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Capital Flight from Russia

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Abstract

The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper documents the scale of capital flight from Russia, compares it with that observed in other countries, and reviews policy options. The evidence from other countries suggests that capital flight can be reversed once reforms take hold. The paper argues that capital flight from Russia can only be curbed through a medium-term reform strategy aimed at improving governance and macroeconomic performance, and strengthening the banking system. Capital controls result in costly distortions and should gradually be phased out as part of that medium-term strategy.

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I. INTRODUCTION

Several years into its transition toward a market economy, Russia is still experiencing massive capital flight. The costs of capital flight are well known: they include a loss of productive capacity, tax base, and control over monetary aggregates—imposing a substantial burden on the public at large and rendering policy-making more difficult. Capital flight may also reflect and facilitate illegal activities, and there is a widespread perception that this is particularly relevant in the case of Russia. Finally, press reports abound on the possibility that part of the funds from the International Financial Institutions (IFIs) have been simply channeled out of Russia and even into individuals' bank accounts abroad. Therefore capital flight may also be undermining public support for the IFIs' programs in Russia.

The root causes of capital flight from Russia include an unsettled political environment, macroeconomic instability, relatively high and unevenly enforced tax rates, an insolvent banking system, and weak protection of property rights. These causes generate a flood of flight capital, which leaves the country through channels such as under-invoicing of export earnings, fake advance import payments, and bank transfers bypassing existing capital controls.

The Russian authorities have been seeking to limit capital flight through a two-pronged strategy. First, economic reforms, often under the auspices of programs supported by the IFIs, attempt to tackle the root causes of capital flight. Second, capital controls attempt to block particular channels of capital flight; efforts in this direction were stepped up in the aftermath of the August 1998 crisis.

This paper documents the scale of the capital flight problem in Russia, compares it with that observed in other countries, and reviews policy options. It finds that capital flight seems to have reached a historical high in Russia over the past couple of years. Russia's experience stands in sharp contrast to that of the advanced reformers in Central Europe and the Baltics in recent years, as well as that of Latin America in the early 1990s. In these cases, capital flight was curbed or reversed by a sustained improvement in macroeconomic performance or institutional reforms. Cross-country studies do not find evidence, however, that capital controls stem capital flight. Indeed, capital controls have clearly not been successful in preventing capital flight from Russia over the past few years, although they may have had some short-term impact in mitigating flight in the immediate aftermath of the August 1998 crisis (along with other developments such as the large depreciation of the ruble and some improvement in the fiscal balance). This paper argues that capital flight can only be curbed in a lasting manner through a medium-term reform strategy aimed at improving governance and macroeconomic performance, and strengthening the banking system; that capital controls result in costly distortions and should be gradually phased out as part of that medium-term strategy; and that, in the near term, the structure of controls ought to be simplified and rendered less distortionary.

II. THE EXTENT OF CAPITAL FLIGHT FROM RUSSIA

This section provides estimates of capital flight from Russia, and places Russia's experience in context by comparing these estimates to those for other transition economies and other developing countries.

Capital flight is usually defined to include all outflows that occur in excess of those that would normally be expected as part of an international portfolio diversification strategy.

This definition includes outflows of funds originating from truly criminal activities; outflows of funds that are earned through honest activities, but are illegal in that they breach capital controls (or evade taxes); and fully legal outflows that comply with existing regulations and are motivated by a desire to flee the country owing to factors such as political uncertainty. The present chapter uses this standard, more encompassing concept of capital flight for two reasons. First, *all* capital flight imposes a burden on a country's macroeconomic performance. Second, using available data it is impossible in practice to distinguish among capital outflows that result from criminal activities, those that are illegal but originally acquired through non-criminal activities, and those that are legal. More generally, as there is no consensus on a single measure exactly pinning down the concept of capital flight, this note uses a number of measures to ensure that its main conclusions are valid regardless of the measure used.

Although all estimates of capital flight are tentative, capital flight from Russia seems to have been extremely high since 1994, averaging more than US\$20 billion a year (about US\$150 per capita) according to the "hot money" measure, and US\$15 billion (slightly above US\$100 per capita) according to the "broad" measure—two commonly-used measures of capital flight. Under the hot money measure, capital flight is defined as net errors and omissions in the balance of payments plus a subset of net private capital outflows. Under the broad measure, all net accumulation of foreign assets by the resident private sector is treated as capital flight.² The exact definitions are given in Box 1.

² Sheets (1996) and Claessens (1997) provide a discussion of the various measures, their pros and cons, and references to the literature.

Box 1: Definition of “Hot Money” and “Broad” Capital Flight Measures

“Hot Money 1” Measure

Net errors and omissions
plus Net flows of non-FDI, non-portfolio investment assets and liabilities held by entities other than the monetary authorities, general government, and banks

“Hot Money 2” Measure

Hot Money 1
plus Net flows of non-FDI, non-portfolio investment assets and liabilities held by banks

“Broad” Measure

Hot Money 2
plus Net flows of portfolio investment assets and liabilities in the form of debt securities¹

¹ As this item may be negative, the “broad” measure may well be smaller than the “hot money” measures.

The data are drawn from the International Monetary Fund’s *International Finance Statistics*.

Existing estimates of capital flight from Russia are broadly similar to those presented above. Tikhomirov (1997) and Loukine (1998) report a wide range of estimates, with their preferred estimates similar to those presented in this chapter. The Russian authorities have tentatively estimated capital flight at US\$11 billion a year in 1994-98. All capital flight estimates are subject to an especially high degree of uncertainty in Russia, owing to the relatively weak quality of the balance of payments statistics. Nevertheless, they seem to provide the basis for meaningful comparisons over time and across countries.

