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DOES RUSSIA OVERCOME THE PROCESSES OF CAPITAL FLIGHT ECONOMY?

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ABSTRACT

The purpose of study is to assess an impact of the capital flight on the Russian economy and to identify the factors, which stipulate returning the capital to the Russian Federation. Analysis shows, in 2019 the share of public external debt denominated in the national currency was continuing to increase. External debt of the private sector has changed slightly, that is probably due to a pressure of sanctions against Russian companies, which impose a restriction of access to affordable sources of capital. Presumably that if the sanctions' pressure continues, this may stipulate a precondition for repatriation of capital. Made a prognosis that by 2025, capital flows from the offshore zone in Cyprus may reach 165.55 billion USD. Therefore, it might assist Russia's attempts to overcome the ongoing process of "flight of capital" and turning it to an economic model based on effect of "capital repatriation". However, in the current situation, when evidently there is a stagnation in the economy, along the risks, it is quite difficult to find appropriate sectors for large-scale investments. Low consuming due to the low personal incomes remains a constraint factor. Therefore, we should not expect a mass influx of investments from the foreign offshores. Moreover, there is a redistribution of the Russian capital among other offshores, so a huge outflow from the Cyprus offshore will not have a serious impact on the Russian economy and financial market in a long-term view.

Keywords: capital flight, economic development, capital repatriation, sanctions

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1. INTRODUCTION

1.1. Problem Statement

According to the Bank of Russia, in 2019, net capital outflow in Russia (net borrowings by non-residents) amounted to 26.7 billion US dollars, almost 2.4 times less than in 2018. Shrinking of foreign liabilities by the banks has had a decisive impact on the results of private sector's financial operations, while the contribution of other sectors to the foreign net debt has significantly decreased. At first glance, the current outflow of capital does not significantly affect the national economy. Inflation in 2019 is projected at less than 4%, and some analysts at 1.5% estimate GDP growth. However, the outflow of capital slows down the country's economic development.

There are two main reasons for the Russia's ongoing capital flight, first, the run-off of foreign investments and incomes from the Russian market. Second, avoiding risks by the Russian business, against the backdrop of high political and economic risks. At the same time, we should not confuse the outflow of capital and the legal export of capital from the country. The ongoing processes of net capital outflow cannot be only identified with the illegal export of capital or flight of capital. Any country with a positive current account balance in an open economy exports capital either through the increasing of state foreign exchange reserves, or through the private sector. Therefore, capital outflows are not necessarily negative, and capital inflows are not always positive processes for the economy.

In 2019, the outflow was mainly due to the growth of foreign assets in other sectors. Thus, the main reason for the capital ongoing outflows has changed. Now it caused by repayment of the banking sector's debts abroad. The decisive factor was the significant strengthening of the trade balance under the influence of continued growth of exports for the second year in a row, outpacing recovery of imports. The positive balance of foreign trade increased, with a slight increase in the total negative balance of other components of the current account, as the Bank of Russia resumed.

Repayment of foreign debts by the banks is not the only main component of the ongoing outflow, because the debts themselves are getting smaller, and payments, as a result, are reduced. Additional oil revenues are stored abroad because there is nowhere to put them inside Russia. This trend will continue while the oil prices remain high and the outflow of capital itself will decrease. Amounts of capital outflow from Russia depends directly on the country's economic model. In the current reality, the sanctions started by the USA have significantly affected the balance of power in the world of business and international trade. Supposedly that if the sanctions' pressure continues, this may stipulate a precondition for repatriation of capital. Thus, a key agenda for the capital repatriation should concern to openness of the Russian economy and finance, the clear principle of financial system, the predictable state investment policy, and proposes to attract the capital from the offshores. Therefore, can we expect Russia will overcome the process of "flight of capital" and turn to a model based on effect of "capital repatriation"?

2. ANALYSIS OF STUDIES AND PUBLICATIONS ON THE SUBJECT

The literature has offered various approaches to a model of capital flight, which have been refined over time in several important ways. There are two broad approaches: the direct 'hot money' approach and the indirect 'residual' approach. The 'hot money' approach relies solely on the official balance of payment data in attempting to identify flows that constitute capital flight. Capital flight is viewed as outflows of short-term capital in response to political and economic risks, expectations of currency devaluation, tax hikes, and other risks.

