance Outlook for 2018, we identified the expectation that this investment-grade versus non-investment grade segmentation between the two nations will be a lasting theme in 2018, acknowledging recovery in Russia against economic imbalances and political challenges in Turkey.

In this comment, Scope elaborates four core arguments for the investment-grade view on Russia's sovereign profile compared with a current non-investment grade rating on Turkey:

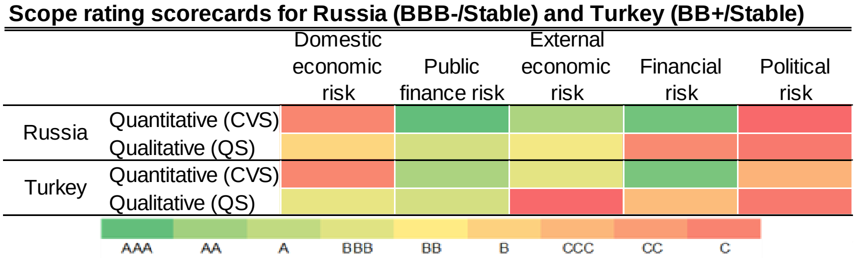
1) Russia's stronger balance of payments and Turkey's external vulnerabilities
2) Turkey's political and institutional challenges
3) Russia's stronger fiscal/debt profile and institutions
4) Comparative weakness in Turkey's monetary and financial management

We conclude the report by addressing two counter-points that support Turkey's credit profile against that of Russia, which narrow the divide to the current one-notch differential:

1) Growth and demographics, which support Turkey's long-run debt sustainability
2) Turkey benefits from lower non-performing loans (NPLs) in the financial system

In Scope's most recent rating assessments, the above areas were evaluated as follows under Scope's dual quantitative and qualitative framework:

Scope rating scorecards for Russia (BBB-/Stable) and Turkey (BB+/Stable)



NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. According to Scope's CVS framework, Russia and Turkey come out in the 'bb' indicative rating group. After Scope's qualititative (QS) adjustment, Scope's final ratings are BBB- for Russia and BB+ for Turkey.

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Reason #1: Russia's stronger balance of payments and Turkey's external vulnerabilities

Russia's high foreign-exchange-reserve adequacy, robust current account surpluses, and its net external-creditor position underpin its external stability.

Russia maintains current account surpluses…

Russia exports oil and oil-related products of 7bn barrels/day[1]. Over 2011-14, Russia maintained net oil exports of about USD 265bn a year, with the lower oil prices of 2015-16 leading to a drop in this to USD 110-150bn. Under conservative oil price assumptions, the IMF estimates Russia's current account surplus at between 3-4% of GDP going forward.

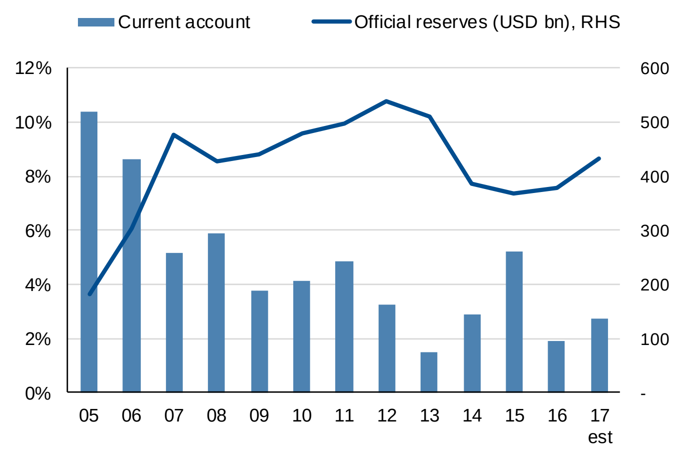
… and is in the process of re-building reserves.

These surpluses, abetted by Russia's shift from a net importer to a net exporter of food, translates into the accumulation of official reserves, including those saved in two sovereign funds, the Reserve Fund and the National Wealth Fund – to be merged next month.

