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The Offshore Nexus, Sanctions and the Russian Crisis

by Anastasia Nesvetailova

ABSTRACT

This paper analyses the 2014-16 crisis in Russia in the context of the country's mode of global economic integration that has evolved over the past 15 years. Russia's model of political-economy has evolved around three main channels of global economic integration: (1) export of natural resources and a national system of redistribution of export revenues; (2) financialisation, acting as a boost for domestic consumption/demand; and (3) the offshore integration of Russian capital into global capital markets. The current crisis is affecting all three channels of Russia's global political economy. Together, reduced export revenues, the deepening financial crisis and the dominance of offshore-sourced investments into Russia, serve as crisis transmission mechanisms, and thus constitute three sets of (interrelated) dilemmas for the Russian authorities. The paper ponders four scenarios of possible development of the current situation.

Russia | Economy | Foreign trade | Foreign direct investments (FDI) | Sanctions

keywords

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Introduction: A common view of the Russian crisis

The widely accepted diagnosis of the current crisis in Russia and the region tends to proceed along the following lines. Pumped by a rainfall of oil and gas revenues over the past 15 years, Putin and his regime have expanded Russia's global ambitions. Unsatisfied with the post-1991 balance of power in the world and, specifically, with American unilateralism, the Kremlin has been plotting a Russian version of the world order, centred on multilateralism as understood from a Russian perspective.[1] Economic growth during 2000-13, averaging 6.3 percent per year, helped sustain the efforts and appearance of a resurgent Russia on the global stage, as evidenced by the country's presence in global forums such as G8, G20, BRICs etc.

The major aim of Russia's ambition to establish a new world order is to counteract US hegemony and unilateralism by reasserting its influence over world affairs and geopolitics, in particular, by building a Eurasian Union ("from Lisbon to Vladivostok"), the idea first mentioned by Putin in Munich in 2007. The Eurasian Economic Union (EEU), officially undersigned in January 2015 by Russia, Belarus, Kazakhstan, Armenia and Kyrgyzstan has so far proved to be economically insignificant (together, the four members account for 3.7 percent of the world's GDP, with Russia being the largest economic partner) and politically destabilising (Ukraine's hesitancy to join the Union triggered a war in the region in the summer of 2014, which in turn, is causing further political tension between Eurasian member states). Russia's aggression towards Ukraine in 2014 has been penalised by external economic pressures from the West. These pressures include financial and diplomatic sanctions and, more critically for Russia, low oil prices in the world

[1] Ray Silvius, "The Russian State, Eurasianism, and Civilisations in the Contemporary Global Political Economy", in *Journal of Global Faultlines*, Vol. 2, No. 1 (April 2014), p. 44-69, http://www.keele.ac.uk/journal-globalfaultlines/issues/volume2number1.

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markets.

The rationale behind the choice of economic instruments to pressure the Kremlin is based on a straightforward assumption. The Russian economy, critically dependent on oil and gas revenues, is unable to withstand the economic pressure. The internal economic crisis in turn, caused mainly by low oil revenues but worsened by the financial sanctions, is calculated to generate two effects. First, it will prove too costly for the Kremlin to continue the military involvement in Ukraine; second, falling incomes and rising inflation will also weaken the popular support for Putin and his rule and may bring about a change of policy (or leadership) in Moscow.

How likely is such a scenario? At first glance, the chosen economic and diplomatic instruments for exerting pressure on Moscow, having coincided with low oil prices, seem to be producing the desired effect. Since April 2014, the rouble has lost nearly half its value; net capital flight out of the country has doubled, reaching 151-160 billion dollars in 2014; economic growth has slowed down to 0.6 percent in late 2014, the lowest since the crisis of 2009. In 2015, Russia officially entered a recession. According to Capital Economics, between April and June 2015, Russia's GDP contracted by some 5 percent (and by 2.2 percent in January-March 2015).

Yet a close look at the structure of Russia's political economy reveals that the link between the unfavourable external economic environment and domestic political changes is not linear. The real sources of structural weakness and policy dilemmas facing Russia today lie not only in the hydrocarbon markets, but in Russia's complex financialised economy, which has become internationalised over the past 25 years.

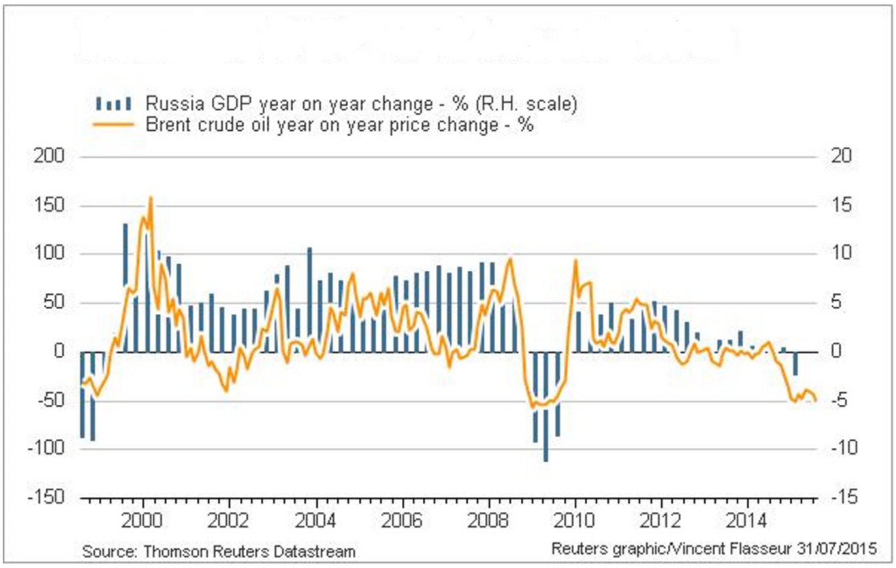
In what follows, I look more closely at the political economy of the ongoing Russian crisis. I identify three main channels behind the economic success of Putin's Russia which now, during an economic downturn, work as crisis transmission mechanisms. Since 2014, the Russian authorities have been addressing all three channels of crisis transmission, yet the chosen approach is proving too costly for the state and ineffective as a policy solution, given Russia's mode of financial integration into the global economy. While this does create further political and economic risks, they are not likely to bring about a dramatic political change in Moscow. The paper explains why by charting four scenarios of possible development of the current situation.

1. Russia's political economy: the "petro-state" and the secondary economy

It has become a convention to ascribe all problems in the Russian economy and its version of capitalism to the country's dependence on oil exports. Oil, gas and other natural resources make up 70-75 percent of Russian exports. The economic recovery and growth associated with Putin's terms in power (2000-08; 2012-) have been financed by oil and gas revenues (in 1999, when Putin first come to power, world oil prices fluctuated at about 13 dollars per barrel; in 2012, when he was elected president for the third time, the Russian Urals blend traded at an average of 100-105 dollars per barrel). The correlation between high oil prices, economic growth and global political aspirations of the Putin regime has led many to argue that Russia today is a petro-state,[2] addicted to hydrocarbon profits. The biggest structural weakness of such an economy, it is argued, is its non-diversified economy; while the corollary of the hydrocarbon addiction is rent-seeking and endemic corruption.[3] Over-reliance on oil and gas exports, a form of resource curse, has slowed down Russia's modernisation and, as a result, the country has been left behind as an industrialised economy. The lack of tangible diversification away from extractive industries, in turn, makes the Russian economy particularly fragile and vulnerable to externally-driven crises.

