

Capital Flight and Russian Economic Reform

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Few problems confronting Russian President Vladimir Putin are as urgent as the continued flight of capital from Russia. Estimates by the US Treasury Department, the International Monetary Fund, and other sources suggest that a net of well over \$100 billion has left Russia--legally or illegally--over the past decade. Some estimates range as high as \$200 billion. In 1996 alone, capital flight amounted to nearly \$39 billion, according to the Institute for International Finance. The outflow in 1998 was more than \$25 billion, and in 1999 another \$15 billion. In March 2000, the Russian government estimated that capital flight this year is running at \$3 billion a month, nearly matching the level of 1996. Most of this money has ended up in Western banks and securities markets, and some has gone toward the purchase of luxury homes in the United States, Western Europe, and tropical resorts.

The extent of the problem in Russia is evident if we compare it with the magnitude of capital flight from other countries. In Russia, the outflow of capital has been equivalent to more than 10% of gross domestic product (GDP) over the past decade, whereas in Mexico, Brazil, and South Korea it has been under 3%.

The resulting shortage of capital in Russia and the depletion of the country's foreign reserves have severely impeded efforts at economic reform. Illegal capital flight has allowed individuals and corporations to evade payment of taxes, thus depriving the central government and local authorities of badly needed revenues. Without sufficient money on hand to finance private or public investment in key sectors, the Russian industrial base has become increasingly obsolescent and inefficient. The depletion of foreign reserves has complicated Russia's efforts to repay its foreign debts and has damaged the country's creditworthiness. The outflow of capital also has been a great boon for organized criminal gangs, who coordinate large-scale transfers of money for generous commissions.

Impetus Behind Capital Flight

The flight of capital from Russia, as from other countries, has stemmed from basic economic and political weaknesses. Chronic political and economic instability and widespread uncertainty about Russia's future have made domestic and foreign investors skittish about keeping money in Russia. Developments that have spurred the outflow of capital can be grouped into two broad categories: 1) underlying political and economic

conditions; and 2) circumstances that have facilitated illegal transfers of money out of the country.

Underlying Political and Economic Conditions

The problems that give rise to capital flight have been acute throughout the post-Communist era. The stalling of Russia's economic reforms in the early 1990s, against the backdrop of a fierce political struggle that ended in violence, fueled the first great wave of capital flight. The problem was exacerbated by the persistence of very high inflation through the mid-1990s, which eroded the purchasing power of the ruble and encouraged domestic elites to transfer their money into stabler currencies. Political uncertainty about the fate of Boris Yeltsin throughout the 1990s also played a major role. This was especially evident in 1996, when Yeltsin faced what initially seemed to be a nearly hopeless reelection campaign. Capital flight in the first quarter of 1996 exceeded \$6 billion a month.

After a lull in 1997, capital flight surged again in the spring of 1998 as a financial crisis intensified. This led in July and early August 1998 to a massive outflow of funds, evidently by well-connected bankers who had been tipped off about the impending currency devaluation and debt moratorium. The confidence of domestic and foreign investors was further shaken by the August 1998 crash. Although the devaluation had a salutary effect on the Russian economy, the crisis itself made capital holders in Russia reluctant to bring any of their savings back home. This sentiment ebbed when the many years of uncertainty about Yeltsin's political and medical status finally ended with his resignation at the end of 1999, but a host of fundamental problems continue to fuel capital flight. The lack of a sound legal system in Russia that can safeguard private property rights and ensure the enforcement of contracts has encouraged investors to take their money out as quickly as possible. Much the same applies to the lack of well-regulated securities markets, corporate governance structures that protect minority shareholder rights, and effective banks that treat depositors fairly. Without such basic institutions in place, very few Russian business elites and foreign investors actually want to keep money in Russia.

The advent of Putin and the promise of a new economic reform program may eliminate some of these uncertainties, but a sustained period of political stability and effective economic reform will be needed before investors truly have enough confidence in Russia. The legacy of the past decade will be an onerous one for Putin to overcome. Moreover, the measures he has adopted so far (discussed below) have actually brought at least a short-term increase in capital flight. Elites in Russia are seeking to transfer their money out while they still can.

Circumstances Conducive to Illegal Capital Flight

Organized criminal activity and money laundering have accounted for part of the capital flight from Russia, but their role often has been exaggerated. Attributing capital flight solely to criminal activity is much too simplistic. The bulk of the capital flight from Russia has not been connected with underground criminal gangs. This is not to say, however, that most of the capital flight has been strictly legal. Although Russia's highly imperfect legal system makes it difficult to know precisely what is legal and what is not, a considerable amount of the capital flight is of very questionable status.

