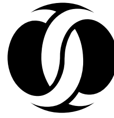

European Bank
for Reconstruction and Development

Capital flight and capital outflows from Russia: symptom, cause and cure

Willem H. Buiter and Ivan Szegvari

Abstract

Capital flight is a fuzzy and unhelpful concept. Russian capital outflows should be analysed in a wider context involving all major determinants of the risk and return faced by Russian savers and investors. Building saver/investor confidence and strengthening the credibility of policies and institutions are preconditions for enhancing the quantity and quality of domestic capital formation in Russia. As reforms progress (financial sector reforms and a fundamental overhaul of the public administration are key), Russian 'capital flight' is set to decrease gradually. Even so, it will remain a feature of the economic landscape for many years. Sharp one-off reversals in net capital flows could disrupt the macroeconomy. A capital repatriation amnesty could prove counterproductive.

Keywords: capital flight, Russia, transition

JEL Classification Number: F32, P2

Address for correspondence: European Bank for Reconstruction and Development, One Exchange Square, London EC2A 2JN, UK.

Tel: +44 20 7338 6805; Fax: +44 20 7338 6111
E-mail: buiterw@ebrd.com szegvari@ebrd.com

Willem H. Buiter is Chief Economist and Special Counsellor to the President and Ivan Szegvari is Senior Economist at the EBRD.

This paper was presented at the conference "Russia's Fight against Capital Flight and Money Laundering", held at the Royal Institute of International Affairs, London, on 30 May 2002.

The working paper series has been produced to stimulate debate on the economic transformation of central and eastern Europe and the CIS. Views presented are those of the authors and not necessarily of the EBRD.

Working paper No. 73 **Prepared in June 2002**

INTRODUCTION

Since 1999, Russia has had almost three years of *recovery* – of *easy growth*. The large improvement in external competitiveness that followed the collapse of the rouble at the end of 1998, the high oil price and significant initial excess capacity permitted actual production volumes to grow without matching increases in productive capacity. These days are coming to an end. With the real exchange rate approaching its pre-collapse level, with oil prices unlikely to rise much further and with the gap between actual and capacity output closing, Russia has to engineer *real growth*, that is *difficult, sustainable growth*, involving the parallel expansion of actual and capacity output.

A high rate of sustainable growth requires high rates of investment – significantly higher than Russia has achieved recently. Without much prospect of an increase in the national saving rate, domestic investment can be boosted only by a reduction in net capital outflows, that is, a reduction in the current account surplus. It also requires effective, efficient, high quality investment. That in turn demands both effective domestic financial intermediation and increased volumes of foreign direct investment (FDI), as well as bundling expertise, know-how and skills with financial resources.

Is a reduction in, or even the elimination of, capital flight a necessary condition, let alone a sufficient one, for Russia to move from recovery to sustainable growth?

Capital flight is a fuzzy concept. We shall argue that it is also an unhelpful and, in some respects, even misleading concept. It means different things to different people and even different things to the same person. It lumps together capital outflows driven by greatly diverging motives and incentives.

At the respectable, legal and (privately as well as socially) beneficial end of the spectrum, we find capital outflows motivated by portfolio diversification and similar risk-sharing considerations. The sources of the funds are legitimate; their transfer abroad is in accordance with the law; and neither tax evasion nor tax avoidance is an issue.

At the other extreme of the spectrum we find capital outflows representing the transfer abroad (and out of reach of domestic law enforcement and national tax administrations) of illegally acquired income or assets. Money laundering – transforming illegal earnings and assets into legal earnings and assets – is an old, established global industry that has only recently prompted a coordinated global response by law enforcement, financial regulators and supervisors, and the international financial institutions (IFIs).

Somewhere in the middle of the spectrum we find capital outflows representing the transfer abroad of legal, legitimately acquired income or assets, motivated by the desire to escape either the legitimate domestic tax authorities and/or the predatory attentions of corrupt and confiscatory agents of the state – central, regional or municipal – or of the criminal community.

