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Russia as a Newcomer to the International Financial Market, 1992-2000[1]

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Abstract

This paper intends to show the peculiar status of Russia in the international financial market. It elucidates the rapid liberalization of the international financial system of Russia by critical analysis of relevant legal documents and makes it clear that that the economy is legally open, and consequently that capital going through the Russian border has increased on a large scale. It also investigates the features of Russia's role in the market by using original data made from the balance of payments statistics. By studying both official and "gray" capital movements, the author came to the conclusion that there has been a large shortage of investment compared to private saving in Russia and that the remainder of savings have been fleeing the country. From the viewpoint of open macro economics, this excess of private saving is absorbed by the external financial market. Russia's emergence on the international financial market produced this curious status of Russia in the world. The characteristic peculiar to this paper is that it investigates not only the illegal and gray aspects of the economy, which have been researched by many experts, but also the legal and official aspects which have also caused some problems of the economy and that it shows the relation between both aspects.

Introduction

After the collapse of the Soviet Union, Russia entered the world market as a newcomer. Here "newcomer" does not mean a new player in the sphere of merchandise trade, where the Soviet Union had been an active player as an exporter of raw materials and as an importer of machines and foods since the

1 Earlier versions of this paper were presented at the Workshop on Political Economy at the University of Tokyo (9 June 2000), the RIEB Seminar at Kobe University (7 July 2000) and the VI ICCEES World Congress, Tampere, Finland (29 July - 3 August 2000). The author would like to thank Professors Sadayoshi Ohtsu (Osaka Sangyo University), Tokutaro Shibata (Tokyo University), Philip Hanson (University of Birmingham), Vladimir Popov (the Academy of the National Economy in Moscow) and Shin'ichiro Tabata (Slavic Research Center, Hokkaido University) who made useful comments on the earlier versions of this paper. The views expressed here are solely those of the author, who is responsible for any and all errors and omissions. Partial funding for the study was provided by the Japan Society for the Promotion of Science in the form of a Grant-in-Aid for Scientific Research on "Comprehensive Study on the Integration of Russia into the World Economy."

1970s. It is rather the international financial market that Russia has recently entered as a newcomer. This means that, in a sense, Russia has totally accepted the international rules of the game and also that the amount of capital that goes through Russia is large enough to be considered as an important factor in the market.

There are three distinctive features of Russia's emergence on the international financial market:

(1) Russia entered the international financial market at the same time that it had been conducting a historical systemic transformation.
(2) Russia's emergence occurred in the midst of structural change of the international financial market as a whole.
(3) Russia entered the market with a complicated structure of assets and liabilities on a stock base and a large amount of current account surplus on a flow base.

The purpose of this article is to present a clear picture of the position of Russia in the international financial market by explaining these three features.

1. Liberalization of the International Financial and Monetary System during the Process of Systemic Transformation

Currency Law

Liberalization of the economic system of Russia began in January 1992 as a core element of systemic transformation. The process of Russia's liberalization was complicated: in some cases the process was compressed in a relatively short period, but in other cases regulations and protective measures have survived a long time. The liberalization in the sphere of the international financial and monetary system is an example of the former case. The international financial and monetary system of Russia has been liberalized more radically than the system of international trade, where complicated regulations such as export duties and export licenses were effective until recently.[2] Here the contents of legal documents are studied in detail. Although some researchers would insist that legal documents have nothing to do with the reality of the Russian economy, it is important to investigate them because they reflect the policy thought of the designers of New Russia including the IMF. Besides, laws, decrees, instructions, etc. form a basis for the activities of participants of the economic games in Russia even if the participants resort to violating them.[3]

The first comprehensive legal document for liberalizing the international financial and monetary system is the federal law on "Currency regulations and

2 Uegaki, Akira, "International Economic Relations," in H. Nakayama, A. Uegaki, M. Suhara and Y. Tsuji, *The Russian Economy Today* (Iwanami Shoten, 2001) [in Japanese].
3 See the last part of this section, [Legislation and reality].

currency control" (October 9, 1992) [hereafter, "Currency Law"].[4] It provides fundamental principles of "currency transactions." Here the phrase "currency transactions" means the transactions that are related to the following:

- Change of ownership on *currency values*[5];
- Use of foreign currencies or the Ruble as means of payments in order to accomplish foreign economic dealings;
- Sending and remittance of *currency values* into (or from) Russia;
- International currency exchange.

The "Currency Law" divides these transactions into two sub-categories: "current transaction" and "capital transaction" [precisely "currency transaction related to capital movement"]. The "current transaction" includes remittance of currencies in order to accomplish payments for export and import; money transfer related to short-term (no longer than 180 days) credit; receipt and offer of short-term credit; and transfer of interests, dividends and other income. Besides, "current transaction" includes money transfers with a non-trade character such as wages, pensions, legacies and expenses of bringing up children. In other words, "current transaction" means monetary transactions that would appear in the part of current account of balance of payments statistics, and also includes a monetary transaction concerning short-term capital movement. Also "capital transaction" includes direct investment, portfolio investment, other long-term credit and transfer and return of capital goods including land. Therefore it is a transaction that would appear in the part of "capital and financial account"[6] of balance of payments (except short-term credit).

According to the "Currency Law," all these transactions are to be carried out through the so-called agent banks (*upolnomochennye banki*). These are commercial banks that received licenses from the Bank of Russia [the Central Bank of Russia] to implement the currency transactions.

The "Currency Law" also prescribes rights and duties of residents and non-residents concerning the holding, use and disposal of foreign currencies and securities. According to the law, residents of Russia have the right to buy and sell foreign currencies in the domestic market in Russia through the agent banks. In Russian territory, the settlement between non-resident juristic persons and resident juristic persons can be made in convertible currencies.[7]

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4 I.N. Platonova, ed., *Valiutnyi rynok i valiutnoe regulirovanie, uchebnoe posobie* (Moscow: Izdachel'stvo BEK, 1996), pp. 29-58, 327-339.

5 "*Currency values*" mean (a) foreign currencies; (b) securities, shares and other liabilities inscribed in foreign currencies; (c) precious metals; (d) natural precious stones; and (e) government bonds named OVGVZ. Ibid., p. 37.

6 "Capital and financial account" is the term used by the 5th edition of the balance of payments manual of the IMF.

7 After the amendment of the "Currency Law" in 1998, the settlement between non-resident juristic persons and resident juristic persons can be made also in Russian Rubles. N.V.

All these provisions of the "Currency Law" suggest that a minimum legal framework of internal convertibility [to be examined later] of the Ruble was already established in October 1992. This means that Russian residents can exchange Rubles for foreign currencies freely in order to conduct "currency transactions."

Foreign Currency Accounts in Russia

As for the foreign currency account of the residents, the two decrees, the Presidential decree of June 14, 1992 and the instruction of the Bank of Russia of June 29, 1992, already prescribed the detailed procedure (effective from July 1).[8] Now all the enterprises, including enterprises with foreign capital, must sell 30% of their earned foreign currency to the Federation's reserve and 20% at the domestic foreign currency market at a rate according to market rates.[9] The new system of 1992 had been effective up to the August crisis of 1998.[10] Whether these figures are too restrictive for a free exchange system or not is a controversial matter. However, we can point out that, at least, the total amount of foreign currency that can be held at enterprises is large enough in comparison with other transition countries considering the size of the exporting sector of Russia. This system was a basis of the "dollarization" of the Russian economy.

According to the above-mentioned two decrees, the enterprises and organizations can open foreign currency accounts in an agent bank by submitting a set of documents to the bank. The bank opens two accounts for the clients in parallel. One is named the "transition account" and the other is called the "current account." The former is the foreign currency account in which all the earnings in foreign currency are to be registered. The compulsory sales of foreign currency are conducted through the "transition account." The rest of the amount after the compulsory sales is transferred to the "current account." With the "current account," the owner of the account can do the following operations:

- Transfer of money abroad in import-export operations;
- Transfer to the accounts of the trade organizations for import payments;

Sapozhnikov, *Valiutnye operatsii kommercheskikh bankov, Pravovoe regulirovanie* (Moscow: Iurist, 1999), pp. 19, 171.

