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Russian Capital Flight, Economic Reforms, and U.S. Interests: An Analysis

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ABSTRACT

Russian capital flight is a longstanding problem with negative effects on the partially reformed Russian economy. Recent reports of Russian money laundering and other financial scandals involving the Russian Central Bank, the Bank of New York, other commercial banks, and even former President Yeltsin's household involve forms of capital flight and have drawn greater attention to the problem. They have been the subjects of Congressional hearings and have focused the attention of Members of Congress and others on U.S. interests in Russia and the effectiveness of U.S. policies. Recent legislation has been proposed as a result of concern over the these scandals and Russian capital flight. This report will be updated as events warrant. For additional information see CRS Issue Brief, *Russia: Issue Brief*, IB92089.

Russian Capital Flight, Economic Reforms, and U.S. Interests: An Analysis

Summary

Russian capital flight is a longstanding problem with very negative consequences for the Russian economy. Authoritative studies estimate Russian capital flight to have totaled \$150 billion from 1992-1999. Recent reports of Russian money laundering and other financial scandals involving the Russian Central Bank, the Bank of New York, other commercial banks, and even former President Yeltsin's household involve forms of capital flight and have drawn greater attention to the problem. They have been the subjects of recent Congressional hearings and have focused the attention of Members of Congress and others on U.S. interests in Russia. Some legislation has been proposed as a result of concern over these scandals and Russian capital flight.

Capital flight deprives the Russian economy of critical financial resources that could be used for investment, tax revenues, restructuring pensions, and other social security programs. More importantly, capital flight indicates a lack of confidence by Russian and foreign investors and residents in the Russian ruble, in the Russian financial system, and more generally in the Russian economy itself. Capital flight is a sign that Russia's transition to a market economy continues to be incomplete.

An analysis of the rationale for Russian capital flight suggests that to reverse capital flight the Russian economy will have to provide an environment that motivates asset-holders to keep their wealth in rubles and repatriate assets that they have sent abroad. To do so, the Russian policymakers will have to take significant steps to establish and maintain macroeconomic stability and to complete the partial economic restructuring.

Post-Cold War U.S. policy has reflected a number of national security, foreign policy, and economic interests. U.S. policy has aimed to decrease the Russia military threat and at the same time encourage the development of democracy in Russia. In the economic sphere, U.S. policy has focused on establishing economic stability and on developing the institutions required for a market economy. The United States also views Russia as a burgeoning trade partner and source of investment opportunities. It can be argued that without a sound economy, Russia will find it difficult to achieve political stability, which in turn might increase the national security threat posed by Russia. Continuing capital flight is an indicator that Russia has yet to realize a functioning market economy.

In the near term, U.S. economic policy on Russia is likely to focus on the issue of whether to delay or move forward with pending IMF assistance. However, whether Russia undertakes complete economic reform will be determined by Russia alone. A key question in U.S. policy is whether it can persuade Russian policymakers to proceed with economic reform.

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Russian Capital Flight, Economic Reforms, and U.S. Interests: An Analysis

Capital flight is an abnormal flow of funds whose holder seeks safe havens from financial uncertainty and taxation or seeks to launder proceeds from illegal activities. Russian capital flight is a longstanding problem with very negative influences and consequences for the Russian economy.¹ It deprives the Russian economy of critical financial resources that could be used for investment, tax revenues, and restructuring pensions and other social security programs. More importantly, capital flight indicates a lack of confidence by Russian and foreign investors and residents in the Russian ruble, in the Russian financial system, and more generally in the Russian economy. Capital flight is a sign that Russia's transition to a market economy continues to be incomplete and far from sustainable.

Recently reported Russian money laundering and other financial scandals involving the Russian Central Bank, the Bank of New York, other commercial banks, and even former President Yeltsin's household are forms of, possibly illegal, capital flight and have drawn greater attention to the problem. (See discussion in appendix.) They have been the subjects of recent Congressional hearings and have focused the attention of Members of Congress and others on U.S. interests in Russia and on the effectiveness of U.S. policies.² Some legislation has been proposed as a result of these scandals and Russian capital flight.³ Still, with its rich natural and human resources, Russia could become a profitable commercial partner for the United States.

Russia remains a formidable political and military force and a focal point of U.S. national interest. It still is the greatest nuclear threat to the United States. Its political and economic stability are critical to the rest of the former Soviet Union, Eastern and Central Europe and the areas these regions border. Russia's participation in significant foreign policy and security issues, such as Kosovo, nuclear proliferation, and the Chechnya insurgency have proved critical to U.S. interests. Continued economic instability, as exemplified by Russian capital flight, could undermine these and other U.S. interests.

¹ This report updates previous CRS reports on economic conditions and reform in Russia—98-578, RS20340, and RL 20266.

² In September and October 1999, at least three committees, the House Banking and Financial Services Committee, the House International Relations Committee, and the Senate Foreign Relations Committee held hearings on Russian money laundering and capital flight and their effects on the U.S.-Russian relationship.

³ See for example, H.R. 2896, *Foreign Money Laundering Deterrence and Anticorruption Act* (Leach, et al.) and H.R. 3027, *Russian Economic Restoration and Justice Act of 1999* (Weldon, et. al).

