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CYP-RUS INVESTMENT FLOWS TO CENTRAL AND EASTERN EUROPE

- Russia's Direct and Indirect Investments via Cyprus to CEE

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Abstract

This paper deals with Russian investments to ten Eastern European EU candidate countries. Eastern European countries are an important destination for Russian OFDI, and the share of Russia in many CEEC's inward FDI stock is substantial. Russian investments to these countries are mostly connected to the internationalisation of Russian energy sector. Russian oil and gas giants have been actively investing to almost all eastern EU candidate countries. However, OFDI constitutes only a small part of Russian capital abroad, as it covers merely 10 % of the Russian capital flight. Cyprus has been an important landing place for Russian capital flight and is currently the biggest direct investor to Russian economy. Also the investment flow from (or via) Cyprus to other Eastern European countries is relatively big. Significant share of these Cypriot investments are considered to be of Russian origin. This paper tries to anticipate the effects of the legislative changes, due to Cyprus's EU accession in 2004, on the role of Cypriot offshore sector as a landing place for Russian capital.

1. Introduction

The majority of the scholarly work concerning the East-West investment activities has focused on the investment flows from the West to the East, and hence, the scholars have almost completely neglected the reverse direction of the investment flows. In this article, the researchers aim at describing the Russian direct investment abroad, particularly in Central and Eastern Europe. The authors have given a special emphasis on the Russian outward direct investment due to the fact that Russian companies are clearly the most active investors abroad among the ex-CMEA countries.

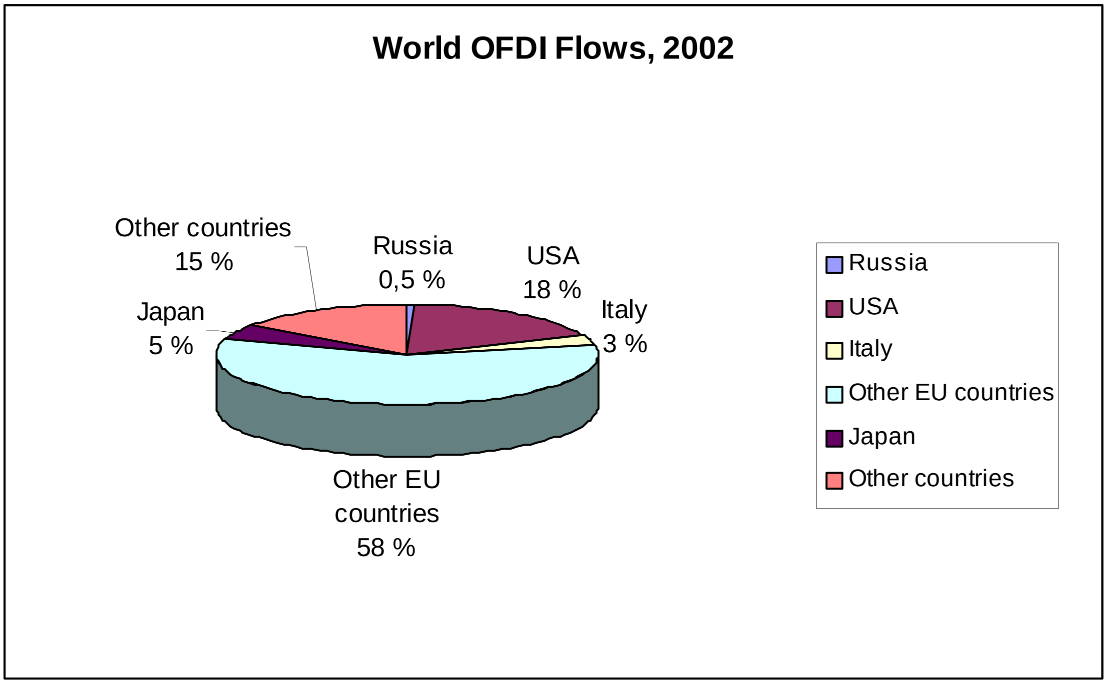
Some studies have already been conducted on the contemporary Russian firms' business activities abroad (e.g. Bulatov 1998, Heinrich 2001a/2001b, Kobyzev 2001, Liuhto 2001a/2001b, Liuhto & Jumpponen 2003a/2003b, Pchounetlev 2000, Rybakov & Kapustin, Survillo & Sutyrin 2001, Trofimenko 2001, Väätänen & Liuhto 2000). These earlier contributions aided the researchers to focus their study on a wide but unexplored phenomenon i.e. the Russian investments via Cyprus to other countries. The changing role of Cyprus as a transit point for Russia capital needs to be studied for two main reasons. First, it is commonly known that Cyprus is one of the destinations, where a great deal of the capital flight from Russia has landed. Secondly, Cyprus is accessing the EU in May 2004, and it is believed that her integration into the Union will have a significant impact on the Russian companies' investment behaviour abroad, since the Russian Eagle may decide to abandon this island and search for more quiet (less transparent) locations in the world to carry on its indirect investments.

