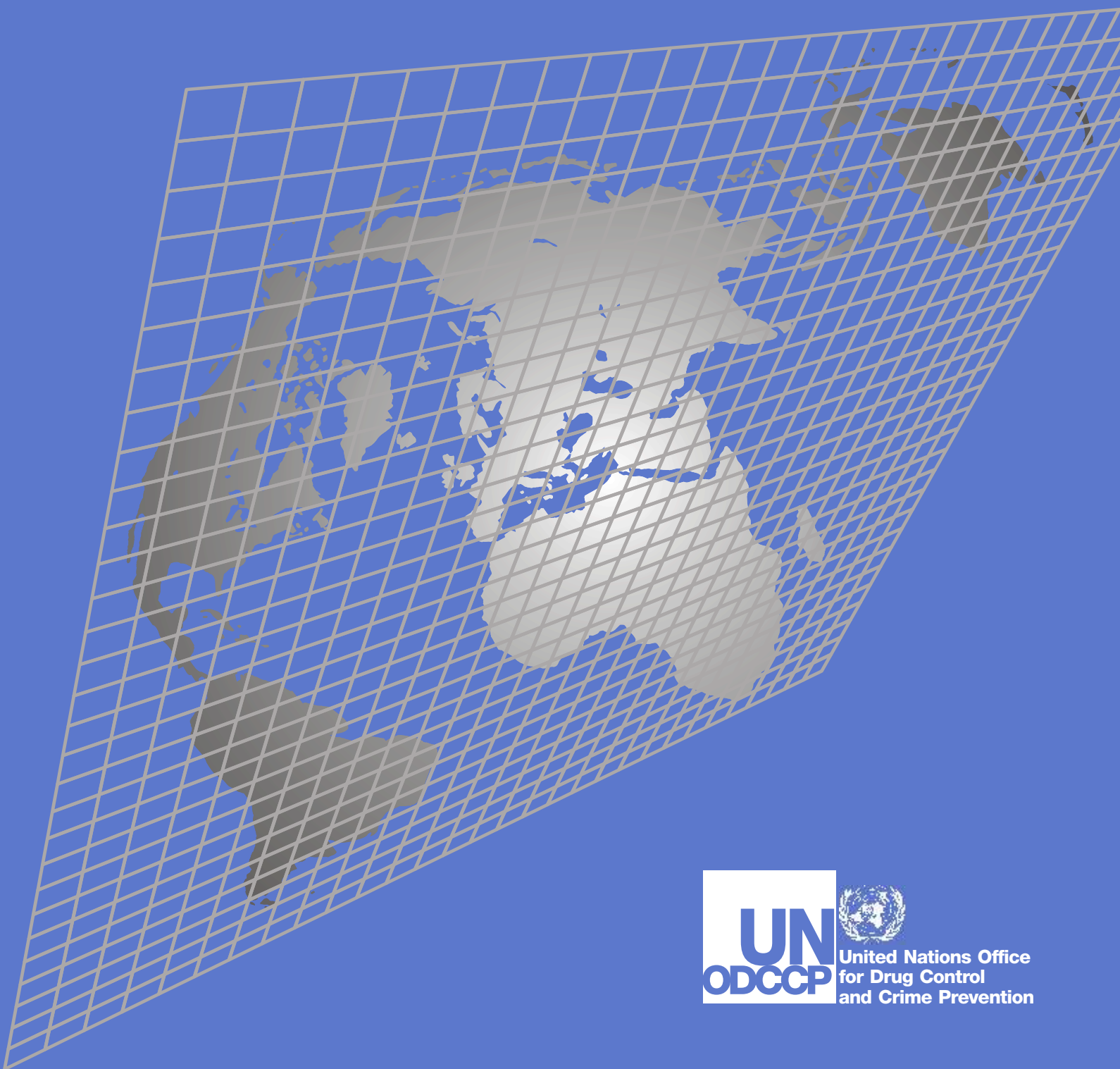


GLOBAL PROGRAMME AGAINST MONEY LAUNDERING

Russian Capitalism and Money-Laundering



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Initiated in 1997, the Global Programme against Money Laundering of the Office for Drug Control and Crime Prevention carries out the United Nations action against laundering of the proceeds of crime. The Programme conducts research, provides technical assistance and stewards the relevant mandates and policy objectives of the United Nations.

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Contents

<i>Chapter</i>	<i>Paragraphs</i>	<i>Page</i>
I. Introduction		1
II. Capital flight and money-laundering		2
III. Dollarization of the Russian economy		5
IV. Privatization or <i>Prihvatization</i>		6
V. Shadow economy, tax evasion and lawlessness		9
VI. Financial liberalization and the banking system		11
VII. Crime and business in the Russian Federation		13
VIII. Legalization and/or amnesty argument		15
A. Developments in the Russian Federation as a rationale for the argument		15
B. International reasons for the argument		16
IX. Countering money-laundering		18
X. Concluding remarks		21
Bibliography		24
Table. Estimated capital flight from the Russian Federation, 1994-1997		3
Figures		
I. Foreign direct investment and capital flight in the Russian Federation, 1994-1998		3
II. Is capitalism good or bad for the Russian Federation?		6
III. Should the reforms in the Russian Federation be continued or discontinued?		6

Chapter I

Introduction

The period of transition from socialism to capitalism in the Russian Federation has appeared to present limitless opportunities for international money-laundering. Financial markets are being liberalized and the economy is becoming privatized and deregulated in the absence of corresponding legal frameworks and institutional capacities to oversee developments. As a result, the country offers an easy entry point (“placement”) for illicit cash into the financial system from where it can easily move within the international financial system.¹ In the last few years, the media and both national and international official sources have increasingly reported about the Russian Federation-related money-laundering as a threat to international financial security. Indeed, the alleged amounts laundered (10 billion United States dollars (\$) in the Bank of New York case alone)² and the type of institutions involved illustrate the vulnerability of the international financial system and the power of criminals to manipulate and infiltrate it.

No accurate figures exist to indicate the overall level of money-laundering in the Russian Federation because it involves activities which are hard to observe or detect. However, the amount of capital flight from the Russian Federation which is likely to be related to money-laundering is estimated at \$133 billion during the period 1992-1997.³ This estimate is a symptom of significant underlying factors. Two inherent features of contemporary capitalism in the Russian Federation—crime and the “shadow” economy—could be linked to the bulk of illicit proceeds which require laundering for safekeeping or further investment. It is usually agreed that opportunities for international money-laundering—for international illicit wealth to be laundered through the Russian Federation—exist in the country. They were particularly abundant during the early phases of privatization in the Russian Federation, when State properties were sold for bearer securities. However, there are few reports of this inflow of criminal proceeds.⁴ This

might be partly explained by the criminal (hence, well-disguised) nature of these operations or their relatively low significance in today’s Russian Federation. Reports are numerous, however, of the profits of crime, particularly of economic crime in the Russian Federation which possibly need laundering. The Russian Federation law enforcement agencies estimated that by the end of 1998, organized crime controlled about half of commercial banks, 60 per cent of public and 40 per cent of private businesses.⁵ The Russian Federation represents a golden opportunity for those seeking to acquire huge assets rapidly by criminal actions while remaining undetected or under arrangements the criminality of which is hard or even impossible to prove. Therefore, the Russian Federation is likely to be a centre of money-laundering operations not only because of the easy placement opportunity it affords, but also because of the availability of illicit proceeds generated in the country that require laundering.

This paper examines aspects of the economic reforms and development trends in the Russian Federation that can reasonably be said to have fostered money-laundering. Problems and difficulties associated with the far-reaching reforms of the transition period make the country vulnerable to money-laundering. These changes include fast-moving privatization, banking and finance sector reforms, as well as political and administrative transformations. The efforts to counter it through various means (legislation, regulation, investigation, prosecution and others) are themselves subject to and closely interconnected with the overall process of political and economic transformation. As such, they need to be undertaken in conjunction with the broader measures designed to streamline economic reforms and develop functioning markets, create an appropriate legal framework, improve public institutions and promote good governance.

Chapter II

Capital flight and money-laundering

Money-laundering involves a broad range of activities and financial instruments which are not directly observable. Hence, comprehensive and meaningful estimates of its size are difficult to compile. As everywhere, no precise official or unofficial estimates exist in the Russian Federation with regard to the quantity of assets laundered. In the Russian Federation, the estimates of capital flight frequently serve as a basis for money-laundering estimates because a significant part of the capital flight is presumed to be laundered illicit proceeds. The magnitude of capital flight itself causes suspicions about money-laundering.

In the 1990s, the magnitude of capital flight from the Russian Federation was significant. This was acknowledged by many sources, although there is no consensus about its nature and size. A joint project on capital flight undertaken by the Institute of Economics based in Moscow and the Centre for Study of International Relations of the University of Western Ontario in Canada has reviewed alternative assessments of capital flight from the Russian Federal Departments, the Central Bank of the Russian Federation and international financial institutions. The project team, headed by Leonid Abalkin,⁶ concluded that the average of different agencies' estimates equals a total of \$133 billion for the period 1992-1997. No credible balance of payments data was compiled during the early years of transition (1992-1994) when the size of capital flight was presumably much higher than later. The project team, therefore, excluded this period and argued that from 1994 until September 1997 capital flight in the Russian Federation ran at an annual \$17 billion (the study includes 100 per cent of "errors and omissions" items of the balance of payments and export trade credits and import advances).⁷ In 1999 the Central Bank of the Russian Federation estimated the size of capital flight to be \$54.2 billion for the period 1994-1998, which suggests an annual flow of about \$11 billion.⁸ The Central Bank used the sum of non-receipt of export earnings, unredeemed import advances, non-equivalent barter and 50 per cent of

errors and omissions. In order to estimate the amount of money-laundering, the Centre for Strategic and Global Studies, a research institute of the Russian Federation Academy of Sciences, assessed and measured indirect indicators, such as the estimated share of the shadow economy in gross domestic product (GDP), similar indicators for the national income and the share of cash and barter transaction in the economy, the official data for capital outflows from the Russian Federation, the amounts of banknote trade by Russian commercial banks, dynamics of visible cash dollar imports as well as shuttle trade⁹ by Russians. Facing a lack of reliable data, the Centre, forced to discontinue its efforts in 1997, suggested anything between \$7 billion to \$100 billion as the amount of money laundered.¹⁰ Such a huge range is explained largely by the lack of reliable data and by a variation in the definition of money-laundering, which could be defined in a narrow or broad sense.¹¹

The team headed by Leonid Abalkin (capital flight project) concluded that from around \$68 billion accumulated by Russian residents abroad between 1 January 1994 and 30 September 1997, 33 per cent was comprised of illegal capital flight (item 1), 37 per cent constituted semi-legal transactions (item 2), and the rest consisted of various financial operations with capital assets (see table below). This classification can be easily challenged and variations offered depending on what assumptions are chosen for the relevant terms (illegal, semi-illegal etc.) as well as for the statistical errors. The existence of a negative entry for "errors and omissions", presumed to be illegal export of assets (\$22.7 billion), could be in fact an underrecording of current account outflows, in particular imports.

