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Russia: Capital Outflows Declining, Inflows Increasing – And What About FDI?

The Central Bank has recently released a preliminary third quarter 2002 balance of payments estimate, including detailed capital account items. This has provided an opportunity to look again into Russian capital flow trends over the last years and during the first three quarters of this year, and especially into the question of how capital outflows, or "capital flight" has developed. An analysis of recent capital flow trends, against the background of the experience of the last decade, supports the following conclusions:

- **Over the last years, capital outflows have consistently moderated, both in absolute and relative terms, a trend that has been sustained during 2002**. Capital outflows have declined from some 70% of the current account surplus in 1999 (and much higher than that before 1999) to 47% in the January-September period 2002. On a seasonally adjusted basis, capital outflows as a percentage of GDP declined from about 14% in the first quarter of 1999 to about 6.5% in the second quarter of 2002.

- **Analysis indicates there is no systematic connection between oil prices and capital outflows** ***per se***. High oil prices have at times been associated with very high capital outflows as has low oil prices, and vice versa. Russia's experience is that a lower oil price can well be accompanied by a similar or higher annual CBR reserve increase than e.g. a previous year with higher oil prices - depending on the dynamics of capital flows. This suggests that the key determining factor behind capital outflows is overall domestic corporate and household confidence in the path of Russian reforms and the Russian economy, as well as corporate restructuring.

- **The major capital inflow trend over the last 3-4 quarters is the return to international financial markets for the Russian private sector, and the associated expansion in bond issuance (notably Russian corporate Eurobonds) or loan related inflows to the corporate sector**. To this can be added that over the last couple of years there are increasing indications of previous capital outflows starting to flow back into the Russian economy.

- **Portfolio inflows to the corporate sector (equity market) remain small, although it increased by USD 200 mn in the three quarters of this year compared to the same period 2001** (total such inflows Q1-3 2002 was USD 500 mn). This probably emphasises further the challenge of broadening and deepening the equity market, a challenge that includes the emergence of an active and broader domestic investor base also.

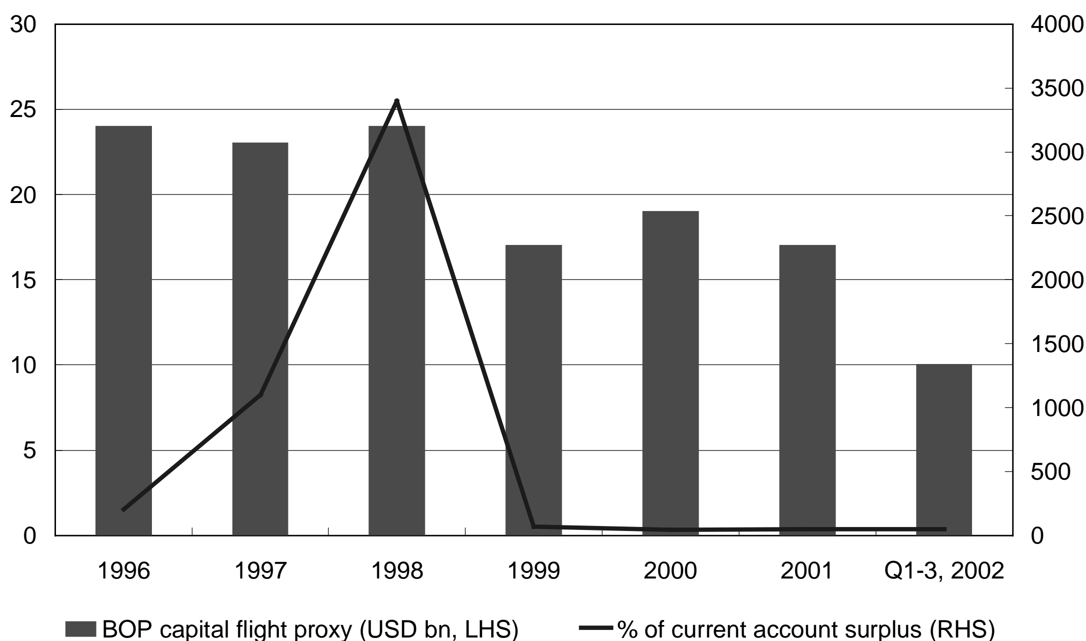
- **FDI inflows remain disappointingly small, both in absolute and relative terms, and no major change for the better has taken place over the recent period. Increasing signs of Russian capital being put to use inside the economy, as well as continued moderation of capital outflows, could well herald a future stage of gradually rising FDI inflows, maybe from 2004-05 and onwards**. Governance concerns of various kinds will though remain a break on the pace on FDI inflows, even if formal legal reforms impresses.