Moreover, the risk of rapid reserve rundowns in instances of foreign-exchange market stress has been reduced, with reform to a floating rouble since November 2014 allowing the exchange rate to act as a shock absorption instrument. Official reserves have been on an upward path, from USD 356bn in a 2015 trough to USD 433bn as of December 2017, while gross external debt remains at 60% of GDP in 2016, with short term external debt at just 6% of GDP.

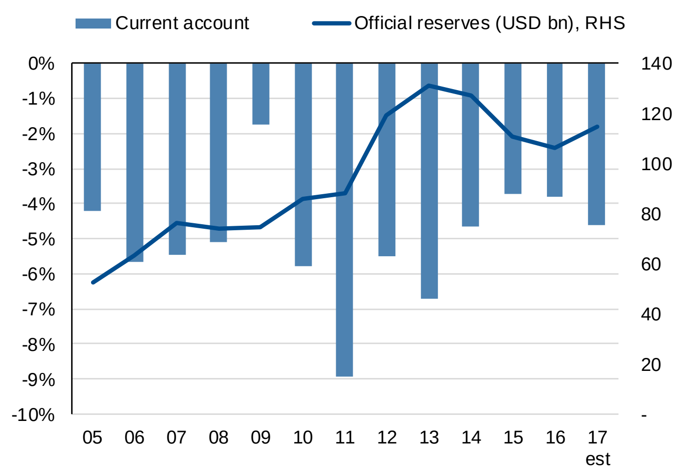
Importantly, Scope's investment grade rating on Russia recognises the new fiscal rule, which restrains budget spending and stipulates that oil-related revenues above a USD 40/barrel level must be saved in government reserves. If this remains in force, it will help reduce external vulnerabilities.

Figure 1: Current account (% of GDP) vs. official reserves, Russia



Source: Central Bank of the Russian Federation, Federal State Statistics Service

Figure 2: Current account (% of GDP) vs. official reserves, Turkey



Source: Central Bank of the Republic of Turkey, Turkish Statistical Institute

While Turkey has posted current account deficits…

Turkey's current account has remained in persistent deficit, reflecting a 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.

The current account deficit widened in 2017, to approximately 4.6% of GDP. A large share of this deficit is tied to energy imports. Unlike Russia, Turkey is a net oil importer of over

[1] EIA Russia country report, October 2016.

800k barrels a day[2], with this demand growing in the last 15 years. In the years to follow, the current account balance will improve only modestly.

… with those deficits financed via volatile capital inflows.

Turkey’s current account deficit is only partially met through net foreign direct investment (in 2016, of 1.1% of GDP), leaving the burden of financing on volatile portfolio flows. This, in addition to high refinancing needs stemming from private external debt maturities, leads to significant external vulnerability. Capital outflows placed the lira under intense pressure repeatedly since late 2016, reflecting capital reversals associated with political and security risks. The lira has since stabilised, but remains vulnerable to shifts in investor sentiment. Scope considers this external vulnerability in Turkey’s non-IG rating.

Turkey has a moderate external debt to GDP ratio (of just above 50% as of 1H17), but this has been on a rising trend and sits at a vulnerable level compared with FX reserves. Around one fourth of external debt is concentrated in short term maturities (less than 1 year), adding further underlying pressure on financing. The IMF estimates that annual external financing needs are in excess of 30% of GDP[3].

Reason #2: Turkey’s political and institutional challenges

Political risk as a key constraint on Turkey’s ratings

In Scope’s most recent rating decision on Turkey, Scope wrote that “*the domestic political environment remains a key constraint to Turkey’s [BB+] credit rating*.” Ongoing institutional uncertainties and geopolitical disputes harm long-run growth, but also impede the quality of policymaking and exacerbate external risks also in the short run.

Earlier this month, the Turkish government extended the state of emergency by another three months, ending in April 2018. Over the last 18 months of emergency rule, more than 50,000 people have been arrested, with the government bypassing lawmakers in order to rule by decree.

