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Byways and Highways of Direct Investment: China and the Offshore World

William VLCEK

Abstract: This paper examines a lacuna in the literature on foreign direct investment (FDI) flows to China: the absence of analysis for the prominent location of small Caribbean and Pacific islands as leading sources of FDI. An indeterminate amount of domestic capital is embedded in these FDI flows, which distorts comparative studies on FDI in developing economies between China and other states. Direct investment from China has also increased in recent years and offshore financial centres (OFCs) often serve as the initial destinations. This paper excavates the rationales behind the presence of OFCs and suggests that Chinese actors will emulate the practices of developed state multinational corporations and high-net-worth individuals. The implications of these investment practices are outlined along with possible trajectories for their impact on the process of financial liberalisation in China. Consequently, it encourages increased Chinese participation in the development of global financial governance.

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Keywords: China, FDI, ODI, offshore financial centre, round-tripping, economic development

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Introduction

The presence of China, and in particular its investment capital, in the global political economy is obvious if one looks at the headlines of the financial press.[1] Good examples of China's presence are the purchase of 20 per cent in Standard Bank of South Africa by the Industrial and Commercial Bank of China for 5.6 billion USD in 2007 and the acquisition of IBM's PC division in 2005 by Lenovo (*The Economist* 2007; Liu 2007). Chinese capital initially emerged more prominently during the global financial-credit crisis as a white knight riding to the rescue of the less cautious. Sovereign wealth funds (SWFs) from China and the Middle East provided critical investment capital used to bail out a number of major European and North American financial firms from their difficulties in connection with the American subprime mortgage debacle (Wighton 2007; Sender 2008; White 2008). Terminology for these investments is important as international standards state that when "a lasting management interest (10 per cent or more of voting stock)" is acquired by a foreign investor, it is recorded as a foreign direct investment (FDI) in the national balance of payments (World Bank 2005: 304). China follows its own convention, using an investment minimum of 25 per cent in order to identify and report an investment in China as FDI (Investment Issues Analysis Branch 2007). This difference should be kept in mind as the various figures on direct investment in and out of China are considered in the following analysis.

FDI is widely identified as one measure of development, and the quantity of FDI flows are interpreted as indicative both of the market's recognition of a state's development potential (read: profit potential) and that the state's economy presents an environment amenable to business. China's active efforts to attract FDI, and in turn, the significant amount of FDI it has successfully attracted make China the leading destination for FDI outside of the Organisation for Economic Co-operation and Development (OECD). Curiously, however, the top sources for FDI to China include Hong Kong, the British Virgin Islands, the Cayman Is-

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lands, Samoa and Mauritius, all offshore financial centres (OFCs). Further, the main sources for FDI to Hong Kong also include the British Virgin Islands, China, Bermuda and the Cayman Islands. Given that the Cayman Islands, Hong Kong, the British Virgin Islands and the Bahamas are leading destinations for China's outbound direct investment, the situation seems at first glance to be decidedly incestuous. It is this complex network of financial flows and the prominent presence of the offshore world in it that motivate this particular study. Methodologically, the determination for an OFC used here follows the definition formulated by the Bank for International Settlements:

> An expression used to describe countries with banking sectors dealing primarily with non-residents and/or in foreign currency on a scale out of proportion to the size of the host economy (Monetary and Economic Department 2006: 70).

The specific focus here concerns transnational capital flows; consequently, the reader should understand that the OFC provides arbitrage opportunities beyond solely the taxation aspect explicit in the use of the term "tax haven" favoured by some commentators.

Table 1: Top Ten Foreign Direct Investment Sources to China

Jurisdiction	2006 (Billion USD)	2007 (Billion USD)	2008 (Billion USD)
Hong Kong	21.31	27.70	41.0
British Virgin Islands	11.68	16.55	16.0
Singapore	2.46	3.18	4.4
Japan	4.76	3.59	3.7
Cayman Islands	2.13	2.57	3.2
South Korea	3.99	3.68	3.1
United States	3.00	2.62	2.9
Samoa	1.62	2.17	2.6
Taiwan	2.23	1.77	1.9
Mauritius	1.11	1.33	1.5

Source: US-China Business Council 2009.