This report examines the phenomenon of Russian capital flight— its definition, forms, and volume. The report then analyzes the relationship between capital flight and key economic success indicators, the underlying causes of Russian capital flight, and the prospects for Russia resolving its capital flight problems. The report concludes with an examination of U.S. policy options and the implications of each. It will be updated as events warrant.

Russian Capital Flight

“Capital flight” is an **abnormal** conversion of financial assets from the national currency to assets in a more stable currency usually in response to or in anticipation of heightened financial risk. The term is generally applied to abnormal capital flows out of the country but has also been applied to hard currency assets withdrawn from the domestic economy by way of internal capital flight or “dollarization.”⁴

What distinguishes capital flight from “normal” capital transactions is the motivation behind the outflow. Normal capital transactions are part of day-to-day business transactions where the investor seeks to accrue future income under conditions of acceptable risk. Within this normal category would be portfolio investments in stocks, bonds, and government securities and direct investments in foreign-based manufacturing facilities.

On the other hand, capital flight entails flows of financial assets that result from the holders’ perception that capital is subject to an inordinate level of risk from devaluation, hyperinflation, political turmoil, or expropriation if retained at home in domestic currencies. The holder seeks in this negative environment a safe haven for the funds, such as, the conversion of local currencies into dollars or deutsch marks and holding them or placing them in foreign bank accounts.

Capital flight represents assets largely unavailable to the source country for investment necessary for restructuring and growth and necessary to generate tax revenue sufficient for government budgetary support. It usually occurs in countries at low stages of economic growth and development. Russia suffers from the perversity of substantial net capital outflow at a time when its development needs call for more massive net capital inflow.

⁴ In 1937, economist Charles Kindleberger defined capital flight as, “abnormal [flows] propelled from a country...by...any one or more complex lists of fears and suspicions.” “On the Definition and Magnitude of Recent Capital Flight,” in Doland R. Lessard and John Williamson, *Capital Flight and Third World Debt*. Washington, D.C. Institute for International Economics. 1987. p. 29, 202. Cited in U.S. Library of Congress. Congressional Research Service. *Capital Flight and High Indebted Countries: An Analytical Survey of the Literature*. CRS Report 91-273 E., by Glennon J. Harrison. March 21, 1991. p. 2-3. Similarly, economists A. Abalkin and J. Whalley use the term to indicate, “transfers of assets denominated in a national currency into assets denominated in a foreign currency, either at home or abroad, **in ways which are not part of normal commercial transactions** [bold added].” Abalkin, A and J. Whalley. The Problem of Capital Flight from Russia. *World Economy*. v. 22. May 1999. p. 423.

Russian capital flight has taken various forms, according to authoritative studies.⁵ An apparent significant amount occurs as *internal* capital flight. Internal capital flight is often referred to as the “dollarization” of the Russian economy, because it has generally been in the form of Russian residents’ conversion of rubles into dollars for use as currency on the black market or as a means of savings for later conversion back into rubles. It results from citizens’ distrust of the Russian banking system and fear of inflation, currency revaluation, or expropriation. Average citizens do not have the option of sending their savings abroad, but their distrust of the financial system mirrors that of the rich.

External Russian capital flight has taken various forms. Some of the capital flight had been carried out, especially during the early period of partial reform, by directors of newly privatized companies selling raw materials, such as oil and metals. During this period domestic prices of Russian commodities were still substantially below world market prices. Some Russian firms bought the commodities on the domestic market, exported the commodities, and kept the profits offshore. In so doing, the directors avoided Russian exchange controls and Russian taxation.

Another form of external capital flight occurs when Russian firms arrange to have offshore affiliated or branch “clients” overbill the company for expenses. The Russian firm sends payment in hard currency abroad and the difference between the real and fictitious expenses are kept offshore. The excess is counted as expenditures and escapes Russian taxation. Illegal Russian capital flight has also occurred as “unrecovered import advances and export subsidies.” Russian residents pay for imports in advance but never receive the imports. Instead, the payments are made to an offshore entity with ties to the “importing firm.” The domestic firm writes off the “loss” as bad debt that escapes taxation.⁶ Similarly, Russian firms have exported goods but have kept the payments offshore.

A distinction should be made between capital flight that involves the transfer of legally obtained funds and capital flight that involves funds obtained from drug trade or other criminal activities. The latter category includes “money laundering” activity which has been the focus of recent investigations pertaining to money processed through accounts at the Bank of New York and other alleged activities of questionable legality. (See discussion in the appendix.) Because the illegal activities, by their nature, escape conventional accounting mechanisms, estimates of what portion of capital flight is “money laundering” is difficult at best. However, several experts have estimated that approximately one-third of capital flight involves illegal activity.⁷

⁵ See footnote 9.

⁶ Jack, Andrew. The Tricks Russians Use to Funnel Cash Abroad. *The Financial Times*. August 27, 1999. p. 2.