8 I.P. Faminskii, ed., *Inostrannye investitsii v Rossii, sovremennoe sostoianie i perspektivy* (Moscow: Mezhdunarodnye otnosheniia, 1995), pp. 76-78; Platonova, *Valiutnyi rynok*, pp. 38-42; Sapozhnikov, *Valiutnye operatsii*, p. 106; *Rossiiskaia gazeta*, 18 June 1992, p. 4; *Ekonomika i zhizn'* 28 (1992), p. 8.

9 This new system was introduced at the same time when the unified floating exchange rate system was adopted in Russia. Until then, all enterprises had been obliged to sell 40% of their earned foreign currency to the reserve at a special commercial rate and 10% to the special fund of the central bank at a market rate. S.M. Borisov, "Obiazatel'naia prodazha eksportnoi vyruchki – 75 ili 100 protsentov?" *Den'gi i kredit* 6 (2000), p. 36.

10 After the August Crisis, the norm of the compulsory surrender of earned foreign currency was raised to 75%. Borisov, "Obiazatel'naia prodazha," p. 37.

- Transfer to the "current account" of other Russians or joint companies for their goods and services;
- Payments for debt, banking commission, postage and expenses of business trips.

On the one hand, these provisions can be interpreted as measures to secure a free exchange system of currencies for the current transaction, which in turn would set the Ruble's exchange rate according to the market mechanism and would accelerate liberalization of the financial system as a whole.

On the other hand, we must pay attention to the other side of the decrees. That is, to have a foreign currency account is an insurance against devaluation of property through inflation. We can see a similar situation in Argentina, where the system of double accounts (Dollar and Peso) was founded taking lessons from the events in the period of hyper inflation.[11] It proved difficult, however, to manage this double account system in the liberalized financial condition. Considering what happened in Argentina, Russia seems to have rowed out to a dangerous liberalized sea.

Here it is worth noting that the dollar account in Russian banks would work as a basis of expansion of dollar cash circulation in the Russian market. Russian banks with dollar accounts would transfer their dollar amounts to their corresponding accounts in the banks abroad, where the amount is to be exchanged into dollar cash. Thus earned dollar cash can be conveyed to Moscow by airplane.[12] The impetus of dollarization in Russia did not stop until the beginning of 1998 in spite of restrictive measures by the government.[13] Table 1 shows the amount of foreign cash currency circulating in Russia. It shows that the cash obtained by banks is withdrawn by shuttle traders and brought out from the country and spent abroad. Of course banks might have brought out their dollar cash abroad by themselves but the flow did not leave any significant figures in Table 1. As for the dollar cash left in the country (see the bottom line of Table 1), other sources reveal that most of the holders of foreign cash currency are not commercial banks but non-banking enterprises and households.[14]

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11 Watanabe, Shin'ichi, ed., *Financial Crises and Regulations* [in Japanese] (Tokyo: The Institute of Developing Economics, 1998), p. 185 [The quoted part was written by Seiro Ito].

12 Another source of dollar cash circulating in Russia is the loosening of access of Russian citizens who travel abroad as shuttle traders to dollar cash. S.M. Borisov, "Dollar v Rossii - partner ili konkurent? (Razmyshleniia po povodu 'dollarizatsii')," *Den'gi i kredit* 6 (1999), p. 55.

13 The most important is the law to prohibit retail transactions through foreign currencies since 1994. *Ekonomika i zhizn'* 41 (1993), p. 5.

14 For example, *Ekonomika i zhizn'* 22 (1996), p. 5; *Finansovye izvestiia* (11 Nov. 1997), p. 4; *Finansovye izvestiia* (11 Aug. 1998), p. 7.

Table 1. Inflow and Outflow of Foreign Cash Currency [FCC] (Billions of US$)

	1993	1994	1995	1996	1997
Inflow - total	8.9	21.9	23.1	39.1	43.2
of which - by banking system	8.9	21.9	20.5	34.1	38.3
- by immigrants	…	…	0.7	1.2	0.9
- by tourists	…	…	1.4	3.0	3.1
- by shuttle traders	…	…	0.5	0.7	0.8
Outflow - total	3.2	15.7	23.1	30.1	29.7
of which - by banking system	0.2	0.2	0.4	0.4	0.8
- by emigrants	…	…	1.5	1.2	0.9
- by tourists	…	4.5	9.0	7.5	7.3
- by shuttle traders	…	8.2	10.1	17.6	17.2
- by other routes	3.0	2.8	2.1	3.4	3.6
Net increase of FCC possessed by residents	5.7	6.2	-	9.0	13.5

Source: S.M. Borisov, "Dollar v Rossii - partner ili konkurent? (Razmyshleniia po povodu 'dollarizatsii')," *Den'gi i kredit* 6 (1999), p.57 [The original source was provided by the Bank of Russia; the figures for 1993 and 1994 are not complete.].

Non-residents' Ruble Accounts

As for the non-residents, new regulations were necessary besides the "Currency Law" to introduce the so-called external convertibility for them. In July 1993, the instructions of the Bank of Russia "On the procedure to set up and manage non-residents' accounts in agent banks in the currency of the Russian Federation" were issued. According to this and other documents, non-residents got a right to open Ruble accounts in the agent banks and there appeared three types of Ruble accounts for non-residents: <T> type account, <I> type account, and an account for non-resident natural persons.[15]

Firstly, non-residents[16] can open <T> type accounts for their import-export transactions and also for the purpose of maintaining their representative offices and branches in Russia. It is important to note that economic units that do not have representatives or branches in Russia can also do business in Rubles through the corresponding accounts of non-resident banks in Russian agent banks.[17] In sum, any non-resident can deal with the Ruble for current economic activities such as imports and for payments of living costs through or based on the <T> type account.

Secondly, non-residents can open the <I> type Ruble account for investment activities. Through the <I> account, all the investments and reinvestments into Russia in Rubles are carried out and foreign currencies can be purchased

15 Platonova, *Valiutnyi rynok*, pp. 42-47.

16 Here "non-residents" are supposed to be production-trade companies, banks and other financial institutions and international organizations which have representatives or branches in Russia or foreign diplomatic, commercial and other official representatives. Platonova, *Valiutnyi rynok*, p. 43.

17 Platonova, *Valiutnyi rynok*, pp. 44-45.

with Rubles for repatriation of income earned by investment activities in Russia.[18] All the transactions are conducted on a non-cash basis.

Apparently the <I> type account was established to attract foreign investment, especially FDI, to Russian territory. In order to attract foreign investment, one of the most important things is to guarantee the right to repatriate income earned by the investment and, in fact, the right was guaranteed by the Bank of Russia. S.M. Borisov points out that the right to purchase foreign currency through the <I> type account is a main "iziuminka" [interesting point] in the documents. According to Borisov, the Russian national currency went out of the limit of "domestic convertibility" in this case.[19]

Thirdly, non-resident natural persons can open Ruble accounts in agent banks for daily expenditures. Rubles in these accounts have high-level (external) convertibility because they can be exchanged to foreign currency without any obstacle and also can be withdrawn from the accounts and used to buy foreign bank notes through exchange houses.[20]

The provisions concerning these three types of non-resident Ruble account were not enough to establish a foreign "reversibility" of currency, which is necessary to accept Article VIII of the Agreement of the IMF. The Presidential decree on May 16, 1996 and the letter of the Bank of Russia on May 28, 1996 resolved this problem, because they lifted the prohibition against transfer of Rubles from a <T> type account to an <I> type account.[21]

Another advance towards foreign convertibility was made by the instructions of the Bank of Russia on July 26, 1996, which set up a special Ruble account named <S> type. The <S> type account is a special account only for introducing foreign capital to the market of the government bonds GKO and OFZ.[22] The <S> type account is different from the <T> type and the <I> type accounts in that non-residents can open several <S> type accounts in various agent banks. This enabled non-residents to buy GKO and OFZ on a massive scale. Borisov estimated that the <S> type account has full convertibility.[23]

Convertibility of Currency

I have used the word "convertibility" several times without any detailed explanation. "Convertibility of currency" has been a controversial concept and has been one of the main issues of transitional economics since the beginning of the 1990s. To examine the process of liberalization of the financial and mone-

18 Ibid., p. 46.

19 S.M. Borisov, "Konvertiruemost' rublia v krizisnoi situatsii," *Den'gi i kredit*, 1 (1999), p. 56.

20 Platonova, *Valiutnyi rynok*, p. 47; Borisov, "Konvertiruemost' rublia," p. 56).

21 Russia achieved Article VIII status of the IMF on June 1, 1996. See Sapozhnikov, *Valiutnye operatsii*, p. 81; Borisov, "Konvertiruemost' rublia," p. 54, 56.