As mentioned, the list for the top ten sources of FDI to China in 2008 as compiled by the US-China Business Council contained five OFCs, with Hong Kong first, the British Virgin Islands second, the Cayman Islands

in fifth place, followed in eighth place by Samoa, with Mauritius closing out the list in tenth (US-China Business Council 2009). The presence of Mauritius on this list (see Table 1) represents yet another peculiar circumstance, because this small state was the recorded origin of between 78 and 90 per cent of all FDI to China from Africa between 2002 and 2008 (see Table 2). There is a further observation to be made concerning this table because the 2009 edition produced by the US-China Business Council differs significantly from previous editions. The OFCs have now been relegated to a footnote that reads "2009 data includes investments sourced in these countries but made through Barbados, the British Virgin Islands, the Cayman Islands, Mauritius, and Western Samoa" without further clarification (US-China Business Council 2010).

The following five sections review the situation behind this table on FDI flows to China in more detail. The following section provides a brief background to the offshore world and the role of Hong Kong as an OFC for China. Building on this foundation, the third section presents the relationship between the OFCs and China through the medium of foreign direct investment. The fourth section looks at the ongoing and impending liberalisation of the financial sector in China through this framework of China and the offshore world. The final section presents some concluding remarks.

Table 2: Foreign Direct Investment to China (Selected Jurisdictions, millions USD)

Region/ Jurisdiction	2002	2003	2004	2005
Asia	32,569.97	34,101.69	37,619.86	35,718.89
Hong Kong SAR	17,860.93	17,700.10	18,998.30	17,948.79
Macau SAR	468.38	416.60	546.39	600.46
Malaysia	367.86	251.03	385.04	361.39
Philippines	186.00	220.01	233.24	188.90
Singapore	2,337.20	2,058.40	2,008.14	2,204.32
Taiwan	3,970.64	3,377.27	3,117.49	2,151.71
Africa	564.64	617.76	775.68	1,070.86
Mauritius	483.69	520.98	602.32	907.77
Europe	4,048.91	4,271.97	4,798.30	5,643.10
Liechtenstein		2.29	47.80	2.86

Region/ Jurisdiction	2002	2003	2004	2005
Luxembourg	13.53	175.43	28.78	142.00
Malta	1.33	1.13	0.73	0.10
Switzerland	199.80	181.34	203.12	205.88
North America	6,490.32	5,161.35	4,977.59	3,729.96
Bermuda	478.42	398.20	422.77	214.00
Latin America & Caribbean	7,549.79	6,906.57	9,043.53	11,293.33
Bahamas	89.90	87.87	48.00	74.67
Barbados	16.11	24.46	31.29	97.01
Cayman Islands	1,179.54	866.04	2,042.58	1,947.54
Dominica	0.38		0.35	1.02
Jamaica		0.10	3.60	1.00
Panama	46.46	32.83	35.92	42.91
Turks and Caicos	0.80	0.57	1.27	3.50
British Virgin Islands	6,117.39	5,776.96	6,730.30	9,021.67
St Kitts - Nevis		14.00	10.57	6.23
St Vincent and the Grenadines			1.27	1.66
Oceanic and Pacific Islands (w/Aus & NZ)	1,417.22	1,731.19	1,974.37	1,998.98
Cook Islands	3.88	2.51	6.37	4.57
Nauru	1.19	2.58	7.00	0.64
Vanuatu				1.71
Samoa	879.47	985.72	1,128.85	1,351.87
Marshall Islands	6.68	11.02	15.43	45.80
World Total	**52,742.86**	**53,504.67**	**60,629.98**	**60,324.59**

Region/ Jurisdiction	2006	2007	2008
Asia	35,084.87	42,117.35	56,345.12
Hong Kong SAR	20,232.92	27,703.42	41,036.40
Macau SAR	602.90	637.00	581.61
Malaysia	393.48	397.25	246.96
Philippines	134.34	195.32	126.87
Singapore	2,260.46	3,184.57	4,435.29

Region/ Jurisdiction	2006	2007	2008
Taiwan	2,135.83	1,774.37	1,898.68
Africa	1,217.35	1,486.83	1,667.88
Mauritius	1,032.71	1,332.50	1,493.71
Europe	5,711.56	4,365.11	5,459.37
Liechtenstein	0.28	0.75	4.96
Luxembourg	94.66	82.46	132.83
Malta	0,27	1,03	
Switzerland	196.63	299.32	242.59
North America	3,686.99	3,390.27	3,957.80
Bermuda	394.81	376.84	468.98
Latin America & Caribbean	14,162.62	20,117.99	20,903.44
Bahamas	83.94	134.93	351.41
Barbados	535.48	709.58	1,255.20
Cayman Islands	2,095.46	2,570.78	3,144.97
Dominica	0.35	0.16	1.19
Jamaica	0.79		0.29
Panama	59.56	25.80	353.9
Turks and Caicos	0.52	1.14	1.30
British Virgin Islands	11,247.58	16,552.44	15,953.84
St Kitts - Nevis	10.07	15.77	13.63
St Vincent and the Grenadines	4.78	3.20	5.07
Oceanic and Pacific Islands (w/Aus & NZ)	2,260.24	2,742.90	3,169.87
Cook Islands	2.71	26.14	20.30
Nauru	0.10	3.00	4.00
Vanuatu	2.98	2.83	0.16
Samoa	1,537.54	2,169.88	2,549.75
Marshall Islands	30.57	73.91	94.56
World Total	**63,020.53**	**74,767.89**	**92,395.44**

