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„The Development of New Spaces in the Global Political Economy: The Case of the Cayman Islands Offshore Financial Centre“

verfasst von / submitted by

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Abstract

This thesis explores the development of new spaces in international political economy. Its specific frame of reference is the Cayman Islands offshore financial centre (OFC) – one of the largest OFCs not only in the Caribbean but also in the world. This work aims to move towards an understanding of processes of economic globalization and the role of OFCs in it. The exponential growth of financial markets in the post-war period has spurred a broad scholarly interest and marked a shift from industrial to finance capitalism. As global wealth increases, so does the opportunity to manage that wealth for ever-increasing rates of return. Private and wholesale banking, offshore trusts and funds, holding companies, captive insurance, shipper registers, and other financial activities are all the makings of the financialization of the world economy. The cost of it is also evident. Politicians and economists are currently busy with assessing the damage of tax avoidance, capital flight, tax evasion, and money laundering. All this contributes to the instability of the financial system. This work aims to explain the relationship between economic globalization, trends in the global political economy and the rise of OFCs. It focuses on two primary issues. Firstly, it looks at the anatomy and evolution of the Cayman Islands OFC. Secondly, it discusses the role of OFCs in general and the Cayman OFC in particular in international political economy. In doing so, the paper offers points of interest to academics researching such fields as OFCs, economic globalization, the political economy of finance, transnational capitalism, investment theory, and microstates' development.

Abstract

Diese Arbeit untersucht die Entwicklungen neuer Räume in der internationalen politischen Ökonomie. Im genaueren befasst sie sich mit dem Offshore-Finanzplatz der Cayman Inseln (offshore financial centre – OFC), eines der größten OFCs, nicht nur in der Karibik, sondern auch der Welt. Diese Arbeit versucht zu einem Verständnis wirtschaftlicher Globalisierungsprozesse und der Rolle der OFCs darin zu kommen. Das exponentielle Wachstum der Finanzmärkte in der Nachkriegszeit hat ein großes akademisches Interesse angespornt und markierte einen Wandel von einem industriellen hinzu einem Finanzkapitalismus. Mit wachsendem globalen Wohlstand steigt auch die Gelegenheit diesen Wohlstand für ständig zunehmende Renditen zu verwatlen. Privat- und Großkundenbanken, Offshore-Treuhand und Fonds, Beteiligungsgesellschaften, unternehmenseigene Versicherungsgesellschaften, Spediteursregister und andere finanzielle Aktivitäten sind alle in Folge der finanzialisierung der Weltwirtschaft entstanden. Die kosten dessen sind jedoch ebenfalls offensichtlich. Politiker als auch Ökonomen sind momentan damit beschäftigt, den Schaden von Steuerumgehung, Kapitalflucht, Steuerhinterziehung und Geldwäsche zu ermessen. All das trägt zu einer Instabilität des Finanzsystems bei. Diese Arbeit versucht die Beziehung zwischen wirtschaftlicher Globalisierung, Entwicklungen in der globalen politischen Ökonomie und der Zunahme von OFCs zu erklären. Dabei liegt der Fokus auf zwei Kernaspekten. Erstens wird der Aufbau und die Entwicklung des OFCs auf den Caymaninseln untersucht. Zweitens wird die Rolle von OFCs im allgemeinen und der des Cayman OFC im genauen in der internationalen politischen Ökonomie behandelt. Dadurch liefert die Arbeit Punkte, die für Akademiker von interesse sind, welche sich mit OFCs, wirtschaftlicher Globalisierung, politischer Ökonomie des Finanzwesens, transnationalem Kapitalismus, Investmentlehre und Mirkostaatenentwiklung befassen.

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Key to Abbreviations

ARQ - American Regulation Q

BIS - the Bank for International Settlements

BOE - the Bank of England

BOJ - the Bank of Japan

BVI - the British Virgin Islands

CBS - the Consolidated Banking Statistics

CIMA - the Cayman Islands Monetary Authority

CPIS - the Coordinated Portfolio Investment Survey

CSX - the Cayman Islands Stock Exchange

CTIA - the Cayman Islands Tax Information Authority

DPIL - derived portfolio investment liabilities

ECB - the European Central Bank

ECU - the European Currency Unit

EUSD - the EU Savings Directive

FATCA - the Foreign Account Tax Compliance Act

FATF - the Financial Action Task Force

FDI - foreign direct investment

FED - the US Federal Reserve

FPI - foreign portfolio investment

FSA - the Financial Services Authority

G20 - the Group of 20

G7 - the Group of 7

GDP - gross domestic product

IDI - inward direct investment

IET - the Interest Equalization Tax

IMF - International Monetary Fund

IMF - the International Monetary Fund

IOSCO - the International Organization of Securities Commissions

IPB - international private banking

IRS - Internal Revenue Service IRS

LBS - the Locational Banking Statistics

NIFA - the New International Financial Architecture

ODI - outward direct investment

OECD - the Organization for Economic Co-operation and Development

OFC - offshore financial center

PSI - the U.S. Senate's Permanent Subcommittee on Investigations

QE - quantitative easing

TRIPS - the Agreement on Trade-Related Aspects of Intellectual Property Rights

U.S. - the United States

UBS - the Union Bank of Switzerland

UK - the United Kingdom

WTO - the World Trade Organization

WWII - World War II

Introduction

A dominant story about globalization starts with mentioning of relatively immobile islands competing to attract increasingly mobile capital. The changing geography of the international financial system has recently attracted much attention among academics, journalists and general public. This was caused by an unprecedented leak of 11.5m files from the database of the world's fourth biggest offshore law firm, Mossack Fonseca.[1] The documents show the secret ways in which the rich can exploit secretive offshore tax regimes. Most recently the consortium of journalists who published the Panama Papers hatched a new brood of stories about the offshore holdings of politicians and celebrities. These papers, referred to as the Paradise Papers, were stolen from Appleby, a Bermuda-based law firm.[2] The reputation of tax havens and OFCs, already leaving much to be desired, was totally destroyed. This study is an attempt to address the issue of OFCs. To this end, the Cayman Islands is taken as a point of reference. Firstly, this tiny group of islands has attracted more external assets than advanced industrial countries such as Japan, Canada or Italy, despite them having economies several hundred times Cayman's GDP. Secondly, the Cayman Islands is located in a very 'offshore concentrated' part of the world – the Caribbean region. Therefore, it is possible to compare the Caymans with its regional competitors, drawing several conclusions.

Major tax havens and OFCs have less than 1 percent of the world's population and 2.3 percent of world gross domestic product (GDP). Per capita real GDP in these countries grew at an average annual rate of 3.3

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[1] International Consortium of Investigative Journalists, *The Panama Papers. Politicians, Criminals, and the Rogue Industry That Hides Their Cash*, https://panamapapers.icij.org/ (September 3, 2017).

[2] International Consortium of Investigative Journalists, *Paradise Papers*, https://www.icij.org/investigations/paradise-papers/icij-releases-paradise-papers-data-appleby/ (November 15, 2017).

percent between 1982 and 1999, which compares favorably to the world average of 1.4 percent. Local governments appear to be adequately funded: their average 25 percent ratio of government to GDP exceeds the 20 percent ratio for the world as a whole.[3] It is estimated that, if one includes offshore bank funds, offshore insurance business, and that of private trust companies, a total of US$ 900 billion resides in, or passes through, the Caribbean.[4] According to Oxfam, the sum could be as high as US$ 6-7 trillion, equivalent to a third of global GDP.[5] Ronen Palan asserts that as much as half of the world's stock of money either resides in, or is passing through tax havens and OFCs.[6] From this, it follows that the bulk location of offshore financial jurisdictions are in the global South.

The Cayman Islands has the largest offshore banking sector in the region, where the asset value of offshore banks in 2005 was estimated at US$ 900 billion. Offshore insurance companies in the Caymans were estimated to have an asset value of US$ 19 billion. Additionally, there are more offshore investment funds listed in the Caymans than in any other OFC.[7] These empirical facts force us to conclude that the Cayman Islands OFC represents a central node in contemporary international finance, whereas the Caribbean region is one of the most important places on global financial maps. The appearance of these new places on the map of international finance poses numerous questions: why and how did they appear?; who controls the process?; who benefits from the process of

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[3] J. R. Hines Jr., *Do Tax Haven florish?* (Tax Policy and the Economy, Vol. 19, University of Chicago Press, 2005), p.65.

[4] D.D. Marshall, *The New International Financial Architecture and Caribbean OFCs: Confronting Financial Stability Discourse* (Third World Quarterly, Vol. 28, No. 5, 2007), 931.

[5] Oxfam, *Tax havens: releasing the hidden billions for poverty eradication* (Oxlam Policy Papers, 2000), 6.

[6] R. Palan, *Tax Havens and the Commercialization of State Sovereignty* (International Organization Vol. 56, No. 1, 2002), 151–176.

[7] J. T .Butkiewicz, L.-R. C. Gordon, *The Economic Growth Effect of Offshore Banking in Host Territories: Evidence from the Caribbean* (World Development Vol. 44, 2013), 166.

reconfiguration of global finance?; what is the impact of OFCs on the global political economy? This thesis will attempt to answer all these questions and provide an explanation of a new phenomenon.

First and foremost, the literature review section will analyze the existing academic literature around the themes of the Caymans Islands OFC and the political economy of OFCs. The methodology section of the paper will introduce the methods of research. The paper is divided into two parts. The first part will elaborate on the development of the Cayman OFC. The second part will reflect on the political economy of OFCs and put the Cayman OFC in this context. The first chapter will focus on geography and history of the Cayman Islands, discussing colonial history, history of decolonization and economic history. The second chapter will introduce the concept of financial globalization and its impact on the Caymans. Particular emphasis will be given to the establishment of the Euromarkets and the rise of the Eurodollar as well as to the collapse of the Bretton Woods system. Moreover, a constitutional evolution of the Caymans will be explained in detail. This will bring both economic and legal factors together and help understand why the Cayman Islands is a relatively transparent OFC. The third chapter will switch from the historical to the economic part of the paper, explaining economy and financial services sector. Special attention will be paid to the taxation system, overall economic performance, FDI, FPI and other offshore features. First conclusions will be made regarding the anatomy and evolution of the Cayman Islands OFC. Afterwards, the final chapter of this thesis will elaborate on the political economy of offshore centres. Conclusions concerning the Cayman OFC and international political economy will be drawn based on the evidence currently available. Two separate conclusion sections will be made with the intent of answering the two research questions of the thesis most accurately. The last section of the paper will summarize the thesis and re-state its main implications.

Literature review

This thesis is situated at the cusp of debates aimed at rendering OFCs. There are many lively discussions in the literature that each occupies centre stage at different moments. These range from the capital mobility/volatility arguments; power relations associated with transnational regulators; and the issues related to banking confidentiality principles to concerns about the proportion of investment in proprietary trading over greenfield options; recurring ethical and political concerns over the puzzles inherent in moralizing financial speculation. Rather than writing a comprehensive review of debates around all the topics I cover in my thesis - a task which would be enormous - I use the existing literature to prepare the ground for the contribution which my thesis makes to debates around the political economy of OFCs in general and the Cayman OFC in particular. To contribute to debates around the Cayman OFC, I supplement my theoretical conclusions derived from academic literature with empirical facts and data collected from primary sources.

An analysis of the creation and growth of OFCs is limited to a handful of researchers, using divergent theoretical and conceptual frameworks. Mark Hampton[8], Jan Fichtner[9], and Jason Sharman[10] employ a political economy approach; Alan Hudson[11] analyses OFCs in the context of unbundling sovereignty; Susan Roberts situates the development of the

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[8] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., 1996).

[9] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016).

[10] J. Sharman, *Offshore and the new international political economy* (the Journal of Contemporary Asia, Volume 17, Issue 1. 2010).

[11] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996).

Cayman OFC within wider social processes and provides a very useful account of its development. Current theory addressing OFCs either adheres to the traditional neoclassical analysis or to variants of the radical critique of capitalism. This thesis aims to take a middle-ground position. The choice of the authors is therefore based on the diversity of schools which those authors represent and is not limited to classical economists. This is evident from the abovementioned scholars and will be explained in detail. However, this is also true for the topics that will not be covered in this section, for example on microstates' development or economics of OFCs. I consider findings of such supply side economists as James Hines, Mihir Desai, and Fritz Foley as well as arguments of such virulent critics of OFCs as Joel Slemrod and John Wilson. However, the diversity aspect was not decisive. It was considered for the sake of objectivity in such ideologically driven topic as offshore finance.

Roberts attempts to further "how capital increases its flexibility and averts crisis (not unproblematically) through the financial system." This system, according to Roberts, produces new spatial forms, or new regulatory spaces, implying that "in the financial markets, spatial advantage may be defined primarily through regulation."[12] Roberts' contribution to debates around OFCs is enormous. The author brings the perspective of economic geography, elaborating on the relationship between economic restructuring and crises on the one hand, and the ever-changing geopolitical realities of the contemporary world on the other. I use Roberts' framework to develop my argument regarding the relationship between current trends in the world economy and increased pressure on OFCs from transnational regulators and governments for the purpose of avoiding crises. Thereby, I attempt to employ similar logical argumentation, reversing the variables.

[12] S. M. Roberts, Small Place, Big Money: The Cayman Islands and the International Financial System (Economic Geography, Vol. 71, No. 3, 1995), 237.

Hampton takes a radical political economy approach by analyzing the importance of the primary attractions of taxation, regulation, and the underlying political and economic relationship of the island or microstate to its nearest big country.[13] The significance of Hampton's contribution to the theory of OFCs in international political economy is twofold. First and foremost, the author is interested in the evolution of an OFC and claims that location appears to be of lesser significance in the first stage of emerging OFCs than the key factors of taxation, bank secrecy, regulation and politics. Nevertheless, Hampton then uses a neo-Marxist fractions-of-capital approach to contend that the special relationship existing between states and their overseas and offshore territories is most significant to the development of offshore finance. In his analysis, Hampton takes Jersey, a Crown dependency, as a case of reference. I apply Hampton`s framework to the Cayman Islands and further his analysis by suggesting that the Cayman OFC is successful due to political ties with Britain and economic ties with the United States. Hence, I extend Hampton`s approach and show how the special relationship argument varies from place to place. To do so, I rely on Fichtner`s paper[14] on ‘anatomy’ of the Cayman OFC, where he utilized all sources of publicly available data about banking, direct investment, and portfolio investment in the Cayman Islands.[15] I then put Fichtner`s findings in geographical context, supplementing it with my quantitative data.

Finally, Hudson[16] seeks to extend Roberts’ analysis by offering a slightly different account. He has provided powerful arguments for further

[13] M. Hampton, Creating Spaces. *The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., H. 2, 1996).

[14] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016).

[15] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016).

[16] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE*

understanding the political positioning of OFCs in the global marketplace by asserting that OFCs are dynamic, "socially constructed entities shaped by local and extra-local actors placing particular emphasis on the roles played by government and multinational banks."[17] Hudson thus leaves the Marxian framework employed by Roberts to include government into play, instead of merely focusing on abstract capitalism. In his work, Hudson concludes that processes of financial globalization reconfigure power/space, reshaping the regulatory landscape. OFCs, playing a key role in economic globalization, reshape the regulatory landscape by providing "a control point for political authorities who wish to regulate the space of flows.''[18] Hence, the practice of unbundling sovereignty is associated with the rise of OFCs.

I contribute to Hudson`s analysis by suggesting that the practice of unbundling sovereignty brings us to a new period – the era of postmodern political economy. To come to this conclusion, I refer to Sharman`s theory of calculated ambiguity: "the ability to give diametrically opposed but legally valid answers to the same question from different quarters."[19] Sharman introduces this most "common feature among offshore financial products"[20] to describe the political economy of OFCs based on offshore firms that are "taking on the advantages of ownership while divesting themselves of the liabilities, borrowing without taking on debt, simultaneously reporting high profits and none at all, and 'round-tripping' domestic capital as foreign investment."[21] I then apply this theory to the

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FINANCIAL CENTRES (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996).

[17] A. Hudson, *Reshaping the regulatory landscape: border skirmishes around the Bahamas and Cayman offshore financial centres* (Review of International Political Economy, DOI: 10.1080/096922998347516, 1998).

[18] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES*, 318.

[19] J. Sharman, *Offshore and the new international political economy* (the Journal of Contemporary Asia, Volume 17, Issue 1. 2010), 1.

[20] J. Sharman, *Offshore and the new international political economy*, 2.

[21] J. Sharman, *Offshore and the new international political economy*, 3.

Cayman OFC, supplementing it with more characteristics, such as partial cooperation with transnational regulators. In essence, my thesis mainly draws on the works reviewed above, empirical data and primary sources. However, the body of the thesis will combine more branches of academic discourse. The next chapter will introduce methods of my research.

Methodology

This thesis is the inter-disciplinary study that combines methods of different social sciences, such as economics, political economy, economic geography, and regional studies. My research employs quantitative and qualitative varieties of data and combines both inductive and deductive elements. The type of research and data used at different stages of this work is driven by the issues in question and the data available. Some issues are best addressed through qualitative data, others are more amenable to quantitative analyses. Therefore, I follow the holistic approach when the whole phenomenon under study is understood as a complex system that is more than the sum of its parts. Although I use many primary sources, in the thesis I will endeavor to demonstrate how my work builds on the existing academic literature on the topic. The research questions of the thesis I posed are the following:

Research question I: Why did the Caymans become one of the most successful offshore financial centres and how did it manage to maintain comparative advantage in financial services?

Research question II: What is the role of the Cayman Islands offshore financial centre in the global political economy?

Needed to be mentioned that by answering the research questions of the thesis I on the one hand will improve understanding of one of the most successful OFC in the world and on the other hand will show how offshore financial development offers a useful window through which to view processes of financial globalization. Additionally, within the hard case of finance, offshore finance provides a harder case. The importance of geographies will be particularly emphasized in the sphere of offshore finance. Taking into account the powers of the U.S. in the Caribbean and the importance of the U.S. in international finance, the close proximity of the U.S. will help understand the development of the Cayman OFC in a wider context.

My research strategy has been one of progressive hypothesis testing. My initial hypotheses were formulated from analyzing the anatomy of the Cayman OFCs and other similar places and how this relates to academic debates about financial globalization. These initial hypotheses were then specified in more detail and interrogated with empirical data. Eventually, I produced a narrative about the political economy of the Cayman OFC through reflection on my hypotheses, my data, and relevant academic debates. My research has used a wide variety of data, of different types, collected in different ways from a range of sources. The range of data includes basic historical data, chronologies of legal and political developments, and quantitative economic data. Basic historical data as well as chronologies of legal and political developments were mostly collected from secondary sources. I am especially indebted to research of Alan Hudson presented in his PhD dissertation named ‘Globalization, regulation and geography: the development of the Bahamas and the Cayman Islands offshore financial centres.’

