ANALYSIS

Russian Capital Flight—How Big a Problem Is It for Russia's Growth?

Ben Aris, Moscow

Abstract

Economists have been wrong footed by 2013, as the expected slowdown of the Russian economy has been a lot more severe than expected. Persistent capital flight is partly to blame, but the problem is not as bad as it was in the 1990s. Capital flight is being driven by a combination of Russia's poor economic performance and by political uncertainty caused by the Kremlin's escalating crackdown on corruption.

Going into 2013, the widely held expectation for the Russian economy was for slower growth than in 2012, but a still reasonable 3% to 3.5% GDP growth. However, the slowdown has proven to be a lot more dramatic and the Russian economy effectively stalled by the middle of 2013, actually coming to a standstill in real terms in the summer, according to Deputy Economic Development Minister Andrei Klepach.[1]

The cause of the slowdown has been a mixture of low investment, low corporate borrowing, persistent inflation and on-going capital flight, not to mention the disappointing performance of economies in the rest of the world. Russia's high interest rates have been blamed for much of this slowdown: as annualised inflation has remained over 6% for all of this year (and actually rose from 6.1% in September to 6.3% in October)[2], the Central Bank of Russia (CBR) has not cut interest rates from the current 8.25%—the highest rate of any major country in Europe –, despite repeated predictions of a rate cut. This has caused wails of pain from companies that say the cost of borrowing it too high. At the same time, the historically low rate of unemployment means the labour market is drum-tight, which has driven up nominal wages by about 10% a year. The upshot is corporate profits are being gradually, but relentlessly, squeezed, which is only adding to the slowdown.

The lack of economic activity and low levels of borrowing, and by extension investment, are similarly squeezing the banks, which have also seen their profits fall, while capital adequacy ratios have dropped close to the mandatory minimum. Over the course of this year, non-performing loan levels in both the consumer and corporate segments have started to rise. As international capital markets are still not functioning, banks have been left dependent on the CBR for funding, except for the blue chip companies, which have been able to issue extremely cheap bonds.

The situation is, however, not yet dire, as the state has plenty of resources to support the economy for the meantime. Nonetheless, Russian companies have been talking about a new, but slow moving crisis, which began in the last quarter of 2012, which is more painful than the crash in 2008. The current situation is not sustainable. But rather than cut interest rates and loosen the public purse strings, the Russian government seems to be banking on a recovery in the rest of the world, and Europe in particular, in 2014 that will lead to an organic recovery for the Russian economy. The CBR and the Russian Ministry of Finance have somewhat perversely chosen now to impose their version of austerity and deal with the country's macroeconomic problems, of which high inflation is the most important.

The oil assumptions for the state budget are now calculated using the so-called 'fiscal rule,' which uses historical prices, rather than expectations for the future, to set the oil price in the three-year budget, which in effect sets levels of state spending. Under this new system, the budgeted oil price has been set at about $91 as opposed to current prices which are closer to $115. This has led to the first fall in state-spending in a decade, about 5% in real terms. Since Vladimir Putin became president in 2000, spending had been increased between 20% and 40% every year.

However, the bet on an organic recovery does not look like a bad one, as in November the Renaissance Capital-New Economic School macro monitor[3]—a leading forward-thinking monthly publication—reported the start of an economic recovery amongst its 92 indicators: the consensus among other economists concurs with this assessment and predicts 3%–3.5% growth next year.

Capital Flight Remains High

In the current economic environment of slowdown, Russian businessmen are reluctant to invest and are instead sending their money overseas. The CBR had predicted

1 See <http://www.bne.eu/archive_story.php?id=5432>

2 Olga Tanas & Ott Ummelas, 'Russian October Inflation Unexpectedly Quickens to 6.3%', Bloomberg, 6 November 2013, <http://www.bloomberg.com/news/2013-11-06/russian-october-inflation-unexpectedly-quickens-to-6-3-.html>

3 Russia: RenCap-NES Macro Monitor November 12, 2013 can be download from: <https://research.rencap.com/eng/RenCap-NES_Leading_GDP_Indicator.asp>

that capital flight would fall to $10bn at the start of 2013, but more than that left in the first two months of this year. Russia's Economic Development Ministry recently increased its net capital outflow forecast for this year to $30bn in October, but even this prediction looks to be on the low side one month later. The CBR is especially pessimistic about the amount of capital that is likely to leave this year: at the start of October, the CBR put the 2013 figure at a total of $62bn for this year, more than the $56.8bn that left in 2012.

Capital flight from Russia peaked at $133.7bn in 2008, when the global economic crisis broke out, and declined to $56.1bn in 2009, and then fell further to $34.4bn in 2010, before it started rising again to $80.5bn in 2011. In the third quarter of this year there was $12.9bn of capital flight, with $48.1bn over the first nine months of this year.