It is reasonable to assume that the capital leaving the Russian Federation illegally might be returning to the country disguised as legitimate foreign investment. The relationship between capital flight (even when estimates with the lowest levels of capital flight are used) and foreign direct investment (FDI) appears to be direct (see figure I). This relationship is particularly identifiable for

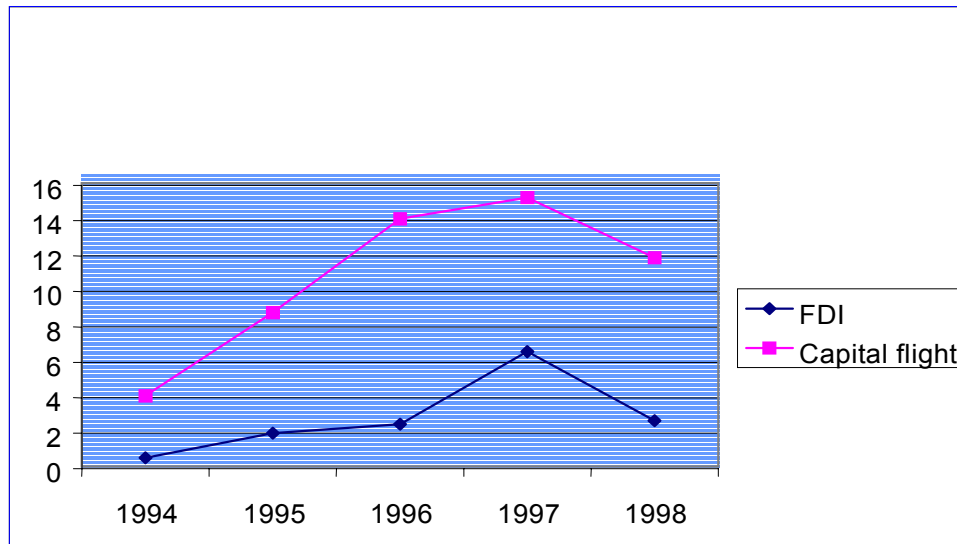
Table
Estimated capital flight from the Russian Federation, 1994-1997
 (Billions of dollars)

<i>Item</i>	1994	1995	1996	1997 ^a	Total for 1994- 1997 ^a
1. Non-registered capital outflow (item "Errors and omissions")	0.4	7.9	8.1	7.3	22.7
2. Export arrears and uncovered import advances	3.9	4.9	9.8	6.5	25.1
3. Export trade credits and import advances: a difference between offered and raised sums	4.7	0.0	10.3	5.1	20.1
Capital flight: (1)+(2)+(3)	9.0	12.8	28.2	18.9	67.9

Source: Abalkin (1999), p. 426, reproduced with some omissions.

^a Data for 1997 is for the first nine months.

Figure I
Foreign direct investment and capital flight in the Russian Federation, 1994-1998
 (Billions of dollars)



Source: Central Bank of the Russian Federation (2000) for FDI and Central Bank of the Russian Federation, quoted in International Monetary Fund (IMF) (1999), for capital flight.

1997 and 1998, when both indicators show simultaneously a significant increase in 1997 and decrease in 1998. However, both of these trends could be explained by the overall economic performance of the Russian Federation: its gross national product (GNP) peaked in 1997, reaching \$479.5 billion, and fell in 1998 to \$456 billion. The increase in capital flight in 1997 could be the result of the fast reaction of capital movements to the deteriorating economic and financial environment towards the end of 1997. Besides, the inflows of FDI into the Russian Federation have been minimal compared to capital flight estimates. In comparison, China with about the same level of capital flight as the Russian Federation (in the 1990s) experienced growth in the inflow of FDI, which reached \$44.2 billion in 1997.¹² In the Russian Federation, the inflow of FDI was at \$6.5 billion in 1997.

The authors of the capital flight estimates, as in the case of the money-laundering “guesstimates”, caution each time that the numbers should be taken as a very tentative approximation because there are great uncertainties as a result of statistical errors and poor quality of data in general. Thus, the numbers should be taken as an indication of problems rather than as a precise measure. Nevertheless, it is far easier to estimate capital flight than the magnitude of money-laundering because of the high level of secrecy integral to the process of money-laundering. Capital flight estimates are a measurement more meaningful for economists, politicians and ordinary citizens. They are an important part of the Government’s financial stabilization programme and a popular topic for politicians eager to demonstrate themselves as patriots fighting against the loss of the national assets.

Few in the Russian Federation worry about money-laundering per se, but many are concerned about the enormous illicit proceeds from the theft and embezzlement of public and private assets. This concern echoes an international perception of the Russian Federation as a source of illicit proceeds, rather than their safekeeping haven. These operations are closely related to the “broad” definition of money-laundering, which includes the legalization of assets from a variety of sources, including various speculations and certain privatization methods, the criminality of which it is impossible to demonstrate since they did not violate any criminal acts at the time they occurred.

In an effort to circumvent the legalization of illegal profits, the Russian authorities have been tightening controls, which have included measures halting financial liberalization and installing foreign exchange controls. More recently, the Government increased the surrender

requirements on export earnings from 50 to 75 per cent and increased to 100 per cent deposit requirements on imports. But the authorities have also tightened tax administration and financial sector supervision. More detailed reporting is required on trade transactions: a system of information exchange and action coordination has been established between the Central Bank of the Russian Federation and the Federal Foreign Exchange Control Board. The Central Bank has determined the criteria for suspicious transactions and instructed commercial banks to report all suspicious transactions.

Exchange control mechanisms, including suspension of operations through non-residents, so-called “S-special” accounts, have also been introduced and prompted innovations circumventing these restrictions. The schemes involved foreign holders of roubles and Russian companies interested in doing business with them. Under the scheme, the shares of the Russian companies sold for roubles to foreign companies were purchased back by the same Russian companies for hard currencies. To purchase the shares, the Russian companies use their foreign currency holdings abroad. It was reported that using this mechanism, the Lukoil company sold its 4.8 million (1 per cent of total stock) shares for 1 billion roubles to Citibank and that the Sibneft company sold shares for 1.5 billion roubles (3.5 per cent of its total stock) to CS First Boston bank. The Russian authorities described these operations as of a limited scale and immoral, but not of a criminal nature.¹³ Nevertheless, they raise questions about why and how Russian companies have been able to accumulate and keep abroad assets of such size.

As a result of measures to contain it, capital flight fell by 40 per cent in 1999 to \$15 billion from \$25 billion in 1998. A major contributor to this trend is capital flight to offshore centres, which fell during 1998-1999 by 60 per cent from an average of \$1 billion per quarter of a year to \$400 million per quarter. Reductions are expected in the capital flight resulting from the nonreceipt of export earnings, unredeemed import advances and payments of fictitious fines related to foreign trade operations.¹⁴ In June 2000, the Central Bank reported that the outflow to offshore zones had further fallen, reaching the level of \$300 million for the first quarter of 2000.¹⁵ Those concerned with money-laundering hope that this decline implies also the containment of money-laundering, which in the Russian Federation seems to be inseparable from capital flight.

Chapter III

Dollarization of the Russian economy

World black markets increasingly use United States dollars as a vehicle for conducting covert wholesale transactions, for hiding international financial transfers and for holding underground savings. This applies to the full spectrum of illicit and underground activities. The more popular the use of United States dollars, the easier it is to convert it into local currency or vice versa depending on need, and eventually obscure the trail of illicit proceeds.

In the Russian Federation, the dollarization of the economy or transfer of assets denominated in national currency into foreign currency (dollars) has been continuous since 1992, when the liberalization of foreign trade began. Since then, the dollarization indicator shows a strong upward trend with some fluctuations reflecting policy decisions by the Russian authorities—undertaken or anticipated. In October 1994, in response to “Black Tuesday”, which saw a one-day drop of 20 per cent in the rouble’s value against the United States dollar, the indicator showed a jump in the dollarization. In 1995, heavy interventions by the Central Bank of the Russian Federation to defend the rouble led to a reverse trend of flight from dollars to roubles. In anticipation of fiscal instability and rouble devaluation, demand for dollars jumped again in 1997 and has continued to rise ever since. In 1996 and in the first seven months of 1997 Russian residents bought \$14.9 billion—twice the amount of dollars purchased in the previous four years.¹⁶ The financial crisis of 1998 further contributed to the dollarization of the Russian economy. Thus, the high rate of dollarization sustained in the second half of the 1990s reflects an increased uncertainty regarding holdings in national currency. Frequent policy changes and reforms by the Russian authorities that led to losses in the value of roubles, various financial speculative schemes, including pyramid schemes, as well as financial crises involving massive bankruptcies, all contributed to the rouble becoming seriously discredited.