Lead-up to executive presidency

The April 2017 constitutional referendum confirmed the incoming executive presidency, becoming effective after the 2019 elections, which will strengthen President Recep Tayyip Erdoğan’s powers. By enabling the president to in the future formally enact certain laws by decree, declare emergency rule, dismiss parliament, and appoint top state officials, the executive presidency further erodes the system of checks and balances.

Turkey's international relations with key allies, such as Germany and the US, have become more strained. In addition, Turkey's accession to the European Union has been suspended for the time being[4] owing to concerns over the rule of law, with discussions now around a possible ‘preferential partnership’ in line with the one to be discussed with the United Kingdom after Brexit. Furthermore, the threat of security incidents and potential spill-over of regional conflicts constitute risks.

Risk aversion impacts demand for Turkish assets

Political developments and the government’s response have raised concerns and induced reversals in foreign investors’ holdings of Turkish local-currency-denominated debt and sharp depreciations in the Turkish lira. Although tourist arrivals have picked up from the lows of 2016, revenues remain well under the peaks of 2014.

Short-term policy responses risk medium-run imbalances

In addition, the policy response of authorities to the 2016 political instability has focused on supporting short-term economic activity, glancing forward to the 2019 elections, and, owing to this, raised medium-run financial risks. Owing to support from fiscal stimulus and support for credit generation, the economy has grown. However, these short-term reactionary measures come at the cost of further advancement on important structural reforms. Scope

[2] Knoema, https://knoema.com/EIAIES2017AUG/international-energy-statistics-monthly-update?location=1000970-turkey
[3] Turkey: IMF 2017 Article IV Consultation, February 2017.
[4] In April 2017, the Parliamentary Assembly of the Council of Europe reopened a monitoring phase on Turkey, which means reopening the discussion on some Copenhagen criteria. This means that the progression of the chapters within the EU accession programme is suspended for the time being. Discussions are now around a possible ‘preferential partnership’ in line with the one to be discussed with the UK after Brexit.

considers the short-term stimulus measures to have risked increasing macroeconomic imbalances, while failing to address underlying structural issues.

Escalation risk in Turkey owing to external sector vulnerabilities

Given the adverse effects of political uncertainty on economic conditions and the policy mix, Scope views the institutional environment in Turkey as a limitation on the nation's sovereign ratings. This limitation is particularly germane in light of Turkey's external financing needs. This interplay between susceptibility to political-event risk and balance of payment vulnerabilities risks episodes that escalate rapidly, fuelled by reversals in global confidence and flows.

Russia similarly exhibits geopolitical vulnerabilities…

Russia also exhibits significant vulnerability to geopolitical risk and weak governance, as shown in the country's poor institutional score in Scope's quantitative framework. Russian presidential elections this March will not bring about substantive changes to governance.

Geopolitical risks related to the ongoing conflict in Ukraine and the threat of additional sanctions remain significant, and already inhibit systemically important Russian companies from access to EU debt-capital markets. However, despite geopolitical tensions, economic ties between Russia and the EU remain close as the EU is by far Russia's largest trading partner while Russia is the leading energy supplier to the union.

… but Russia has raised its resilience to economic and geopolitical risks.

However, Scope believes Russia exhibits a strengthened resilience, which has shielded its economy from major external shocks like lower oil prices, geopolitical tensions and subsequent international sanctions in the short run. This resilience owes partly to an import-substitution policy and related ongoing industrial development programmes. The adaptation of Russia's economic model to the lower oil price environment has included strengthening economic self-sufficiency.

Reason #3: Russia's stronger fiscal/debt profile and institutions

Improvements in Russia's fiscal balance underpinned by new fiscal rule

Russia's fiscal balance improved to -2.1% of GDP in 2017, from -3.7% of GDP in 2016[5], driven by recovering energy-related revenues as well as non-oil revenue collections.