According to both the “hot money” and the “broad” measures, estimated capital flight intensified in 1996-97, and has remained high since then. Estimates of yearly capital flight are reported in Figure 1, with two variants of the hot money measure in the middle panel and the broad measure in the bottom panel. The top panel shows real GDP growth, which serves

here as a summary statistic of the (lack of) success of reforms. Estimates at the quarterly frequency seem to be less reliable, but by some estimates (e.g., those by Westin, 2000), capital flight declined somewhat in the aftermath of the ruble's sharp depreciation beginning with the August 1998 crisis and the tightening of controls, only to pick up again as the world market price for oil increased.³

Not surprisingly, Russia's experience with capital flight stands in sharp contrast to that of the more successful transition economies (Figure 2). Following Fischer and Sahay (1999), the early reformers among the group of Central and Eastern European economies are defined to include Croatia, Hungary, Poland, the Czech and Slovak Republics, and Slovenia. Capital flight from this group averaged \$15 per capita using the "Hot Money 1" measure in the early years of transition, a far more moderate level than that experienced in Russia. Moreover, as reforms took hold and output growth resumed in these countries in 1993, capital flight reversed, with inflows averaging \$75 per capita during 1993-98.⁴ Using the "Hot Money 2" measure, the extent of the reversal was even more pronounced, from flight of \$60 per capita to inflows of \$90 per capita. A similar qualitative pattern holds with the broad measure. The Baltics' experience is analogous (Figure 3). For these countries, there was

³ Another factor that can affect estimates of Russian capital flight is the investment in GKO and equity markets over the latter half of our sample period, particularly the large inflow during 1997. Anecdotal evidence suggests that a large part of the investment in these markets by purported nonresidents was actually by Russian residents who had previously taken capital out of the country. This suggests that the stock of flight capital waiting to return to Russia in the event of an improvement in the investment climate may be lower than would otherwise be the case.

⁴ For the pre-1994 period, Sheets (1996) found that capital flight slowed or reversed in Poland, Hungary and (former) Czechoslovakia as reforms took hold, but continued unabated in Russia.

relatively small capital flight (US\$30-US\$40 per capita) in the early years of transition (1992-94), and capital flight reversed once growth resumed in 1995. The fact that Russia seems to be a special case among transition economies is confirmed by Garibaldi, Mora, Sahay, and Zettelmeyer (1999). They find that, considering the financial account as a whole for a broader set of transition economies, Russia is the only transition economy to have been a net exporter of capital over the past few years.

The extended period of capital flight in Russia is reminiscent of the experience of Latin America in the aftermath of Mexico's 1982 debt-servicing difficulties, which were followed by a decade of capital flight (Figure 4). While the level of flight was lower, on average, than currently in Russia, some individual countries did experience very high levels of flight. For instance, capital flight from Mexico exceeded \$250 per capita in 1983. The more recent crises in Latin America have not led to the same degree of capital flight, though here again the average conceals a fair degree of variation across individual countries.

III. THE DETERMINANTS OF CAPITAL FLIGHT FROM RUSSIA

This section discusses the determinants of capital flight from Russia, making a distinction between the *root causes* of flight and the *channels* through which flight occurs.

Root causes of capital flight from Russia

Since the onset of the transition process, Russia has been struggling with a number of problems that make it risky for residents to hold their savings in the country and provide strong incentives to send savings abroad. These problems include the following.

- Macroeconomic instability, due in large part to an unsettled political environment, has caused uncertainty about the future returns on investment within Russia.
- Relatively high and unevenly enforced tax rates encourage tax evasion; funds are sent abroad to keep them hidden from the tax authorities.

- Lack of confidence in the banking system provides incentives to send savings abroad.
- Widespread corruption and weaknesses in the institutions for protecting property rights have discouraged asset accumulation within Russia.
- Finally, in some cases the privatization process has resulted in opportunities for managers to hollow out the assets they control and to hide the proceeds abroad.

While some attempts have been made to address these problems, the quality of the reform effort has been uneven.⁵ These root causes generate the desire to send (or keep) capital abroad, through a variety of channels.

Channels of capital flight from Russia

The channels of capital flight from Russia are well-recognized and include the following.⁶

- Misrepresentation of export earnings, particularly in the energy sector.

Misrepresentation takes place through various means⁷: (a) under-invoicing of exports; (b) export smuggling, with proceeds deposited in foreign companies or accounts; and (c) exports via an offshore subsidiary, recorded at a low transfer price, with the margin between transfer and market prices deposited offshore.⁸

⁵ Much has been written about the reasons for the uneven performance. See Fischer (1999) for a succinct account.

⁶ Additional channels are reviewed by Grigoryev and Kosarev (2000).

⁷ See IMF (1999) and Oxford Analytica Brief, "Russia: Capital Flight", September 8, 1999.

⁸ In addition, there are many cases in which earnings from exports that are themselves recorded are not repatriated.

The concentration of Russia's exports in the energy sector makes this a dominant channel of Russian capital flight. In fact, Fischer and Sahay (1999) suggest that the "curse of oil"⁹ may partly explain the combination of slow reforms, corruption, and capital flight in Russia. The apparent association between the intensity of capital flight from Russia and the world market price for oil also seems to support the view that capital outflows to a large extent reflect non-repatriation of export earnings by the energy sector.¹⁰

Consistent with these views, Tikhomirov (1997) estimates that, on average, in 1995 recorded Russian export prices fell short of world prices by approximately 7 percent for crude oil, 29 percent for petroleum products, 15 percent for coal, 11 percent for natural gas, 21 percent for aluminum, and 13 percent for copper. These commodities account for almost half of Russia's exports.

- Overstatement of import payments, including fake import contracts for goods and services.

The extent of flight through this channel is much more difficult to estimate than in the case of exports because Russia's imports are much more diversified than its exports.

Tikhomirov (1997) estimates that the proportion by which recorded import prices exceeded world prices was as high as 40 percent for foodstuffs such as wheat and sunflower oil.

⁹ That is, "the availability of a ready source of wealth, available without much productive effort, a prize to be fought over, rather than an investment to develop and foster" (Fischer and Sahay, 1999, p. 32).