A hot money model measures the capital flight with the 'net errors and omissions' of the balance of payment and then add 'other short-term capital' associated. This view capital flight as abnormal resource outflows motivated by uncertainty (Kindleberger, 1987) with 'other sectors' (i.e., excluding the official sector and banks), which are taken to represent 'speculative capital exports' (Cuddington, 1986, 1987).

Another broad definition is simply an outflow of money or securities, which is often related to sudden adverse economic conditions. Not all capital flight viewed to be illegal. The part which is, can be coined illicit financial (out) flows. The source of money for such flows can be illegal or the money is transferred in an illegal way, e.g. by avoiding taxes. Capital flight can occur due to action by individuals or within firms via tax-motivated shifting of profits. Firms can also be engaged in a trade operation to transfer money across borders in a nontransparent, if not outright illegal way. (Johannesen and Pirttilä, 2016).

A common approach to estimating capital flight is "sources-and-uses method". The method makes inference about capital flight based on balance-of-payments statistics. If the sources of capital inflows, that is (net) increases in foreign debt and (net) increases in foreign direct investment (FDI), exceed the uses of capital inflows, that is the deficit on the current account and increases in the country's foreign reserves, this must be due to transfers of capital to foreign countries by private individuals. This residual is therefore a measure of capital flight (Nitsch, 2016).

Researchers at the World Bank in the mid-1980s originally developed the residual measure of capital flight. In the wake of the developing countries' debt crisis that began earlier in that decade, observers discovered substantial imperfections in the official balance of payments statistics, especially the data on external debt where inflows were often under-reported. The World Bank assembled more detailed and accurate data on external debts, and these were published in the World Debt Tables (subsequently incorporated in the Global Development Finance database). Under this approach, estimating capital flight entails attempting to track down flows that ought to have been recorded in the balance of payment, but which in practice were not recorded (Ndikumana, et.al., 2014)

The residual approach to measuring capital flight takes the view that recorded flows should not be considered as capital flight. It therefore defines capital flight as a residual, the difference between recorded inflows and recorded uses of foreign exchange. If balance of payment data were the sole source of information used, this would simply mean 'net errors and omissions.' Because debt inflows very often are under-reported in the balance of payment accounts, however, researchers obtain information on these flows from other official sources – typically the World Bank's Global Development Finance database – and recalculate the residual on this basis (Cuddington, 1986, 1987; Erbe, 1985).

The method is employed widely both by international organizations like the World Bank and the United Nations (e.g. Claessens and Naudé 1993), non-governmental organizations (NGOs) like the Tax Justice Network (e.g. Henry 2012) as well as academic studies (e.g. Pastor 1990; Boyce 1992; Lensink et al. 2000). It has been used both to gauge the magnitudes of capital flight as well as to identify its economic and political determinants.

There is a tendency in the literature to use the terms 'capital flight' and 'illicit financial flows' interchangeably. By definition and in practice, the two are different. Using the conventional measures described above, illicit financial flows include more than what is captured as capital flight. In particular, the measure of illicit financial flows developed by researchers at Global

Financial Integrity (GFI) include some payments for unrecorded imports (Tørsløv, et.al, 2019).

While such payments are illicit, they are not capital flight: the money is not parked abroad, but rather it is spent on goods that return to the country. In other words, while all capital flight can be considered illicit, not all illicit financial flows are capital flight. Illicit financial flows are a broader category that includes payments for smuggled imports, payments arising from trade in narcotics and other contraband, laundered money that flows through officially recorded banking channels, and the effects of intra-firm transfer pricing (Boyrie, et.al, 2005).

It is not possible to ascertain precisely what fraction of capital flight originated as licit or illicit capital, just as it is not possible to determine its ultimate destinations and uses. Presumably, some of the unrecorded movements of capital across borders may be funds that were honestly acquired. All capital outflows that evade official recording can be considered illicit, however, by virtue of their clandestine transfer. Much of the funds that ‘go missing’ may be illicit, however, by virtue of the acquisition of funds and the illicit holding of funds abroad, as well as by virtue of the transfer of funds (Walter, 1986).