Not only is capital flight a fuzzy concept, it is also highly emotionally charged. The view prevailing in the media is that capital flight is something verging on the criminal, if not outright criminal. The combination of the phrases ‘capital flight’ and ‘money laundering’ fits in well with this conventional wisdom. Money laundering, international tax evasion and the international financial flows that sustain terrorism around the world are important issues for Russia and for every other nation in the world. The EBRD, along with the other IFIs, is part of a global coalition to combat money laundering and to sever the financial life-lines sustaining global terrorism.

However, the ‘criminal-justice’ view of capital flight is, in our view, of limited relevance from the perspective of what needs to be done to achieve a significant increase in the quantity and quality of capital formation in Russia. Even if it were possible immediately and permanently to eliminate money laundering, cut off the international financial tentacles of global terrorism and close all offshore havens for tax evasion, we would not expect to see capital rushing into Russia to be sunk in infrastructure, private plant and equipment, R&D and other long-term, irreversible commitments.

In what follows, we shall de-emphasise capital flight and focus instead on the magnitude and determinants of gross capital inflows, gross capital outflows and the difference between them, net capital inflows, and the quantity and quality of domestic capital formation in Russia. These processes are driven by quite conventional risk-return considerations, albeit in quite unconventional settings. They are also shaped by the degree of development of the institutional environment that underpins the functioning of markets in Russia.

1. INVESTMENT, THE INVESTMENT CLIMATE AND CAPITAL OUTFLOWS

Throughout much of Russia's transition so far, no Russian company or entrepreneur could fully comply with every aspect of the existing legal and regulatory framework and stay in business. The insecure property rights and widespread predation that have characterised Russia since the beginning of perestroika have depressed capital formation in all its dimensions.[1] The elimination of the conditions that gave rise to insecure property rights and predation is a necessary condition for the kind of sustained economic growth the Russian government anticipates in its economic strategy. This was promulgated on 28 June 2000 and has been implemented since then with admirable determination, yet gradually and still only partially.

FIXED INVESTMENT

When the returns to productive activity are low because property rights are insecure and investors and entrepreneurs cannot be confident that they will reap what they sow, the accumulation of capital is discouraged and distorted.

The national saving rate becomes sub-optimally low, and within this diminished national saving rate, the allocation of saving across instruments is heavily influenced by the perceived security of the owners' title to these instruments. When the tax collection system is both inefficient and arbitrary, taxation tends to become *source-based* rather than *residence-based*: the jurisdiction of the tax authorities tends to be restricted to tax bases located within the geographic national boundaries. Also, title to offshore assets is less easily contested than title to onshore assets.

For domestic savers, financial assets abroad are superior, as regards security of title, to financial assets at home. Hard currency under the bed is superior to hard currency or rouble accounts in domestic banks. Real, tangible enterprise assets at home become an especially unattractive proposition. The current owners often have insecure title, and the asset is highly visible and accessible to the tax authorities and to private and public sector predators.

We therefore expect to see the following in post-perestroika Russia: a declining national saving rate, an even greater decline in fixed domestic capital formation, and massive gross and net capital outflows. We have seen all three, most dramatically during the later Yeltsin years, and despite recent improvements no major breakthrough is yet in sight. The good news is that the magnitude of the net capital outflows and the decline in the domestic capital formation rate are gradually diminishing since the Putin administration took over. Table 1 tells the story. The quality of the data in Table 1 ranges from poor to very poor, so caution should be applied when interpreting them.

It is not surprising that the gross national saving rate has come down significantly from the very high levels (up to 35 per cent of GDP) of the central planning period. While there are examples of countries with demographic structures similar to Russia's that have national saving rates of 30 per cent of GDP or more (e.g. Japan), the norm in both the advanced industrial countries and in the advanced transition economies is a significantly lower national saving rate.

---

[1] Predation includes rent-seeking and 'dupe' activities, from lobbying to corruption and other illegal forms of influence seeking. It also includes theft, the involuntary and unrequited transfer of property rights, through the use of inside information and through confiscation, intimidation, extortion, threats and actual violence against property or persons (see Buiter, 2000).

What *is* surprising is the dramatic decline in Gross Fixed Capital Formation from 33 per cent of GDP in 1989 to just over 14 per cent of GDP in 1999, with a slight recovery to about 18 per cent of GDP in 2000 and 2001. Private sector gross investment in 2001 was only 12.2 per cent of GDP, and this represented a strong recovery from the low of 4.4 per cent reached in 1998. There are no reliable estimates of capital consumption (depreciation) in the private or public sector. It is possible that, at least during 1998 and 1999, both the private sector and the economy as a whole were decumulating physical capital.