Table 1: Capital Flight ($bn)

2008	133.7
2009	56.1
2010	34.4
2011	80.5
2012	56.8
2013 *	62

* *estimate for full year*

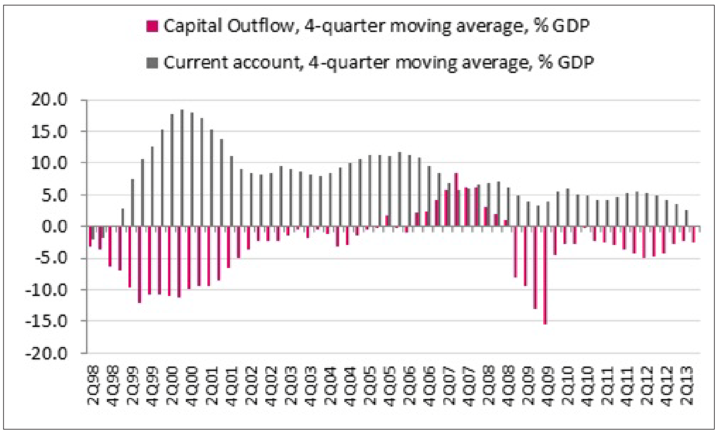
Source: Central Bank of Russia

Not as Bad as it Looks

Despite the high numbers, the overall level of capital flight is not quite as bad as it appears. Although the numbers are big as a proportion of GDP, the amount of capital flight is still a lot less than was leaving the country in the 1990s. Today's capital flight is equivalent to about 5% of GDP, whereas in the 1990s the level of capital flight was running at closer to 15%. Indeed, economists say that capital flight at the current level has become a persistent feature of the Russian economy. The reason that it has become more noticeable now is that this capital flight is not being recovered by concurrent capital inflows from outside. Looking at the issue from this perspective, then the current level of capital flight can be seen as less of an problem and more like 'business as usual.'

As the chart below shows capital flight in the latter part of the 1990s was actually much higher in absolute terms than now, and those levels were only surpassed in the depths of the meltdown in 2009. A credit boom began in the second half of 1999, as international lenders flocked to Moscow, enticed by the high returns, just as economic growth soared to over 10% a year—a record that has not been surmounted since—and continued for the rest of the decade. Indeed, it was this high-level of borrowing in the previous decade that caused so much damage to the Russian economy in 2008: the state was not heavily indebted, but several of the biggest and best companies were.

Interestingly it was only between 2006 and 2008 that capital flight reversed completely, as returning Russian money replaced international borrowing as the main source of investment capital at the height of the boom, only to rapidly flee again the following year.

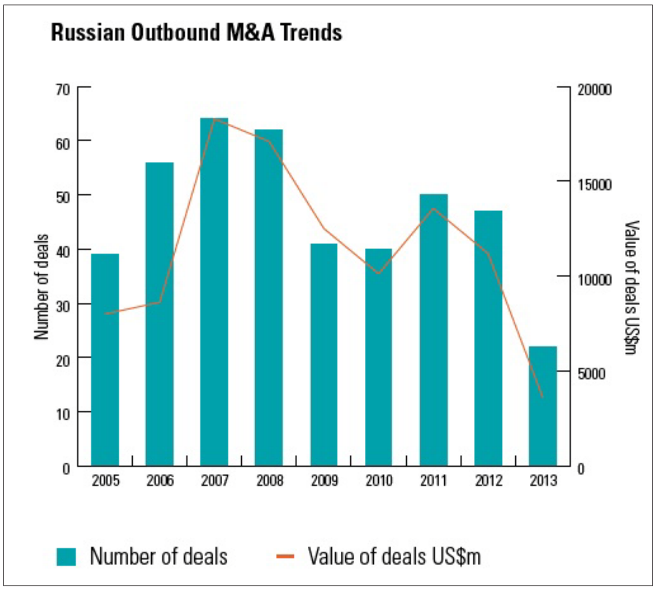


Source: VTB Capital

Furthermore, not all this "capital flight" is actually capital flight. Part of the reason the number was so high in 2008 was that the cash-rich foreign banks with Russian subsidiaries were bailing out their parent banks by sending money back in the form of loans. The amounts got to be so big—some $30bn in 2008 alone—that the CBR called in the heads of these banks and threatened to impose administrative restrictions if this borrowing was not curtailed, as it was threatening the stability of the Russian banking sector. However, this lending fell off rapidly in 2009 as the global financial markets stabilized.

A quirk of Russian national accounting means that the profits of Russian companies with overseas assets that reinvest their profits into those assets are counted as 'capital flight'. This is not standard practice amongst most national accounts, where it is seen as a 'net plus' by most countries, but in Russia's case this investment accounts for up to a quarter of all 'capital flight'.

In addition to the profits, Russian businessmen are continuing to buy foreign assets, which represents true capital flight, but has a positive economic impact, as this sort of capital flight is ultimately productive for the Russian economy. This trend is actually increasing because the increased political uncertainty in Russia has led more and more businessmen to seek to diversify their wealth by investing overseas. Between 2008 and 2012 Russian companies' outbound-mergers and acquisition-deals were worth a total of $71bn, according to law firm Squire Sanders,[4] or 20% of the total capital flight in that period.