22 GKO is the abbreviation of *Gosudarstvennye Kratkosrochnye Obiazatel'stva* [State short-term bond] and OFZ is the abbreviation of *Obligatsii Federal'nykh Zaemov* [Federal bond]. Both are denominated in Rubles and estimated as short-term state bonds.

23 Borisov, "Konvertiruemost' rublia," p. 56.

Table 2. Legal Framework of Minimum Conditions of Convertibility

Exchange with \ Exchange for	**Current transaction**	**Capital transaction**
Residents	internal current convertibility	internal capital (unrestricted) convertibility
legal bases	Jun. 1992[1]; Oct. 1992[2]	Oct. 1992[3]; Feb. 1994[4]
Non-residents	external current convertibility	external capital (unrestricted) convertibility
legal bases	Jul. 1993[5]	May. 1996[6]; Jul. 1996[7]

Notes:
[1]=Presidential Decree [Jun. 14, 1992] and Instruction of the Bank of Russia [Jun. 29, 1992]
[2]=»Currency Law» [Oct. 9, 1992]
[3]=»Currency Law» [Oct. 9, 1992]
[4]=Document of the First Deputy Minister of MVES [Feb. 3, 1994]
[5]=Instruction of the Bank of Russia [Jul. 16, 1993]
[6]=Presidential Ordinance [May 16, 1996] and the Letter of the Bank of Russia [May 28, 1996]
[7]=Instruction of the Bank of Russia [Jul. 26, 1996]
Source: Made by the author modifying Borisov's chart (S.M. Borisov, *Rubl', zolotoi, chervonnyi, sovetskii, rossiiskii...: Problema konvertiruemosti* [Moscow: INFRA-M, 1997], p. 28).

tary system in Russia, we need to reflect on the arguments of ten years ago.

John Williamson clearly sorted out alternative concepts of convertibility. At first he distinguishes "unrestricted convertibility (capital account convertibility)" from "current account convertibility" according to the traditional western framework. A currency gets "unrestricted convertibility" only when "exchange restrictions on capital export are abolished, so that residents have the right to export capital in unlimited quantities at the official exchange rate."[24] "Current account convertibility" is "the concept of convertibility embodied in Article VIII, section 2(a) of the IMF's Articles of Agreement." Therefore under "current account convertibility," "anyone – whether a domestic importer or a foreign exporter or investor – should be able to exchange domestic for foreign currency at the official exchange rate to settle any transaction involving the purchase of goods or services from abroad, the payment of interest, or the repatriation of profit."[25] It is worth noting that both the "Currency Law" and Article XXX(d) of the IMF's Agreement include payments concerning short-term bank credit in "current transactions."[26] This means that the current account convert-

24 "Convertibility does not today generally imply the right to convert at a fixed exchange rate, but it does imply the right to convert at the legal exchange rate." John Williamson, "The Economic Opening of Eastern Europe," in Williamson, ed., *Currency Convertibility in Eastern Europe* (Washington, D.C.: Institute for International Economics, 1991), p. 377.

25 Ibid.

26 Werner F. Ebke, *Internationales Devisenrecht, Verlag Recht und Wirtschaft GmbH* (Heidelberg, 1991) [Quoted from Japanese version – translated by Kazuko Jitsukawa], pp. 39-40.

ibility includes freedom of short-term capital movement to some extent. Besides, residents of Russia had been enjoying much freedom in current and capital transactions from the beginning.[27] Therefore the significance of the acceptance of Article VIII of the IMF's Agreement in June 1996 is not a watershed in the history of international finance in Russia.On the contrary, Williamson points out, in Eastern Europe (this can be interpreted to include Russia or the former socialist countries), the concepts of "internal" and "external" convertibility have been used. He writes "the distinction relates to *who* should be allowed to exchange domestic for foreign currency, rather than to the *purpose* for which such exchange should be allowed." Therefore "internal convertibility relates to a right of domestic residents to make such exchanges, whereas external convertibility relates to an analogous right for foreigners, interpreted to include foreign investors."[28]

Following the arguments by S.M. Borisov, I made a legal framework of minimum conditions of convertibility (see Table 2). It shows four kinds of convertibility and also indicates when the relevant convertibility was permitted in Russia. Here the problem is not to achieve full freedom of exchangeability of currency without any governmental regulations. In Russia it is not necessary to have full freedom for the people who are eager to make fortunes using the slightest weakness of the government. It is different from the bureaucratic problems that the foreigners *in good faith* face when they try to transfer dollars or bring back Rubles to their home countries. Under the circumstance of free access of residents and non-residents to foreign cash currency at 11,295 official exchange offices scattered all over Russia (at the end of 1997),[29] these four kinds of convertibility can be re-defined as follows:[30]

(a) Under the internal current convertibility, residents have the right to exchange domestic for foreign currency in order to conduct current transactions such as payments for import;
(b) Under the internal capital [unrestricted] convertibility, residents have the right to exchange domestic for foreign currency in order to conduct capital transactions such as acquisition of foreign securities;
(c) Under the external current convertibility, non-residents have the right to exchange domestic (Rubles) for foreign currency (dollars) in order to conduct current transactions such as transfer of dividends or interests;[31]

27 Richard Layard and John Parker, *The Coming Russian Boom, A Guide to New Markets and Politics* (New York: The Free Press, 1996), pp. 63-64.

28 Williamson, "The Economic Opening," pp. 377-378.

29 Borisov, "Dollar v Rossii," p. 55.

30 These are based on the definition of convertibility by Ronald I. McKinnon, *Money in International Exchange, The Convertible Currency System* (New York & Oxford, 1979), p. 6.

31 The right of non-residents to open a Ruble account is the right of non-residents *to exchange foreign for domestic* currency. It is not the same as the definition of (c). According to the decree, however, the <I> type account can be used for "purchase of foreign currency in the

(d) Under the external capital [unrestricted] convertibility, non-residents have the right to exchange domestic for foreign currency in order to conduct capital transactions such as repatriation of invested capital.

As for (a), (c) and (d), the arrangements of the legal framework were explained above. As for (b), a special comment is necessary here. In fact the right of (b) is the right of residents to export capital, which is the crucial element of unrestricted convertibility. Surprisingly it has been virtually permitted from the beginning. Because there was no special regulation on the export of corporate capital, a resolution of the Ministers' Meeting of the USSR "On development of the activities of the Soviet organizations abroad" [No. 412, May 18, 1989] had been effective in the first years of the Russian Federation. The document of the first deputy minister of MVES [Ministry of Foreign Economic Relations] on February 3, 1994 approved the basic line of resolution No. 412. As for the monetary aspects of capital export, the "Currency Law" of 1992 provided the practical procedure of capital export, and the Law was, basically, not restrictive with respect to that export.[32]

It is important to recognize that the liberalization of the international financial and monetary system in Russia can be argued to have proceeded from *internal* to *external* convertibility (both in *current* convertibility and *capital* convertibility). Borisov points out that most countries' experiences of introducing convertibility began from the introduction of external convertibility.[33]

The arguments of Borisov and Williamson suggest that Russia is a unique country in the sense that it introduced internal current convertibility and permitted the residents' right to export capital (internal capital convertibility) from the beginning. This led Russia to a situation where a large amount of dollars in bank accounts or in cash is held by Russians without any route to invest and a considerable part of the capital is fleeing the country. This is the core point of the problems of the so-called capital flight (see the section "How to 'use' current account surplus" below). Of course, there is a big current account surplus behind this situation. I surmise that the designers of the international financial and monetary system of Russia did not expect such a big current account surplus. This might be a fatal mistake.[34]

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domestic Russian market." Therefore the Ruble account of non-residents is the basis for the non-residents' right *to exchange domestic for foreign* currency.