3. METHOD OF ANALYSIS

The study based on Bank of Russia’s statistics on direct investment by institutional sectors of the economy. The method of capital flight estimation based on reviewing the balance-of-payments statistics and assumptions that funds going offshore are no longer returned to Russia. Analyzed the financial transactions on the balance of payments of the Russian Federation in order to estimate the volume of annual capital outflows from 2008 to 2018. It considered the net acquisition of financial assets and the net acceptance of liabilities by the banking and private sector. Estimated the outgoing investments in foreign non-banking companies and incoming investments in the Russian non-banking sector for period 2008-2018.

We compared the amount of sovereign debt of the Russian Federation and sums of capital outflow from 1998 to 2018 in order to assume a trend of the economy decapitalization and assess stability of the financial system. Analyzed returns of Russian capital from offshore zones following to changes in the volume of direct investments of the Russian Federation by institutional sectors of the economy (balance of transactions balance of payments) for 2014-2018. To assess the impact of capital repatriation on the Russian economy, we used a simple prognostic analysis that tracked the volume of capital exportation and repatriation on the example of Cyprus offshore for 2008-2018 and to 2025.

4. RESULTS OF RESEARCH

The predominance of capital outflows over inflows in a broad sense called “capital flight”. In the context of the study, individuals and legal entities abroad in order to make investments more reliable and profitable, as well as to avoid expropriation, high taxes and losses from inflation consider capital outflow as a spontaneous, unregulated export of capital. In order to estimate the volume of annual capital outflows from 2008 to 2018, an analysis of financial transactions based on the balance of payments of the Russian Federation was performed, taking into account the net acquisition of financial assets and the net acceptance of liabilities by the banking and private sector (figure 1). Net errors and omissions of the balance of payments are considered. Position "net errors and omissions" is fully attributed to operations in other sectors, considering that the greatest difficulties in compiling the balance of payments arise in connection with accounting for financial transactions in these sectors.

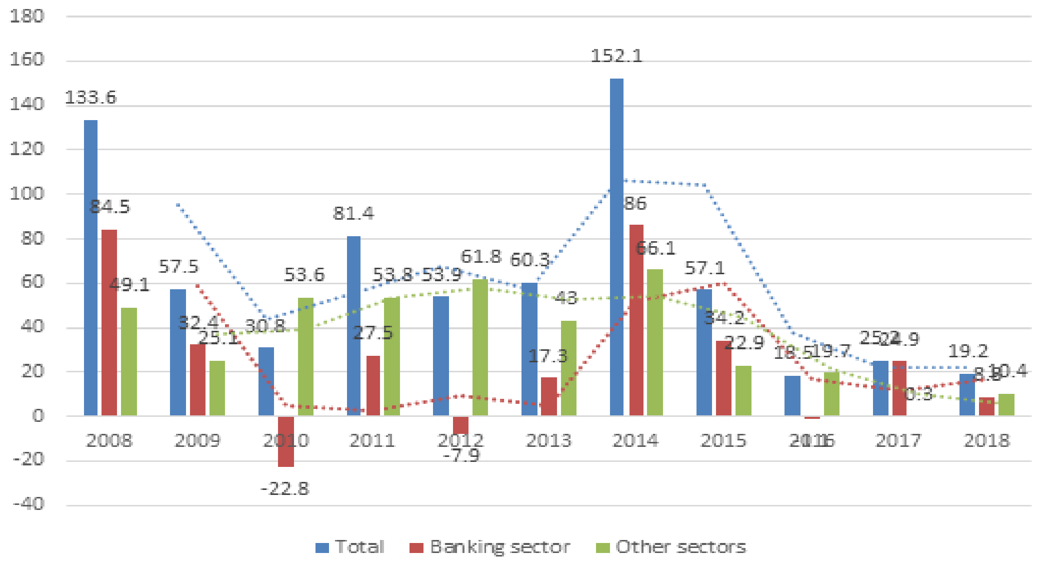

Figure 1 Capital flight from Russia in 2008-2018 (net outflow/inflow of capital), billion US dollars[1]

Some conclusions follow from the analysis of net outflow/inflow of capital of the banking sector and other sectors. During the entire period, export of capital from the territory of the Russian Federation prevails. It is noteworthy that, except for 2006 and 2007, there were capital inflows of 43.7 billion US dollars and 87.8 billion US dollars. There has been a relatively prosperous period for the economic system. When the oil prices were high, the Russian Government established the Stabilization Fund and National Welfare Fund that together accumulated more than $ 170 billion US dollars. For 20 years some about 653.2 billion US dollars has been withdrawn off the national economy of Russia. For those the banking sector accounted by 33.14%, while other sectors accounted by 66.86%.