¹⁰ The experience of Nigeria—another large country with substantial oil resources—points to an extended period of flight over the past fifteen years, though on a smaller scale than currently in Russia. Ajayi (1997) discusses some of the reasons behind capital flight from Nigeria and other countries in sub-Saharan Africa in the period through 1993.

- Fake advance import payments.

This seems to represent another significant channel of capital flight. There appear to be numerous instances where enterprises are set up solely with the intention of presenting to the bank an import contract providing for a large advance payment; the enterprises are dissolved as soon as the transfer of funds has been carried out.

- A variety of capital account transactions evading present regulations, often effected through the correspondent accounts of nonresident banks with Russian banks.

There are also instances of Russian residents acquiring offshore banks (typically in countries where supervision of banks is inadequate) to set up correspondent accounts with a resident bank; these accounts serve as a channel of flight over which the CBR has little control.

IV. CROSS-COUNTRY EVIDENCE ON CAPITAL FLIGHT

This section discusses some cross-country evidence on the determinants of capital flight to shed light on Russia's case and to draw policy recommendations based upon the experience of other countries. Evidence from other countries provides hope for the view that "once Russia's economy improves, the flight capital will return ..." (Fischer, 1999).

First, the experience of the advanced reformers in Central Europe, the Baltics and Latin America suggests that flight can be reduced or even reversed by a sustained improvement in either macroeconomic performance or institutional reforms or both. Figure 5 summarizes this evidence by comparing the average values of the inflation rate, fiscal balances and an index of the quality of reforms in the period of intense capital flight with those in the period of flight reversal. In the case of Central Europe, the reversal in flight was associated with a decline in inflation and improvements in the quality of structural reforms,

as proxied by the *Institutional Investor* (II) rankings of countries. The Baltics, too, made progress on both these fronts, while also keeping fiscal balances in check. In Latin America, the big improvement was in reducing fiscal deficits. The gradual improvement observed in these countries' inflation rates, fiscal balances and II rankings during the period under consideration suggests that while the improvements do not necessarily have to occur in one fell swoop, flight can be reversed once the direction of reforms is clearly established.

Second, the evidence in Box 2 shows—using the data set for transition economies assembled by Fischer and Sahay (1999)—that there is an association between capital flight and the determinants of growth. A key difficulty in analyzing the relationship between capital flight and other variables is the direction of causality, and clearly capital flight is a symptom, as well as a cause, of poor macroeconomic performance. Nevertheless, it seems likely that sustained improvements in a country's macroeconomic performance and institution (in the form of greater political stability, protection of property rights, and the rule of law) would help curb capital flight.

Third, evidence from existing studies on a broader cross-section of countries also suggests that capital flight is associated with poor macroeconomic performance and weak institutions. Using a small panel of transition economies, Sheets (1996) presents evidence that high inflation, large budget deficits, rapid exchange rate depreciation, and low real interest rates are all associated with increased capital flight. Schineller (1997a, 1997b) finds for a sample of 18 developing countries over the period 1978 to 1988 that fiscal consolidation and the presence of an IMF adjustment program help to check flight. Collier, Hoeffler, and Pattillo (1999) show, in a cross section of developing countries, that capital

Box 2. Capital Flight, Macroeconomic Stabilization and Reforms in Transition Economies

Fischer and Sahay (1999) present canonical regressions to understand the growth performance of transition economies. Their evidence confirms that anti-inflation policies and structural reform policies are associated with higher growth.

Using their data set, regression analysis shows that higher growth is significantly associated with lower capital flight, confirming the visual impression conveyed by Figures 1 to 3.

Given the association between growth and capital flight, it is not surprising that the factors that Help growth performance also turn out to help counter capital flight. The regression results for the 'hot money 1' measure are as follows:

$$\text{FLIGHT} = -19.4 \quad -12.7 \text{ INFLATION} \quad + 22.2 \text{ FISCAL} \quad + 124.8 \text{ REFORMS}$$

(0.4) (1.8) (2.0) (2.6)

Adjusted $R^2=0.20$. Numbers reported in parentheses are absolute values of *t-statistics*; Number of observations = 107. The starting year is the start of the transition year for each country, and the last year is 1998; the sample is therefore an unbalanced panel. FLIGHT is a negative number when there is net outward capital flight; FISCAL is the fiscal balance as a share of GDP—a surplus is a positive number; REFORMS is an index constructed by the World Bank measuring the intensity of structural reform efforts.

The regression indicates that larger outward capital flight is associated with higher (log) inflation (INFLATION), higher fiscal deficits and the quality of the reform effort. Using the other two measures of capital flight yields broadly similar results.

When capital controls (CONTROLS) are added to these regressions, the effect is almost never statistically significant and the coefficient estimates on CONTROLS switch signs depending on the measure of capital flight that is used.

flight is correlated with policy distortions resulting in exchange rate overvaluation. Indeed, the factors that are prompting flight capital to leave Russia may well be the same factors that are preventing foreign direct investment from flowing into Russia. Cross-country studies such as Kant (1996) show that there is a strong negative correlation between capital flight and foreign direct investment. On this basis of this evidence, Kant (1996) argues that countries are typically unable to offset the impact of weak institutions and general economic mismanagement by preferential treatment of foreign capital versus resident capital (in the

form of tax advantages, investment or exchange rate guarantees, and priority over resident claims in the event of a financial crisis).

On the basis of the cross-country evidence, it is less clear, however, whether capital controls are effective in stemming capital flight. The majority of existing studies suggests that controls on outflows—and in particular, quantitative controls on outflows—have been largely ineffective.¹¹ In a panel of industrial and developing countries, Johnston and Ryan (1994) do not find evidence that capital controls were effective in insulating developing countries' balance of payments. Schineller (1997b) finds that capital controls have no impact on capital flight, controlling for fiscal imbalances and the presence of an IMF program. While in a few cases controls may be effective for a short time, soon investors learn how to circumvent them.¹² In addition, in many countries there seems to be a tendency for capital controls to become permanent, and this seems likely to happen in Russia as well.

