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"CAPITAL FLIGHT: SCALE AND NATURE"

Capital flight from Russia in the 1990s is a problem at the focus of the attention of Russian and foreign state officials, and the mass media.[2] Avoidance of country risks to capital, a desire to conceal capital removed from circulation in enterprises under scrutiny, and a desire to take capital abroad for personal possession and use are usually interpreted as the causes of its export. This interpretation, the simplest, doubtlessly reflects the new realities of Russian capitalism: "theft from one's own enterprise." It is insufficient however, and the idea that this is classical behavior of capital exporters responding to political and economic risks isn't adequate either. Practically speaking, this important, complex problem has only just become an object of serious research.[3]

There is also considerable variation in the estimates of the scale of export: anything from several billion per year, to hundreds of billions in the past decade.

A totally unique mythology has also evolved according to which exported Russian capital is trying to return to the motherland, or it can be forced to return to the Russian economy by special measures--for example by granting amnesty. Politicians see capital that has gone abroad in the last decade, and the public's dollar savings "stuffed in mattresses" as well, as a kind of unutilized reserve for the country's development. This is of course somewhat akin to looking for an economic miracle when things get tough. Just about each of our governments has resumed this quest. One thing is indisputable--capital flight exists, its scale is enormous, and it has an unfavorable effect both on the possibilities for the country's development and on the solution to the problem of dependence on foreign debt.

The overall assessment of loss of Russian capital in the 1990s cannot be reduced solely to its flight. The processes of capital export can be understood only by accounting for the interests and goals of owners and managers controlling the cash flows. Liberalization during the years of reform naturally led to exchange of capital between the Russian economy and the outside world, which is nothing surprising. Obviously, it was to be expected that after prices and foreign economic activity were liberalized, large Russian enterprises would try to establish an infrastructure abroad to support their exports, imports, and borrowing. Normal (and permitted) export of capital would have been fully understandable. However, the old system precluded export of private capital by lawful means. Nor did much change for

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[1] A version of a chapter of the BEA [Bureau of Economic Analysis] survey "Economic Policy in Russia in 2000" prepared for periodical publication.

[2] There is a vast literature on capital flight, especially in Latin America in the 1970s-1980s. See for example: "Capital Flight and Third World Debt," edited by Lonal R. Lessard and John Williamson, Institute for International Economics, Washington, D.C., USA, 1987.

[3] See Gvozdeva, Ye., et al. "An Interdisciplinary Approach to Analysis of Capital Export From Russia," *Voprosy Ekonomiki*, No. 2, 2000, pp 15-45.

practical purposes after liberalization--there was practically no real way to legally justify capital export. The mentality of regulatory bodies changes slowly, and in all of these years it remained sharply opposed to all capital export. Consequently although export of Russian capital was illegal from the standpoint of exchange control and taxation, because this is a country with an enormous international commodity turnover and a huge need for commercial credits it was still essentially seen as something reasonable and inescapable. Large Russian private and state companies and banks had an inescapable need for holding assets abroad in private hands. It would hardly be possible, at least without first conducting extensive special research, to retrospectively distinguish capital flight from economically justified export of capital from Russia, creation of marketing networks, and consolidation of promising assets and possibilities of Russian companies. Such that for the moment we have to treat all capital export that is illegal under Russian laws as "flight." Concurrently, a tangible amount of capital was conveyed into Russia in different forms, especially before the financial crash. This is why the country's external capital turnover reveals a rather complex pattern of opposing trends.

1. The Nature of Capital Export

"Capital flight" means illegal conveyance of capital abroad--that is, conveyance in violation of some rules of law of the country of origin. It should not be confused with "capital export"--that is, conveyance of capital in full compliance with all requirements of the law. Phenomena characterized by these two concepts differ not only in form but also to a greater degree in content. It is difficult to estimate the total amount of capital conveyed out of Russia in the 1990s because of problems with statistics (especially before 1996), the absence of any real record-keeping on sanctioned conveyance of capital, and other factors.

Capital export is a normal economic phenomenon, subject to regulation by definition and not presenting a danger to the national economy. Capital export can facilitate the export of goods and maintenance of employment, and solution of other national economic problems. On the other hand capital flight is evidence that problems in the national economy are at the critical level, and that domestic investing is low in its effectiveness, or it lacks promise. It leads to the national economy's impoverishment and a decrease in possible investments, and consequently to further worsening of the prospects for development.

It should be emphasized that both capital of criminal origin and legitimate capital can flee. While any operation involving illegal transfer of capital abroad is contrary to law, the source of the capital within the national economy can itself be absolutely legitimate. For example, legitimately obtained profit entering the flow of capital fleeing abroad in avoidance of taxes becomes the subject of a violation only after its successful illegal conveyance out of the country. And on the other hand, income from drug trafficking or racketeering that is conveyed abroad is criminal right from its origin. Thus capital flight may be associated with an extremely variable degree of offenses depending on the source from which the resources originate. As an example we can draw a parallel with the concepts of a shadow economy adopted in the international methodology and practice of settlements. In particular, the concept of illegal production written into standards on national accounting systems approved jointly by the United Nations, the IMF, the World Bank, the OSCE, and Eurostat consists of two parts--production of goods and services prohibited by law, and production of legitimate goods and services by illegal means ("SNS-93," Par. 6.30).

We can think of conveyance of capital out of Russia in the conditions of the transitional period as a result of the combination of several factors. Naturally, export of significant amounts of capital in the first years of reform for the purpose of creating a foreign export-import infrastructure that would provide for normal access to markets and to credit resources was something to be expected back then. As for credit resources, it was important to maintain liquid deposits in Western banks so that all of the Russian commercial and political risks would not be factored into the cost of credit to a Russian client. Deliveries of products such as oil and so on or stockpiles of these products abroad played a similar role. At the same time, this economically justified process continued to be interpreted under the law basically as illegal conveyance of capital abroad. Understandably, it's easier to start this process than to stop it. While it is very difficult to draw a distinction between export and flight, it may be surmised that over the years, the ratio changed in favor of the latter.

Capital flight is also complex in terms of the purpose served by the capital making up this flow. As a rule it encompasses processes associated with change in the apparent ownership of the capital when it crosses the border, although of course the capital actually remains in the same hands. Transfer of capital to other legal entities (or individuals) is not necessarily flight--in our conditions, even justified export has usually involved a complex operation of sheltering resources and transferring them to the accounts of subsidiaries and affiliated persons. We can distinguish some other purposes for which capital is exported, although making a quantitative distinction is extremely difficult: its use as liquid assets abroad to support Russian business; its transfer to private hands for personal use abroad; its reinvestment into Russian stocks with the purpose of gaining and maintaining control over enterprises; its speculative reinvestment into Russian securities (government short-term bonds and others); direct investments per se into the Russian economy, disguised and protected as foreign investments.