⁷ For example, Russian First Deputy Finance Minister Oleg Vyugin estimated that in 1999 Russia capital flight was valued at around \$17 billion, of which \$6 billion is illegal. Chase Bank. *Next Week*. October 1, 1999. p. 20.

Because the distinction between capital flight and other capital flows is one of motivation rather than form, measurements of capital flight are rough estimates at best. The limitations of Russian balance of payments data challenges experts. Nevertheless, available data provide some parameters for estimating capital flight.

Estimates of the volume of Russian capital flight vary.⁸ Some authoritative estimates are contained in studies from a symposium of Russian and Canadian economists. These studies estimate Russian capital flight from 1992 to 1997 cumulatively to be within the \$60 billion-\$150 billion range, or roughly \$10-\$25 billion per year.⁹

More recent estimates provided by other analysts fall within this range and thus seem to confirm the reasonableness of the earlier estimates. Russian Central Bank Chairman Viktor Gerashchenko has estimated it at \$1 billion per month (around \$103 billion), a relatively conservative estimate, but still a substantial amount.¹⁰ The international credit rating group Fitch IBCA estimates total Russian capital flight from 1993 to 1998 at \$136 billion or about \$23 billion per year.¹¹ The Institute for International Finance, a Washington-based group representing major international commercial banks, estimates the volume of capital flight from 1992 to 1999 at around \$1.5-\$2 billion per month or between \$18 billion-\$24 billion year. Chase Bank estimates that Russian capital flight in 1999 will be around \$17 billion, based on interview with Russian deputy finance minister.¹² Thus, a reasonable working estimate for capital flight from 1992-1999 would appear to be around \$150 billion.

Estimates of the volume of “internal capital flight” or “dollarization”— foreign currency held within the economy – are also difficult to make. One study estimates that Russian resident holdings of foreign currencies (including dollars) accounted for

⁸ Some estimates put Russian capital flight since 1991 at over \$300 billion. Cited in Global Organized Crime Project *Russian Organized Crime* Center for Strategic and International Studies. Washington. 1997. p. 38.

⁹ One estimate from the symposium values Russian capital flight between 1992 and 1997 at \$125 billion -\$140 billion. Abalkin, A. and J. Whalley. The Problem of Capital Flight from Russia. *World Economy*. v. 22. May 1999.p. 425. A second estimate places the value of capital flight during the same period at \$10 billion to \$25 billion annually (or a total of \$60 billion -\$150 billion). Sicular, Terry. Capital Flight and Foreign Investment: Two Tales from China and Russia. *World Economy*. v. 22. May 1999. p. 594. And a third estimate for the same period values Russian capital flight at \$127.8 billion, or \$21.3 billion per year Loukine, Konstantin. Estimation of Capital Flight from Russia: Balance of Payments Approach. *World Economy*. v. 21. July 1998. In a December 1999 discussion at the Washington, D.C.-based Nixon Center, Russian Minister to the G-8, Alexander Livshits, estimated that Russian capital flight will have totaled \$150 billion. He stated that \$12 billion went abroad as “normal investment,” while \$35 billion returned to Russia as investment, speculation in government securities or for other purposes. Twenty billion dollars went to offshore enterprises as “working capital,” probably an umbrella for abnormal transactions, such as tax evasion. See also interview with Livshits in *Obshchaya Gazeta*. November 25, 1999.

¹⁰ RFE/RL Newsline. September 29, 1999. [<http://www.rferl.org/newsline>].

¹¹ Reuters. August 16, 1999.

¹² Chase Bank. *Next Week*. 24 September 1999. p. 11.

over 53% of money flows in the Russian economy in 1992, and 40% as late as 1997. Periods of especially high volumes of internal capital flight have tended to mirror periods of severe financial crises in the Russian economy.¹³ This capital remains in the country and may facilitate some unofficial economic activity but likely escapes Russian taxation. Dollarization also undermines the effectiveness of government monetary policy by reducing the flow of the national currency, that is currency in circulation and bank deposits.

Capital Flight and the Russian Economy

Capital flight is a symptom of poor economic conditions in Russia. But it also *re-enforces* poor economic conditions as it deprives the economy of the critical investment and budgetary resources to build sustainable economic growth and finance social welfare programs.

Poor economic conditions are measured by indicators of overall performance. They have been the product in part of ineffective monetary and fiscal policies that were implemented early in Russia's transition to a market economy. But the poor economic performance has continued largely due to the incomplete or partial institutional and capital restructuring of the economy, which undermines achievements made in macroeconomic policy and establishes a perverse economic system that encourages capital flight.

Russian Economic Performance: Past, Present, and Prospects

Russia has endured deteriorating economic conditions since it embarked on a transition from central planning to a market economy.¹⁴ Along the way, Russian GDP has contracted more than 30% and living standards (measured by personal consumption) have declined more than 15% by 1998.¹⁵ In addition, Russia's unemployment rate has grown from the negligible levels of the Soviet period to more than 12% in 1999.¹⁶ Russia is also plagued by government budget deficits which have contributed to a burgeoning domestic debt burden and is encumbered by an ever growing foreign debt burden. In 1999, 40% of the Russian Federation budget was designated for interest payments on foreign and domestic debt.¹⁷

Russia's poor economic situation hit a crisis point on August 17, 1998. At that time, the government of then-Prime Minister Sergei Kiriyenko abandoned its defense

¹³ Abalkin and Whalley. p. 430-433.