V. POLICY MEASURES

The root causes of capital flight in Russia seem to include uncertainty over policies, the confiscatory nature of the tax system, the banking system's weakness, and the unusual power of vested interests related to the energy sector. While the problem of capital flight is unlikely to be resolved in the short run, the experience of other transition countries shows

¹¹ Dooley (1996), Eichengreen, Mussa and others (1998), and Edwards (1999) provide reviews of existing studies, and Ariyoshi et al. (2000) survey a number of recent country experiences.

¹² At present in Russia it seems that capital controls are less effective in preventing capital flight originating from vested interests in the energy sector, and more effective in keeping in check flight from the more reliable banks, consistent with the presence of excess liquidity in the banking system.

that a few years may be sufficient to attain a turnaround in capital flight if progress is made in eliminating its root causes through ambitious reforms aimed at strengthening the banking system, improving the tax system, promoting good governance, and keeping vested interests in the energy sector in check.¹³ Although these are difficult reforms, the capital flight problem will likely persist as long as its root causes are present.

In an attempt to stem capital flight, the Russian authorities have introduced a number of exchange controls.¹⁴ Although multiple exchange rates were eliminated in 1993, considerable effort was devoted to the control of foreign trade in the initial stages of transition. In 1992-93, the authorities established and subsequently tightened a system of licenses for exports of “strategic” (raw) materials. In 1993-94, they set up a requirement for “transaction passports” providing the details of export transactions and, later, “export certificates.” In 1995, trade was liberalized considerably, notably with the elimination of export quotas on most goods, leading to Russia’s acceptance of the obligations of the IMF’s Article VIII in 1996.

Capital controls were relaxed considerably in 1997, and by mid-1998 nonresidents were able to repatriate the proceeds of their investments in Russian securities. Capital controls were, however, reinstated and strengthened in response to the August 1998 crisis.

¹³ Specific suggestions are provided in a number of papers presented by other authors at the conference on “Investment Climate and Russia’s Economic Strategy,” Moscow, April 2000.

¹⁴ A detailed chronology of changes in the exchange system is available in IMF (1999a) and IMF (1999b). The latter also provides the full status of exchange arrangements and exchange restrictions as of January 31, 1999. Russia’s experience with capital controls is also reviewed in Ariyoshi et al. (2000).

The requirement to surrender export proceeds has also featured prominently among the measures introduced by the authorities. Beginning in July 1993, all Russian exporters have been required to exchange 50 percent of their hard currency earnings into rubles. That proportion was increased to 75 percent in January 1999, and a further increase to 100 percent has been considered.

All these exchange controls may have brought benefits, in the form of (temporarily) lower capital flight but, some authors have argued, also costs in the form of greater corruption and lower economic efficiency. The controls have created economic rents, and many resources are spent circumventing the controls to capture those rents. To the extent that enforcement is subject to bureaucratic discretion, this provides scope for corruption. Indeed, there is evidence of a significant association between corruption and capital controls in a cross section of countries (Box 3). Finally, not all firms are equally able to circumvent the controls, which contributes to uneven competitive conditions and distorts resource allocation. Tikhomirov (1997) argues that as controls were extended to more and more areas of the Russian economy, so did corruption. In his view, the system of export licenses nurtured the corruption of bureaucrats; later, the requirement that banks certify the accuracy of the transaction passports caused the spread of corruption to the banking system as well.

A precise cost-benefit analysis of controls in these terms is not easy. The costs resulting from higher corruption are difficult to quantify. The benefits in the form of reduced capital flight are similarly unclear, because it is difficult to estimate to what extent capital flight would have been higher in the absence of controls. However, in light of both international experience and developments in Russia it seems that capital controls are

Box 3. Exchange Controls and Corruption

Although the relationship between exchange controls and corruption has not been analyzed in detail in existing studies, cross country regressions provide evidence of a positive association between controls and corruption. Of course, causality may well go not only from controls to corruption, but also from corruption to controls and from other factors to both corruption and controls. Nevertheless, this association is consistent with the view that phasing out the controls would reduce the economic rents they create, thereby lowering the incentives for corrupt, rent-seeking behavior.

The coefficient on controls is positive and significant (at the 5 percent level) in a regression of a corruption index (CORRUPT) on an index of controls (CONTROLS) and a set of variables that existing studies have found to be associated with corruption, including the logarithm of per capita GDP (GDP), the Gastil index of political rights (DEMOCR—to capture monitoring by civil society), and the logarithm of the ratio of imports to GDP (OPEN—capturing the influence of foreign competition on domestic firms).¹ There are 75 observations and the data are averaged over 1982-94. The corruption index ranges from 0 to 6 (a higher index indicates higher corruption). It is based upon consultants' responses and is provided by *Political Risk Services*, a private firm. The index of controls ranges from 0 to 4 and it is the sum of four dummy variables that take the value of one if the country has (a) multiple exchange rates, (b) current account restrictions, (c) capital account restrictions, (d) export proceeds surrender requirements, respectively. The regression results are as follows:

$$\text{CORRUPT} = 7.23 \quad -0.58 \text{ GDP} \quad -0.74 \text{ DEMOCR} \quad -0.07 \text{ OPEN} \quad +0.33 \text{ CONTROLS}$$
$$(3.32) \quad (-2.58) \quad (-1.36) \quad (-0.50) \quad (2.04)$$

White-heteroskedasticity-corrected *t*-statistics are reported in brackets. $R^2=0.55$

Therefore, other things being equal, countries that have all four types of controls have, on average, higher corruption by 1.3 notches on the 0-6 scale than countries that have no controls at all. The results are similar when the CONTROLS variable is defined as the sum of two dummy variables that take the value of one if the country has (a) capital account restrictions and (b) export proceeds surrender requirements, respectively.

¹ See, for example, Ades and Di Tella (1999) and Braun and Di Tella (1999).

unlikely to be very effective by now. Moreover, there seems to be considerable corruption involved in activities aimed at circumventing the controls.

