FREE NETWORK POLICY BRIEF SERIES

Torbjörn Becker, SITE
April 2019

# Capital Flows from Russia — The Bigger Picture

There is an increasing focus on how Russian capital flows are being channeled through Western banks to various destinations, including offshore havens. There are of course legitimate reasons and legal ways of moving capital across borders, but much of the international focus on capital flows in recent decades is linked to the financing of terrorism, tax evasion, and money laundering in connection with criminal activities. This brief provides the macro view of capital flows between Russia and the rest of the world to paint the bigger picture behind the more specific stories we read about in the news that involve individual businessmen, corrupt officials, criminals, and banks.

International capital movements have a clear role in allocating resources efficiently across countries. However, today's media coverage instead typically focuses on the role of capital flows in financing terrorists and avoiding taxes. Recently, money laundering has been creating headlines around the world in the Panama papers and other similar stories, illuminating complicated schemes in the global financial system in connection with illegal activities such as tax evasion, corruption, drug dealing and human trafficking.

In the international policy making arena, since 1989, the Financial Action Task Force (FATF) has the objective "to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system". After the terrorist attacks in 2001, the issues of anti-money laundering (AML) and combatting the financing of terrorism (CFT) also became a central area of the IMF's work and has since become an increasingly important policy question.

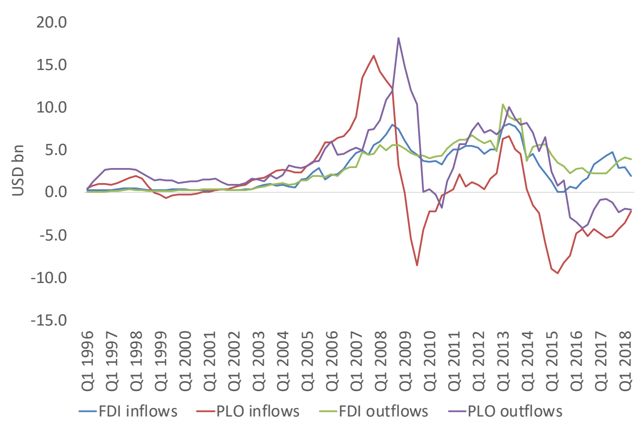
In several of the news stories, money flowing from Russia features prominently. This brief provides the bigger picture of Russian capital flows based on publicly available data as a complement and background to the news stories that are based on inside information, or "leaks", and that focus on particular individuals and banks.

## Composition of capital flows

In the official balance of payments statistics, capital flows are divided into a number of different categories, for example private vs public or banks vs non-banks. There is also a distinction made between foreign direct investments (FDI) on the one hand and portfolio flows, loans and other types of transactions (PLO) on the other. Since the balance of payments also has to balance (despite the fact that not all international transactions have been recorded) there is also a term called errors and omissions (E&O) that take care of various discrepancies. In environments with poor data collection and a large share of activities that take place "off the books", this term tends to be large. For Russia, this term has become smaller over time as the economy and data collection has matured.

In terms of volatility and magnitude of flows, the distinction between FDI and PLO is often important and so also in Russia. Figure 1 shows the private sector flows to and from Russia over the last two plus decades.

*Figure 1. Capital flows to and from Russia*



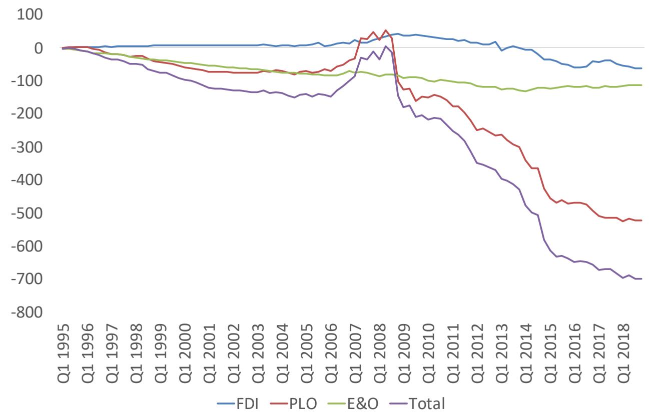

*Source*: Central Bank of Russia and author's calculations

After a rather slow start in the early years of transition, capital flows took off as Russia started to generate growth in 2001, and the flows kept growing until the global financial crisis. As expected, FDI flows have been less volatile than PLO flows but perhaps more surprising, in- and outflows in both categories seem to move closely together (see Becker (2019) on why this is the case). We can also note that there has been a marked downturn in flows at the time of the annexation of Crimea and subsequent sanctions and counter sanctions between the West and Russia.