¹⁴ For more information on Russian economic conditions see, CRS Report 98-578 E, *The Russian Financial Crisis: An Analysis of Causes, Trends, and Implications*, by William H. Cooper.

¹⁵ Calculations based on data found in PlanEcon, Inc. *Review and Outlook for the Former Soviet Republics*. October 1998. p. 21-23.

¹⁶ *Russian Economic Trends*. September 1999. p. 21.

¹⁷ *Russian Economic Trends*. October 1999. p. 9.

of the ruble against the dollar, defaulted on \$40 billion in government domestic debt, and imposed a 90-day moratorium on commercial external debt payments. The immediate impact of the crisis was the firing of Kiriyenko, a 64% depreciation in the ruble from July to December 1998, and a 41% increase in consumer prices during the same period.¹⁸ In addition, the IMF halted disbursement of credits under a \$22.6 billion program, and eventually canceled the program.

Many experts had predicted that the Russian economy would continue to deteriorate in the wake of the crisis. However, preliminary data for 1999 show some improvements with low inflation, a relatively stable ruble exchange rate, and modest growth in GDP. This growth has been primarily as a result of ruble depreciation that has made imports more expensive, thus encouraging Russians to consume import-competing domestically produced goods.¹⁹ The Russian economy has also benefitted from higher world oil prices, a major Russian export. Tax revenues have increased because of the jump in oil earnings and also because of more efficient tax collection, but a large share of increased oil profits may go into capital flight to avoid taxation.²⁰

However, these positive trends may be only a temporary and not a sustained improvement. While GDP has improved slightly in 1999, fixed investment, that is the economy's investment in productive capacity, continues its slide (down 0.8% on a year-to-year basis as of July 1999) that began before the collapse of the Soviet Union. As of 1999, the stock of fixed investment in the Russian economy is 36% of its level in 1992. Without new investment, sustainable growth is not possible.²¹ The absence of domestic investment makes foreign direct investment even more critical. In addition, the standard of living of the average Russian continues to decline. Russian disposable money income and average wages are declining, while the number of Russians living below the poverty level and the number of unemployed workers rise.²²

The problem could worsen if the percentage of the Russian government's budget that must be allocated to domestic and foreign debt servicing (currently around 40%) increases, leading the government to reinstitute a suspension in wage and pension payments, possibly increasing social tensions. Deteriorating living standards further deter growth in domestic savings and demand, which are essential for sustainable economic growth.

Poor economic prospects encourage capital flight. Indeed, although Russia's current account surpluses are growing, its foreign reserves have been declining, suggesting that confidence in the ruble remains low and that capital flight continues

¹⁸ Calculations based on data found in Ibid.

¹⁹ PlanEcon, Inc. a Washington-based economic forecasting group predicts that the Russian GDP will have grown by 2.0% by the end of 1999 which would be only the second year of growth since the fall of the Soviet Union. (Russian GDP increased 0.8% in 1997.) Monthly Report. *PlanEcon Report*. September 24, 1999. p.7.

²⁰ A recent study by the Russian Finance Ministry, suggests that capital flight has increased in 1999 because of an increase in oil revenues. Hoffman, David. Capital is Leaving at Quickened Pace. *Washington Post*. November 24, 1999. p. A17, A18.

²¹ Marrese, Michael. *Next Week*. (Chase Manhattan Bank). September 24, 1999. p. 10.

²² Ibid.

at a rapid pace. This could worsen as Russia meets debt service obligations without inflow of capital.

Short Falls in Economic Reform: Partial Economic Restructuring

While Russian macroeconomic performance has improved, the absence of microeconomic or structural improvements in enterprise efficiency and productivity and of market-friendly institution building have had negative effects on overall performance and may undermine macroeconomic achievements.²³ Russia's reform governments under Boris Yeltsin took steps toward destroying the old Communist party command economy system, but failed to establish a rule of law necessary for a market system. The absence of a new set of rules left the economic decision making process in the hands of the politically powerful, not the economically competitive, resulting in an economically negative motivational system that has stimulated capital flight. Four shortfalls have been especially critical in maintaining a perverse system:

Retention and Expansion of Security Forces and Administrative Bureaucracy. A government administrative system operating, under old, inefficient rules of the game, is a major contributing factor to Russia's incomplete reform starting in 1991. The failure to reform Russia's security forces and administrative bureaucracy puts a heavy burden on the state budget and has been an incentive to inefficiency and corruption. Retention of the old bureaucratic structure and staff is especially deleterious to financial reform.

The central administrative civilian bureaucracy has doubled since 1991 to 1.2 million, operating within much the same ministerial system as the old regime, despite the fact that the Russian Federation has half the population of the former Soviet Union. According to international comparisons, Russia's state administration ranks with Nigeria, Bolivia, and Colombia as most prone to corruption.