A part of exported capital is comprised of liquid assets conveyed out of the country in avoidance of taxes and to create the possibilities for making settlements abroad.[4] Nonpayments between enterprises within the country are compensated in part by their mutual settlement with assets held abroad. In this respect capital flight means removal of a part of assets beyond the boundaries of the country's banking system. While funds remain within the world's banking system and are used for their intended purpose, they are beyond national control. This naturally weakens the regulatory role played by any efforts of federal administrative bodies, and the effectiveness of programs of macroeconomic stabilization. Practically speaking, this is one other means of mitigating budget constraints and maintaining freedom of action.

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[4] See "Survey of Economic Policy in Russia in 1997," BEA, 1998, p 44.

Another important part of exported capital consists of resources transferred from enterprises to the ownership of the owners and (or) managers of the enterprises. These resources are then used either for personal consumption and acquisition of property abroad, or for investment into stocks with the purpose of gaining control over Russian joint-stock companies. It's of course impossible to divide the flows of exported capital by the purposes for which it is intended. Capital conveyed out of the country is included within the cycle of the world financial system, and is protected from claims of a general nature. Realistically, only the owners of the enterprises have the power to make the capital of their companies come back home; however, it would be difficult to expect this to happen on a significant scale.

The reasons listed above for export show that capital export is associated with the nature of property and corporate management in Russian companies. Export is a part of the corporate strategy of a company's foreign development, or of partial reinvestment in Russia, or conversion of a company's resources into the personal assets of its owners or managers. While general political or macroeconomic stability plays an important role in all of these cases, it is not a critical one, which explains the staying power of export even when conditions are relatively good. Correspondingly, purposeful organized export of capital creates serious problems for those who are trying to put a stop to it.

The "I Account" Scheme

This is the most universal and widespread scheme for big business; it came into use in recent years, and it exists in different variants, more or less complex. Because it is lawful, it need not even be classified as capital export--it's simply the competent exploitation of existing legislation to solve corporate problems.

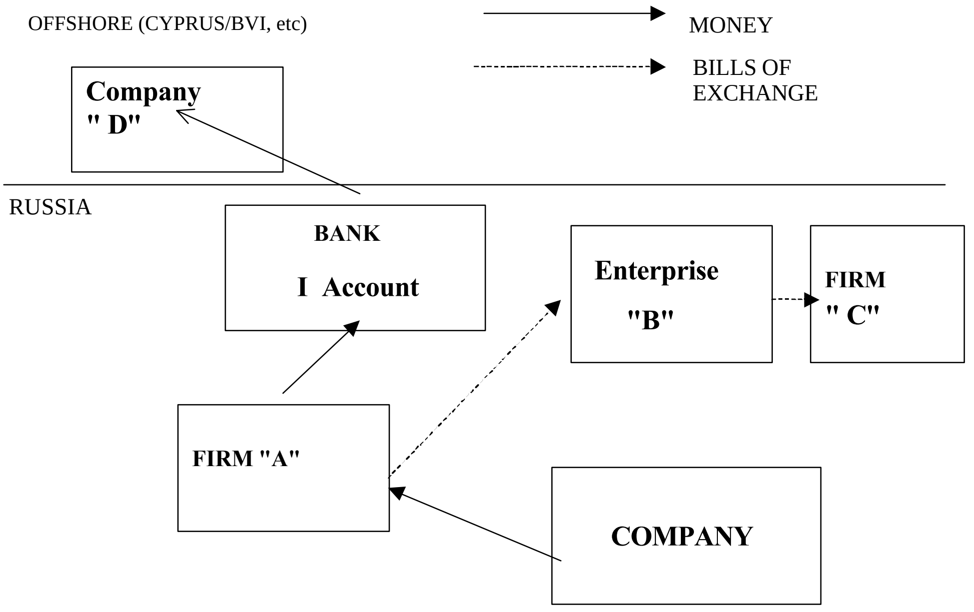
The scheme requires a well-tuned mechanism for creating offshore and fictitious Russian companies (and desirably, the mechanisms of their liquidation as well). By and large it is totally legal, and when things are set up properly, it can operate for a long time without change. It is usable by large companies of any sector conducting any kind of activity. The simplest variant is diagrammed in the figure below. In this scenario the "Company" wants to convey a part of its financial assets abroad to offshore accounts. This scheme pursues two separate objectives in succession: removing capital from a particular enterprise within Russia by the most legitimate means, and transferring it abroad just as scrupulously. What is good about the scheme is that it can be implemented in non-exporting sectors of the economy.

Preparatory Phase

A Russian firm A is created (sometimes the slang term "*martyshka*" ["monkey"] is used), preferably in one of the free zones inside Russia. Kalmykia is often used for these purposes because the "rates" charged for these kinds of services by local authorities and favorable tax treatment are well established. In principle, such a firm can be created without difficulty in any region of Russia, though with a somewhat larger risk of attracting the attention of tax and other authorities.

A contract for delivery of something by firm A to the "Company" is executed, and delivery is prepaid to firm A's account, opened as a rule with "one of its own" banks.

The amount of the conveyance is equal to practically the entire amount of the prepayment. When work is done through "outside" banks, transaction costs increase. Firm A "assigns" the delivery contract to some enterprise B, and settles with it, though this time with its own bills of exchange.



Enterprise B is a firm that is already in bankruptcy or one against which bankruptcy must be filed to permit its takeover. Enterprise B may deliver the products under the contract (gratis, for all intents and purposes), or it might not deliver them and become indebted to the "Company." While this is not essential to the capital export scheme, default by the supplier may attract notice. In the case where the goods are delivered (and the corresponding outlays are made), B suffers a loss equal to the difference between the cost of the delivery and the loss in earnings upon payment with bills of exchange. The existence of failing firms is necessary to this operation, as is a sufficiently significant volume of nonpayments between the firms, so that such schemes would not stand out from the general background.