Note: An empty field indicates less than 10,000 USD of investment.
Source: National Bureau of Statistics of China (various years).

Offshore Financial Entrepôts

The Background for Offshore Finance

The phenomenon of the offshore financial centre in the Caribbean and the Pacific dates from the early 1960s. A set of documents in the United Kingdom Public Record Office, for example, included an article published in 1966 in *The Times* (London) with the headline "Bahamas: the tax-free haven" (United Kingdom. Public Record Office 1967-1969). At that time, the creation of a financial centre was viewed as a development approach for the small island developing economy with few alternatives. A number of these centres received encouragement and to some extent support from the British colonial government. Such was the case for Vanuatu (formerly the colony of New Hebrides), which in turn attracted the attention of the Australian government because it was used as a "tax haven" by Australian residents. British Prime Minister Harold Wilson's reply to the Australian Prime Minister acknowledged that tax evasion was just as much an issue for the British government as it was for the Australian government. At the same time, the greater concern in this instance for the government in London involved the economic development of the New Hebrides. "The problem for us in the New Hebrides must also be viewed in the context of the need to promote the territory's economic development" (United Kingdom. Public Record Office 1974: Folio 68). The focus on the economic development opportunity that is offered by the establishment of an OFC has remained central to the development policies of small jurisdictions (Vlcek 2008: 24-25).

The rationale that emerged to support the establishment of an OFC as economic development is fairly basic, situating the OFC as a low-impact, high-gain strategy. It was seen as low-impact to the territory because it would not consume large quantities of local resources or compete with local businesses. At the same time, it presented the opportunity for high returns to the territory through the license fees collected from banks and other service providers in addition to the employment opportunities that require a higher skill level and a higher level of education than the alternatives, such as tourism (Vlcek 2007). The tax-minimisation features of the OFC, along with changing regulatory environments at the national and international levels, have encouraged observers since the 1970s to forecast the decline and disappearance of the offshore financial sector. One analysis from the International Monetary Fund

(IMF) suggested in 1979 that "it seems possible, indeed probable, that there is little unsatisfied demand for new offshore centres. There are even some signs of an excess supply" (McCarthy 1979: 48). Demand for offshore services in fact increased with the end of most national-level capital controls and the increased liberalisation of financial markets in the 1980s. During the 1990s several Caribbean jurisdictions introduced or revitalised their offshore financial sector in order to offset the changing dynamics of banana exports (Vlcek 2007). More recent activity to re-regulate global finance, particularly due to concerns about money laundering, terrorist financing and tax competition, led some observers to conclude that "cumulative pressures for reform will significantly reconfigure the offshore finance industry" (Hampton and Christensen 2002: 1667). The OECD project to counter "harmful tax competition" initiated in 1998 predominantly concerned the small OFCs (Organisation for Economic Co-operation and Development 1998, 2000, 2004, and 2008). And while the most recent effort at global regulation over offshore finance was initiated by the G20 in April 2009, specific action was to be undertaken through the OECD (G20 2009). It remains to be seen if this latest initiative will be any more successful than the earlier OECD project, particularly given the fact that it was dropped off the agenda of subsequent G20 gatherings.