Even the name 'Cyprus' is inspiring for the researchers following the activities of Russian firms abroad, as the name ends with three letters 'rus', which are often used to describe the presence or involvement of Russia.

2. Russian Direct Investment in Central and Eastern Europe

As of the end of 2002, Russian outward foreign direct investment (OFDI) stock amounted to some $ 18 billion. In a world-wide comparison, however, Russia still remains a minor outward investor. In 2002, the Russian OFDI flow covered only half of percent of the world's total (UNCTAD, 2003).

Table 1. Russia's Role in the World OFDI Flow in 2002



Source: UNCTAD, 2003.

The world OFDI flows amounted 647 363 million of USD in 2002. The share of the EU was almost 62 %, USA covered over one sixth and Japan some 5 % of total OFDI flows in the world. Italy with her share of almost 3 %, offers a good point of comparison, as the two countries' economies are about the same size[1]. In this respect, Russian OFDI can be considered quite modest.

[1] In 2002, Italian GDP (PPP) was about $ 1.44 trillion and Russian $ 1.35 trillion (CIA, 2003).

Although Russia accounts only for a marginal share in world's OFDI, she plays a substantial role among the transition economies. Russia has invested abroad more than the eastern EU candidates as a whole (see Table 2).

Table 2. OFDI Stock of 10 Eastern EU Candidates and Russia [2]
($ million by the end of 2002)

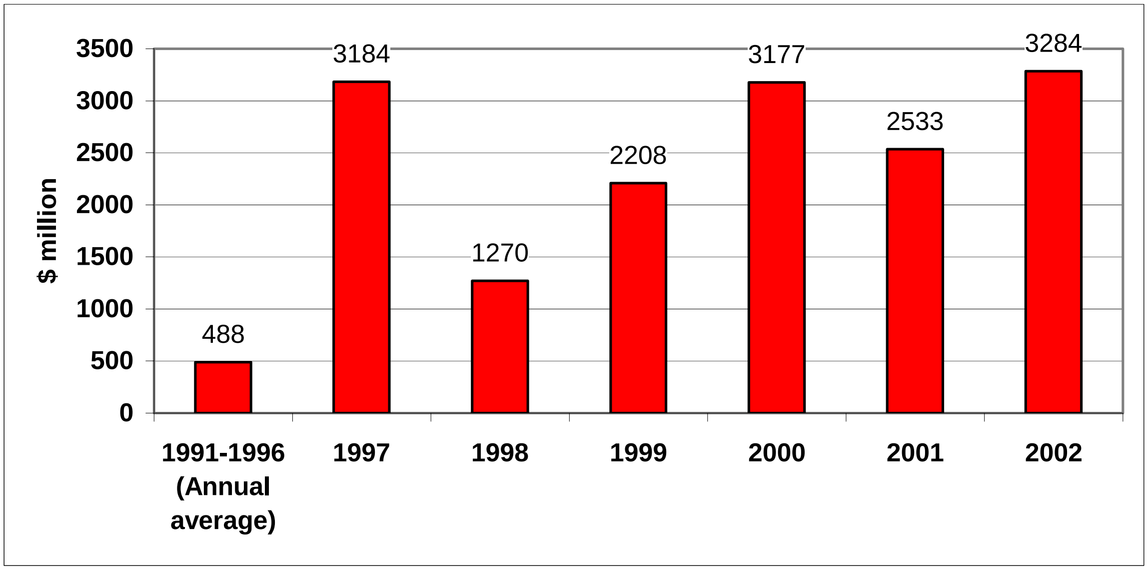
10 EU candidates	**9969**
Bulgaria	*125*
Czech Republic	1 496
Estonia	670
Hungary	4 641
Latvia	67
Lithuania	60
Poland	1 280
Romania	*155*
Slovakia	409
Slovenia	1 066
Russian Federation	18 018

Source: UNCTAD, 2003.

Russian OFDI is growing at a rapid pace. Over 80% of the country's OFDI have accumulated during the past six years. This shows that the Russian companies, particularly those involved in the oil and natural gas business, have noticed the importance of the internationalisation in building their competitiveness (UNCTAD, 2003).

[2] From the 10 eastern candidate countries Bulgaria and Romania do not access the EU in May 2004, but perhaps in the end of this decade.

Table 3. Annual FDI Outflow from Russia.



Source: UNCTAD, 2003c.