Finally, enterprise B sells the bills of exchange it receives to yet another dummy firm C at the maximum possible discount (99 percent, for example). Firm C never presents these bills for payment, and for practical purposes they drop out of circulation. Firm C does not suffer large losses, and it simply lets the entire chain of transactions with the bill fade into nonexistence. Theoretically these bills could be repurchased or settled. Financial specialists of all participating companies must be co-participants of the entire chain of bill transactions, and obviously they must receive some remuneration, which will come out of the "Company's" capital. This is absolutely necessary because they are acting in this operation against the objective interests of their enterprises and the owners thereof.

And so, as a result of the preceding actions the "Company" transferred a certain amount to the account of Firm A, and the latter "settled" with it. The bill has completed its entire cycle. All of the procedures described above comprise the "preparatory" phase of concentrating resources outside the "Company." "Profit centers" can be created by other means as well, for example through schemes such as internal tolling, etc. Offshore companies join the game in the next phase.

Export Per Se

An offshore firm D opens a type I (investment) account with a large Russian bank for the purposes of making investments in Russia. Conversion of ruble profits in this account into foreign exchange and their repatriation proceed unrestricted. The bank must be a large one, since it must have a general license and a high turnover so that the large payments wouldn't catch the eye.

Company D buys some shares in Russian companies for a kopek or two, thus making an investment. Firm A buys shares from Firm D amounting to the total of the exported capital. And then having thus received a profit from its "investment" activity in Russia into its I account with the bank, firm D converts this amount and transfers it abroad.

The lion's share of these operations are carried out with Cyprus (on the order of 90 percent). The British West Indies (in the Caribbean), the Channel Islands, and the Antilles (Dutch Caribbean) are also used. Cyprus is used because it is one of the three countries (Finland, Austria, Cyprus) with which agreements to avoid double taxation exist. In this case the profit tax rate on Cyprus (4.3 percent, or 5 percent starting in 2000) is incomparably lower than in other countries. Even this rate could be decreased significantly as well, by the way, by employing tax avoidance schemes.

This scheme is universal, but it requires export of large amounts of resources, inasmuch as the costs of organizing it are rather high, and it requires the coordinated actions of many people. The joy of this scheme is that export is absolutely legal, and it is difficult to trace the Company's losses within Russia.

Attentive analysis of data on foreign investments provides the grounds for suggesting that a certain part of the "fugitive" capital returns to Russia in the form of foreign investments. Capital "cycling" is best known in China, the exported capital of which was returned to the country on a huge scale in the 1980s-1990s through Hong Kong and other routes. It is commonly recognized that foreign economic operations conducted through offshore zones, and to a significant extent through Cyprus, are one of the largest channels of covert conveyance of capital out of Russia. At the same time, according to Russian statistics, on paper Cyprus is one of the largest investors in the Russian economy, one of the top five investing countries. The volume of Cypriot investments into Russia accumulated as of October 1, 1999 was $3,214 million--that is, barely below the investments of France ($3,350 million) and Great Britain ($3,584 million).[5]

It is also indicative that over 80 percent of Cypriot investments are direct investments, which is an absolute record, far ahead of other countries. It would be pertinent to recall that according to data from Cyprus's balance of payments, direct investments to the abroad as a

[5] As of October 1, 1999, investments into the Russian economy by the leader--Germany--were $6,647 million, and investments from the USA were $6,017 million.

whole (all countries of the world) do not exceed a miserly amount averaging $15 million per year. Consequently Cyprus's foreign investments that are declared in Russia are actually not of Cypriot origin. More than likely Russian capital is their source, the owners of which first convey it out of the country illegally, legalize it, transform it into "foreign" investments, and then convey it back into Russia. In this case Cypriot authorities aren't even cognizant of this, or at least they don't admit to it in official data.

Without question, Cyprus is not the only country through which Russian capital returns in the form of foreign investments. There are grounds for believing that to a significant degree, capital illegally conveyed out of Russia is the source of the investments of most investing countries. A number of factors support such a supposition. First, capital conveyed out of Russia must overcome the stiffest competition imaginable in order to access the world market. On the other hand people who have managed to create capital in Russia find it much easier to reinvest it "at home." Second, an incomparably higher rate of return can be maintained in Russia. Third and finally, reinvestment "beneath the roof" of foreign investments can create significantly greater guarantees for capital.

According to official reports, in certain periods Belgium was also among the top foreign investors into Russia. This even provoked the concern of Belgian experts, since the Belgian government had no data supporting such a scale of investment, and according to the law, Belgian investors have the right to demand guarantees from their government for their foreign investments. The corresponding consultations were conducted with Belgian experts at the Russian State Statistical Committee. It was established that there is no reason to doubt Russian statistics on foreign investments as to the official origin of these investments. But Russian statistics are unable to identify the real source of foreign investments, which may be capital of Russian origin. An indirect confirmation of such capital movement can also be found in the fact that in the end, exporters of capital into Russia never apply to the Belgian government for guarantees covering the entire volume of their investments into Russia.[6]

On the whole, it would be rather difficult today to find the grounds for an accurate estimate of the fraction of capital that "flees" Russia and returns disguised as foreign investments. It appears probable that its share of foreign investments is extremely significant, comprising a significant part of actually invested resources. The problem with conveyance of large amounts of capital out of Russia is that only part of the Russian capital is returned for productive use. Another generally negative factor is that such capital obviously doesn't contribute in any sizable way to managerial or scientific-technical experience in Russia. For practical purposes this is only a means of extending credit to Russian enterprises from abroad (given the weakness of the banking system), or securing control over Russian enterprises for the actual owners of the capital.

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[6] England's Alcem, which acquired the Vyborg TsKB [not further identified] some time ago, can be cited as the freshest illustration of practical implementation of this scheme for investing into Russia under the guise of foreign capital. This firm is registered in Great Britain, but press reports name a St. Petersburg entrepreneur as its real owner.

The generally complex and in many ways contradictory pattern of foreign borrowing, and of the influx of and payments on foreign investments and credits, is contrasted by the stable pattern of capital outflow from Russia in the 1990s. Because of this, two of the country's most acute economic problems of this period go unsolved: servicing external debt; accessibility and prices of investment capital to be used for the country's development and for transition from crisis to steady growth.