In the medium term, therefore, it seems that capital controls ought to be eliminated, but a number of short-run considerations suggest that a gradual approach is desirable and prudent. Existing controls may have *some* effect in reducing capital flight and their abrupt

elimination might prompt a run on the ruble and the Russian banking system. The removal of capital controls may also imply that speculative attacks would have a greater impact, and it might be argued that the August 1998 crisis would have been somewhat less virulent in the presence of more stringent capital controls. To avoid the possibility of a run on the currency, it would be imperative to combine the gradual elimination of controls with measures to strengthen the banking system, governance, and macroeconomic performance more generally.

In the near term, a number of measures may help improve the structure of exchange controls—and permit an early elimination of controls that are inconsistent with the IMF's Article VIII—while not creating the risk of a sudden burst of capital flight. These measures include the following.

- Russia's foreign exchange regulations seem to be too complex. These regulations could be streamlined to make it easier to apply them in a monitorable and consistent manner, and without issuing individual permits.
- The number of licensed banks is currently very large, and many seem to play some role in the evasion of exchange restrictions. Tighter bank licensing rules would help alleviate these problems. In particular, the licenses of those banks that have been clearly unreliable in meeting exchange regulations could be withdrawn, and a general ban could be imposed on accounts with banks headquartered in poorly supervised offshore centers.
- Advance import payments are now subject to the Central Bank of Russia's prior approval, and there are cases in which permission is denied. This system may in some cases impose an undue burden on legitimate importers.¹⁵ It would seem desirable to facilitate procedures related to legitimate imports, while maintaining the CBR's ability to monitor advance import payments.¹⁶

¹⁵ This restriction is against the IMF's Article VIII.

¹⁶ One option would be to substitute the existing requirement for prior approval with a reporting requirement accompanied by stiff penalties in cases where the goods for which advance import payments has been made are not delivered within a prespecified period.

The schedule for the medium-term, gradual phasing out of controls initially ought to focus on those controls that are complex and that leave room for bureaucratic discretion in applying and enforcing them. On the other hand, controls that consist of a requirement for the provision of simple information might be retained to the extent that they are aimed at making it more difficult for the proceeds of truly criminal activity to leave the country and be hidden abroad.

The final question to be addressed is whether lending by IFIs facilitates capital flight. The question of whether the specific banknotes that are given to the central bank of Russia remain in Russia or leave the country is obviously irrelevant, because money is fungible.¹⁷ The relevant question is to what extent capital flight would have been higher in the absence of lending by the IFIs, but unfortunately it is impossible to know the answer to this question. The answer depends on whether lending by the IFIs and the policies that are undertaken in the context of this lending contribute to restoring confidence in the country's ability to provide attractive opportunities for all investors.

To summarize, the root causes of capital flight include political uncertainty, an uneven record of reforms, and institutional weaknesses, particularly corruption. The evidence from other transition economies suggests that efforts to tackle these root causes are likely to be successful in reversing capital flight. Capital controls, while possibly having brought some short-run benefits by mitigating the volatility of capital flows, seem however to have been ineffective in stemming capital flight over a medium-term horizon, and may have had

¹⁷ Nevertheless, to put the scale of IMF lending to Russia into perspective, Russia's exports of goods and services averaged about \$80 billion a year in recent years, which is over 25 times the average annual disbursement from the IMF since 1992.

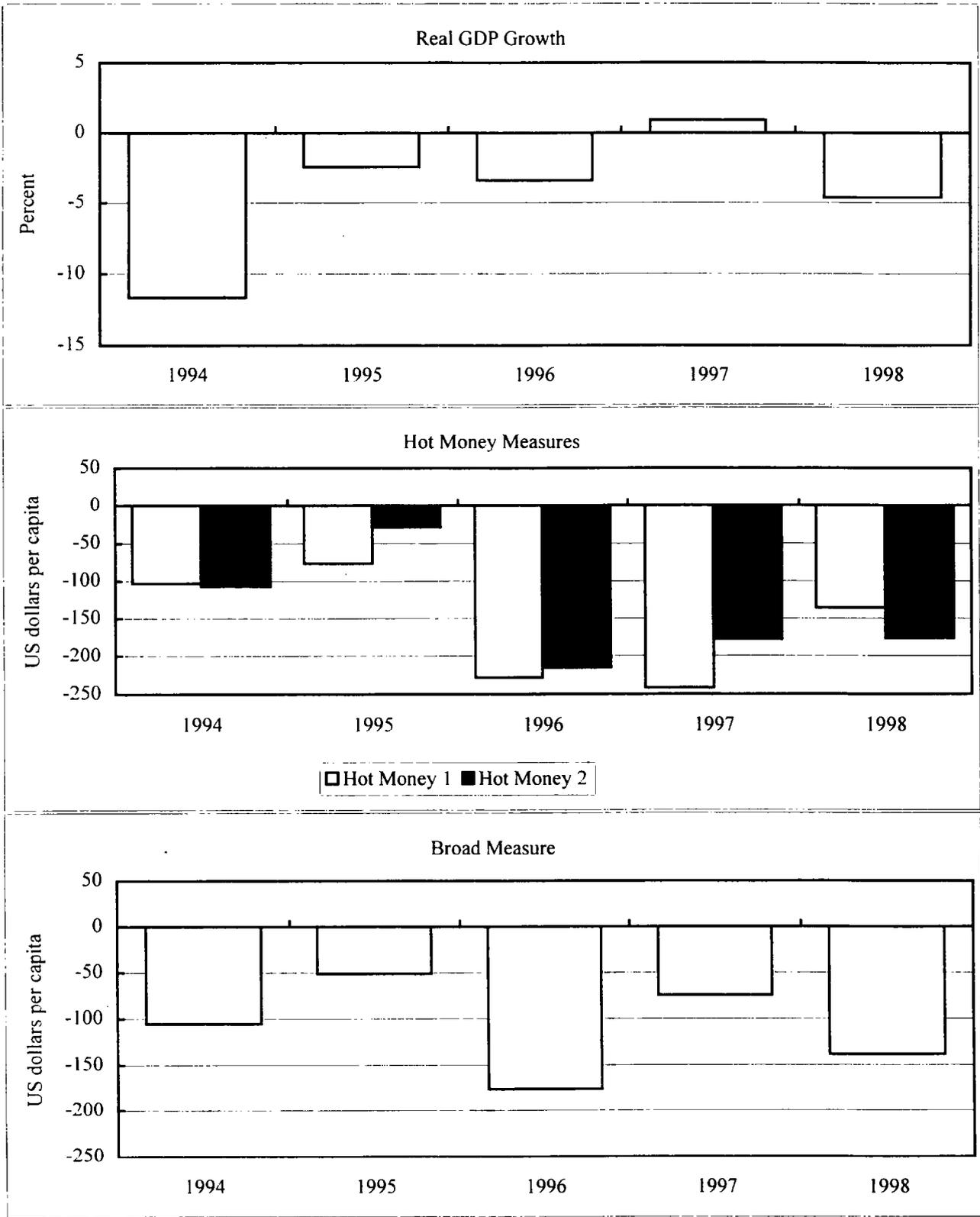
considerable costs through increased corruption. Therefore, the medium-term, post-election strategy ought to include a timetable for the gradual phasing out of controls, combined with a package of measures to improve governance and macroeconomic performance and to strengthen the banking system.