OFDI presents only a fraction of the amount of Russia's capital abroad. During the 1990s, the estimated amount of capital flight from Russia is some $ 150-300 billion, indicating the vast overseas purchasing power of Russian corporations and individuals. However, as due to Russian economic boom of recent years and economic downturn in most other parts of the world, the capital flight has contracted and the Russian capital has started to return to home (The Foreign Investment Mystery, 2003). However, the scandal around the oil major Yukos[3] is supposed to increase the capital flight from Russia again, and slow down the return of Russian capital from abroad.

Russian OFDI flows in the second half of the 1990's indicate that the EU is the main destination for Russian FDI with the share of some 31 %. Within the EU the main destination was Germany covering over a half of Russian FDI outflows to the EU. Germany, the UK, the Netherlands and Spain together accounted for more than 90 % of Russian OFDI within the current Union. (Liuhto & Jumpponen, 2003a.) One fourth of the Russian OFDI flows went to European ex-socialist countries (Kalotay, 2003).

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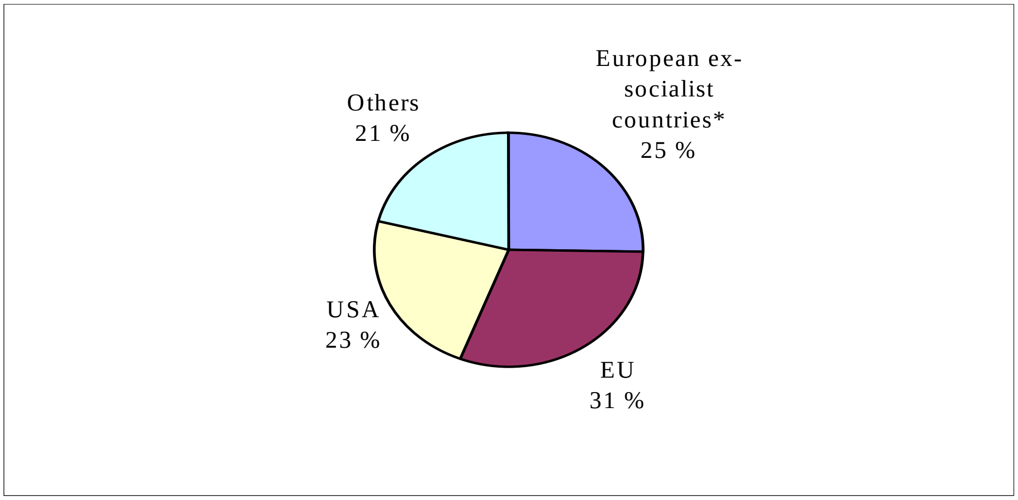
[3] The criminal investigations of Yukos culminated in Oct 25th 2003 in the arrest of Mikhail Khodorkovsky, the CEO and principal owner of the company. Few days later Khodorkovsky resigned his post in Yukos. The accusations against him are commonly considered to be based on political reasons.

Table 4. The Geography of the Russian FDI Outflow during 1995-1999



* Here European ex-socialist countries include, in addition to the eastern EU-candidate counties, the former republics of Yugoslavia, Moldova, Belarus and Ukraine.
Source: Kalotay 2003.

Based on data offered by the national banks of the Central and Eastern European EU-candidate countries, their share of Russian OFDI seems to be about 12 % (see Table 2). However, as the statistical information from different sources deviates significantly, the figure should be regarded as a rough estimation. The following figures are based on host-country reports since no verified data were available from Russian sources.

Table 5. Russian OFDI Stock in the EU's 10 Eastern Candidates

	FDI stock ($ million)	*Share of country's total FDI stock (%)*	*Ranking among investor countries*
Bulgaria (1.1.2003)	202.10	3.80	10
Czech Republic (31.6.2003)	28.50	0.073	
Estonia (31.3.2003)	69.73	1.40	10
Hungary (1.1.2001)	35.91		
Latvia (1/2003)	157.31	5.28	
Lithuania (1.1.2003)	235.56	5.21	8
Poland (2002)	1291.90	1.89	12
Romania (30.9.2002)	..	<0.01	..
Slovakia (1.9.2001)	9.00	1.60	
Slovenia (1.9.2001)[4]	0.00		

Source: National Banks, authors' calculations

Among the future EU members, the main target for Russian investments is Poland, followed by Lithuania, Bulgaria, and Latvia. The Russian OFDI stock in Poland consists almost entirely of equity investments and holdings of Gazprom in manufacturing and distribution activities in natural gas sector, worth $ 1,28 billion (Liuhto & Jumpponen 2003b).