The mirror of the moderate decline in national saving rates and the steep decline in domestic capital formation rates is that in every year since 1989, Russia has had a surplus on the current account of the balance of payments. During 1999, 2000 and 2001 the current account surplus reached the staggering figures of 12.7 per cent of GDP, 17.9 per cent of GDP and 11.1 per cent of GDP respectively. No other transition economy comes close.

The estimated annual gross private capital outflow (estimated by most experts at US$ 20-25 billion annually for the last decade) frequently exceeded the budgetary revenues of the federal government. The current gross private capital outflow total, following a decline from late 2001, is estimated to be about US$ 15 billion/year. We can put this next to related phenomena that are also of an exceptional magnitude, such as the shadow economy (estimated to amount to 35-40 per cent of GDP), the stock of domestic hard currency savings outside the banking system (roughly equal to the money supply in 1999-2000), and tax evasion, especially by small businesses. Cash bribes have recently been estimated at circa US$ 35 billion per year.[2]

It surely makes no sense for a country so poorly endowed with physical capital (both private fixed capital and social overhead capital or infrastructure) to be a persistent net exporter of capital. It can only mean that the social returns to investment greatly exceed the private returns. A poor investment climate, reflecting a syndrome of market failures, policy failures and institutional inadequacies, lies behind this gap between private and social rates of return.

The decline in capital formation in Russia is not restricted to the conventional national income accounts categories of private and public investment. It applies also to human capital formation, to the degradation of environmental capital, and to the historical weaknesses and slow build-up of the country's social capital.

[2] See Indem Foundation (2002).

2. A CLOSER LOOK AT THE EXTERNAL FINANCES OF RUSSIA

The evidence that, despite recent improvements, the investment and business climate in Russia continues to be poor is reflected not only in the large current account surpluses. It is also evident from the FDI flows into and out of Russia.

Foreign direct investment into Russia remains quantitatively insignificant, and tiny outside the natural resource sector, although individual projects may well have had high private and social returns and positive transition impact. Table 1 shows that gross FDI flows (according to the Goskomstat definition) in 1999, 2000 and 2001 were US$ 4.26 billion, US$ 4.43 billion and US$ 3.98 billion respectively. The figure for the first quarter of 2002 shows no improvement in gross inflows of FDI: the Q1 gross inflows of around US$ 830 million were down by 14 per cent on Q1 2001. During 2000 and 2001, gross FDI outflows from Russia exceeded gross FDI inflows.

FDI inflows and outflows, portfolio inflows and outflows, other private financial flows and international reserve flows can also be tracked in the external financial balance sheet of Russia. The Russian state, which inherited the external assets and liabilities of the former Soviet Union, has a gross external debt position which has been quite stable in dollar terms over much of the last decade. The dollar value of the external public debt peaked in 1998 and has come down steadily since then.

Russia also has considerable external assets, which include sizeable rouble claims on former socialist and developing countries. The odds on collecting a significant share of the notional value of these assets, which at the demise of the Soviet Union amounted to US$ 140-150 billion, are poor. Official foreign exchange reserves have risen sharply since the low reached in 1998 and today stand at over US$ 42 billion, covering more than six months of imports.

In addition, there are large private holdings of external, hard currency financial instruments and real assets. No reliable figures exist on Russia's private external assets. Based even on the lower end of the typically estimated annual US$ 20-25 billion gross private capital outflow, the cumulative Russian capital flight could by now substantially exceed the Russian external debt of US$ 160 billion.

Earnings will have accrued to these external assets, and some of these earnings may have been re-invested abroad. Capital gains or losses drive a further wedge between the value of the gross external asset stock and the cumulative capital flight since the beginning of the 1990s. Nevertheless, it is hard to imagine scenarios under which the current stock of private external assets would be smaller than the current stock of financial liabilities. The persistently positive current account balance (see Table 1) certainly suggests that Russia may well be a significant net external creditor. Since 1994, cumulative current account surpluses amount to over US$ 135 billion.