To underpin fiscal consolidation and reduce budgetary volatility arising from oil price fluctuations, Russia's new fiscal rule is progressively being incorporated. Under the framework, oil and gas revenues will be budgeted at a conservative USD 40 per barrel (based on a 50-year oil price average), and any divergence in revenues from this target are to be saved or financed via the sovereign wealth fund. In Scope's view, the incoming mechanism will buffer the economy against volatility in petroleum prices, stabilise fiscal spending, replenish fiscal reserves in the near term, improve the predictability and discipline of fiscal policymaking, and ease a structural dependence on oil-related revenues.

Public debt is low, with some improvement in composition

The Russian public-debt framework stipulates compliance with public-debt sustainability thresholds. According to estimates from the IMF, public debt should increase to 18.2% of GDP by 2019, remaining under a threshold of 20% of GDP. In 2016, the Ministry of Finance in its debt management policy for 2017-19 reported that the average duration of new bonds rose to 5.5 years in 2016, extending the overall duration of the OFZ portfolio to 3.9 years[6].

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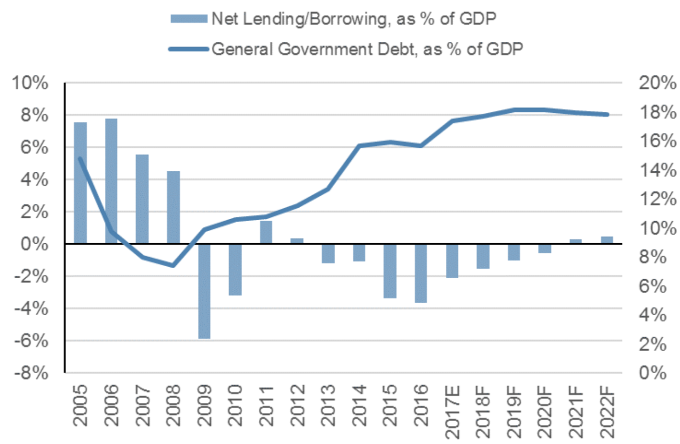
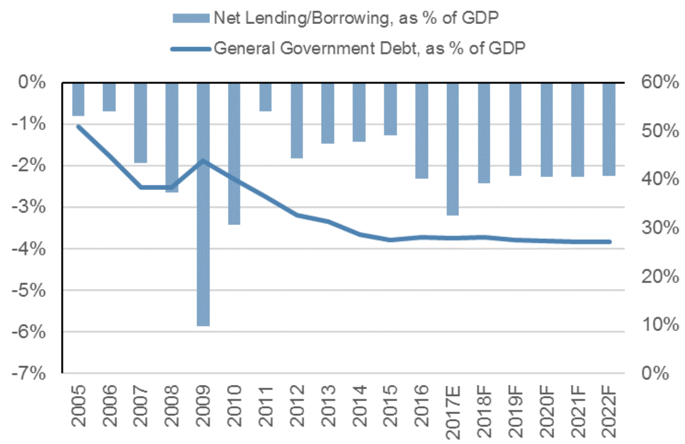
[5] Based on IMF figures.
[6] http://old.minfin.ru/common/upload/library/2017/06/main/2017-2019_Debt_Management_Strategy__Eng.pdf

Figure 3: Public debt and deficit ratios, Russia



Source: IMF, Haver Analytics

Figure 4: Public debt and deficit ratios, Turkey



Source: IMF, Haver Analytics

Growth-supportive fiscal policy to continue ahead of Turkish elections

Similar to Russia, one of Turkey's main strengths lies in its public finances. Turkey's budget process is underpinned by implementation of a rolling three-year budgeting system and internal budgetary rules. Turkey recorded primary surpluses from 2010 to 2015, demonstrating fiscal discipline.

But, owing to increased spending ahead of 2019 elections, the budgetary deficit widened to about 3.2% of GDP in 2017, from 2.3% in 2016 and 1.3% in 2015. Despite Turkey's past record, Scope considers this adverse fiscal trajectory to be a constraint on Turkey's rating. Going forward, Scope anticipates the fiscal balance to recover somewhat to around -2.5% of GDP in the next years.