In the conditions of Russia (in contrast to a number of countries of Latin America and Asia), essentially noncriminal capital taken out of national use is the main source of illegal export. This is precisely why conveyance of capital out of Russia was for a long time not so much an object of the world community's concern, as an inexpensive source of funding for the world economy. At the same time, an influx of Russian capital into the world financial system of even $100 billion is not going to independently influence the world economy one way or another. The scale of savings and of financial flows in the world exceeds export of Russian capital by a minimum of two orders of magnitude. The capital origin factor is extremely important, inasmuch as even the term "money laundering" originated in the fight against capital of criminal origins. It would be worth recalling that a special international working group (FATF[7]) created to fight money laundering envisages four typical stages in this process. The first stage is the initial crime committed with the purpose of obtaining illegitimate income to be laundered: income obtained through drug trafficking, financial manipulations, and racketeering. With such forms of income, violation of exchange and tax legislation is unavoidable. In Russia, meantime, evasion of taxes on an enterprise's legitimate income is apparently the main initial violation. In our conditions the important factor is transfer of resources from a company's ownership to a subsidiary within the country or off-shore. Abroad, the owners of the company would see this as theft, and they would prosecute. The entire world system of laws is essentially set up so that owners would have control over managers. In Russia, however, owners and managers oftentimes do not draw much of a distinction between cash belonging to the enterprise and their own cash, such that the owners themselves aren't doing anything to fight this evil.

In the second stage, the funds are transferred to a legitimate financial system (preferably a banking system). It is mainly in this stage that the fight against such capital is waged. In our case, funds are mainly transferred abroad in violation of foreign exchange legislation. In the third stage the funds are quickly transferred through a succession of accounts held by dummy companies located throughout the entire world with the purpose of covering the tracks. In the Russian case, this has often been done by means of transfers abroad.

Finally, in the last stage the laundered resources are reinvested in legitimate business. The seizure of these resources through the courts requires proving, in relation to each exported million, that these were not ordinary commodity exports. Hard evidence of the criminal origin of the resources obtained through the corresponding courts must be presented for each element of property in the West. The long time it takes and the cost of the process

[7] FATF--Financial Action Task Force on money laundering.

make it impossible to obtain significant results quickly. The Bank of New York scandal was a real demonstration of the extremely wide gulf between accusations printed in the newspapers and legal evidence. In any case, what makes Russian capital abroad different from criminal capital obtained, let us say, by the drug mafia is mainly the first stage, which is not criminal in nature, and which falls under the jurisdiction of Interpol, and not national tax and foreign exchange services.

2. Assessment of the Scale of Flight

The scale of capital flight from Russia can be determined by different approaches. To begin with, it would be worth estimating the scale of legitimate conveyance of capital out of Russia using data from the balance of payments

Table 1. Legitimate Conveyance of Capital Out of Russia

	1995	1996	1997	1998	1999 (I-II)	Total
Capital transfers paid out	3.5	3.5	2.9	2.1	0.5	12.6
Direct investments abroad	0.4	0.8	2.6	1.0	0.9	5.6
Portfolio investments (assets)	1.7	0.2	0.2	0.3	0.2	2.5
Current accounts and deposits	-4.3	1.0	-1.0	-1.0	2.5	-2.8
Foreign cash ("internal export")	-0.0	8.7	13.4	-0.9	-1.8	19.3
Total	1.3	14.2	17.7	1.5	2.3	37.2
Total less foreign exchange purchases	1.3	5.5	4.3	2.4	4.1	17.9

Legitimate capital export wasn't large for such a big country, and was perhaps fully justified from an economical standpoint. Of course, when we take purchases of foreign cash into account, credits to the rest of the world do increase in volume somewhat during these years. But on the whole according to official data, legitimate conveyance of capital out of Russia in four and a half years was on the order of $18 billion, or approximately a year's volume of illegitimate capital export, by moderate estimate.

Considering that it is impossible to directly calculate the volumes of capital flight, any estimates of it have to be indirect. The most proper approach would be comprehensive examination of data from different areas of statistics, and mainly statistics on the balance of payments. While the approach employs calculations that cannot claim to be precise in the details, analysis would show that it does permit us to arrive at an extremely well-substantiated estimate of the scale of capital flight from Russia.[8] A number of indicators that

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[8] Payment balances were prepared in Russia only from 1994 on, and the first balances were not devoid of shortcomings, as is true of any new undertaking. In 1998 for example, the data for 1994 on the balance of miscellaneous investments were changed significantly, and "net errors and omissions" were radically reduced concurrently. There remain serious questions concerning the payment balance for 1995. The possibility is not

can be used to arrive at an estimate of capital flight volume can be found in the balance of payments the Bank of Russia prepares. Primary among such indicators are:

- the item "Net Errors and Omissions" of the payment balance;

- data on commercial credits and advances extended by Russian enterprises and organizations to foreign partners;

- data on change in indebtedness under export proceeds in foreign exchange and rubles not received on time, and under prepayments on imports not repaid on time.

Each of these three items of the payment balance is not formally associated with illegitimate capital export in the methodological aspect. However, analysis of these items of the Russia's payment balances allows us to reveal patterns showing that their content objectively reflects capital flight.

The item "Net Errors and Omissions" is computed in the payment balances of all countries according to IMF methodology. The latter accounts for the diversity of the ways in which the initial information is collected. Preparation of a payment balance requires processing of an enormous quantity of raw data that can be obtained objectively from different sources and by different collection methods, which is why there are problems in consolidating these data into a single system of balance of payment indicators. As a result inaccuracies may arise in calculating the overall balance, and they are commonly accounted for in the balancing item "Net Errors and Omissions". Because these "errors" should generally be random, and their yearly balance may assume both positive and negative values, on the average their sum should tend toward zero over a number of years. This is what we actually see in data from the payment balances of different countries (Figure 1).

Figure 1 graphs changes in the "Net Errors and Omissions" item of a number of countries (based on currently available data). To eliminate the effect of scale, and to ensure comparability of the data, they are presented as percentages of the sum of the credit[9] items of the corresponding payment balances. It is evident from the figure that this item of the payment balance fluctuates around the zero level in the payment balances of all countries (both developed and developing) except Russia.