The extent of currency substitution is reflected in the ratio of foreign currency cash to national currency cash. The extent of substitution of domestic bank deposits by foreign currency deposits can be seen in the ratio of these deposits to the M2 aggregate, which is equal to money in circulation (MO) plus domestic currency assets

held by residents (households and non-financial firms) at settlement in current and deposit accounts in banks.¹⁷ Dollarization is expressed in the use of United States dollars as a means of payment (currency) and as a means of savings (assets). Comparison of two trends—holdings in cash and deposits in the Russian Federation—shows high and continuous growth of the foreign currency in cash versus deposits. In 1997, the foreign currency component in the money flow was above 40 per cent, of which 27.5 per cent was in cash.¹⁸ Strong preference for foreign cash might imply that the rise in shadow activities determines the dollarization trend in the Russian Federation. According to the Central Bank of the Russian Federation, in 1996 \$33.8 billion of cash in foreign currency flowed into the Russian Federation through the banking system while the outflow was only \$309.5 million (balance of \$33.5 billion). In 1997, the difference between inflow and outflow was \$37.1 billion, and, in 1998, \$15.8 billion, the latter reflecting a reduction in inflow as a result of bankruptcies during the financial crisis. Thus, between 1996 and 1999 on average \$22.8 billion of foreign cash entered the Russian Federation, the number exceeding some estimates of capital flight from the Russian Federation.¹⁹ As a result of these inflows, the amount of foreign currency significantly exceeds cash holdings in roubles (expressed in United States dollars at the current exchange rate). It is ten times higher than the roubles holdings if bank transactions only are included, and three times higher if unorganized imports (“shuttle” trade) is taken into account. According to official estimates “shuttle traders” account for 14.5 per cent of total imports and consume as much as \$10-15 billion. Thus, if one deducts “shuttle trade” import (about \$60 billion) from the amount of foreign cash accumulated from 1996 to 1999 (\$90.2 billion), then the balance of over \$30 billion is estimated, which is still three times higher than the amount of roubles in circulation.²⁰ This increasing amount of foreign cash in the Russian Federation should be examined closely as a possible symptom or catalyst of criminal and shadow activities, which eases transactions with illicit proceeds. The dollarization debate²¹ with regard to the Russian Federation should incorporate this examination.

Chapter IV

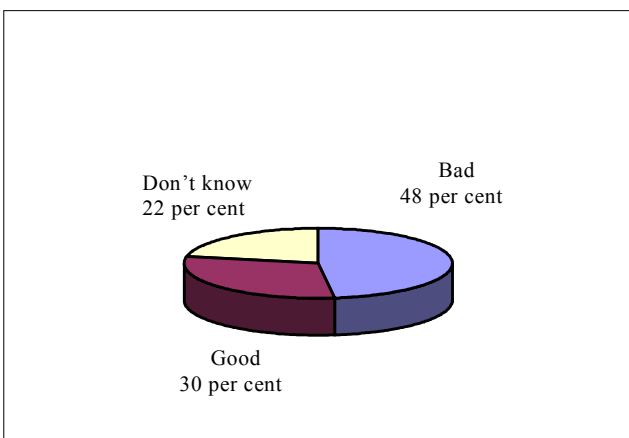
Privatization or *Prihvatization*

Millions of Russians are deeply dissatisfied with the process of market reforms that intended to introduce capitalism. According to one recent opinion poll, 48 per cent of Russians believe that capitalism is bad for the Russian Federation, while only 30 per cent think it is good and 22 per cent don't know (see figure II). When asked whether the Russian Federation should continue reforms or halt them, 39 per cent of respondents answered that they should be halted, while 33 answered that they should be continued and 28 per cent were uncertain (see figure III).

Privatization on a massive scale has been a critical part of market reforms in the Russian Federation on its road to capitalism. From the outset it had priority over other components of reform, such as the creation of institutional and legal frameworks to regulate the markets. It was assumed that the fast creation of capitalists—property owners—was the first and critical step in building capitalism. It was hoped that inefficient

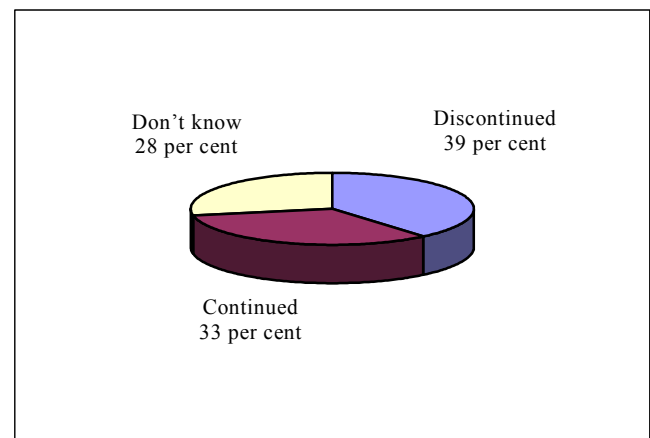
industries would be miraculously transformed by the new capitalists of the Russian Federation.²² Privatization did create the property owners in the Russian Federation—masses of small shareholders without any power to influence decisions over the enterprises they “own”. It also produced few “new Russians”, who have acquired enormous wealth by skilfully taking advantage of the weaknesses of the transition period, including the lack of transparent and clear rules and diminished law enforcement capacities of the State. In the absence of appropriate rules to regulate or mechanisms to monitor the developments, the market-oriented transformations, particularly privatization, stimulated an unprecedented rise in the legalization of criminal assets and property acquired by unlawful means. A popular Russian pun equates privatization to the grabbing of State assets. *Privatisation* is referred to as *prihvatization* (“hvatat” in Russian means to grab, which could be also understood as a robbery).

Figure II
Is capitalism good or bad for the Russian Federation?



Source: Public Opinion Foundation polls (1,500 respondents) in *Kommersant*, 15 February 2000.

Figure III
Should the reforms in the Russian Federation be continued or discontinued?



Source: Public Opinion Foundation polls (1,500 respondents) in *Kommersant*, 15 February 2000.

The mass privatization of 1992-1994 of over 15,000 medium and large enterprises shifted over 80 per cent of the industrial workforce into the private sector. During the same period, most prices were freed, the exchange rate was unified and foreign trade was liberalized. It was anticipated that these policies would help the newly created private sector to get on its feet and take off. By 1996, the private sector was already reported to account for 70 per cent of GDP. In 1998, only 6.1 per cent of firms were considered State-owned and only 7 per cent of retail trade turnover was accounted for by State-owned enterprises. By the end of 1998 over 13,000 enterprises had been privatized.

The desperately hoped-for benefits of privatization have yet to arrive while some of the privatization experiences and schemes have become targets of criticism. The mass privatization of 1992-1994 with its privatization vouchers represented an easy opportunity for legalization of criminal proceeds. Vouchers were issued for each Russian citizen and represented the share of national wealth to be divided among them. The vouchers entitled their owners to purchase a stake in a State property. The bearer nature of vouchers allowed safe money-laundering as nobody questioned how and using what means the vouchers were obtained. During this first phase of privatization, criminals were able to purchase unlimited amounts of privatization vouchers from the impoverished population and use them at tenders and privatization auctions to obtain controlling shares in existing State businesses.²³ The scheme turned out to be a blessing for individuals with large amounts of hidden cash obtained through crime, and enabled them to become lawful, rich citizens.

The loans-for-shares programme of 1995 has been widely criticized for its lack of transparency and for its fraudulent arrangements. Under this programme, the gems of the Russian economy—most promising companies in the industrial and energy sector—were in fact sold out to businesses in exchange for minimal loans to the Government. State shares in 12 profitable firms with strong potential for growth were used as collateral against major bank loans to the Government. It was specified that if the Government decided not to repay the credits—which totalled about \$1 billion—the banks had the right to sell the shares held in trust and keep 30 per cent of the capital gains. The circumstances of the auctions, in which the same bank sometimes served as both an organizer and a bidder, and in which larger bids were disqualified on technicalities, aroused fierce criticism in the Russian Parliament and press. Nevertheless, the programme was continued and after the deadline passed in September 1996, banks began selling off the State share packages.

Between November 1996 and February 1997, three such sales occurred—for shares of three companies—Yukos, Sidanko and Surgutneftegaz. In each of these cases, the trust holders themselves or an affiliated company bought the stock.²⁴ It was widely commented that, as a result, a politically connected few were able to acquire large national assets in exchange for minimal sums, and that the programme may have been designed from the outset for the purpose of such a fraudulent redistribution.

Even from the economic efficiency point of view, privatization has failed to meet its objectives. The incentive to seek short-term personal gains instead of long-term shareholder value has arisen even when the managers and owners were one and the same, as was commonly the case in the Russian Federation. Uncertainty about formal ownership rights and lack of trust in the legal system to uphold their rights continued to be widespread and prevented initiation of restructuring designed to ensure long-term sustainability of the enterprises. It became apparent that where no transparent, credible and fair rules of the market exist, none of the parties involved, including not only workers and managers, but also shareholders and creditors were interested in maintaining and increasing the value of assets. As a result, the enterprises acquired have been mostly used for quick short-term gains (going into the pockets of a few), such as their sale through fraudulent schemes or their use for various underground purposes. The rights of ordinary citizens—holders of minority blocks of shares—were universally violated, with the value of their shares falling to nothing.

The Federal Commission for Securities Markets, established in 1996, has generally lacked the enforcement power needed to tackle the problem of violation of shareholder rights. In July 1998, the Government announced a Programme on Protection of Investors Rights which has yet to be implemented effectively. A new bankruptcy law, which took effect in March 1998, also has yet to see its effective implementation, as it is impeded by contradictory policy decisions. In January 1999, for example, the Government decided to cease initiating bankruptcy proceedings against tax debtors. This decision threatened to worsen tax compliance and delay constructively needed bankruptcies. The number of bankruptcy cases has grown sharply in recent years, to around 4,000 in 1998, but this is still low given that 50 per cent of firms were reported to be making losses in mid-1998.²⁵

The State Anti-Monopoly Committee is responsible for the support of entrepreneurship and the promotion of competition. However, it has continuously suffered from underfunding and has had to close its 12 regional offices since 1994. Moreover, regional branches were accused of

bowing to local political pressure to protect established firms, which raised suspicions about widespread local corruption. The capture of critical businesses at the local level by individuals with criminal pasts have helped erode local power structures to a significant degree. Reports appear daily about criminal actions by the high-ranking elected or nominated officials with already tainted pasts.²⁶ Russians quickly invented for these individuals a new pun, “blue mayors”, which links the elected posts of politicians and blue tattoos of gangsters and former prisoners.