While the dominance of natural resources in Russia's exports and the rainfall of commodity revenues harvested by the state are not in dispute (Figure 1), it is important to acknowledge that commonly used labels such as "petro-state" or the "oil needle" conceal a set of complex economic relationships, institutional linkages and sectors that make up a large, state-centred secondary economy in Russia today.

Figure 1 | Russian GDP and the oil price, 2000-2014



Source: Reuters, *Russian Investment Summit*, http://graphics.thomsonreuters.com/11/09/RussiaSummit.html.

[2] Marshall I. Goldman, Petrostate. Putin, Power, and the New Russia, Oxford, Oxford University Press, 2008; Randall Newnham, "Oil, Carrots, and Sticks: Russia's Energy Resources as a Foreign Policy Tool", in *Journal of Eurasian Studies*, Vol. 2, No. 2 (July 2011), p. 134-143, http://dx.doi.org/10.1016/j.euras.2011.03.004.

[3] Peter Rutland, "Russia as an Energy Superpower", in *New Political Economy*, Vol. 13, No. 2 (June 2008), p. 203-210; Douglas B. Reynolds and Marek Kolodziej, "Institutions and the Supply of Oil: A Case Study of Russia", in *Energy Policy*, Vol. 35, No. 2 (February 2007), p. 939-949.

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During the 15 years of Putin's prosperity, the Russian state has expanded its economic presence significantly. The secondary economy of services, manufacturing and the public sector has evolved on the back of the hydrocarbon boom. To put it in some perspective, in 2005, the Russian budget was balanced at 20 dollars per barrel. In 2013, the budget was balanced at 102 per barrel dollars. Today, the welfare of many people directly depends on the federal budget and regional transfers and subsidies. If in 2004 for instance, 16.4 million of people were employed in the state sector, today 20 million workers (or 28 percent of the total workforce) are employed in the state sector. This number is higher than the number of people who were employed in the government sector of the Soviet Union.[4] Sustaining and funding this secondary economy is the tallest economic challenge facing the Russian authorities amidst the unfolding crisis.

Schematically, the political economy of Putin's Russia can be described as that of "imported" development,[5] embedded in the socio-political contract of authoritarian rule. During the past fifteen years this model has evolved around three main channels of global economic integration:

1. export of natural resources internalised through a national system of redistribution of export revenues;
2. financialisation, acting as a boost for domestic consumption/demand;
3. the offshore mode of integration into global capital markets by (recycled) Russian capital.

In the unfolding crisis all three channels serve as crisis transmission mechanisms, and thus constitute three sets of (interrelated) dilemmas for the Russian authorities. Resolving them in the long-run would require bold political imagination and a re-organisation of the existing model. The measures currently employed by the Russian state in dealing with the crisis, although apparently thorough, are not long-term in orientation.

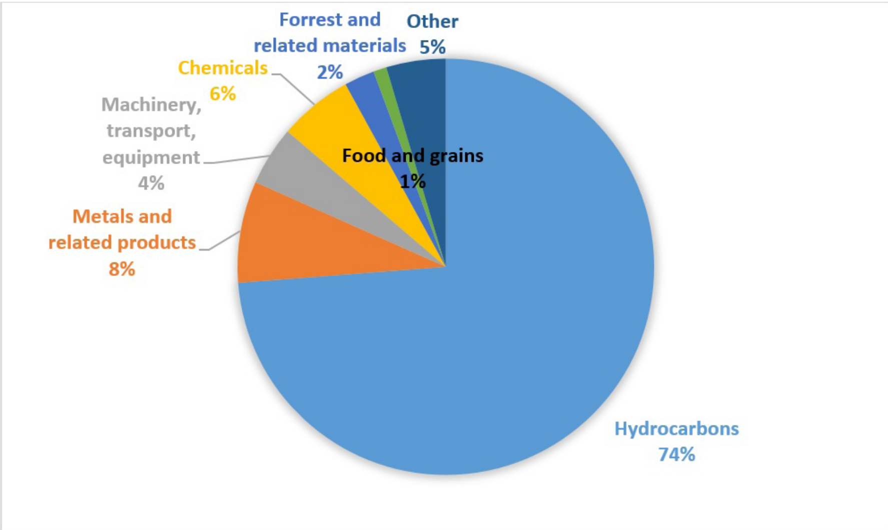
2. Export of natural resources and a national system of redistribution of export revenues

Even though it is affected by a resource curse, Russia is not a classic petro-state: production of oil and gas account for only 9 percent of Russia's GDP. Russia has inherited a relatively developed industrial infrastructure; it has a highly skilled labour force compared to other petro-states, with a high proportion of women; the service sector, including finance, trade, transport and communications, accounted for 45 percent of the country's GDP in 2013.

[4] Petr Aven, "1990s: Back to the USSR?", in *The World Today*, Vol. 71, No. 3 (June 2015), p. 38.

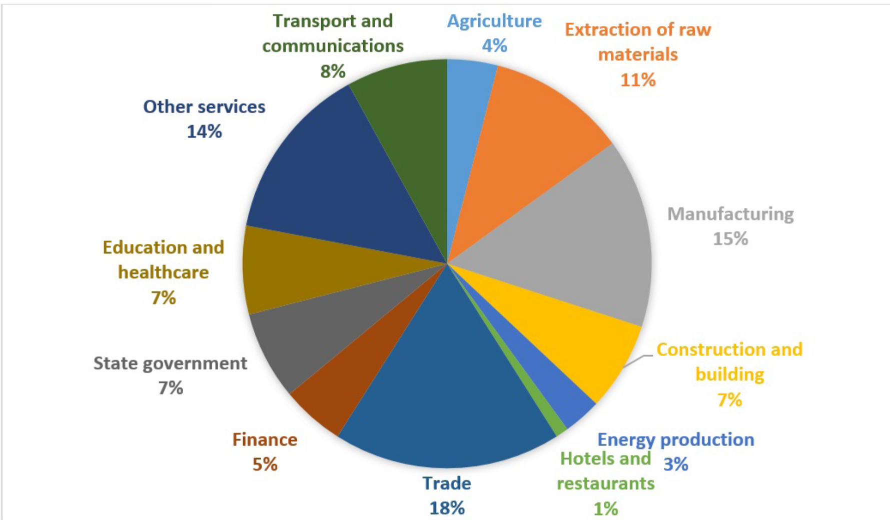
[5] Alexey Kudrin and Evsey Gurvich, "A New Growth Model for the Russian Economy", in *Russian Journal of Economics*, Vol. 1, No. 1 (March 2015), p. 36, http://dx.doi.org/10.1016/j.ruje.2015.05.002.

Figure 2 | Structure of Russia's exports, January-July 2014 (%)



Source: Author's elaboration on Russian Federal State Statistics Service (Rosstat) data.

Figure 3 | Structure of Russia's GDP, by sector, 2013



Source: Author's elaboration on data from Rosstat annual statistics.