Some of the earliest capital flight occurred at the beginning of the 1990s when senior Soviet Communist Party officials transferred the party's liquid resources to foreign accounts. The initial outflow of capital was also fueled by spontaneous privatization in the early 1990s, which allowed managers to engage in asset stripping, the diversion of capital, and the illegal transfer of money to foreign bank accounts. The trend accelerated when the mass large-scale privatization program of 1992-1994 resulted in a high degree of insider (managerial) control of key Russian enterprises. Even more egregious was the loans for shares privatization of 1995-1996, which involved the "sale" of highly lucrative energy and natural resource companies to well-connected elites on a non-competitive basis. Through the manipulation of export prices for commodities (detailed below), these firms brought in huge amounts of unreported revenue that could be transferred abroad. In many cases, the opportunities for price manipulation were made feasible by pervasive corruption, which affected the highest levels of the Russian government during the Yeltsin era.

Two techniques have been particularly important in the illegal flight of capital: the use of artificially low prices in export contracts, and the use of one-day firms as channels for money laundering.

Many exporters in Russia deliberately understate the prices of their goods. They then keep the difference between what they have declared as the price and what the buyer actually pays. (Sometimes the difference is split between the exporter and buyer.) The scale of the phenomenon is evident from a recent case in which inspections showed that the Almazyuvelirexport company fraudulently lowered its prices by \$2.4 billion in 1999 alone. Because inspections are so spotty and compulsory inspections of most contracts are not permitted under law, the doctoring of export contracts is rarely punished.

The use of one-day firms (firms that are set up for a single set of transactions and then dissolved) has been another important technique for those hoping to spirit money out illicitly. In 1999 alone, inspectors recorded some 16,000 cases in Moscow of export contracts that were processed by one-day firms. A substantial portion of the billions of dollars channeled through these firms is thought to be associated with money laundering. Although the federal authorities have cracked down on some abuses, banks that deal extensively with one-day firms have usually operated with impunity.

Reducing the Flight of Capital

Over the longer term the only way the Russian government can stem capital flight is by fostering a political and economic climate in which Russian elites and foreign investors are willing to keep money in Russia. If political uncertainty continues under Putin, and if suitable economic and legal institutions are not developed soon, it is highly unlikely that the flight of capital from Russia will abate. Nor is it likely that any of the capital that has left will return.

The steps needed to make Russia attractive for capital will not take root overnight. Undoing the mishaps of the 1990s will be a difficult and protracted process. Nevertheless, it is crucial that bold reform begin promptly. Otherwise, the opportunity afforded by Putin's election may be squandered. It is encouraging that first deputy prime minister Mikhail Kasyanov has argued that far-reaching market reforms, not administrative measures, will be the only way to halt capital flight. It is also encouraging that Putin has authorized Kasyanov and others to draft a program of radical reform. The appointment of Andrei Illarionov, a staunch proponent of free-market principles, as an economic adviser to Putin is a particularly heartening development. Whether Kasyanov's and Illarionov's recommendations will ultimately be adopted, however, remains to be seen.

Although it is certainly possible, even probable, that Putin will move ahead with some urgently needed changes (e.g., a new tax code and law on land ownership), it is disturbing that his initial response to the problem of capital flight was not to promote market conditions that would encourage the return of capital, but to adopt punitive administrative measures to prevent capital from leaving. To be sure, regulation of Russian export and import contracts, especially those channeled through offshore banks, is needed to ensure that egregious abuses (of the sort described above) do not occur. Even so, the administrative measures adopted or proposed by the Russian government, including the possibility of controls on currency flows, are no substitute for market reforms. Such measures would stifle legitimate market activity as well as abuses, and are therefore best kept to a minimum. A crackdown on one-day firms and other conduits of illegal capital transfers can be accomplished without the highly intrusive, anti-market restrictions recently proposed by Aleksandr Gromov, the head of the Federal Currency-Export Control Service. If the Russian government eventually imposes strict currency controls (one of Putin's first proposals after becoming acting president) and requires onerous licenses for small businesses, it will be moving in the wrong direction. The early drafts of a new law on the prevention of capital flight and money laundering, which is slated for consideration this summer, offer further troubling signs that some members of the government want to emphasize heavy-handed administrative measures over market approaches. Kasyanov and Illarionov have argued strongly against such an emphasis, and if their view prevails, the outlook for Russia will be much brighter.