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The Dirty Truth About Russia's 'Dirty' Money

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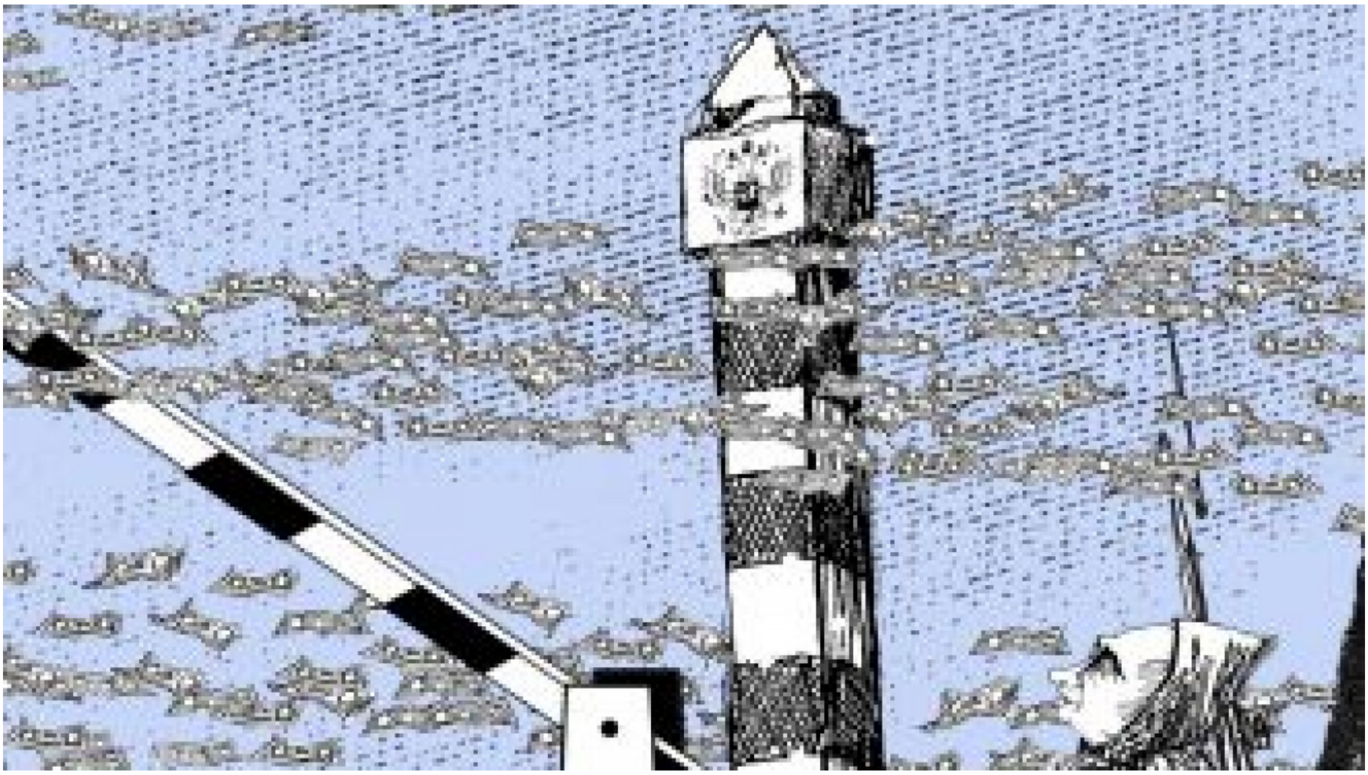

Recently passed restrictions on ownership of foreign assets for the members of Russian officialdom and the Cyprus saga earlier in the year have brought attention the scale of the supposedly "dirty" cash that flows out of Russia. The reality is far more insidious: most of Russian capital flight over the last several years has been perfectly legal. The data reflect the success of the Kremlin's efforts to embed and legitimize state-run corporations within the global financial system. The trouble with this state of affairs is that it obviates the need to create reliable, independent financial and legal institutions within Russia.

Russian capital flight over the last few years has been perfectly legal. The absence of a reliable legal system drives assets' movement abroad.

A study by Global Financial Integrity, or GFI, a Washington-based think-tank, reveals that between 1994 and 2011, the Russian economy lost $782.5 billion in capital flight. Of that sum, unrecorded, illicit outflows amounted to $211 billion. Yet a closer look at the data reveals a quite different and extraordinary story. The fact is that there has been a remarkable transformation in the composition of capital flows into and out of Russia. While outflows accounted for by official statistics have remained sizable, the share of unrecorded outflows has plummeted since the middle of the last decade.