The years of the oil and gas harvest (2000-14) have enabled the Russian state to develop a system of redistribution of oil and gas revenues through centralisation of export taxation. This redistribution system ensures that profits from hydrocarbon exports are being partly used to build up counter-cyclical buffers – such as a Federal Reserve (stabilisation) Fund and a National Welfare (future generations) Fund –, but also importantly, to finance those regions and sectors that are not directly involved in oil and gas exploration. Under this redistribution system, 15 percent of current oil and gas revenues go into the Stabilisation Fund, 55 percent into the federal budget, and 30 percent into regional budgets. Overall, duties on oil exports

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make up 16.2 percent of the federal budget revenue; similar taxes on gas exports make up 5.3 percent of the federal budget revenues.[6]

Therefore, hydrocarbons are an indirect source of Russia's growth. As a proportion of Russia's GDP, their share is relatively low, yet by contributing about 50 percent to the state budget, they serve as a critical source of funding for the secondary economy and the non-resource sectors, digested through the system of public finances. Since 2000, an important trend across this secondary economy has been the growing scope of state ownership, the public sector and state bureaucracy. Recent estimates suggest that the share of state ownership in the economy has grown from 38 percent in 2006 to 50 percent of Russia's GDP in 2012, compared to the world average of 30 percent. The crisis of 2008-09 is believed to have escalated the trend. The share of state-controlled companies in Russia has grown, too. For instance, if in 1998-99 the state controlled only 10 percent of the oil sector, today, it controls 40-45 percent. In banking, the share is 49 percent, in transportation, 73 percent.[7]

The large, state-dominated secondary economy, in turn, needs to be financed, staffed and governed. Between 2000 and 2014, its expansion has been funded by hydrocarbon revenues redistributed through the federal budget. The rainfall of "extra" revenue has contributed to the growth of Russia's "consuming classes" and has been a major engine of growing domestic demand. More specifically, the extra revenues from high oil prices allowed the government to raise pensions and other social provisions. Effectively, Kudrin notes, Russia's model of growth is based on translating oil and gas extra revenues (2 trillion dollars in total between 2000 and 2013) into domestic demand. In the context of favourable macroeconomic conditions, this has ensured rapid growth in manufacturing, real wage increases and rising social benefits across all sectors of the economy. Yet, comforted by the benign economic environment, businesses were oriented towards qualitative aims – the expansion of markets and production – rather than improving efficiency through innovation.[8]

One insight into Russia's competitiveness is particularly instructive. Although nominally a country with high R&D potential and a developed infrastructure, throughout the 1990s and 2000s, Russia has been losing its human capital involved in R&D activities. In parallel, during the same period, the number of staff employed in various layers of the state bureaucracy increased by more than 50 percent, and is now twice the size of the labour force employed in the R&D sector (Figure 4).

[6] Galina Kurlyandskaya, "Москва и регионы делят доходы России от нефти и газа" (Moscow and Regions Share Russia's Oil and Gas Revenues", in Федерации (Federations), Vol. 6, No. 1 (February-March 2007), p. 19, http://www.forumfed.org/ru/pubs/V6N1_RU.pdf.

[7] Julia Tsepliaeva and Yury Eltsov, *Russia: The Land of the Bountiful Giants*, BNP Paribas Economic Desknote, 22 October 2012, http://www2.deloitte.com/content/dam/Deloitte/ru/Documents/finance/report_bnp.pdf.

[8] Alexey Kudrin and Evsey Gurvich, "A New Growth Model for the Russian Economy", cit.

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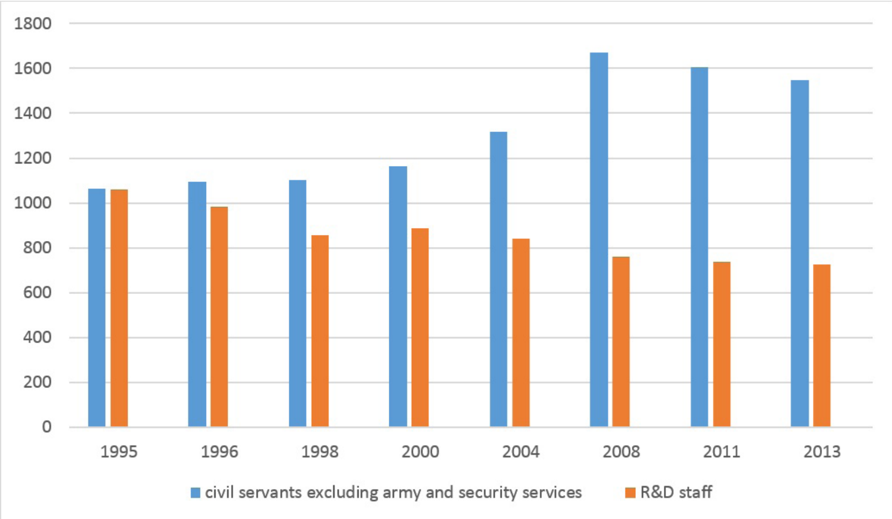
Figure 4 | Expansion of the state bureaucracy in Russia, 1995-2013 (thousands)



Source: Author's elaboration on Rosstat data.

The structure of the Russian economy today is more advanced and complex than it was in, say, 1998.[9] On the one hand, the expansion of the secondary, service centred economy should have made Russia more resilient to crisis today.[10] Yet on the other hand, two factors make the secondary economy fragile and particularly vulnerable to systemic crises: first, its dependence on state transfers for sustaining domestic demand; second, its dependence on imports.

Kudrin and Gurvich note that while Russia's economy did have some tangible non-oil sources of growth until 2012, since then they have been crowded out by oil and gas revenues.[11] The deterioration of R&D potential in Russia's imported growth model has solidified its status as an import-dependent economy. Although the largest country in the world, Russia is a net food importer, with almost 40 percent of its food items coming from abroad (Figure 5). Even in products and brands produced in Russia, components or ingredients tend to be imported from the West. For instance, the share of imported components in canned food produced in Russia (metal packing and labels are imported)[12] is 70 percent, the same as for Russia's clothing and shoe industry; there is practically no textile production to speak of

[9] David Lane, "From Chaotic to State-led Capitalism", in *New Political Economy*, Vol. 13, No. 2 (June 2008), p. 177-184.

[10] Chris Weafer, "The Upsides to Russia's Ruble Collapse", in *The Moscow Times*, 22 December 2014, http://www.themoscowtimes.com/opinion/article/513786.html.

[11] Alexey Kudrin and Evsey Gurvich, "A New Growth Model for the Russian Economy", cit.

[12] Irina Zhavoronkova and Anna Deryabina, "Россияне увеличили потребление консервов на фоне девальвации и санкций (Russians have increased their consumption of canned food on a background of devaluation and sanctions), in *RBC.ru*, 9 February 2015, http://top.rbc.ru/business/09/02/2015/54d4ad3c9a7947e85703f545.

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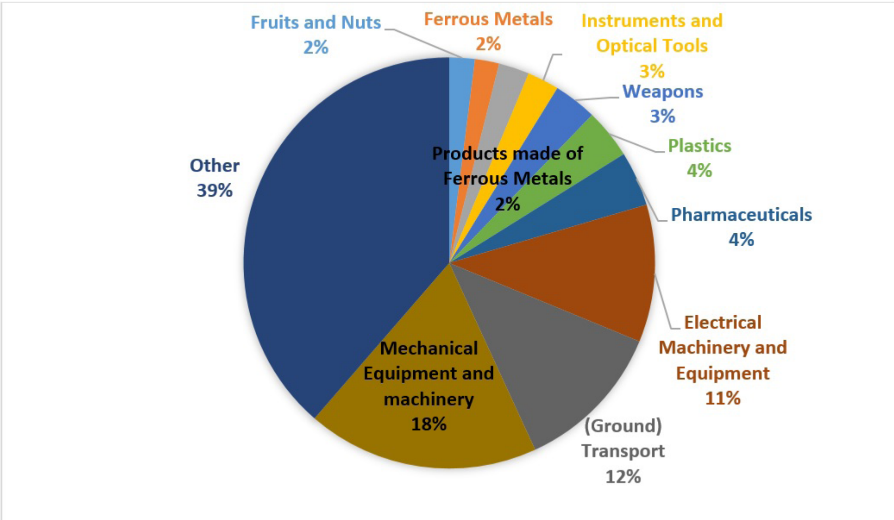
domestically,[13] in some Russian industries, the share of imported components reaches 90 percent.

