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After Cyprus Bath, Russia Needs New Haven

By Alexei Bayer

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The International Herald Tribune ran a cartoon of tourists snapping pictures of a classical ruin with an inscription over its architrave: "Cyprus Tax Haven." Following its financial rescue, which inflicted losses on larger depositors, Cyprus's status as a financial center has been irreparably damaged. But other offshore centers will pick up the slack, and Russian companies and individuals, after taking a bath in Cyprus, will eventually find another home for their money.

Their critics blame offshore financial centers for a variety of ills. For example, they help corrupt businesspeople and bureaucrats launder profits from illegal activities, and they make financial oversight difficult. Nevertheless, while authorities in the U.S. and Europe appear to be restricting their activities, in reality they allow them to exist and flourish.

The truth is that offshore banks help correct severe inefficiencies and imbalances in the global economy and allow the international financial system to function smoothly. Take money

laundering. The illegal drug industry earns some $400 billion annually, with drugs sold in the U.S. alone estimated at some $150 billion. While indicative of some real failures in our society, the existence of such enormous underground flows is a fact of life. There has to be some kind of mechanism for accommodating them within the financial system.

Similarly, the new international class of the super-wealthy, while economically inefficient, requires a special banking system to cater to their needs, including tax avoidance. They increasingly live in a world of their own and use few of the regular services provided by nation-states. Yet national governments in industrial countries, faced with a shrinking middle class, demand that they pay more and more taxes.

The global macroeconomic system is also skewed. The U.S. runs massive trade deficits and finances them by printing dollars. Meanwhile, some countries that run trade surpluses — especially exporters of oil and other commodities — are politically unpredictable, corrupt and have no rule of law. Well-connected elites in these countries have been able to accumulate considerable assets. Obviously, given the precarious political situation and terrible business climate, they have no wish to keep their wealth at home. They do not want to invest in the domestic economy or pay taxes to their own government. They prefer to shift their money abroad to countries with stronger safeguards for private wealth and greater political stability. This is when offshore banking systems come in handy.

Russia is case in point. Its current account surplus is among the largest in the world, measuring close to 6 percent of gross domestic product. But unlike China, which also has a large surplus, Russia's wealthy who get the bulk of the country's oil earnings don't invest at home. Money steadily leaves Russia, and even though a study by Ernst & Young shows that only half of the $350 billion leaving the country since 2008 has been genuine capital flight, it is still an enormous amount. Experts expect more of the same this year and next, with another $100 billion leaving over the next two years.

Much of it has been siphoned through Cyprus. With the effective closing of this route, financial outflows from Russia are not about to stop. On the contrary, the vision of Cyprus, another weakling on the periphery of the euro zone, being used as a whipping boy will only increase the attraction putting one's assets into Switzerland, Germany and the U.S. But getting your money out of Russia and shifting it to your Miami condo will now become more difficult, expensive and risky.

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