According to GFI's data, from 1995 to 2005, illegal outflows averaged 3 percent of gross domestic product on an annual basis, but from 2006 to 2011 that number plummeted to less than one percent of GDP. Consider this: half of all capital flight in 2001 was unaccounted for in official statistics, but only 10 percent of it was unrecorded a decade later. Data from other sources, including the Central Bank and a recent study conducted jointly by the Russian Direct Investment Fund, EY and the Center of National Intelligent Reserve at Moscow State University confirm the trend.

So, what accounts for this surprising legalization of Russian capital flight? Certainly, many factors have played a role, including an indisputable maturation of the corporate sector, the rise of Russia-based multinational corporations and a deepening of financial integration with world markets.

But the most important reason why unofficial capital flight has declined stems from government policy. Liberalization of capital controls that began in President Vladimir Putin's first term culminated in full capital account deregulation by 2006. This made many illicit cross-border transactions simply superfluous. For example, the Central Bank did away with the practice of forcing exporters to sell dollar-denominated proceeds from foreign sales, so those funds could remain abroad. The government stopped controlling the foreign borrowing practices of Russian companies, residents' purchases of securities abroad and the purchases of Russian securities by nonresidents. Of course, the"nonresident investors" in Russia are mostly foreign subsidiaries of "resident" corporations.

Big business supported and welcomed easier access to a global financial system that was founded on the principles of hyper-mobile, unregulated and under-taxed capital. In addition to providing easier access to more favorable tax regimes in the Cayman Islands and the reliable court systems of Britain and the Netherlands, this arrangement provided the moneyed elites with an insurance policy against governmental expropriation. After all, their wealth was tenuously based, just like the ill-defined property rights of the 1990s or the fortune of their former colleague Mikhail Khodorkovsky. Incorporation in foreign jurisdictions, listings on foreign exchanges and occasional purchases of famous sports teams legitimized oligarchs' wealth while placing them outside of the Kremlin's reach. Finally, by the late 2000s, the process of financial integration reached a new stage: Russian corporations were using offshore locations to run their financial operations not only outside, but also — and most strikingly — within Russia itself.

A superb infographic constructed by Forbes magazine in February demonstrated the difficulty of finding a Russian oligarch who does not use foreign dominions to run his finances. The trail of Russian money stretches from exotic Caribbean islands to Europe and Asia. Oleg Deripaska controls "Basic Element" through the British Virgin Islands and RusAl via the Island of Jersey. The English Channel is the place Mikhail Prokhorov's Polyus Gold also calls home. Viktor Vekselberg buys Faberge eggs through his Panama-based Lamesa outfit. Gennady Timchenko's Volga Resources is registered in Luxembourg. Even Gazprom relied on its Dutch subsidiary to complete the acquisition of Roman Abramovich's Sibneft in 2005.

According to various estimates, about a third of all global direct investment is routed though offshore centers. If the EY study is to be believed, the corresponding figure for Russia approaches 100 percent. In fact, according to the GFI data, illicit inflows declined by 50 percent between 2006 and 2011, just like the outflows. Meanwhile, from 2006 to 2011 the amount of outgoing, perfectly official foreign direct investment has tripled from about 1 to 3 percent of GDP. Today Russia is a leading originator of foreign direct investment among the emerging market economies. Those estimates, of course, do not account for the fact that as much as 50 percent of the money that leaves Russia is "round-tripped" back into the domestic economy through offshore financial centers. At the "Russia Calling!" investment forum last week, Putin proudly advertised a spike in foreign direct investment into Russia during the first half of 2013. However, it is likely that most of the inflowing capital originated in Russia and acquired its "foreign" status after passing through several offshore jurisdictions.

In light of all of this, recent reforms and Putin's pronouncements regarding the "de-offshorization" policies are commendable, but these efforts, even if well-intentioned, will not succeed unless Kremlin recognizes where the real trouble lies. Corrupt officials and the tax-evading oligarchs are a secondary problem.

Instead it is the the absence of a credible system of the rule of law that drives individuals and corporations to move their assets abroad, sometimes just for a few days before bringing it back under the guise of foreign investment. The proverbial cat is out of the bag. The last decade of policies, for all intents and purposes, officially sanctioned the outsourcing of the provision of a reliable and independent legal and financial infrastructure to other governments and jurisdictions. If the Russian president wants to see offshore capital return to Russia, there is only one way to do it — build a legal system that works better than what Nicosia, London, Amsterdam and Zurich are offering today. I would not hold my breath.

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