The problem with Russia's external portfolio is that most of the liabilities are public, 'onshore' and on budget, while most of the assets are either 'dead' (in the case of most of the Soviet-era claims on sovereign states) or private, offshore and out of reach of the Russian tax authorities.

Even when the funds channelled abroad were acquired in legitimate activities, the manner of their transfer abroad will often have criminalised them. There exists a vast global industry that assists the owners of these assets to hide them from the interested tax and police authorities. The result is that these assets and the earnings they generate are hidden and do not constitute part of Russia's effective tax base. Capital outflows of this kind therefore create a public finance problem as well as pressures on the balance of payments.

Table 1 – Saving, Investment and external capital flows from Russia since 1989

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Cumulative
Current account (US$ billion)	NA	NA	NA	NA	NA	8.4	7.5	11.7	2.1	0.7	24.6	46.3	34.2	135.6
Current account (% of GDP)	2.0	1.0	NA	NA	NA	3.0	2.2	2.8	0.5	0.3	12.7	17.9	11.1	
Gross reserves (eoy) Incl. gold (US$ billion)	NA	NA	NA	4.5	8.9	6.5	17.2	15.3	17.8	12.2	12.5	28.0	36.6	
External debt stock (US$ billion)	NA	NA	NA	NA	NA	137.5	148.0	166.1	164.6	189.9	185.7	171.8	166.0	
Of which public debt	NA	NA	NA	NA	112.7	127.5	128.0	136.1	134.6	158.2	154.6	140.7	134.0	
Public debt (in % of GDP)	NA	NA	NA	NA	NA	46.0	37.9	32.5	31.4	57.5	79.8	54.2	43.3	
Total FDI gross inflows (US$ billion) (Goskomstat)	NA	NA	NA	NA	NA	NA	1.88	2.09	3.90	2.69	4.26	4.43	3.98	
Total FDI gross inflows (US$ billion) (bop def.)	NA	NA	NA	0.70	1.21	0.64	2.02	2.48	6.64	2.76	3.31	2.70	2.54	21.8
Total FDI gross outflows (US$ billion) (bop def.)	NA	NA	NA	NA	0.14	0.10	0.36	0.77	2.60	1.01	1.96	3.05	2.7.4	14.4
FDI, net inflows (bop def.)	NA	NA	NA	NA	NA	0.41	1.46	1.66	1.68	1.50	1.35	-0.35	-0.20	7.50
Gross Fixed Capital Formation Rate (% of GDP)	33.0	29.0	23.81	24.68	20.39	21.81	20.32	20.43	19.41	17.31	14.33	18.00	17.80	
Of which private	10.0	15.0	20.0	22.0	21.0	22.0	9.0	9.0	9.6	4.4	6.4	9.3	12.2	
Gross National Saving Rate (% of GDP)	35.0	30.0	NA	NA	NA	24.81	22.52	23.23	19.91	17.61	26.9	35.2	30.6	
Of which private	NA	NA	NA	NA	NA	NA	NA	NA	16.8	13.0	21.4	23.7	20.1	

Sources: Goskomstat, Central Bank of Russia, IMF and UNCTAD.

3. IS IT IMPORTANT TO 'REPATRIATE' PAST FLIGHT CAPITAL?

Should Russia devote special efforts to attracting back the capital that has left the country since the late 1980s? The short answer is 'no'. What matters is that the quantity and quality of investment in Russia be raised significantly. An important part of this process of investment enhancement is an increase in both gross and net capital inflows. It does not matter, in principle, whether these capital inflows represent the return of past flight capital or instead foreign direct or portfolio investment by non-residents or other parties not linked to the owners of offshore private Russian assets.

There are two economic reasons why it may be desirable to try to attract past flight capital back to Russia instead of aiming to attract capital inflows without special focus on past flight capital. The first reason is a fiscal one. It may be possible for the state to strike a deal with the owners of offshore assets returning to the country that would benefit the Treasury more than the normal taxation of the income generated by capital inflows in general.