Figure 5 | Commodity structure of Russia's imports, January-August 2014 (%)



Source: Author's elaboration on Rosstat data.

Domestically, this model of imported development is embedded in an important political mechanism. Namely, a social contract of the political regime personified by Vladimir Putin with the population of Russia. This social contract is based on the implicit understanding that the elites (be they the "original" oligarchs, the new generation of state oligarchs, or "spookocrats"[14] maintain power by enriching themselves and diverting resources in the name of Russia's national interests, while ordinary Russians get wealthier (partly by relying on corrupt mechanisms or informal networks), share the patriotic drive and do not engage in active politics.[15] This social contract is institutionalised around the vast public sector and administrative apparatus which is incentivised to keep the oil and gas profile of exports. Over the last 15 years, the growing state presence has appeared to ensure political stability, while remaining a reliable source of rent extraction and economic prosperity. Although according to many academic studies, the correlation between resource extraction and corruption in Russia is no higher than in other states exporting natural resources, there is a consensus in the literature that the three

[13] Inessa Papernaya, "Нас спасет китайский ширпотреб" (We will save the Chinese consumer goods), in *Lenta.ru*, 19 February 2015, http://lenta.ru/articles/2015/02/19/odejda.

[14] Refers to "spooks" in power. Spook is the informal word for a spy. In Russia the term is used to describe members of the security apparatus – mainly the FSB (formerly KGB), but also the army and other branches of the coercive apparatus – coming to hold key positions of power since 1999. Edward Lucas, *The New Cold War. Putin's Russia and the Threat to the West*, 3rd ed., London, Bloomsbury, 2014.

[15] C.f. Richard Sakwa, *Putin Redux. Power and Contradiction in Contemporary Russia*, London and New York, Routledge, 2014.

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levels of corruption and far-reaching informal power networks in Russia[16] are deeply embedded in the existing model of exports and revenues redistribution.[17]

The crisis of 2014-2015 however, has altered this balance, with some regions already suffering from diminished flow of resources from the federal centre,[18] and some social programmes and financial provisions affected by spending cuts. It is Russia's domestic economy that is hit the hardest by the current crisis; in the absence of a sustainable source of growth in the medium term, the stability of domestic demand and the resilience of the social contract with the regime will critically depend on the mechanism of redistribution of revenues.

3. Borrowed growth: financialisation

Although the 1990s saw the beginnings of financial capitalism in Russia (including the collapse of Ponzi capitalism[19] in 1998,[20] it is during the last 15 years that the deepening of the banking system and credit channels has become a tangible factor in Russia's economic growth. Russia's financial system is bank-based, with four large state banks dominating the credit system, yet the vast majority of commercial banks are private. Russian banks are the main providers of credit to enterprises and households, and in addition to state transfers, became a second important channel of financing domestic demand between 2000 and 2014. In addition to rising incomes generated by the oil revenues, the boom in domestic demand was financed through international channels. The years of macroeconomic and currency stability (mid-2000s) facilitated the expansion of Russian banks internationally: they became global borrowers, actively taking loans from Western banks, enjoying access to international capital markets and even importing some practices of securitisation.

16 Alena V. Ledeneva, *Can Russia Modernise? Sistema, Power Networks and Informal Governance*, Cambridge, Cambridge University Press, 2013; Karen Dawisha, *Putin's Kleptocracy. Who Owns Russia?*, New York, Simon & Schuster, 2014.

17 Morten Anker and Per Sonnerby, "Russian Revenue Management Under Vladimir Putin", in *RUSSCASP Working Papers*, June 2008, http://www.fni.no/russcasp/WP-2008-007_MAN_Russian_revenue_management_under_Vladimir_Putin.pdf; Gavin L. Kretzschmara, Ewan Simpson and Mujibul Haque, "Russia's Resource Capitalism – Market vs Political Signalling", in *Energy Policy*, Vol. 61, No. 1 (October 2013), p. 771-782.

18 While many Russian regions are seeing their funding cut, extra subsidises are directed to Chechnya and newly annexed Crimea.

19 After Carlo Ponzi, the Italian American who fleeced off thousands of Americans in the 1920s financial boom by constructing fraudulent financial pyramids. After Hyman Minsky coined the term Ponzi finance, it is used to describe unsustainable financial structures where old debt can only be paid by new loans. In the 1990s Russian Ponzi financial pyramids were extremely widespread; between 1993 and 1998, the government was running its own pyramid of Treasury bills to cover the fiscal deficit. The pyramid collapsed in 1998 when Russia declared default and entered into a massive financial crisis. Hyman P. Minsky, Can "It" Happen Again? Essays on Instability and Finance, Armonk, M.E. Sharpe, 1982.

20 Anastasia Nesvetailova, *Fragile Finance. Debt, Speculation and Crisis in the Age of Global Credit*, Basingstoke and New York, Palgrave Macmillan, 2007.

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The currency stability and the expansion of the banking sector have enabled the financialisation of Russian domestic consumption and most crucially, of the households. The year 2007 marked a notable point in the financialisation of Russian growth: against the background of low interest rates in the West, international capital flows favoured emerging markets. Russia in particular benefited from this reversal: the endemic capital flight out of the country was replaced by net capital inflow, which peaked in 2007. That year, total investable resources in Russia (including financial resources and export revenues) stood at 100 billion dollars. The inflow of capital, in turn, facilitated a credit boom. Between 2000 and 2008, the real value of loans extended to enterprises and households increased more than tenfold, from 10 to 41 percent of GDP. Some areas of this financialisation trend have grown from scratch. For instance, between 2000 and 2008, loans to households increased 46 times, on average by 53 percent per year.[21]

The stability of the rouble between 2000 and 2014 made loans denominated in non-rouble currencies attractive to Russian borrowers. Until 2008-09, foreign currency loans accounted for about 25 percent of the total Russian loan market. Many households opted for dollar-denominated mortgages which appeared cheaper: in 2006, the share of dollar mortgages was 31.9 percent of the total mortgage market in Russia.[22] In the run up to the 2014 crisis, it was unsecured loans that drove financialisation further. The share of total lending of unsecured loans in 2012-13 stood at 38 percent. Fearing the bust of the consumer credit bubble, the Central Bank of Russia (CBR) began tightening the lending conditions and in 2013-14, the share of unsecured loans had come down to 17 percent.[23]

Thus the structural underpinnings of the current financial crisis in Russia go back to late 2013 – early 2014 (and thus predate the annexation of Crimea and the ensuing sanctions). Although macroeconomic data for the period suggests otherwise, by late 2013, the Russian economy had become quite fragile. The consumer boom financed by unsecured loans created nodes of fragility across the Russian banking system, and in 2013 after the central bank began toughening its regulatory stance, the first wave of the banking crisis was felt.