Direct foreign investment to Russia decreased to 8.785 billion US dollars in 2018, those more than three times comparatively to 2017. There has been the lowest indicator for the last ten years. The net outflow of investment from the Russian economy (the difference between incoming and outgoing direct investment) reached 23.1 billion US dollars. The largest position since 2014, according to the data of Central Bank (Figure 2).

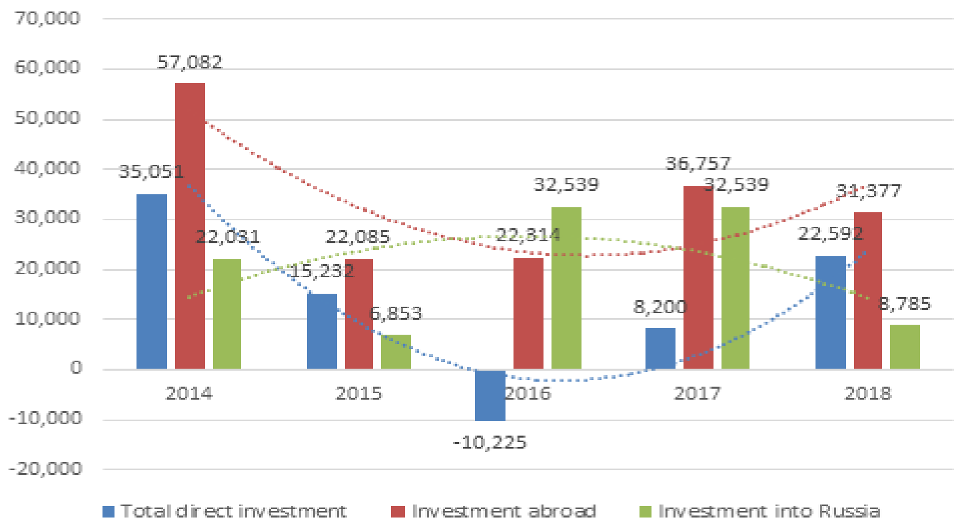

Figure 2 Direct investments in Russia by institutional sectors of the economy (balance of payments transactions), million USD[2]

Analysts of the Central Bank explain the current trend is due to decrease in returns of Russian capital from the offshore zones. If earlier a large outflow of funds abroad was accompanied by a comparable inflow to Russia, which was largely due to SPV transactions through offshore companies, now there is a sharp reducing in investment inflows with only a small reducing in outflows abroad. The countries' distribution of investments shows that the inflow of capital was mainly from Cyprus. In the third quarter of 2018, Russian investments in the amount of 7.9 billion USD went to Cyprus in — the largest amount for the period.

According to the Bank of Russia's data on direct investment in institutional sectors of the economy, outgoing investments in foreign non-banking companies amounted to 30 billion USD in 2018, while incoming investments in Russian non-banking sector amounted to 6 billion USD. This fact allows analysts of the Bank of Russia to conclude that funds going offshore are not returning to Russia as before. It is noteworthy that a relation between the inflow and outflow of foreign direct investment in other sectors has significantly weakened since 2012. Previously, a part of inflow of foreign direct investment in Russia behaved synchronously with the outflow of capital. That could be related to intra-group transactions and transactions within offshore companies. Now there is a tendency to decrease the flow of foreign direct investment in the Russian Federation while stabilizing the amount of foreign direct investment abroad.