The common portrayal of the OFC today as a tropical island "tax haven" fails to acknowledge that it provides other forms of regulatory arbitrage beyond taxation. It may be the home to mutual (hedge) funds, captive insurance and re-insurance firms, trust companies, and shipping registries, as well as an international business company (IBC) registry. It is the latter feature that serves the needs of FDI, for the IBC or corporate special purpose vehicle is the means to acquire the "lasting management interest" in a Chinese firm. Moreover, the IBC will take on the national identity (citizenship) of the jurisdiction that is home to the IBC registry. It is this feature that helps to explain the presence of the OFCs among the major sources of FDI to China, because the ultimate origin for the investment capital may remain hidden behind a veil created with the use of the IBC. This feature may be used to facilitate "round-tripping", which consists of moving domestic capital across state borders (by legal or illegal means) and placing it in a "foreign" account or with a "foreign" firm such that it may then return as foreign direct investment (Vlcek 2010). The question that arises from this situation with regards to China is: To what extent does the FDI from any OFC truly represent a

foreign investment, rather than simply representing Chinese domestic capital that has been reflagged as a foreign investment via its passage through the offshore world?

Hong Kong as Offshore Financial Centre

The reintegration of the modern Chinese economy into the global economy brought China into contact with the offshore world. It represented a return to the prominent location in the global economy held by China in previous eras and carried historic echoes for the use of an "offshore" regime in trade with China (Hobson 2004: 64, 151-152). The initial financial interface between Mainland China and world markets was Hong Kong, which possessed a mature international financial centre with the financial skills and expertise for financial intermediation needed by the Mainland economy. As of October 1978, Hong Kong was home to 851 licensed banks, 234 other deposit-accepting firms, and 104 foreign bank offices (Jao 1979: 675). In 2006 the banking sector of Hong Kong SAR consisted of 135 licensed banks, 33 deposit-accepting firms, and 86 local offices for foreign banks (Census and Statistics Department 2008: FC8). While these crude figures might suggest a decline in the size of the banking industry, the overall financial services sector (banking, insurance, investment and holding companies, credit-providing firms, and other financial services companies) continued to provide 5 per cent of Hong Kong's total employment along with "16 per cent of GDP at factor cost" (Census and Statistics Department 2008: FC2). These figures on the location of the Hong Kong financial sector in the Hong Kong economy are comparable to those from a sampling of Caribbean OFCs (Vlcek 2007; Williams, Suss, and Mendis 2005).

Recall that until 1972 Hong Kong was part of the British Sterling Area and was therefore obligated to maintain formal currency-exchange controls on the Sterling circulating in Hong Kong. The collapse of the Sterling Area in 1972 brought about the end of all currency controls in the territory (as the exchange of US dollars and other major currencies had from the outset not been subject to capital controls). The light regulatory approach towards foreign-currency exchange undertaken in Hong Kong echoed the earlier development of London as a financial centre in the 1950s (Schenk 1998).

> The crucial determinant of Hong Kong's competitive position as an international banking centre was the freedom from onerous regulation that weighed on regional and global financial centres elsewhere. Hong

> Kong's unusual position straddling the sterling area and dollar area allowed its banks to offer unrivalled services in the otherwise tightly controlled Bretton Woods international monetary system (Schenk 2002: 338).

In this fashion, the development of Hong Kong followed a pattern similar to the British jurisdictions of the Caribbean and Pacific. The ties connecting Hong Kong to the Caribbean expanded in 1982 when it was announced that Hong Kong would revert to Chinese jurisdiction in 1997. Very quickly, many Hong Kong firms relocated their corporate domicile (registration) to other jurisdictions as a defensive measure against expropriation and nationalisation. A preference for OFCs with familiar legal systems quickly developed and those included in particular Bermuda, the British Virgin Islands and the Cayman Islands. In fact, Sung Yun-Wing reported that 60 per cent of all Hong Kong-listed firms had relocated their corporate registration by mid-1993 (Sung 2005: 26). As shown by historical data collected across various editions of the *Hong Kong Annual Digest of Statistics*, the connection between Hong Kong and the Caribbean for direct investment capital flows extends back to at least 1994 in the case of the British Virgin Islands (Census and Statistics Department 1998: 316). The impact on Hong Kong's economy (in terms of the collection of company registration fees) was not long lasting. Data from the Companies Registry shows that in 2003 there were 49,674 private companies incorporated, a number that grew to 108,587 by the end of 2009 (The Government of Hong Kong SAR 2010).