In Lithuania, the Russian energy majors have been active during the past few years. In 2002, Yukos acquired a majority stake in Mazeikiu Nafta, significant investment worth some $ 150 million. In the same year, a Gazprom-led consortium won a $ 30 million privatisation deal over a hydroelectric power station in Kaunas, with a commitment to further investment of $ 30 million for the improvement of the unit (Liuhto & Jumpponen, 2003b). In April 2003, Gazprom issued a bid for 34% stake in the Lithuanian gas distribution company, Lietuvos Dujos. The sale was originally to be completed by the end of 2002, but Gazprom then failed to present the final offer before the due date being unsatisfied with the price and conditions of the deal. In January 2004, the Lithuanian

[4] Major investments by Russian energy companies have taken place since, including the $ 74mln investment by Yukos in Transpetrol and pre-emption right of Gazprom to acquire some $ 1bln stake in SPP (Slovakian gas pipeline operator)

government agreed on selling the stake valued from some $ 37 million, to Gazprom. Resulting from the recent Yukos crisis, the negotiations of the deal were partially delayed earlier due to unusual demands by Lithuanian opposition party to suspend negotiations with Gazprom and even buy back the Yukos' share in Mazeikiu Nafta not to jeopardize the sensitive sector of country's economy. (Rosbalt.Ru 2003, Pravda.Ru 2003, Europe Energy 2003)

In Latvia, the main Russian investors responsible for some $ 157 million investment stock are Transnefteprodukt, Gazprom and Lukoil, covering over 70% of Russian FDI stock in the country (Liuhto & Jumpponen, 2003a). Recently, the Latvian port of Ventspils is considered to be a target for the sale negotiations with Russian investors. Ventspils used to be the main port on the Baltic Sea for Russian oil exports, before Transneft ended its crude oil transportation to the port in January 2003, resulting to a contraction in Ventspils' operating results. Although some information exists about Russian Yukos being interested in Latvijas Nafta Transit (LNT), which holds some 47,9% stake in Ventspils Nafta (Pinchuk, 2003), this deal is most probably not realisable for some time to come, due to the widespread crisis around Yukos. As of recent, however, another Russian oil major, TNK-BP, has shown increasing interest in acquiring LNT after outperforming Yukos as the main exporter through the port in the beginning of 2004.

Gazprom is also the biggest Russian investor in Estonia, owning a third of a gas company, Eesti Gaas, together with German Ruhrgas and Finnish Fortum Oil and Gas. Total value of the investment is estimated to amount to some $ 9 million. (Estonian Investment Agency, 2003) In addition, Russian company Itera controls some 10% stake in Eesti Gaas. (Liuhto & Jumpponen, 2003a)

In Bulgaria, the biggest Russian investments can once again be found in oil and gas industry, placed by Gazprom with 50% share in a gas trading and transportation company, Topenegro, and Lukoil by acquisition of a 58% stake in a Bulgarian oil refinery, Neftokhim Burgas.

In Romania, Russian Investments have far been negligible, but will most probably increase if and when Russian energy companies establish their presence in the country. In November 2003, Russian Gazprom joined some $ 1 billion bidding race for the biggest oil company in CEEC to be privatised since the fall of communism. Altogether eight companies bid for the 51% stake in Romanian SNP Petrom, which produces some 60% of Romanian oil and controls over a quarter of the country's retail fuel market. (Penz, 2003) In addition, Gazprom is repeatedly being cited to have an interest in participating in the privatisation process of Romanian gas distribution companies, a view backed also by the representatives of Romanian government. In Romanian oil sector, Russian oil major Lukoil owns a controlling interest in a Petrotel oil refinery, which has recently been upgraded and re-opened in 2002 (OAO Lukoil 2003) Lukoil is further mentioned as a likely bidder in a privatisation procedure of a Romanian petrochemicals plant Oltchim, where a 53% stake is currently offered for sale (Economist Intelligence Unit, 2003).

Although the Russian investment in Czech Republic and Slovakia remained modest throughout the 90's, the recent development suggest growing interest of Russian energy companies in the region. In a $ 74 million deal in 2002, Yukos purchased a 49% stake in Slovakian pipeline operator, Transpetrol, which manages a part of the main Russian export oil route, Druzhba pipeline. The investment thus is extremely strategic in nature and is connected to Russian ambitions to reverse the Adrian pipeline in Croatia and connect it with Druzhba, in order to enable straight transportation of Russian crude to Croatian Mediterranean port of Omisalj. In 2002, Gazprom together with Ruhrgas and Gaz de France was granted the right to buy a 49% stake worth some $ 2,7 billion, in a Slovakian gas pipeline operator, SPP, through the pipelines of which some 70% of the gas supplied from Russia to Europe is transported. Currently, Ruhrgas and Gaz de France own an equal 24,5 % of SPP, with Gazprom having a pre-emption right to acquire 16,3% share out of the stake currently held by the two companies. (Pravda.Ru 2002a, IGU 2003.)

In Czech Republic, Gazprom owns a controlling stake in gas supply company, GasInvest, which operates in close co-operation with Czech gas distributor, Transgas. (Gasinvest 2003.) Also Transgas is mentioned to be an interesting acquisition target for Gazprom and some West European gas majors.