In order to assume the trends of decapitalization of the economy and estimate stability of the financial system of the Russian Federation, we compared the volume of sovereign debt of the Russian Federation and the volume of capital outflow from 2008 until 2018. Observing the statistical data of the Central Bank, we can draw several conclusions. The sovereign debt of the Russian Federation as of December 31, 2018 amounted to 454.68 billion USD (Figure 3). At the same time, the net outflow of capital for the period has amounted to 653.2 billion USD. Noteworthy that for the past 8 years, the total outflow of capital has amounted to 467.7 billion USD, which is higher than the sovereign debt of the Russian Federation. Even though net outflow of capital from Russia in January–November 2019 reduced from 54 billion USD to 34 billion USD compared to the same period in 2018, however, the national economy is still following to a model of "money flight" economy.

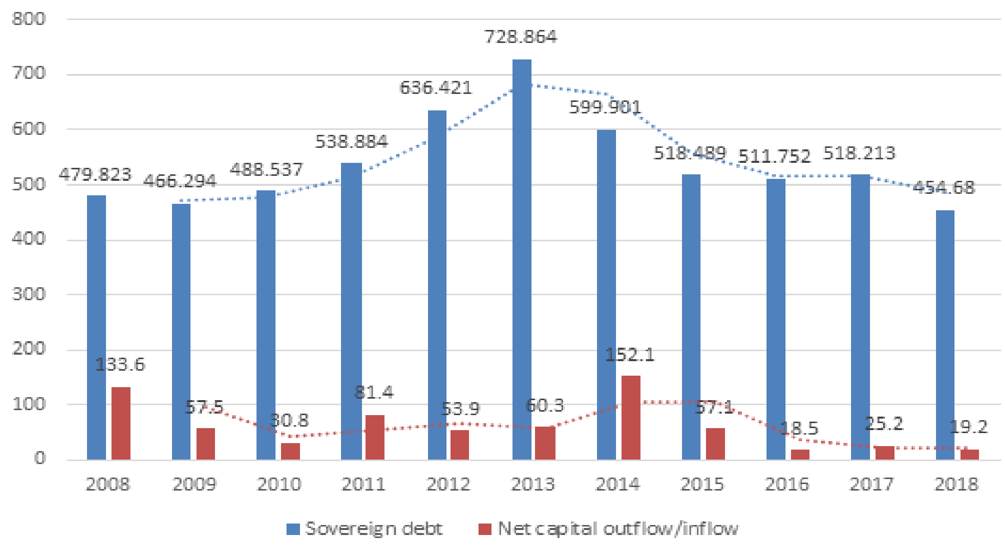

Figure 3 Sovereign debt of Russia and net capital outflow/inflow in 2008-2018, billion of USD[3]

The Gross Domestic Product in Russia was worth 1657.60 billion USD in 2018, so it represents 2.67 percent of the world economy. GDP in Russia averaged 933.62 billion USD from 1988 until 2018, reaching for the period highest point at 2297.10 USD billion in 2013 and a record low of 195.90 billion USD in 1999. In the long-term period, the Russia GDP is projected to trend around 2080.00 billion USD in 2020. In the same time, it third quarter of 2019 Russia recorded a capital and financial account surplus of 8.601 billion USD. Capital flows in Russia reached 9.340 billion USD from 1994 until 2019, reaching the highest point at 32.845 billion USD in the first quarter of 2008 and a record low at 47.789 billion USD in the fourth quarter of 2014. Capital outflow to gross domestic product was 1,15 percent, compared to 7,4 percent in the crisis year of 2014. (Figure 4)