1. Russia's capital outflows

Capital outflows, or "capital flight", from Russia are not a new phenomenon[1]. Larger scale outflows began from the Soviet Russian economy already in the 1980s, and then accelerated during the collapse of the Soviet Union and especially during the initial years of post-Soviet Russia. For our purposes here, what is interesting is the behaviour of capital outflows from 1996 onwards, the year of President Yeltsin's re-election, then the couple of years leading up to the August 1998 crisis, and then the post-1998 period.

The graph below outlines the behaviour of capital outflows in the 1996-2002 (third quarter) period, both in absolute terms and as a percentage of the current account surplus. As a rule, in the period before (and including) 1998, annual capital outflows were many times the current account surplus. This was because capital outflows were "financed" not only by the current account surplus, but also by various kinds of capital inflows, such as e.g. a massive inflow of non-resident GKO portfolio inflow in 1997. After 1998, however, capital outflows drop dramatically, both in relative and absolute terms. From having been over 1000% of the current account surplus in 1997, capital outflows decreased to 70% in 1999 and further to 49% in 2001. Similarly, capital outflows have decreased significantly as a percentage of GDP, and the graph below captures the evolution over the period between the first quarter of 1999 and the second quarter of 2002, seasonally adjusted (capital outflows as a percentage of GDP tends to exhibit a seasonality whereby it is higher end-year and lower mid-year)[2].

Figure 1. Russia: Capital Outflows 1996-2002



Source: CBR, Citigroup.

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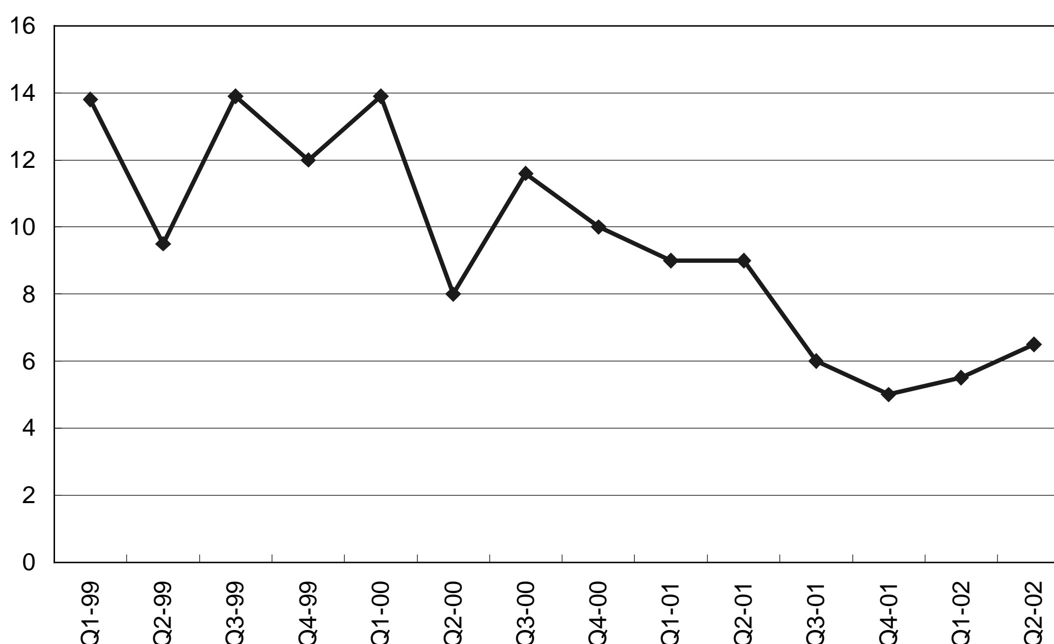
[1] There are many ways to approximate what is "capital outflows" or "capital flight". We use a balance of payments-based proxy, combining a number of items in the capital account, a method with now years of comparative track record in Russia. In general, all the various measures we have seen will produce similar conclusions.