Non-Productive Wealth Generation Limiting Productive Investment and Tax Revenue. In 1992 over three-quarters of the GDP was channeled to wealth creation that did not contribute to investment or state revenue and instead weakened the value of the ruble and the balance of payments. Due to weakness in state regulation and politically controlled benefits, substantial fortunes were built up, e.g., by buying oil at very low domestic prices and selling at the world market price, by buying consumer goods including food at competitive foreign prices and selling at subsidized internal prices, and by obtaining "soft" bank loans for which repayment was not enforced. The newly rich oligarchs channeled much of their wealth abroad, motivated by the classical reason for capital flight, fear of losing their assets.

Privatization Without Restructuring of Enterprises. In 1993 and early 1994 transfer of state assets by voucher privatization, and in 1997 loans for shares at low cost to some politically influential rent seekers, further reduced the effectiveness of reform by directing financial flows away from new capital assets for generating new output and shifting revenue away from the state budget.

²³ For more discussion on the short comings of Russian economic reform see CRS Report RL30266, *Russia's Economic Policy Dilemma and U.S. Interests*, by John P. Hardt.

Imprudent Budget Deficit Management Burdening the State Budget and Leading to Default. With the burden of rent-seeking subsidies on the state budget and slow growth in taxable income, expenditures, including debt service continued to substantially exceed state revenues. Taxable income was especially constrained by exemptions and offsets for politically powerful, profitable enterprises such as Gazprom, the world's largest gas company. Revenue from the sale of state assets in competitive auctions to foreign buyers failed to materialize to generate substantial income due to high risk perception in the global market resulting in part from lack of legal protection of foreign investors in Russia. Direct investment fell far short of expectations and needs.

Impact on the Economy: The Relationship Between Capital Flight and Key Economic Indicators

The magnitude of Russia's capital flight problem can be grasped by various comparisons outlined below. Capital flight is a severe drain on the Russian economy:

Investment. Capital flight represents foregone investment in manufacturing plants, infrastructure, and other productive capacity. Russia requires infusions of capital for investment to rebuild outdated infrastructure, to modernize its industrial base, and to upgrade labor skills. Capital flight therefore, inhibits Russian economic growth and development, depressing Russian living standards.

The Russian Central Bank has conservatively estimated the average annual flow of capital flight to be approximately \$12 billion which, compared to investment data, is²⁴

- ! five and half times the **total** flow of foreign direct investment into Russia in 1998 (\$2.2 billion) and ten times the flow of **net** foreign direct investment(\$1.2 billion) into Russia in 1998;²⁵
- ! more than the value of **net** foreign direct investment in Russia since 1992 (\$11.6 billion);²⁶
- ! one and a half times **net** portfolio investment (\$7.8 billion) into Russia and about 1.5 times **total** portfolio investments (\$8.1 billion) in 1998;²⁷ and

²⁴ The \$12 billion figure is probably a conservative estimate and is used for illustration. The \$150 billion estimate for the 1992-99 cumulative capital flight, cited earlier, suggests that actual annual figure is much higher.

²⁵ Foreign investment data published by the Russian Central Bank. [<http://www.cbr.ru>].

²⁶ Center for Strategic and International Studies. *Net Assessment of the Russian Economy*. October 1999. [<http://www.csis.org>].

²⁷ Ibid.

! about 60% of gross fixed investment in the Russian economy in 1998 (\$20 billion).²⁸

Federal Budget. Capital flight escapes Russian taxation depriving the Russian government of revenues contributing to fiscal deficits and constraining expenditures on social welfare programs, defense, and infrastructure redevelopment. Furthermore, the magnitude of tax evasion by the wealthy class, an opportunity not open to middle class and the poor, accentuates income disparities and aggravates social instability.²⁹ \$12 billion is

! roughly equivalent to 50% of the federal government budget for Russia in 1999 (estimated at \$24 billion using a 24R/\$1US exchange rate).³⁰

Debt. Shortages of investment funds and tax revenues related to capital flight have led to a massive buildup of foreign debt requiring Russia to borrow abroad. In comparison to debt and debt service indicators, \$12 billion is

! equal to about 70% of Russian foreign debt repayments due (\$17.5 billion) in 1999³¹ and

! nearly equal to 55% of the *entire amount* of IMF loans (\$22.1 billion) extended to Russia *since 1992*.³²

Prospects For Effective Reform and Capital Flight Reversal

The discussion above suggests that in order for capital flight to slow or reverse, the Russian economy will have to provide an environment that motivates asset-holders to keep their wealth in rubles and to repatriate assets that they have sent abroad. To do so, the Russian policymakers will have to establish and maintain a program of macroeconomic stability and of economic restructuring. But to do so will require a broad political consensus supporting legislation and policy action. To date the rate of capital flight has continued, perhaps increasing after the 1998 financial crisis. The first indication of progress would be a slowing of capital flight. Major changes in the system would be needed to reverse the flow.

²⁸ Economist Intelligence Unit. 3rd Quarter 1999. p. 5.

²⁹ According to one estimate, in 1997, 20% of the Russian population earned 47% of all personal income but paid only 23% of the taxes they owed. Moody's Investors Service. Report on Russia. July 8, 1999. p. 4.