Even renowned supporters of reforms in the Russian Federation began expressing their disappointment with the process of reforms in the Russian Federation, pointing at the absence of a normal market environment. In his new book,²⁷ financier and famous philanthropist George Soros openly blames the members of the Russian political elite, including the media and oil magnate Boris Berezovsky,²⁸ for getting involved in a selfish, deadly fight of oligarchs, hungry for power and money. The oligarchs, including those in power, continuously engaged in the fight among themselves that drew enormous resources. Meanwhile, grave economic and social problems of ordinary Russian citizens remained neglected. Mr. Soros describes how he personally witnessed the oligarchs’ attitudes when he purchased a telephone holding company Svyazinvest by auction. Mr. Soros reports repeated attempts by

Mr. Berezovsky to acquire ownership before the auction using various means including political pressure because he considered the ownership of Svyazinvest to be critical in his power struggle against Prime Minister Chubais. Later, a failed attempt by Mr. Berezovsky to use Mr. Soros in his manipulations to obtain the Presidency of Gazprom ended their relationship. George Soros acknowledges with bitterness his failure to advocate and promote the creation of a law-abiding capitalism in the Russian Federation as opposed to the capitalism of robbers.

In general, privatization was a big disappointment for ordinary Russian people as well as for the many international supporters of reform. Many recognized with hindsight that institutional capacities and regulatory safeguards should have been put in place before embarking on privatization.²⁹ In the Russian Federation, privatization as it evolved not only halted the trend towards fair, competitive and efficient markets, but also promoted inefficiency and wider acceptance of arbitrary rules and lawlessness. A rapid and extensive privatization process with its fraudulent schemes damaged the credibility of reform in the Russian Federation and further hindered efforts to create an appropriate legal and institutional framework to support a market economy. It facilitated the capture of the Government at various levels by groups whose critical mission was to use the State to legalize their fraudulent acquisition of wealth and mask their origins.

Chapter V

Shadow economy, tax evasion and lawlessness

The surge in the share of the shadow economy and its impact on the national economy of the Russian Federation surprised greatly the enthusiasts of market reforms. Before market reforms, it was thought that the shadow economy during the Soviet period was the result of distortions created by the centrally planned economy and that with the economic liberalization and the introduction of free market principles, it would fade away. On the contrary, during the transition period, the shadow economy has reached sizes unimaginable in the Soviet Union. It has become closely intertwined with the legal economy and accepted by the Russians as a part of capitalism in the Russian Federation.

According to the Ministry of Internal Affairs of the Russian Federation, in 1990-1991, the shadow economy produced 10-11 per cent of GDP; in 1993, 27 per cent; in 1994, 39 per cent; in 1995, 45 per cent; and in 1996, 46 per cent. According to the same source, 58-60 million people are employed in the shadow economy. Goskomstat (the State Statistical Office) gives more modest numbers: the share of the shadow economy reaching 9-10 per cent of GDP in 1992-1994, 20 per cent in 1995, and 23 per cent in 1996.³⁰

The nature of the shadow economy in the capitalist Russian Federation is different from the underground activities of the Soviet period. During communist days, anything produced without direct supervision or planned instructions could be considered shadow economy. It included outputs exceeding planned figures, which were usually for sale to non-assigned enterprises, various barter transactions, moonlighting, i.e., anything beyond centrally planned assignments. Additionally, according to some classifications, various criminal activities, such as corruption, theft and fraud were also counted as a part of the shadow economy. However, it is commonly acknowledged that the primary reasons for the shadow economy included market distortions created by the rigid planning figures and instructions and the need for people to explore their entrepreneurial skills. Thus, to a great extent, the role of the shadow economy was to fill the gaps of the

centrally planned economy in meeting supply and demand and as such it became an integral part of the Russian Federation's economic and social life.

With the introduction of market reforms, many activities classified as criminal immediately became legal and many endeavours, such as entrepreneurship, were promoted. However, neither the authorities nor the population could immediately define what should be criminal and what should be legal in the new society. Even when they were able to define this, they could not immediately create new legal or institutional frameworks to regulate these new activities or the process of change itself. Those benefiting from the lack of transparent and uniform laws perhaps played a part in prolonging such a period. Lack of appropriate legal provisions meant limitless opportunities for various manipulations for personal gain. Meanwhile, the State has largely withdrawn its law enforcement capacities, as the State was considered too big, too powerful and too oppressive. During the early years of reforms, law enforcement actions by the State against economic crimes (many of which were not even defined as crimes at the time) could be easily hampered by the offenders, who would declare these actions to be counter-market assaults of former communists or apparatchiks.

The lack of norms defining the new role and functions of public institutions contributed to the corruption of government offices. Vagueness about the responsibilities of government officials encouraged the so-called privatization of government posts. Government officials increasingly fulfilled their duties only to meet their personal economic interests. Personal networks or bribes became more effective than official procedures. As a result, people began to resent any government rules or procedures, considering them redundant. Taxation is particularly resented because it produces virtually a system of double taxation as public services are "purchased" individually anyway.

Hence, with the introduction of market reforms in the Russian Federation, the shadow economy not only

survived but transformed into an even more critical segment of the economy. The transition process prompted the authorities to establish temporary arrangements or institutions (authorized offices with various powers), which often become the subject of misuse of powers for personal gain. The preservation of some features of the planned economy, such as State subsidies to some industries, also creates opportunities for various illegal activities. The drastic social consequences of the transition period, such as the unprecedented rise in poverty associated with the loss of jobs, savings and decent salaries and wages, are also an important factor in the growth of the shadow economy. In order to survive, people have to look for various sources of income through activities not licensed or registered. This includes their activities at work used for purposes other than the work they were hired for.

The problem of payment arrears led the enterprises to come up with various forms of non-cash transactions. The use of barter transactions has increased dramatically since the beginning of the transition period, peaking at over 50 per cent of sales in mid-1998.³¹ Easier to misreport or not to report at all, barter transactions form a significant part of the shadow economy. To handle their payments or mostly their payment arrears, big enterprises also use forms of promissory notes. Some Russian enterprises were reported to be issuing quasi-money to pay their expenditure arrears and others to be using non-monetary wage payments. However, it is also believed that enterprises starve themselves of cash in order to negotiate tax breaks. This assumption applies to the enterprises that decide to legally minimize their tax obligations. Many others simply do not pay taxes at all. With a badly organized State administration and with few experts to enforce the rules, there are numerous opportunities for small businesses to escape into the underground. There appear to be no compelling reasons for them to become legal. Therefore, a large share of the activities of a shadow economy is legal in nature and includes activities that are permitted by law (as opposed to criminal activities), but conducted without official permits or registration.

According to some estimates, 35 per cent of Russian businesses do not pay taxes at all, and over 50 per cent pay taxes only occasionally. Many believe that the complexity of tax laws and their repressive nature encourages tax evasion. According to some estimates, businesses are expected to pay as much as 60 to 80 per cent of their profits as taxes. This is in conditions where most businesses thought that 28 per cent of the profits was a fair level of taxation they could bear.³²

More pervasive than tax evasion is the problem of tax arrears which contributes to the failure of the Russian

authorities to reverse the sharp reduction in revenues that has taken place since the beginning of transition. The tax arrears have reached such levels that their damage can be equated to tax evasion. The tax police reports that it brings about 40 per cent of tax revenues to the Government which means that the Government has to use force to get nearly half of its tax revenues. Considering the limited capacities of this hazardous service, one can assume that a large portion of taxes remain not paid at all.

The problem of non-payment and tax arrears led to the use of non-monetary fiscal operations or tax offset schemes that have been criticized for opening new opportunities for fraud.³³ Under the scheme, the Government began accepting goods and services in lieu of taxes. This method not only led to the decline in expected tax revenues (it was estimated that only 50-75 per cent of face value was collected through this method), but more importantly it further promoted corruption and fraud, particularly at the regional and municipal levels. The discretionary use of this method allowed businesses to accumulate arrears in order to force the Government to purchase their goods. The schemes effectively operated as a tax amnesty, which has had an adverse impact on tax payment discipline. Moreover, fraud was often embedded in the programmes, as prices were set or the quality of goods supplied were set at higher than their actual levels, increasing artificially the size of tax payments. It was often reported that local officials were thoroughly compensated personally (through bribes) for the loss of Government tax revenue. The scheme turned out to be another mechanism for extracting State assets.

The existence of a sizeable shadow economy and tax evasion practices contribute to the flourishing of “krishas” (*krisha* in Russian means roof)—informal or criminal groups which control the respective market segments. The need to conceal their activities or to ensure the continuation of business activities often makes businesses turn to krishas. The economic sense of krisha is to support the earning of profits by limiting the number of those with access to the market controlled. Part of these protected profits go to those who enforce krisha—mostly organized crime groups. It is common for krishas to use physical force against those who do not comply (do not pay protection fees), and it is becoming even more common for them to use the State structures, including police or tax police, as their tools. For example, it is safe and easy to report the rebellious business to the local tax police, which would conveniently raid and destroy it. Even if the tax police is not a part of the “krisha” the likelihood of the tax police to find tax non-compliance is so high that the raid damages seriously the business anyway.

Chapter VI

Financial liberalization and the banking system

Financial liberalization in the Russian Federation involved the abolition of State controls on credit allocation and interest rates, privatization of financial institutions, elimination of restrictions on the flow of capital into and out of the country, development of securities and money markets as alternative sources and depositories for funds. It was expected that liberalization would promote investments contributing to economic development. However, it became apparent that the failure to install the supporting monetary and legal infrastructure in tandem with these changes exposed the economy to the flow of illicit wealth. It revealed the weaknesses of the system, exposing it to many risks and increasing its dependence on foreign sources of financing in general and, in all likelihood, sources of dubious origin.³⁴

The development of commercial banking—regarded as a symbol of success of reform in the financial sector—has been spectacular, at least from the quantitative perspective. Following the 1988 banking reform, commercial banks mushroomed all over the country. There were 225 registered banks in 1989, 1,360 in 1991, 2,019 at the end of 1993 and 2,605 in June 1996.³⁵ It appears that much of the growth was due to existing legal gaps and lack of supervision. For example, some of the entities registered as banks were simply exchange points or branches of a few State banks. Much of the commercial banks' profits in the early 1990s came from investing cheap funds, obtained from enterprise deposits that were paid negative real interest rates. Moreover, to a great extent their methods of earning profits could be considered illegal, as many came from the deliberate delays in executing transactions—payments between enterprises and social security payments to beneficiaries.