[2] This data series looks at the increase in foreign assets of the banking sector, the corporate, non-financial, sector, and households. For this approach, see the ongoing work of the EEG-the Ministry of Finance (e.g. *Obzor*, EEG-Ministerstvo Finansov, October 10, 2002).

Figure 2. Russia: Capital Outflows (% of GDP, seasonally adjusted)



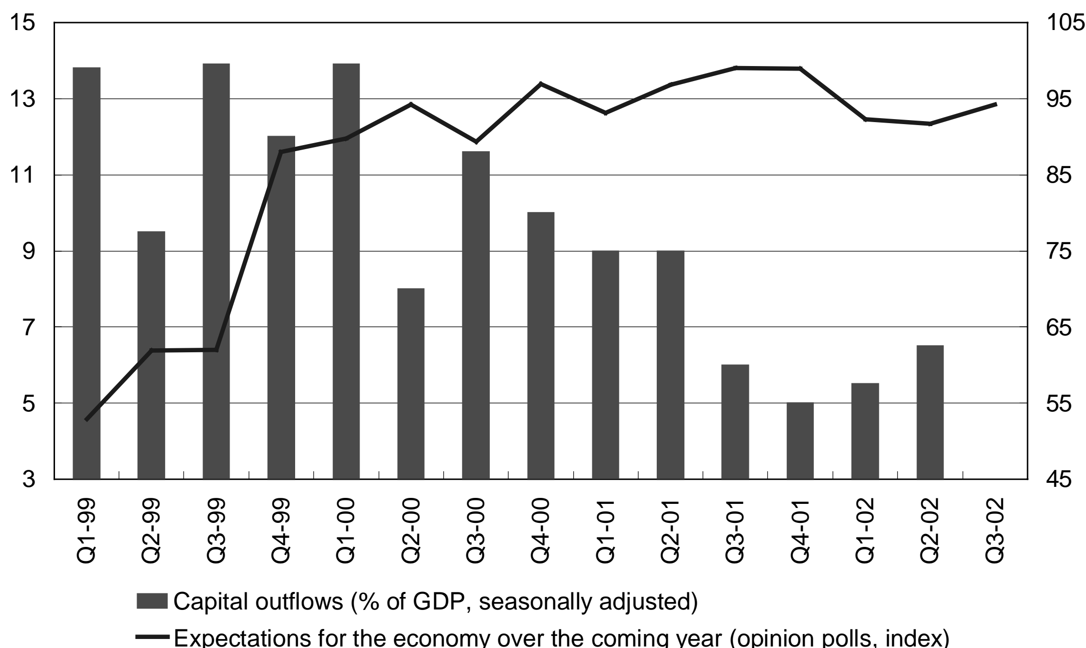
Source: EEG-the Ministry of Finance, Citigroup.

Contrary to popularly held beliefs, there is no obvious systematic connection between oil prices and capital flight/outflows *per se*[3]. One popular belief is that as soon as oil prices go down, capital outflows will go up, or as it is alternatively sometimes expressed, it is only because of high oil prices that the Russian Central Bank has been able to rebuild reserves. However, these views are not supported by actual developments. In 1996 and 1997, the export price in Russian oil contracts was notably *higher* than in 1999, but capital flight was much, much higher in 1996-97 than in 1999. In 2000, the oil price was much *higher* than in 1999, but capital outflows *declined* further nevertheless. In 2002 (the first three quarters), the oil prices is on average *lower* than in 2001, but capital flight has continued to moderate, both in absolute and relative terms.