By early 2014, Russia was already experiencing a banking crisis which was only aggravated by the external pressures in spring 2014. The financial sanctions that followed the annexation of Crimea and the eventual cut-off of Russian banks from international capital markets aggravated the situation further. The collapse of the rouble, the decrease in oil revenues and hence in available budget resources,

[21] Alexey Kudrin and Evsey Gurvich, "A New Growth Model for the Russian Economy", cit., p. 34.

[22] Ekaterina Sakharova, "Как выбраться из валютной кабалы" (How to Get Out of Bondage Currency), in *Gazeta.ru*, 12 November 2014, http://www.gazeta.ru/realty/2014/11/10_a_6297005.shtml.

[23] Anastasia Lichagina, Mikhail Doronkin and Stanislav Volkov, Рынок потребительского кредитования в 1 полугодии 2014 года... (The Market of Consumer Credit in the 1st Half of 2014...), Moscow, Expert RA, 15 September 2014, http://www.raexpert.ru/researches/banks/potrebcred_1h2014.

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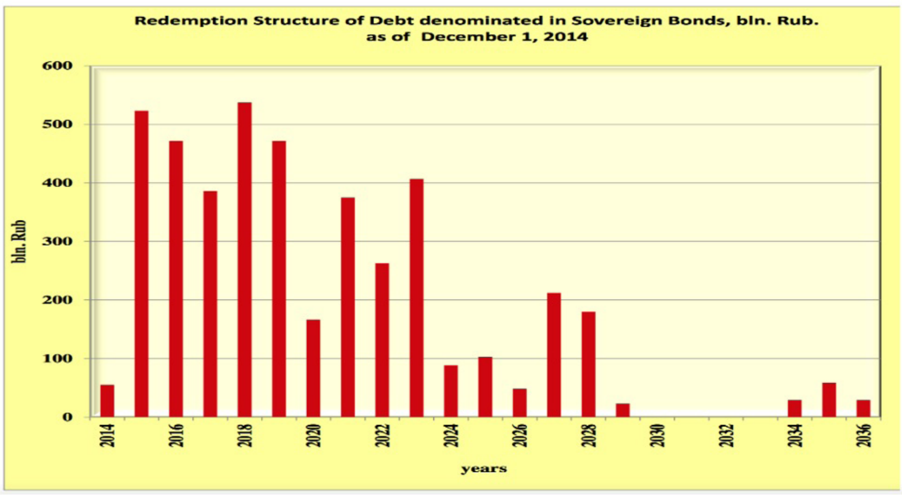
translated into a full-scale banking crisis in late 2014, which continues to the present. The ongoing second wave of the financial crisis is claiming not only small and regional banks, but increasingly, larger banks and corporations. Between 1 March 2014 and today, more than ninety Russian banks were either liquidated or had their licenses revoked by the CBR. Additionally, around ten large banks had to be "additionally capitalised" to avoid bankruptcy. Current estimates by the CBR suggest that in the event of large stress, about 39 banks are likely to face a liquidity crisis, which in the current environment is likely to lead to bankruptcies.

The Russian authorities have deployed the resources of the Federal Reserve (stabilisation) Fund on a range of anti-crisis measures (in February 2015 only, they used RUR 500 billion). Assuming the crisis continues through 2015, and more cash injections are needed, by the end of 2015, the Federal Reserve Fund, currently valued at 5.8 RUR trillion, will be depleted. With no incoming capital, sharply reduced opportunities for borrowing and the peak of debt repayments to international creditors falling between 2015 and 2016, some observers pondered the possibility of default (Figure 6).[24]

Figure 6 | Russia's debt redemption schedule



Source: Russian Ministry of Finance, *Redemption Structure of Debt ... as of December 1, 2014*, http://minfin.ru/common/upload/library/2014/12/main/pogashenie_dolga_v_strukture_na_angl._za_noyabr.pdf.

The key dilemmas for the authorities faced with the crisis therefore, centre on how to sustain domestic demand and mitigate the systemic risk during the crisis period. Any serious plan of restructuring or demand boost requires large-scale investment. Here we come to the third major aspect of the internationalisation of the Russian economy and crisis transmission mechanism, namely, the problem of capital flight, and more specifically, the offshore nexus of Russian capital.

[24] Julia Tsepliaeva and Yury Eltsov, "Russia: The Land of the Bountiful Giants", cit.

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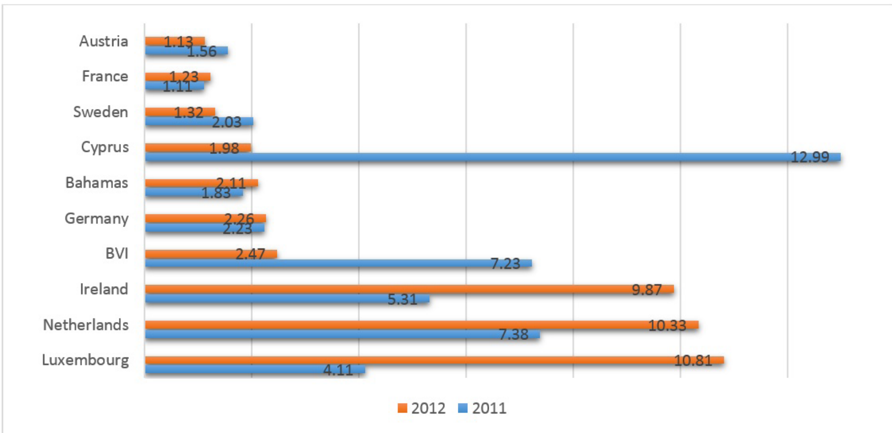
4. Capital flight and the offshore nexus of Russian investments

The international sanctions and capital flight that escalated in 2014 laid bare the reality of Russia's appeal to international investors. Although nominally part of the BRICs and deemed an emerging market with great potential for capital, Russia had never become successful in attracting foreign investment.[25] Although the years 2006-07 saw a net inflow of capital into Russia, disaggregating the data with respect to geographical origins of foreign investors in Russia reveals that the top foreign investors in Russia have consistently been Cyprus, the British Virgin Islands (BVI), Bermuda and the Netherlands.

Figure 7 | FDI flows into Russia by country of origin, 2011-12 (billions of dollars)



Source: Author's elaboration on Central Bank of Russia data.

Table 1 | FDI inward and outward stocks of Russia, 2011 (millions of dollars)

Inward 2011		Outward 2011	
Total	455,904	Total	361,738
Cyprus	128,816	Cyprus	121,596
Netherlands	59,745	Netherlands	57,291
BVI	56,442	BVI	46,137
Bermuda	32,545	Switzerland	12,679
Bahamas	27,089	Luxembourg	11,599
Luxembourg	20,316	UK	10,662
Germany	18,741	USA	9,501
Sweden	16,088	St.Kitts & Nevis	7,035
France	15,420	Jersey	6,692
Ireland	8,893	Germany	5,701

Source: Central Bank of Russia, 2012.

[25] Svetlana Ledyaeva, Päivi Karhunen and John Whalley, "If Foreign Investment is Not Foreign: Round- trip versus Genuine Foreign Investment in Russia", in *CEPII Working Papers*, No. 2013-5 (February 2013), http://www.cepii.fr/CEPII/en/publications/wp/abstract.asp?NoDoc=5149.

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The key destinations for Russian investment abroad in turn, are Cyprus, the Netherlands, the BVI and Luxemburg.