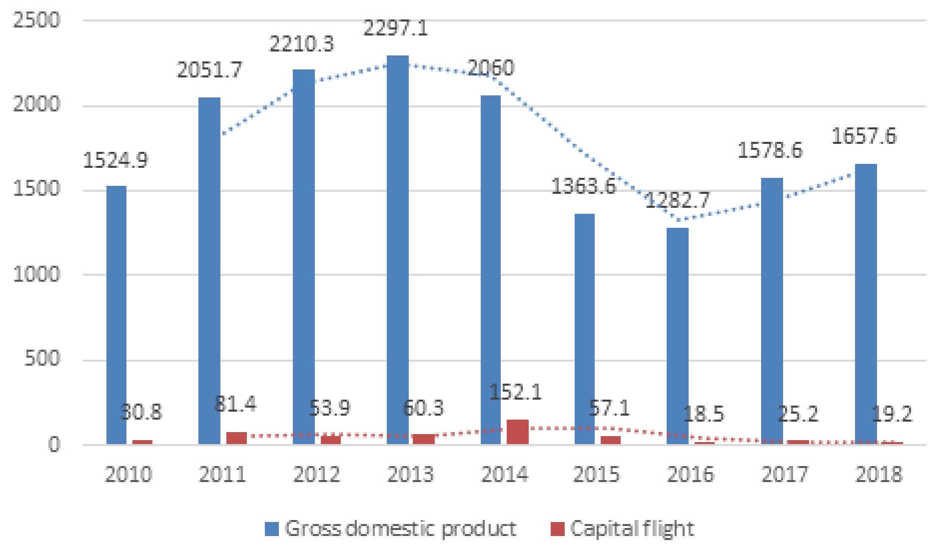

Figure 4 Gross domestic product and capital flight in Russia in 2016-2019, billion USD[4]

Statistics on balance of payments by Bank of Russia for October 2019 show that after rising of the capital flows by $ 1.3 billion USD in early autumn, the private sector withdrew 6.7 billion USD from the country. The outflow of capital, as in the crisis years, became an avalanche. Since April, more than 80% of the free currency has left after exemptions off import duties and taxes. It appears as a system problem for the economy that is almost impossible to prevent or stop.

At first glance, the current outflow of capital does not really interfere with the economy. Inflation for the year is projected at less than 4%, and GDP growth is estimated by some economic strategists at 1.5%. On the other hand, people no longer have money in their pockets for consuming. The real personal incomes increased by the end of the year, but only symbolically by 0.2-0.3%.

It is noteworthy that since the introduction of sanctions, Russia's GDP has declined, falling by 2.8 percent in 2015. Although it is more difficult to establish a causal link between the impact of sanctions and the decline in economic growth in Russia, it seems that the decline in trade volumes will slow down the country's economic development. Preliminary data showed that Russia's gross domestic product grew by 1.7 percent year-on-year in the third quarter of 2019, following a 0,9 percent expansion in the previous period and beating market expectations of 1.6 percent. Agriculture, industry, and wholesale trade mainly supported growth.

In 2019, the sanction pressure on Russia's economy was increasing. The prospects of being "blacklisted", e.g. fined or banned in dollar transactions for relations with Russia is a serious concern for private business. Presumably that if the sanctions' pressure continues, this may stipulate a precondition for repatriation of capital. In order to suggest the prospects for returns of capital, we have tracked the movement of capital on the example of Cyprus for 2008-2018 (Figure 5). Traditionally, investments from Cyprus and other offshore companies in Russia are financed with money of Russian origin.

Figure 5 Russia's capital flows in/off Cyprus for 2008-2018, billion US dollars[5]

At the end of 2018, 10.1 billion USD more direct investment went back to Cyprus from Russia than came from Cyprus to Russia. The negative balance of operations has been the largest for 12 years. The last time a serious outflow of Cyprus investments from Russia was observed in 2015. It decreased by 7.1 billion USD in 2016, then slowed down, and in 2017, the balance of investments from Cyprus was positive and amounted to 8.6 billion USD. Deposits of Russian clients in Cyprus amounted to about €3 billion by the end of the summer of 2018. For six years before, only Russian firms, not taking the individuals, held in Cyprus some about 19 billion USD (€14.8 billion at the then current rate).

The net outflow of investments from Cyprus is primarily due to a reducing in participation in the capital of Russian companies. For the last year, it has amounted to $13.9 billion, which would a record for three years of calculations. Partially, the overall statistics on Cyprus investments were supported by the reinvestment of incomes from Cyprus (another component of investment), which results in net inflows of 5.0 billion USD.

It was reasonably noted above that Cyprus is a popular offshore zone for Russian business. To assess the impact of capital repatriation on the Russian economy, a prognosis was used that tracked the volume of capital exportation and repatriation for this country until 2025 (Figure 6). It assumed that the repatriation of capital could be carried out in the form of transfer to the homeland of capital previously withdrawn abroad, and its profits, as well as revenues in foreign currency by the sale of goods and services.