In Hungary, the Russian direct investment has remained only at the level of some $ 35 million. This amount can be considered extremely small taking into account the actual operations of Russian companies in the country. Gazprom alone possesses remarkable shares in several Hungarian companies, including the gas and petrochemical companies and banks. Among others, Gazprom holds a controlling stake in Hungarian Borsodchem, the country's second largest chemical manufacturer. The ownership is considered to be extremely controversial since in its acquiring, Gazprom has used its separate subsidiaries, principally the Irish-based Milford Holdings, and petrochemical unit, Sibur, to complete the deals not supported by the Hungarian company's management or even governmental bodies. (Pravda.RU, 2002b; Milmo, 2000)

In addition to Borsodchem, Gazprom indirectly holds several other stakes in Hungarian energy and petrochemical companies. A significant share of Russian money in Hungary can therefore be assumed to be hidden behind the indirect capital floatation in the country through various foreign units and cover firms (Liuhto & Jumpponen, 2003b). The Hungarian case thus serves as an example of the fact that the real size of Russian outward direct investment can be up to tenfold compared to the official amount. This results from the procedures of financing a part of Russian assets abroad through outflows registered under other flows, such as portfolio and service payments flows (Kalotay, 2003).

3. Investment Flows between Russia and Cyprus

Registered outward FDI from Russia to Cyprus have been fairly modest: the accumulated flow during 1995-1999 was $ 27 million, which was a mere 0,4 % of total FDI outflow from Russia (Kalotay 2003). On the contrary, according to the Cyprus Central Bank data, the FDI figure of $27 million is comparable to yearly inflow of Russian direct investments to the country in 1999, indicating the large capital outflow not registered by home country sources (Central Bank of Cyprus 2003). According to the Bank, Russians were among the most active non-resident portfolio investors to the Cyprus Stock Exchange in 2001-2002 (Monetary Policy Report, 2002.) However, the overwhelming majority of Russian capital in Cyprus undoubtedly derives from Russian capital flight.

The fact that Cyprus has been one of the main investors to the Russian economy for many years, confirms the return of Russian capital. Statistics of Goskomstat showed that the investment stock from Cyprus to Russia was $ 6 606 million by July 2003. Of these, $ 4 432 million were direct investments, making Cyprus the main source of FDI to the Russian economy with a 20%-share of the Russian total inward FDI. During the first half of 2003, the FDI stock of Cyprus exceeded that of USA. Other major investor countries to the Russian economy are the UK, the Netherlands, and Germany (Ilykhina 2003).

Table 6. The Structure of Accumulated Foreign Investment to the Russian Economy

	Accumulated by 01.07.2003 ($ million)			
	Total	***Direct***	***Portfolio***	***Other***
USA	5558	4212	37	1109
Germany	10671	2344	385	7942
France	2670	278	0,1	2392
UK	5887	2407	108	3372
Cyprus	**6606**	**4432**	**295**	**1879**
The Netherlands	2941	2329	6	606
Other countries	14008	6364	359,9	7284
Total	48341	22566	1191	24584

Source: Goskomstat, 2003.

The share of Cyprus in the Russian inward FDI is strikingly large, considering that Cyprus has a population of only 750 000. Furthermore, Russia is not even a major trade partner to Cyprus: Russia’s share of Cypriot imports was only 3,6 % and of exports 0,2 % in 2002 (Foreign Trade by Main Partner Country, 2003). Russian trade statistics show a

3,29 % share for Cyprus in Russian exports and a tiny 0,022 % share in imports. (GTK, 2003)

According to UNCTAD (2003c), Cyprus is not a particularly active outward investor. In the end of 2002, the outward FDI stock of Cyprus was $ 731 million (7 % of her GDP), whereas the inward FDI stock was much higher, namely $ 4 827 million (48 % of the GDP). The deviation of figures offered by different organisations is remarkably large. According to Goskomstat, the FDI stock from Cyprus to Russia was $ 3 927 million in the end of 2002, whereas at the same time, the total outward FDI stock from Cyprus was registered to be a mere $ 731 million. Consequently, Cyprus's foreign investments that are declared in Russia are actually not of Cypriot origin but most likely originate from Russia (Grigoryev & Kosarev, 2000) or some other country.

Thus, the persistent high share of FDI from offshore Cyprus is considered to be a proof of a phenomenon called 'round tripping' that is connected to Russian capital flight. It means the transfer of funds abroad in order to bring them back, partly or wholly, as FDI, and obtain the tax and other benefits offered to foreign investors (Kalotay, 2003). This assumption is further strengthened by the fact that whereas according to Russian data, FDI stock from Cyprus amounted to over $6 billion in 2003, the registered outflow by the Central Bank of Cyprus was more than 1000 times lower for the same period (Central Bank of Cyprus 2003). Certainly, Cyprus is not the only country through which Russian capital returns home but there are a number of factors supporting the assumption that to a significant degree of capital illegally conveyed out of the country is the source of foreign investments to Russia from many investing countries (Grigoryev & Kosarev, 2000).