Source: Squire Sanders, Global M&A Briefing: Russia Outbound M&A, October 20135

New Rules of the Game, Desire to Diversify

Having said that capital flight is not quite the bogeyman that it seems to be, Russia nonetheless needs to reduce the amount of money leaving the country. Foreign direct investment into Russia has recovered well this year: Putin said in October that foreign direct investment was up three-fold over the first three quarters of this year to $55bn, which more than covers the outflows. European retailers, in particular, are flocking to Moscow to set out their stalls, pulled in by the rising income levels—per capita income in Russia, which if calculated on a price purchasing parity basis is now over $18,000, or, in other terms, at the lower end of the EU pay-scale—and pushed out of their home markets by the economic stagnation most European countries are facing.

However, the task at hand for the Kremlin is to convince its own businessmen to return home, if Russia really wants to return to high levels of growth; the returning flight capital in 2006–2008 supercharged the boom years. But that is unlikely to happen in the near-term, due to the growing political uncertainty in Russia that has unsettled Russia's business elite. Three factors are contributing to this generalised nervousness.

The first was the reappearance of a real political opposition following the parliamentary elections in December 2011 that has ended the status quo and brought Putin down from the Elysian levels of support he had previously enjoyed, forcing him into the dirt of doing real politics. Prior to the large-scale demonstrations in December 2011, Putin was in complete charge of the political agenda, but since then he has to some extent lost control of the debate. Putin retains a firm grip on political power, but the population has at least won some control over setting the terms of the debate, if not the ability to force the Kremlin to react to it.

The second factor is the growing momentum of the Kremlin's anti-corruption drive. The first real attempt to deal with the endemic problem of corruption was launched by Dmitry Medvedev after he became president in 2008. However, Putin has made this campaign his own more recently, which went up a gear in November 2012 with the sacking of Anatoly Serdyukov[6] due to corruption allegations. The corruption drive has now touched all branches of government with sackings and charges brought against state officials on a weekly basis. More recently the state-owned enterprises have come into the firing line. The income-disclosure rules applied to Duma deputies have been extended to cover the civil service and more recently employees of state-owned enterprises.

Corruption levels have fallen a little according to the Transparency International's Corruption Perception Index, which rank Russia 133 out of 174 states, but the main affect so far has been to drive up the cost of bribes five-fold[7], according to press reports. The anti-corruption drive is proving deeply unsettling, as anyone in business in Russia is now exposed to accusations of corruption and subsequent imprisonment and/or confiscation of property. The upshot has been to encourage Russian businessmen to invest abroad to safe guard at least some of their wealth.

The third factor is Putin's decision to submit a bill to the State Duma on February 12 banning Russian officials from having foreign bank accounts or owning foreign property, which was passed in the summer. This bill is part of the anti-corruption drive and in the summer of 2012 the then-governor of the CBR Sergei Ignatiev intimated that government officials are responsible for half of all the illegal money transfers out of Russia[8]—a truly shocking statement. Since the introduction of the ban several Duma deputies have resigned their

4 See <http://www.bne.eu/archive_blob.php?id=391342>
5 Available from: <http://www.squiresanders.com/global-m-and-a-briefing-russia-outbound-m-and-a/>

6 'Russian Defence Minister Anatoly Serdyukov fired by Putin', BBC, 6 November 2012, <http://www.bbc.co.uk/news/world-europe-20218216>
7 See <http://www.bne.eu/archive_story.php?id=3970>
8 See <http://www.bne.eu/archive_story.php?id=4601>

seats and other have been forced to resign for ignoring the new rules.

With these moves Putin has drastically changed the rules of the game. Previously a state functionary could assume that provided one showed loyalty to Putin's administration, one was free to benefit from the position. However, under the new rules even if one shows loyalty, positions of power—up to and including minister—are no guarantee against investigation or arrest. This change also has consequences for business as in effect Putin has introduced capital controls by limiting some people's ability to transfer funds out of the country. Even in the depths of the 1998 and 2008 crises the Kremlin had shied away from the use of capital controls. Given it is a short step from politics to big business, this has also unsettled businessmen and encouraged them to divest their wealth out of Russia.

The Duma ban on foreign assets can be seen as a repeat of the famous 'oligarch meeting' between Putin and Russia's captains of industry in 2001, in which the president offered a deal: "Keep what you have got, but stop the stealing". The Duma deputies have been offered the same deal, but as this is a change in the rules of the game, it could take several years before all the players in the game are comfortable enough with these new rules to want to invest in Russia again.

About the Author

Ben Aris is the editor/publisher of Business New Europe (<http://www.bne.eu/>), an online news resource and publication covering business, economics, finance and politics in Central, Eastern and Southeast Europe and the former Soviet Union.

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