The data suggests that it is the capital of Russian-owned structures, recycled out of Russia through a chain of offshore jurisdictions that has been recycled back into Russia as FDI. According to the most recent investigations, 14 out of 20 privately owned companies on Russia's Forbes list are owned by companies registered in offshore havens. Eight of such firms are from Cyprus, four from the Netherlands, and one each from Switzerland and the BVI. Two typical models are used in constructing offshore chains:

1. A Russian company belongs to a Cyprus "mother." The Cyprus company gives its Russian "daughter" a loan (or a right to use the brand name, licence, etc.). The Russian company sells products in the Russian market and earns revenue. Most of this revenue goes to paying off the Cyrus mother (either as interest on the loan or as a fee for the title/right/royalty). As a result, the net profit of the Russian daughter is minimal, most of the sum goes to Cyprus.
2. A sub-type of the same model is based on exports: a Russian company sells products to a Cyprus firm at a low price. The Cyprus company in turn, sells products to the final consumer at a higher price. In reality, these are only recorded "paper" transactions; the products go directly from Russian producer to final consumer.

As elsewhere in the world, offshore havens also play a central role in real estate operations in Russia. Say a building in Russia belongs to a Russian company, but the Russian company itself belongs to a Cyprus company. What you buy in this case is not the piece of real estate, but the shares of the Cyprus Company. This saves on VAT and defers profits. In light of the anti-offshore law announced by Putin, this scheme is supposed to be banned in Russia by the end of 2015.[26]

While tax avoidance is a common drive for offshore schemes around the world, in Russia, the use of overseas offshore havens has a distinct purpose. Typically, in advanced economies, offshore structures are used to conceal profits flows. In Russia, intricate chains of offshore based entities are constructed with the aim of hiding the ultimate ownership of assets. In Russian offshore "envelopes," Cyprus has historically been a popular node of initial incorporation of the offshore entity, which in turn would have financial and legal links to other financial havens in order to be able to tap into the onshore financial systems of Europe and North America.

To take one example, Yukos, the Russian oil giant owned by Michael Khodorskovky, is in fact a group of companies registered in offshore havens.[27] This is one of

[26] Natalia Telegin, "Бегущие миллиардеры. Почему героям Forbes теперь лучше не жить в России?" (Running Billionaires. Why Forbes Heroes Do Not Live in Russia?), in *Slon*, 19 March 2015, https://slon.ru/posts/49438.

[27] More specifically, Hulley Enterprises Limited ("Hulley" or "Claimant"), a company organised under the laws of Cyprus; Yukos Universal Limited (YUL), a company organised under the laws of the Isle of Man; and Veteran Petroleum Limited (VPL), a company organised under the laws of

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the reasons Yukos was able to bring a case against the Russian Federation in international arbitration courts. Another more recent example is Gunvor, one of the world's largest oil trading firms widely suspected ofto having a close relationship with the Kremlin; since mid-2014, it has been under international sanctions. Officially, Gunvor employs a staff of 3,000 in 20 locations (Figure 8).

Figure 8 | The international structure of Gunvor

Source: Gunvor factsheet, http://gunvorgroup.com/wp-content/uploads/2014/03/GunvorFactSheetforweb3.jpg.

But according to the investigation by Ukrainian journalists, Gunvor is a complicated network of offshore shell companies. It is comprised of at least 27 offshore shells spread across 11 locations, with the majority in Cyprus and the Netherlands. Four anonymous companies are said to be conducting business in the UK, two in BVI.[28] (Figure 9)

Cyprus.

[28] Daryna Kaleniuk and Tata Peklun, "Hitting Putin's Pocket Would Be a Fitting Response to Russia-backed Terrorism", in *Kiyv Post*, 8 August 2014, http://www.kyivpost.com/opinion/op-ed/europes-911-in-search-for-a-proper-response-to-the-russian-terrorism-359761.html.

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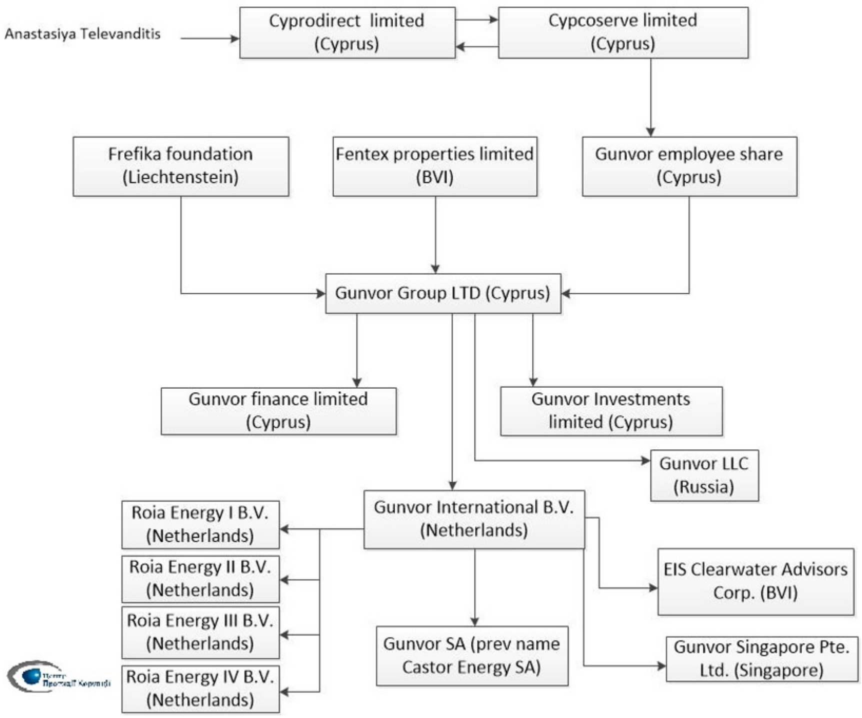
Figure 9 | The offshore nexus of Gunvor



Source: Daryna Kaleniuk and Tata Peklun, "Hitting Putin's Pocket ...", cit.

It is hard to overestimate the role of the offshore havens network, a peculiar remnant of the British Empire,[29] both for the Russian owners of capital, as well as for Western financial centres. Access to offshore ownership envelopes has enabled Russian owners to avoid the post-Crimea sanctions.[30] Offshore havens have also been benefiting the City of London in the current crisis, as money flowing out of Russia is not being recycled back into Russia but is invested in Western financial and property assets. (With the exception of Crimea, which in 2014 saw an upsurge of foreign investments from Cyprus, the BVI and other offshore havens, led by inflows from Guernsey which accounted for 80 percent of all FDI into Crimea in 2014).[31]

[29] Ronen Palan, "International Financial Centers: The British-Empire, City-States and Commercially Oriented Politics", in *Theoretical Inquiries in Law*, Vol. 11, No. 1 (January 2010), p. 149-176, http://www7.tau.ac.il/ojs/index.php/til/article/download/736/695.

[30] "Fancy footwork", in *The Economist*, Vol. 414, No. 8925 (14 February 2015), p. 52-53, http://econ.st/1AeEoop.

[31] "Куда 'осели' $26,2 миллиона иностранных инвестиций предназначенных для экономики Крыма?!" (Where are 'Settled' $26.2 Million of Foreign Investments Intended for the Crimean Economy?!), in *RuInformer.com*, 11 December 2014, http://ruinformer.com/page/kuda-oseli-262-milliona-inostrannyh-investicij-prednaznachennyh-dlja-ekonomiki-kryma.