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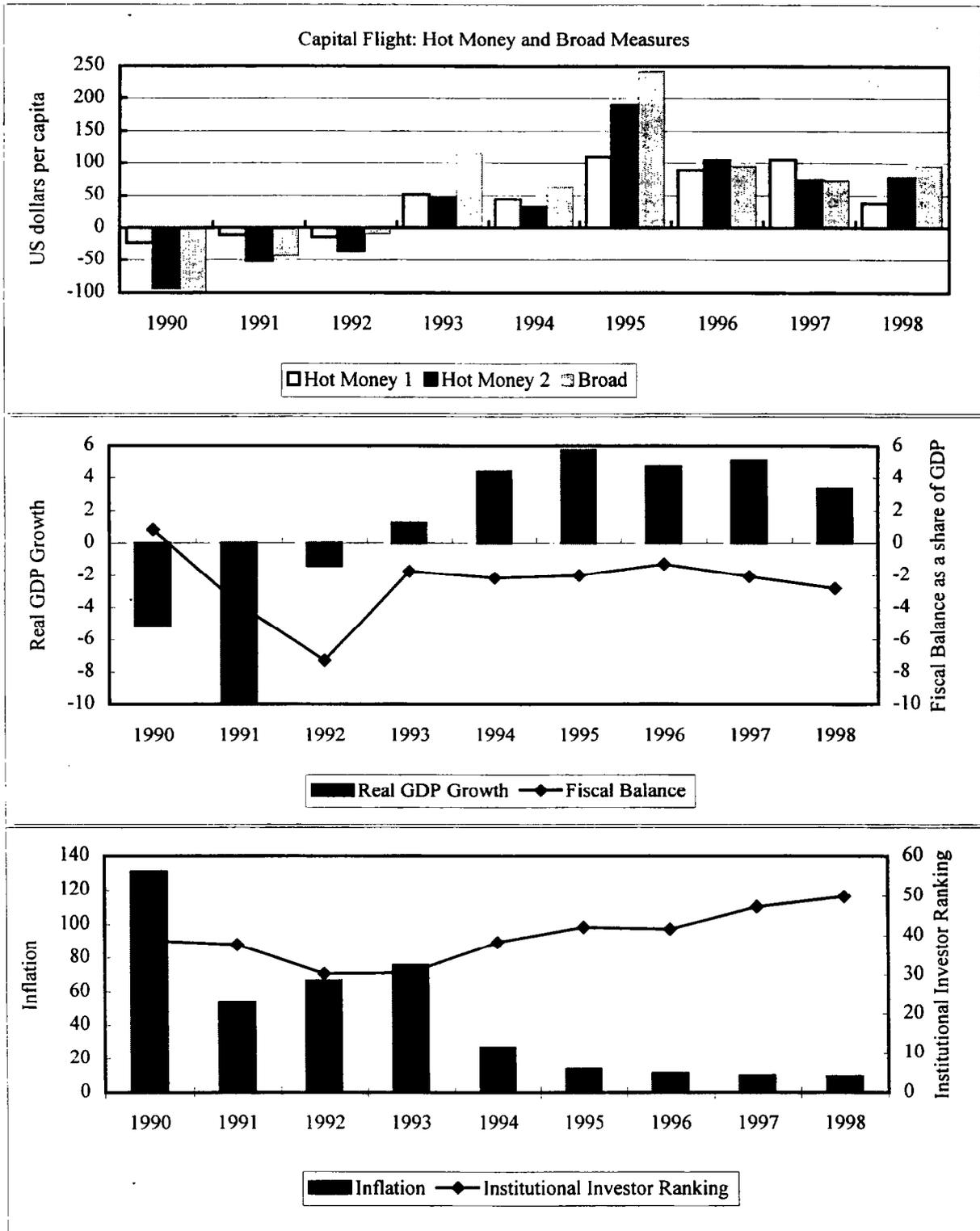
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Figure 1. Russia: Capital Flight, 1994-98



