Capital Flight: Does the Balance of Payments Capture the Flying Capital?

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Capital movements: legal and illegal channels

From the experience of different countries, capital outflows occur in 2 ways: through legal and illegal channels. In capitalized developed economies, which normally live in a certain saturation phase of investment, with funds available in huge amounts, capital outflows more through legal channels. The domestic demand of the countries for capital is fully fulfilled both by internal savings and external capital. Therefore, surplus funds look for favorable markets for earnings. At the same time, the high value-generating economy creates huge gains (savings) in the form of wages, property income and retained earnings for households and businesses at the final stage of the distribution process of national income. Those freely available funds leave the country either in the form of portfolio investments (mostly, various securities) or direct investment. These are those countries where capital accumulation is more official, with minor corruption and “shadow economy”.

In the Third World and transition countries, despite the fact that the national economy is in dire need for investments, and low levels of national savings, the capital does not stay in the country due to the lack of security for property immunity, economic and political stability, and in many cases, the capital flees from the country through illegal mechanisms or channels – to a more secure jurisdiction and geography. Since the scale of “black economy” is so great in these countries, the capital accumulation happens largely through unlawful ways (for example, tax evasion of businesses, earnings of officials via corruption). As a result, such capital can not be legalized through the banking sector without specifying its source. This is especially the case after international money laundering mechanisms have been tightened, preventing the banking sector from having such transactions, and the capital owners are forced to take out their wealth through illegitimate channels and mechanisms.

One of the main reasons why developing countries are chronically experiencing capital deficit and depend on foreign capital and international financial institutions is that capital flows out of the country through illegal channels. this problem is no longer of a lmited national character, but rather poses a threat danger to the global economy through money laundering. Generally speaking, it is often difficult to determine the real scale of capital outflows which do not happen via the banking sector. Capital outflows from the country are often carried out illegally in the form of cash without registration in the customs checkpoints at borders. After the departure from the borders, it is enough for these funds to reach to a third country which does not restrict the arrival of capital so that it gets legitimized through the banking sector and easily go to the offshore areas, which do not question the origin of the wealth. In short, determining the scale of capital fleeing from a country through illegal channels in the form of cash is a difficult problem for any national statistics to address.

Finally, capital outflows do not have serious consequences for those developed countries where there are democratic political and sustainable market economy systems, and opportunities to earn capital in honest and transparent ways. For example, in Japan, the volume of capital outflows in recent years has been 10-12 times more than the capital inflows, and no competent think-tank in the country has raised capital flows as a catastrophic issue for the economy for the reasons mentioned above: the high level of national savings (both households' and businesses', as well as total government savings) and no restriction imposed on the capital inflows meet the investment needs of the national economy.

In all cases, it is extremely important that capital flows through legal channels. It is not difficult to follow the movement of capital when there is transparent banking sector and border customs system and fine balance of payments statistics are calculated on their data. However, a completely different situation emerges in the absence of such a system. Do the balance of payments statistics provide at least some “clues” for analysis under the conditions of widespread illicit capital flows? Below is an attempt to explain this issue.

Balance Sheet Statistics: How to Identify “Capital flight”?

If political institutions are interested in solving the problem, the balance of payments statistics may provide certain information on the scale of capital flight. It is true that this is rather an indirect way and may help only to get a certain idea of the capital flight. In the international practice, when the possible scale of “capital flight” is studied through balance of payments statistics, the figures of three concepts are reviewed:

(i) *Doubtful operations*;

(ii) Net errors and omissions;

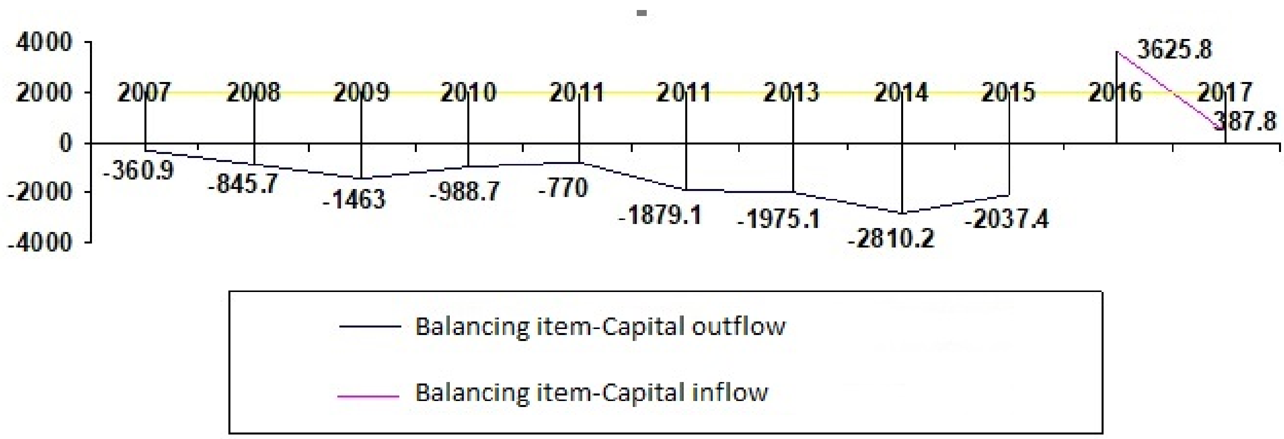
(iii) Trade credits and advances.