By 1997, the Russian banking system became significantly exposed to external and foreign currency risks. Data from early 1998 indicates that the maturity structure of foreign assets and liabilities was mismatched, with liabilities to non-residents denominated in foreign exchange of under \$11.8 billion offset by similar assets of

only \$5.9 billion. Although balance-sheets assets of the commercial banking sector denominated in foreign currency exceeded liabilities, the quality of the assets was extremely poor due to large loans of dubious quality extended in foreign currency to domestic enterprises. Furthermore, the gross foreign currency exposure of the banking system as a whole was substantial, with assets and liabilities denominated in foreign currency exceeding \$40 billion. About 26 per cent of foreign currency liabilities had maturities of less than one month.³⁶ Exposed to foreign exchange and interest rate risks, highly dependent on government securities, a large number of banks, particularly Moscow-based banks, became insolvent during the financial crisis of 1998.

Following the crisis of 1998, by the end of 1999 the number of operating banks had fallen to 1,400, the Central Bank having withdrawn over 1,000 bank licences since the beginning of 1995. Additionally, the crisis and after-crisis actions by the Government and the banking sector seemed to contribute to the concentration of the banking sector. At the end of 1997, the top five banks accounted for 36 per cent of total assets and the top 50 per cent for 71 per cent. The dominating bank of the system—Sberbank, which accounted for almost a quarter of all assets at the end of 1997—managed not only to survive the financial crisis. It was moreover able to increase its share of the retail market from 65 per cent before the crisis to 75 per cent and its loans portfolio from 16 to 35 per cent.

In the aftermath of the crisis, the Russian authorities began extending ad hoc support to a number of banks in the form of “rehabilitation” credits. The Central Bank developed the Bank Bankruptcy Law, which was ratified in 1999 by the Parliament. With the adoption of the Bank Restructuring law the sole responsibility for restructuring banks was given to ARCO (the bank restructuring agency). The banks can be transferred to ARCO only by a Central Bank of the Russian Federation directive based on specific criteria for shareholder write-down, and ARCO is empowered to undo transactions made with the

intent to defraud depositors and creditors of insolvent banks. It limits liquidity support to solvent banks or those implementing ARCO-approved restructuring plans. It was reported that ARCO had begun extending support to four banks implementing ARCO-approved restructuring plans. However, even operations by ARCO arouse suspicions about corrupt political and business interests influencing its decisions. Alfa bank is one of the winners of the crisis which has strengthened its market position by benefiting from a large influx of clients from its former and now insolvent competitors. But it also seems to have benefited from its far-reaching political connections as it received \$40 million in capital injection from ARCO, which equals one tenth of ARCO's \$400 million budget.

Despite the ill fate of many banks, Russians continue to believe that bankers are the most prosperous members of society. The prosperity of bankers in the opinion of the public seems to have less to do with the profitability of legal banking operations and more to do with their criminal or illegal activities. Those bankers who knew how to bend or break the rules were apparently better prepared to handle the crisis and even take advantage of it. The financial crisis of 1998 revealed that the crisis environment could be easily manipulated by those with access to the banks' assets. The crisis and insolvency problems led to the enrichment of some bankers who used them to accumulate assets using various illegal mechanisms. There were reports of assets-stripping, of banks shifting assets to shell entities and the initiation of unilateral restructuring of their own balance sheets. Owners of banks stricken by the crisis have transferred their good assets into parallel banking structures, largely at the expense of foreign creditors and Russian retail depositors.

The creation and operation of bridge banks can illustrate the point. Bridge banks are an ingenious creation of bankers by now insolvent banks, such as Menatep, Uneximbank and SBS-Agro.³⁷ Run by these bankers, they were created for stripping and shifting of assets. The Rosbank, the shadow bank of the troubled Uneximbank, is thought to be one of the best examples of resurrected banks. The bank has taken on the infrastructure and key clients of Uneximbank, most notably Interros industrial group. It left behind the insolvent Uneximbank, which was estimated to owe up to \$2 billion to creditors, including \$1 billion in forward currency contracts. Rosbank became one of the top 20 banks in the Russian Federation, with a capital base of \$50 billion. The scheme worked so well for Rosbank that later on it even officially absorbed its original Uneximbank and turned the event

into an unprecedented demonstration of good will by a major bank.

Crimes in the banking and financial sector were more apparent and less sophisticated in the early and mid-1990s. During this period, the Russian media was flooded with reports about fraudulent banks and financial schemes. Many banks appeared to have been criminal enterprises, designed to exploit their customers, from the very beginning. For example, in 1994, Adelphi, a small Moscow bank, was reported to have profited greatly by cheating its customers. The bankers sold their customers shares of an infamous MMM fund, a pyramid type of investment scheme, which stripped many Russians of their savings. Despite periodic price updates, Adelphi bank kept selling to its customers shares of the MMM fund at a higher rate (quoted earlier) and simultaneously purchasing them at a lower (updated) rate. The shares of the MMM fund were plummeting at the time, as the fund had crashed twice by then, and all of its board members, except for the boss, Sergei Mawrodi, were in prison. Mr. Mawrodi, while out of jail on bail, managed to get elected to the State Duma (Lower House of Parliament) and gained immunity from prosecution.³⁸

The period of massive fraud in the banking and financial sector was also the period of massive violence against high-ranking banking officials. The Association of Russian Bankers reported that 83 armed attempts on the lives of bank presidents and prominent bank officials were made during the three and a half years from mid-1991 to 1995.³⁹ A high frequency of violence was indicative of the efforts of criminal groups to establish their control over banks. In 1995, the Scientific Research Institute of the Ministry of Internal Affairs (VNII MVD) believed that criminal groups controlled over 400 banks and 47 exchanges.

The control over banks enables an easy generation of illicit proceeds. It significantly simplifies criminal actions (for example, extortion or kidnapping for ransom) against the bank's customers. It also facilitates the criminal penetration into other sectors of the economy, as it simplifies the financial servicing of criminal operations. For money-laundering activities, the control provides a long-term advantage and considerable protection in the event that banking regulations are imposed. When the criminal organization itself owns and runs a bank, even the most stringent regulation would not contribute much to curbing money-laundering. "It is not necessary to worry about suspicious transaction reports when one owns the bank."⁴⁰

Chapter VII

Crime and business in the Russian Federation

In the 1990s, there was a significant rise in crime in the Russian Federation. Economic crime is a major contributor to the increased gravity of the criminal situation in the Russian Federation. Legally, the term “crime in the sphere of economic activities” (in this paper simply named economic crime) was introduced in 1996 when the new Criminal Code of the Russian Federation was adopted by the State Duma. The Code contains a chapter entitled “Crimes in the Sphere of Economic Activity”, with 31 articles specifying provisions against a wide range of offences. The offences include legalization (or laundering) of monetary means or other property acquired by illegal means, bribes, smuggling, illegal entrepreneurship, illegal banking, illegal use of trademarks, tax evasion, evasion of customs payments, violation of rules for handing over precious metals, failure to return monetary means in foreign currency from abroad, obstruction of legal entrepreneurial activity, intentional and fictitious bankruptcy and many others.

In 1998, compared to the previous year, the number of reported economic crimes increased by 15 per cent, while the increase in crime in general was by 7.7 per cent. In 1994, about 60,000 cases of economic crime were reported; in 1995, almost 100,000; in 1996, about 115,000; and in 1998, over 250,000 cases. Experts believe that these cases represent only a tiny segment (or from 1 to 3 per cent) of all the crimes committed in the economic sphere.⁴¹ In the banking and finance sector, the number of crimes increased 45 times during the period 1991-1997. In 1994, the damages from economic crimes were estimated at \$4 billion; if losses of the victims of the financial pyramids were added to the above, the figure stood at \$30 billion or 5 per cent of GDP. In 1996, the damages were estimated at 10 billion roubles and, in 1998, at twice that amount—20 billion roubles (new denomination).⁴² The damages from the crimes in the banking and financial sector were equal to three quarters of all damages caused by crime.

Crime is increasingly committed by criminal groups, and particularly organized groups. The number of

crimes committed by organized criminal groups has increased more than fourfold.⁴³ According to the Ministry of Interior, from 1991 to 1996, the number of identified criminal groups increased from 952 to 6,743 (sevenfold increase), while the number of criminal groups with international links increased two times, and those with links with corrupt State structures more than six times. In 1997, there were 9,000 organized criminal groups in the country, controlling 40,000 businesses, including 450 banks. By the end of 1998, organized crime controlled about a half of commercial banks, 60 per cent of public and 40 per cent of private businesses.⁴⁴ According to a survey of the managers of military enterprises, criminals controlled around 25 per cent of military enterprises, and the number was likely to increase according to 43 per cent of the managers.⁴⁵

A major activity of crime-controlled businesses is money-laundering. Over 3,000 organizations seem to be specialized in money-laundering, as they have created special structures for that. Many of them started their operations in 1992 and 1993, when they reportedly laundered through money exchanges over 50 billion roubles.⁴⁶ During the money-laundering process, Russian criminals habitually invest in seemingly legitimate businesses in other countries. They acquire stakes in or control of companies to ensure profits and safe deposits. They often obtain foreign citizenship or the protection of foreign Governments.⁴⁷

Russian organized crime appears to play a significant role and exercise considerable power over the economic and political life of the Russian Federation. It has significant financial power and legal properties—information networks as well as well-developed structures for strategic planning and action. The groups are evolving increasingly into networks of associations. They imitate and create State structures, such as professional security and intelligence. They are advised by specialist lawyers, financial experts and economists. The most dangerous trend, however, is the active participation of

criminal groups not only in the legal economy, but also in administrative and political structures.

The phenomenon of a democratically elected mafia is widely discussed and acknowledged in the Russian Federation. Hundreds and thousands of criminals who took advantage of the reform processes have been able not only to legalize their proceeds but also to enrich themselves further. These profits are being used to purchase local electorates and governments. As a result, the formal economy is often controlled by criminal groups that further increase their influence and monopolize the economy through their political dominance and power over the State structures.