32 A.S. Bulatov, ed., *Ekonomika vneshnikh sviazei Rossii* (Moscow: Isdachel'stvo BEK, 1995), pp. 495-500.

33 S.M. Borisov, *Rubl', zolotoi, chervonnyi, sovetskii, rossiiskii...: Problema konvertiruemosti* (Moscow: INFRA-M, 1997), pp. 279-287; Borisov, "Konvertiruemost' rublia," p. 53; Ebke, *Internationales Devisenrecht*, p. 17.

34 This is connected with the IMF's policy. The IMF's policy is usually adopted in a developing country which is recommended to open up its borders to introduce investment from abroad. The support-receiving country usually has a large current account deficit and suffers from capital shortage. Russia is not a country like this.

Legislation and Reality

Anyone who knows the Russian economy well might have doubts about the feasibility of the arguments above, saying that the legislation in Russia would be seldom observed by the people and that the real economy in Russia does not function according to legislation. In fact, such an assertion might be true in many cases, but I do not think that the present arguments according to legislation are meaningless. The most important point is that in the sphere of international monetary and financial activities in Russia, most legislation [especially in the first phase of New Russia] does not prevent something but liberates something.

Under the circumstances of a disordered society, the once liberated system cannot be controlled again in Russia. Many of the laws and decrees quoted above are worth mentioning if we pay special attention to this relation. They have had an undermining effect like ants burrowing in an embankment. In this context, the law[35] to prohibit retail transactions through foreign currencies since 1994 is interesting because this is a law to prevent an activity after it was liberated. As many Russians and foreigners know, this law has not been observed seriously (The strength to enforce the law differs from one city to another and one year to another). Although cash foreign currency held by Russians did decrease in 1995 because of stabilization of Ruble prices, "dollarization" began to expand again in 1996. At the beginning of 1998, the value of dollar cash held in Russia was 1.8 times as much as that of the Ruble.[36]

2. Russia and Structural Changes of the International Financial Market

Primitive Open Macro Analysis

Here we can use primitive open macro economics to compare the main countries. The following is the basic open macro formula.

$CA=(S^p -I)+(T-G)$

Where Y=GNP, C=Consumption, I=Investment, G=Government expenditures, CA=Current account, S^p =Private saving, T=Tax.

This equation means that a current account of a country is the sum of excess of private saving [S^p -I] and budgetary surplus [T-G]. Table 3 shows how these items (annual average in billions of US$) are related to each other in several countries.

As is well known, Japan, as well as Russia, produced a large budgetary deficit until the late 1990s. In contrast, the USA improved its fiscal balance in the late '90s. As for current accounts, whereas Japan and Russia (Russia's current account surplus is to be examined in section 3) have had a large surplus,

35 *Ekonomika i zhizn'* 41 (Oct. 1993), p. 5.

36 Borisov, "Dollar v Rossii," p. 58.

Table 3. Annual Average of Macro Statistics (Billions of US$)

		CA = Current account	T–G = Budgetary surplus[1]	S^p-I = CA–(T–G) = Excess of private saving[7]
Russia	1995-1997	7.1	–23.3[2]	30.4
	1999-2001	35.4	4.4[2]	31.0
USA	1995-1997	–123.6	–86.5	–37.1
	1999-2001	–395.5	167.9	–563.4
Japan	1995-1997	90.1	–192.8[3]	282.9
	1999-2001	104.3	–291.5[3]	395.8
Germany	1995-1997	–9.9	–40.2[4]	30.3
	1999-2001	–10.9	–7.4[4]	–3.5
Brazil	1995-1997	–24.0	–59.1[5]	35.1
	1999-2001	–24.1	–4.7[6]	–19.4
South Korea	1995-1997	–10.4	2.2	–12.6
	1999-2001	9.3	–3.2	12.5

Notes:
[1] = Converted from each national currency to US Dollar value by exchange rates [yearly average] quoted in *IFS.*
[2] = Excluding social security funds and extra-budgetary spending.
[3] = Calculated from newly issued state bonds in each fiscal year [April to March].
[4] = Including special spending for the unification.
[5] = Figure in 1997.
[6] = Average of 1999 and 2000.
[7] = Calculated as a residual [CA–(T–G)] instead of calculated from indigenous sources.
Sources: Calculated by the author using the data of *IFS* (*International Financial Statistics*) 2 (2002) and Economic Planning Agency of Japan [for Japan's budgetary surplus].

the current account of the USA has been continuously in deficit, and the deficit reached a tremendous level in the late '90s and the beginning of the 21st century.

Table 3 reveals that there was a large excess of private saving in Russia both in 1995-97 and 1999-2001. Here it must be noted that *private saving* means not only individual household saving but also the un-invested amount of companies, which would go to foreign and domestic financial markets. The amount of more than US$ 30 billion can compare with the German figure in 1995-97. Although most of the private saving was used to cover the budgetary deficit in 1995-97, there was still some amount left to be invested abroad (including the sum as official international reserve). The current account surplus of US$ 7.1 billion equals the amount thus pushed out of the country.

After the August crisis of 1998, the Russian economy has shown a rapid recovery based on high oil prices and currency depreciation. This led to significant reduction of the budgetary deficit which had been considered as an incurable disease of Russia. Interestingly, the economic recovery was not accompanied by a reduction of current account surplus (see also Table 5 and Fig. 1). On the contrary, the latter has even increased after the shock of the 1998 crisis. According to the formula above, this means that the excess of private saving is not decreasing. This compels us to reconsider the government policy to activate domestic investment.

Considering the fact that a positive current account of a country means the outflow of financial assets from that country, a comparison of the current accounts of the listed countries leads to an interesting finding. Russia, together with Japan, is a provider of financial resources to the world market, whereas the USA, Germany and Brazil are absorbers of them.[37] Though the amount of financial resources provided by Russia is not as much as those of Japan, it is enough to cover the financial shortage of Germany and Brazil in 1999-2001. As the fiscal deficit disappeared in 1999-2001 in Russia, the excess of Russian private saving is absorbed exclusively by the external financial market including the American market. It is curious that Russia is a net capital provider in the international financial market. The significance of this fact for Russia and the world as a whole must be investigated.

Changing Framework of the International Financial System

Apart from the structural change of the capital movement, it is also necessary to note that the framework of international finance has changed radically since the 1980s and especially the '90s. In other words, the rules of the game or the methods to win in the international financial market have changed. The following three examples of new trends are relevant to the Russian economy:

- Securitization of international finance;
- Development of offshore financing;
- Development of new financial techniques including derivatives.

These three things entered Russia in the midst of its systemic transformation. Securitization took place as a form of the prosperous state bonds (GKO and OFZ) market. Against the background of poorly-developed domestic investment banking and stocks trading, banks and other firms, including non-resident investors, dealt with state bonds as a tool of the money game without any linkage with the real economy. Especially, the role of non-resident investors in the Russian state bond market must be noted. On July 1, 1997, the share of GKO/OFZ held by non-residents reached 30.3% of the bonds issued. Al-

37 Of course, this is a picture described from the viewpoint of overall *net* balance. From the viewpoint of *gross* movement, it is important to know, for example, that there has been a tremendous amount of capital that has moved between the USA and the EU. The FDI from the EU to the USA was ECU 112 billion in 1998; that was 112 times more than the FDI of the EU to Japan. The FDI from the USA to the EU was ECU 61.7 billion in 1998; that was about 25 times more than the FDI of Japan to the EU. European Commission, *European Union Direct Investment, Yearbook 1999*, (Luxembourg, 1999), p. 53.

though the share had been declining, it remained at a level of 27-28% at the beginning of 1998.[38] Alexei Medvedev found that residents and non-residents behaved differently in the GKO market during the crisis (November 1997 – August 1998) and that non-residents were more sensitive to negative external news and some domestic news. He asserted that non-residents strongly contributed to the negative developments.[39] This reveals that the securitization along with internationalization brought an un-tamable factor into Russia.