³⁰ Federal government budget number published by *Russian Economic Trends*. February 1999. p. 8. [<http://www.hhs.se/site/ret/update/default.htm>].

³¹ Foreign debt data published by Economist Intelligence Unit. *Country Report—Russia*. First Quarter 1999. p. 37.

³² IMF data published by IMF [<http://www.imf.org>].

At a minimum an effective economic program to move toward a functioning market economy with prospects for sustained growth would include the following:

- ! developing and maintaining sound fiscal and monetary policies that would keep inflation in tow and provide sufficient currency flows to allow for economic growth and permit a sufficient level of government expenditures to maintain a necessary social safety net, competent civilian administrative system, and national security forces;
- ! scaling down and restructuring the civilian bureaucracy and the national security forces along with reforming the legal and regulatory framework to reduce incentives for corruption;
- ! reforming the tax code and tax administration in order to move to a balanced budget regime by improving tax collection and increasing revenues and also to make taxation more equitable, thus reducing disincentives to productivity and incentives for tax evasion;
- ! reforming the banking sector to restructure or eliminate unprofitable banks and implementing internationally accepted operating standards to raise confidence in the system as a holder of deposits and conduit for investment capital with the development of an independent central bank able to effectively regulate the banking system; and
- ! developing a rudimentary commercial legal and regulatory system to protect contracts and property rights and to guarantee shareholder rights to improve corporate governance all of which would help to raise investor confidence in the economy and reduce motivation for capital flight.

This list is by no means complete, but it represents fundamental changes that Russia still needs to undertake. By doing so, Russian policymakers could help ensure a slowdown in capital flight, which would help to build a foundation for sustainable economic growth. This, in turn, would increase motivation for investors to return capital to Russia, thus reversing the vicious downward spiral of the recent past and creating a virtuous cycle leading to sustained economic growth.

Successful economic reform has been stymied in the past by, among other things, the failure of Russian policymakers to reach the strong political consensus that must be in place for fundamental reforms to take place. There had been a lack of consensus between the Yeltsin government and the Russian parliament. A politically fractured State Duma was dominated since 1995 by factions from the Russian Communist and Agrarian parties and by nationalists who have been critical of economic reform policies and of the role played by Western countries and international organizations, particularly the International Monetary Fund (IMF), in promoting economic reform in Russia.

In addition, there had been a lack of consensus between the Yeltsin government in Moscow and the regional governments. Divisions emerged between those Russian regions that have been more successful in moving toward reform and those who carry

an especially large burden of the Soviet legacy and thus are dependent on subsidies from the federal government.

Divisions over economic reform also existed within the Yeltsin government itself. Influence has shifted within the government between ardent reformists such as Yegor Gaidar, Chubais, and Nemtsov and those, such as, former Prime Ministers Primakov and Chernomyrdin, who favor more moderately paced reforms.

Economic reform has also suffered the strong influence of the so-called oligarchs who have a vested interest in the status-quo as they have been able to take advantage of political connections and the incomplete reforms to gain control of valuable assets, extract wealth, and send it abroad in the form of capital flight. In addition, economic reform was hampered by political uncertainty associated with Yeltsin's frequent changes of Prime Ministers and with his physical health.³³

One of the first tasks that the new Russian president, Vladimir Putin, will have to undertake is building a new political consensus for economic reform. But he will face an issue that confounded his predecessor—confronting those, namely the oilgarchs and bureaucrats, who have benefitted from incomplete economic restructuring and would be most threatened by vigorous reforms.

U.S. Economic Policy Initiatives and Options

Russia's importance as a foreign policy and national security issue has dramatically diminished with the demise of the Soviet Union in 1991. Nevertheless, Russia remains a formidable political and military force and could potentially become an important economic force. It remains a focal point of U.S. national interests. Russia is still the greatest nuclear threat to the United States and remains an important participant in world affairs, as its involvement in Bosnia, Kosovo and the Chechnya insurgency demonstrate. Russia's physical presence dominates two continents, and therefore, its political and economic stability are critical not only to the region but to the rest of the world, including the United States.

Post-Cold War U.S. policy has reflected these national security, foreign policy, and economic interests. U.S. policy has aimed to decrease the Russia military threat and at the same time encourage the development of democracy in Russia. In the economic sphere, U.S. policy has focused on establishing economic stability and on developing the institutions required for a market economy. The United States also views Russia has a potentially burgeoning trade partner and source of profitable investment opportunities.

While in one sense these various objectives— national security, foreign policy, political and economic— are distinct, they are very much interrelated. It can be argued, for example, that without a sound economy, Russia will find it difficult to achieve political stability which in turn might increase Russia as a national security

³³ CRS Report RL30266, op. cit.

threat. Continuing capital flight is an indicator that Russia has yet to realize a sound economy.