My quantitative data has been drawn from the Bank for International Settlements, IMF reports, the Coordinated Portfolio Investment Survey, reports of EVESTMENT Global Asset Management Firm, General Registry of Cayman Islands, Cayman Islands Government, Office for National Statistics, the European Commission, the Bank of England, Eurostat, Institute on Taxation and Economic Policy, and the Boston Consulting Group. The main challenge of creating a narrative out of empirical facts was the lack of reporting in regard to hedge fund industry – the biggest financial activity in the Caymans. This challenge was resolved by referring to data of derived portfolio investment liabilities. All quantitative data are expressed in billions of U.S. dollars in non-inflation-adjusted prices and include: data about macroeconomic fundamentals, data about the volume of financial activity hosted in the Cayman Islands, data on cross-border banking, and data on cross-border direct and portfolio investment. The concluding chapter uses macroeconomic data as of November 2017. Basic historical data include historical facts and narratives referring to economic globalization and history of the Caymans in a wider context. Finally, chronologies of legal and political developments refer to the introduction of legislation and political events behind it. To sum up and reiterate, it should be noted that the purpose of the thesis is to contribute to a growing body of work concerning economic globalization and the role of OFCs in it.

Chapter 1: Offshore Financial Centres and Microstates

1.1 Offshore Financial Centre vs. Tax Haven

In this study, the question under discussion is OFC. Therefore, the first chapter will begin with defining OFC. The discussed criteria will be applied to the Cayman OFC in Chapter 4. By defining an OFC, this part aims to deconstruct the mistaken belief that OFCs and tax havens refer to the same category. Even though there is some confusion with tax havens, OFCs can be identified as being centres that host a range of economic activities such as private banking, offshore funds and trusts, holding companies, captive insurance, shipping registers etc., whereas tax havens are just based upon tax differentials with foreign jurisdictions. There is also a political aspect since many governments strongly oppose the tax haven label and thus claim to be OFCs or even international financial centres.[22]

In particular, tax havens tend to be jurisdictions rather than countries. Frequently, as seen in the case of Switzerland, this distinction is irrelevant. Some tax havens include territories within larger political structures that have a special status and enact their own laws – including the Cayman Islands and other dependencies of Great Britain. Basic tax havens employ few people and exist simply to facilitate secrecy, tax evasion and money laundering, while OFCs offer a wider range of financial services but still perform the basic tax haven functions. Both types provide relative security for financial assets. In general, tax havens offer greater opportunities for secrecy, while OFCs are better points from which to integrate illicit assets in more visible, recorded activities.[23] However, there

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[22] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., H. 2, 1996), 104.
[23] M. Moore, *The Practical Political Economy of Illicit Capital Flows* (Institute of Development Studies, 2011), 14.

is a big diversity of OFCs in terms of transparency and legality. Not all OFCs are involved in illegal or semi-legal activities.

Many variants of the term are usually used in academia, including International Financial Center, International Banking Center, International Banking Facilities, and Offshore Banking Center. All these terms are usually associated with the concept of OFC. Disregarding the motivations for nonresident financial dealings with OFCs and the nature of the activities undertaken, the creating of OFC is commonly associated with a conscious effort to specialize the economy in the export of financial services with the purpose to generate revenues that often make up a crucial proportion of the national income. The receipts of these exports normally consist of financial services billed to nonresidents by entities domiciled offshore and registration fees for licensed entities. Revenues in financial services normally include but not limited to bank fees for advisory; services and financial engineering; intermediary service fees; commissions on funds administration and on securities transactions, such as brokerage, placements of issues, underwritings, arrangement of swaps, options, and other hedging instruments; services related to asset management; and security custody services. Registration fees are usually paid for offshore banks, insurance companies, collective investment vehicles, international business companies, trusts etc.[24]

The International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) have published lists of OFCs based on a qualitative assessment of the jurisdictional regulations and taxation frameworks.[25] Lately in 2012, the IMF's Statistics Department

[24] A. Zoromé, *Concept of Offshore Financial Centers: In Search of an Operational Definition* (IMF Working Paper, WP/07/87, 2007), 4–19.
[25] J. Garcia-Bernardo, J. Fichtner, Frank W. Takes, E. M. Heemskerk, *Uncovering Offshore Financial Centers: Conduits and Sinks in the Global Corporate Ownership Network* (Scientific Reports 7, 2017), 2.

labeled OFC as ‘a jurisdiction in which international investment position assets, including as resident all entities that have legal domicile in that jurisdiction, are close to or more than 50 percent of GDP and in absolute terms more than $1 billion.’[26] However, this definition is not always relevant when it comes to specific jurisdictions as OFCs and is also vulnerable to political influence.

Contrary to the stated definition, Zoromé has defined OFCs as jurisdictions that ‘provide financial services to nonresidents on a scale that is incommensurate with the size and the financing of their domestic economies’.[27] Zoromé as well as Cobham, Jansky, Meinzer used flow data on the export of financial services to calculate ratios that indicate how significantly a jurisdiction acts as an OFC.[28] Fichtner further expanded this approach by using stock data on international banking assets, portfolio investment, and foreign direct investment in relation to GDP of a jurisdiction to calculate an ‘offshore-intensity ratio’.[29] These definitions will be applied to the Cayman OFC in Chapter 4. To sum up and reiterate, it must be noted that there are three distinctive and recurrent characteristics of OFCs that have emerged from stated definitions: (i) the primary orientation of business toward nonresidents; (ii) the favorable regulatory environment (low supervisory requirements and minimal information disclosure) and; (iii) the low-or zero-taxation schemes.[30] Moreover, OFC usually performs basic tax haven functions, whereas tax haven cannot be classified as OFC.

[26] A. Zoromé, *Concept of Offshore Financial Centers: In Search of an Operational Definition*, 6.
[27] Zorome, *Concept of Offshore Financial Centers: In Search of an Operational Definition*, 1–32.
[28] A. Cobham, P.Jansky, M.Meinzer, *The financial secrecy index: Shedding new light on the geography of secrecy* (Economic geography 91, 2015), 281–303.
[29] J. Fichtner, *The offshore-intensity ratio. Identifying the strongest magnets for foreign capital* (CITYPERC Working Paper Series 2015/02, City University London. SSRN ID 2928027, 2015).
[30] A. Zoromé, *Concept of Offshore Financial Centers: In Search of an Operational Definition*, 4.

Both definitions apply to the Cayman Islands (which will be demonstrated Chapter 4) and will be used in the course of this paper. The next part of this chapter will elaborate why most of the existing OFCs are small countries or even tiny islands.

1.2 Microstates' Development: Limitations and Options

A large number of small islands host OFCs, and some islands are highly dependent upon offshore finance. The most extreme examples have more than 90 percent of government revenues obtained from finance sector activities. For example, the British Channel Island of Jersey has over 90 percent of its government revenues derived from such activities, and the OFC directly employs approximately 20 percent of the local labor force. The reason for such an undiversified economy lies in the fact that many small territories are characterized by profound economic disadvantages: restricted comparative advantages, diseconomies of scale, dysfunctional market structures, high transport costs, high level of openness to international trade, tendencies to be price-takers not price-makers, and limited natural resources.[31] Moreover, small population often implies that the range of skills available in the local labor market, the size of the local market for products and services, and the availability of local investment capital, are limited.[32]

In his work on the development of tiny states and small islands, Baldacchino acknowledges the relatively few economically successful microstates and contends that dissimilar to their low-income counterparts,

[31] M. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance* (World Development Vol. 30, No. 9, 2002), 1657-1663.

[32] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 107.

the gainers were those that had managed to succeed in dealing with disadvantages of small scale and small size, and had actively linked their dependency on large countries.[33] Carefully reversing Gunder Frank's classic dependency theory,[34] Baldacchino claims that successful micro economies were those who were able to manipulate the larger countries to create a local advantage for themselves. According to Baldacchino, this 'opportunist pragmatism' with microstate governments seizing passing opportunities similarly to which local inhabitants have historically been pirates and privateers in many parts of the world.[35]

Baldacchino asserts that microstates are treated as deviant, and have been ignored by mainstream development theory which focuses on industrialization. He defines the strategies of tiny states as 'pseudo-development', stating that they adopt a rentier development strategy of integration into the global economy. For small states 'economic development is a problem of management - of timing, sequencing, and manipulating in an unending effort to perceive or create, and in any case to exploit, a multiplicity of little openings and opportunities'[36]. For Abbott and Palan such behaviour is parasitical.[37] On the other hand, Park maintains that hosting an OFC would promote the internationalization of the local economy by attracting FDI and generating specialist knowledge and

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[33] G. Baldacchino, *Bursting the bubble: the pseudodevelopment strategies of microstates* (Development and Change, 24(1), 1993), 29–51.
[34] G. Frank, *Capitalism and underdevelopment in Latin America* (Harmondsworth: Penguin, 1967).
[35] M. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, 1663.
[36] L .Best, *Size and survival* (Readings in the political economy of the Caribbean. Jamaica, New World Associates, 1971).
[37] J. Abbottand, R. Palan, *Tax havens: parasitical behaviour in the international system* (Newcastle discussion papers in politics, no. 12, 1995).

experience thereby 'helping local industry become internationally competitive'.[38]

Many small states and tiny islands, understanding the obstacles to development through industrialization, have eventually adopted other strategies such as the hosting of export-processing and assembly activity, tourism and offshore activities. These strategies are less limited by the size of states and their smallness can play an advantageous role. Since state sovereignty in the international system is held by all independent jurisdictions, micro or not, and is a resource which tiny states have put to use and defended strongly. The smallness and nature of local economies, can also imply that there is little difficulty in creating a set of tax benefits which not only do not harm the domestic tax base but actually expand it beyond what the local economy itself could dream about.[39]

From a more critical point of view, microstate and small island cultures turn out to be well suited to the successful establishment and development of OFCs and tax havens due to fact that media independence is often partial or absent; there is a general absence of higher education institutions or an intellectual community to raise awareness and object; and the insularity and inward-looking focus associated with island communities suppresses whistle-blowing.[40] From a more optimistic point of view, local governments keep many tax instruments available, including personal income taxes, property taxes, consumption or sales taxes, excise taxes, and others, that can finance necessary expenditures. Moreover, very low rates of

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[38] Y. Park, *The economics of offshore finance centers* (Columbia Journal of World Business, 1982), 31–35.
[39] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 109.
[40] M. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance* (World Development Vol. 30, No. 9, 2002), 1664.

direct taxation of business investment may yield significant tax revenues if economic activity expands, generating wealth that augment tax bases.[41] To take a middle ground, both costs and benefits must be discussed.

The advantages of establishing an OFC may include: public revenues from fees, licenses and profit tax; the operating expenditure of foreign firms in the local economy; direct employment and training opportunities for local citizens; and linkages to other sectors such as hotels, restaurants, office supplies etc.[42] Moreover, regulation and supervisory activities will definitely improve the work of local institutions. Potential indirect advantages may include: the provision of a low or no-tax regime for citizens, a more efficient local financial system through increased competition, better access to international capital markets, linkages and spin-offs to other sectors of the economy, and the internationalization of the local economy. The multiplier effects of the offshore sectors are generally observed in areas such as tourism, construction, business services and communications.[43]

Small island OFCs interact with international economy in a threefold way: through information exchange, knowledge creation, and development of trust with the nearest financial centre through interaction with other financial services professionals in other parts of the world and through local cooperation with global supervisors. Therefore, addressing such issues as local vulnerability to changing global economic environment, creation of new financial services and products to take advantage of the evolving global economy and increasing consumer sophistication, provision of suitably

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[41] J. R .Hines, Do Tax Havens Flourish? (Tax Policy and the Economy, Vol. 19, 2005), 66.

[42] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., 1996), 110.

[43] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 110.

qualified human resources, and maintenance of political stability will all be on the benefit side.[44]

From the perspective of the neoclassical theory, the establishment of an OFC generates additional wage income through the use of foreign funds. Since workers save a portion of their income, the economy is able to increase its capital stock per worker, therefore increasing steady state level of income per capita. The assumption of this theory is that the offshore sector allows countries to increase their rate of economic growth as far as they transition to a new higher steady state of income per capita. Moreover, due to the fact that banking is technologically advanced, the introduction of banking technology may facilitate technology transfer to other sectors.[45] Finally, the existence of economically booming regions such as South East Asia, China and parts of Eastern and Central Europe, leads to rising demand for OFC. This is exemplified by the constantly increasing international private banking.[46]

The costs of hosting an OFC can also be significant. Regulators unable to raise great sum of money by taxing mobile business income may be able to use other direct and indirect taxes, but the revenue potential of alternatives to business taxes is limited by international considerations. With regard to personal income taxes, the ability to use international financial transactions might encourage tax avoidance and tax evasion by rich taxpayers. Furthermore, international mobility of individuals and their earnings increase the mobility of the personal income tax base. Downward pressure on business tax rates created by international competition is likely

[44] S. C. Cobb, *Globalization in a Small Island Context: Creating and Marketing Competitive Advantage for Offshore Financial Services* (Geografiska Annaler. Series B, Human Geography, Vol. 83, No. 4, 2001), 161.
[45] J. T. Butkiewicz, L.-R. C. Gordon, *The Economic Growth Effect of Offshore Banking in Host Territories: Evidence from the Caribbean* (World Development Vol. 44, 2013), 176.
[46] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., 1996), 111.

to put downward pressure on income tax rates of rich individuals because of the ability of high income taxpayers to select the forms of business organization. Top personal income tax rates that greatly exceed top corporate income tax rates encourage individuals to establish corporations funded with personal investments which in the end convert personal income into corporate income and by that undermines the revenue potential of high personal tax rates. The indirect effect of this may be felt in unrealized investments.[47]

The disadvantages of having an OFC may also include: creating the infrastructure, possible land and housing price increases, the crowding out of investment opportunities in other sectors of the economy, and the possibility of immigration There are two further aspects: the possibilities of criminal abuse and corruption; and the limited checks and balances in island government that may counteract potential abuse. Additionally, by hosting an OFC, the island could possibly become a rentier state rather than having direct production as its main economic activity. As part of the interface with the global financial system, companies or individuals might become involved with questionable international financial activities such as major fraud, large scale corruption or money laundering of drug proceed. Particularly, new and unexperienced OFCs might be much less selective in the business accepted compared with older OFCs.[48] A loss of control over monetary policy, the penetration of the local banking sector by foreign banks, increased pressure on resources, and costs to other countries by facilitating capital flight are among other indirect costs.[49]

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[47] J. R. Hines Jr., International Financial Centers and the World Economy (Step Report 2009), 10-11.

[48] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., 1996), 111–112.

[49] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE*

Finally, in case of the absence of monetary links with a reserve currency, an independent currency used by a small island would inevitably appreciate in both nominal and real terms in relation to the currencies of its trading partners as a consequence of the rapid growth of offshore activity. The effect of such currency appreciation on those industries reliant upon the financial sector would be quite severe. Crowding out might occur as an effect of price inflation triggered by the demand pressures exerted by a booming leading sector.[50] Finally, arguments for the economic success of high income OFCs are based upon aggregate indicators such as government revenue surpluses or rising GDP per capita figures. Nevertheless, such partial economic indicators have problems as they mask income redistribution within the state.[51]

If the worst comes to the worst, microstates could suffer from a crash of real estate and land prices, massive emigration off-island where the most mobile leave and a deep financial crisis of the local state. For non-independent island economies this could result in increased direct control from their 'motherlands'. For independent small islands, the economic crisis could require IMF emergency loans to keep the economy afloat.[52] In the best case scenario, small islands could use OFC as a starting step and then diversify the economy and enjoy all the benefits of globalization without being too dependent on external economic environment. The case of the Cayman Islands will test the existing theory on microstates' development. The last part of this chapter will elaborate on demand for OFC.

FINANCIAL CENTRES (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996).

[50] M. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance* (World Development Vol. 30, No. 9, 2002), 1665.

[51] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., 1996), 110.

[52] M. Hampton, J. Christensen, *Small Island Economies: Exploring Alternative Development Strategies to Hosting Offshore Finance* (Kent Business School, Working Paper No. 227, ISSN 1748-7595, 2010), 14-15.

1.3 Demand for Offshore Financial Centres

The neoclassical theory points out the following factors explaining demand for OFCs: fiscal autonomy, independence from mainstream regulatory authorities, judicial independence and secrecy in the banking and political spheres. Factors of comparative advantage such as minimization of transactions costs and economies of scale for transnational corporations in the arena of international business are seen as the main driving force behind the decision to go offshore.[53] Big corporations use extremely sophisticated corporate structures of parents and subsidiaries to organize their international operations and ownership structure. For instance, the UK-based banking and financial services company HSBC has 828 legal corporate entities in 71 jurisdictions. Anheuser-Busch InBev, the largest brewing company in the world, is composed of 680 corporate entities involving 60 jurisdictions. These complex corporate structures increase competitive advantage by minimizing costs and accountability.[54]

There are three main reasons behind the decision to establish offshore subsidiary. Firstly, multinational corporations aim to increase legal protection. By creating subsidiary in offshore jurisdictions and using such subsidiaries to invest in other countries, corporations can hedge their investment against decisions of governments. Secondly, business friendly regulatory regimes in OFCs are used by multinationals to avoid corporate accountability and public scrutiny of their operations. For example, many of the speculative financial products that caused the global financial crisis since 2008 were created in OFCs. Thirdly, complex ownership structures contribute to minimization of tax payments - especially for corporations that

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[53] M. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance*, 1667.
[54] J. Garcia-Bernardo, J. Fichtner, Frank W. Takes, E. M. Heemskerk, *Uncovering Offshore Financial Centers: Conduits and Sinks in the Global Corporate Ownership* Network (Scientific Reports 7, 2017), 1.

have many intangible assets, such as intellectual property rights. To give an example, between 2007 and 2009 Google moved the majority of its profits generated outside the U.S. to Bermuda through corporate entities in the Netherlands. As a consequence, the company paid an effective tax rate of 2.4 percent on all operations. Apple used Ireland to avoid taxes, and Starbucks UK voluntarily paid £20 million after it was found out that it had paid virtually no taxes since establishing in the UK. In sum, annually corporations avoid paying US$50-200 billion in taxes only in the EU. Thereby, tax avoidance gives a competitive advantage to corporations over small companies, which are taxed at national rates.[55]

This chapter addressed the issue of OFCs. Firstly, an OFC was distinguished from tax haven. It must be reiterated that while OFCs can be identified as being centres that host a range of economic activities, tax havens are just based upon tax differentials with its neighbors and other jurisdictions. Secondly, it can be deduced that since small islands economies are characterized by profound economic disadvantages, classic development models do not apply to them. A flexible option of becoming an OFC may bring both costs and benefits, depending on how the government constructs it. Finally, the demand for OFC is high and will increase exponentially as long as capitalism exists in its current form. Therefore, it might be assumed that the supply will adjust and will meet new financial and legal challenges. The next chapter of this paper will test the definition of OFC on the Cayman Islands and explore the rise of the Cayman OFC.