The relationship between offshore banking and Russia's economy cannot be investigated easily because of the secrecy of the offshore organizations.[40] However, we have much indirect evidence for a strong relationship between them. For example, the data on foreign investment show that some small countries such as Luxembourg and Cyprus have invested in Russia more than would be expected from their size.[41] These countries are famous for their offshore activities. This suggests that a considerable amount of financial resources had once left Russia for the "offshore" and that a part of them has been repatriated to Russia.[42]

The new financial techniques (forwards, futures, swaps and options) have also entered the Russian Federation. Although this trade actually started later, the "open foreign currency position," which is a key tool of the currency option, was already approved by an instruction and a letter of the Bank of Russia in May 1993.[43] Although the instruction of the Bank of Russia on May 22, 1996 introduced an upper limit of the open foreign currency position,[44] the limit could be easily bypassed by some banks. As of August 1, 1998, the average amount of open foreign currency position held by the leading 30 banks in Russia was 38.6% of their capital, which was more than twice the limit set by the CBR.[45]

These new financial techniques were used in the state bond market.[46] As the state bonds like GKO or OFZ were denominated in Rubles, non-residents

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38 *TTDKS [Tekushchie tendentsii v denezhno-kreditnoi sfery]* (Moscow: Tsentral'nyi bank Rossii) 4 (1998), p. 20.

39 Alexei Medvedev, *International Investors, Contagion and the Russian Crisis*, BOFIT Discussion Papers, No. 6 (Helsinki: Bank of Finland, Institute of Economies of Transition BOFIT, 2001), p. 19.

40 This might be connected with tax-evasion.

41 Goskomstat Rossii, *Rossiia i Strany Mira 1998* (Moscow, 1998), pp. 318-319.

42 *(Interview with)* Vladimir Sokolin, "Glavnyi investor – Kipr; Statistika priamykh inostrannykh investitsii shokirovala dazhe Goskomstat," *Izvestiia* (5 May 2000), p. 3.

43 Platonova, *Valiutnyi rynok*, p. 84; A.Iu. Simanovskii,"Regulirovanie valiutnogo riska: otkrytaia valiutnaia pozitsiia," *Den'gi i kredit* 2 (1997), pp. 43, 69-72.

44 Sapozhnikov, *Valiutnye operatsii,* pp. 46, 72, 83, 190.

45 A. Astapovich and D. Syrmolotov, "Rossiiskie banki v 1998 godu: razvitie sistemnogo krizisa," *Voprosy ekonomiki*, No. 5 (1999), pp. 51-52, 54.

46 As one of the contributing factors to the 1998 crisis, we must also note the influence of the so-called "REPO" transaction. "REPO" is "Repurchase agreement" and means a transaction agreement to sell bonds on condition that the seller would re-purchase the bonds after

who purchased them wanted to hedge the risk of exchange rate fluctuation. In connection with the government policy to attract foreign capital to the state bond market, the significance of the currency forwards and futures increased in 1996. However it is estimated that such trades had a destabilizing effect in the exchange rate fluctuation right before the 1998 crisis.[47]

There have been acute discussions about the role of derivatives in economic crises. Some assert that derivatives accelerate and enlarge crises because of their leverage effect. Others maintain that derivatives function to moderate crises because they have a risk dispersing effect. As for the Russian crisis in August 1998, we cannot say definitely which side is correct. However, we can say that the Russian banking system would have suffered from the crisis to a lesser degree if it had not been involved in these new financial techniques. Until the crisis, the big Russian banks took the risk vis-à-vis non-residents through currency futures contracts and, in turn, the big banks shifted the risk onto small Russian banks also through futures contracts.[48] The depreciation of the Ruble since August 1998 made Russian banks fall into a difficult situation in which they had un-repayable debt in foreign currency. Thus the Russian banking system lost people's confidence and experienced deposit withdrawals on a massive scale.[49]

Securitization, offshore banking and derivatives are three important factors which made Russia's economic system an oddly shaped one where the latest financial techniques lie on an old-fashioned, unstable real economy. We could not expect the Russian government to prevent these factors from affecting Russia as it was a strong worldwide tendency. However, Russia could have

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a fixed period at a more expensive price. It is a tool to raise short-term credit and the difference between the selling price and re-purchase price functions as a kind of interest. Before the crisis, the Russian banks actively employed this transaction to borrow foreign currencies and money raised in this way was transferred into Rubles and used to buy Ruble-denominated state bonds. As the bonds prices in the world market fell, the Russian banks tried to escape from the "REPO" trading and preferred to forfeit state bonds denominated in foreign currency as mortgage. As a result they had to pay the so-called margin calls [the difference between the amount of credit received and the current price of the bonds]. Shiobara, T., *Some Problems Concerning the Relation between Banks and Enterprises in Russia* [in Japanese, Working Paper Series (Tokyo: Center for Business and Industrial Research, Hosei University, 1999), p. 17; Astapovich and Syrmolotov, "Rossiiskie banki v 1998 godu," pp. 46-48, 53-54.

47 Astapovich and Syrmolotov, "Rossiiskie banki v 1998 godu," p. 51. As of February 1998, the following futures were traded in the Moscow Interbank Currency Exchange [MICEX]: (1) cash settled futures on the US dollar; (2) cash settled futures on GKO; (3) cash settled futures on the MICEX Russian stock index; and (4) deliverable futures on individual Russian stocks. Vladimir Kuznetsov, *Derivatives Trading and Risk Management at the Moscow Interbank Currency Exchange* (1998), quoted from the Webpage of MIPT/Term Derivatives Society [Page numbers cannot be identified].

48 Bank Rossii (Tsentral'nyi bank Rossiiskoi Federatsii), *Godovoi otchet 1998* (1998), p. 97.

49 Ibid., p. 98.

taken some restrictive measures, taking lessons from the experiences of Mexico, Argentina, Thailand, Indonesia, and other countries.

3. The Complex Structure of Debt, Credit and Current Account Surplus

Succession of the Debt

In the last years of the Soviet Union, Soviet journals came to report openly that the Soviet Union had a considerable amount of foreign debt.[50] When the existence of the Soviet Union itself came to be threatened in the second half of 1991, the western creditors were worried and tried to ask the Soviet Union to guarantee debt repayment.[51] In October 1991, the Soviet Union and eight of her republics signed a "Memorandum" about the debt and approved "collective responsibility." In return, the G7 recognized the postponement of repayment of the public debt. The eight republics that signed the "Memorandum" reached an agreement on the "Succession of the rights and duties of the Soviet Union's state debt and credit" on December 4, 1991. The collective responsibility system to pay back the debt seemed to be effective, but things did not proceed smoothly.

After the dissolution of the USSR by the summer of 1992, it had become clear that the collective responsibility system could not function after all. The creditor countries considered Russia as the only country that had the ability to pay back the debt and put pressure on Russia. The so-called "zero option (*nulevoi variant*)" was chosen under such conditions, and the collective responsibility system of the CIS countries to pay back the former Soviet Union's debt was given up. An agreement was concluded to the effect that the Russian Federation should be solely responsible for the former Soviet Union's debt in March 1993. Thus the Russian Federation is the successor state of the Soviet Union in the international financial community. According to the World Bank, the debt at the end of 1991 was $67.94 billion, and this was inherited by the Russian Federation (the debt of European COMECON countries was added to the data since 1993).[52] According to the Debtor Recording System of the World Bank, this amount was the 5th biggest in the world after Brazil, Mexico, Indonesia, and India.[53]

Credit of the Former Soviet Union

It was also well known in the late 1980s that the Soviet Union had a large amount of credit against developing countries. In March 1990, "*Izvestiia*" pub-

50 For example, *Ekonomicheskaia gazeta (Ekonomika i zhizn')* 50 (1989), p. 21.

51 Hereafter based on P.A. Averkin, "Dolg platezhem krasen, Osobennosti vneshnego dolga Rossii i stran SNG," *EKO* 10 (1999), pp. 32-35.