Slightly higher debt ratios, but significant financing pressures

Like Russia, Turkey enjoys manageable public debt ratios. Successful fiscal consolidation reduced Turkey's public debt to GDP from 44% in 2009 to 28% in 2017, though this decline has now flat-lined. An IMF baseline scenario[7] sees the debt ratio remaining near present levels, ending a 2022 horizon at around 27% of GDP.

Turkey's maturity profile alongside the participation of foreign investors in capital markets highlight financing demands. Refinancing needs are worth noting: at 7.8% of GDP in 2018, with much of this to meet maturing debt[8]. In view of this weakness, Turkey maintains a conservative debt strategy: since 2003, the government has shifted issuance from FX-denominated debt, FX-indexed debt and floaters to fixed-coupon local-currency bonds. As of 2016, 38% of public debt was denominated in foreign currency.

Reason #4: Comparative weakness in Turkey's monetary and financial management

Turkey: Problems concerning the achievability of the inflation target…

In the second half of 2017, Turkey was hit by higher oil prices alongside a sharp depreciation in the lira against the dollar (since last June, of 19%). The inflation target of 5% is projected to only be reached towards the end of 2019. In December 2017, headline inflation stood at an elevated 11.9% YoY, with core inflation at 12.3%.

Turkey's central bank has been slow to raise rates in response to high inflation. The central bank discontinued use of the one-week repo rate as the standard monetary policy instrument in early 2017, and has shifted system funding to the late liquidity window (the

[7] IMF World Economic Outlook, October 2017
[8] IMF Fiscal Monitor, April 2017

rate of which was hiked to 12.75% in December). According to the OECD, the shift in policy instruments is limiting the effectiveness of the central bank, with presently neither a significant moderation in consumer price inflation nor a re-anchoring of inflation expectations.

… and building on macroeconomic imbalances.

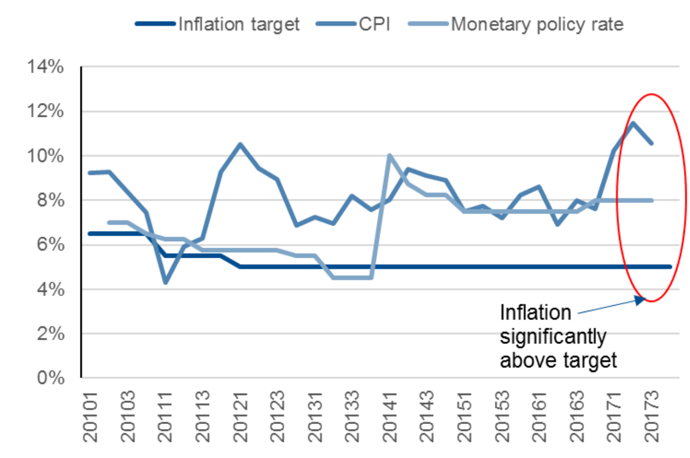
Failure to address inflation, pro-cyclical fiscal stimulus and elevated credit growth tied to programmes like the Credit Guarantee Fund (CGF) are areas of concern, in Scope's view, relating to the development of macroeconomic imbalances. Corporate loans, backed by government guarantees, have risen sharply, aggravating the risk of increases in non-performing loans down the road and, consequently, government support. The sizeable dollarisation of deposits (60% of total deposits as of Q3 2017) is advancing once again, limiting the effectiveness of monetary policy transmission.

Russia: Tight monetary policy contributing to lower inflation

By contrast, in Russia, consumer price inflation has dipped under the central bank's 4% target (inflation is now at 2.5% YoY as of December 2017, compared with a peak of 16.9% in early 2016). This has come thanks to a stabilisation in the rouble, low demand pressures, favourable food price dynamics and the Central Bank of Russia (CBR)'s tight monetary policy. Given present inflation trends and the medium-term forecasts for the economy, the CBR cut the key rate by 50 bps in December to 7.75%. There is still significant leeway for further easing, in Scope's view.