The mysteriously stable negative value of net errors and omissions in Russian payment balances observed year after year may be considered to be evidence of continual conveyance of resources out of the country that is not accounted for in other items of the

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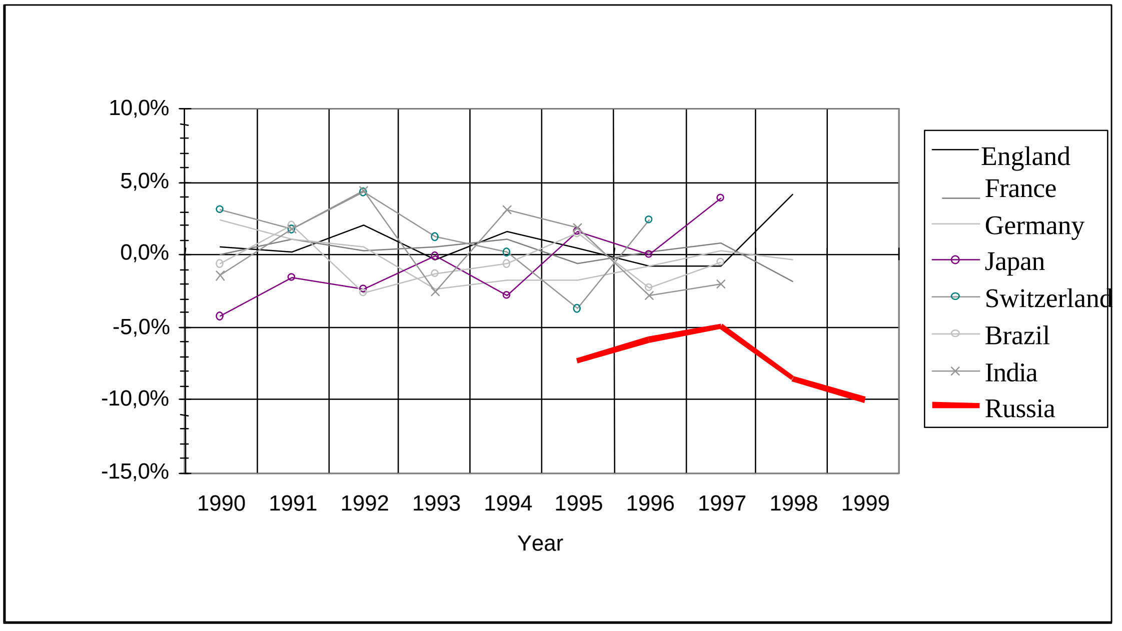
excluded that it also may undergo significant correction 4-5 years after its first release. Data from Russia's payment balances starting with 1996 seem more acceptable for inspection, and are reliable to a certain degree.

[9] "Net Errors and Omissions" in the payment balances of different countries have different nominal values owing to different scales of a particular country's foreign economic ties, which is why it would be wrong to directly compare these positions by countries. To ensure correct comparisons the net errors and omissions may be expressed relative to the sum of the payment balance's credit positions reflecting the inflow of resources into the country--exports, receipts of investments, etc.

payment balance. "Net errors and omissions" in the annual payment balances released by the Bank of Russia may be treated as one of the factors of an estimate of the volume of covert capital export.

Figure 1. Ratio of the Item "Omissions and Errors" to the Sum of Credit Items of the Payment Balance (Percent)



Another item of Russia's payment balance--"Commercial Credits and Advances Extended" by Russian economic agents to nonresidents--also draws attention due to its persistently negative values. This means that from quarter to quarter, from year to year, the total volume of commercial credits and advances extended by Russian enterprises to foreign economic agents is growing steadily, and outflow of resources from the country persistently exceeds their possible inflow in the form of repayment of credits and advances issued earlier. From what resources could Russian enterprises actively extend credit to someone abroad in the conditions of a protracted economic crisis? Outflow under this item continued through all of 1998, when most of industry was operating at a loss. Even leaving this question aside, the constant growth of the negative balance of this item attests to outflow of capital from Russia in the form of extension of commercial credits and advances to foreign partners.

Finally, these payment balances attest to unceasing growth of indebtedness of Russian economic agents under transfer of export proceeds to Russia. A part of the money earned from exports consistently remains abroad, which is a clear violation of Russian legislation. Possible understatement of prices in export contracts compared to actual prices, and equally so, overstatement of import prices (and regrading), which do not have any statistical expression[10], are not considered in this case.

Thus, we can substantiate an estimate of the volume of capital flight from Russia relying just on data from the balance of payments. This estimate is indirect, inasmuch as we certainly can't treat official data of the balance of payments as direct indicators of capital flight. However, the aggregate estimate of capital flight volume obtained from an analysis of payment balance data may be considered to be the most demonstrative, since it is arrived at with reliance on the strictest statistical base of the greatest detail (in particular, concealed imports are already accounted for in balance calculations).

The yearly volume of capital flight from Russia may be estimated at an average of around $25 billion on the basis of official payment balance data released by the Bank of Russia (Table 1). We believe that this can be treated as the upper estimate. The level of "net errors and omissions" in Russia's balance of payments may be used as the lower estimate. In this case there are grounds for believing that the best estimate is most probably closer to the upper limit than the lower limit. The estimate is indirect on the whole, and it cannot claim to be absolutely precise.[11] We will subsequently work with the upper estimate of capital export, even though the volume of the capital is actually smaller and it possesses, as we showed, a rather complex composition in terms of its purpose.

One fundamental conclusion must be emphasized. The figures show that there was no bump of any kind in the trend of capital flight from Russia after the August crisis of 1998. Similarly, the relative political and economic stability in Russia in 1997 did not provoke a decrease in capital export, as might have been anticipated from general theoretical considerations. We are dealing for practical purposes with a process of capital export that is built into the country's economy and is immune to market conditions in the country, although it does depend on fluctuations in the prices of Russian exported goods on the world market.

This says that most likely, the most significant participants of this process simply didn't change the intensity of their operations: the amounts they exported after August 1998 were just as large as before. And possible expansion of illegitimate capital export by smaller (midsized) participants immediately after the August crisis may have been offset to a relative degree by an abrupt decrease in the volume of the smallest participants, who were the ones that suffered the problems of the ruble's devaluation to the greatest degree.

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[10] According to our calculations, exports to Russia based on foreign sources are approximately 20-25 percent higher than the corresponding volume of imports based on Russia data. See BEA bulletin, No. 5, April 1998.

[11] The quarterly distribution of credits and advances extended to Russian residents by foreign partners in 1999 raises some additional doubt. The seasonality exhibited by this indicator within the year in settlements of the Bank of Russia may be the product of not only objective causes but also difficulties of statistical treatment (discrepancies in annual data charged off to the last quarter). There are grounds for doubting the first positive balance of extended credits and advances in all of these years, appearing in the second quarter of 1999. At the same time according to data now released by the Bank of Russia the increment in foreign exchange proceeds that were not returned doubled during this period, which also attracts attention. The possibility is not excluded that later on, these quarterly indicators may be adjusted.