52 S.M. Borisov, "Vneshnie dolgi Rossii," *Den'gi i kredit* 2 (1997), p. 20; World Bank, *Global Development Finance* (Washington, D.C., 1999), p. 619.

53 World Bank, *Global Development Finance* (Washington, D.C., 1998), pp. 10-12.

Table 4. Credit of the Former Soviet Union (Millions of Rubles, as of 1.1.1989)

Cuba	15490.6	India	8907.5
Mongolia	9542.7	Syria	6742.6
Vietnam	9131.2	Iraq	3795.6
Poland	4955.0	Afghanistan	4055.0
North Korea	2234.1	Ethiopia	2860.5
Socialist countries, total	43805.9	Algeria	2519.3
		Angola	2028.9
		Yemen, PDR of	1847.6
		Egypt	1711.3
		Libiya	1707.3
		Developing countries, total	42039.7

Note: Including principal and interest. *Source*: *Izvestiia* (1 March 1990), p. 3.

lished the data shown in Table 4 and made the problem clear. This table shows us that the debt and credit of the former Soviet Union differ in character. Credit against the countries shown in Table 4 can be considered as a result of the global strategy of the Soviet Union who gave them military aid. Actually, the developing countries shown in Table 4 are the countries that Jane's International Military Yearbook has pointed out as receiving weapons from the Soviet Union.[54] They cannot be considered to have the intention and ability to repay their debt. Therefore, the debt of the former Soviet Union cannot be offset by its credit.

Although there is a plan to securitize the credit and sell it at a discount, the probability of success must be low. In this connection, the Russian Federation became a member of the Paris Club (in other words, the creditor nations' club) from September 1997 and is trying to deal with its credit problem there.

Structure of credit/debt transfers

I would like to examine strictly the complex structure of the credit and debt of the Russian Federation from the data on balance of payments. I modified the framework of the debt analysis of the World Bank[55] and made an original table (Table 5) in which the factors of legal financial movement are considered. I call this "Legal Capital Flow [LCF]." Many researchers of the Russian economy are emphasizing the importance of the so-called "Capital Flight" instead of legal financial flows. Though I admit the significance of capital flight

54 Alan Smith, *Russia and the World Economy, Problems of Integration* (London & New York, 1993), pp. 148-151.

55 The World Bank analyzes debt problems by using terms such as "Net resource flows on debt" (Loan disbursements *minus* Principal repayments), "Aggregate net resource flows" (Net resource flows on debt *plus* FDI, portfolio equity flows, and official grants), "Net transfer on debt" (Net resource flows on debt *minus* Interest payments), "Aggregate net transfers" (Aggregate net resource flows *minus* Loan interest and FDI profits). See World Bank, *Global Development Finance* (1999), p. xxi.

Table 5. Russia's Legal Capital Flow according to the Author's Framework (Millions of US$)

	1993	1994	1995	1996	1997[5, 6]	1998	1999	2000
[0] Curent account (for reference)	12792	8434	7484	11753	2060	687	24647	46342
[1] Net balance of loan[1] received by Russia[2]	5857	1980	9085	11152	13320	7325	–2880	–3550
[2] Net balance of loan[1] supplied by Russia[3]	7913	9535	8641	9499	7004	5345	4855	5365
[3] Planned amount of interest/ dividends payments and receipts	–2302	–1726	–3069	–5029	–8350	–11626	–7937	–6919
[4] Arrears of Russia's debt[4]	3364	3162	1131	2672	3862	5315	2027	–1637
[5] Arrears of Russia's credit[4]	–11619	–12774	–10553	–9475	–3048	–7425	–5809	–7488
[6] Real net transfers on loan ([1]+[2]+[3]+[4]+[5])	**3213**	**177**	**5235**	**8819**	**12788**	**–1066**	**–9744**	**–14229**
[7] Net balance of direct investment and portfolio investment	695	429	–984	6066	19256	10110	400	–10874
[8] Real aggregate net transfers ([6]+[7])	**3908**	**606**	**4251**	**14885**	**32044**	**9044**	**–9344**	**–25103**

Notes:
[1]=Bank and other loans and export/import credit (excluding «short-term trade-related finance» and «change of bank deposit»).
[2]=Including the planned but not paid amount of Russia's repayments.
[3]=Including the planned but not paid amount of foreign repayments to Russia.
[4]=Including interest and dividend payments.
[5]=Omitting the amount of securitized debt (US$ 28.2 billion, see *Finansovye Izvestiia*, 11 Aug. 1998, p.8.) of former USSR from [4] and [7].
[6]=According to the latest data [CBR's Web Page as of 5 Jan. 2003], the current account of 1997 is US$80 Million.
Source: All the figures were calculated by the author using the data of the Web Page of Bank Rossii [http://www.cbr.tu/dp/P_balance93-94.htm] (1993) and *Vestnik banka Rossii*, No. 33-34, 29 May 2001 (1994-2000).

(in fact I will investigate it later) in Russia's international financing, I would like to attract readers' attention to the problem of the LCF. The LCF includes "bank loans and other loans including long-term export/import credit", "interest and dividends payments," "arrears of credit and debt," "portfolio investment" and "direct investment." In contrast, "Short-term trade-related finance" [discount of trade bills, advance payments, etc.] and "changes of bank deposits" are excluded. The differences between my tables and the World Bank's tables are the following:

- My table considers not only the debit side of the balance but also the credit side;
- I take the unpaid amount (assets and liabilities) into consideration because

there have been many cases of rescheduling and expirations of due dates;
- I do not calculate “resource flows” (according to the World Bank’s terminology) which do not include interest and dividend payments;
- Positive signs and negative signs[56] are used according to the method of balance of payment statistics.

In Table 5, item [6] (*Real net transfer on loan*) is the net amount that Russia really received not only as loan principal but also as interest and dividends. It is a “net” amount because it considers all the factors such as the offered loan, received loan, and repaid (to Russia and from Russia) principal and interest. It is a “real” amount because it deducts arrears from the planned amount. Item [8] (*Real aggregate net transfers*) is the sum of item [6] and the net real received amount of direct investment and portfolio investment.

As for the period before the August crisis of 1998, we must note that the “Net balance of loans received by Russia” [1] shows large positive figures from 1995 through 1998.[57] This means that Russia received many bank loans and other long-term export/import credits during that period. This was the result of the active policies of Russian enterprises, including banks, against the background of the stabilization of the macro economy.

The increase of item [7] (Net balance of direct investment and portfolio investment) is also striking during the same period. This can be attributed to the increase of portfolio inflow promoted by the positive policies of the government.

At the same time we must pay attention to the fact that item [3] (Planned amount of interest/dividends payments and receipts) recorded large negative figures in the period of 1995-1998 and thereafter. This means that the received money caused a considerable amount of interest and dividends to be paid. In 1998, this amount set off the received bank loans and other scheduled export/import credits. Even if we take the amount of arrears (on the debt side and the credit side) into consideration, the overall balance of loan transfer (item [6]) fell into deficit in 1998. One of the causes of the change was the rapid increase of the interest and dividends outflows. Besides, we must not overlook the effect of item [5], which is interpreted as the amount of un-received repayments for the loans provided by Russians and may reflect some special characters of the international monetary flows of Russia. Item [5] recorded considerable minus figures from 1993 through 1996, after which the deficit showed a decreasing trend

56 In the balance of payments statistics, positive signs are recorded when the financial liability of residents against non-residents increases. On the other hand, negative signs are recorded when the financial assets of residents against non-residents increases. Therefore when an English resident provides a loan to a Russian company, it must be recorded as a positive sign in the Russian balance of payments and vice versa.