The use of an IBC to create a "corporate veil" in order to facilitate forms of tax arbitrage is widely recognised, and in the case of China, FDI received preferential tax treatment until 2008. A change in national corporate income tax was implemented with the Enterprise Income Tax, imposed from 1 January 2008 (KPMG Huazhen 2007). The law contains exemptions, however, for designated industries, while preferential tax treatment by subnational tax authorities remains possible. Beyond taxation, the use of an IBC to establish a foreign corporate residence may help to reduce the risk of expropriation, aside from any other legal and political reasons motivating a move to obscure the beneficial ownership of an investment. A legal reason was that a firm created or controlled via FDI also received preferential treatment with respect to property rights before 1999 (Patibandla 2007: 363). Another reason was a need or desire to disguise the jurisdiction of origin on the part of Taiwanese investments. Initially, the preferred jurisdiction for incorporation of an IBC by

Taiwanese investors for use in the Mainland was Hong Kong, but with the imminent return of Hong Kong to the Mainland, these firms re-domiciled their corporate registration. As the politics of relations between Taiwan and the Mainland ebb and flow, the impetus to obscure the source of the investment may change; nonetheless, the routing of Taiwanese investment via an OFC has served to further cloud the true picture of FDI flows into the Mainland (Sung 2005: 29). At the same time, routing Taiwanese investments through Hong Kong has been a very profitable exercise for the Hong Kong financial and legal sectors. It is a situation that may be drawing to a close with the completion of a free trade agreement between Taiwan and the Mainland (Tsang 2010).

FDI, OFCs, and China

Rough estimates for the proportion of round-trip capital as a component of FDI flows to China range from 10 to 66 per cent. A report from the US-China Business Council in 2008 stated that Chinese government officials believed "as much as two-thirds of Chinese FDI" could be round-trip capital (US-China Business Council 2008: 2). Nonetheless, Edward Chen suggested measures instituted following the Asian financial crisis by the Chinese government were successful in reducing "unauthorized capital flows" including the round-trip activity (Chen 2006: 133). Other analyses of the post-Asian Crisis period suggest otherwise; for example, the World Bank in 2002 calculated that round-trip capital continued to account for 17 per cent of FDI to China. Its estimate was developed from an analysis of the net errors and omissions data reported in China's balance-of-payments data (World Bank 2002: 41). More recently, an International Monetary Fund working paper argued that FDI inflows via OFCs are not so much a case of round-tripping, as they are more likely to represent

> flows from sources such as Japan, Taiwan Province of China, and the United States that are channeled through such offshore financial centers in order to evade taxes in the source countries (Prasad and Wei 2005: 5).

Their conclusion represents one of the several possible explanations for FDI flows to any location from an OFC, not just to China. Yet the question remains as to why significant quantities of FDI continued to originate directly from Japan and the US rather than taking a similar route through an OFC in order to minimise taxes. As a result, the unique na-

ture of FDI flows to China and the countervailing direct investment emerging from China argue that the variety of estimates made for round-tripping within these FDI flows fails to capture the true extent of the activity in what is a very complex situation; though one wide-ranging effort is (Xiao 2004).

The bi-directional nature of direct investment identified in Tables 3, 4, and 5 demonstrates the complexity and attendant difficulty that confronts any attempt to distinguish Chinese round-trip capital from truly foreign investments. Tables 3 and 4 contain the figures on direct investment flows in and out of Hong Kong SAR, as most analysts feel that a substantial portion of Hong Kong SAR's received investment moves on to yet other locations, including Taiwan (Sung 2005; Xiao 2004). Hong Kong SAR's direct investment flows therefore should be seen as additive to the direct investment data for Mainland China in Table 2. The fact that Mainland China was the number-one source and number-two destination for direct investment from Hong Kong SAR, while the number-two source and number-one destination was the British Virgin Islands, represents one indicator for this relationship. The situation for Mainland China's direct relationship with OFCs is slightly different, with the Cayman Islands being its leading destination for direct investment in 2005 and 2006, followed by Hong Kong and the British Virgin Islands. In 2007 Hong Kong and the Cayman Islands exchanged positions (National Bureau of Statistics of China 2008: 736). As seen in Table 5, for 2008 the rankings changed yet again, putting Australia and Singapore above the Cayman Islands; however, these shifts reflect more the changes in the location of the registration for the intermediate investment vehicle (in Hong Kong SAR, the British Virgin Islands and the Caymans) than the relative merits of these jurisdictions as "destinations" for Chinese outbound direct investment (ODI). While some measure of the capital sent to Hong Kong SAR would remain there as its final investment destination, that would not be the case with the British Virgin Islands, the Cayman Islands or the Bahamas. In the case of the Caribbean destinations, there are few additional opportunities for local investment, thus it may be accepted as given that the direct investment capital in question merely transited these locations, and one potential destination would be its return to China as a foreign investment through the use of a locally registered IBC.