These concepts are either completely missing or defined in different ways in the statistical reports on the balance of payments of Azerbaijan, as well as, in the official instructions and regulations for the preparation of these reports. For example, the concept of “doubtful operations” does not exist at all. It should be noted that “doubtful operations” in the Russian Central Bank’s Balance Sheet compilation statement are those that involve the fleeing of capital from the country and define in the following way: “fraudulent transactions that include the non-transfer of the export revenues to the corresponding bank account for exported goods and services during the period stipulated in the contract, non-shipment of the paid goods and services to the importer during the period stipulated in the contract, as well as other transactions related with loans, securities, and money transfers abroad.” For example, according to the Central Bank of Russia, the volume of capital outflow from the country in 2015-2016 through operations classified as “doubtful operations” was around 1.5-2 billion USD annually, whereas this figure for 2012-2014 years varied between 8.6-38 billion dollars. The rigid regulations and tightening of capital flows led to a tenfold reduction of doubtful operations.

The definition of “net errors and omissions” is also reflected in the “International Monetary Fund’s Guidelines on Balance of Payments and International Currency Position”, which was revised in 2009. The Central Bank of Azerbaijan uses the term called “balancing item” instead of this term. The concept of “net errors and omissions” covers the gap between debit and credit items in the balance of payments. Theoretically speaking, the two sides of the balance of payments (financial flows that reflect capital inflows and outflows) must be equal. However, in in practice, this does not happen for a number of reasons, including the time difference between the time of shipment and delivery of goods (services), exchange rate differences caused by conversion of the national currency to convertible currency in the process of mutual payment between the countries sending and receiving goods and services, and the entry and exit of funds with no specified origin through illegal channels. As a result, such a balance is created through the “net errors and omissions” as proposed in the IMF methodology. However, the Central Bank should regularly attempt to provide a reasonable explanation for such difference in its balance sheet reports and indicate which part of that amount is attributed to the difference between the exchange rates, the time differences and the illegal capital flows with no specified origin.

The analysis of Azerbaijan's balance of payments for the last 10 years shows that the volume of capital outflow under the name of "balancing item" for 2007-2015 years was quite large.

Capital inflows and outflows under the name of "balancing item", in million dollars



As you can see from the chart, the negative difference of "balancing item" in 2011-2014 sharply increased, varying between 1.9-2.8 billion dollars. However, after 2015 when the national currency lost value sharply, the dynamic reversed completely, with the capital flowing to the country under the "balancing item" in the amount of more than $ 3.6 billion in 2016 and $390 million in 2017. Undoubtedly, on the one hand, the maximum tightening of capital outflows as a result of sharp devaluation prevented the outflow of capital from the country, while on the other hand, the sharp increase in demand for foreign currency resulted in the bringing of some oligarchy-related capital from some foreign sources to the country through various channels. As a result, we have such a picture with the payment statistics.

Are all of the funds that come in and out of the country within the "Balancing item" a result of illegal activities? Of course, not. According to the Methodology of calculating the balance of payments, the difference in the time of making payments for imported and exported goods and services, as well as, the difference in the exchange rates in the foreign economic relationships, also lead to the formation of “balancing item”. However, such differences do not exceed 10-15% of the total turnover in international practice. On the other hand, if cash funds, which are unreported, enter and leave the country, it results in the formation of “balancing item”. if the illegal turnover of tourism enterprises or public-catering enterprises are large, and they do not register the payments of foreign tourists but convert their cash flows into the national currency through the banking sector, the resulting surplus of currency is reflected in the size of “balancing item”. The same applies to the currency exchange infrastructure: if banks do not register all their currency purchases, the real turnover is evident when foreign currencies are utilized, with the Central Bank forced to reflect that turnover in the “balancing item.” Finally, cash investments of foreigners into the real estate market and other areas, these funds are accounted for through “balancing” items, as “without record”, “without source”.