[55] J. Garcia-Bernardo, J. Fichtner, Frank W. Takes, E. M. Heemskerk, *Uncovering Offshore Financial Centers: Conduits and Sinks in the Global Corporate Ownership Network*, 2

Chapter 2: The Cayman Islands from a Historical Perspective

2.1 Mapping the Caymans

The Cayman Islands are a group of three islands in the Caribbean Sea, 290 km north of Jamaica and 750 km south of the United States. Cayman Brac and Little Cayman are the two smaller islands, while Grand Cayman is the main touristic destination, the centre of finance and commerce, and the most populated part of the country. Grand Cayman is 35 km long and 12 km wide at its widest point.[56] As of 2016, the population of the Caymans constituted 57,268, with vast majority of citizens living on Grand Cayman.[57] Columbus was the first person to map the Caymans in 1503. The "Las Tortugas" was given due to the large numbers of turtles in vicinity of the islands. Sir Francis Drake was the first representative of England to pay a visit to the Caymans in 1586. The Treaty of Madrid in 1670 shared out the Caribbean possessions of Spain and England resulting in the situation when London gained the Cayman Islands. Since then, Cayman has remained a British

[56] A .Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 26.

[57] The World Factbook, https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html, (June 15, 2017)

colony.[58]

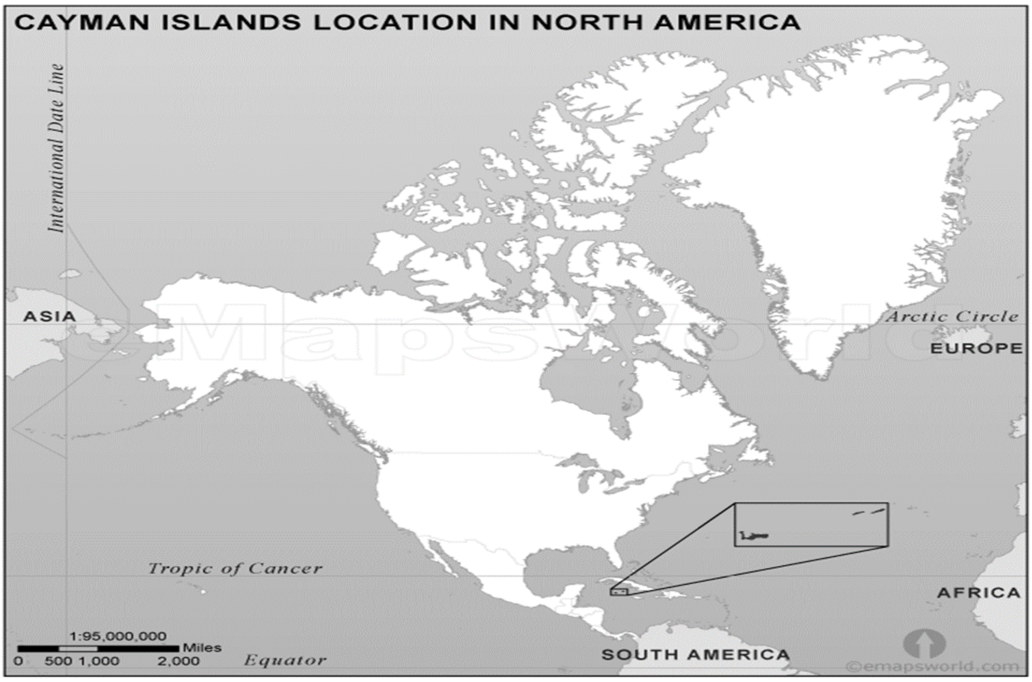

Figure 1: Location of the Cayman Islands

2.2 A little background and economic history of the Caymans

Long and diverse history of colonization, economic dependence, migration, and cultural exchange has earned the Caribbean a role of case study in recent works on globalization, serving as an indication that many of the processes associated with current globalization are not altogether new.[59] The Cayman Islands is not exceptional in this respect. This part will briefly summarize history of the Caymans from colonial period up until today. Understanding history of this group of islands is central to analyzing the development of OFC. Despite the fact that the Caymans was always on the

[58] Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES*, 27.
[59] V. Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands* (American Ethnologist Vol. 28, No. 3, 2001), 574.

periphery of the British Empire, it was never isolated from the rest of the world. Although infrastructure left much to be desired and a largely barter-based domestic economy was in place, a large proportion of local male population served as seamen and officers aboard merchant marine ships or on turtle-fishing boats that ranged widely throughout the Caribbean.[60] The Caymanian population was therefore aware of changes in the world economy and able to compare home country with the rest of the Caribbean and the outside world. Moreover, Caymanians grew increasingly sophisticated through this process.

Sharing much resemblance with other Caribbean nations in terms of economic development, Cayman had one distinctive feature - its dependence on the colonial metropoles was historically vested in seafaring rather than a plantation economy.[61] At the outset, the economy was based on the exploitation of abundant turtle resources in local waters. However, after these resources were almost completely depleted by the end of the 18th century, small Caymanian turtling ships ventured further afield to the south coast of Cuba and finally to the cays off Nicaragua. Due to the lack of mines and plantations, there was a higher proportion of whites and a relatively small population of African slaves. Hence, in 1802, a third of the inhabitants of Grand Cayman were white contrasted to Jamaica where 94 percent of the population were blacks[62]. This peculiarity played a pivotal role in Cayman history.

Taking into consideration these economic and demographic differences, the abrogation of slavery had different consequences in Cayman compared to many other parts of the Caribbean. Elsewhere in the region, the

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[60] R. Smith, *THE MARITIME HERITAGE OF THE CAYMAN ISLANDS Bodden, CAYMAN ISLANDS IN TRANSITION*, supra note 17, 82.

[61] Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands*, 580.

[62] E. Doran, *A Physical and Cultural Geography of the Cayman Islands*, (Ph.D. dissertation, University of California at Berkeley, 1953), 163.

abolition did not automatically entail the end of the plantation economic system or its racial hierarchy. Emancipated slaves continued to experience serious obstacles in acquiring land, and many remained without it or could only acquire small plots of land, often marginal.[63] In 1923, according to official statistics for Nevis, then a part of the British Leeward Islands colony, only 82 land holdings, 58 of which exceeded 100 acres, were listed.[64] In St. John's, a Danish West Indies colony, the abolition brought almost no changes. Denmark instituted regulations preventing the emancipated from leaving the plantations, and a system of contract labor remained in place and tied them to their former owners.[65]

To put this in perspective, in the Caymans, the absence of a plantation system and the dominance of a maritime economy caused little pressure on land following the 1834 abolition of slavery in the British colonial empire. The former masters could not maintain their old influence over the freed, as Grand Cayman was sufficiently sparsely populated for the latter to receive land of their own. Cayman could not support an absentee landowner class either. Moreover, many resident whites were of the same modest means and lifestyles as former slaves. With the course of time, some of the emancipated stayed on close to the old settlements, in some cases on land given to them by their masters, and these may have remained largely under the strong influence of the old slave-owners. Many others went north and east in order to settle down on uninhabited land, where the agriculture was in most cases on a subsistence variety.[66]

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[63] V. Amit, A clash of vulnerabilities: *citizenship, labor, and expatriacy in the Cayman Islands* (American Ethnologist Vol. 28, No. 3, 2001), 580.

[64] K, Olwig,, *Cultural Sites: Sustaining a Home in a Deterritorialized World* (In Siting Culture: The Shifting Anthropological Object, London: Routledge, 1997), 23.

[65] K. Olwig, *Caribbean Place Identity: From Family Land to Region and Beyond. Identities* (1999a), 446.

[66] Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands*, 580–581.

The vertical integration and compression of the biosocial hierarchy of the Cayman Islands left little motivation for the establishment of institutions such as family land, which appeared throughout the Caribbean. According to Karen Fog Olwig,[67] family land meant a rejection of the plantation system's association of property with a colonial society that restricted economic and political enfranchisement to a tiny European minority. It established a system in which land became a source of family unity and rootedness. As the Caribbean region began to export population in big numbers through the 19th century and the 20th century, family land turned into a structural linchpin of rotating transmigration, allowing a continuing physical and cultural connection between family members who emigrated and those who stayed.[68] The Caymans experienced the same processes. However, the aftermath was different. While family land was not established and thus did not bring all the related economic consequences, migration came to the islands with advancements in maritime economy. This was a distinct peculiarity of Cayman. Moreover, lack of economic opportunities and the increasing propensity for Caymanian men triggered massive emigration of former slaves.

Caymanian seamen travelled far from their islands seeking out work and new homes, while the Caymans remained relatively isolated from the outside world with few economic incentives. Regional roads were limited and internal transport and communication could be very challenging especially for those living in the outlying districts and the two smaller islands. In sum, an orientation toward and dependence on the outside world was combined with highly localized and isolated district communities.[69]

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[67] Olwig, *Caribbean Place Identity: From Family Land to Region and Beyond. Identities*, 450.

[68] Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands*, 581.

[69] V. Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands* (American Ethnologist Vol. 28, No. 3, 2001), 581.

Although such economic model was undoubtedly more beneficial when compared to the rest of the Caribbean, the goals of development were unachievable without further reforms. In the 1950s, local economy was based on agriculture and seamen's remittances, combined with turtle and other fishing, shipbuilding, and hand crafts. Poor airline service sustained an embryonic tourist business built around hotels and small guest houses. New economic challenges were ahead. In the late 1950s, the global shipping industry was adopting large-bulk cargo ships, which translated into fewer jobs for Caymanians. Additionally, Nicaragua reduced Caymanians' access to Nicaraguan turtle fisheries.[70] This was the right time to think about new economic development strategies. By the late 1960s, this situation began to change dramatically.

As far as politics is concerned, within the British Empire, Grand Cayman and the smaller islands of Cayman Brac and Little Cayman were a dependency of the colony of Jamaica, which also separately administered the Turks and Caicos island group. The London-appointed Crown Governor was responsible for all three jurisdictions while exercising colonial authority from Jamaica. In addition, subordinate commissioners represented Britain in the two outlying dependencies.[71] Decolonization elsewhere in the Caribbean, the independence of Jamaica and internal processes brought new political and economic realities.

The no-tax status of the Caymans has a long history, but only in 1960`s significant attention was paid to developing Cayman` tax haven role. The other developing economic sector was tourism. The two main obstacles to bringing tourists had been tackled in the previous decade: an airstrip had been opened in 1953, and the mosquito population was being brought under

[70] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 8.
[71] Freyer and Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960*, 8.

control.[72] Putting the mosquitoes under supervision triggered the improvement in the tourist trade as well as in the financial sector. These two sectors turn to have been mutually reinforcing with people who came for business reasons but then returned for vacations or vice versa. The real estate sector expanded with the increasing number of visitors. The more hotels and condominium complexes were built, the better it was for the construction industry. Land, which had been not highly desirable before this construction boom, now immediately appreciated in value. Thereby, many locals were able to profit both from the employment and entrepreneurial prospects brought by the construction industry as well as from the wide distribution of land ownership. However, incoming expatriates, from the U.S., Britain, Canada, and Jamaica also jumped at the opportunity.[73]

In spite of new chances for employment, tourist sector was not able to absorb all the Caymanian men who were displaced from their jobs on merchant vessels as supertankers, containerized cargo, and cheaper, less-skilled labor changed the merchant shipping industry and labor market. Facing this issue, local business leaders and politicians shifted to on a deliberate strategy to develop Caymans` economy relying dually on tourism and, by augmenting the tax haven role, offshore finance.[74] Even more than control of mosquitoes, the building of an airport, the implementation of financial legislation facilitating offshore banking, the economic transformation of the Cayman Islands in the 1960s has been enabled through the invitation of numerous foreign workers. Imported workers rendered assistance in the development of the social, civil, and medical service sectors. Additionally, expatriates have provided skilled and semiskilled

[72] S.M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 240.
[73] V. Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands* (American Ethnologist Vol. 28, No. 3, 2001), 582.
[74] S.M. Roberts, S*mall Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 240.

labor in the construction sector, served as domestics, provided critical expertise in financial services, and performed variety of roles in the tourist sector. In a nutshell, imported workers have been employed in almost every economic and occupational domain in the Cayman Islands.[75] These economic developments were in step with political processes associated with decolonization.

2.3 Political environment of the 1960s

Cayman's constitutional evolution was influenced by larger scale constitutional developments in the Caribbean region. Particularly, British officials throughout the region considered the establishment of a West Indian Federation as a path to self-government beginning in 1955. London treated the Federation as the tool to cutting the costs of its smaller colonies, as the Federation would consolidate the smaller islands with the larger colonies of Trinidad and Tobago, Barbados, the Bahamas, and Jamaica. Coincidently, the economic challenges of the Caribbean colonies attracted relatively little attention from Great Britain preoccupied with more urgent imperial problems elsewhere in the world. A distracted metropolitan power with attention concentrated on narrow fiscal issues contributed to developing an OFC because the Federation was meant to become a vehicle to independence for those territories that were regarded at the time as too small to proceed to independence alone. However, the larger colonies did not need such a vehicle in order to become sovereign.[76]

Britain put pressure on the Caymans to give consideration to an association with the Federation, offering a status similar to that of the Channel Islands with Britain, even proposing to take the islands back as a

[75] Amit, *A clash of vulnerabilities: citizenship, labor, and expatriacy in the Cayman Islands*, 575.
[76] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 10.

colony if such status proved unfulfilling after five years. London was in fear that if it did not convince the Caymans to accept its proposal to join the Federation, the Caymans would remain a permanent U.K. dependency.[77] In 1959, Cayman's colonial administrative connection to the Jamaican legislature terminated. The old Cayman legislature of Justices of the Peace and Vestrymen ended and a new Legislative Assembly replaced it. Even though the formal changes in Cayman's ties to London were definitely less dramatic than those occurring in the region, the shift from Jamaican dependency to Crown Colony both increased Cayman's autonomy and improved the political basis for the Islands' government.[78]

Firstly, local politics took measures towards the same type of political culture emerging elsewhere in the Carribean, but important differences were soon evident. First and foremost, issues of class and race played a less significant role in the Caymans than in other territories. Consequently, Caymanians had to choose either independence or preservation of colonial status, albeit with greater self-government. Even though the 1959 colonial constitution had formally put an end to the Jamaican administrative connection, practical political implementation anticipated the resolution of disputes over Jamaica's place within the Federation. After Jamaicans chose independence in a referendum in September 1961, Jamaica, immediately followed by Trinidad and Tobago, left the Federation in spring 1962. Jamaican independence materialized on August 6, 1962.[79] Taking into account its concerns over remaining with an expensive legacy of financially dependent territories, London`s interest in the region focused on finding means for fiscal self-sufficiency. The Colonial

[77] Freyer and Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960*, 11.
[78] J.A. R. Bodden, *Patronage, Personalities and Parties: Caymanian Politics from 1950 – 2000* (Ian Randle Publishers, 2010), 66–75.
[79] M. Craton, *Founded Upon the Seas: A History of the Cayman Islands and Their People* (Ian Randle Publishers, 2003), 315.

Office was intent that Britain not be left with a residue of financially dependent territories such as the Caymans, the British Virgin Islands (BVI), and Turks and Caicos.[80]

Caymanians saw Jamaican withdrawal and independence as the break and sought stability in their relationship with Britain. As members of the Legislative Assembly debated these issues, a formal petition from voters in Cayman Brac and Little Cayman endorsed remaining a British colony and declared support for secession from Grand Cayman if the larger island followed Jamaican suit. Caymanians' broad public support for a direct link to Britain under increased self-government facilitated the promotion of OFC.[81] It was too late to look for the escape bottom.

This chapter focused on economic and political circumstances behind Cayman` constitutional evolution. Although the Caribbean influences on Cayman were evident in terms of the decolonization process, the path of this territory was somehow unique. First and foremost, its economic model during the colonial period was based on seafaring rather than plantation economy. The Caymanian population was thus open to the outside world, and numerous seamen were able to compare their region with the rest of the Caribbean. In the long run this circumstance allowed the Caymans to oversee the globalization processes and to benefit from them. In addition, the absence of a high proportion of African slaves due to the lack of plantations prevented racial tensions with locals and whites during decolonization.

The land in the Caymans was not scarce, and the 1834 abolition of slavery did not support an absentee landowner class. Almost equal

[80] Freyer and. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960*), 15.
[81] M. Craton, *Founded Upon the Seas: A History of the Cayman Islands and Their People* (Ian Randle Publishers, 2003), 316-317.

economic conditions of resident whites and former slaves assured the vertical integration of the vast majority of Caymanians, creating good preconditions for labor market. New economic challenges of the 1950s provided impetus to shift from a largely barter-based economy and to seek diversification. The construction of an airport, the implementation of financial legislation, and the invitation of numerous skilled foreign workers facilitated the establishment of two leading industries – offshore banking and tourism. Finally, the Jamaican withdrawal from a West Indian Federation triggered massive support among locals to preserve stability in relationship with Britain. The economic and political transformation occurred. However, the Caymans was not alone in focusing on tourism and finance. The broader picture of global economic developments will help in understanding why Cayman has become the world`s most successful OFC. Chapter 2 will cover history of financial globalization after 1950s.

Chapter 3: Financial Globalization and the Rise of the Caymans as Offshore Financial Centre

3.1 Economic realities of the 1960s

The limitations of microstates in terms of economic development have already been discussed in the first chapter. Island microstates in the Caribbean such as the Caymans, the Bahamas, Nassau and others face the same issues, having small local markets and limited resources. Therefore, economic development through industrialization is limited. On the other hand, their jurisdictions, their allocation of authority within the regulatory landscape, and their legal sovereignty to attract investments are their best resources for development. The specialty and smallness of microstates' economies, relying on imports and lacking internal linkages, also implies that there is little difficulty in designing a set of fiscal benefits which not only do not weaken the domestic tax base but actually widen it beyond what the local economy itself could achieve.[82] Hence, offshore finance, based upon jurisdiction, or the sovereign right to construct a place through regulation, offered the Caymans feasible development strategy.[83]

In the 1960, this search for a suitable development strategy coincided with the desire of international business for profitable and safe location of financial activities. This desire was motivated by restrictions on banking sector imposed in the United States with an eye to control the outflow of capital which threatened to undermine the role of the U.S. dollar and the Bretton Woods international monetary system. These restrictions included American Regulation Q (ARQ) and the Interest Equalization Tax (IET)

[82] E. Dommen and P. Hein, States, *Microstates and Islands* (London: Croom Helm, 1985), 12.
[83] A.C. Hudson, *Reshaping the regulatory landscape: border skirmishes around the Bahamas and Cayman offshore financial centres* (Review of International Political Economy, DOI: 10.1080/096922998347516, 1998), 543.

which was imposed from 1963 to 1974.[84] Regulation Q prohibited banks to pay interest within checking accounts in order to prevent loan sharking.[85] The Interest Equalization Tax was designed to levy the purchase price on foreign stocks and bonds bought by U.S. citizens for the purpose of encouraging investment in domestic securities.[86] Those regulations were met positively in the Caymans, since they open the door for various financial innovations and the development of offshore banking.

Banking is considered to be the historical foundation upon which the Cayman Islands has built OFC. In the course of 1960s, the Caymans implemented a series of laws designed to attract financial business from abroad, especially banks. One of the most important decisions that facilitated the later development of the Cayman OFC was to remain under British sovereignty when in 1962 Jamaica opted for independence. Expatriate lawyers from Canada and Britain drafted many Cayman laws, either adapting British laws or copying them from the Bahamas. During the colonial times, the Caymans inherited English common law.[87] According to William Vlcek,[88] this was of crucial importance to the success of the Cayman OFC, since financial actors from Anglophone countries are used to it and because in the English legal tradition law evolves in a bottom-up fashion from individual case decisions, therefore dramatically facilitating transnational finance. The principal difference between common law and

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[84] A.C.Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 25.

