The 2013 Cyprus bailout and the Russian foreign direct investment platform

By Kalman Kalotay

In March 2013, as a new episode of the Great Crisis that started in 2008 and whose end is not yet at sight, Eurozone members and the International Monetary Fund (IMF) offered a €10 billion (about US$13 billion) rescue loan for fellow member Cyprus – representing more than half of its gross domestic product (GDP). Bailout would come with conditions, which will weaken Cyprus' traditional role as an offshore financial centre within the European Union (EU). In the two largest banks of the island on the verge of bankruptcy, only deposits up to €100,000 (US$ 130,000) were to be saved; the rest would disappear of suffer from a huge discount. As a symbolic measure, depositors might be offered shares in the banks concerned, although their real value would be close to nil due to the bad shape of those financial institutions. While these were already heavy blows, capital controls required to stabilize Cyprus in the short and medium term heralded the effective end of the offshore financial centre of the island.

These developments were bad news for Russian investors, which used the island as the most important platform for their trans-shipped and round-tripped foreign direct investment (FDI). Trans-shipment means FDI destined to third countries while round-tripping denotes projects targeting the Russian market proper with a detour in Cyprus. The phenomenon dubbed Cyp-Rus investment was analysed in detail in the context of trans-shipped FDI to other economies in transition by the Pan-European Institute a decade ago. Since then it has grown in size and in terms of targets of trans-shipment, going in reach to developed economies. The Bank of Russia estimated the inward and outward FDI stocks of the country linked to Cyprus to US$129 and 122 billion at the end of 2011 (table 1), respectively (it is not by coincidence that the values of the two are so similar). They represented 28 and 34% of the inward and outward stock of the country. These values were five times higher than Cyprus' GDP. However FDI data reported by the Central Bank of Cyprus were way lower, begging the question where the difference can be registered (such as bank account, real estate, portfolio investment, to mention a few possibilities). Official data on portfolio investment are not only of little help but also contradictory (table 1): Russian statistics show asset growth in crisis years while Cyprus data show divestment. As for bank accounts held by Russians, statistics are missing; estimated vary largely, from €5–10 billion (US$6.5–13 billion, according to the Central Bank of Cyprus) to US$31 billion (Moody's). In either case, their size would indicate large losses for Russian individuals and firms keeping their assets in the wrong banks (the top two: Bank of Cyprus, whose large depositors face a severe discount in their assets, and Laiki Bank whose large deposits are literally wiped out).

While Russian investors could probably not foresee the degree of measures Cyprus would be forced to engage in, the financial crisis had prompted them to think of strategies not putting all eggs into the same basket. The most salient trend in this respect is the rise of other offshore financial centres in Russian inward and outward FDI, especially that of the British Virgin Islands (table 1; and to a lesser degree Bermuda and the Cayman Islands). Flow data show large fluctuations, however. The changing relationship between the two top offshore centres is more noticeable in FDI stocks. By 2011, the ratio between the British Virgin Islands and Cyprus rose to an all time high of 44% in inward FDI stocks and 38% in outward FDI stocks.

The Cyprus bailout package can be expected to accelerate the shift of Russian corporate strategies to new offshore financial centres. It is unlikely that Russian firms would change the long-term patterns of their management style, and come on-shore in Cyprus or elsewhere. However the outward FDI dynamism of the Russian Federation may be affected as the potential write-offs related to Cyprus may reduce the free resources available for expansion abroad. Russian firms can switch activities not only to pure financial centres, but also to more mixed trans-shipment hubs such as Luxembourg. To what degree these changes would affect the size and composition of Russian outward FDI is difficult to forecast at this point of time when data series are available only until the third quarter of 2012.

Although the Russian State is in general not in favour of offshore finance, it may be obliged to defend Russian interests. In the case of Cyprus, it already offered a five-year financial assistance of €2.5 billion (US$3.2 billion) to the country in 2011, which could be extended until 2021 in case of emergency, and may offer case-by-case help to Russian firms that suffer disproportionately from the Eurozone rescue package. However during the depth of the Cyprus crisis it made it clear that it would not engage additional resources and by no means would it replace the EU or the IMF as leading agencies dealing with the macroeconomic woes of the island, nor would it offer any systematic help to the Russian business community engaged in Cyprus.

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Table 1. Inward and outward FDI of the Russian Federation by home/host country, 2007–September 2012

(Millions of U.S. dollars)

Home/host country	Year	2007	2008	2009	2010	2011	2012[a]
Inflows							
Total		54'619	75'201	36'336	43'076	55'615	33'080
From EU 27 excluding Cyprus		19'525	21'773	12'199	20'696	27'031	23'660
From British Virgin Islands		3'246	7'341	1'753	2'138	7'196	1'283
From Cyprus	Russian data	10'595	19'555	4'270	12'250	13'569	4'567
	Cypriot data	..	-1'434	197	-611	-120	..
Inward stock							
Total		..	..	378'837	489'256	455'904	..
From EU 27 excluding Cyprus		..	..	111'323	148'686	168'015	..
From British Virgin Islands		..	..	36'599	50'966	56'442	..
From Cyprus	Russian data	..	..	129'930	179'217	128'816	..
	Cypriot data	..	2'587	146	773	785	..
Outflows							
Total		45'897	55'540	43'632	51'886	67'221	37'499
To EU 27 excluding Cyprus		17'992	16'694	11'717	18'003	16'511	8'947
To British Virgin Islands		1'425	3'822	2'305	1'833	4'194	2'646
To Cyprus	Russian data	14'630	8'879	15'391	18'046	22'400	16'110
	Cypriot data	..	466	641	-372	396	..
Outward stock							
Total		..	..	302'188	365'961	361'738	..
To EU 27 excluding Cyprus		..	..	81'093	93'798	110'514	..
To British Virgin Islands		..	..	33'285	38'762	46'137	..
To Cyprus	Russian data	..	..	119'672	153'933	121'596	..
		..	2'206	1'984	1'491	1'905	..
Memorandum items							
Russian portfolio investment flows to Cyprus							
	Cypriot data	..	..	-5'817	-544	-20	-1'060[b]
Russian portfolio investment stock in Cyprus							
	Russian data	368	1'366	1'877	2'840	4'633	..
	Cypriot data	..	443	1'726	1'517	1'509	..
Estimated GDP of Cyprus at current prices		21'769	25'250	23'474	23'000	24'713	22'446

Source: Author's calculations, based on Bank of Russia and Central Bank of Cyprus data.

Note: Data are calculated by the nationality of the immediate investor.
a January-September 2012.
b January-June 2012.