At the same time, as the amount of funds of doubtful operations grows, the “balancing item” inflates. For example, as per the law, goods or services for which payments are made should be brought into the country within 270 days, or the payments for local products that have been exported through consignment should be made to the country during that period. If this does not happen, the amount, which, either negative or positive. is considered to be “suspicious” in international practice is classified as the “balancing item”. Since there is no such approach in the reporting practice of the Central Bank of Azerbaijan, it is difficult to say anything about the reasons for the formation of “balancing item”, the share of separate transactions in the flow of capital in and out of the country.

As mentioned above, one of the ways international practice to facilitate the capital flight from a country is via transfers and payments under the “trade credits and advances” of the balance of payments. When the currency control is not properly arranged, trade credits and advances can become a favorable mechanism for capital flight from the country. In terms of the methodology of the balance of payment statistics, the situation is as follows: the amount shown in “assets” section of the item “trade credits and advances” of the balance of payments is for the payments to Azerbaijan, while the amount shown in the “liabilities” for the payments out of Azerbaijan. In the first case, it concerns the export of goods from Azerbaijan through credit and consignment, and in the second case, it is the purchases made by an importer from Azerbaijan for the goods received by credit and consignment on the basis of an agreement with a foreign merchant. Consignment is the method of transferring the payment to the merchant after the sale of the goods is completed within the period enshrined by the contract.

The Balance of Payments Statistics is calculated based on the methodology of the International Monetary Fund’s Balance of Payments and International Investment Position updated in 2008, as well as the Decree of the Central Bank of 18 December 2013 on “Regulations on compilation and submission of reports on financial operations and neutral operations of residents of the Republic of Azerbaijan with non-residents”. Trade credits and advances are categorized in the Regulations as short-term and long-term trade (commercial) loans granted to foreigners by state and non-state organizations in Azerbaijan.

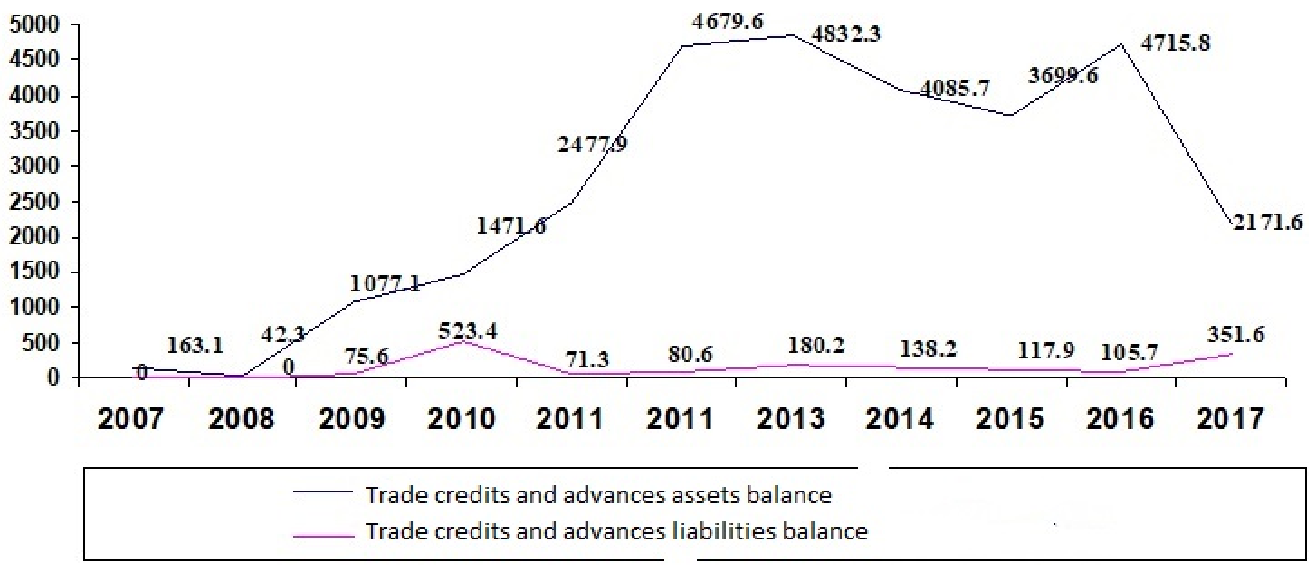
Approved by the Decree of the President of the Republic of Azerbaijan dated June 24, 1997, the Rules on the “Regulation Of The Import-Export Operation In The Republic Of Azerbaijan”, as well as rules on “Regulations on currency operations of residents and non-residents in the Republic of Azerbaijan” approved by the Central Bank’s decree of November 28, stipulate that legal entities and physical persons shall ensure the transfer the funds for the goods (works, services) exported through consignation to the accounts in the authorized bank of the Republic of Azerbaijan within 180 (one hundred and eighty) days after the date of their disclosure.