Most experts estimate that the annual capital outflow from Russia during the 1990's has been $ 20-25 billion but has since declined being now about 15 billion per year (Buiter & Szegvari 2002). Although there are slightly different estimations about the amount of current capital flight[5] (e.g. see Liuhto & Jumpponen, 2003b), nevertheless, capital flight represents the core of Russian capital abroad. During 1994-2001, the capital outflow from Russia totalled almost $ 150 billion. Thus, the recorded FDI stock is some 10 % of capital flight (Liuhto & Jumpponen, 2003a).

The reasons for capital flight from Russia include an unsettled political environment, macroeconomic instability, relatively high and unevenly enforced tax rates, an insolvent banking system and weak protection of property rights. The capital flight uses a variety of channels: the major channel for Russian capital flight is under-invoicing of export earnings, especially in energy sector. The apparent association between the intensity of capital outflow and oil market price supports the view that capital outflows to a great extent indicate non-repatriation of export earnings by the energy sector. (Loungani & Mauro, 2000).

Another channel of capital flight is the overstatement of import payments. The extent of this channel is more difficult to estimate as Russian imports are more diversified than exports. Also using the fake advance import payment is used to transfer capital abroad. In addition, capital transfers can be arranged through a variety of capital account transactions evading the regulations (Loungani & Mauro, 2000).

One of these, a so-called Investment Account (or I Account)–scheme is the most commonly used for large businesses. It requires a well-designed mechanism for creating offshore and fictitious Russian firms through which the capital is finally transferred (even legally) to an offshore company. The overwhelming majority of these transactions are carried out with Cyprus, although other tax havens like the British West Indies, the Channel Islands and the Antilles are used. The advantage of using Cyprus is based on the fact that – unlike any other tax haven – Cyprus is one of the few countries with which Russia has an agreement to avoid double taxation. Of those countries, the corporate profit

[5] Capital flight refers to illegal conveyance of capital abroad and should not be confused with capital exports - that is conveyance of capital in full compliance with all requirements of the law (Grigoryev & Kosarev 2000).

tax rate in Cyprus has been considerably lower than in the others (Grigoryev & Kosarev, 2000).

While direct investments make up the majority of Cypriot investments to Russia (67 % of stock by July 2003), Cyprus is also a major investor in Russian securities market. These investments are often considered to mean the return of Russian capital. However, the top position of Cyprus may also indicate that many foreign companies trading with Russia use Cypriot subsidiaries in order to take advantage of the favourable taxation in Cyprus and the double-taxation agreement between Cyprus and Russia. (Cook, 2002.)

The new income tax law[6] that came into force in the beginning of 2003 has brought some major changes to the Cypriot tax system. The lower corporation tax rate of 4,25 % for international business companies[7] has been abolished. Thus, all companies registered in Cyprus have a tax rate of 10 %[8]. Furthermore, the new law adopts management and control as the key test for applying the residence rules for companies. Thus, the registration alone is not sufficient to subject companies to tax in Cyprus, but also the decision-making processes should take place in Cyprus (Andreas Neocleus & Co. 2003). With the substantial tax reform Cyprus has fully complied with the OECD criteria about harmful tax practices, transparency, exchange of information and tax competition, and has conformed to EU Code of Conduct for Business Taxation (Neocleaous & Bevir, 2003).

The new tax law has an impact not only on Russian companies registered in Cyprus, but also on western investors in Russia, who are using the island as an offshore tax haven. The raise of the tax harms the companies that relied on Cyprus for its low profit tax rates. These companies include firms that operate transfer-pricing schemes to shift profits offshore to avoid as much tax as possible. They do not gain any great benefits from the

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[6] Income Tax Law 118 (I) of 2002.
[7] International Business Company refers to any legal entity whose beneficial ownership and business activities lie outside Cyprus.

double tax treaty with Russia, and are therefore likely to move their business elsewhere (Bush, 2002).

4. Cypriot Direct Investment in Central and Eastern Europe

In addition to the dominant role of Cyprus as a foreign investor in Russia, Cyprus is also a relatively big investor to some other Central and Eastern European countries. Even if the recorded OFDI stock from Cyprus amount only to $ 731 million, in the host country statistics the investments from Cyprus are considerably larger. Russia alone reports inward FDI from Cyprus to total almost $ 4,5 billion (Ilykhina, 2003), followed by Poland with reported inward FDI from Cyprus of almost $ one billion.