The use of force remains an option when vast amounts of money are involved. The famous case of the Afghanistan War Veterans' fund is a case in point. After 34 deaths and 62 injured and hundreds of billions of roubles lost without any trace, the best criminal investigators, after months of investigation, have come up only with one case involving 2.5 million roubles and three offenders, and they could say nothing about the bulk of the funds stolen—over 267 billion roubles, as some report. The most critical witnesses of or participants in the crime have already been murdered, including the former manager of the fund and his widow, as well as his successor as a fund manager. Occasional reports emerge linking the money disappeared with the activities of the Russian secret services and the election campaign of the former Russian president.⁴⁸ Another widely reported case is the Fund for the Rehabilitation of Chechnya. It was reported that, of 800 billion roubles appropriated for the rehabilitation of Chechnya, 600 billion mysteriously disappeared. Fraud, theft and corruption on an outrageous scale are mentioned in connection with this case.

In general, however, the period of wild capitalism with its senseless chaos and violence against random small businesses seems to have ended.⁴⁹ The markets are divided between krishas that are powerful and confident in their controlling abilities. Organized crime groups increasingly invest their money in the industries and markets they control, thereby increasing their profits and legalizing their assets. Occasional use of force appears to be related to the struggle between large business oligarchs using armed groups as their settlement tools. However, even these empires, as they grow larger, become

interested in securing their dominant position through a stable economic and political environment, strong central Government, and a police force capable of combating conventional crime.⁵⁰ More sophisticated crimes, such as international financial crime, mostly remain to be addressed.

The lack of appropriate legal frameworks in the Russian Federation (and in other countries, in fact) to fight sophisticated financial crimes, often makes it impossible to incriminate alleged criminals. An interview with Semyon Mogilevich (considered to be one of the world's top criminals) published in a Russian newspaper reveals that he is enjoying a quiet family life in the suburbs of Moscow, while many in the West believe him to be in hiding and on the run.⁵¹ The western media has already "convicted" Semyon Mogilevich of vast money-laundering, manipulation and fraud. He is quoted as being one of the "most dangerous gangsters", and one American author has written an account of him in a book named after the organized crime group (Red Mafia) that he allegedly ran.⁵²

The company which he set up in suburban Philadelphia, YBM Magnex, pleaded guilty in a case of securities fraud in the Federal District Court of Philadelphia after it had been caught making money by artificially pumping up its stock price and cheating its investors. In addition, however, he has been accused of arms smuggling, drug trafficking, the smuggling of art treasures and their subsequent sale at auctions, trafficking in human body parts and murder. Mr. Mogilevich claims the accusations are groundless because he notes that, in 1997, a French court revoked the ban on his entry to France by the French authorities; in 1995, a British court decided to return his seized assets; and the Bank of New York case investigators seemed to lack any evidence to link him with money-laundering operations. According to Mr. Mogilevich, in the Bank of New York case, the grounds for suspicion were based on a confusion by the media about company names: he has a company called "Benex-Trade Medical Corporation" while in the files of the case a company called "Benex Worldwide" is mentioned. Until the Russian and international authorities come up with better grounds for Semyon Mogilevich's arrest, he can continue living "peacefully" in his dacha near Moscow.

Chapter VIII

Legalization and/or amnesty argument

A. Developments in the Russian Federation as a rationale for the argument

In the Russian Federation, money-laundering is always linked with the problem of capital flight and a subsequent lack of investments and with the market reforms in general. It is commonly argued that since it is now impossible to identify the origins of assets, it is easier to assume that all capital is legal. This contention renders the concept of money-laundering meaningless.

A popular politician Mikhail Prusak (Governor of the Novgorod region in the central Russian Federation—one of the showcase regions of successful economic reform in the Russian Federation), supported by many inside and outside his region, has launched a national campaign to declare the legality of all assets currently held and prepared the corresponding package of bills. In his opinion, “trying to see what is criminal capital and what not, would be the most useless step any leader could make”.⁵³ Mr. Prusak believes that only a small share (2-10 per cent) of the wealth has been acquired by criminal means. Thus, as long as the courts have not determined the assets are criminal proceeds, the authorities should presume the assets to be legally earned. In Novgorod region, this has meant that all assets which have appeared in the region have been accepted as legal. Considering the current miserable status of the justice system in the country, one can reasonably expect the same for the whole country if the same policy is adopted.

Novgorod region also offers greater tax breaks and more legislative guarantees to investors than most other regions. It presumes that what looks like money-laundering is in fact just capital flight occurring because of imperfect legislation (primarily excessive taxation) and an unstable economic environment. Therefore, by offering a stable and favourable economic environment and guarantees against criminal persecution and confiscation of assets, the region is aiming to attract

capital fleeing to offshore zones. Indeed, the Novgorod region is a Russian champion in attracting investments. It has the highest rate of investments per unit of natural resources in the Russian Federation. Despite the fact that the region is not the most attractive locality in terms of availability of natural resources, the region has managed to attract Russian and foreign investments on a large scale, and this has fostered economic growth and created jobs.

Academic arguments are also used to advance the “legalization” proposal. Karl Marx’s *Das Kapital*⁵⁴ is frequently invoked in this connection. The book’s chapter on the “genesis of the industrial capitalist” describes the period of “primitive accumulation of capital” in eighteenth and nineteenth century Europe. It was a period when, “in the public opinion, Europe lost its last remnant of shame and conscience, ... bragged cynically of every infamy that served them as a means to the accumulation of capital”.⁵⁵ At the time, these included slave trade, child-slavery, public debts benefiting only a few, trade protection, commercial wars and others. Hence, it could be understood in general that early capitalism (such as that of the early 1990s in the Russian Federation) is a revolutionary period of lawlessness, when capital is generally accumulated by illegal and/or treacherous means.

More substantiated arguments are also available to advocate legalization. For example, Nataliya Lopashenko, the author of several books on economic crime in the Russian Federation, believes that all criminal capital has already been legalized. It happened during the early phase of the privatization process, through the mass privatization voucher scheme of 1992-1994. Hence, she argues that there is not much criminal capital left to legalize. The bulk, if not all, of the hidden capital is just a shadow capital trying to escape taxation and an unfavourable economic and political environment. The sources of the assets accumulated are activities that cannot be unambiguously defined as criminal. Therefore,

it can be concluded that it is indeed economically and legally prudent to declare all capital legal.⁵⁶

Many politicians support the idea of legalization based on rather pragmatic arguments. Until recently, there had been no official records of assets owned by Russians. Hence, they argue that it is impossible to question the legality of these assets. People can easily claim that their families have had these assets for a long time without any official records. An acknowledgement of this reality can provide some law enforcement officials with an excuse not to take any action against the owners of capital of unknown origin. Deprived of funds and skilled personnel, law enforcement and justice system structures, including the police and the judiciary, are reported to be lacking minimum functional capacities. In view of this, one can argue that it is logical not to strain the limited resources of the system by attempting to launch a combat doomed to fail.

B. International reasons for the argument

Besides numerous domestic problems, investigators in the Russian Federation face difficulties associated with the international nature of money-laundering. Economic difficulties and budgetary constraints prompt the Russian authorities to focus primarily on the recovery of assets. Since it appears that more resources are leaving the Russian Federation than entering the country, the focus is on the recovery of assets placed in other countries. This means that cases require fruitful cooperation between several countries, which often fails to happen. Successes in the investigation and prosecution of money-laundering cases have been the result of coordinated actions with the law enforcement agencies of other countries, and these remain exceptions rather than the rule.⁵⁷

Russian investigators and prosecutors state that they usually fail to locate or confiscate the proceeds of crime because they are outside the Russian Federation. The criminals themselves are also often located outside Russian jurisdiction. Differences in the legal frameworks of various jurisdictions make it hard or sometimes impossible to convict criminals or even to initiate investigations. Moreover, Russian law enforcement representatives argue that the misapprehension of the political realities in the Russian Federation by the foreign authorities often play into the hands of criminals, who manage to obtain from these authorities decisions on their non-extradition or political protection.⁵⁸ Even in cases when the criminals are eventually convicted and the assets confiscated (with the cooperation of the Russian

law enforcement agencies), the Russian authorities often do not receive the assets confiscated. The assets remain in the countries where they have been confiscated. This situation is not unique with regard to the Russian Federation, as Shelley notes in general that existing legal policies merely enrich the developed countries that have already benefited from the illicit capital,⁵⁹ while developing and transition countries badly need these assets for their sustainable development.

This failure to acquire assets (in addition to the lack of capacity to build strong cases and convict criminals in the Russian justice system) gives the Russian authorities the most compelling motivation to seek other means to recover assets. It is believed that proposals are often discussed and arguments are built on cutting deals with the suspects of money-laundering cases. In return for the promise from the authorities not to pursue criminal investigations, the suspects are expected to surrender to the Government a share of the assets laundered. Or they might be offered just to invest their capital in the Russian Federation, for example, in enterprises that would provide employment to a large number of Russians.

The Russians did not invent the idea of injecting illegal money into the legal economy. Many other countries have already tried various strategies to amass black money and to fill the gaps in their national budgets or investment funds. It has been done by the issuance of securities with or without the identification of the owners of cash, through tax amnesties or capital flight amnesties.⁶⁰ Spain, in 1985, issued black treasury bills to finance its deficit. India, Pakistan and Sri Lanka over the last few decades have issued several varieties of securities, all with conditions—"no questions asked about the source of funds". Furthermore, in addition to asking no questions about the source of the money, Pakistan pledged to drop all tax evasion cases outstanding against persons or companies buying them. Tax amnesties have been offered by Argentina, Austria, Belgium, Colombia, Ecuador, France, India, Ireland, Italy, Panama and the Philippines. Hit by the capital flight of about \$85 billion during 1977-1987, Mexico announced in 1989 that Mexicans could receive a complete amnesty by paying a maximum tax of 5 per cent on interest and dividends received for the period when the money was held abroad.

The results of these policies have been mixed and little success was reported about the subsequent inflow of funds. However, they have turned out to be good instruments for laundering money. Moreover, in some cases they have even encouraged people to turn to the underground economy. The measures offered not only legalization of past crimes and other illegal activities, but also rewards for the sums generated. Hence, the main

danger of the legalization policies lies in its ability to blur further the distinction between what is legal and what is illegal. The consequences of this policy could be far-reaching and harmful. Although the policy might bring financial gains in the short run, it might bring greater problems in the future as well. It can promote tolerance

towards the crime. It might encourage further breakdown of social cohesion and the spread of more predatory forms of economic behaviour. Hence, international experiences in legalization and amnesty call for careful consideration of various policy alternatives before opting for legalization and/or amnesty.