At the same time, the goods shall be imported into the country within 270 days after the date of the payment, with the customs declaration confirming the imports or the papers confirming the import of services being submitted to the bank.

According to Article 430.4 of the Administrative Violations Code, if the goods and services are not imported within the period specified for which the advance payments have been made, the fines in the amount of 10-20% and 20-30% of the total value of the payment shallp be imposed on the legal physical and legal entities respectively for not returning the currency paid abroad to the country.

Strengthened after 2015, the controls on currency transactions in import-export operations and the tightening of legislation on trade credit payments are reflected on the balance of payments statistics.

Turnover of trade credits and advances, in million dollars



As is seen from the chart of the Central Bank for the balance of payments statistics, since 2008 the balance of trade credits and advances has started to increase sharply, and this is mainly the case with ‘assets’. The assets rose from $ 42.3 million in 2008 to $ 1,077 billion in 2009, to $ 2.478 billion in 2011 and to $ 4.832 billion in 2013. That is, the volume of these transactions has increased more than 100 times over the period of 7-8 years. Why is the increasing trade loans considered a method of secret capital flight? When we look at the mechanism of this transaction, the answer is clear: a company does not receive the payments for its goods in advance and sends the goods abroad on the condition of receiving the payment after the sale. If there is no strict control over the financial markets and the banking sector, or if some companies are privileged to bypass such a control, an exporting company will have a chance not to bring in the full or part of its export revenues to the country or bring it only after using it for other specific purposes abroad. The weak currency control inside can even allow the funds for the goods sold through consignment to be transferred to the off-shore accounts without being first brought to the country.

As is seen from the chart, the amount of trade credits and advances on assets decreased in 2017 by 2.2 times from 4.716 bln to $ 2.172 bln. The Central Bank’ said in its statement to the local media that the changes to the legislation on tighter control over the consignation transactions and currency settlements have played a role in the formation of this decline. Indeed, if the volume of export-related consignment operations declines more than 2 times while the exports of non-oil goods and services increase up to 10%, then there are considerable grounds for suspicion and there is a need for impartial assessment.

Interestingly, the volume of trade loans and advances on imports is very small, which can be explained by two reasons:

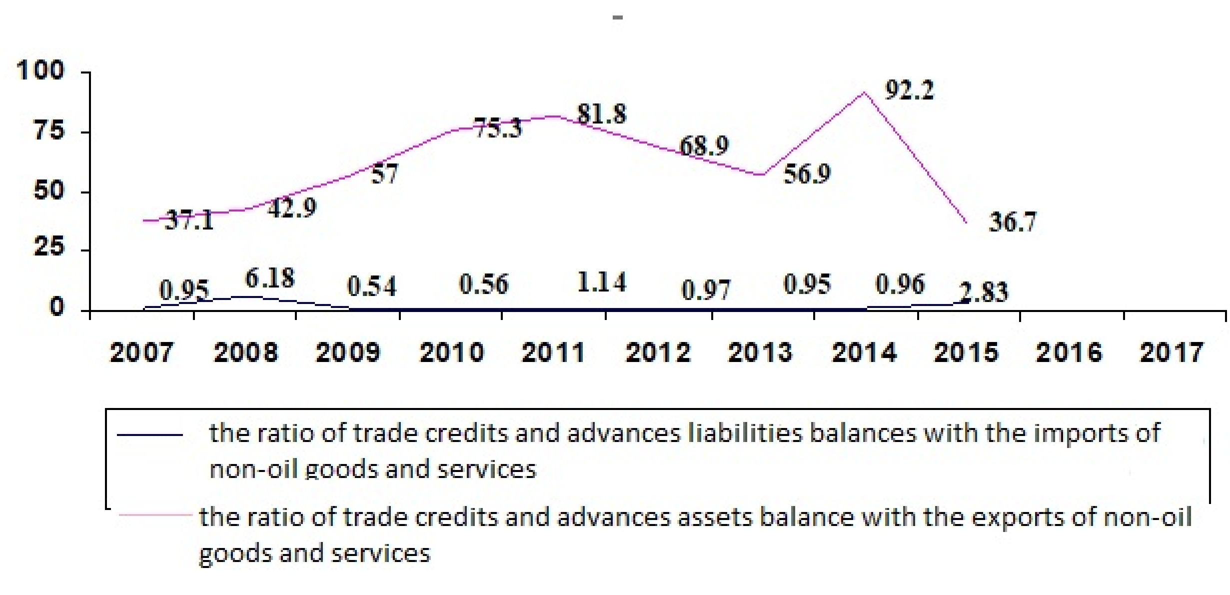
- **foreign exporters do not trust in our country’s importing companies and do not sell goods through consignment, and mainly require advance payments;**
- **more stringent requirements are imposed on importing**