Preliminary analysis of data for the first three quarters of 1999 suggests that the intensity of conveyance of capital out of Russia may be decreasing. There are grounds for using the ratio of the capital flight volume to the commodity export volume for this purpose as an analytical indicator. Use of this indicator to analyze the Russian economy is justifiable from the standpoint of its content: inflow of foreign exchange resulting from export of goods is the most important factor contributing to formation of Russia's balance of payments. That use of this indicator is reasonable is also confirmed by calculations--the ratio of the volume of concealed export of capital to the volume of exports is exceptionally stable in Russia: despite noticeable fluctuations in export volumes, it has remained at around 30 percent over a number of years. The data in Table 2 confirm this.

Table 2.

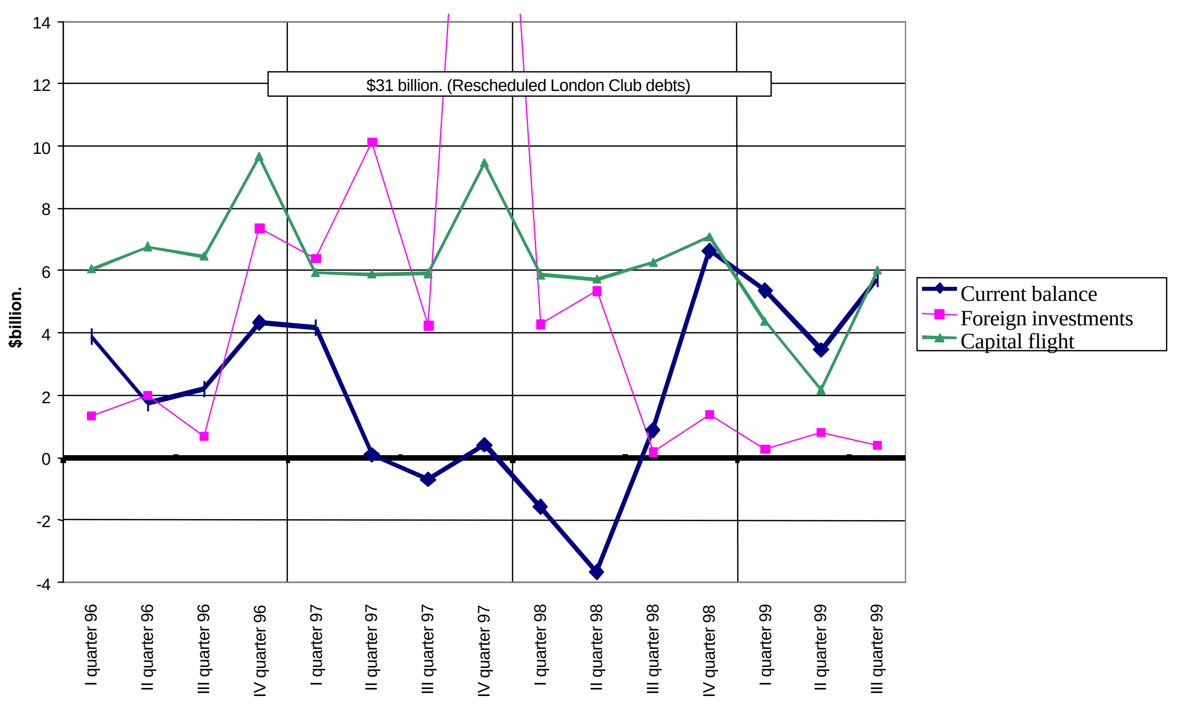
	Commodity Export Volume (CBRF Data), $ Billion	**Volume of Capital Flight (Estimate), $ Billion**	**Ratio of Capital Flight to Commodity Export, Percent**
1996	90.6	28.9	31.9
1997	89.0	27.2	30.6
1998	74.8	24.9	33.3
January-September 1999	50.6	12.6	24.9
Estimate for 1999	71	18-20	25-28

In the first three quarters of 1999 this ratio decreased for the first time, to 24.9 percent (this is assuming that these data will not be adjusted). Its level for 1999 seems low, even considering that as a rule, it is somewhat lower in the first half of the year than in the second. This permits the suggestion that the action of objective causes retarding capital flight from Russia intensified in 1999. We should probably include among them an increase in the efforts of bodies of executive government, and in particular, the Central Bank's introduction of requirements on creating reserves with which to back contracts. At the same time, it may be supposed that the scandals that have occurred in the international arena regarding illegitimate conveyance of capital out of Russia also had a retarding influence, creating additional difficulties for foreign parties to contracts with Russian illegitimate capital exporters.

3. The Visible Consequences

A statistical estimate of capital flight does not by itself give us a feel for the scale of the problem created for the Russian economy. Recall that imports of machinery and equipment (including motor vehicles and home appliances) were on the order of $16 billion in 1998. A decrease in capital flight might have doubled imports of investment goods, though of course on condition of the existence of effective plans, the corresponding climate, and so on. Similarly, according to statistics on the GDP (converted using monthly exchange rates of the dollar) the entire volume of investments in the country in 1998 was on the order of $46-47 billion. Two years of capital flight are equivalent for practical purposes to one additional year of the country's investment fund. The question of uplifting the economy by tapping national savings and investments depends in many ways on the direction of capital flows and on the policy of Russian companies, and in particular, on specifically where they invest--in the country or abroad. The development budget for 1999 was planned at Rub 20.8 billion, which is of course such a negligible amount that it wouldn't make any sense to compare it with capital export.

Figure 2. Capital Flight Compared to the Balance of the Current Balance of Payments and to the Inflow of Private Foreign Investments (Direct and Portfolio)



Capital export in 1996-1998 (before the crash) was covered to a great degree by import of private portfolio capital and by state borrowing. After the crash, capital export was covered exclusively by a positive balance in the current balance of payments. Figure 2 shows that the aggregate estimate of capital flight is relatively stable on a yearly basis, but starting with the third quarter of 1998 its numerical value has coincided almost exactly with the balance of the current balance of payments. What is unique to Russia in this case is that the country was unable to use the latter to pay off debts accumulated in earlier years. Strictly speaking, all of Russia's debt to the IMF, refinancing of which is being accomplished with considerable difficulty with the help of new loans from the IMF, is equal to the balance of the current balance of payments for the year. And if restructuring of "Soviet" debt is necessary, and fully justified by a large number of considerations, then from the standpoint of the condition of the payment balance, payments could be made to other creditors as well. Estimates of capital flight from Russia directly impact the decisions made by investors, inasmuch as trust in the country and in its financial system depends on them. Views of investors on the behavior of Russian businessmen when it comes to investing in Russian assets also plays a role of no small importance. It stands to reason that capital flight raises risk premiums on the country's borrowings in all of this period. Finally, this also affects negotiations on restructuring Russia's debts.