[85] R. Gilbert, *Requiem for Regulation Q: what it did and why it passed away* (Review from Federal Reserve Bank of St. Louis, issue Feb, 1986), 22–37.

[86] THE STAFF OF THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, *SUMMARY OF INTEREST EQUALIZATION TAX AND TREASURY PROPOSAL FOR EXTENSION* (Washington: U.S. Government Printing Office JCS-2-73, 1973), 1.

[87] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 1039.

[88] W. Vlcek, *Offshore Finance and Small States: Sovereignty, Size and Money* (London: Palgrave Macmillan, 2008), 44.

civil law is that common law only determines what is prohibited, whereas civil law stipulates what is permitted. It is thus clear how beneficial is common law for mobile capital and finance.

In general, British overseas jurisdictions were well positioned to satisfy the booming postwar demand for jurisdictions creating opportunities to structure businesses and personal affairs to reduce tax. A long history of such activity was already in Bermuda, the Bahamas, Isle of Man, and the Channel Islands. Moreover, the City of London had the cluster of legal, accounting and banking services designed to create and implement strategies that went beyond simple relocation of assets.[89] Meanwhile, some international banks were already present on Grand Cayman in the 1960s. Barclays Bank had been opened in 1953 and was followed in ten years later the Royal Bank of Canada and the Canadian Imperial Bank of Commerce.[90] The political and legislative foundations for an offshore financial sector were not long in coming. Crucial to this plan was the building of Owen Roberts International Airport in 1952 and the increasing availability of electrical power.[91]

Not only ARQ and IET are to be blamed for the development of offshore finance. It was the British government that restricted the availability of loans in sterling for trade financing outside the sterling area in the first place. With the purpose to satisfy their customers' demands for finance, the banks turned to the unrestricted U.S. dollar. The London-based market for U.S. began to grow, turning into an offshore center for

[89] Freyer and Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* , 4.
[90] S.M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 240.
[91]A.C.Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 26.

Americans.[92] British tax policy and economic developments during the 1950s and 1960s gave overseas territories motivation to use the opportunity, both through the capital controls that restricted asset flows out of the post-war ‘Sterling Area’ and through a combination of increasing tax and surtax rates. Additionally, there was a discussion of wealth taxes and other measures that encouraged wealthy residents to look for alternatives. Along with that, the post-war push for decolonization created the political space needed by the overseas territories to meet this demand by limiting London`s control and lobbying interests within the British government which focused on the territories’ economic sustainability. Therefore, just when London was increasing overseas territories’ autonomy with the purpose of reducing tax burden, it was also creating conditions that provided a market for offshore financial services which City firms were happy to help drive. The development of the telex and long distance telephone systems meant an opening for new jurisdictions to enter the market. In contrast, France made its overseas territories integral parts of the French state, leaving no room for those jurisdictions to adopt such a strategy.[93]

Combined with all mentioned above economic trends, Cayman began to emphasize several beneficial factors in promoting itself as an OFC. Susan Roberts points out[94] such factors as the Caymans’ location in the same time zone as New York and Miami, the ease of communication via frequent flights to America, and the stable political environment of a British overseas territory. This was a truly crucial factor. When Nassau experienced political instability in the late 1960s, leading to the independence of the

[92] S.M. Roberts, Small Place, *Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 243

[93] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 4–5.

[94] S.M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System*, 240.

Bahamas from the UK in 1973, Cayman was ready and took over much of the fleeing business.[95]

In sum, the central issue addressed in this part is the relationship between tendencies in international political economy in the 1960s, decolonization processes in the Caribbean and the establishment of the Cayman OFC. The Caymans' development into one of the world's largest OFC was initially triggered by a combination of fundamental core factors – protectionist tendencies in international economy, the wave of decolonization in the Caribbean, and a foundation of stable and liberal economic and legal regulatory regimes. However, such important factors as restrictions imposed on the Sterling Area and the enactment of AMQ followed by IET in the U.S. cannot solely be attributed to the rise of Cayman as leading OFC. Mentioning of such important consequences of excessive regulation as the establishment of the Euromarkets and the subsequent collapse of the Bretton Woods system is necessary to fully understand offshorization of the world economy in general and the rise of the Caymans in particular. The next two parts will be dedicated to these phenomena.

3.2 The establishment of the Euromarkets and the rise of the Eurodollar

In 1972, more than 3,000 registered companies and more than 300 trust companies had been opened in the Cayman Islands. Even though a number of Canadian and British banks had located in the Cayman Islands already in the early 1970s, the number of banks, principally from the U.S., increased significantly on Grand Cayman during the late 1970s. From 1972 to 1982, the average annual growth rate in the number of category 'B' bank licenses

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95 J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 12.

constituted 23.4 percent. From 1982 to 1989, the average annual growth rate was just 3.1 percent. Susan Roberts explains this sudden rise in offshore banking between 1972 and 1982 by referring to the development of the Euromarkets.[96] Since World War II (WWII), large international corporations, especially American, have decentralized production centers to places where labor was clearly cheaper. Thus, profit centers have emerged in countries characterized by the absence of direct taxation. Thereafter, it has become attractive to redistribute profits attributing most important part of these companies within the group.[97] The ground for fundamental changes in international economy was laid. The discussed ARQ and IET came as a reply to decentralization efforts by American corporations and European borrowers.

The sterling area served as 'a formal collective arrangement for discriminating against the scarce U.S. dollar.'[98] Exchange control on the one hand complicated offshore strategies, but on the other hand created demand for them as a means of avoiding regulators. Jurisdictions within the sterling area faced the problem that the authorities asked entities dealing in dollars and U.S. securities to be non-resident for exchange control purposes but barred such entities from selling shares into the sterling area. In the United Kingdom (UK) a hefty tax was imposed on sales of foreign currency securities. Moreover, no official exchange was accessible for portfolio investment outside the sterling area. Nevertheless, Sterling area residents' were motivated to invest outside the exchange control region. This implied there was a market for strategies and structures that allowed them to sidestep the regulators. British efforts at exchange controls were only

[96] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 243.
[97] E. Constantin, *METHODS OF TAXATION IN THE TAX HAVENS. EXAMPLES OF TAXATION IN THE BAHAMAS, BERMUDA AND THE CAYMAN ISLANDS* (University of Târgu Jiu, Economy Series, Special Issue ECO-TREND, 2015), 210.
[98] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 18.

partially successful, as outward direct investment increased from £102 million to £157 million between 1964 and 1966. Unsurprisingly, British exchange controls tightened after 1965, limiting investment even into Australia, New Zealand, Ireland, and South Africa. Fears Britain would devalue sterling motivated sterling area businesses to seek shifting their assets out of the British currency.[99]

Meanwhile, a pool of U.S. dollars had been accumulating outside America because since 1957, when the U.S. trade surplus had evolved into a trade deficit, a European market for deposits and loans in U.S. dollars emerged. Moreover, American demand for offshore finance grew after the U.S. enacted the Interest Equalization Tax in 1963, as well as the Voluntary Foreign Credit Restraint program and the Foreign Direct Investment Regulations in 1965. Reserve Regulation Q's limits on interest paid on deposits in the U.S. also pushed dollars into the Eurocurrency markets. Both U.S. firm`s foreign subsidiaries and non-American firms therefore entered the increasingly growing Eurodollar market in search of cheaper financing. The establishment of the Eurodollar market was crucial for the Caymans since even though it was headquartered in London, Eurodollar transactions were behind much of the financial activity based on the islands. International banks further globalized financial markets, since branches kept in touch with their home offices even outside local trading hours, constantly creating more continuous trading opportunities. Therefore, just when the Caymans was entering the market, regulatory measures in the UK and the U.S. were encouraging demand for offshore jurisdictions' services and spurring the financial and legal industries in both countries to exploit their competitive advantages in developing that demand.[100]

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[99] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 18–19.
[100] Freyer and Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960*, 21.

The demand for strategies to sidestep British exchange control and the growing Eurocurrency market in the UK granted sterling area jurisdictions an advantage and a home market in the sterling area that promoted financial innovation, while also allowing growth into the larger American market. In the early 1970s, Cayman's constitutional structure was consolidated, tested, and further developed to benefit from the jurisdiction's competitive advantages. The success of this process could be witnessed in Cayman growing financial sector. Cayman's evolution occurred in a shifting business environment for Caribbean OFCs in the early 1970s. Furthermore, the decline of exchange controls changed the international financial landscape. Finally, the price of oil rose sharply in the 1970s. Hence, the infusion of petrodollars into the Eurodollar market vastly expanded its scope.[101] The sudden collapse of the Bretton Woods system escalated the situation even further.

3.3 The collapse of the Bretton Woods system

The Bretton Woods system was the first system of a fully negotiated monetary order created to coordinate and govern monetary relations among sovereign states. The founders of this system sought to design a set of monetary arrangements that would combine the advantage of the classical gold standard with the advantage of floating rates. They tried to sidestep the defects of floating rates, such as destabilizing speculation and forced devaluations, and the defects of the fixed exchange rate gold standard, such as subordination of national monetary policies to the dictates of external balance. Consequently, they created an adjustable peg system of fixed

[101] Freyer and Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960*, 25.

parities that could be changed only in the event of a serious disequilibrium.[102]

However pragmatic the intentions of the architects were, there were many problems inherent in the Bretton Woods system. Alan Hudson stresses the following contradictions: the Triffin dilemma; the N-1 problem; and tensions due to the dollar being both a domestic and an international currency. The Triffin dilemma explains the necessary trade off between expanding liquidity and maintaining confidence in the value of money: these goals are not compatible under the Bretton Woods System. For maintaining liquidity as world trade expanded, the amount of dollars in circulation needed to be increased. With a stable supply of gold and a fixed exchange rate, an increase in liquidity necessarily reduced levels of confidence in the currency. Holders of dollars began to fear that their money was not backed by adequate supplies of gold.[103]

Gilpin describes the N-1 by asserting that a monetary system composed of N countries, N-1 countries are free to change their exchange rate but one country cannot change its exchange rate due to the fact that its currency is the standard to which all other countries peg their currencies.[104] Finally, the dual role of the dollar as international and US domestic currency could also explain the collapse of the Bretton Woods system. The role of the U.S. as both guarantor and governor of this regulatory order is contradictory, since actions such as interest rate changes taken by America for domestic reasons caused international repercussions. On the other hand, the U.S. economy was vulnerable to the actions of foreign holders of dollars

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[102] M.D. Bordo, *The Bretton Woods International Monetary System: A Historical Overview* (University of Chicago Press, 0-226-06587-1), 5.

[103] A .Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 46.

[104] R. Gilpin, *The political economy of international relations* (Princeton, Princeton University press, 1987), 138.

who exchanged dollars for gold.[105] It is thus evident that the Bretton Woods system was self-defeating. Even though it had been working more than expected, its collapse was undoubtedly inevitable under the weight of its own contradictions.

Meanwhile, the Eurocurrency market has experienced fundamental widening. More currencies became important. For example, the Japanese yen and some other currencies have expanded the scope of the Eurocurrency market. Moreover, the European Currency Unit (ECU) was also used. Additionally, there was also a Eurobond market that was originally a market for fixed-interest, long-term borrowing by governments, municipalities and corporations. This market included floating-rate notes and has been open to numerous innovations. Greater and greater securitization was achieved due to a host of ingenious financial instruments that have been created as part of the global trend.[106] While dollars outside the U.S domestic economy undermined U.S. macroeconomic goals, many countries – particularly Communists states – feared the seizure of their dollar assets by the USA and shifted to the Eurocurrency market.[107] The Euromarkets were thus stimulated by efforts to provide dollars with liquidity, but contributed to the dollar's problems by making it more difficult for US regulatory authorities to control it.

The establishment and rise of the Eurocurrency market as a source of private liquidity for the world economy marked the shift from the Bretton Woods monetary system. Moreover, transition from public to private

[105] Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES*, 47.

[106] S.M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 246.

[107] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 46–47.

liquidity was coupled with transition from relative stability to a high degree of volatility. President Nixon closed the gold window in 1971 and thus signaled the end of the fixed exchange rate system. As a consequence, currencies began to float against one another. Everyday fluctuations in exchange rates have been followed by variations in the other major prices in the world economy, including interest rates and inflation. Capital has adopted numerous measures to avoid the risks stemming from volatility, such as hedging in foreign exchange. It is therefore evident that the flip side of the risk inherent in volatility is the opportunity to profit from change.[108] Cayman has seized this opportunity and profited from it.

Fundamental changes have occurred on micro level. Traditional manufacturing firms evolved into huge multinational corporations that began to run their finance departments as profit centers in their own right. These departments actively engaged in profit-making from mergers and acquisition activity, foreign exchange dealing, and interest rate and currency swaps. Therefore, these corporations have become financial institutions in their own right, challenging traditional banks. As a response, banks have carried out important reforms in their structure and practices. Traditional sources of income, such as deposits and loans, were no longer regarded as the most important ones. More complex financial instruments that allow risk management and profit in the face of volatility have emerged.[109] The Economist characterized this new tendency as ‘a shift from mass production to flexibility’.[110]

Another newly developed service of banks was international private banking (IPB). Even though this service has a long history in traditional

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[108] Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System*, 247.
[109] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 247.
[110] The Economist, *Survey: International banking* (Supplement, 7 April 1990).

banking, it was the first time when banks have reorganized their internal structure in order to offer cluster of services marketed as IPB on global scale. Susan Roberts points out two beneficial developments for the Cayman Islands related to IPB: firstly, the wealth of the rich has grown dramatically; secondly, the internationalization of this private money pushed it to the local banks in the Caymans.[111] However, a deeper understanding of legal developments drafted by expatriate lawyers is essential to see the broader picture of how the Cayman Islands outdistanced numerous regional competitors in offshore finance and became one the most attractive places for IPB. The last part of this chapter will be dedicated to the legal evolution of the Caymans.

3.4 Developments in banking and financial law

The 1960 Companies Law contributed to the development of OFC more than the new 1959 constitution under which the Caymans was created. It established a Caymanian Registrar of Companies, liquidating formal dependence upon Jamaican law. In addition to the preexisting customs duties and collectable stamps, the registration fees brought revenues that gave the Caymans greater autonomy from the United Kingdom by allowing it to finance its own activities. The 1960 Companies Law encouraged foreign investment, replacing Jamaican incorporation with the local registration of firms. The Law provided both individual and corporate freedom from direct taxation. This was clearly an improvement on the possibilities for tax avoidance offered by the Bahamas and other Caribbean nations.[112] Other core legal developments are best summarized by Timothy Ridley, former Chairman of the Cayman Islands Monetary Authority.

[111] Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System*, 249.
[112] T. Freyer and A. P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure & Strategy since 1960* (ARIZONA STATE LAW JOURNAL, 2013), 14.

Phase One – 1966 to 1976

The Banks and Trust Companies Regulation Law, the Exchange Control Regulations Law, and the Trusts Law followed the Companies Law. From 1966 to 1976, the industry put down roots, much assisted by political instability in the Bahamas and the establishment of the Eurodollar market, which was the consequence of the mentioned Interest Equalization Tax in the United States. In 1976, 7,521 companies, 126 banks & trusts with assets worth US $21.9 billion, and one captive insurance company were registered. In 1970, the Caymans decided to begin issuing its own currency, thereby contributing to local stability. Previously, the Caymans had used the Jamaican dollar as legal tender. It was the right decision, baring in mind the rapid progress of the Cayman economy, to have its own currency and a Currency Board. Moreover, the 1974 decision to delink the currency from sterling and to tie it to the U.S. dollar cemented financial stability since sterling had lost its former liquidity. Up until now the local currency is linked to dollar. Therefore, the Cayman Islands has always enjoyed a healthy surplus in the reserves backing the Cayman dollar.[113]

Phase Two – 1976 to 1986

In 1976, the Confidential Relationships Law was crafted to protect confidential information of financial services from improper disclosure as a reaction to actions by the U.S. administration at the time to receiving information from offshore jurisdictions. All exchange control restrictions were repealed during the late 1970’s. The Insurance Law was implemented in 1979 with the purpose of regulating the developing captive insurance industry. Afterwards, the Caymans came into its own in financial services, such as banking, captive insurance and general financial transactions. In the end of this period, in 1984, Cayman entered into the Narcotics Agreement

[113] T. Ridley, *What makes the Cayman Islands a successful international financial services centre?* (BIS Review 72, 2007), 1.

with the U.S., which evolved into the Mutual Legal Assistance Treaty in 1986. Already in 1986, there were 16,791 registered companies, 456 banks and trusts with assets worth US$ 202 billion, 6 company managers and 107 captive insurance companies.[114]

Phase Three – 1986 to 1996

From 1986 to 1996, growing financial services activity continued over a wide array of areas, particularly in on and off-balance sheet secured and unsecured financing, captives and mutual funds. Meanwhile, the regulatory infrastructure developed into state-of-the-art financial architecture, in particular with the enactment of the Mutual Funds Law in 1993, which guaranteed a clear and secure framework for the fund industry. The Trusts Law and other legislation was constantly being amended to maintain Cayman's leadership in financial services. In 1996, 37,919 companies, 575 banks & trusts with assets worth US$ 507.8 billion, 75 company managers, 378 captive insurance companies, 121 mutual fund administrators and 1379 mutual funds were registered.[115]

Phase Four – 1996 to current times

In the late 1996, the Proceeds of Criminal Conduct Law and related anti money laundering regulations were implemented. This was one of the first in the region anti-money laundering legislation. For this purpose, the Cayman Islands Monetary Authority (CIMA) was established in order to replace the Financial Services Supervision Department. In 1997, the Cayman Islands Stock Exchange (CSX) was opened. In 2000, the Caymans committed to joining controlled bilateral on-request arrangements for assisting OECD member states in tax matters. The Tax Information

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[114] Ridley, *What makes the Cayman Islands a successful international financial services centre?* , 1.

[115] T. Ridley, *What makes the Cayman Islands a successful international financial services centre*? (BIS Review 72, 2007), 2.

Exchange Agreement signed with the United States in 2001 was the first of these. Moreover, the Caymans also arrived at the agreement to enact the automatic reporting of interest payments under the EU Savings Directive (EUSD). The Securities Investment Business Law was implemented in 2001 and provided for the licensing of investment advisors and managers. In 2001, 64,495 registered companies, 427 banks with total assets worth US$ 800 billion, 3,648 mutual funds, 542 captive insurance companies, 418 listings on the CSX with a market capitalization worth US$ 38.1 billion, 92 company managers, and 217 mutual fund administrators were registered. In 2002, CIMA began to operate independently. In 2003, the Caymans was assessed by the International Monetary Fund (IMF) and received favorable feedback confirming compliance with international regulatory standards. Anti-money laundering culture was particularly emphasized.[116]

In summary, Cayman has undergone a long way until it appeared on global financial maps. The rise of the Caymans as leading OFC in the Caribbean is strongly linked to history of financial globalization. Since the end of WWII, business has experienced rapid internationalization. The fear of capital flight from both the U.S. and the Sterling area triggered the tightening of regulations enacted by the United States and the United Kingdom. As a consequence, the Eurocurrency markets emerged, and the Bretton Woods system died under the weight of its own contradictions. This was a clear signal for the Caymans to use the opportunity and to develop offshore banking sector, since economic development through industrialization was limited. The establishment of IPB and the legal developments in the islands drafted by expatriate lawyers made this possible. As a result, Cayman has outdistanced numerous regional competitors and became one of the most important OFC in the world. The

[116] T. Ridley, *What makes the Cayman Islands a successful international financial services centre?* , 2–3.

next chapter will elaborate on economic consequences of such a rapid transformation and explain current trends in the Cayman Islands' economy and financial sector. This will help understand how Cayman succeeded in maintaining the role of one of the most successful OFC in the world, given that the competition is indeed stiff.