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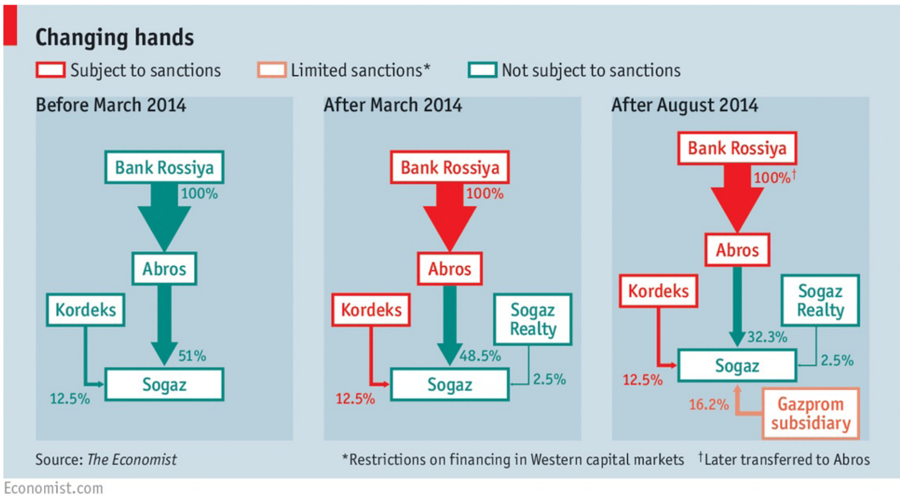
Figure 10 | How sanctioned Russian entities bust the sanctions



Source: "Fancy footwork", in *The Economist*, cit., p. 53.

President Putin has identified the offshorisation of the Russian economy as a problem that needs to be addressed. The new anti-offshore law requires, first, that a Russian business owning 10 percent or more of a foreign company has to declare this ownership to Russian tax authorities. (In December 2014 Putin also offered amnesty on all ownership by civil servants, their relatives and former relatives). Also, if a Russian citizen owns, directly or indirectly, 50 percent or more of a foreign company, he/she will have to pay tax on its profits. It remains debatable as to what extent the new anti-offshore law will be successful, as opportunities to avoid new requirements exist. In the first half of 2015, Russia remained a net exporter of capital, albeit at a lower rate than in late 2014.[32]

Russia's offshore-led mode of financial integration into the global economy brings out two issues. Russia is considered a part of the BRICs, given its impressive growth rates generated by the expanding consumer market in 2000-14. As an investment opportunity, however, Russia has mostly been attracting Russian capital, with few non-Russian investors seizing the opportunities for capital growth (although there were several high-profile deals with foreign MNCs in the 2000s). As Ledyaeva et al. find in their study of investment round-tripping in Russia, round-trip investors tend to favour flows into the service sector, tend to establish manufacturing firms in resource-based industries and support the development of corruption in Russia by investing in corrupt Russian regions.[33] Cumulatively, lack of investment, shrinking internal market potential and an unfavourable external economic environment pose serious political-economic risks.

[32] The CBR estimates that capital flight out of Russia will reach 111 billion dollars in 2015.

[33] Svetlana Ledyaeva, Päivi Karhunen and John Whalley, "If Foreign Investment is Not Foreign: ...", cit., p. 4.

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5. The crisis: policy dilemmas and risks

The main response of the Russian authorities to the current crisis is formulated in the anti-crisis programme signed by Prime Minister Dmitry Medvedev in winter 2015. It includes a detailed set of measures and a division of responsibilities aimed at sustaining domestic demand. This is done mainly by compensating for loss of revenues through investments financed by the sovereign funds (including the National Welfare Fund). The programme also calls for development of efficient mechanisms of import substitution and support to small and medium businesses. The baseline scenario underpinning the plan is based on the calculation that by the end of 2016, oil prices will recover and stabilise at around 70 dollars per barrel, which would spur Russia's economic recovery.

The anti-crisis programme, by definition, is not a development strategy, and it is not surprising that there is little long-term planning in the document. At the same time, the programme drafted by the cabinet is thorough, partly demonstrating that the economic bloc in the government has learned lessons from dealing with earlier crises (1998 and 2008/9). Beyond that however, potential feasibility and effectiveness of measures announced is inevitably undermined by the three structural problems outlined above. They can be briefly summarised as follows.

1. The main instrument for addressing the fiscal and financial crises have been Russia's sovereign wealth funds. These reserves are at risk of being exhausted quite soon, and some painful choices about which industries (firms, banks and social programmes) to favour in rescue measures, will have to be made. These decisions will produce their own winners and losers, and may add to the rifts already present in the ruling elites in Russia.
2. The anti-offshorisation campaign launched by Putin, while apparently aimed at raising state revenues, can also be interpreted as the state's drive to control the key nodes of Russian business. Perhaps because of this, the initiative is not likely to generate tangible extra revenue for the budget (according to some reports, most Russian businessmen plan to become non-residents of Russian for tax purposes in 2015, simply to avoid having to comply with the new law). The idea of an amnesty on state bureaucrats' firms, in turn, has already created problems for the Russian authorities: a sweeping amnesty contradicts the principles of the Financial Action Task Force (FATF) and would put Russia on FATF's black list, isolating it even further from international capital.
3. The deepening financial crisis is likely to claim more casualties among banks and corporations in 2015. Indicatively, in December 2014, the Duma passed a law on personal bankruptcy. With recession already under way, most people will see their real incomes shrink further, especially if the authorities choose to monetise the deficit in order to ease credit conditions.
4. The only element of the Russian political economy that remains relatively resilient in the current situation is the social contract between the population and the ruling elites. President Putin remains highly popular, and while more and more Russians feel the effect of the sanctions and the economic crisis on their personal lives, they are not associating the economic problems with

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the governance system in the country or Russia's foreign policy stance. This stability and the credibility of the regime are a vital resource for the Kremlin, which it carefully nurtures.

The key question for the medium term, therefore, is whether there are enough resources in Russia's sovereign wealth funds to sustain the popularity of the regime, and maintain the social contract while waiting for oil prices to recover.

The pressure on sovereign wealth funds is prompting a search for alternative sources of funding. As shown above, Russia has mostly been attracting Russian investment, and Putin's Russia has few friends with purchasing power. Against this background, there are four possible (and not mutually exclusive) long-term scenarios for development of the current crisis. All of them are speculative, some pose serious risks.

Scenario One (short- to medium-term): oil prices rebound to 70-80 dollars per barrel, and Russia's consumption and growth stabilise at a lower level.

This speculation is consistent with the baseline oil scenario (70 dollars per barrel) of the government anti-crisis programme. While this scenario can potentially ensure the continuity of the political and economic course through the 2016 (parliamentary) and 2018 (presidential) elections, oil revenues alone will be not sufficient (and indeed may prove counter-productive) to the efforts to diversify Russia's economic sectors. Even if oil prices do recover to 70-80 dollars per barrel therefore, unresolved structural issues and finite financial cushions will continue to put economic pressure on Russia's political economy.

Scenario Two (medium- to long-term): the situation in the hydrocarbon markets continues to worsen, Russia is financially rescued by China and becomes a (resource) satellite of China. This merger starts a global realignment of powers and geopolitics.