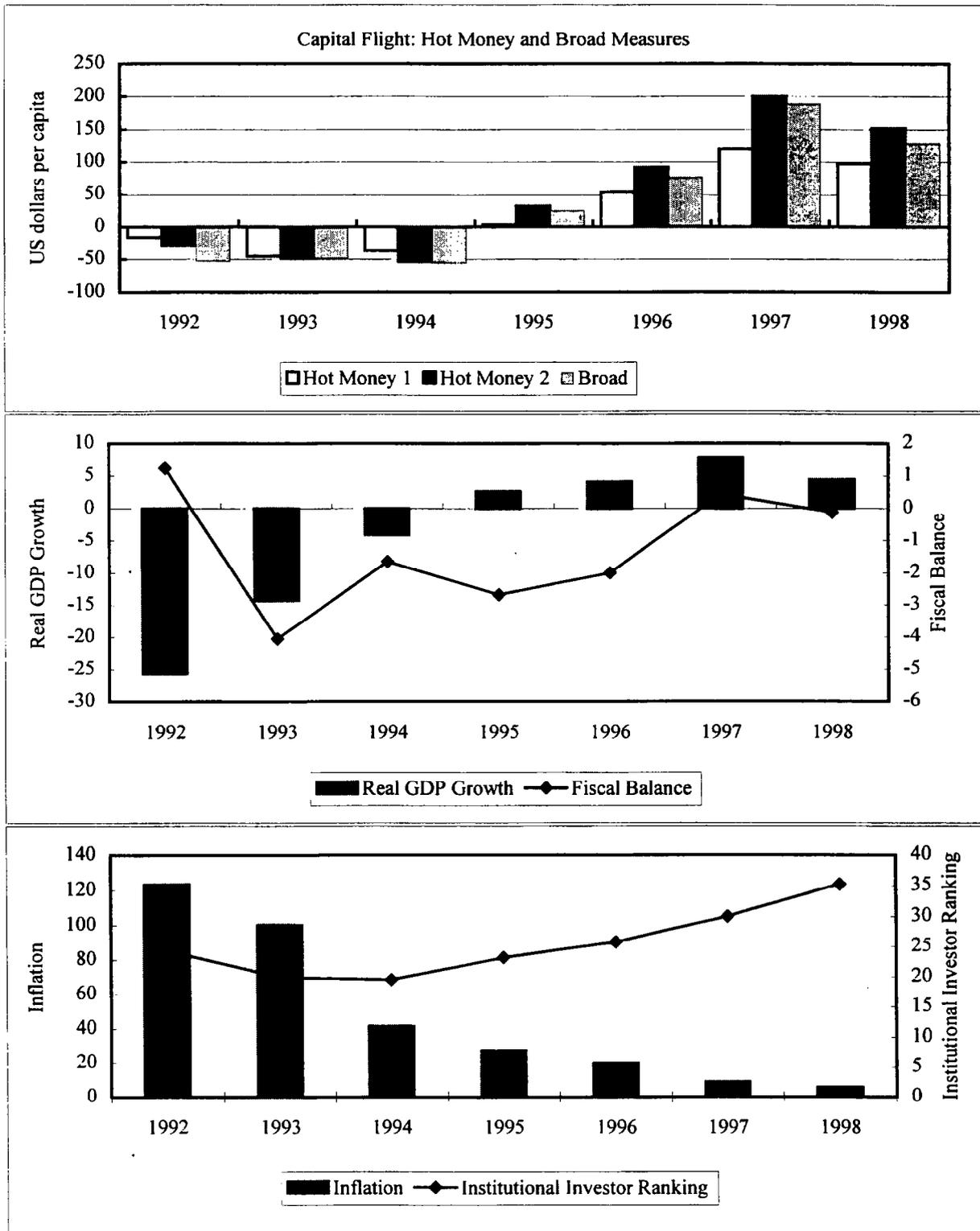
Source: *International Financial Statistics*, WEO

Figure 2. Central Europe: Capital Flight, 1990-1998



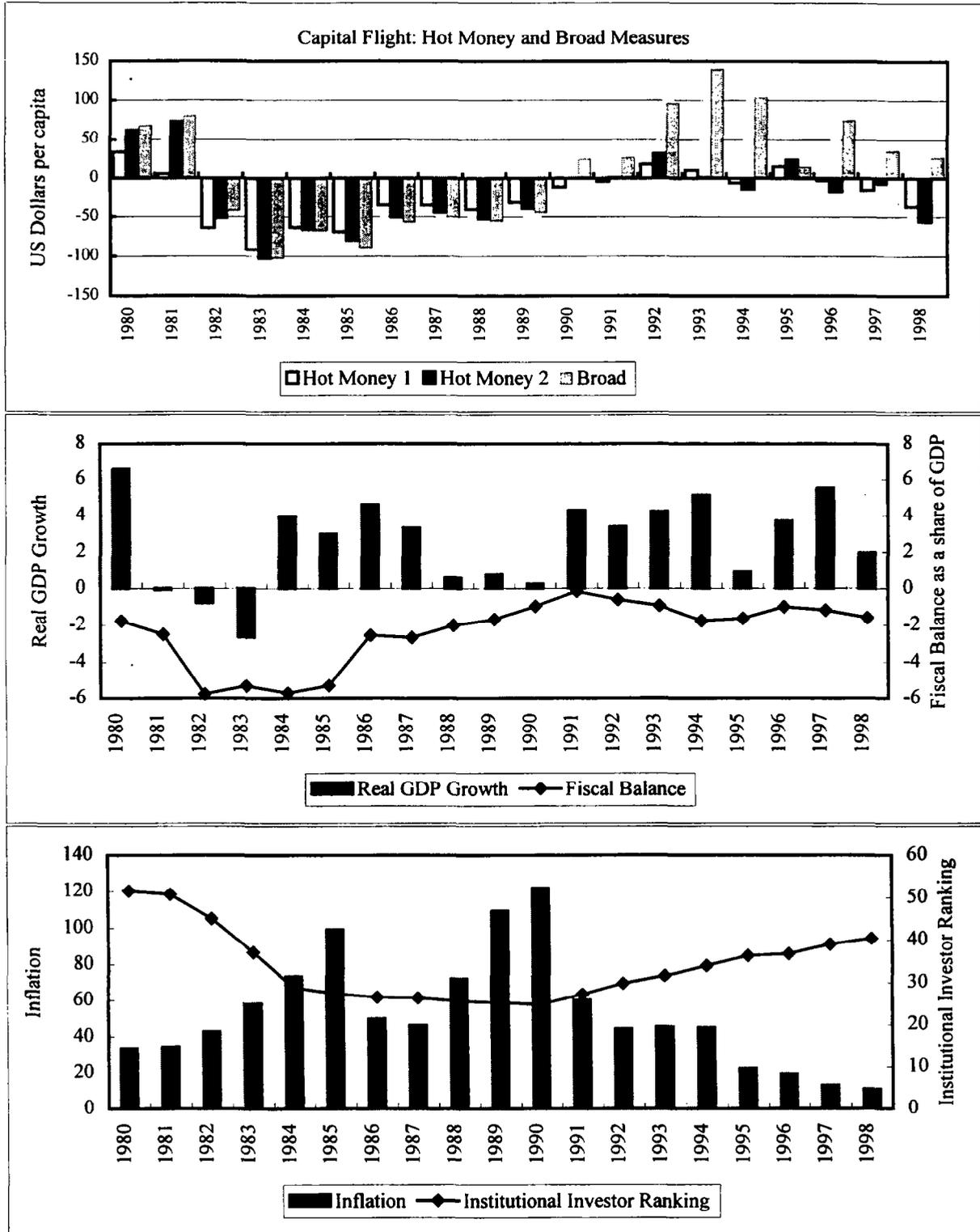
Source: *International Financial Statistics*, WEO, Institutional Investor