Chapter 4: Economy and Financial Services Sector of the Caymans

4.1 Business climate and taxation in Cayman

The Caymans has no-tax jurisdiction, meaning that even though duties are levied on imports and there are sales taxes; income, capital gains, or inheritance taxes are absent. Cayman is therefore regarded as a well-established OFC with a diversified offshore sector. Trusts, captive insurance, offshore banking services, offshore companies, offshore mutual funds, and numerous complex financial deals are to be found in the islands. However, the establishment of offshore exempted companies such as trading, investment, or holding operations is a lower order offshore activity, which requires neither sophisticated infrastructure or legislation, nor a big number of skilled professionals.[117] Thus, such companies are not famous in Cayman. Currently, there are roughly 20,000 companies registered, and approximately 100,000 companies in the Caymans as a whole. In sum, twice as many companies as citizens are present there.[118]

Two categories of companies are offered by local legislation: companies under ordinary law and exempted companies that are not allowed to conduct business in Cayman. Businesses gaining benefits from this last state resulting from a discretion larger to the extent that the shareholder register should not be available to the public at the registered office of the company. Additionally, no capital required to show only one annual document assuring that the firm operated under Cayman law. A meeting of the board of directors must be held annually in Cayman, but attorneys are

[117] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 242.

[118] General Registry Cayman Islands, http://www.ciregistry.gov.ky/portal/page/portal/reghome/companies (July 19, 2017).

also welcome. No permit is required for formation of a no society that can be completed up to three days, without consideration for its status. Moreover, no minimum capital required and no rules requiring the ratio debt / equity are in place. Companies may even be single-member.[119] In sum, most offshore companies are exempted for 20 years from any taxes that may be imposed in the Cayman Islands. Offshore corporations allow a high degree of confidentiality concerning their ownership and are not subject to many reporting or capitalization requirements.[120]

A corporation created as a hedge fund in Cayman must pay a fee to set up the corporation and pay the annual Mutual Funds Law fee which means that the hedge fund would not be taxed at home. This particularly applies to income tax or any of the other taxes attributable to an international corporation. The Mutual Funds Law provides investors with flexible regulations and therefore enables hedge fund managers to be more creative with investments. At home, hedge funds usually take on a limited partnership or general partnership form. Therefore, the hedge fund is taxed as a partnership and investors are considered to be limited partners. The investors are afterwards singularly taxed. The aim of the domestic hedge fund is to eliminate being taxed as a corporation or a publicly traded partnership to avoid double taxation.[121]

Local Cayman companies are frequently used as tools in contracting. In business terms, this is attributive to transfer-pricing. For instance, a local firm may be created by international corporations for rental or leasing purposes, renting or leasing equipment to external affiliates. The rent or

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[119] E. Constantin, *METHODS OF TAXATION IN THE TAX HAVENS. EXAMPLES OF TAXATION IN THE BAHAMAS, BERMUDA AND THE CAYMAN ISLANDS* (University of Târgu Jiu, Economy Series, Special Issue ECO-TREND, 2015), 210.
[120] Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System*, 242.
[121] C. Horton, *The UBS/IRS Settlement Agreement and Cayman Island Hedge Funds* (The University of Miami Inter-American Law Review, Vol. 41, No. 3, 2010), 367–368.

lease payments are therefore stored in the Cayman company, reinvested without taxes, and might be repatriated at any time. Similarly, a local company may also be used by a multinational firm as a sort of intermediary, and via double invoicing reserves can be accumulated tax-free. Moreover, the title of a Cayman company could be hold to land where secrecy of ownership is sought. Finally, local companies may also be used to own ships or planes, to hold patents or film rights, or as investment companies.[122] On the other hand, the government receives fees from company registrations. Numerous trust companies and law and accountancy firms help multinational corporations. Besides taking care of the registration and incorporation, local managers can provide a registered office and nominee shareholders.[123] The use of local companies is thus a win-win strategy for both the government and foreign investors.

Based on conditions discussed above, it is evident that the main objective of the Caymans is not to attract illicit financial flows, but to function as a channel for large international financial institutions, allowing them to reduce taxes and to evade regulation. That is why Vered Amit-Talai compares the Caymans to Luxembourg, which is a major hub for European investment funds, rather than to Switzerland, which attracts private funds or the Netherlands, which acts as the largest direct investment conduit.[124] Comparison with the remaining Caribbean neighbors, many of whom are also involved in offshore banking, is even less valid. The unique combination of factors that have been discussed up until this point are attributive for such a special role of the Cayman Islands. Another core factor explaining the rise of Cayman is dynamic development of local economy.

[122] C. S. Gill, *Incorporation and investment in the Cayman Islands* (Grand Cavman, C. S. Gill, 1982), 7–9.
[123] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 242.
[124] V. Amit-Talai, *In Pursuit of Authenticity: Globalization and Nation Building in the Cayman Islands* (Anthropologica, Vol. 39, No. 1/2, 1997), 53–63.

The next part will elaborate on economy of the islands and the role of the offshore sector in it.

4.2 Economic overview

In 2016, approximately 100,000 companies were registered in the Caymans, which includes around 300 banks, 10,000 mutual funds, and 800 insurers. A stock exchange was established in 1997 and facilitated trade. However, offshore sector is surprisingly not the major source of income for the Cayman Islands. Tourism is a crucial sector which accounts for roughly 70 percent of GDP and 75 percent of foreign currency earnings. Local tourism is aimed at the luxury market and attracts mainly visitors from the United States. Total tourist arrivals exceeded 1.9 million in 2008, with about half from North America.[125]

GDP in purchasing power parity terms constituted $2.549 billion in 2014, while real growth rate was 2.2 percent. In 2016, governmental revenues exceeded expenditures by $117 million, which translates into budget surplus of 5.2 percent. Industrial production growth rate constituted 2.4 percent in 2016. Inflation of the Caymanian dollar was surprisingly low in the very same year – just 0.6 percent. Around 90 percent of the islands' food and consumer goods are imported. As of 2016, exports made up just US$ 47.6 million[126], while imports constituted $854.2 million[127]. The disparity between budget surplus and high level of exports might be explained by GDP composition by sector where services made up 92.5 percent in 2016.[128] From 2014 to 2016, unemployment rate was shrinking up until full employment. In sum, a standard of living in the Cayman Islands

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[125] Index Mundi Cayman Islands Economy Profile 2017, http://www.indexmundi.com/cayman_islands/economy_profile.html (July 24, 2017).
[126] Index Mundi Cayman Islands Economy Profile 2017
[127] Cayman Islands Government, *the Cayman Islands` Annual Economic Report 2016* (The Economics and Statistics Office, 2017), 6.
[128] Index Mundi Cayman Islands Economy Profile 2017.

could be compared to that of Switzerland if main macroeconomic indicators are considered.

The Caymans` economic growth in 2017 is estimated at 2.3 percent, conditional on the timing of some investment projects, growth in tourism and stable demand for financial services. Domestic inflation is expected to turn positive after two consecutive years of deflation. This might be achieved due to an expected recovery in global prices and rising demand for housing.[129] Table 2 will summarize all remaining core macroeconomic indicators for 2016. These indicators were calculated by Cayman Islands Government. However, some of them are preliminary estimates due to insufficient data.

[129] Cayman Islands Government, *the Cayman Islands` Annual Economic Report 2016*, 55.

Indicators	2014	2015	2016
Real GDP ($million)*	2,549.6	2,621.8	2,691.6
GDP growth in real terms (%)*	2.2	2.8	2.7
Real GDP per capita ($)*	44,735	44,397	43,938
Nominal GDP per capita ($)*	48,344	48,167	47,864
Nominal GDP ($million)*	2,755.3	2,844.5	2,932.1
Population (year-end)	58,238	60,414	61,361
Of which Caymanians	33,447	34,237	34,113
Population (mid-year)	56,993	59,054	61,259
Average inflation rate (%)	1.3	(2.3)	(0.6)
Employment	37,643	39,138	40,411
Unemployment rate (% of labour force)	4.6	4.2	4.2
Total imports (in $million)	814.4	830.9	854.2
Total imports (% of GDP)	29.6	29.2	29.1
Total money supply (M2, in $million)	4,932.4	5,898.0	6,155.3
Domestic credit (in $million)	2,971.2	2,981.2	3,083.9
Mutual funds (including master funds)	11,010	10,940	10,586
Insurance licenses	788	739	740
Banking and trust licenses	198	184	159
Trust companies	110	118	117
Stock exchange listings	1,066	1,048	1,022
New company registrations	11,010	11,875	11,174
New partnership registrations	2,893	3,377	3,356
Stay-over tourists (in thousands)	382.8	385.4	385.5
Cruise ship passengers (in thousands)	1,609.6	1,716.8	1,711.8
Grand Cayman building permits ($million)	356.1	186.9	247.0
Cayman Islands planning approvals ($million)	417.0	464.9	416.8
Cayman Islands property transfers ($million)	562.8	612.2	860.3
Overall fiscal balance of the central government ($million)	95.2	116.3	101.0
Overall fiscal balance of the central government (% of GDP)	3.5	4.1	3.4
Outstanding debt of the central government ($million)	534.0	511.0	483.9
Outstanding debt of the central government (% of GDP)	19.4	18.0	16.5

*Preliminary estimate for 2016 based on indicators.

Table 2: The Cayman Islands Economic Performance

The financial industry of the islands is permanently growing in most areas. Figures for 2006 demonstrate that the number of active registered companies had grown to 81,783, a 27 percent increase from 2005. In 2006, Cayman Islands Stock Exchange had 1,225 listings with total market capitalization of US$ 111.5 billion. To put this in perspective, in 2005 it had 1000 listings. The Caymans continues to be the world's leading destination for hedge funds and for structured finance transactions.[130] Moreover, Cayman is the largest holder of US securities in the world. Jan Fichtner asserts that such a concentration of hedge funds is accountable for this strong Cayman-US link.[131]

The number of trusts and company managers remains almost the same with some relatively modest growth in the number of private trusts. The only discrepancy from the numerical growth trend is in the banking industry. Bankers tend to treat consolidation and cost-efficiency arguments very seriously. For this reason, the number of licensees at the end of 2006 was 3 percent down from 2005 and constituted 291. On the other hand, the quantum of assets on deposit at approximately US$ 1.4 trillion is still climbing, with the Caymans remaining the biggest offshore bank booking centre. The resident population is also rapidly growing. With around 57,000 people currently living in this territory, 400 percent growth in 33 years is observed.[132]

To analyze the scale of the Cayman OFC, it is useful to consider Jan Fichtner` offshore-intensity ratio that has been discussed in the first chapter. This ratio is determined by the amount of foreign assets in relation to the GDP.[133] According to it, Cayman is the most intensive OFC worldwide with foreign assets constituting over 1500 times domestic economy. Moreover, the Caymans has attracted more external assets than such developed economies as Japan, Canada and Italy, even though they have economies several hundred times Cayman's GDP. Therefore, Cayman is actually one

[130] T. Ridley, *What makes the Cayman Islands a successful international financial services centre?* (BIS Review 72, 2007), 2.
[131] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1034.
[132] T. Ridley, *What makes the Cayman Islands a successful international financial services centre?* (BIS Review 72, 2007), 2–3.
[133] J. Fichtner, *The offshore-intensity ratio: identifying the strongest magnets for Foreign Capital* (CITYPERC Working Paper Series 2015/02, City University London, 2015).

of the largest financial centers worldwide and a central node in contemporary global finance.[134] This role is definitely beneficial for local economy, but on the other hand it might sometimes be harmful for the rest of the world. According to Cetorelli and Peristiani, Cayman is the second largest jurisdiction in the world concerning the issuance of asset-backed securities from 1983 to 2008.[135] Furthermore, Culp and Forrester suggest that the Cayman Islands had even been the largest jurisdiction regarding the issuance of collateralized debt obligations from 2004 to 2007.[136] The creation of asset-backed securities led to the establishment of collateralized debt obligations which in turn contributed to the most severe economic crisis after the Great Depression. This shows how much money and financial innovations are associated with the Cayman OFC.

Data on cross-border banking in Cayman began in 1983 and came from the Bank for International Settlements (BIS). The BIS collects two kinds of statistics, the Locational Banking Statistics (LBS) and the Consolidated Banking Statistics (CBS). In short, the locational statistics explain the aggregate international claims and liabilities of all banks resident in the reporting countries. Both domestic and foreign-owned banking offices in the reporting countries report their positions on a gross basis and on an unconsolidated basis, along with those acting versus own affiliates, which is in line with the principles of national accounts, money and banking, balance of payments and external debt statistics. On the other hand, the consolidated statistics collect quarterly data on world`s consolidated international financial claims of domestically-owned banks

[134] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1035.
[135] N. Cetorelli and S. Peristiani, *The Role of Banks in Asset Securitization* (FRBNY Economic Policy Review July, 2012).
[136] C. Culp and P. Forrester, *The shape of CDOs to come* (Cayman Financial Review 2010).

broken down by remaining maturity and sector of borrower. They show the extent of foreign claims of banks.[137]

To put it differently, LBS measure all international positions of banks resident in the Cayman Islands. Figure 2 shows LBS claims and CBS data for the Caymans from 1983 to 2014. From1990s until the mid-2000s both measures increased similarly. However, afterwards LBS climbed by 50 percent in just two years to a peak of more than US$ 1800 billion in 2007–2008. The financial crisis did not affect the upward trend of Cayman in CBS. Consolidated foreign claims briefly declined from over US$ 900 billion in 2007 to US$ 735 billion in 2008. Nevertheless, since then claims have grown steadily.[138] It is thus evident how intensively the Cayman offshore banking sector has been growing since 1983. Even though tourism is still accountable for the biggest share of GDP, banking industry will challenge this sector already in the short run, if the current trend remains in place.

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[137] Bank for International Settlements, *Guidelines to the international locational banking statistics* (CH 4002 Basel, ISBN 92 9197 727 6, 2012), 1.

[138] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1039–1040.

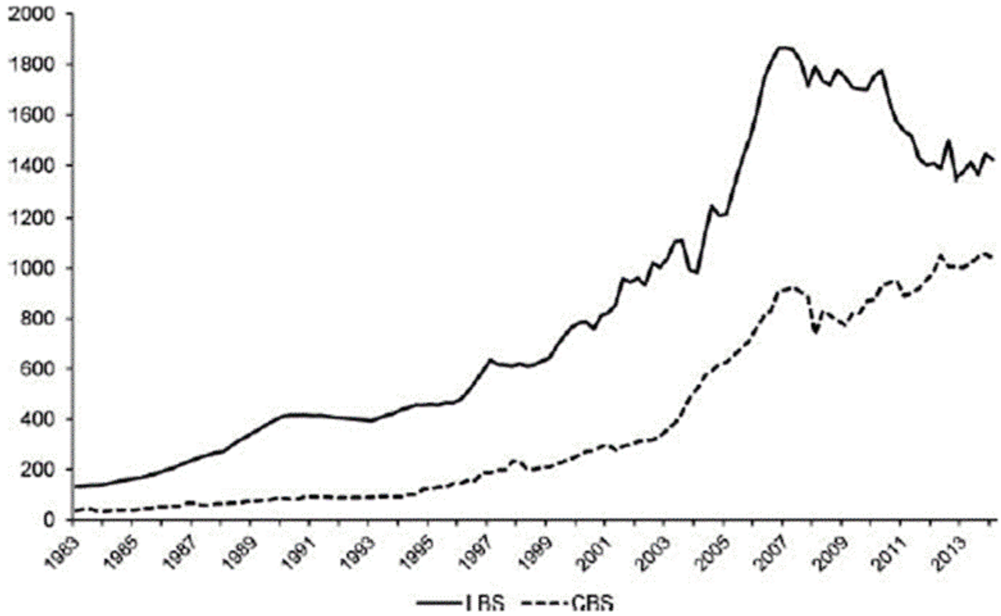

Figure 2: Development of the Cayman Offshore Banking Sector, 1983–2014

Cayman is in the world top five in most segments of cross-border banking. In one specific measure Cayman even occupies the third position. This is external deposits and loans of reporting banks versus individual countries. Table 1 shows the 15 largest jurisdictions in this measure. The claims announced by banks located in the Caymans are intragroup, 26 percent are to non-banks and only 6 percent are to other banks. Over 91 percent of all claims are in US dollar.[139] Jan Fichtner states that the largest factor for the Cayman banking sector is US banks that transfer money to overnight sweep accounts in Cayman. Such sweep accounts reduce reserve requirements. The money is transferred between accounts in the United States without being exposed to how a Cayman banker invests it.[140]

[139] Bank for International Settlements, *Locational Banking Statistics*, https://www.bis.org/statistics/bankstats.htm (July 25, 2017).
[140] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1041–1042.

External loans		External deposits	
United States	3113	United Kingdom	3060
United Kingdom	2854	United States	2962
Cayman Islands	1319	Cayman Islands	1781
France	1035	Germany	1334
Japan	998	France	1039
Germany	867	Japan	691
China	729	Luxembourg	687
Netherlands	603	Switzerland	611
Hong Kong	548	Netherlands	539
Luxembourg	536	China	511
Singapore	522	Hong Kong	499
Switzerland	518	Ireland	483
Ireland	427	Singapore	430
Canada	364	Jersey	297
Italy	331	Belgium	292
Other	4486	Other	5151
All Countries	19,250	All Countries	20,368

Table 1: External loans and deposits of reporting banks versus individual countries

In a nutshell, the Caymans has enjoyed a thriving economy over the course of many years. Cayman macroeconomic indicators could be compared to those of world`s leading economies. Luxury tourism and offshore banking sector play a pivotal role in this steady development. As seen from the mentioned statistics, even the financial crisis of 2007–2008 did not alter fundamentally the upward trend of Cayman in CBS. There is overwhelming evidence for the notion that the Caymans will remain one of the world`s major OFC. This position will continue to benefit Cayman economy. In turn, a thriving economy as well as stable political environment will offer the Cayman Islands an advantage vis-à-vis numerous competitors in the Caribbean. However, some other advantageous factors explaining the leading position of the Caymans are to be mentioned in the next sections –

direct investment and portfolio investment as well as trusts and captive insurance.