A detailed analysis of the political and economic fundamentals throughout this period would suggest that the key determinant behind capital flight trends is the state of Russian corporate and household confidence in the path of the economy and economic policies, expectations about political stability and the extent of corporate restructuring. The graph below combines an index of domestic confidence (the sub-index "Expectations For The Economy Over The Coming Year") with the capital outflow development over the 1999-2002 period, which illustrates rather strikingly this point. Basically, Russia's experience is that a lower oil price, in the context of a continued pursuit of structural reforms and continued strong or at least improving corporate and household expectations about the path of Russia, can well be accompanied by a similar or higher annual CBR reserve increase, due to lower capital outflows (e.g. higher export revenue repatriation) than a case with high oil prices but shakier confidence.

[3] According to First Deputy Central Bank Governor Vyugin, this is also the conclusion of the Central Bank's analyses.

Figure 3. Russia: Capital Outflows And Domestic Confidence



Source: EEG-the Ministry of Finance, Tsentr Razvitia, Citigroup.

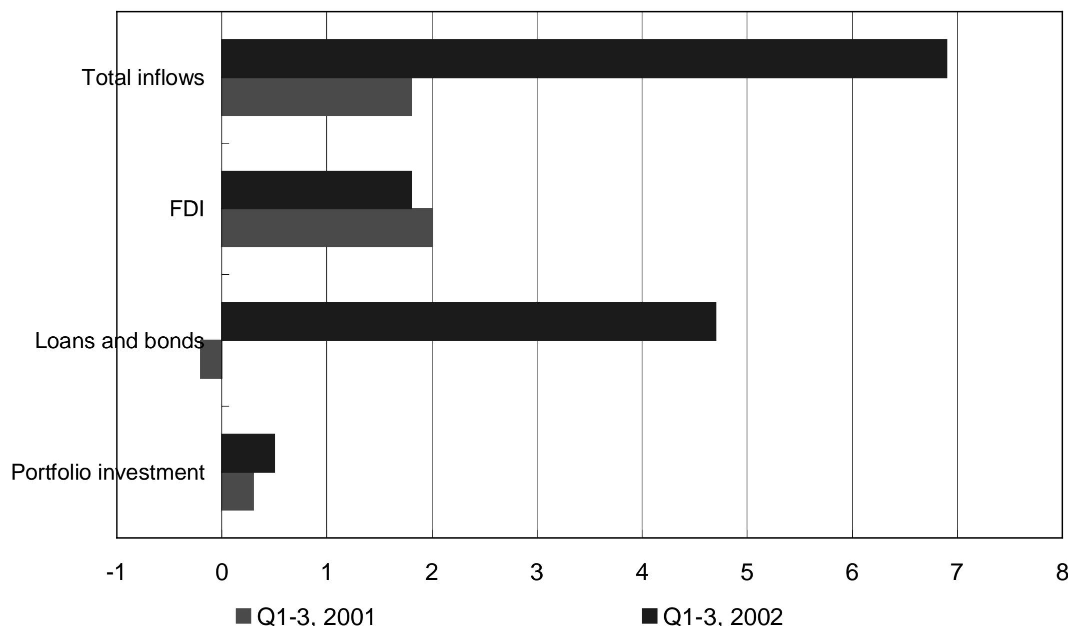
2. The recent capital flow trends: continued decline of outflows, jump in corporate sector loans and bonds

With capital flight/outflows having decreased very significantly over the 1999-2001 period compared to the 1996-1998 period, the Central Bank's *preliminary* 2002 third quarter balance of payments data shows that both relative and absolute capital flight continues to moderate. Per our capital flight proxy, capital flight fell to some 47% of the current account surplus in the first three quarters of this year, from 70% in 1999. In absolute terms, capital flight is about USD 1 bn *less* per quarter in 2002 compared to 2001 and about USD 1.4 bn *less* compared to 2000 (and about USD 3 bn less per quarter compared to pre-1998). As noted above, this decrease can also be seen in figures relative to GDP, where capital outflows were about 9% of GDP in the first half of 2001, declining to about 6% of (preliminary) GDP in the first half of 2002[4].