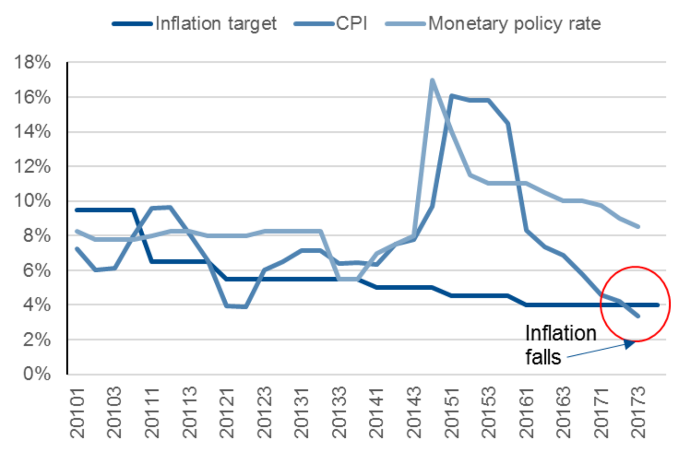
The low and decreasing dollarisation of Russian banking liabilities (23.4% of total liabilities in Q3 2017) supports the effectiveness of monetary policy and achievement of inflation objectives, though this may also be attributed to restrictions in place for local entities on the conversion of funds between rouble and foreign currencies.

Figure 5: Turkey: CPI vs. inflation target vs. policy rate



Source: Central Bank of the Republic of Turkey, Turkish Statistical Institute

Figure 6: Russia: CPI vs. inflation target vs. policy rate



Source: Central Bank of the Russian Federation, Federal State Statistics Service

Two arguments supporting Turkey

Against the arguments that favour a higher rating for Russia compared with Turkey, Scope notes two counter-arguments in Turkey's favour.

Taken together, the pros and cons inform Scope's one-notch rating differential between the two countries.

Counter-argument #1: Growth and demographics, which support Turkey's long-run debt sustainability

Turkey's growth, supported by a growing labour force

The strongest argument in Turkey's favour is its dynamic growth, which, according to the IMF, is expected at over 5% YoY in 2017. This should moderate to around 3.5% in 2018 and in the years after. Domestic demand is the major driver, with private consumption expanding at near 4% YoY in 2017. This increase has been helped by fiscal stimulus (to be withdrawn this year), which entailed temporary tax measures encouraging consumption and employment, alongside government credit guarantees backing private lending.

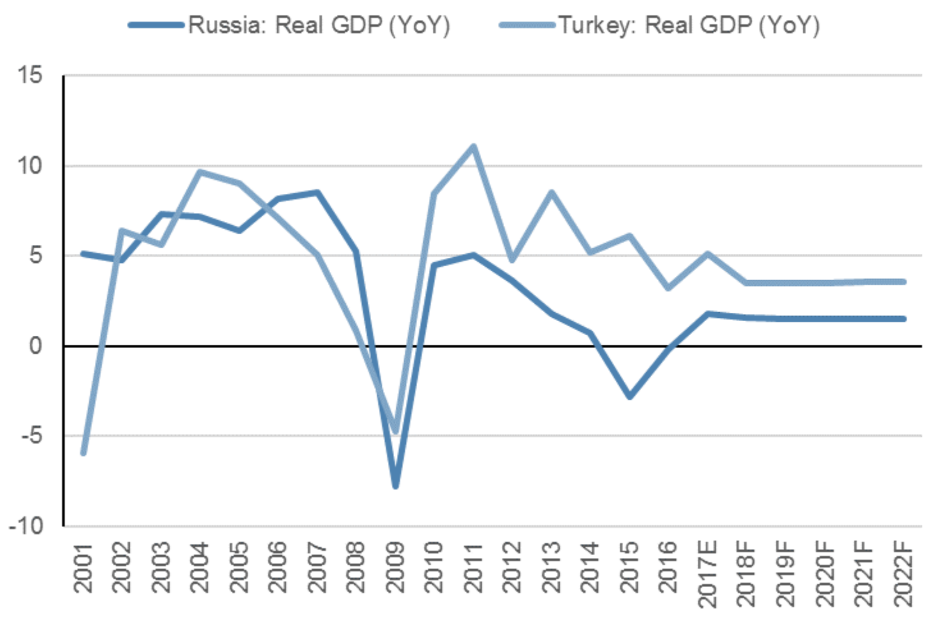
Turkey's working-age population will grow at about a 1.1% per annum rate over 2015-2025, according to the UN Population Division. This compares with -0.9% per annum in Russia over the same period. Based on the IMF, Turkey's medium-run [9] growth rate is approximated at 3.6%, compared with Russia's at 1.5%. Robust real growth rates support Scope's assessment of Turkey's debt sustainability.