Table 3. Dynamics of Foreign Capital Inflow ($ Billion)

	1996	1997	1998	First Half of 1999	1996 to First Half of 1999
Credits to state sector*	1.3	0.3	3.1	-3.2	1.5
Inflow	9.1	7.4	10.7	0.7	27.9
Federal authorities**	9.1	7.2	6.0	0.7	23
Local authorities	0	0.2	0.9	0	1.1
Central Bank	0	0	3.9	0	3.9
Settlement	-7.8	-7.1	-7.6	-3.9	-26.4
Principal	-3.6	-2.8	-4.6	-2.8	-13.8
Interest	-4.1	-4.3	-3.0	-1.1	-12.5
Credits to banking sector*	1.7	3.8	-2.7	-0.4	2.4
Credits to nonfinancial enterprise sector*	1.0	7.7	5.1	-0.1	13.7
Direct investments*	2.3	5.7	1.8	1.0	10.8
Inflow	2.5	6.6	2.8	1.4	13.3
Payment of income on direct investments	-0.2	-0.9	-0.9	-0.4	-2.4
Portfolio investments*	8.6	13.1	2.7	-1.7	22.7
Inflow**	9.9	17.6	10.1	-0.1	37.5
Payment of income on portfolio investments	-1.3	-4.5	-7.4	-1.6	-14.8

* Net increment of obligations
** According to payment balance statistics, government short-term bonds amounting to $6 billion rescheduled as foreign debt in July 1998 are accounted for as investments of nonresidents into government short-term bonds.

On the whole, in the last three and a half years (Table 3) the gross inflow of capital (including a number of netting items) into Russia was on the order of $95 billion--a huge amount if it is used effectively. However, the net inflow can be estimated at only $51.1 billion, mainly in the form of direct and portfolio investments, as well as credits to the nonfinancial sector. The amount of "omissions and errors" for this period (see Table 3) is around $31 billion--more than the sum of net foreign credits to the nonfinancial sector and direct investments. This comparison is important as an indicator of the Russian economy's loss of capital. Return of Russian capital in the form of foreign investments does not of course reach proportions compensating for losses of the nonfinancial sector. The investment balance of the "real" sector with the abroad remains consistency negative.

Losses of capital through the state sector are readily evident. State borrowing ultimately supports consumption of one form or another in the country. Repayment of principal and interest is covered by taxes, which may be thought of as diverted savings of enterprises and the public--that is, as losses of potential investments. In those same three and a half years the state sector remained at practically "zero" (+1.5 billion), having repaid a part of the principal and paid out $12.5 billion in interest. That is, the state sector also "exported" potentially investable capital. Factoring portfolio capital into the calculations, we find that it was attracted in 1996-1997 and early 1998. Generally, however, since the crisis there has been an outflow, and the cumulative positive balance is gradually diminishing. Payment on Eurobonds of the government (including bonds of the Foreign Economic Bank restructured on February 13, 2000 with the London Club) will diminish this balance even further in the next few years, on the condition that access of Russian issuers to the Euromarket will not be reinstated.

We hardly need to argue long and hard about the advantages of attracting direct investments. State borrowing in these years was associated with investment programs to only a small degree (World Bank and European Bank for Reconstruction and Development). Programs to stabilize the economy and the corresponding borrowings were buried by the crash of August 1998.

4. Forms of Export and the Fight Against Capital Outflow

A systematic struggle was waged against capital flight as state policy in the past years basically in words only. The scale of capital exports, the purposes for which the capital was intended, and the sources of the capital never were established. It was the general belief that there were high political risks in investing in Russia. Formulated and documented extremely well in the West, these risks in a sense served as a justification for the flight of national capital. Up until the end of the period of macroeconomic stabilization in fall 1997 and the financial failure, hopes were officially laid on retrieving the capital by creating the appropriate investment climate. During the term of Ye. Primakov's government there was discussion of the unsuccessful attempts at creating a combined system of voluntary and compulsory return of capital. From the start of 2000 the issue returned to its classical definition--exchange control as a countermeasure against capital export.

For practical purposes the struggle against export of foreign exchange usually reduces to ineffective, mostly friendly pressure on shuttle traders, small contractors, tourists, and business travelers. A system of nit-picking by various agencies was created, as was the possibility for banks to nit-pick participants of international economic ties, with emphasis on tight control of relatively small (usually midsized) operations of relatively law-abiding persons. Practically speaking, an effective system for protecting against capital flight, based not on capital items of the payment balance but on current items, could hardly exist without significant constraints on the freedom of trade or without imposition of control directly over the companies themselves. Of course, even those measures that monetary authorities could have implemented against unlawful capital export were hardly used for an entire decade, showing that the governments that superceded one another were generally kept on a tight leash by big business, and were unable to defend the budget's interests.

The fight against capital outflow basically reduces in the world to anti-crisis measures, to protection of national currency, and consequently to control over movement of resources between capital items of accounting.

The typical schemes of conveyance of capital out of Russia are so diverse that it would hardly be possible for anyone to make a complete classification of them and their antidotes. This is associated with the fact that most of the schemes involve commercial transactions--that is, ones that do not yield to simple control over movement of capital. The essence of the problem lies in property ownership relations and corporate management. Understandably, big companies with good financial experts and lawyers are far superior to the weak state in intellectual and lobbying power. External administrative control can raise the transaction costs of export and change the directions and methods of export, but it is incapable of stemming the outflow of capital. Several commonly encountered outflow schemes are described below.

<u>External Tolling.</u> This scheme has been around the longest (though it is far from the most commonly occurring). Customer-supplied raw materials enter Russia from abroad at inflated prices, products are exported without payment of any taxes, and as a result all of the profit (and sometimes a significant share of the costs) ends up abroad. This is actually a variant of transfer prices. Although the scheme was subjected to considerable scrutiny in 1999, it survived. The scheme became most widespread in the early 1990s in aluminum industry, predominantly at plants using imported alumina. It was recently abolished because the new owners have apparently created their own foreign trade network, and have accumulated the working capital they need for global operations.

<u>Internal Tolling.</u> So-called internal tolling also became widespread in Russia, but this scheme only provides a possibility for shifting the centers of profit to one link of the production and marketing chain or another. The problem of conveying obtained profit out of the country has to be solved by other means.