Second, some of the owners of the offshore Russian assets may have the kind of local, sector- or industry-specific knowledge that would make them potentially valuable contributors to FDI ventures in Russia. This problem, if indeed it is a problem, is mitigated if the source and ultimate ownership of foreign funds invested in Russia can be effectively hidden. For at least a couple of years there have been reports of both portfolio investment and FDI moving to Russia from such locations as Cyprus and Gibraltar. One suspects that many of the ultimate owners of these funds are Russian. However, the argument that repatriated flight capital might be especially productive could be qualified, or even turned upside down, by the argument that Russian flight capital returning in the form of FDI may not be accompanied by the blend of technology, marketing and managerial skills, know-how and financial resources that Russia so badly needs.

Thus, enticing past flight capital to return would only be superior to creating conditions under which all potential investors (onshore Russian, offshore Russian and foreign) are induced to invest in Russia, if the owners of the past flight capital had knowledge and other skills that would make them uniquely socially productive investors in Russia. Only in that case would there exist an argument for a capital repatriation *amnesty*. Even then, capital repatriation amnesties are a two-edged sword.

Two kinds of credibility are required for amnesties to be socially efficient. First, the government has to convince the owners of the flight capital that it will not renege on the terms of its amnesty offer once the funds have returned. Second, the government has to make a credible commitment that there will be no future amnesties. If it fails on the second count, it will undermine its ability to raise any kind of tax revenue. How this credibility could be achieved in the prevailing culture of mistrust between the state and its citizens is unclear. Not much should be expected from such an amnesty, and there is a real risk of reputational damage.

4. LACK OF INTERMEDIATION AND THE INEFFICIENCY OF INVESTMENT

The previous section suggests that, even though aggregate investment is inadequate, aggregate saving is adequate. Intermediation between savers and investors is woeful, however. The institutions, especially banks, that should be at the forefront of the intermediation process channel savings into productive investment only to a very limited extent, despite some recent expansion in the scale and scope of their activities. The stock of credit extended to the real economy amounts to about 13.5 per cent of GDP. However, much of this tends to be related lending or politically motivated lending to state enterprises or to former state enterprises that continue to have political clout at the local, regional or even national level. Political influence over bank lending has expanded with the growing dominance of Sberbank following the August 1998 crisis. Another significant part of the loans to enterprises originates from pocket banks of industrial-financial holdings.

Commercially motivated loans to domestic private non-financial enterprises remain more the exception than the rule. Some very successful credit lines for small and medium-sized enterprises (SMEs) unfortunately do not change that sombre overall picture.

Securities markets remain underdeveloped and thin, including the stock market, even though it is by far the largest stock market (absolutely and relative to GDP) in the EBRD’s 27 countries of operations. The extreme difficulty of obtaining external finance of any kind is one reason why SMEs play a smaller role in Russia than in virtually any other transition economy. There are, of course, other important obstacles to investment, especially for SMEs. Excessive red tape, arbitrary licensing requirements, harassment by armies of underpaid tax collectors and inspectors of various kind, extortion and forced purchases of ‘protection’ by the criminal fraternity make for an unrewarding investment climate.

Without radical reform of the banking sector, the transformation of domestic and foreign savings into domestic capital creation will remain haphazard and inefficient. The far-reaching changes in institutions and practices that are required include the following:

- Establish a level playing field in the banking sector. End the role of the Central Bank of Russia as owner of the largest commercial banks. Owners should not be supervisors and regulators.
- Establish and enforce uniform criteria governing eligibility for and cost of deposit insurance.
- Enforce free entry and exit from the banking sector, subject only to the proper prudential norms and the requirements of capital adequacy. This requires effective and non-discriminatory resolution procedures for insolvent banks.
- Implement measures and create effective institutions to strengthen prudential regulation.

It is good news indeed that the authorities, through policy announcements and through key appointments, have signalled their determination to tackle banking sector and financial sector reform as a key priority. As always, implementation will be key.

5. WHAT ELSE IS TO BE DONE?

Large gross and net capital outflows from Russia are a symptom, one highly visible manifestation of the deeper and wider problems of the country's investment climate. What lies behind this symptom is a syndrome of country-specific historical afflictions that provide the backdrop for Russia's deep and decade-long confidence crisis and the resulting low level of trust in the rules of the game, policies and institutions. A crucial factor in this is the continued low level of confidence of savers and investors in the banking/financial sector. *The depth of the confidence crisis has probably been the single most important driver of Russia's continuing large gross and net private capital outflows.*

The current high approval ratio of, and confidence in, the President does not automatically mean a breakthrough in the confidence-building process. Strengthening the credibility of some of the federal institutions/policies does not automatically imply trust in the state and policies in general. It is a necessary but not a sufficient condition for such confidence building.