Figure 3. Baltics: Capital Flight, 1992-1998



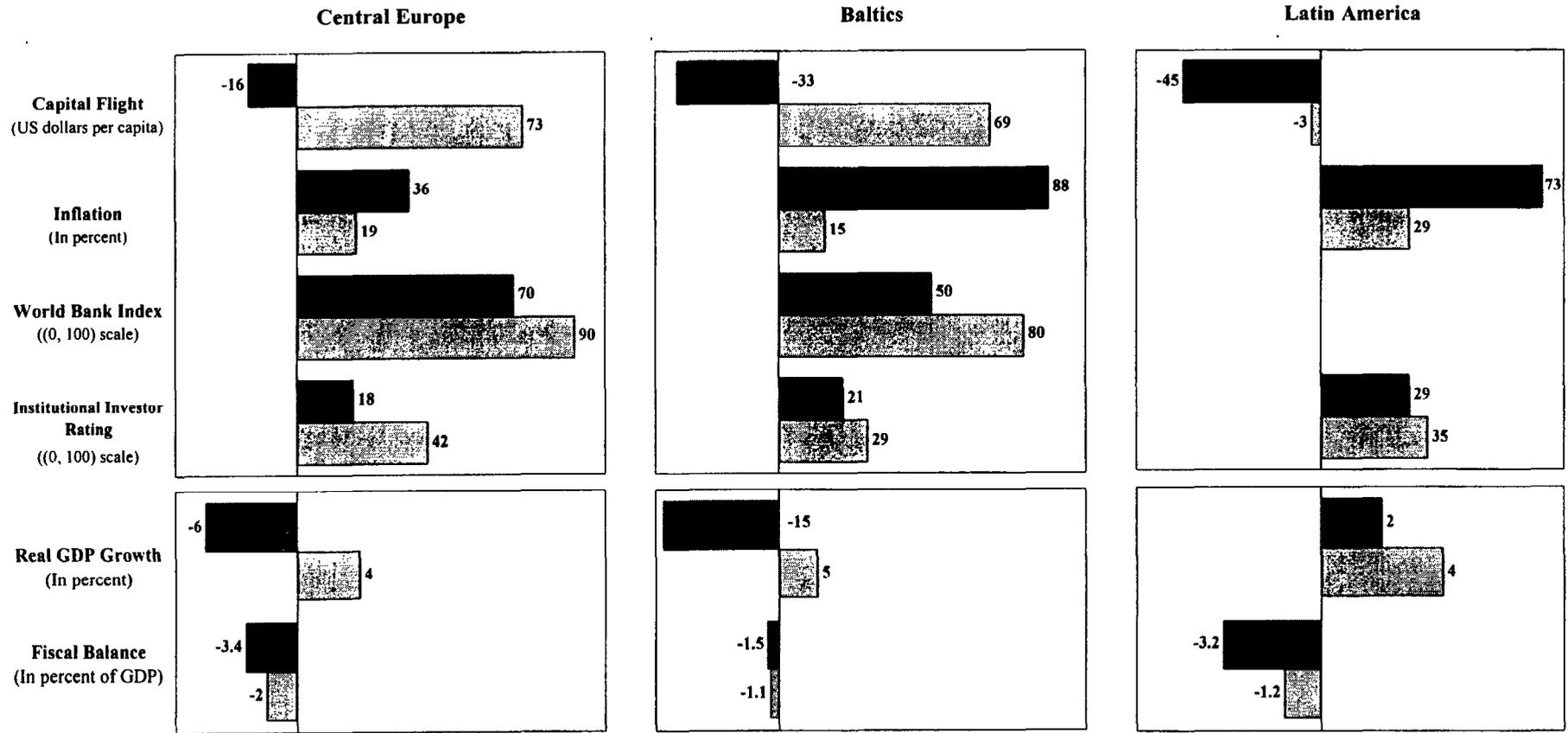
Source: *International Financial Statistics*, WEO, Institutional Investor

Figure 4. Latin America: Capital Flight, 1980-1998



Source: *International Financial Statistics*, WEO, Institutional Investor

Figure 5. Capital Flight Reversals



Sources: International Financial Statistics, IMF; World Bank; Institutional Investor Rating

Notes: All of the data are averages over the period indicated. The upper bar for Central Europe is for the period 1990-92; the lower bar for the period 1993-96. The upper bar for the Baltics is for the period 1992-94; the lower bar for the period 1995-98. The upper bar for Latin America is for the period 1982-91; the lower bar for the period 1992-98. Capital flight is denoted by a negative number. The World Bank index measures the quality of reforms.