Enormous differences in statistics can partially be interpreted by the policy of registering the investment flows through Cyprus. The registered OFDI from Cyprus consists of only the investment made by Cypriot residents, whereas the inward FDI reported by recipient countries is apparently registered on the home country basis, no matter what the residency of an investor. This clearly reflects the position of Cyprus as an intermediate region used for re-investment purposes to other economies. From the deviation of the registered outward FDI figures of Cyprus and Cypriot FDI registered by recipient countries, one can hence only estimate the real amount of foreign capital flowing through Cyprus to Central and Eastern Europe.

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[8] There is a transitional period until 2005 with the lower corporate tax of 4,25 % for the international business companies that have been active in Cyprus before the change of the law and that fulfil certain criteria.

Table 7. Cypriot OFDI Stock in the 10 Eastern Candidates of the EU and Russia

	FDI stock ($ million)	*Share of recipient's total FDI stock (%)*	*Ranking among investor countries*
Bulgaria (1.1.2003)	274.50	5.16	8
Czech Republic (31.6.2003)	469.19	1.21	
Estonia (31.3.2003)	9.02	0.20	
Hungary			
Latvia (1.1.2003)	5.95	0.20	31
Lithuania (2.6.2003)	74.7	3,3	29
Poland (1.1.2003)	998.90	1.46	16
Romania (30.9.2002)	422.43	4.90	8
Slovakia (1.9.2001)	n.d.	< 0.01	n.d.
Slovenia	0.00		
Russia (1.7.2003)	4432.00	19.64	1

Source: National Banks, authors' calculations

The main targets for the Cypriot investments (or investments through Cyprus) among the eastern EU-candidates are Poland, the Czech Republic, Romania, and Bulgaria. As a curiosity, Cyprus barely registers in the trade statistics in any of the above mentioned countries, still investing considerable sums in a form of FDI. The significant amount of the Cypriot FDI particularly in South-Eastern Europe (Bulgaria and Romania) is generally considered to be of these countries' domestic or of Russian origin (Hunya 2000). Interestingly, the Cypriot FDI seems to be relatively bigger in those ex-socialist states where the Russian FDI is perceptibly low, e.g. the Czech Republic and Romania.

However, the statistical differences in Cyprus-originated FDI between reporting countries cannot be explained only by the different registration methods. Already the biggest single Cypriot investor in Poland, Kronospan Holdings Ltd, contributes to Poland's registered inward FDI stock with some $ 985 million (PAIZ, 2003), already alone remarkably exceeding the total registered OFDI amount of Cyprus ($ 731 million). In addition to Poland, Kronospan Holdings Ltd has ongoing activities and investments in almost all

Central East European countries, mainly in the field of wood manufacturing processes. Clearly, the investments are not officially registered in Cyprus in the form of OFDI despite the fact that the company is registered in the island and all of its activities include direct managerial control and interests in foreign countries.

The investment agency of the Czech Republic reports inward FDI from Cyprus worth some $ 469 million, but does not provide, however, any information of the individual companies investing in the country. In an extensive list of some 1000 foreign investors, none of the companies were originated from Cyprus, whereas in case of several hundreds companies, information on the country of origin was not available (CzechInvest, 2003).

The Cypriot companies seem to have considerable presence also in Baltic countries. In Estonia, there are nine registered enterprises established with the Cypriot capital. The Cypriot investment stock in Estonia totals some $ 9-10 million, depending on the reporting source (Estonia and Cyprus, 2003). In Lithuania, 39 Cypriot capital companies were registered as of June 2003 with investment stock totalling some $ 74 million. (Relations of the Republic of Lithuania…, 2003). In Latvia, the Cypriot investment stock amounted to $ 5,95 million at the end of 2002, and 54 Cypriot-Latvian joint enterprises were registered in the country by September 2003. In all three Baltic countries, Cyprus has remained a marginal trade partner, responsible for well under 1% of foreign trade turnover in each of the countries. (Relations Between Latvia… 2003)

5. Changing Role of Cyprus as Landing Place for Russian Capital

Cyprus has good relations with all East European countries and former Soviet republics. She has treaties avoiding double taxation with most of these countries[9] and new treaties under negotiation. This has placed Cyprus in a favourable position for tax planning

[9] Currently Cyprus has double-taxation treaties in force with the following CEECs: Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia.

purposes, and together with the low taxation and better reputation compared with pure tax haven countries, contributed largely to the development of the offshore financial sector in Cyprus (Central Bank of Cyprus 1999; Cyprus – assessment of … 2001).

The Central Bank of Cyprus has actively advertised the excellent possibilities to do business in Eastern Europe via Cyprus (Total Flexibility… 1999) and the capital flow to Cyprus from Russia and East European countries has indeed contributed significantly to the development of the Cypriot economy. Russia has been the leading source of capital into the Cypriot economy, and in certain years, the estimated annual flow of Russian money through the bank of Cyprus has far exceeded the Cypriot GDP (Medvedev 1997).