Confidence is easily lost, but can take a long time to regain. The relevance of this truism is underlined by the slow pace with which gross and net capital outflows from Russia are declining, despite significant progress in most of the areas typically identified as the root causes of capital flight and of investment climate weakness. These areas include major political stabilisation and consolidation, impressive macro-performance, and significant advances in structural reforms including tax reform.

One key reason for the continuing weakness of the investment climate is the remaining major lacunae in the reform process. Banking sector and financial sector reform was already mentioned as a key area where implementation was only just beginning. Likewise, only limited (albeit important) steps have been taken to reform the key players in the energy sector, including mainly RAO-UES. Restructuring the gas sector is the next big challenge. Railway restructuring has recently begun, but agricultural reform, including rural land reform, has not yet begun in earnest.

The other general core task is a fundamental overhaul of the bureaucracy at all levels of government. The stakes involved here are high. The credibility of the state's policies and institutions stand or fall with it, and the policy implementation capacity of governments and of other state bodies is itself a function of the quality of public administration.

What makes this especially important (and difficult) is that:

- Most of the new structural and institutional reform measures are at their very early stage of implementation – frequently just approved by the parliaments.
- Bureaucratic/administrative hurdles are among the most powerful obstacles to small-business development. Murky/cosy relationships between the large companies and the regional/local authorities are among the main reasons why enterprise restructuring has not yet started on a massive scale.
- Contrary to the reforms of the first decade of transition, when the term meant primarily liberalisation (with some exaggeration this required little more than a stroke of a pen), institutional reforms require years of consistent government behaviour.
- The reform of the public administration in itself is one the most complex, time-consuming and sensitive institutional reforms opposed by powerful vested interests.
- Confidence in the overall rules of the game and, by implication, the degree of compliance with these rules crucially hinges on the degree of confidence in the public administration.

6. SUMMING UP

Probably the most important policy conclusion is that one cannot efficiently treat capital flight (or excessive capital outflows in general) as a problem by itself but *only in conjunction with the underlying investment climate problems*. That is, to tackle capital flight effectively, one is forced to face the challenges of building saver/investor confidence and of strengthening the credibility of policies and institutions. Policy responses focusing on the control of possible channels of and vehicles and mechanisms for capital flight are addressing only the symptom and are not – cannot be – cures. Effective measures to combat money laundering and to cut off the financial life-support system of international terrorism are important in their own right. Even if successful, they would not put any significant dent in capital flight from a country such as Russia.

Amnesties cannot provide a solution to the underlying investment climate problems. In Russia's case *the signal conveyed by an amnesty might even add to the existing credibility and confidence-related problems*. The two amnesties carried out in the region (in Kazakhstan and FR Yugoslavia) had mixed results. Chances of success (in the sense of a large-scale repatriation of offshore assets) are better if the amnesty is introduced in the immediate aftermath of a fundamental break with past policies. Russia is not in a position to claim that now.

Significant capital outflows are likely to remain a feature of the Russian economy at least in the medium term, although their magnitudes can be expected to come down gradually, provided confidence-enhancing policies continue to be adopted and implemented. The key reason for this is the complexity and time-consuming nature of the confidence-building process and the necessary associated key institutional reforms (i.e. reform of the public administration, relationships between the different levels of government, banking sector reform).

It may well be fortunate that the reduction in the magnitude of capital outflows is likely to be gradual and not a one-off sea-change. *Sharp reversal in capital flight could involve potentially painful macroeconomic adjustment*. In particular a sudden reversal from large capital outflows to a position of sustained large capital inflows could have adverse consequences for monetary and exchange rate management. In 1997 misplaced euphoria about Russia's economic prospects induced investors from all over the world, many of them with only the most rudimentary knowledge of the country, sector or enterprise they were investing in, to pour money indiscriminately into Russia. Irrational exuberance and boom were, inevitably, followed by irrational despondency and bust. Dislocation and hardship resulted. Russia ought not to welcome a return of these bi-polar financial lemmings.