Chapter IX

Countering money-laundering

The development of effective anti-money-laundering legislation has been slow. Several versions of the Federal Law on Countering Money Laundering have been prepared since 1994. In June 1999, the Russian Parliament even adopted the legislation, but the Russian President later vetoed it. Several other laws aimed at combating the spread of economic crime (such as corruption) have been discussed (but never passed) by the State Duma, the Lower House of the Russian Parliament. The deputies debated and objected not only specific aspects of the laws, but also their scope and practical applicability.

The most heated debate on the draft anti-money-laundering legislation has revolved around the interpretation of the word “nezakonny” (illegal) income. The opponents of the word “nezakonny” argue, inter alia, that it contradicts the provisions of the European Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, which for its purposes defines “proceeds” as economic advantage from criminal offences. Lately, however, many in the Russian Federation argue that it is only a matter of translation of the word “nezakonny”, which can be translated into English as criminal. This debate is not simply about the proper legal term. It signifies the profound dilemma which has arisen as a result of the recent reforms in the Russian Federation. When the broadest interpretation of the type of proceeds and activities involved is used, the law could affect too many in the Russian Federation. This would affect minor offenders cheating on taxes for just a few hundred roubles. But it could be used, if consistently and retroactively applied, against many others, including those in the political elite, who manipulated and benefited from the economic reforms, particularly privatization.

It is also argued that the legislation would violate human rights and provisions of the Constitution of the Russian Federation, which safeguard privacy of personal data and freedom of economic activities. Provisions of the draft law require reporting and monitoring of the financial

transactions (both legal and illegal) and disclosure of certain personal data, the disclosure of which without the consent of the concerned individual is prohibited by the Constitution. Moreover, under the draft legislation, the parties to the business transactions are obliged to monitor and evaluate the validity of operations in order, for example, to determine the validity of transactions and report about those having elements of void transactions. Therefore, it is argued, these parties would be acting as branches of the law enforcement system, which again contradicts the Constitution. Although this type of argument is more typical of an earlier period of transition, in a refined fashion it continues to be used by the opponents of the anti-money-laundering legislation. These arguments echo the sentiments of democratic change of the early 1990s when massive legislative changes were undertaken to guarantee human rights and democratic principles.

A recent version of the anti-money-laundering law prepared by the Office of the President has already been widely criticized and it is now more likely that the version adopted by the Parliament in 1999 will form the basis of a new draft to be discussed by Parliament. In response to the new initiatives towards strengthening of the law enforcement functions of the State and control of the central Government, many in the Russian Federation are optimistic about the passage of the corresponding laws. In line with this trend, a number of key politicians, including Alexander Gurov, Chairman of the Security Committee of Parliament (the Committee developing the draft), believed that the draft would be discussed and adopted in 2000.⁶¹ However, since anti-money-laundering legislation was not considered to be a priority (compared to others, such as taxation) these predictions turned out to be overoptimistic.

Meanwhile, the offence of money-laundering already exists in the Russian Federation. The Criminal Code of the Russian Federation approved in 1997 includes a chapter on economic crimes (chapter 22), with

31 articles describing penalties for a broad range of offences. Article 174 of chapter 22, on legalization (laundering) of monetary means and other property acquired by illegal means, specifies a punishment of up to four years in prison for financial operations with monetary means and other property known to have been acquired by illegal means. The article does not specifically state that the money and property should be the proceeds of crime, only that these could be any assets illegally obtained. If an offence is committed by a group of people or repeatedly, it is considered to be a serious offence and harsher punishments are expected.

The use of this article of the Criminal Code has not only been minimal, but also inconsistent. This reflects not only the present economic and political realities, but also a number of uncertainties and debates with regard to the application of the provision. The debates among practitioners revolve around the possibility of convicting the offender if no conviction was obtained in connection with the primary offence as a result of which assets had been acquired. So far, those already convicted of the predicate offence have been convicted of money-laundering. Contrary to the above argument, others suggest that the same person cannot be convicted for both type of offences—for the predicate offence and for the secondary offence (money-laundering). And again there is no agreement on the word “nezakonny” (illegal) income. While some Russian experts are convinced that the provision applies only to criminal proceeds, others apply it to proceeds from a broad range of offences covered under administrative and civil codes.⁶²

Interviews conducted by the Research Institute of the Ministry of Internal Affairs of the Russian Federation (VNII MVD) with law enforcement officers unveil both their lack of understanding of the money-laundering process and the ambiguity of the provisions of the Criminal Code to begin with.⁶³ Ten per cent of respondents included visits to theatres, movies and athletic events using the money gained by illegal means as part of the money-laundering process. A slightly lower proportion of the respondents (7.4 per cent) included in the process payments to prostitutes. Seventeen per cent of respondents believed that tourist trips and gifts to relatives should be classified as money-laundering activity. However, less than one quarter of the respondents classified the purchase of securities as potentially signifying a money-laundering operation, and 46 per cent did not think that the purchase of real estate could constitute money-laundering. It is significant to note that the responses given by the respondents in 2000 did not differ much from those given in 1998, suggesting

that the training in this area has not been effective in increasing awareness of money-laundering offences.

In general, the effectiveness of the justice system, at least with regard to economic crime, seems to be deteriorating rather than improving. For example, the conviction rate for corruption fell during the 1990s: 1,072 offenders were convicted for corruption in 1995, but only 345 were convicted in 1998, of whom only one third were sentenced to prison terms.⁶⁴ In 1997, under article 174 of the Criminal Code, only 241 cases were registered and only 166 cases were completed.⁶⁵ In 1998, 1,003 cases (as experts believe, only 0.3 per cent of all the economic crime cases) were reported, and, in 1999, 965 cases were reported, of which 105 were completed and only 33 offenders convicted. Variations in the interpretation of the provisions of the Criminal Code on Countering Money Laundering (mainly on the sources of proceeds) partially explain the minimal application of these provisions.⁶⁶ But inconsistencies in practices concern not only variations in defining “illegally acquired monetary means and property”, but also variations in defining offenders. For example, a case was reported where the offender was not charged with committing a crime under the article on money-laundering because the same offender had already been charged with committing a crime to acquire the assets (which were later laundered).⁶⁷

The gap between the realities of the Russian Federation and the outcomes of the law enforcement measures is acutely reflected in the composition of offenders and nature of offences. In 1999, only 105 persons were charged with money-laundering, 12 of whom were workers, 19 civil servants, 40 businessmen and 24 unemployed. On closer inspection, one can conclude that their offences were mostly minor and could hardly be classified as money-laundering. Most analysts believe that the real situation in the Russian Federation is different, and involves a different type of people operating on a large scale. Russian experts on money-laundering (from the law enforcement agencies) observe that casinos and discos (56 per cent of the respondents), commercial banks (46 per cent of the respondents), restaurants and bars (33 per cent of the respondents) and shops (31 per cent) are the prime locations of money-laundering operations.⁶⁸ Commenting on the use of the proceeds, they mentioned future criminal projects (56 per cent of respondents), real estate purchases, or purchase of arms and financing of specific criminal actions (35.4 per cent).

The need to deal with the complex problem of money-laundering, which is becoming a national problem of great magnitude, prompted the Government of Russia

to establish in 1999 the Interministerial Centre for Countering the Legalization of Illicit Proceeds. It was set up under the Ministry of Interior by the decision of nine ministries and agencies, including the Ministry of Interior, Ministry of Finance, Ministry of Taxation, State Customs Committee, Federal Security Service, Federal Tax Police, Foreign Exchange Commission, Ministry of Economy and Ministry of Justice, and in coordination with the Central Bank and the General Procuracy of the Russian Federation.⁶⁹ Composed of the staff members delegated from all the relevant ministries and agencies, the Centre is expected to collect information on illegal or economically imprudent transactions with monetary means and property, provide analytical support to the detection and halt of money-laundering measures, coordinate anti-money-laundering actions of the federal agencies and cooperate with foreign units with similar functions. The Centre became fully functional only in 2000 and has contributed to the operational work related to the detection and investigation of cases, particularly those requiring the cooperation of several government agencies.

The Centre's political significance and policy development role has been gaining momentum as it is charged with the preparation of a number of policy documents and proposals.

In general, the grave criminal situation has prompted the Russian Government to undertake a number of actions to curb crime. For example, in January 2000, the Russian authorities approved two anti-crime programmes for over 3.3 billion roubles. The first includes actions against conventional criminals, such as car thieves, robbers, terrorists, mobsters etc. The second programme is directed against corruption and any abuse of their position by officials for personal benefit. However, the pessimism about any effective actions by the Government to curb corruption and crime is so widespread that many in the Russian Federation think that the anti-corruption, anti-crime drive of President Vladimir Putin might become a fight between oligarchs trying to destroy their competitors.

Chapter X

Concluding remarks

Money-laundering in the Russian Federation is closely intertwined with the wide-ranging political, economic and social processes under way in the country. It has become an identifiable feature of contemporary capitalism in the Russian Federation. It exploded when market reforms, including financial liberalization, privatization and many others were undertaken. It followed the destruction of the old public institutions which, in many cases, were not replaced. Money-laundering in the Russian Federation feeds on the perceived decline in the strength of the State and the weakening of its law enforcement institutions. It is linked to the loss of jobs and huge shadow economy. Economic instability and crime are among the reasons for the shadow capital and its flight from the Russian Federation. Money-laundering has gained a significant international dimension and has become a problem not only for the Russian Federation but also for the international community.

Effective measures against money-laundering in the Russian Federation necessitate the consideration of the whole process of reforms, particularly the requirement to build regulatory and institutional capacities for the functioning markets. It includes improvements in banking supervision which increasingly needs to be coordinated with the law enforcement efforts. Banking supervision in the Russian Federation cannot be limited to the traditional methods used to ensure the prudence of financial operations, as it has become critical to join efforts to eradicate illegality and criminality in the banking sector.