The integration process towards the European Union has induced a large volume of legislative changes to bring Cyprus into line with the EU (Cyprus – Assesment of…2001). Due to the tight anti-money laundering law enacted in 1996, Cyprus has been excluded from an international money-laundering black list, and because of the abolition of special tax treatment for offshore companies[10] by 2005, Cyprus cannot be considered a pure tax haven either (Central Bank of Cyprus, 2003). The tightening control over international business companies, increased taxation, and the new requirement for offshore companies of having physical premises and management activities on the island in order to be taxed by Cyprus, has decreased the attractiveness of Cyprus as an offshore location.

[10] Offshore companies here refer to businesses owned by non-residents providing services primarily to non-residents.

Year	*Cumulative number of international business companies (permits issued by the Central Bank of Cyprus)*
1976	83
1980	900
1984	3 000
1988	5 100
1992	10 100
1996	26 500
1998	38 700
2003	14 000 (active companies)

Source: The Central Bank of Cyprus 1999, 2003.

Table 8. The Number of Offshore Companies in Cyprus

Only 1100 of the active 14 000 offshore companies have physical presence in Cyprus, which means that the majority of the companies cannot be taxed by Cyprus in the future (Central Bank of Cyprus, 2003). Currently, about 30 % of the offshore companies in Cyprus are Russian, while until recently the share of Russian companies of the international companies on the island was over half (Page, 2003; Poznakhirko, 2003).

According to some estimation, within the last one and a half years up to 30 % of Russian companies have abandoned Cyprus. This is mostly because of being afraid that, according to the agreement of information exchange between the Central Bank of Cyprus and the Russian Federal Commission for the Securities Market, harmful information about Russian companies' activities could be available for the Russian authorities. However, this fear may be exaggerated, as according to the law of Cyprus, the information about the beneficiary owners can be available only after a court decision. Nevertheless, the increased transparency has revealed that offshore companies in Cyprus are owners of Russian large businesses, whereas until recently it was practically impossible to prove any connection between the offshore company and the actually owner. (Poznakhirko 2003.)

The recent years have witnessed growing inflow of Cypriot FDI into Russia, and during the first half of 2003, Cyprus has taken over the USA as the main investor in Russia (Goskomstat 2003). On one hand, the increasing capital flows from Cyprus to Russia can be connected with the improved and somewhat stabilised situation on Russian markets thus indicating the repatriation of Russian money under more favourable conditions. On the other hand, the new Cypriot tax law and increasing transparency of foreign investment practices according to the EU standards have probably diminished the role of Cyprus as a Russian tax haven.

6. Concluding Remarks

In the global business, Russian foreign direct investments (OFDI) are still relatively modest amounting to only $ 18 billion. The US firms have invested abroad over 50 times more than their Russian counterparts. Despite Russia's modest OFDI figures, one should keep in mind two issues.

First, the Russian OFDI is growing (some 80% of the country's OFDI flow has taken place during the past six years). The future growth rate depends heavily on the price development of oil and natural gas; higher the price for these natural resources, higher the OFDI from Russia.

Secondly, the total amount of the Russian capital abroad is significantly higher than the officially recorded OFDI indicates. One should not forget that the <u>annual</u> capital flight during the past few years exceeds Russia's total OFDI stock. It has been estimated that the Russian capital flight totaled $ 150-300 billion in the 1990's i.e. some 10-15 times the recorded OFDI stock. To put it differently, Russian firms and individuals possess a sufficient amount of capital to acquire many business units abroad.

A lot of Russian capital flight has landed in tax havens and in Cyprus, and thereafter, continued its journey to the final destination. Though this article is unable to reveal the exact amount of ‘the Russian transit capital’, it is interesting to note that in some Central and Eastern European (CEE) countries, Cyprus ranks among the 10 largest investors. Moreover, this study revealed that the share of Cyprus was usually higher in those countries where the foreign direct investment from Russia was lower. This might indicate that Russian firms have used Cyprus as a financial transit gate, when conducting investments directly, has met some obstacles. Furthermore, Cyprus has double taxation treaties with most of the CEEC, whereas Russia has with only few (UNCTAD 2003a), thus making Cypriot subsidiaries beneficial for Russian companies when investing to Eastern Europe.

This article confirms earlier assumptions that the Russian capital moves away from Cyprus, at least to some extent, when the legislation and procedures of this country become more transparent along with the EU integration. The move of Russian firms from Cyprus has already started prior to the accession of Cyprus in the EU in May 2004.

To what extent Russian firms will abandon this island and where they will ahead thereafter is still a mystery. Solving this mystery would require a creation of a large EU-funded research project around the theme.

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