In terms of inflows to the corporate sector, the graph below summarizes the main categories for the first three quarters of this year compared to the same period 2001. It shows that total such inflows jumped significantly to nearly USD 7 bn in the first nine months of 2002, up from below USD 2 bn in the corresponding period last year. The decomposition indicates the main reason for this is a large increase in international bonds and loans, showing an increase of USD 4.7 bn compared to a decrease of USD 200 mn same period last year. This development reflects mainly the return to international financial markets for Russian private sector entities, from last winter. Portfolio, equity inflows increased somewhat over the 2001 period, up USD 500 mn during January-September 2002 compared to USD 300 mn the same period last year.

[4] A very recent development is that in the third quarter of 2002 there are some indications that foreign investments of the Russian private sector increased somewhat, compared to the previous two quarters. This development could be in connection with some expansion/take-over of companies abroad by Russian entities. See also Tsentr Razvitia, *Plyatezhny balans v III kvartale*, October 14, 2002, mimeo.

Figure 4. Russia: Corporate Sector Inflows (Q1-3 2002 and Q1-3 2001, USD bn)



Source: CBR, Citigroup.

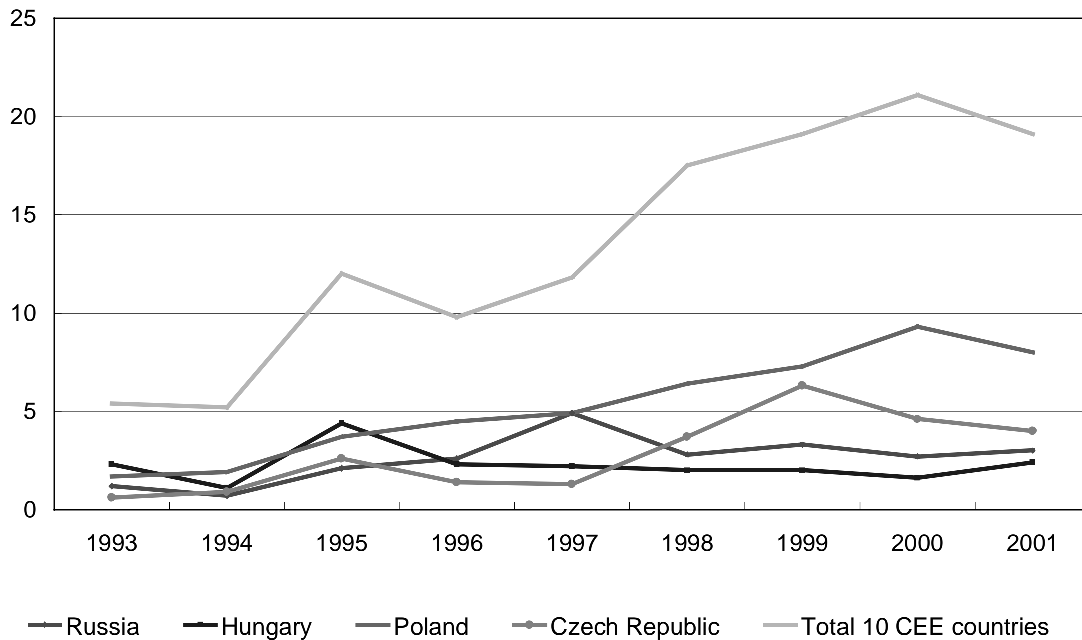
3. Russia's disappointing FDI inflows

However, continuing a disappointing trend, foreign direct investments even decreased slightly, to be a mere USD 1.8 bn in the first nine months of 2002[5]. In the 1999-2002 period, the share of FDI in the total international inflows has now decreased from some 45%in 1999 to 27.9% in 2001 and yet further down to 26% in Q1-3 2002. At one level, Russia's relatively small FDI inflows have been a disappointment for a number of years. The graphs below outline both the annual FDI inflows to Russia and to countries in Central and Eastern Europe over the last decade, as well as outline a set of comparative FDI indicators (the state of play as of the beginning of 2002). Russia's accumulated stock of FDI was the equivalent of just over 7% of GDP, compared to 22-46% of GDP for countries in Central Europe, but also lower than that for countries in Southeastern Europe and the Balkans, e.g. Macedonia (29% of GDP) and Romania (19% of GDP). At the same time, while there is no argument that FDI inflows to Russia have been small, there is also the perspective that the quite phenomenal experience with FDI inflows in Central Europe is rather exceptional for the region, and has had a lot to do with the prospect of being "first-wave" candidates for EU membership and integration[6].