4.3 FDI, FPI and other financial activities

The huge domain of investment is separated into foreign direct investment (FDI) and foreign portfolio investment (FPI). The difference between both types is best explained by Itay Goldstein and Razin Assaf: FDI investors, who gain both ownership and control positions in the domestic companies, are also the managers of these companies; while FPI investors, who take ownership without control of companies, must transfer powers over decisions to managers, but limit their freedom to make decisions since the managers' agenda might not be in line with that of the owners.[141] The amount of FPI is much larger than FDI worldwide. According to IMF, the former measures US$ 48 trillion[142] and the latter amounts to US$ 28 trillion.[143] This discrepancy is even more obvious for the Caymans. Moreover, the vast majority of Cayman direct investment has to do with non-material industry – finance.[144]

In turn, FDI could be divided into two subgroups – inward direct investment (IDI) and outward direct investment (ODI). The ODI stock is the value of the resident investors' equity in and net loans to enterprises in foreign countries. The IDI stock is the value of foreign investors' equity in and net loans to enterprises resident in the given country. Cayman ODI constitutes $540 billion and is slightly lower than IDI. The difference of US$ 17 billion could be explained by the fact that Cayman invests into non-

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[141] I. Goldstein and A. Razin, *FOREIGN DIRECT INVESTMENT VS FOREIGN PORTFOLIO INVESTMENT* (NATIONAL BUREAU OF ECONOMIC RESEARCH, Working Paper 11047, Cambridge, 2005), 2.
[142] IMF, *Coordinated Direct Investment Survey*, http://cdis.imf.org (July 26, 2017)
[143] IMF, *Coordinated Portfolio Investment Survey*, http://cpis.imf.org (July 26, 2017)
[144] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1044.

reporting OFCs or by means of outward portfolio investment. Given the small size of the domestic Cayman economy almost all inward investment, including portfolio investment, leaves the jurisdiction again. It might even change its form while passing through. Therefore, the Caymans and other OFCs with small GDPs are entrepôt jurisdictions regarding investment. In 2014, just two categories accounted for 80 percent of Cayman IDI from the United States: holding companies and finance with more than 40 percent each. On the other hand, all categories associated with manufacturing are insignificant.[145]

According to IMF, Cayman FDI has more than doubled from 2009 to 2014.[146] On the other hand, the data yielded by this study does not provide strong evidence that these numbers reflect genuine growth. A better reporting might explain such an increase. In 2014, total Cayman IDI constituted roughly $550, or over 180 times the GDP of Cayman – a very high number. It might also be the case that Cayman FDI is even higher than these numbers suggest since there is no corresponding FDI data from other large OFCs, such as Bermuda, BVI or Jersey.[147] The available evidence forces to conclude that even though the amount of FDI is indeed enormous, almost all of it leaves the jurisdiction without contributing to development of manufacturing and thus diversification of local economy. This, however, does not affect the status of the Cayman OFC. On the contrary, such a great concentration of ODI and IDI creates new facilities and brings in new expectations for bankers and managers. However, FDI represents the smaller financial segments. The larger one is portfolio investment.

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145 J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds*, 1045–1046.

146 IMF, *Coordinated Direct Investment Survey*, http://cdis.imf.org (July 26, 2017).

147 J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1045.

The bulk of global cross-border portfolio investment is represented by debt instruments and equity. The Coordinated Portfolio Investment Survey (CPIS) by the IMF is one of the most authoritative sources for this segment of investments. Cayman has participated in the CPIS along with other 69 jurisdictions. Nonetheless, hedge fund sector is excluded from Cayman reports which leaves this data almost worthless.[148] Additionally, derived portfolio investment liabilities (DPIL) are also published by the IMF. DPIL are especially important for underreporting jurisdictions and non-reporting OFCs. In 2015, Cayman reported portfolio investment assets of $61 billion.[149] However, the reported DPIL indicate that Cayman portfolio investment is more than $2574 billion – 42 times over what the official Cayman data suggest. Therefore, in 2015 the Caymans have been the sixth largest financial center in the world regarding cross-border portfolio investment.[150] Gabriel Zucman asserts that the significant disparity between reported assets and derived liabilities reveals how huge the role of hedge funds in Cayman portfolio investment is.[151]

If the Cayman accounted for 60 percent of total hedge fund assets in 2013, the global hedge fund industry would have been approximately US$ 3400 billion instead of US$ 2630 billion, since according to eVestment global assets under management by hedge funds are estimated to be US$ 3411 billion.[152] The gap between Cayman hedge funds assets of US$ 2030 billion and Cayman portfolio investment of US$ 2200 billion could be

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[148] P. Lane and G. M. Milesi-Ferretti, *Cross-border investment in small international financial centers* (IMF Working Paper WP/10/38, 2010).
[149] IMF, *Coordinated Portfolio Investment Survey*, http://cpis.imf.org (July 26, 2017)
[150] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds*, 1048.
[151] G. Zucman, *The missing wealth of nations: are Europe and the U.S. net debtors or net creditors?* (The Quarterly Journal of Economics 128(3), 2013), 1321–64.
[152] Pensions and Investments, *Hedge fund administration assets jump 13.3%*, http://www.pionline.com/article/20130924/ONLINE/%20130929973/hedge-fund-administration-assets-jump-133 (July 27, 2017).

explained by the estimated 15 percent of global private equity assets that are located in the Caymans.[153]

Figure 3 shows development of hedge fund assets and Cayman portfolio investment. The data gathered in the study suggest that the world`s largest concentration of hedge funds is behind such an impressive number of portfolio investment. This, however, cannot come as a surprise. Hedge funds require a range of services to be in place, such as net asset calculation as well as transfer agency services and registrar. The vast majority of these services is provided in just three jurisdictions: the Caymans, Ireland, and the United States.[154] Strong link between North America and the Cayman Islands foster the establishment of new hedge funds and thus new portfolio investment.

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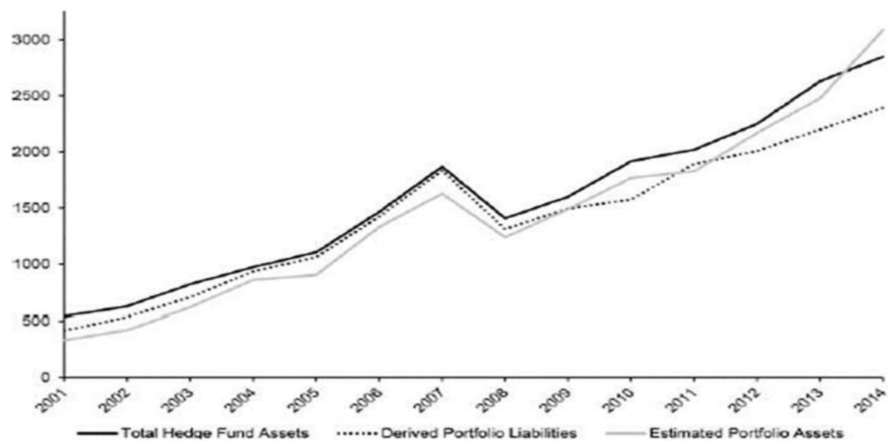

Figure 3: Development of hedge fund assets and Cayman portfolio investment

[153] J. Fichtner, *The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds* (Review of International Political Economy, 23:6, 1034-1063, DOI: 10.1080/09692290.2016.1243143, 2016), 1051.
[154] J. Fichtner, The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge fund, 1053.

The trust is a defining feature of the Caymanian OFC. A private trust company is one that holds itself out as a trustee or fiduciary for hire and operates for the benefit of businesses regardless of whether compensation is received or anticipated.[155] Trust law in the Cayman Islands rests upon the English Trustee Law 1925, subject to some statutory modifications. There are, however, some key differences. For example, the Cayman Islands Trust Law did not include forced heirship provisions, which has benefited the attractiveness of local trusts. Moreover, the Caymans introduced the perpetuities law of 1995, which increased the perpetuity period to 150 years, in contrast to many other jurisdictions. Once a trust is formed in Cayman, it does not take on its own judicial personality. It is defined as a fiduciary relationship between the settlor and the trustee in order to fully benefit the beneficiaries. No taxation on profits, income, dividends as well as no capital gains taxes are in place. In addition, no minimum capital is required and no exchange control regulations apply.[156] A sophisticated professional trust sector, modern trusts legislation and an effective judicial system with the possibility to appeal to the Privy Council in the UK make Cayman the most attractive spot on offshore map for trusts.[157] More than 40 entities are licensed to conduct trust business in the Cayman Islands; the most important ones are owned by large American, British, Canadian and Swiss banks. This makes Cayman one of the most ‘trust-concentrated’ places worldwide.[158] The number of trusts is constantly growing.

Captive insurance is another booming entity of Cayman offshore market. A captive is a wholly owned subsidiary set up to issue insurance to

[155] South Dakota Legislature, July 28, 2017.

[156] General Registry Cayman Islands, *Trusts*, http://www.ciregistry.gov.ky/portal/page/portal/reghome/trusts (July 28, 2017).

[157] Carey Olsen, *An overview of the types and uses of Cayman Islands law trusts*, https://www.careyolsen.com/briefings/overview-types-and-uses-cayman-islands-law-trusts (July 28, 2017).

[158] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 245.

its non-insurance parent company. Captives are created with the purpose to meet the risk-management needs of the owners. They are a form of self-insurance whereas the insurer is owned by the insured. After the establishment the captive began to cooperate like any commercial insurer. However, it is still regulated as a captive, rather than as a traditional insurer. Captives are held by the majority of Fortune 500 companies as an alternative method of risk financing. Microeconomic reasons such as cost reduction and risk management are central when deciding upon creation of captive.[159] Like offshore companies in general, a captive may also be used as a profit center for minimizing or deferring taxes. The Caymanian Islands rank second in the world as a center for offshore insurance, while Bermuda is the world's largest offshore insurance center.[160] While being on top of world`s ranking in terms of captive insurance, Cayman still yields the first position to its main competitor in offshore sector in the Caribbean region. There are many more competitors in every walk of offshore business. The last section of this chapter will discuss the intern-island competition in this region.

4.4 Inter-Island Competition in the Caribbean

Companies registration is extraordinary competitive. The time it takes to create a company and the fees levied are crucial when analyzing the competitiveness. In Cayman this implies cooperation between private and public sector in regularly analyzing legal developments in other jurisdictions. The final aim is to enact new legislation in order to attract new financial innovations or products and to promote reputation of the Cayman Islands': set up tents at industry conferences, organize seminars in Miami

[159] National Association of Insurance Commissioners, *Recent Developments in the Captive Insurance Industry*, http://www.naic.org/cipr_newsletter_archive/vol2_captive.htm (July 28, 2017).

[160] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System* (Economic Geography, Vol. 71, No. 3, 1995), 245.

and New York, and publish information on the Caymans as an OFC. The main rivals competing with Cayman are Bermuda and the Bahamas. The Bahamas are known as a banking center, and in comparison to the Cayman Islands they have a higher proportion of functional operations, even though in size of foreign liabilities the Bahamas have fallen behind Cayman since 1985. The crucial source of tension in many OFCs in the Caribbean is that in many instances the same people who are in charge of supervision and regulation of OFCs are also involved in active solicitation and promotion.[161]

In the financial markets spatial advantage is defined solely through regulation. The constantly changing regulations are the key factor in understanding competition in the Carribean for offshore businesses. The existence of an elite coalition of private and public interests continues to be crucial to the competitiveness of the Cayman Islands. There are strong links between leading figures in accountancy, law, insurance, banking and the state. This allows the state to react to information from those directly involved in the financial sector regarding how the Caymans may make improvements to their position when circumstances change. A further fundamental aspect of this process is that since offshore finance is extremely mobile, any source of political instability will send it to competing jurisdictions.[162] Good governance in the Caymans as well as constant attempts of its governors to be in contact with investors give the Islands comparative advantage in offshore business. Other key factors include geography, demography and diversification of the economy. The Caymans has the advantage over its Caribbean neighbors in all these aspects: its population is relatively big, diversified and does not suffer from ethnic divisions; Grand Cayman is located in the same time zone as New York and

[161] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System*, 251–252.
[162] S. M. Roberts, *Small Place, Big Money: The Cayman Islands and the International Financial System*, 252–253.

Miami; its economy relies mostly on tourism, which makes the Caymans less vulnerable to external shock. Political and economic stability are undoubtedly fundamental to big investors and businesses.

In conclusion, this chapter focused on current trends in the Cayman Islands' economy in general and on features of the offshore industry in particular. The available evidence seems to suggest that living standards in the Caymans can be compared to those of the most developed countries in the world – in 2016 nominal GDP per capita income was estimated at US$ 47,864.[163] Such an economic prosperity coupled with political stability and strong ties with Great Britain and the United States determine the formula for success. In turn, economic prosperity is achieved via two main tools – tourism and offshore services. The development of these crucial industries fosters the development of other sectors, such as construction, real estate, utilities and communication.

Tourism still accounts for almost 70 percent of GDP. However, in 2016, total visitors to the Caymans declined marginally to total 2.1 million. This decrease was due to a reduction of 0.3 percent in cruise passengers whilst stay-over arrivals remained almost unchanged.[164] On the other hand, offshore banking is booming and the upward trend of its main industries remains in place. Cayman is now in the world top five in most segments of cross-border banking and the biggest offshore bank booking centre. The biggest number of trust companies per capita is registered in the Caymans. Cayman is the home for the greatest concentration of total hedge funds assets. Finally, the Caymans ranks second in the world as a centre for offshore insurance.

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[163] Cayman Islands Government, *the Cayman Islands` Annual Economic Report 2016* (The Economics and Statistics Office, 2017), 4.
[164] Cayman Islands Government, *the Cayman Islands` Annual Economic Report 2016*, 5.

All these achievements were due to the decision to constantly improve regulations benefiting trusts, captive insurance, offshore banking services and mutual funds. Offshore exempted companies are of less importance in the Caymans. This gives Cayman a good reason to focus solely on the most profitable industries of offshore business. Cooperation between private and public sector, represented mainly by highly educated expatriates from the Anglosphere, in analyzing legal developments in other jurisdictions gives the Cayman Islands a comparative advantage over other Caribbean OFC. On the other hand, such a strong link between private and public sectors represents quite serious limitations due to the possible conflict of interest.

Other economic limitations include insignificant FDI into manufacturing and the excessive amount of FPI, which put the Caymans under the risk of external shock. However, Cayman experience during the financial crisis of 2007–2008 proves the opposite: one could gain when everyone else loses. Everything considered, history gave the Caymans the chance and the Caymans took it. This chapter demonstrated how the local authorities and international businesses have been working together to accelerate to success. The last section of this chapter will draw conclusions.

4.5 Conclusions: the anatomy and evolution of the Cayman Islands offshore financial centre

The Caymans was taken as a point of reference in view of the fact that it represents one of the largest financial centers in the world and a central node in contemporary global finance. Therefore, it was decided to look at the anatomy of the Cayman OFC through the prism of Weber`s monocausality, ignoring the fallacy of the single cause and understanding the relationship between trends in international political economy, the processes of decolonization in the Caribbean, and a foundation of stable and liberal economic and legal regulatory regimes. To this end, a thorough understanding of history of financial globalization as well as current economic, legal and political developments was essential.

Based on the evidence discussed in these chapters, several important implications must be pointed out. Firstly, the key factor to take into consideration is that in all three financial segments – offshore banking, FDI, and FPI – the largest counterparty involved in the Caymans is the United States. Given its constitutional status as an autonomous British Overseas Territory and its strong economic ties with North America, it seems fair to suggest that it is the Anglosphere that makes the Caymans such an important place on global financial maps. Throughout the course of history, this connection played a pivotal role for the Cayman OFC – its dependence on the colonial metropoles was historically vested in seafaring rather than a plantation economy. The dominance of a maritime economy caused little pressure on land following the 1834 abolition of slavery. Moreover, a relatively small population of African slaves prevented racial tensions during and after decolonization. Almost equal economic conditions of resident whites and former slaves came into play in local politics, outdistancing the Caymans from its numerous competitors in the Caribbean in many spheres.

Later came broad powers of autonomy, integration into economic globalization, and assistance in creating business friendly constitutional structure. English common law, English language, expatriate lawyers and managers, the stable political environment of a British overseas territory, booming U.S. economy after WWII, internationalization of big American firms are all important features of the Anglosphere. Even the measures against offshorization of finance, such as British exchange controls, American Regulation Q and the Interest Equalization Tax, benefited Grand

Cayman in the end. It is therefore argued that the Anglosphere factor is decisive. No other financial industry represents it better than hedge funds, which are predominantly American, British and Canadian. Therefore, Grand Cayman is a core element of the global Anglo-American hedge fund industry, not to say the financial order. Furthermore, the Caymans enables indirect access to the crucial US financial markets that may be particularly suited for investors from China, given that Beijing has restrictions on foreign investment in industries such as IT, e-commerce and education.

Secondly, a closer look at the financial data and legislation indicates that the Caymans functions as a conduit for large international financial institutions, allowing them to reduce taxes and evade regulation. This goes in contrast with many other tax havens and OFCs, specializing in attracting illicit financial flows. Understanding how constitutional structure shaped the history of OFC offers a response to critics' preoccupation with preconceived and constructed images. This paper elaborates on Cayman constitutional evolution and shows how it became possible to exploit niches in world markets without violating international law. Constantly improving legislature and the inter-island competition had some profound impact in 2003 when the Cayman Islands was assessed by IMF and received favorable feedback confirming compliance with international regulatory standards. The OECD's reports on harmful tax practices, the Group of 7 (G7) Financial Action Task Force on Money Laundering (FATF), the UN Global Program on Money Laundering and other regulators also did not list the Caymans among violators. On the other hand, current research has provided ample support for the assertion that the Caymans is hardly airtight in terms of transparency. This view is based on some valid facts, including the massive issuance of collateralized debt obligations from 2004 to 2007 and significant disparity between reported assets and derived liabilities of hedge funds. It is thus concluded that although the Cayman global competitive advantage did not originate in corrupt practices, more and more policy implications must arise. In the first place, local authorities should not exclude the hedge fund sector when reporting to regulators.

Finally, contemporary capitalism is characterized by the ongoing development of an enormous and unprecedentedly complex international financial system. New geographies, known as tax havens and OFCs, compete with each other to become distinct spaces within a changing global political economy. The concentration of tax havens is particularly high in the Caribbean region. It is argued that the Caymans, already the leading regional OFC, will not face strong competition from its neighbors in the short run. The only feasible competitors are BVI and Bermuda – both representing British Overseas Territories. Historical reasons, which demonstrate the unique evolutionary path of the Caymans, have been already discussed in detail. They are best summarized by referring to the Anglosphere approach. Britain`s interest in the region focused on finding means for fiscal self-sufficiency of its small colonies and islands. Since the Caymanians decided to preserve constitutional ties with the UK, local authorities have taken advantage of their 'Britishness'. Interests of both sides overlapped.