## Cumulative capital flows

By computing net flows from the data in Figure 1 and accumulating this over time, we get a clearer idea in Figure 2 of the massive amounts of capital that have left Russia over the last decades. In the early years, the outflows were in the form of errors and omissions (E&O) and PLO, but the PLO trend was reversed in the early 2000's and turned total accumulated flows back to zero before the global financial crisis hit. The global financial crisis was a clear turning point for capital flows in general and PLO flows in particular.

*Figure 2. Net private capital flows*




*Source*: Central Bank of Russia and author's calculations

In the year following the global financial crisis, almost USD300 billion left Russia. Outflows then continued, albeit at a slower pace, only to accelerate again at the time of Russia's annexation of Crimea. By mid-2018, USD700 billion had left Russia since 2008, mainly in the form of PLO flows. This is equivalent to twice the amount of fixed capital investments in Russia in 2017.

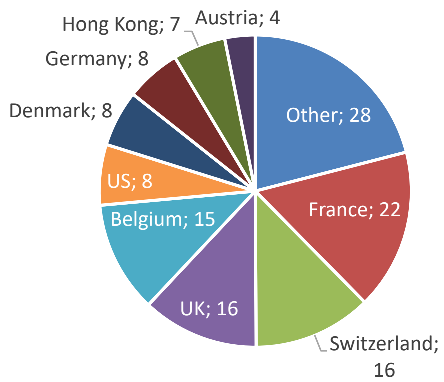
For a country like Russia that is in need of increased investments both from domestic and foreign sources to generate long-term sustainable growth, these outflows are very costly at the macro level even if they are beneficial to individual entities that are behind the flows.

# Destinations of capital flows

Where the money from Russia ultimately ends up should matter less to people in Russia than the fact that they are not invested and generating growth at home. However, it can matter a great deal to people, policy makers and businesses in the destination countries. Not only because it involves business opportunities and employment to some, but also because it generates concerns among regulators, law enforcement and tax authorities regarding the origins and purposes of the investments.

We do not have full coverage of where all the money Russian entities invest or park abroad end up, but official statistics are available for at least part of the investments. First of all, there is data on cross-border assets and liabilities of the banks that report to the Bank of International Settlement (BIS), which shows what foreign residents have deposited in the banks. Russian claims on BIS reporting banks are shown in Figure 3, where we can note that total claims by Russians amount to USD131 billion. Half of this amount was deposited with French, Swiss, UK, and Belgian banks at the end of September 2018.

*Figure 3. Russian claims on BIS reporting banks in different countries (USD bn, Sept. 2018)*




*Source*: BIS and author's calculations

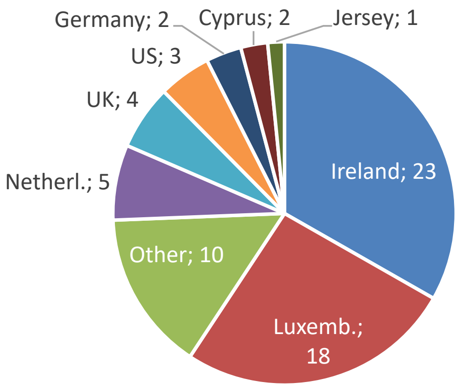
Given the recent scandal in Danske Bank, we can also note that USD8 billion was deposited by Russian entities in Danish banks, which may not sound much in this context but amounts to around 2 percent of Danish GDP.