[5] Russia's FDI inflow remains fairly regionally concentrated, with 44% of the first-half 2002 FDI inflow going to the City of Moscow area. After that, nearly 9% went to Omsk oblast, nearly 8% to Sverdlovsk oblast and 6% to St.Petersburg.

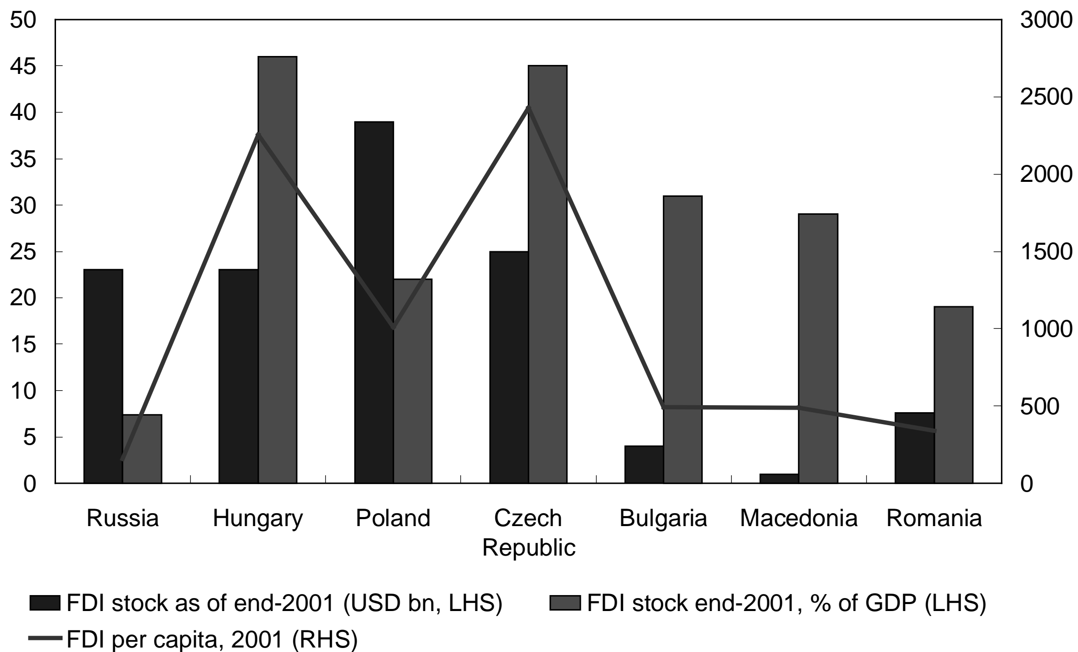
[6] The leading research institute tracking and analysing FDI trends in transition economies is the Vienna Institute for International Economic Studies. For recent analyses, see the excellent, G. Hunya, *Recent Impacts of Foreign Direct Investment on Growth and Restructuring in Central European Transition Countries*, Research Report No.284, May 2002, and P. Havlik et al, *Competitiveness of Industry in CEE Candidate Countries*, Final Report, July 2001. While Central Europe's experience with FDI has been phenomenal, it is still the case that also the Russian economy would structurally stand to benefit very substantially from a serious increase in FDI involvement. This is especially emphasized by the studies identifying notable positive productivity spillover effects from FDIs to domestic firms. For a very recent study into this point, see B.K Smarzynska, *Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages*, World Bank Policy Research Working Paper, October 2002.

Figure 5. Russia: FDI Inflows, 1993 – 2001 (USD bn)



Source: WIIW, Citigroup.

Figure 6. Russia: FDI Indicators, Russia-Eastern Europe



Source: WIIW, Citigroup.