The analysis shows that by 2025, if the sanctions pressure will be continuing, the total amount of repatriating capital (i.e. money returned to the Russian economy) may reach $ 165.55 billion. Therefore, we can expect increasing of capital investments, which stipulate capitalization of the Russian economy. In the context of our research, we understand the term capitalization of the economy as a fundamental process, the economic meaning of which is to increase the cost of capital by non-residents and by Russian companies.

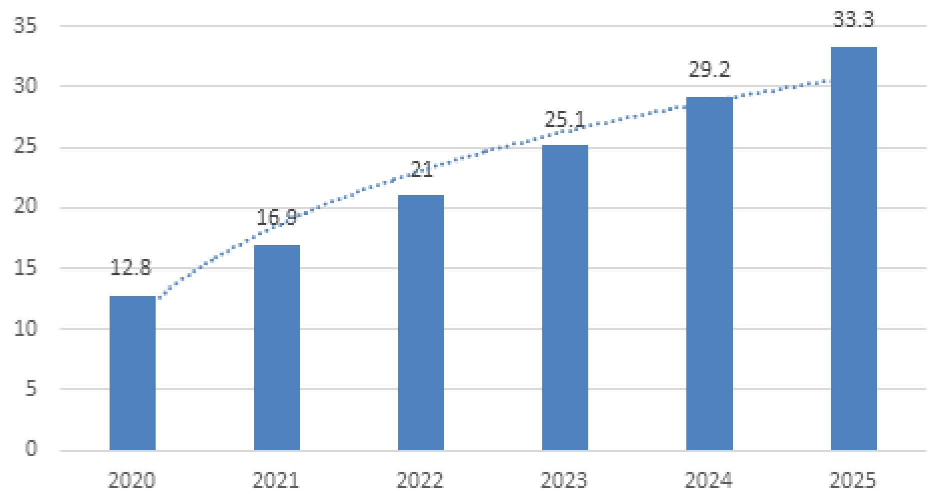

Figure 6 Estimated amount of capital repatriation from Cyprus to Russia, billions of US dollars[6]

Allocation of capital in the Cyprus jurisdiction has become less comfortable for Russian companies for several reasons. First, the risks increased for Russian money due to possible sanctions that may lead to blocking of accounts. The second reason is increased regulatory pressure in Cyprus. Last summer, the Central Bank of Cyprus tightened the rules for foreign clients of commercial banks. Now banks must identify companies that do not run activities and terminate relations with them. In addition, since last year, Russia and Cyprus have been cooperating under the system of automatic transfer of tax information. Thus, Russian authorities, for example, can get information about the accounts of Russians in Cyprus.

5. CONCLUSIONS

Russia has been largely integrated into the world economy and interrelated with external financial markets while their risks remain significant. Declaration of new foreign trade restrictions, primarily by the USA, may negatively affect advances for economy in Russia. Imposition the anti-Russian sanctions set restrictive measures on lending to domestic enterprises abroad and has led to a fact that significant number of Russian exporters have been hampered by access to cheap borrowed funds abroad. The analysis shows that by 2025, if the sanctions pressure will be continuing, the total amount of repatriating capital may probably reach $ 165.55 billion only from Cyprus offshore. Allocation of capital in the Cyprus jurisdiction has become less comfortable due to possible sanctions that may lead to blocking of accounts. The second reason is increased regulatory pressure in Cyprus. However, can we expect increasing of capital investments into Russian economy? In the current situation, when evidently there is a stagnation in the economy, it is quite difficult to find appropriate sectors for large-scale investments in a long-term view. Low consuming due to the low personal incomes remains a constraint factor, therefore, we should not expect a mass influx of investments from the foreign offshores. Moreover, there is a redistribution of points of location of the Russian capital, so the huge outflow of Cypriot money will not have a serious impact on the Russian economy and financial market. Some offshore jurisdictions, on the contrary, showed an influx of investments into Russia against the background of the outflow of Cypriot money.

KEY NOTES

1. Bank of Russia, https://cbr.ru/VFS/statistics/credit_statistics/bop/
2. Bank of Russia, https://cbr.ru/vfs/statistics/
3. Bank of Russia, https://www.cbr.ru/statistics/macro_itm/svs/; https://cbr.ru › statistics › credit_statistics › bop › outflow
4. https://tradingeconomics.com/russia/gdp
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6. Bank of Russia, https://cbr.ru/vfs/statistics/

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