THE ROLE OF THE INTERNATIONAL COMMUNITY

There are important and interesting questions related to the link between the Russian capital outflow problems and actions and role of the international community. Among the long-standing questions about past actions of the international community *vis-à-vis* Russia one stands out.

Was it sensible to provide significant bilateral and multilateral funds (generally under IFI programmes) to Russia at a time when capital was flowing out of Russia on a very large scale? This question continues to be hotly debated, especially in relation to the run-up period to the August 1998 financial collapse. It is important not to answer this question with the benefit of hindsight, but only with the benefit of information available at the time. We are relieved we did not have to make these decisions in 1997 and 1998. We must take seriously the views of those at the front line during these bewildering times, who argue that, given the circumstances, given the constraints on the decision-making latitude of the Russian

government actors, given (ex-ante) reasonable expectations and assumptions, and given the magnitude of the stakes involved, there was no politically acceptable alternative.

The key question, however, is not about the past but about how the international community can be of help to Russia in the future.

Conclusion number one is a lesson in modesty: *solutions can come only from Russia*, though the international community can assist this Russian Government-driven process.

Any kind of contribution to the improvements in the general investment climate will be a major contribution. This is especially true in the regions and municipalities, given the limited policy implementation capacity of the federal institutions. Examples of useful international contributions are the investment climate-related policy dialogue pursued by the IFIs, the World Trade Organization, the Organisation for Economic Co-operation & Development, the European Union, the Foreign Investment Advisory Council, the American Chamber of Commerce in Russia, etc. One can add to this list special technical cooperation projects for policy advice in specific legislative and other sector reform areas.

Another important contribution of the international community is its support for FDI through the provision of political comfort against unfair and discriminatory treatment by regulatory and other institutions, and through the demonstration effects of its own investment projects in Russia and the co-financing they attract.

There is also *the special role of foreign strategic investors* in technology, know-how and skills transfer at a time when enterprise and sector restructuring is the number one challenge in the transition process.

A key role for the international community involves the setting of standards for market-oriented behaviour, corporate governance and transparency. A forward-looking example is the EBRD's (and other foreign investors') role and responsibility in the implementation of the recently endorsed Corporate Governance Code.

As an important special case of the previous point, we would like to emphasise the importance of client selection, the due diligence process and project covenants. This now involves special checklists for integrity and money laundering issues.

Finally, during the early 1970s in the USA, there was a well-known car bumper sticker which read: *'Don't buy books from crooks'*.[3] It is essential that the financial regulators and supervisors in the advanced industrial countries ensure that the banks and other financial institutions in their jurisdictions do not undermine attempts by the Russian authorities and by IFIs, including the EBRD, to require high standards of corporate governance from their Russian corporates.

In the EBRD's case, high standards of governance in clients are pursued through covenants, through other forms of conditionality, and ultimately through a refusal to extend finance to would-be clients that do not meet standards of proper corporate governance. All key institutions, private as well as public, must adopt and implement in their financial operations the maxim: *'Don't do deals with crooks; don't do deals with those who play fast and loose with corporate governance'*. Don't provide them with finance; don't enhance the status of their boards with token directors; only take a seat on the board if you are reasonably confident that you can make a material difference to the quality of corporate governance. Unless these rules of good conduct are observed, external financing could become an obstacle to sustainable growth rather than a means for enhancing it.

---

[3] The reference was to books published by recently convicted Watergate conspirators.

REFERENCES

W.H. Buiter (2000), "From Predation to Accumulation? The Second Transition Decade in Russia", *Economics of Transition*, 8(3), pp. 603-622.

P. Garibaldi, N. Mora, R. Sahay and J. Zettelmeyer (1999), "What Moves Capital to Transition Economies", paper presented at an IMF Conference "A Decade of Transition: Achievements and Challenges", Washington D.C., February.

Indem Foundation (2002), "Diagnostic of Russian corruption: Sociological Analysis", Moscow, May.

P. Loungari and P. Mauro (2000), "Capital Flight from Russia", IMF Policy Discussion Paper, June.

J. Odling-Smee (2002), "Capital Flight and Economic Reforms in Russia", paper prepared for the Conference "Russia's Fight Against Capital Flight and Money Laundering" 30 May 2002, Chatham House, London.