U.S. foreign assistance has reflected the multiple facets of U.S. policy toward Russia. The United States has provided bilateral technical and humanitarian assistance through a number of different programs. This assistance has included an estimated \$2.4 billion through September 1999 in financial and technical assistance through the Newly Independent States (NIS) account of the foreign aid appropriations administered through the U.S. Agency for International Development (USAID). In addition, a number of U.S. agencies have used their own budget resources to provide assistance to Russia and other former Soviet states for specific purposes, including military threat reduction, food aid, nuclear safety, space cooperation, and education and cultural exchange.³⁴ The U.S. Export-Import Bank (Eximbank) makes available export credit assistance, credits for the purchase of U.S. oil and gas exploration equipment under a special agreement with Russia.³⁵ In addition, the Overseas Private Investment Cooperation (OPIC) makes available investment insurance to exporters and investors, respectively who want to do business with Russia.

It has been through its participation in the multilateral institutions— the IMF and the World Bank— that the United States has focused its efforts in trying to encourage economic stabilization and restructuring in Russia. The IMF has extended around \$22.1 billion in credits to Russia since 1992, when Russia became a member of the Fund. Russia has repaid IMF around \$4.6 billion, leaving approximately \$17.5 billion outstanding. Russia is the IMF's largest borrower.³⁶ The IMF requires recipient countries to meet certain conditions, usually regarding exchange rates, fiscal and monetary policies, before they disburse the credits.

The latest IMF program for Russia was announced on July 28, 1999, a stand-by credit of \$4.5 billion to be disbursed in tranches over a 17-month period. The first tranche was distributed immediately. The second tranche was to have been delivered in September 1999 but has been delayed until questions about Russian Central Bank (RCB) activities have been resolved.³⁷ These latest IMF credits are to be used by Russia only to service previous IMF loans due in 1999 and 2000.³⁸

³⁴ NIS account assistance for Russia has been used in large part to encourage structural economic reforms. However, this assistance has been declining and most aid is now targeted to local governments and to grassroots private sectors rather than to the central government. For more information on U.S. bilateral assistance to Russia see CRS Issue Brief 95077, *The Former Soviet Union and U.S. Foreign Assistance* and CRS report RL 30112, *Russia's Economic and Political Transition: U.S. Assistance and Issues for Congress* both by Curt Tarnoff.

³⁵ A pending \$500 million loan package to foster development of an oil field is currently in question. *New York Times*. December 17, 1999. p. A14.

³⁶ International Monetary Fund. *IMF Approves Stand-By Credit for Russia*. Press Release no. 99/35. July 28, 1999.

³⁷ *Ibid.*

³⁸ As required payment to service IMF debt is greater than current loans, Russia will actually (continued...)

U.S. and multilateral assistance to Russia has drawn criticism over time from various quarters questioning the effectiveness of the aid in light not only of the apparent failure of Russia to complete the transition to a market economy. Some of the criticism has been leveled against the so-called Washington Consensus, that is the policy adopted in 1991 by the United States, other major creditor countries, and the IMF, that presses Russian economic reformers to move ahead, emphasizing macroeconomic stabilization (tight fiscal and monetary policies and liberalized exchange rate policy) and immediate privatization of state-owned assets before appropriate tax regimes, commercial legal system, banking system, and other economic institutions could be established.³⁹ The conditions contained under the most recent IMF credit program seem to respond to this criticism by highlighting structural reform requirements, including financial reform.

But recent reports of money laundering and other financial scandals have raised questions about the appropriateness of any assistance at all to Russia. Added to this is criticism of Russia's military actions in Chechnya and the possibility of restricting U.S. and multilateral assistance as a sign of U.S. displeasure.⁴⁰

In examining U.S. options in encouraging Russia to proceed with economic reforms, it is crucial to first measure the strength of U.S. leverage. Because it is through the multilateral institutions, especially the IMF, that most of the assistance for economic restructuring and stabilization is channeled, it is U.S. leverage in the IMF that would likely be the major tool for influence on Russian economic policy.

U.S. influence within the IMF is substantial. The vote of each member in IMF decisions is weighted based on the size of that country's IMF quota. Therefore, the U.S. vote counts for 17.56% of the total votes, giving the United States an effective veto in a process which requires 85% super majority to approve decisions. Furthermore, the United States position as the most influential financial center in the world adds bulk to its authority within the IMF.⁴¹ In effect, IMF decisions on assistance or other matters must take into account U.S. policy.

Then, how important is the IMF to Russia? As mentioned earlier the Russian budget has been increasingly constrained by the growth of debt servicing obligations with close to 40% of its 1999 budget targeted for interest payments on foreign and domestic debt. While the current IMF package of \$4.5 billion is a small amount compared to the annual volume of capital flight and the Russian investment capital requirements, without it Russia faces the choice of defaulting on IMF loans,

³⁸ (...continued)

pay back more than it receives by around \$1 billion.

³⁹ See among others, the critique of Joseph Stiglitz, former chief economist of the World Bank.

⁴⁰ IMF Managing Director Michel Camdessus himself has indicated that Russia involvement in Chechnya could play a role in IMF's decision to disburse the next tranche of credits. Urrutia, Laura. Chechnya War Hurts Russia Loan Chances— IMF. *Reuters*. November 27, 1999.