companies by their partners and they are able to make payments in a shorter time.

The shorter the time the payments for imports are made, the smaller the trade credits and advances will be on the balance of payments (quarterly or annual) statistics. In practice, capital flights is also possible through import-related trade credits and advances: a certain amount of money is paid for the import. But since the import of goods and services happen on the paper, there is a risk that the payment made abroad for these paper-based goods and services will be used for other purposes.

The study of the official statistics reveals that the transactions of trade credits and advances cover only import-export transactions in the non-oil sector. In this regard, when the volumes of the exports and imports of non-oil goods and services are compared with the volume of trade credits and advances on assets, the asset indicator is very high, while the liabilities indicator is very small.

Trade credits and advances for assets and liabilities, in million dollars



As can be seen from the diagram, the level of use of trade loans in exports is very high. Even in 2011-2012, the ratio of trade loans and advances on assets with non-oil goods and service exports varied between 75.3-81.8%, with the peak indicator recorded in 2016, 92.2%. However, in 2017, the figure dropped dramatically to 36.7%.

Thus, the analysis of statistics covering the balance of payments for the past 10 years shows that both the big size of the “balancing” item and the export-related trade credits item give rise to suspicion of the possibility of capital flight from the country even through official channels.

That being said, in countries like Azerbaijan where transparent financial relations are not established, most of the capital flights occur through illegal (non-bank) channels and in cash.

Summary: Typical Reasons for “Capital flight”

The capital does not stay long where it does not feel safe. It is always in search and settles in the geography where its immunity is guaranteed at the highest level. What can these warranties be?

First of all, there should be the finest legal framework guaranteeing the immunity of property, with laws making it impossible for possessions to be taken away from people, regardless of their political convictions, sex, ethnic background and residential status.

Secondly, there should be a fully independent court system in the country which cannot be affected even by the first person in the country.

Third, there should be an independent media that is capable of publicizing any problem related even with the minor risk of breach of the property immunity.

Fourth, there should be an independent civil society, which can provide the social protection of the person whose property right is breached up until the end of the process, regularly publicize the issues related with the process, and have the power (and ability to) organize public campaigns against the perpetrators.

Fifth, the existence of the stock market, real estate market and the stable banking sector, which are transparent and flexible, are extremely important in the country. An equity holder must make sure that it is as comfortable to invest in financial and non-financial assets (securities, bonds, debt securities, stocks) through various investment, retirement, trust funds, and professional brokerage institutions as well as through a flexible stock market as it is to withdraw his or her investments through the secondary market when needed.

Sixth, there should be the finest legislative framework regulating the liberalization of capital flows in the country, with no legal and non-legal obstacles and bureaucratic procedures for the entry and exit of the capital.

Seventh, a country should have a stable banking sector and perfect insurance mechanisms, with capital owners who convert their savings into deposit facing no problems with withdrawing their deposits in any amount and at any time.

Eighth, *there should be a guarantee for* the stability of the economy. Capital owners should be assured that as a result of a change in exchange rate for the forecast period of time, their assets acquired in national currency will not be devalued, and that they will not lose their investment in the times of challenges caused by high inflation and recession, and that they will not be faced with bankruptcy except for caused by force majeure circumstances.

Finally, a country should ensure political power based on the democratic electoral system. In the absence of checks and balances over the division of political power, capital in the form of “hot money” triggered by high speculation may visit a country, but the term of such a “visit” is very short (sometimes a few months).

This list can be exhausted, but the full ground is formed to make the capital feel secure in the environment in which these guarantees are provided as minimum necessary conditions. Otherwise, the capital escapes in order to protect itself and its owner in the place where these conditions are provided.