In contrast, France made its overseas territories integral parts of the French state, leaving no room for those jurisdictions to become tax havens or OFCs. Hence, French West Indies did not make it to offshore maps. The economy of the Netherlands Antilles is as diversified and as developed as the economy of the Caymans. However, these islands lack English common law and similar financial traditions, although offshore finance is the mainstay of this small economy. Moreover, geographic position is less beneficial compared to Grand Cayman. The U.S. Virgin Islands did not evolve into a tax haven. Many other nations, such as the Bahamas, Jamaica etc., gained independence and experienced political instability. The

Bahamas, once the main offshore rival of the Caymans, is the best example of how political turmoil may give a fright to business. The British West Indies, namely Anguilla, Bermuda, Turks and Caicos Islands and Montserrat, all had similar historical chances. However, other than historical factors appeared determinative. Demography, geography and economics came into play. Although Anguilla is a famous tax haven, its size as well as its population is too small to grow bigger. In contrast to the Caymans, Anguilla suffered a setback in 2008. This was due to different offshore specialization and diseconomy of scale. Montserrat did not establish itself as a tax haven. Since the devastations of Hurricane Hugo and the eruption of the Soufriere Hills volcano, its economy has been effectively halted and is now heavily subsidized by the British government.

Bermuda is a well-established OFC, but it is located relatively far away from the United States. Turks and Caicos Islands as well as BVI could compete with the Caymans, given demography, size and experience in offshore services. However, the unfortunate case of the Turk and Caicos Islands' Chief Minister's arrest in 1985 destroyed the reputation of this OFC for many years to come.[165] Moreover, Grand Cayman has a growing number of offices that might eventually become operational branches with a real presence. It employs a smaller proportion of the local labor force, ranging between 3 percent and 10 percent of the economically active, and contributing approximately 24 percent of GDP. Hence, the Caymans used historical chance, became one of the largest OFC in the world, and then diversified the economy and stopped relying solely on its financial industry. The absence of rent is therefore the key to success. The crowding-out effects of international financial capital do not affect the Caymans to the extent that they affect other OFCs. The Cayman Island is probably one of the few

[165] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., 1996), 110.

examples of territories that proceeded with successful diversification away from tax haven activities. Precisely for this reason the Caymans has become a trusting place where major businesses are willing to place trust. The last chapter of this paper will elaborate on the role of the Cayman OFC in international political economy and by that will answer the second research question of this paper.

Chapter 5: International Political Economy of Offshore Financial Centres

5.1 Do Offshore Financial Centres Divert Economic Activity?

Before elaborating on the political economy of OFCs, it is worthwhile to answer the question: do OFCs actually divert economic activity? Both arguments for and against the posed question will be considered. The degraded quality of information, economic crimes associated with OFCs, the unrealized investments in high-taxed jurisdictions, increased tax competition and waste of resources to defend revenue base collaborate the notion of 'parasitical' islands. The opposite arguments are the following: increased investments of multinationals in high-taxed countries, reduced tax competition, the efficient use of tax systems, competition and discipline to financial markets, the availability of credit, and reduced power of local financial intermediaries.

Firstly, most critics start with the affirmation that OFCs may lead to a wasteful expenditure of resources, both by firms and by governments in their attempts to enforce firms` tax codes. Additionally, OFCs worsen tax competition problems by inducing jurisdictions and countries to reduce their tax rates further below levels that otherwise would have been in place.[166] There is widespread concern that low tax jurisdictions impose a fiscal externality on other jurisdictions and may attract investment that would otherwise locate in high tax countries.[167] Moreover, the use of chains of offshore subsidiaries severely degrades the quality of information available

[166] J. Slemrod, J. D. Wilson, *Tax competition with parasitic tax havens* (Journal of Public Economics 93, 2009), 1262.
[167] M. A. Desai, C. F. Foley, J. R. Hines Jr., *ECONOMIC EFFECTS OF REGIONAL TAX HAVENS* (NATIONAL BUREAU OF ECONOMIC RESEARCH, Working Paper 10806, 2004), 1.

to the market.[168] Finally, the misuse of this information leads to semi-legal or illegal practices, such as tax avoidance, capital flight, tax evasion, money laundering, and hiding corrupt monies. The banking secrecy that some OFCs could be used to facilitate criminal activities in other jurisdictions, including terrorist and drug-related activities that virtually all countries want to fight.[169]

To start with the opposite arguments, it is necessary to consider some contradictory claims from both sides, such as investments and tax competition. While some academics assume that a fiscal externality will necessarily be imposed and many investments will not be realized, the others state the opposite. The theory and some empirical facts will help understand those claims. Jurisdictions increase the return to investing in high-tax countries, if low-tax areas facilitate deferral of home-country taxation of income earned elsewhere, or if affiliates in low-tax areas offer valuable intermediate goods and services to affiliates in high-tax jurisdictions. Many multinationals that face reduced costs of establishing offshore operations respond in part by expanding their foreign activities in nearby high-tax jurisdictions. Therefore, it turns out that the use of tax haven affiliates allows investors to avoid some of the tax burdens imposed by regulators, thereby maintaining FDI at levels exceeding those that would be in place if tax havens imposed more costs.[170]

The use of tax havens by multinationals may help explain this empirical pattern, since high-tax jurisdictions are able to maintain high-tax rates while continuing to draw significant levels of foreign investment.[171]

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[168] J. Sharman, *Offshore and the new international political economy* (the Journal of Contemporary Asia, Volume 17, Issue 1. 2010), 11.
[169] J. R. Hines Jr., *International Financial Centers and the World Economy* (Step Report 2009), 6.
[170] M. A. Desai, C.F. Foley, J.R. Hines Jr., Do tax havens divert economic activity? (Economics Letters 90, 2006).
[171] M. A. Desai, C.F. Foley, J.R. Hines Jr., *Do tax havens divert economic activity?*

Empirically speaking, foreign offshore activity and nearby investment in higher-tax jurisdictions turn out to be complementary: a 1 percent greater likelihood of establishing an offshore affiliate is associated with 1 percent greater investment and sales in nearby onshore countries.[172] Some empirical support for the this argument is offered by Desai et al., who argue that the scale of U.S. multinationals in high-taxed jurisdictions drives the establishment of affiliates in low-taxed jurisdictions.[173]

From this follows the counterargument to the assertion that OFCs promote tax competition. It might be deduced that the tax avoidance opportunities presented by OFCs enable other jurisdictions to maintain high capital tax rates without suffering severe reductions in FDI. Thus, the use of OFCs may retard what would otherwise be an aggressive competition between other countries to reduce taxes in order to attract investments. The empirical evidence indicates that despite incentives in place to compete over tax rates, the tax burden on corporate income in OECD countries has fallen little over the past 25 years.[174] Consequently, there is good reason to believe that OFCs allow large jurisdictions to implement the domestic tax policies they need in the face of international economic pressures.[175] However, even if the empirical evidence is biased due to methodological difficulties, it might be argued that by distinguishing between highly mobile international investments that are very responsive to tax rate differences, and less mobile, more commonly domestic, investments that large countries are able to tax at high rates, regulators learn how to use domestic tax system in the most

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[172] J. R. Hines, *Do Tax Havens Flourish?* (Tax Policy and the Economy, Vol. 19, 2005).
[173] M. A. Desai, C.F. Foley, J.R. Hines Jr., *Do tax havens divert economic activity?*
[174] M. A. Desai, C.F. Foley, J.R. Hines Jr., *Do tax havens divert economic activity?*
[175] J. R. Hines Jr., *International Financial Centers and the World Economy* (Step Report 2009), 13.

efficient way.[176] On the other hand, non-OECD countries with low level of investments may indeed feel pressure from OFCs and react by cutting taxes.

The availability of credit is another key argument. Banks in countries with nearby OFCs have lower interest rate spreads than do other countries. Moreover, OFCs and tax havens contribute to the discipline of financial markets worldwide by limiting the degree to which banks and other financial institutions can exploit local monopolies to the disadvantage of individuals and businesses. Undemocratic states with governmental ownership of the banking sector and cronyism in the allocation of credit contribute to the lack of competition and hence inability of obtaining credit at any feasible price. According to empirical estimates by Rose and Spiegel,[177] commercial banks in countries with nearby OFCs have lower interest rate spreads than other countries. This and the larger total number of commercial banks in countries close to OFCs reflect the difficulty of monopolizing a domestic banking sector when investors have alternatives in nearby jurisdictions. According Rose and Spiegel, the private financial markets of economies with nearby OFCs extend more credit to their private sectors, have greater aggregate quasi-liquid liabilities, and higher levels of M2 (a monetary aggregate that is partly the product of intermediation by the banking sector).[178] It is thus evident that international finance facilitates domestic finance and OFCs play a key role in this process.[179]

To conclude, it must be mentioned that OFC and tax haven affiliates serve to facilitate the relocation of taxable income from high-tax areas and to facilitate deferral of repatriation taxes, implying that multinational

[176] J. R. Hines Jr., *International Financial Centers and the World Economy*, 4

[177] A. Rose, M. Spiegel, *Offshore financial centres: Parasites or symbionts?* (Economic Journal, 2007), 117.

[178] J. R. Hines Jr., *International Financial Centers and the World Economy* (Step Report 2009), 26.

parents with differing foreign tax rate exposures can benefit from such activities. By that OFCs do not necessarily divert economic activity. The economic crimes associated with offshore activity depends from the local legislature and reports to international authorities. The case of the Cayman OFC clearly demonstrated how this could not be the case. In general, OFCs contribute to financial development in neighboring countries, encourage non-haven investment, employment, and other aspects of business development, have salutary effects on tax competition, promote good governance, and enhance economic growth elsewhere. However, all these arguments are first and foremost arguments benefiting the supply side. To see the whole picture, it is necessary to explore the political economy behind OFC. The next part of this chapter will elaborate on that.

5.2 The Political Economy of Offshore Financial Centres

Aspects associated with late twentieth century globalization – rising income inequality, the financialization of the world economy, growing rents from exports of oil and other natural resources, and the large international drug economy – have reshaped the political economies of many countries.[180] The rise of OFCs and tax havens is attributed to this change. The political economy of small islands, where all major OFCs are located, feeds the element of secrecy that is a prerequisite for offshore activity, and any move to prize open that secrecy space, for instance, through the introduction of information exchange agreements, is likely to reduce the benefits of holding assets offshore.[181] This part will attempt to open it by analyzing what leading academics addressing the issue of OFCs have already found out. In this context, it is worthwhile to consider the following characteristics

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[180] M. Hampton, *Creating Spaces. The Political Economy of Island Offshore Finance Centres: The Case of Jersey* (Geographische Zeitschrift, 84. Jahrg., H. 2, 1996).
[181] M. Hampton, J. Christensen, *Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance* (World Development Vol. 30, No. 9, 2002), 1664.

associated with the political economy of OFCs: the regulatory construction of places and the relational nature of competing places,[182] the pursuit of a calculated ambiguity, and transnational network of regulations.[183]

Firstly, OFCs operate by establishing business-friendly regulatory environments of international finance. Two sets of legislation provide the fundamental regulatory building blocks for the construction of OFCs. These regulatory building blocks are the tax and secrecy laws of each country. There are no direct taxes in most of OFCs and the confidentiality of their financial systems is supported by strict secrecy laws and state sovereignty of jurisdictions hosting them. Moreover, the identity and position of each OFC is affected by how it relates to other OFCs. The competing OFCs have different characteristics and try to construct themselves as more attractive to business than their rivals. Under such circumstances, OFCs rarely cooperate with each other in the construction of their regulatory environments, for fear of losing their competitive edge. In other words, there are limits to the ways in which the OFCs compete.[184] That is why different OFCs have different comparative advantages. From this follows that there is no universal narrative for all existing OFCs and it is unfair to make generalized statements in regard to illegality of all of them. The case of the Cayman OFC favors this notion.

Secondly, the pursuit of a calculated ambiguity refers to the ability to give completely opposite but legally accurate responses when replying to the same question from different audiences. Thereby, individuals and

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182 A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 298.

183 J. Sharman, *Offshore and the new international political economy* (the Journal of Contemporary Asia, Volume 17, Issue 1,2010), 2–3.

184 A. Hudson, *Offshoreness, globalization and sovereignty: a postmodern geo-political economy?* (Transactions of the Institute of British Geographers, Vol. 25, No. 3, 2000), 271.

companies can simultaneously take on the benefits of ownership while divesting themselves of the liabilities, borrow without taking on debt, report high profits and none at all, and present domestic capital as foreign investment. Specialized offshore service provider firms have sometimes privatized a key governmental prerogative in drafting their own banking. For instance, Asset Protection Trusts provide ownership and non-ownership; offshore shell companies report both high and low profits; Special Purpose Entities are used so multinationals can borrow without taking on debt; and FDI can actually be domestic money exported and re-imported through OFCs.[185]

To give an example of a calculated ambiguity, one case must be pointed out. In 2004, the peer-to-peer music file-sharing network Kazaa was sued by record industry bodies in Australia and the U.S. However, Kazaa had set up corporate defenses. The firm re-combined and split ownership, control, assets and revenue in intersecting chains of companies. Some companies were subsidiaries, others acted as corporate directors. The strands came together as Sharman Networks with a trust based in one famous OFC in the Pacific – Vanuatu.[186] Kazaa had established a corporate structure whereby for the purposes of being sued the ultimate beneficiary of the trust was the International Committee of the Red Cross. However, for the purposes of exercising practical control and collecting profits the beneficiaries were Kazaa executives. The authorities of Vanuatu OFC levy no income taxes, have no tax treaties, and impose prison terms on any party disclosing financial information (in sharp contrast to the authorities of the Cayman OFC). Not being a member of the World Trade Organization (WTO) or the Agreement on Trade-Related Aspects of Intellectual Property

[185] J. Sharman, *Offshore and the new international political economy* (the Journal of Contemporary Asia, Volume 17, Issue 1,2010), 3.
[186] T. Woody, *The Race to Kill Kazaa*, https://www.wired.com/2003/02/kazaa/ (June 25, 2017).

Rights (TRIPS), this microstate does not have any modern intellectual property rights law. Although the court case succeeded in taking down Kazaa's web page, the question of ownership was never resolved. As a consequence, control of the advertising revenue that had been generated remains a mystery.[187]

FDI calculation is another tricky feature in developing countries, especially in China. Beijing is often pointed to as an example of economic development on the basis of its ability to attract FDI. Even considering its vast population and size, this country annually receives a disproportionate share of FDI. It is fair to assume that China's success in this domain has been overemphasized. Consequently, there is a good reason to think that local money sent out of mainland China and then returned via offshore shell companies The top investment sources for Beijing in the first five months of 2007 (jointly providing 86 percent of total FDI) are: Hong Kong, BVI, Japan, South Korea, Singapore, the U.S., the Caymans, Samoa, Taiwan and Mauritius.[188] The investment becomes legally foreign, and thus qualifies for special regulatory and tax concessions. In the end many developing countries receive so called round-tripped FDI. According to Vlcek,[189] China is the second-largest foreign investor into the Caymans, investing ten times more there than in the U.S.

Finally, the third feature to describe the political economy of OFC is the response to offshore from transnational network of regulators which are generally based and represented by the most developed economies. Central banks, private financial institutions, regulatory agencies, credit rating

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[187] J. Sharman, *Offshore and the new international political economy*, 5–6.
[188] Embassy of the People`s Republic of China in the United States of America, F*DI in China grows 12% in first half of 2007*, http://www.china-embassy.org/eng/gyzg/t340052.htm (October 27, 2017).
[189] W. Vlcek, *From Road Town (BVI) to Shanghai: FDI, IBCs and Global Capital Flows* (paper presented at the Ocean Conference on International Studies in Brisbane, Australia, 2008).

agencies, heads of state, international organizations such as the Basel Committee on Banking Supervision, the Group of 20 (G20), the Group of 7 (G7), the IMF, FATF, the Financial Services Authority (FSA), the BIS, international non-governmental organizations such as the International Organization of Securities Commissions (IOSCO), and others represent these transnational actors.[190] Don Marshall calls this network the New International Financial Architecture (NIFA).[191] The cornerstone of a good reputation for an OFC lies with the regulatory regime developed through regular interaction and dialogue between politicians, civil servants and service providers.[192] On the other hand, directives, norms, best practice guides and ethics flow through NIFA and guide many misguided OFCs and tax havens. There is a widespread concern that transnational network of regulators is slowly becoming more and more powerful. The same can be said about major OFC.

The key initiatives of transnational network of regulators include: the Financial Action Task Force on money laundering, the International Organization of Security Commissions and the International Association of Insurance Supervisors on the exchange of financial information, the Basel Committee committed to ban offshore shell banks, the OECD with its efforts to combat tax competition, the Financial Stability Forum through its Offshore Working Group etc. Most of these bodies have regional equivalents, such as the Asia-Pacific Group on Money Laundering, the Offshore Group of Banking Supervisors, and others.[193] Cooperation with

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190 S. C. Cobb, *Globalization in a Small Island Context: Creating and Marketing Competitive Advantage for Offshore Financial Services* (Geografiska Annaler. Series B, Human Geography, Vol. 83, No. 4, 2001), 161–174.

191 D. Marshall, *The New International Financial Architecture and Caribbean OFCs: Confronting Financial Stability Discourse Author* (Third World Quarterly, Vol. 28, No. 5, 2007), 917–938

192 S. C. Cobb, *Globalization in a Small Island Context: Creating and Marketing Competitive Advantage for Offshore Financial Services*, 161–174.

193 J. Sharman, *Offshore and the new international political economy* (the Journal of Contemporary Asia, Volume 17, Issue 1,2010), 10.

transnational network of regulators might bring both reputational benefits and costs. The case of the Cayman Islands clearly demonstrates the beneficial part. The case of Internal Revenue Service (IRS) vs. the Union Bank of Switzerland (UBS) shows the opposite.

In 2006, the U.S. Senate's Permanent Subcommittee on Investigations (PSI) released a report in cooperation with a Senate hearing that introduced statistics concerning wealthy American individuals' appreciation of offshore banking. The PSI report culminated in the subcommittee's investigation into tax haven abuses revealed that many rich Americans regularly use offshore banking for the purposes of tax evasion. Moreover, it assumed that law enforcement would be unable to control the growing misconduct. Switzerland has historically been regarded as a favorite place for U.S. citizens to have secret accounts. Even though there is an existing tax information exchange agreement between America and Switzerland, a judicial battle has evolved over the U.S. new efforts to attack Swiss accounts and obtain account-holder information from UBS.[194] Every U.S. citizen who has one or more foreign bank account(s) that at any point during the year reaches an aggregate balance of over US$ 10,000 is required to submit a report to the US Department of Treasury listing all foreign accounts. U.S. investors in offshore hedge funds and private equity funds are also obligated to submit a report of Foreign Bank and Financial Accounts. The failure to submit this report or to disclose foreign accounts may lead to civil and criminal penalties. The IRS found the unreported accounts at UBS and requested Switzerland to share this information.[195] Thereby, the IRS obtained information located abroad from banks to prove that this case fell within settled U.S. law.

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[195] B. Cantley, *The UBS Case: the U.S. Attack on Swiss Banking Sovereignty* (7 BYU Int'l L. & Mgmt. R. 1, 2011), 1-8.