⁴¹ De Gregario, Jose, Barry Eichengreen Takatoshi Ito, and Charles Wyplosz. *An Independent and Accountable IMF*. Center for Economic Policy Research. London. 1999. p. 80.

constraining expenditures, possibly withholding payments to workers and pensioners, or financing the budget deficits by printing money, thus precipitating inflation. Russia negotiating with the Paris Club creditors to get its Soviet-era debt rescheduled (or forgiven). But failure to receive IMF's *imprimatur* might derail such attempts (although Russia successfully negotiated a rescheduling agreement with the London Club). According to one financial analyst, failures to receive timely IMF tranches could lead in the year 2000 to a severe Russian balance of payments crisis, threatening Russian defaults and closure of international capital markets to Russia for the foreseeable future. IMF leverage, and therefore, U.S. financial leverage would appear to be powerful at this time.⁴²

How should the United States use that leverage? In the near term, U.S. economic policy on Russia may focus on two options relating to Russian foreign policy actions and IMF assistance. One would be to maintain assistance; the other would be delay assistance. The Clinton Administration appears to be following the first option but leaving itself open to move toward the second.⁴³

Arguments for maintaining assistance are that it would help to maintain U.S.-Russian relations and U.S. leverage in Russian policy, especially on the new parliament (elected in December 1999) and the new president (elected in March 2000). More directly, it is argued that the financial assistance will help Russia face serious balance of payment and budgetary crises and avoid going into default on some major loans which could undermine its transition to a market economy and prolong capital flight.

On the other hand, delaying or diminishing assistance may convince the Russian leadership that their best interests lie in conforming to widely accepted human rights standards and cooperating with western industrialized nations in making a transition toward a democratic market society. At the same time, it could encourage Russian leadership to undertake the politically tough steps at completing economic reform which, in the long term, would help to ensure economic stability and growth and would help to reverse capital flight.

In the end, whether Russia undertakes sufficient economic reform to develop a functioning market economy will be determined by Russia alone. The test of U.S. policy lies in its ability to persuade Russian policymakers to precede with economic reform that restructures the system and leads to a slow down and eventually a reversal of capital flight.

⁴² Brown, Stuart. Russia— How Critical is IMF Money?. *Paribus Emerging Markets Research*. October 22, 1999.

⁴³ AFP. No U.S. Suspension of Aid to Russia: Berger. *AFP*. December 19, 1999.

Appendix: Recent Banking Scandals

Interest in the problem of Russian capital flight has been heightened by recent reports alleging at least three banking scandals. The first scandal (in chronological order of reporting) involved the Russian Central Bank (RCB). From the end of 1990 through 1996, the RCB (and its predecessor organization, the Soviet Gosbank) was involved in channeling assets through an offshore entity, the Financial Management Company (FIMACO). The transactions included the transfer in 1996 of RCB assets offshore which resulted in an understating of Russian foreign reserves. Because of concerns raised that the transactions might have involved International Monetary Fund (IMF) credits, the IMF requested and received an independent audit of the activities by PricewaterhouseCoopers. The audit confirmed that the transfers had taken place. The IMF concluded that while the transfers did not involve IMF-origin funds, they did result in undervaluing Russian foreign reserves that might have affected IMF decisions on disbursing credits to Russia.⁴⁴

The second scandal involves alleged money laundering. Between October 1998 and March 1999, around \$4.2 billion was processed at the Bank of New York through accounts under the control of a company that reportedly was used by Russian businessmen to “launder” illegally obtained funds from Russia. The account was kept open to allow investigators to follow the trail of funds, and an estimated total of at least \$10 billion (with some estimates going as high as \$15 billion) is believed to have been processed through the account.⁴⁵

In connection with this case, the Bank of New York suspended a senior vice president of the bank working in New York who is in charge of the bank’s business with Eastern European countries and countries of the former Soviet Union. She is married to a Russian national who is allegedly tied to the possible money laundering activities and who is also the former Russian representative to the IMF.⁴⁶

In addition, the Bank of New York fired a vice president of the bank working in London also on the bank’s businesses with customers in Eastern European countries and countries of the former Soviet Union. She is married to a Russian-American, who owns the company that controlled the Bank of New York account and that is tied to the possible money-laundering activities. In relation to this case, U.S. and British investigators are reportedly also focusing on the activities of Semyon Mogilevich, a Russian national long suspected of being involved in criminal activities, such as drug trade.⁴⁷

⁴⁴ *IMF Approves Stand-By Credit for Russia*. IMF Press Release no. 99/35. July 28, 1999. Available at IMF website: [<http://www.imf.org/external/np/sec/pr/1999/PR9935.HTM>]. See also the PricewaterhouseCoopers audit available on IMF website: [<http://www.imf.org>].

⁴⁵ O’Brien, Timothy L. Follow the Money, If You Can. *New York Times*. September 5, 1999. p. 1, 12.

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

At least two Russian banks, Inkombank and Menatep Bank, once controlled by some Russian financiers, known as “oligarchs,” but now insolvent, had accounts with the Bank of New York. Investigators are examining whether they might have been involved in the scheme. The Bank of New York case may be part of a larger money laundering scheme involving Russian citizens and banks in other countries.⁴⁸

⁴⁸ Ibid.