In today's Russian Federation, it is hard to expect fast actions and fast results in the combat against money-laundering. It is a long process that requires coherent national and international efforts. Fighting money-laundering and economic crime in the Russian Federation means addressing a set of wide-ranging problems. The privatization dilemma inevitably surfaces in any thorough attempts to overhaul the criminal situation. The dilemma implies rethinking and reconsideration of the outcomes of

the privatization process—an issue very sensitive and dangerous politically and economically. Embarking on a crusade against powerful moguls continues to face the risk of becoming a fruitless undertaking. Changing the way of thinking of people who have begun accepting lawlessness, the shadow economy and tax evasion as a part of their lives is acknowledged to be a lengthy and gradual process. Russians, faced with economic hardships, are receptive to the policies that promise immediate financial gains. Despite the dangers of the amnesty and/or legalization proposal, many in the Russian Federation are attracted to its features, such as the possibility of quick recovery of some assets without fatal political clashes and economic downturn. The policy of legalization might contribute to the aggravation of the criminal situation and further delay any effective actions against money-laundering.

Money-laundering in the Russian Federation so far has been an issue related to the proceeds of crime, primarily of economic crime, or of economic and financial operations, which could not be immediately classified as criminal. Millions of Russians think that the 1990s evidenced massive, unpunished theft of public assets and their concealment abroad. This massive theft and concealment draws attention to the situation and inspires calls for action. Russian society is receptive to the idea of capturing criminals and punishing them appropriately. However, the idea looks even more attractive to them if it is linked with the possibilities for using the assets seized to solve social problems. Increasing poverty and joblessness make it a compelling task to produce immediate financial gains as a result of the anti-money-laundering drive. The gains are expected to demonstrate success of the law enforcement efforts and help to address pressing social problems, including escalating poverty. The Russian authorities plead for international facilities and assistance in returning to the Russian Federation assets seized in other countries. This measure might eventually contribute to the anti-money-

laundering drive and sentiment more than any other action.

Condemnation of money-laundering per se as a criminal act is yet to gain ground among Russians. Standard anti-money-laundering actions, such as the adoption of laws on money-laundering and related guidelines for law enforcement agencies or banking regulations, are yet to be absorbed, accepted and utilized. Actions in these directions have been often regarded not only as low-priority measures, but also as practically impossible to implement. Meagre capacities and the tainted reputation of the law enforcement agencies or the close association of banks with scams and fraud have often served as examples of a dismal reality.

Those charged with fighting money-laundering not only lack knowledge of the specific aspects of the legislation or techniques used in the analysis of data or in investigations. They also need opportunities to learn and compare experiences in setting up the overall anti-money-laundering framework and to choose the features that are expected to work in the conditions of the Russian Federation. This has been one of the undertakings of the Russian Interministerial Centre for Countering the Legalization of Illicit Proceeds, the institution mandated to address the money-laundering problem. During its short existence, the Centre has already demonstrated itself as an institution with competencies for policy development, research, international cooperation and investigation of money-laundering cases. This specialized institution, as well as others charged with combating money-laundering, require support and encouragement if one expects faster outcomes in the fight against that phenomenon.

Notes

- ¹ See Shazeeda (1998) for a brief discussion of the argument.
- ² In 1999, the international media extensively reported about the investigations by law enforcement officials of the United States of America of transfers of as much as \$10 billion of Russian money through the Bank of New York. Some of the money appeared to have come from Russian organized crime bosses and has been described as a part of a money-laundering scheme to conceal the origin of criminal profits.
- ³ Average of different estimates of capital flight in Abalkin (1998), p. 425.
- ⁴ Some examples of the inflow of the criminal monies into the Russian Federation from the United States during the early stages of privatization (1992-1994) are mentioned in Fituni (1998).

- ⁵ *Rossiiskaya Gazeta*, 29 December 1998, quoted in Lopashenko (1999), p. 8.
- ⁶ Leonid Abalkin is the director of the Institute of Economics of the Russian Academy of Sciences.
- ⁷ Abalkin (1999), p. 425.
- ⁸ International Monetary Fund (1999), p.104.
- ⁹ Shuttle traders are individuals who travel abroad to purchase and bring back to the Russian Federation commodities and sell them at home at a profit. They use the local currency obtained to purchase foreign cash and use it to travel again abroad and bring more goods with them.
- ¹⁰ Fituni (1999), p. 362.
- ¹¹ More on that in the later part of this paper.
- ¹² China's capital flight estimates from Gunter (1996).
- ¹³ Rushailo (1999), p. 23.
- ¹⁴ From the interview with Viktor Melnikov, Vice-President of the Central Bank of the Russian Federation. *Moskovskii Komsomolets* (2000).
- ¹⁵ From the statement by Yelena Ishchenko, director of the Foreign Exchange Department of the Russian Central Bank, reported by Radio Free Europe, 12 June 2000.
- ¹⁶ Russian Economic Trends (1997-1999).
- ¹⁷ The Central Bank of the Russian Federation has been using this definition since 1998.
- ¹⁸ Central Bank of the Russian Federation (2000).
- ¹⁹ Buchs (1998) estimated that the amount of cash entering the Russian Federation annually was \$25-40 billion (equal to 10 per cent of GDP) and, accordingly, the dollarization rate was 42 per cent.
- ²⁰ Mentioned in Chegodaev (1999).
- ²¹ The dollarization debate is about costs and benefits of dollarization. For example, full dollarization of the economy is discussed as a way of enabling developing countries to overcome monetary and exchange rate instability. More on that in Berg and Borensztein (2000) and in Calvo and Reinhart (1999).
- ²² Silverman and Yanovich (2000), p. 152.
- ²³ Argued, for example, by Fituni (1999).
- ²⁴ Discussed in Schleifer and Tresiman (1998).
- ²⁵ IMF (1999), pp. 125-127.
- ²⁶ For example, in 1999, in the Russian town of Volgograd, the regional bureau against organized crime finally was able to locate and arrest Mr. Aleksandr Fatyanov, who illegally acquired a promissory note for 2 million roubles from a Volgograd enterprise. Before that, in October and November 1999, the local court of Mr. Fatyanov's home town Krasnoyarsk and its regional prosecutors' office both issued warrants for his arrest based on two separate criminal investigations for fraud and embezzlement. At the same time, when the Krasnoyarsk's investigators were trying to locate Mr. Fatyanov, he was managing in another town, Volgograd, the regional office of the Federal Centre for Arrears of the Russian Federation. He was nominated as its head on 28 July 1999, after being recommended as the best-qualified candidate by the Federal Centre for Arrears, an agency that is expected to solve high-priority problems of arrears and non-payments among local industries and offices. *Izvestiya*, 7 February 2000.

- ²⁷ A chapter from his new book was published in a Russian newspaper *Moskovskie Novosti*, Soros (2000).
- ²⁸ In 1997, *Forbes Magazine* named Berezovsky as the richest man in the Russian Federation, worth an estimated \$3 billion. During the Presidency of Boris Yeltsin, he was often reported in the media as the most politically influential financial baron, as a ruthless New Russian, artful in turning money into power. Recently, after the election of Vladimir Putin as President of the Russian Federation, Boris Berezovsky relinquished his seat in the Russian Parliament in a protest against what he saw as the Government's destructive attack on businesses.
- ²⁹ See, as an example, Nellis (1999) and Tanzi (1999).
- ³⁰ Data by the Research Institute of the Ministry of Internal Affairs (VNII MVD) in Kalachev (2000).
- ³¹ Russian Economic Barometer (1999).
- ³² Kosals (1998), p. 72.
- ³³ On non-monetary transactions and arrears, more in IMF (1999).
- ³⁴ Argued, for example, in Shazeeda (1998) and Fituni (1999).
- ³⁵ Ekspert (1996).
- ³⁶ Data on banks from IMF (1999), pp. 72-89.
- ³⁷ Argued by Gregory (1999).
- ³⁸ More on criminal activities in the Russian banking system in Burlingame (1997).
- ³⁹ Quoted in Burlingame (1997), p. 52.
- ⁴⁰ Williams (1997), p. 16.
- ⁴¹ Dolgova (1998), p. 92.
- ⁴² Lopashenko (1999), pp. 8-9.
- ⁴³ Dolgova (1998), p. 254.
- ⁴⁴ Lopashenko (1999), p. 8.
- ⁴⁵ Radaev (1998), p. 83.
- ⁴⁶ Lopashenko (1999), p. 13.
- ⁴⁷ See Galeotti (2000) for a brief review of international involvement of the Russian mafia.
- ⁴⁸ Bukshin (2000), p. 10.
- ⁴⁹ Discussed in Radaev (1998).
- ⁵⁰ Ledeneva (2000) argues further that as a result, the efficiency of police and tax police are increasing.
- ⁵¹ *Moskovskie Novosti* (2000), p. 4-5.
- ⁵² A chapter in a new book by Robert Friedman, *Red Mafia: How the Russian Mob has Invaded America*, describes Semyon Mogilevich's operations.
- ⁵³ *Business in Russia* (2000), p. 37.
- ⁵⁴ *Capital: a critique of political economy* by Karl Marx, which condemns capitalism as an exploitative society, used to be required reading material at universities during the Soviet era, hence most educated Russians are familiar with its content.
- ⁵⁵ K. Marx (1976), p. 924.
- ⁵⁶ Interview with Nataliya Lopashenko by the author, May 2000.
- ⁵⁷ Statements at the Conference on International Co-operation on Money Laundering Investigations, St. Petersburg, 18-19 May 2000.
- ⁵⁸ For example, Russian banker Alexandre Konanykhine, whom the Russian prosecutors wanted to be extradited from the United States to the Russian Federation to be tried for financial crimes, was granted political asylum in the United States.
- ⁵⁹ Shelley (2000), p. 52.
- ⁶⁰ More on that in Naylor (1995/96).
- ⁶¹ Interview with Mr. Gurov by the author.
- ⁶² See Aliev and Bolotskii (1999) for the review of the arguments.
- ⁶³ In Kalachev (2000).
- ⁶⁴ Dolgova (1998), p. 167.
- ⁶⁵ Lopashenko (1999), p. 13.
- ⁶⁶ Discussed earlier in this paper.
- ⁶⁷ Kalachev and others (2000).
- ⁶⁸ Interviews by VNII MVD in Kalachev (2000).
- ⁶⁹ Some of them were abolished during the Government restructuring in 2000.

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