On July 18, 2008, a federal district court in Florida permitted the IRS to ask UBS the names of 20,000 U.S. citizens who were UBS customers that failed to meet reporting or withholding obligations.[196] The legal battle has begun. On August 12, 2009, the United States and UBS announced that they had settled the litigation, ending their year-long war. Eventually, UBS agreed to produce account information regarding roughly 4,450 accounts to the Swiss Federal Tax Administration on a regular basis. In the meantime, the Swiss courts have ruled against the executive branch deal with the U.S. On January 21, 2010, Switzerland's Federal Administrative Court made the decision to prevent disclosure. More recently, the court ruled in favor of two UBS customers who did not agree that to their information will be handed over to the IRS.[197] The IRS had a very important target in bringing the UBS case: deterring U.S. citizens from opening unreported foreign bank accounts and deterring foreign banks from tolerating this practice and assisting taxpayers in doing so. This legal collision demonstrates how transnational regulators can intervene, undermine country`s sovereignty and achieve their goals even though the local judiciary opposes them. With the new focus of the IRS on international enforcement, the hedge funds located in the Caymans seem like a logical place for the IRS to continue with its practices. The last part of this paper will bring all collected arguments together in order to make conclusions regarding the role of the Cayman Islands OFC in the global political economy.

[196] B. Cantley, *The UBS Case: the U.S. Attack on Swiss Banking Sovereignty*, 18.
[197] C. Horton, *The UBS/IRS Settlement Agreement and Cayman Island Hedge Funds* (The University of Miami Inter-American Law Review, Vol. 41, No. 3, 2010), 379.

5.3 Conclusions: International Political Economy and the Cayman Islands Offshore Financial Centre

Analyzing the role of OFCs in the global political economy, it must be pointed out that the development of offshore finance is explicitly intertwined with processes of financial globalization. Both processes of financial globalization and offshore centres produce paradoxes. Elaborating on the first group of paradoxes, it is worthwhile to consider Hudson`s paradox of absolute globalization.[198] Financial globalization is associated with the practice of unbundling sovereignty, the distinction of sovereignty into sovereignty over physical space and sovereignty over access to the space of flows. Many authors subscribe to the similar notion. The chief economist of the American Express Bank Richard O'Brien argues that financial globalization has led to the end of geography in terms of the dynamics of banking and finance.[199] John Agnew and Stuart Corbridge maintain that that the globalization of international political economy, i.e. the internationalization of production and finance, the new international division of labor etc., is a product of a new form of hegemony – transnational liberalism. The authors refer to this new hegemon as to an example of the phenomenon that puts space-centrism within the discourses of international relations into question.[200]

Contrary to the stated claims, Alan Hudson asserts the perception of absolute globalization is erroneous due to the inherent paradox of this notion. The paradox of absolute globalization resides in the fact that the practice of unbundling sovereignty gave rise to a transnational network of

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[198] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 30.
[199] R. O'Brien, *Global Financial Integration: The End of Geography* (Council on Foreign Relations, Chatham House Papers, 1992).
[200] J. Agnew, S. Corbridge, *Mastering space. Hegemony, territory and international political economy* (London: Routledge, 1995).

regulators. These regulators attempt to limit the power of transnational liberalism in order to undermine the end of geography thesis. According to Hudson, OFCs help resolve the paradox of absolute globalization by providing an access point into stateless economic space for political and regulatory authorities.[201] On the other hand, OFCs make things even more complicated by trying to combine the principle of national self-determination and the principle of openness in the world economy. This represents paradox associated with OFCs. As has already been discussed, OFCs and firms involved in offshore business simultaneously divert economic activity and contribute to financial development in neighboring countries; give completely opposite but legally accurate responses when replying to the same question from different audiences; report and cooperate with transnational network of regulators and put a blind eye on numerous violations of international standards. In this context, it is argued that the coexistence of a state-centered international monetary system and a more decentralized flexible system in which OFCs play a key role point to the fact that global capitalism is currently based on postmodern political economy.

The Cayman Islands OFC plays a central role in postmodern political economy. On the one hand, the Caymans reports to many transnational regulators and foreign governments. On the other hand, local authorities fail to provide any information regarding the hedge fund industry which represents the largest concentration of hedge funds in the world. Therefore, the Cayman OFC attempts to both defend and surrender aspects of its sovereignty. This postmodern ambiguity does not go unnoticed. The U.S. has pushed hard on Caribbean and Central American nations. The Foreign Account Tax Compliance Act (FATCA) is the centerpiece of U.S.

[201] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 314.

efforts to curb tax evasion. FATCA collects information on accounts held by U.S. taxpayers and obligates U.S. financial institutions to withhold payments made to foreign financial institutions that do not agree to report information on U.S. account holders. Almost no one wants to be in that position. The U.S. has already signed an agreement with the Caymans, implying that the Caymans must report information about U.S. account holders to the Cayman Islands Tax Information Authority (CTIA). In turn, CTIA sends the information to the IRS. Moreover, the U.S. and the Cayman Islands signed a new Tax Information Exchange Agreement.[202] The example supports conclusions made by Alan Hudson[203] - major OFCs re-shape the regulatory landscape, reconfiguring power/space. It is thus evident that by creating loopholes in the global political economy such big OFCs as the Caymans also create a link to economic space for transnational regulators who seek to regulate the space of flows. It is simultaneously mutually beneficial and mutually disadvantageous process for both sides - a hallmark of postmodern political economy.

Elaborating on the main reasons behind this process, it is worthwhile to examine the relationship between trends in international economy and the rise of OFCs. Since the beginning of the global crisis in 2008, some of the world’s largest Central Banks, namely the US Federal Reserve (FED), the Bank of England (BOE), and the European Central Bank (ECB), have implemented quantitative easing (QE). This is an unorthodox way of pumping money into the economy in order to lower the long-term interest

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[202] R. W. Wood, *FATCA's Bleak Choices For Accounts, Income, Disclosure*, https://www.forbes.com/sites/robertwood/2013/09/24/fatcas-bleak-choices-for-accounts-income-disclosure/ (November 30, 2017).

[203] A. Hudson, *GLOBALIZATION, REGULATION AND GEOGRAPHY: THE DEVELOPMENT OF THE BAHAMAS AND THE CAYMAN ISLANDS OFFSHORE FINANCIAL CENTRES* (A dissertation submitted for the degree of Doctor of Philosophy, Sidney Sussex College, 1996), 314.

rates for combating a recession.[204] Since interest rates in developed economies had declined to near zero in the aftermath of the financial crisis, the scope for further monetary easing through lower policy rates became very limited. After some time, QE expanded the amount of money circulating in the economy, which in turn reduced long-term interest rates.

However limited the impact of QE was, it looks like the global economic recovery is for real. As of the last quarter of 2017, the developed economies are settling into a reasonable growth path, and the danger of deflation has been staved off. According to the EU executive's Autumn Economic Forecasts, the Eurozone economy will grow by 2.2 percent in 2017.[205] Bureau of Economic Analysis estimates 3.3 percent growth for the U.S. in the third quarter of 2017.[206] According to the Office for National Statistics, Britain's economy grows 0.4 percent in the same time frame.[207] In order to prevent overheating, the ECB has already announced that it would halve its bond-buying programme from 60 billion Euros to 30 billion Euros a month starting from January.[208] The BOE is yet to move to unwind its 445 billion pound QE.[209] However, whereas in the UK inflation of 2.8 percent[210] is above the BOE target, Euro area inflation of 1.5 percent does not meet the

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[204] M. Ncube, *The Impact of Quantitative Easing in the US, Japan, the UK and Europe*, https://www.afdb.org/en/blogs/afdb-championing-inclusive-growth-across-africa/post/the-impact-of-quantitative-easing-in-the-us-japan-the-uk-and-europe-12812/ (December 1, 2017).

[205] European Commission, Autumn 2017 Economic Forecast, https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/autumn-2017-economic-forecast_en#autumn-2017-economic-forecast-continued-growth-in-a-changing-policy-context (December 1, 2017).

[206] Bureau of Economic Analysis, U.S. Economy at a Glance: Perspective from the BEA Accounts, https://www.bea.gov/newsreleases/glance.htm (December 1, 2017).

[207] Office for National Statistics, *Gross Domestic Product (GDP)*, https://www.ons.gov.uk/economy/grossdomesticproductgdp (December 1, 2017).

[208] The Guardian, *ECB to halve bond buying as it plans to scale back quantitative easing*, https://www.theguardian.com/business/2017/oct/26/ecb-to-halve-bond-buying-as-it-plans-to-scale-back-quantitative-easing (December 1, 2017).

[209] Bank of England, *Quantitative easing and the Asset Purchase Facility* http://www.bankofengland.co.uk/markets/Pages/apf/default.aspx (December 1, 2017).

[210] Office for National Statistics, *Inflation and price indices*, https://www.ons.gov.uk/economy/inflationandpriceindices (December 1, 2017).

ECB 2 percent target.[211] The FED has also announced that it will throw QE into reverse and even raise interest rates.[212] Unemployment in the U.S. is only 4.1 percent. The yield curve is flattening. The difference between ten-year and two-year interest rates is at its lowest since November 2007; long-term interest rates have not risen as the FED has tightened monetary policy. An inverted curve, where long-dated bonds yield less than short-dated ones, might precede a recession. Yet inflation also remains beyond the target. Markets put the chances of a rate rise when the FED next meets, in December 2017, at more than 9 to 10.[213]

All these tendencies in the world economy force to the conclusion that although central banks did a great job in terms of economic recovery policies, inflation targets were not met. Inflation in the UK is above 2 percent due to the economic consequences of leaving the EU. The recent growth acceleration has been achieved by an increase in aggregate demand, caused by expansionary monetary and fiscal policies, as well as higher consumer and business confidence. Because stronger demand means less slack in product and labor markets, the recent growth acceleration in the developed countries would be expected to bring with it a pickup in inflation. As seen from the abovementioned empirical facts, this is not the case. Decreasing unemployment did not increase inflation, once again undermining the concept behind the Phillips curve. One possible explanation for the untypical combination of stronger growth and low inflation is that, in addition to stronger aggregate demand, leading economies have been experiencing positive supply shocks. This might

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[211] Eurostat, *Euro area annual inflation and its main components (%), 2017, November 2016 and June-November 2017*, http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Euro_area_annual_inflation_and_its_main_components(%25),_2017,_November_2016_and_June-November_2017-e.png (December 1, 2017).
[212] Financial Times, *US Federal Reserve calls historic end to quantitative easing*, https://www.ft.com/content/caf45d6a-9e28-11e7-8cd4-932067fbf946 (December 1, 2017).
[213] The Economist Espresso, *Watch for curveballs: Yellen speaks* (November 29, 2017).

happen due to several factors, such as low wage inflation, cheap goods and services from emerging economies, low oil and commodity prices etc.

Conventional economics suggests that the best monetary-policy response to such positive supply shocks depends on their persistence. If a shock is temporary, central banks should not react to it. If the shock is permanent, central banks should ease monetary conditions. The decisions of the central banks clearly demonstrate that policymakers regard supply shock as temporary. Otherwise, they would need to sustain for much longer their unconventional monetary policies, including QE and negative policy rates – an approach with which most central banks are not comfortable.[214] The only option to abandon QE and reach its target without risking too much is to receive the vast sums of already printed money. The properly organized injection of money hidden in the OFCs may accomplish this objective. Drawing on newly published macroeconomic statistics, Alstadsæter, Johannesen, and Zucman estimate that the equivalent of 10 percent of world GDP is held in tax havens and OFCs globally. This includes around 15 percent of GDP in Continental Europe and 30–40 percent of all the wealth of the 0.01 percent richest households in the UK.[215] According to the Institute on Taxation and Economic Policy, Fortune 500 corporations avoid approximately US$ 767 billion in federal income taxes by holding more than US$ 2.6 trillion offshore, mostly in the Cayman Islands.[216]

Hence, it is fair to assume that in the event of a temporary positive supply shock, successful treasure hunting might allow central banks more flexibility given current stormy times. In this context, it is argued that

[214] N. Roubini, *Why central banks are not hitting their 2% inflation target?*, https://www.theguardian.com/business/2017/sep/19/why-central-banks-are-not-hitting-their-2-inflation-target (December 1, 2017).
[215]A. Alstadsæter, N. Johannesen, and G. Zucman, *WHO OWNS THE WEALTH IN TAX HAVENS? MACRO EVIDENCE AND IMPLICATIONS FOR GLOBAL INEQUALITY* (NBER Working Paper No. 23805, 2017).
[216] Institute on Taxation and Economic Policy, *Fortune 500 Companies Hold a Record $2.6 Trillion Offshore* (Report 2017).

transnational regulators and foreign governments may use OFCs not just to regulate the space of flows for the purpose of national budget replenishment but also to reclaim fraudulent gains of tax evaders in order to achieve global macroeconomic goals. This is especially true in the days of economic recovery when the nature of supply shock remains unclear, unconventional economic policies such as QE continue unabated without clear results, and conventional measures such as interest rate rise are too risky. Moreover, the rise of blockchain as an ultra low-fee competitor might deprive commercial banks of transaction revenues. According to the Boston Consulting Group, in 2013 the banks handled a staggering US$ 410 trillion in non-cash transactions.[217] If that revenue is removed or at least significantly reduced, it may be replaced by risky loans or trading. Given this orientation, the 2008 scenario might happen again, offsetting all the efforts that have been made by central banks. Even though such a scenario is very unlikely, it is not just economic rationality that dictates certain decisions to regulators. Finance ministers representing the EU vowed to take action following the recent leak of the Paradise Papers.

On December 12, 2017 the EU has named 17 jurisdictions and put 47 on notice, including the Cayman Islands. The move was named a vital first step but the failure of the member states to agree on any sanctions for those on the blacklist provoked Pierre Moscovici, the European commissioner for economic and financial affairs, to state it was “an insufficient response”.[218] The backlist includes American Samoa, Bahrain, Barbados, Grenada, Guam, Korea, Macao, Marshall Islands, Mongolia, Namibia, Palau, Panama, Saint Lucia, Samoa, Trinidad and Tobago, Tunisia, and the United Arab Emirates. It labels the Cayman Islands as well

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[217] The Boston Consultancy Group, *Global Payments 2014. Capturing the next level of value* (Boston, 2014).

[218] The Guardian, *EU blacklist names 17 tax havens and puts Caymans and Jersey on notice*, https://www.theguardian.com/business/2017/dec/05/eu-blacklist-names-17-tax-havens-and-puts-caymans-and-jersey-on-notice (December 6, 2017).

as other British dependencies, such as Bermuda, Guernsey, Isle of Man and Jersey, tax regimes that facilitate offshore structures which attract profits without real economic activity. It is mentioned that the Cayman OFC is committed to address the concerns relating to economic substance by 2018.[219] This implies that the Cayman OFC is regarded by the EU as a partly co-operative jurisdiction. The fresh designations open a new front on tax diplomacy. The EU is no longer demanding greater transparency from OFCs; it is insisting, on pain of sanctions, that companies registered there have substance. To put it otherwise, Brussels wants OFCs to outlaw shell companies which are to be blamed for the pursuit of a calculated ambiguity discussed earlier.

Ugland House is a building located in George Town, the capital of the Cayman Islands. This relatively small building is famous for being the registered office address for around 19,000 entities, including many major investment funds, international joint ventures, capital market issuers and of course shell companies. President Barack Obama called out Ugland House specifically in a 2009 speech, asserting that "either this is the largest building in the world or the largest tax scam in the world". However, a 2008 U.S. Government Accountability Office report found no evidence of illegal activity by any of the entities registered at Ugland House, about half of which have billing addresses in the U.S.[220] Things may change with a new initiative of the EU. Moreover, as has been already discussed, the construction boom in the Caymans contributed to a growing number of offices. Since the local authorities agreed to meet European requirements by 2018, these offices might soon be occupied.

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[219] General Secretariat of the Council, *The EU list of non-cooperative jurisdictions for tax purposes. Council conclusions* (FISC 345 ECOFIN 1088, 2017), 16.

[220] J. Keating, *House of 19,000 Corporations*, http://foreignpolicy.com/2012/01/24/house-of-19000-corporations/ (Foreign Policy, 2012).

Although the political economy of the Cayman OFC does not differ much from political economies of other relatively transparent OFCs, the size of its financial sector and its political ties with Britain and economic ties with the U.S. make the Caymans a special spot for regulators. For the time being, it is only the EU that put the Caymans on grey list. Meanwhile, the Trump administration calls for slashing the corporate tax rate to 20 percent from 35 percent, treating repatriation of taxes on corporate profits kept offshore as part of the deal[221] – a reform aiming to target the Caymans as a primary beneficiary of the offshorization of American economy. Moreover, Mark Carney, the Bank of England`s governor, suggested which European regulations might be up for review once Britain leaves the block. Items that could be reconsidered include the current cap on bankers` bonuses, some insurance regulations and bank rules.[222] Although there is insufficient evidence to claim that that post-Brexit Britain would embark on a financial services race to the bottom, the UK will definitely compete with its overseas territory in the field of finance. It is thus deduced that the Cayman OFC, owing much of its success to the Anglosphere, may soon face more pressure from its main lobbyists. However, in the course of history the Caymans learned how to temporarily adopt a particular course in order to conform to the circumstances.

[221] G. Thrush, A. Rappeport, *Trump to Propose Sweeping Tax Cut for Corporations and Individuals* (New York Times, September 26, 2017).
[222] The Telegraph, *UK free to scrap excessive EU red tape after Brexit, says Carney*, http://www.telegraph.co.uk/business/2017/11/29/uk-free-scrap-excessive-eu-red-tape-brexit-says-carney/ (December 6, 2017).

Executive Summary and Conclusions

This research builds on existing knowledge in the fields of political economy of the Cayman OFC. Insights drawn from scholarly literature were supplemented with macroeconomic empirics, leading to the following conclusions. Firstly, it was argued that the key factor behind the Caymans Islands` success is represented by the Anglosphere. It was shown how political ties with Britain and economic ties with the United States shaped and continue to shape the Cayman OFC. Secondly, it was deduced that the Caymans is qualitatively different from most other OFCs, especially from many small ones, for its relative transparency. This was demonstrated by referring to constitutional evolution of this tiny group of islands and to multiple reports made by transnational regulators. On the other hand, it was concluded that the Cayman OFC can hardly be regarded as a case in point concerning transparency and good governance. The recent report by the EU, which put the Caymans on a grey list, supports this claim. Finally, it was inferred that the Cayman OFC, one of the largest in the world and the largest in the Caribbean region, will not face meaningful competition from rival OFCs, not counting the other British dependencies. These three conclusions helped answer the first research question of the thesis, explaining the anatomy and evolution of the Cayman Islands OFC.

After having discussed the unparalleled rise of the Cayman OFC in detail, this research switched to its place in the global political economy. It was argued that such big and relatively cooperative OFCs as the Cayman Islands contribute to reallocation of regulatory power, bringing the world to a new era – the era of postmodern political economy. Reallocation of authority materialized when the Cayman government agreed to share information about U.S. account holders with the IRS or promised to meet requirements of the EU by 2018. Moreover, it was deduced that the case of offshore reallocations of authority is especially evident in the event of global macroeconomic uncertainty – the current untypical combination of stronger growth and low inflation. Following this logic, it was argued that the Cayman OFC may face more pressure from its main lobbyists – the UK and the US. These conclusions helped reflect on the second research question of the thesis. Further research should analyze the role of Britain in promoting and lobbying the interests of its overseas territories, especially in terms of compliance to international standards. Additionally, a further contribution to analysis of relationship between trends in the world economy and attacks on OFCs and tax havens will be very helpful.

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