While the short-to-medium-term growth outlook is healthy, Turkey's longer-term growth potential faces challenges related to the slowdown in convergence with advanced economies since 2008, making structural reforms needed.

But modest growth in Russia

Assuming stable oil prices, the Russian economy is expected to expand at a modest rate of 1.5–2% over 2017 and 2018, close to estimates of Russia's medium-run potential growth. In Scope's view, an increase in potential growth will depend on structural reform and institutional changes, with countervailing downward pressures exerted by international sanctions, low productivity and a shrinking workforce.

Figure 7: Real growth with IMF forecasts to 2022, Turkey and Russia



Source: IMF World Economic Outlook

Counter-argument #2: Turkey benefits from lower non-performing loans in the financial system

Turkey has implemented important banking reforms

Turkey has implemented reforms in the banking sector, and while the full application of Basel III requirements remains underway, the net stable funding ratio regulations and IFRS

[9] Using the IMF's forecasted real growth rate in 2022.

9 will be in force from January 2018[10]. A new resolution framework has been drafted based on recommendations from the Financial Stability Board and the IMF in line with the European Union's Bank Recovery and Resolution Directive (BRRD). The Banking Regulatory and Supervisory Authority (BRSA) is also working on the requirements for systemically important banks, due to become effective from 2019.

Average loan quality in Turkey slightly deteriorated in 2016, however the CGF programme should shield banks' balance sheets from future losses to an extent. The NPL ratio remains modest at 3.1% as of 2016. As of November 2017, the banking sector's capital adequacy ratio[11] was 16.4%, well above the regulatory requirement of 8% and target ratio of 12%, constituting adequate buffers to cover potential negative shocks.

Russia exhibits higher, and rising, NPL ratios

In Russia, despite the ample liquidity in the banking sector, persistent vulnerabilities are reflected in the ongoing bank restructuring process.

The IMF estimates the NPL ratio at around 9.7% as of Q1 2017 (rising from a 2013 low of 6%). The relatively low coverage of bad loans through provisions remains a key short-term risk particularly for the privately-owned banks. The presence of state ownership in the banking sector is, moreover, high and rising, with the four largest banks accounting for 50% of total system assets.

Table 1: Non-performing loan and bank capital ratios, Turkey and Russia

	2010	2011	2012	2013	2014	2015	2016	2017
Bank Non-performing Loans to Total Loans								
Turkey	3.49	2.58	2.74	2.64	2.74	2.99	3.11	na
Russia	8.23	6.59	6.03	6.00	6.73	8.35	9.44	9.72
Bank Regulatory Capital to Risk-Weighted Assets								
Turkey	18.97	16.55	17.89	15.28	16.28	15.57	15.57	na
Russia	18.09	14.66	13.69	13.46	12.49	12.70	13.07	13.43

Source: IMF

10 EBRD Transition Report Assessments: Turkey 2017-18.
11 CEIC Data

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