57 Correctly speaking it increased until August. According to the CBR’s statistics, this item increased until the third quarter of 1998, but showed minus figures in the fourth quarter of 1998.

in 1997 but again increased in 1998. Therefore the amount of item [5] influenced the trend of item [6] in the years 1998-2000.

In Table 5, one of the striking facts after the 1998 crisis is that item [1] fell into deficit in 1999 and 2000. This means that the amount of loans received by Russia was smaller than the amount of loans to be repaid by Russia *on schedule*.[58] This caused a large amount of minus figures of item [6] in 1999 and 2000. We can realize from the table that the real outflow of loan transfers did occur after the crisis. This shows the troubles that the Russian banks faced after the crisis.

As for direct and portfolio investment, it decreased suddenly in 1999 and fell into deficit in 2000. By considering other balance of payments data, this can be attributed to the escape of foreign funds once invested in Russian portfolio markets.

Table 5 shows that Russia had been receiving net real financial resources until 1997 if we consider all the factors of financial movement. That is, the financial resources that Russia could use had actually been growing until 1997. In 1998, however, the *real net transfer on loans* became negative for Russia and in 1999 the *real aggregate transfer* fell in deficit. This suggests that a considerable amount of financial resources have really fled by legal ways since the currency crisis of August 1998. However the analysis concerning Table 5 shows only one side of the situation. The other, "gray" side must be studied by another approach.

How to "Use" Current Account Surplus

The Russian Federation recorded a large current account surplus from 1992 through 2000. Russia is the only country in the transition countries that has had a current account surplus every year since the collapse of the old regime until 2000.[59] This was caused by the surplus of the goods and service trade, especially the surplus created by the export of oil and gas.

As pointed out in the previous section, there had been real inflow of financial resources until 1997 through legal routes. As far as the current account records surplus, we must seek other routes of resource outflow. By definition, "Current account" + "Capital and financial account" + "Errors and omission" = 0 according to the 5th version of the balance of payments manual of the IMF. I found that three items have been recording minus figures during almost all periods from 1993 through 2000. The three items are "Increase of foreign cash currency circulating in Russia," "Un-received (or unpaid) trade charges" and "Errors and omission." The current account surplus has been "used" [in an

58 By considering the figures of items [3] and [4], the real received amount was smaller than the real repaid amount.

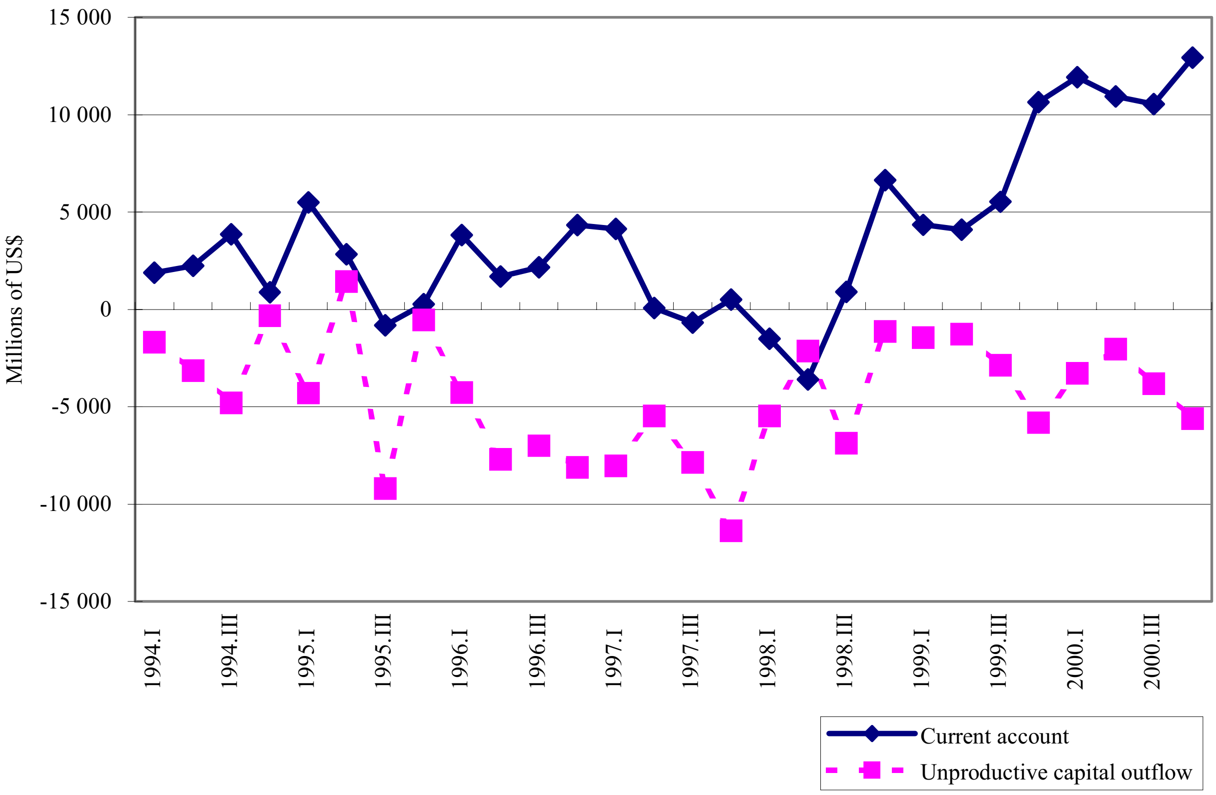
59 According to the latest data, the current account in 1997 was US$80 million (see the Web site of the CBR).

Table 6. Unproductive Capital Outflow (Millions of US$)[1]

	1993	1994	1995	1996	1997	1998	1999	2000
Increase of foreign cash currency circulating in Russia[2]	–3619	–5740	134	–8740	–13444	824	921	–321
Unreceived (or unpaid) trade charges (net)	0	–4085	–5239	–10119	–11591	–7959	–5051	–5293
Errors and omissions	–6252	442	–7973	–4892	–4851	–9084	–6916	–9342
Total	–9871	–9383	–13078	–23751	–29886	–16219	–11046	–14956

Notes:
[1] = All the positive and negative signs are placed according to the system of balance of payments.
[2] = The «increase» of this item is recorded as a «minus» sign in the system of balance of payments.
Source: Made by the author using the data of the Web Page of Bank Rossii [http://www.cbr.tu/dp/P_balance93-94.htm] (1993) and *Vestnik banka Rossii*, No. 33-34, 29 May 2001 (1994-2000).

Fig. 1. How to "Use" Current Account Surplus



Source: Made by the author using the data of *Vestnik banka Rossii*, Nos.33-34, 2001, Prilozhenie 2.

accountancy sense[60]] by these three items. As for the period after 1998, the outflow of the three items has been accompanied by the above-mentioned legal outflow. This is connected with the problem of capital flight. There are many definitions of "capital flight" and I regard the sum of these three items as a kind

60 Here the word "use" cannot be interpreted as to "use" the earned money for purchases. It is an accountancy outcome from the double entry system of balance of payments statistics.

of capital flight. The problem is not the definition but the functioning of the transactions. The minus figures of the three items mean that the financial resources have fled the country through a route that would not function to put the resources back into the country in the near future. For example, "foreign cash currency circulating in Russia" cannot be included in the category of "capital flight" in the sense that it is staying at home. But it is functioning like fleeing capital because it is hoarded up under peoples' beds or in chests and does not go to financial institutions. Furthermore, foreign cash currency can be easily brought out of the country through illegal routes.[61] I would like to call these three items "unproductive capital outflow [UCO]."

