

CREDITWORTHINESS AND RISKS

Creditworthiness and Bank Exposure

73. *Russia's creditworthiness has improved significantly over recent years in tandem with a reduction in its external debt.* The high oil prices of recent years have built up reserves, strengthened the fiscal position and by end-July 2006 allowed for the accumulation of US\$67.2 billion in the Stabilization Fund. Russia became a net external creditor in 2004. In 2005 Russia paid off its outstanding US\$3.5 billion to the IMF, as well as some US\$20 billion in Soviet-era debt, including US\$15.6 billion in prepayments to the Paris Club. This brought the total public external debt stock down to US\$71.4 billion at the end of 2005 (or 9.4 percent of GDP), compared with US\$97.4 billion (16.5 percent of GDP) at the end of 2004. In 2006 Russia prepaid all of its remaining debt to the Paris Club (US 21.3 billion), which should bring Russian sovereign foreign debt down to 4.5 percent of GDP by the end of the year. The federal domestic debt stock is small, amounting to 4 percent of GDP at the start of 2006. The sovereign's commitment to pay its external creditors remains strong. By the end of April 2006, Russia became the fourth-largest holder of gold and foreign-currency reserves in the world. With oil prices expected to remain broadly at current levels over the forecast period, Russia would have no problems servicing its debt.

Figure 10: Share of Public Debt in GDP

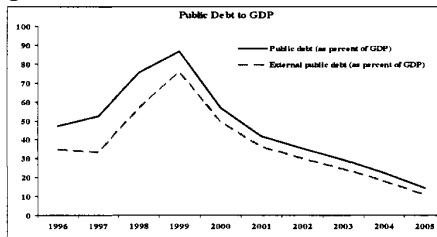
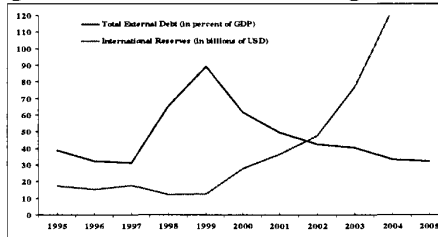


Figure 11: External Debt and Foreign Reserves



74. *At the sub-national level, the creditworthiness of Russia's strongest regions also continues to improve and offers expanding opportunities for lending without sovereign guarantees by the Bank Group's Sub-National Development Program.* High economic growth in industrially developed Russian regions and the service-oriented largest cities has led to increasing revenues. In addition, a series of tax, financial and legal reforms are reshaping Russian sub-national operational environment, influencing the financial profile and creditworthiness of regional and local governments. Standard and Poor's rates 11 local and regional governments in Russia. The creditworthiness of Russia's strongest regions has improved over the past few years in line with that of the Russian federation, as evident by increased credit ratings (to "BB+" for Moscow and St Petersburg from "BB-" in 2002 and "CCC-" in 1998). But uncertainties associated with the implementation of the Russian inter-governmental reforms, the difficulties to sustain growth in industrial-based regions under the current circumstances (high oil prices and a strong currency), and the uneven revenue growth across regions and local governments call for a cautious and selective approach for Bank Group lending to regions without sovereign guarantees (such lending by the Sub-National Development Program will be on IFC's books).

75. *In line with the modest CPS lending scenario, IBRD's exposure in Russia's will continue to decline.* IBRD's exposure in Russia is expected to fall from US\$4.9 billion at end-FY06 to less than US\$4.0 billion in FY09. Its share of the overall IBRD portfolio would decline from 4.7 percent to 3.8 percent over the period.

Risks

76. *Macroeconomic risks associated with Russia's oil dependency are considered low during the CPS period.* The repayment of foreign debt and the rapid accumulation of reserves have insulated Russia to a significant degree from external shocks. A very sharp decline of oil prices could send ripples through Russian financial markets. Even in this event, government finances would be protected during the CPS period by the large accumulated fiscal reserve (Stabilization Fund). The Stabilization Fund (fiscal reserve) has accumulated resources to the point that it could sustain the government budget at current expenditure levels with oil prices under US\$20 a barrel during the CPS period. Given that the Russia's dependence on foreign money concerns primarily sales of oil and gas, as opposed to inflows of foreign investment, its immediate macroeconomic vulnerability to changes in investor sentiment is lower than in many other emerging market economies. The immediate risks from a sharp fall in oil prices, together with a significant depreciation of the ruble, would likely be confined to the non-government financial sector in the short run, and could be contained through responsible macroeconomic policy and bank regulation. Simulations reported in Annex 1 indicate that significant economic growth and macroeconomic balances should be maintained over the CPS period even in the event of low oil prices. A possible implication of Russia's high fiscal reserves for the Bank's program may be a further reduction of IBRD's lending program below the already modest levels foreseen. Future Bank lending is focused on leveraging Russia's own funds through increased national co-financing. Ultimately, the Government will decide on borrowing from the Bank based on fiscal conditions and the alternative options for availing the Bank's value added, such as fee-for-service arrangements.

77. *While macroeconomic risks are considered low, there are implementation risks related to the pace and the direction of economic reforms.* Russia's political environment is currently stable. President Putin has a strong mandate and enjoys a constitutional majority in the Duma. The executive branch has more leverage over regional and local governments than in the past. The next presidential election in 2008 is not expected to lead to significant changes in policy. Nonetheless, there remains some uncertainty about the pace and the direction of economic reforms. While the current medium-term development program follows the general transition goals of the 2000 program, they also include more controversial areas of economic policy which have a mixed world experience. These include active state interventions along a 'new industrial policy' which aim at stimulating diversification and the innovation economy. The Bank's involvement in areas such as the new economic zones and industrial parks help to bring best global practice to Russia for development of such policy areas. Differing views could also exist within the government on administrative and budgetary reform, particularly on the degree to which these reforms should or should not concentrate attention on increasing control of the federal center over sub-national bodies. In these areas, the Bank can play a valuable advisory role in transferring global experience and the state of knowledge on potential advantages and risks from the pursuit of one or another specific policy.

78. *Finally, there are implementation risks in the Bank moving to a more regional approach and to the new modalities of operation.* Some of the proposed modalities such as sub-national lending and the development of a fee-for-service advisory program are either relatively new for the Bank or limited in terms of prior experience, and operational details are still evolving. To address these risks, the Bank will be selective in how it approaches the evolving work in the regions to ensure a critical mass and impact of its interventions. In moving to the new modalities

of operation, the Bank can build on the significant progress achieved with successful pilots already completed in many of the new areas. A complicating factor may be the recent public procurement and competition laws which appear not to exempt IFIs from competition with private market participants when seeking to provide paid services to all levels of government or direct sub-national lending. Consultations with the Government are underway to resolve this apparent bottleneck, through expeditious amendments to the laws and/or the execution of a stand alone framework agreement with the Government.