Again, macro level data does not tell us if the flows behind the numbers are illicit or legitimate, but it provides some sense of the order of magnitude and possible significance for the entities involved in the transactions and their regulators and supervisors.

The next piece of information is due to the IMF's and others' efforts to collect and harmonize data on the destination of portfolio and FDI assets, and the data for Russia is presented in Figures 4 and 5.

The prime locations for Russian owned portfolio assets are Ireland and Luxembourg, followed far behind by the Netherlands, UK and US. In total, official portfolio assets are rather modest at USD69 billion, which is far off the cumulative net PLO flows in Figure 2 of over USD500 billion even if we add the BIS reporting bank deposits in Figure 3.

*Figure 4. Russian portfolio assets by destination country (USD bn, Sept. 2018)*



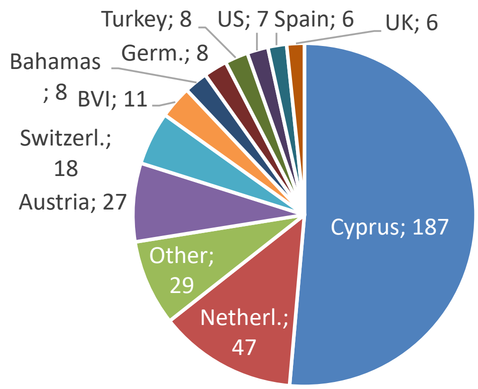

*Source*: Central Bank of Russia and author's calculations

This could have many explanations, including that a significant share of Russian PLO assets is not in BIS reporting banks or in countries that provide transparent reporting of other types of PLO assets. The fact that cumulative flows and stocks reported in international statistics are so different, though, clearly asks the question where the remaining assets are invested.

The last component for which we have data is the location of Russian FDI assets. This turns out to be the most significant asset class available in the official statistics with a total of USD364 billion invested abroad. Given that the magnitudes of FDI flows in Figures 1 and 2 are much smaller than PLO flows, this is somewhat surprising. Less surprising is the fact that more than half of this is invested in Cyprus, which is a well-known destination for Russian money.

However, it also begs the question on how assets are classified and where; Cyprus annual GDP was USD24 billion in 2018, or 13 percent of what is classified as Russian FDI assets in Cyprus. The only reasonable interpretation is that Cyprus is an offshore destination to park Russian money and not the ultimate location of direct investments from Russia. It is not unlikely that similar explanations are also valid for a significant share of the assets recorded as investments in the Netherlands, Austria and Switzerland, not to mention the British Virgin Islands (BVI) or the Bahamas. This problem is not unique for Russian data, but the magnitude of the problem regarding this data is still striking.

*Figure 5. Russian FDI assets by destination country (USD bn, Sept. 2018)*




*Source*: Central Bank of Russia and author's calculations

# Policy conclusions

Capital leaving Russia is mainly a problem for investments and growth in Russia, but, as has become far too clear recently, some of the flows also create problems in other countries. In particular, flows that are associated with money laundering and channeled through financial institutions in the West can create massive problems for banks that do not have sufficient control mechanisms in place or are guided by short-term profit maximization that encourages staff to look the other way when illicit flows are coming in.

Given the massive scale of flows coming from Russia, it can obviously be tempting to be part of this business while at the same time very costly to implement procedures and routines that control all of the flows adequately. However, not understanding the bigger picture of Russian flows can be even costlier.

## References


Becker, T, (2019), "Russia's macroeconomy—a closer look at growth, investment, and uncertainty", forthcoming SITE Working paper.



## Torbjörn Becker

The Stockholm Institute of Transition Economics (SITE)
torbjorn.becker@hhs.se
www.hhs.se/site


Director of the Stockholm Institute of Transition Economics (SITE) at the Stockholm School of Economics in Sweden since 2006 and a board member of several economics research institutes in Eastern Europe. Prior to this he worked for nine years at the International Monetary Fund (IMF) where his work focused on international macro, economic crises and issues related to the international financial system. He holds a Ph.D. from the Stockholm School of Economics and has been published in top academic journals and has contributed to several books and policy reports focusing on Russia and Eastern Europe.