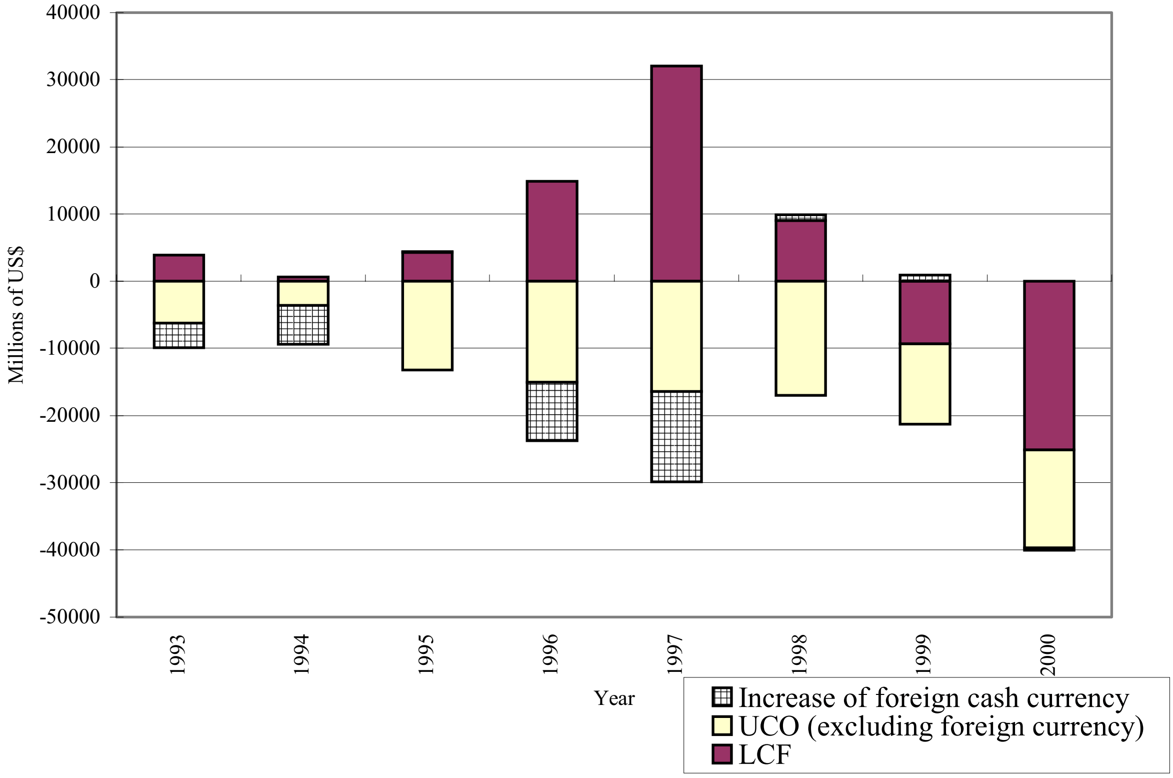
Table 6 and Figure 1 show that the sum of the three UCO factors corresponds to the trend of the current account surplus. The more current account surplus is produced, the more unproductive capital outflow occurs. I suspect that this phenomenon is derived from the fact that any juristic or natural resident person in Russia can hold foreign currency in cash or in the form of deposits in Russia. To keep property in a form of foreign currency (actually the dollar) means to have property with a value internationally recognized. In such a case, the location of property can be easily moved from one place to another. This is a result of the liberalization of the foreign monetary and financial system at the beginning of the reforms. In the first section I quoted an argument that liberalization started misguidedly from the introduction of "internal convertibility." In Russia, liberalization policies for capital movement were carried out to introduce capital from abroad. In fact they were effective, especially in 1996 and 1997. This is, however, one side of the coin. The other side is a simple liberalization policy of foreign currency, which promoted the outflow of financial resources from the beginning.

UCO and Capital Flight

Here we need a short note on "capital flight." According to my theoretical framework, "capital flight" from a country is divided into two categories. One is (1) Long-term, continuous flight and the other is (2) Short-term, sudden flight. It is worth mentioning that orthodox economists call only category (2) "capital flight" and that they would not see any problem to be resolved in the phenomenon of category (1), because they regard it as the result of rational behavior of participants in the market. In contrast, I see a serious problem in some part of the phenomenon of category (1). I regard it as a kind of economic evil because it diminishes the national resources if they would not return home again. Category (1) can be divided into three sub-categories: (a) Legal financial outflow which can be traced in the balance of payments, (b) illegal or gray ways of financial outflow which can be indirectly traced in the balance of payments, and (c) illegal or genuine black ways of financial outflow which leave no footprint

61 Of course, some part of the resources may be repatriated in a secret way.

Fig. 2. Legal Capital Flow [LCF] and Unproductive Capital Outflow [UCO]



Source: Tables 5 and 6.

on the balance of payments. *Outflow* of the LCF can be included in (1)-(a) and the UCO in (1)-(b).

Legal Capital Flow and Unproductive Capital Outflow

To sum up the analysis above, I made Figure 2. According to Figure 2 and Tables 5 and 6, the sum of Legal Capital Flow [LCF] had been in surplus (inflow > outflow) for Russia until 1998, but in 1999 and 2000 it fell into deficit. As for the sum of Unproductive Capital Outflow [UCO], it has always been in deficit (inflow < outflow) from 1993 through 2000. Comparing the sum of LCF and UCO, it is found that the UCO has been more than the LCF (in absolute value) every year from 1993 through 1998, except in 1997. Even if we omit the item of "Increase of foreign cash currency circulating in Russia" from the calculation of UCO, the absolute value of UCO was more than the absolute value of LCF from 1993 through 1998 except for 1997. In 1999 and 2000, the figures of LCF were negative[62] and those of UCO were, of course, negative. This means that when we calculate the sum of capital movement by combining legal and illegal/gray ways,[63] there have been net real outflows of capital from Russia. The governmental measures to attract foreign capital achieved a slight positive result only in 1997. It is widely believed that it is necessary to liberalize the international financial system to attract foreign capital. If not, foreign investors would hesi-

62 This is one aspect of the economic recovery of Russia after the crisis.
63 Genuine "black ways" are not considered here.

tate to invest for fear they could not repatriate their earned money. For developing countries where the current account is in deficit and shortage of private savings is observed, this argument might be true. However, for Russia, where the current account has been recording surplus and excess of private saving is observed, the domestic capital had fled the country before foreign capital came in. This is the structure of Russia's capital movement.

CONCLUSIONS

This paper shows that there are three distinctive features of Russia's emergence on the international financial market: (1) simultaneity of Russia's emergence and its historical systemic transformation, (2) simultaneity of the emergence and the structural change of the global international financial market, and (3) complexity of the structure of assets and liabilities on a stock base and a large current account surplus on a flow base.

As for the first feature, it was shown that under the oversimplified liberalization of the international financial and monetary system, especially the introduction of internal convertibility in the first stage, capital movement into and out of Russia had been expanding until 1997 and remained at a considerable level even after the August Crisis of 1998. As for the second feature, it was found that the structural changes of the global international financial market, that is, *securitization, offshore financing* and *derivatives*, supported strong capital movement through the borders of Russia. As for the third feature, by using official statistics, the author calculated the amount of capital movement of Russia considering all the factors like planned supply and receipt of loans, debt servicing of the former USSR and the new Russia, arrears of credit and debt, and portfolio and direct investment, and came to the conclusion that the overall balance of capital movement had been in surplus (that is, the inflow was more than the outflow) for Russia until 1998. The author also investigated gray ways of capital outflow and found that a large amount of financial resources fled the country, exceeding the above-mentioned capital "surplus" until 2000 except for 1997. Interestingly, the amount of the gray outflow corresponded to the fluctuation of the current account surplus. Studying both official and gray ways led to the conclusion that there has been a large shortage of investment compared to private saving in Russia and that the remainder of the savings have been fleeing the country. From the viewpoint of open macro economics, this excess of private saving is absorbed by the external financial market. These three features of Russia's emergence on the international financial market produced this curious status of Russia in the world.