In terms of official expectations, the Ministry for Economic Development and Trade, as part of the government's 2003-2005 macroeconomic projections and scenario analysis, has outlined two FDI paths, depending on underlying global economic scenario[7]. In a realistic-conservative scenario for the global economy, it is expected that FDI will be some

[7] See *Prognoz sotsialno-ekonomicheskovo razvitiya Rossiiskoi Federatsii na 2003 god i osnovnye parametry prognoza do 2005 goda*, the Ministry for Economic Development and Trade/the Russian government, mimeo.

USD 6 bn in 2003, USD 7.1 bn in 2004 and USD 7.8 bn in 2005. In a more positive scenario, it is expected FDI inflows will total USD 6.5 bn in 2003, USD 7.8 bn in 2004, and USD 8.5 bn in 2005. The increase in FDI inflows is expected as a result of an improved investment climate, further implementation of structural reforms such as legal reforms, corporate governance reforms, land reforms, and de-bureaucratization reforms. While these expectations, at least for 2003, while not actually large in relative terms, may look like quite optimistic given that the recorded (WIIW data) "all time high" was in 1997 with nearly USD 5 bn, the overall path envisaged is *not* that unlikely – given that the reform pursuit continues.

4. Decreasing capital flight, still disappointing FDI – what is going on?

The point here would be that there might be more things going on than first meets the eye, at least if one is allowed to combine a number of processes in evidence of the last years. Together, this might suggest that while still low, FDI inflows could indeed start to pick up in a few years' time and that the current phase could be a "preparatory phase". Above developments (a jump in corporate sector inflows, but still low FDI) are accompanied by a preserved trend of decreasing capital outflows and continued (anecdotal) signs of a gradual return of some previous capital outflows[8] – as well as signs of business-motivated, foreign acquisitions by Russian companies. Furthermore, there are signs of a gradual increase in the importance of firms with foreign participation. Over the last year, almost unnoticed by the general discussion, statistics show that companies with foreign participation has increased their share of Russia's GDP and employment. According to Goskomstat, in the first half of 2002, companies with foreign participation accounted for 27% of GDP, up from 23.6% in the same period last year. These companies employ some 1.87 mn people, up from 1.44 mn in the same period 2001. Anecdotal indicators would suggest that much of this increase in foreign participation could well be in reality Russian capital, returning to the Russian economy in one way or other.

The common denominator behind all of these developments could be the process whereby the Russian corporate sector over the last 3 years has started to restructure and consolidate in various ways, and the process whereby Russian capital has started to expand into various domestic sectors: e.g. food industry, automotive sector, machine building, and transport. The capital flow trends mentioned above have partly financed this development, made possible by increasing corporate confidence in the direction of the Russian economy, economic policy and institutional changes.

At the same time, indications are that the interest and the fact-finding missions on behalf of large foreign direct investors are growing. **Encouraged by the track record under President Putin, it is not unlikely that this interest will eventually result in a gradual increase of serious FDI, particularly after the next presidential elections in March 2004**. It would in this context not be amiss to argue that while Russian capital would have been best placed to move in first to take advantage of gradually changing institutions and an improving investment climate in the real economy (this would be the current phase), if this track record is extended, one would expect the level of confidence also among the foreign investor community to rise and eventually, in the scenario where reforms continue, one would expect FDI to start rising to take advantage of the objective opportunities which exists (highly educated labour force, cheap labour costs, large domestic market but also over time manufactured exporting potential – all in the context of continued implementation of institutional, structural reforms and further international integration, e.g. WTO membership).

This, perhaps one could call it a "second phase" is also something which is expected to some extent in the existing Russian corporate community. Many leading Russian

[8] There have been increasing signs of a return of previous Russian capital outflows/moderating capital outflows, to be invested in mainly domestic Russian sectors. As indications of this encouraging capital flow trend, one can point to the expansion into the Russian food industry by Interros, as well as by some oil companies, including an interest in Russian retail networks, and also the expansion into the Russian automotive industry pursued by large Russian metals companies. Another indication would be the strong position of "Cyprus" among the top foreign investors in Russia.

corporate executives have in public over the last year or so outlined expectations for more serious strategic FDI investments, or large multinationals buying into Russian companies, to take off within 3-5 years, when a domestic restructuring and consolidation cycle is expected to have been worked through.

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