<u>Understatement of Export Prices.</u> This scheme was used rather extensively in the first phases of the reform (even before 1992). It has a number of significant shortcomings: (a) it is suitable only for exporters; (b) considerable deviation of the export price from the world price draws the attention of controlling bodies; (c) the volume that can be exported is limited to the difference between production cost and price, which in many cases cannot support the needed scale of export. Big companies are now using it to a lesser extent due to the presence of more-universal schemes (see below). Export of a product under the guise of a raw material and "regrading" in general--identifying gasoline as fuel oil, and so on--is a variation on this

theme. It is important to note that the amount of capital exported is not limited in this case to some share of profit, and export of capital on a larger scale can be supported.

Fictitious Import Contracts. This scheme also employs a variant of import price overstatement. The scheme is rather "dangerous" because it may require partial liquidation of foreign "partner firms," which is complex and expensive. Big business doesn't use it much. It is suitable for laundering small sums through execution of contracts to render various services (for example, "fictitious consulting").

The Central Bank has identified six suspicious types of transactions for itself that must be subjected to special analysis in order to detect unlawful capital export:

1. Participation of a Russian firm that is in existence for less than 3 months in a transaction. This is a classic example of an attempt to introduce a formal cut-off line. The antidote--create 3-month firms in advance.

2. The recipient of exported goods and the payor to the Russian exporter are different foreign firms. This is an attempt to prevent someone from getting “stiffed” deliberately: the delivery has been made, but the payor has refused to pay. What you have here is nonreturn of export proceeds.

3. A contract has not been fulfilled--payment has not been made--but penalties are not imposed by the Russian party. In our variant, sanctions without recourse of monstrous proportions are written into the contract. In this case all that the "defenseless" Russians can do is complain that their hard-nosed foreign "partner" is robbing them.

4. A prepayment of more than 30 percent is made on an import contract. The essential element here is that this prepayment is often not refunded, even if the import delivery doesn't go through. Nonreturn of prepayments is one of the three large contributors to capital export on the balance of payments.

5. The foreign partner makes a loan at very high interest. In the conditions of high political risks, it is difficult to distinguish between high and abnormally high interest.

6. A firm registered in an offshore zone takes part in the transaction. This popular form of capital export works through offshore companies paying low taxes and enjoying preferential treatment. The problem is that offshore companies are widespread and legitimate. Many big Western companies prefer to use offshore companies when they can, especially in Russia. Because the state apparatus is always weaker than private business, it is difficult to anticipate any changes on the administrative front.

The large amount of work done recently by the IMF on this issue emphasizes a number of important properties of control in this area. The experience of three countries (Spain, Malaysia, and Thailand) shows that (1) in order for constraints to be effective, they must encompass a rather broad range of operations, they must be introduced under tight control, and they must be accompanied by the necessary reforms and change in economic policy; (2) constraints do not ensure protection, especially when there exist stimuli for circumventing legislation such as the attractive profitability level of the offshore market and the market's persistent anticipation of devaluation of the foreign exchange rate; (3) the capability authorities have for controlling operations on the offshore market plays a significant role in restricting outflow of capital and reducing speculative pressure on the exchange rate.

All that the IMF came up with after a year half was that the effects of exchange control measures on the situation in Russia are not entirely clear because the economic situation in the country hasn't fully stabilized. Pressure on the exchange rate and capital outflow continued even after the constraints were introduced on the backdrop of the banking system's worsening condition and ongoing problems with the revenue side of the budget. The ruble's devaluation contributed to making this a major financial crisis. Banks suffered sizable losses in foreign exchange because their foreign exchange position was not insured. For practical purposes the exchange control measures that were implemented and default on state debt shut Russia's door to foreign financial markets. In reality, this was an admission of the fact that exchange control measures were ineffective. The IMF notes that in the case of Russia, capital export is continuing in the face of a huge positive balance in the current balance of payments.

There is considerable importance to the question as to the purposes for which capital is conveyed abroad, inasmuch as the myth that it is easy to retrieve this capital for the purposes of national development is encountered very often in the literature. The legal protections afforded to capital gone abroad make hopeless any attempts at granting amnesty for capital export as a way to encourage its return. There are three fundamental problems in granting amnesty to fugitive capital: How do you document its return? For what crimes and offenses can amnesty be granted? How do you combine amnesty with the trust (anonymity) of the recipients of amnesty? The first problem can be solved only by investing in government securities. But there is no need for any kind of amnesty for direct investments into Russia. Immunity from liability for violating exchange control is not enough. The amnesty would have to apply both to the means by which the capital was brought into being in the first place, and to the entire set of possible concomitant violations and crimes. A law like this would hardly be fulfillable, and people would hardly put any faith in it. Finally, if amnesty were predicated on purchase of government securities, then it wouldn't differ in any way from registering when "giving yourself up." On the whole it is not very probable that amnesty would solve the problem of retrieving capital, even though in certain clear-cut cases use of this approach could be entertained.

In February 2000 the government submitted new measures to the Duma to fight capital export. Most of these measures will increase administrative barriers to transfers of foreign exchange abroad per se, such as requiring registration of transactions and increasing the rights of banks to hold up suspicious operations possessing the attributes stated above. It may be anticipated that the new measures of the Central Bank will be oriented on creating a fine-mesh sieve that would be not very effective against big exporters of capital. Looking to the future, the solution to the capital flight problem evidently lies both in creating a new atmosphere of trust in the country and changing the attitude of big business toward its financial resources and its investment goals on one hand, and radically improving the investment climate on the other.

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The overall estimate of the scale of capital flight from Russia in the second half of the 1990s based on data from the balance of payments is consistently on the order of 30 percent of exports, or $20-25 billion per year. While capital conveyed out of Russia illegally is mostly not of criminal origin, it does sidestep Russian taxes, and it serves as an inexpensive source of capital for the world economy. Fluctuations in the political climate in Russia and the financial crash of 1998 did not have a visible impact on conveyance of capital out of Russia, which permits us to predict that capital export will stay at the same level in the future. Capital export was covered to a great degree in 1996-1998 by import of private portfolio capital and state borrowing. After the crash, capital export has been covered exclusively by maintaining the current balance of payments at a positive balance. Import of direct (and, possibly, portfolio) investments into Russia represents to a significant degree a partial return of Russian exported capital. Unless we decrease capital export, and solve the problems of taxing export income, we will be unable to arrive at a long-term solution to the problem of debt-dependence. The proposed exchange control measures will create certain difficulties to midsized and small business, and increase the costs of capital export to the benefit of middlemen, but they will hardly affect the main channels of conveyance through current accounts in any radical way.