Some developments indicate that such a re-alignment has already began. It is not unreasonable to think that generally, an interim solution to the unfolding crisis may be found in the privatisation (full-scale or partial) of some of state companies.[34] It may very well be that some foreign buyers broadly, and Chinese firms specifically, would be keen to invest in Russia despite the current economic climate and political risks. In February 2015, Russia's Deputy PM Dvorkovich suggested that Russia's oil reserves might be offered to the Chinese under partnership agreements as 50 or 51 percent stakes. In July 2015, the Russian Ministry of Natural Resources and Environment has proposed a draft law that would allow foreign companies to develop the Russian reserves they discover, a deregulation move that marks a significant change to the restriction for foreign companies access to Russia's natural reserves that were deemed a protected part of the national wealth.

[34] This technique famously created the first generation of oligarchs in 1995-96.

There have also been some serious political moves recently driving Russia's economic orientation closer to China. In late 2014, Russia and China signed a (very unfavourable to Russia) gas deal for transporting Russian gas to China. Its construction began later in 2015. Also in late 2014, Putin signed a Law on the Territories of Advanced Development, mostly concerning Russia's Far East. The law designates several large territories as special economic and governance zones which could be leased on a long-term basis to foreign investors. The document also makes provisions for Russian law (federal and local) to be suspended in the territories leased out to foreign proprietors. The law was signed on the 31st of December 2014, traditionally a busy holiday in Russia, and thus received little public attention. A large-scale loss of territory to China will not be popular with the Russian electorate. Also, a drastic redistribution of resources is likely to upset the current oligarchs and may open up further tensions among the political elites in Moscow.

The crisis has already eroded the personal wealth of Russia's richest men, some of them on the sanctions list. According to Bloomberg, Russia's top 20 billionaires lost a combined 62 billion dollars in 2014, but still control a combined 174 billion.[35] There are speculations about elite in-fighting around the Kremlin and deepening rifts between the more liberal wing of the Russian government[36] and the pro-nationalistic neoconservative *siloviki* clan.[37] Nevertheless, any public response to the economic partnership with China is likely to take some time, while benefits from Chinese contracts can be used to placate the existing owners, at least in the short- to medium-term.

Scenario Three (mid- to long-term): Russia returns to the Western fold and an inevitable modernisation path. Theoretically, this can be the outcome of Putin remaining leader, or of a Kremlin recasting.

Since 2012, Western powers, led by the USA, have been extremely reluctant to work closely with the current regime in the Kremlin. This reluctance may prove to be an unsurmountable hurdle for Russia's liberal economic clan and policy-makers; yet, potentially, in a worsening economic situation, it could become a factor prompting a recasting in the Kremlin in 2018.[38]

[35] Alexander Sazonov, "Russian Rich Lose $10 Billion in Two Days as Ruble Drops", in *Bloomberg Business*, 17 December 2014, http://www.bloomberg.com/news/articles/2014-12-17/russian-rich-lose-10-billion-in-two-days-as-ruble-drops.

[36] The economic bloc associated with Prime Minister Dmitri Medvedev.

[37] Associated with Sergey Ivanov, former Defence Minister and current head of Presidential Administration; Nikolai Patrushev, chair of the Security Council, and other figures from the FSB (former KGB) and security services.

[38] Stanislav Belkovsky's video on *TV Rain*, 8 July 2015, https://youtu.be/LBZM1zB0JoQ.

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Some commentators and scholars[39] suggest that, even though he is the personification of absolute power to many Russians, Putin is, in reality, the arbiter between the different elite factions, and has to make choices between the liberal economic clan, and the more conservative nationalistic security bloc.[40] Many in Russia, including some analysts close to the Kremlin,[41] comment that the real gravity of the current crisis lies in the fact that it is the result of the misguided nationalistic drive that thrived on the back of hydrocarbon prosperity and intensified the country's self-isolation from the West. These critics reiterate that, historically, any progress in Russia, at any point in time, has only been possible due to the adoption and internalisation of Western (European) institutions of modernity, principles of economic organisation, etc. Retreat from modernisation has tended to coincide with regression, wars and crises. Theoretically, therefore, an incremental return to modernity and economic openness is possible even if Putin is re-elected in 2018.

Scenario Four (short-term): The Kremlin attempts to distract attention from the deepening economic crisis by entering into another security conflict, either by further escalating the ongoing war in Ukraine, or by heightening the security situation domestically through pro-Kremlin militia.

In support of this dark scenario, some analysts interpret recent political appointments and legislative changes as groundwork for further political repression.[42] Military expenditure remains ring-fenced in the new, crisis budget for 2015. The 2015 military budget is at a record high, at 4.2 percent of GDP, compared to some 2-2.5 percent of GDP in the 1990s.[43] There have been many visible anti-NATO gestures, such as large-scale war games launched by the Russian Army and Navy in the northwest and west of the country, as well as the new Russian naval doctrine articulated by Putin in July 2015. A pro-Kremlin militia has been supported by the regime, and part of it has been institutionalised as an Anti-Maidan movement. To what extent these are controllable developments, and to what extent they represent the real attitude of Russia's military establishment[44] are questions that are increasingly difficult to answer. Any balance between economic reform and military escalation depends on the constellation of forces around the Kremlin, and the mechanisms of mitigation of the economic pressures analysed above.

[39] Richard Sakwa, *Putin Redux*, cit.

[40] The murder of Boris Nemtsov, a fierce critic of Putin, in late February 2015, is widely interpreted as an outcome of a long rivalry between the FSB elite and the leadership of Chechnya. The disappearance of Vladimir Putin from the public eye in March 2015 triggered rumours about a possible coup d'état in Moscow and its potential outcomes. After initial patriotic euphoria about the "re-unification" with Crimea, Russians seem to be growing more critical of the war with Ukraine. Notwithstanding this however, President Putin remains hugely popular.

[41] E.g., Alexey Kudrin and Evsey Gurvich, "A New Growth Model for the Russian Economy", cit.

[42] E.g., Karen Dawisha, *Putin's Kleptocracy*, cit.

[43] Petr Aven, "СССР был опасной страной в отличие от России сегодня" (The USSR Was a Dangerous Country, Unlike Russia Today), in *Slon*, 4 July 2015, https://slon.ru/posts/53631.

[44] So far, no army generals have publicly threatened to deploy Russia's nuclear arsenal, while some Russian diplomats and Putin himself have.

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Table 2 | Evolution of the crisis: four scenarios

Scenarios	Conditions	Outcome	Political Course
1. Short-term	Oil prices rebound to 70-80 dollars per barrel	Economic stabilisation at a lower aggregate level; economic pressures remain	Political course unchanged through 2016 and 2018
2. Mid-to long-term	Oil prices deteriorate. Infusion of Chinese capital and presence in Russia	Some tensions in the Russian elites; global geopolitical re-alignment	Political course unchanged through 2016 and 2018
3. Mid- to long-term	A change in the economic wing of Russia's government, possibly under a new Prime Minister	Re-opening to the West; modernisation	Change of Prime Minister and/or government in 2016 or 2018
4. Short-term	Escalation of security situation in or near Russia	Diversion of attention from the economic crisis	Political course unchanged

Looking forward to 2015-16, it is becoming clear that, unlike the previous 2008-09 crisis, the ongoing crisis will not be a V-shaped but will instead, evolve as a protracted recession. During such a recession, the things to watch out for include banking and corporate failures; shifts within and around Kremlin circles and the security forces; privatisation, including partial privatisation, of some state companies and banks. At the same time, despite the tangible nodes of economic and financial fragility, there is no linear link between the unfolding economic crisis and political change in Russia. Most short- to mid-term scenarios outlined above do not assume a need for drastic change in Moscow's political course.

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