Table 3: Inflow and Position of Direct Investment to Hong Kong (100 millions HKD)

Jurisdiction	Inflow 2005	Position 2005	Per cent of total
Mainland China	729	12,719	31.4
British Virgin Islands	470	12,707	31.3
Netherlands	170	3,271	8.1
Bermuda	360	2,715	6.7
USA	-297	2,058	5.1
Japan	141	1,317	3.2
United Kingdom	137	885	2.2
Cayman Islands	120	667	1.6
Singapore	110	843	2.1
Taiwan	35	300	0.7
Others	303	2,533	7.2
Total	2,651	35,219	

Jurisdiction	Inflow 2006	Position 2006	Per cent of total
Mainland China	1,087	20,243	35.1
British Virgin Islands	788	19,506	33.8
Netherlands	281	3,909	6.8
Bermuda	238	3,501	6.1
USA	513	2,779	4.8
Japan	180	1,514	2.6
United Kingdom	154	1,056	1.8
Cayman Islands	184	1,013	1.8
Singapore	81	852	1.5
Taiwan	87	337	0.6
Others	-94	3,009	5.2
Total	3,500	57,719	

Jurisdiction	Inflow 2007	Position 2007	Per cent of total
Mainland China	1,042	37,374	40.7
British Virgin Islands	1,093	33,585	36.6
Netherlands	380	5,305	5.8
Bermuda	277	3,832	4.2
USA	358	2,786	3.0
Japan	143	1,647	1.8
United Kingdom	230	1,345	1.5
Cayman Islands	109	1,115	1.2
Singapore	164	1,055	1.1
Taiwan	28	399	0.4
Others	416	3,423	3.7
Total	4,239	91,865	

Note: The Hong Kong Monetary Authority has maintained a peg close to 7.80 Hong Kong dollars to the US dollar since 1983.
Source: National Bureau of Statistics of China 2009.

Table 4: Outflow and Position of Direct Investment from Hong Kong (100 millions HKD)

Jurisdiction	Outflow 2005	Position 2005	Per cent of total
British Virgin Islands	181	16,093	44.0
Mainland China	1,303	14,774	40.4
Bermuda	125	1,261	3.5
United Kingdom	49	596	1.6
Singapore	60	400	1.1
Cayman Islands	148	251	0.7
Thailand	26	230	0.6
Liberia	-11	223	0.6
USA	9	263	0.7
Malaysia	0	216	0.6
Others	291	2,077	5.7
Total	2,115	36,539	

Jurisdiction	Outflow 2006	Position 2006	Per cent of total
British Virgin Islands	780	24,676	46.9
Mainland China	1,666	21,172	40.2
Bermuda	-50	1,378	2.6
United Kingdom	-2	621	1.2
Singapore	21	331	0.6
Cayman Islands	79	411	0.8
Thailand	64	347	0.7
Liberia	25	233	0.4
USA	31	291	0.6
Malaysia	39	256	0.5
Others	268	2,438	4.6
Total	3,494	52,645	

Jurisdiction	Outflow 2007	Position 2007	Per cent of total
British Virgin Islands	1,039	37,737	47.8
Mainland China	2,839	34,237	43.4
Bermuda	162	1,330	1.7
United Kingdom	121	735	0.9
Singapore	184	569	0.7
Cayman Islands	294	501	0.6
Thailand	-2	383	0.5
Liberia	53	410	0.5
USA	41	306	0.4
Malaysia	40	347	0.4
Others	-7	2,336	3.0
Total	4,765	78,890	

Note: The Hong Kong Monetary Authority has maintained a peg close to 7.80 Hong Kong dollars to the US dollar since 1983.

Source: National Bureau of Statistics of China 2009.

Table 5: Significant Destinations for China's Direct Investment (millions USD)

Jurisdiction	Net ODI 2005	Net ODI 2006	Net ODI 2007	Net ODI 2008	ODI stock at end of 2008
Total	12,261.17	17,633.97	26,506.09	55,907.17	183,970.71
Hong Kong	3,419.70	6,930.96	13,732.35	38,640.30	115,845.28
British Virgin Islands	1,226.08	538.11	1,876.14	2,104.33	10,477.33
Australia	193.07	87.60	531.59	1,892.15	3,355.29
Singapore	20.33	132.15	397.73	1,550.95	3,334.77
Cayman Islands	5,162.75	7,832.72	2,601.59	1,524.01	20,327.45
Macau	8.34	-42.51	47.31	643.38	1,560.78
United States	231.82	198.34	195.73	462.03	2,389.90
Russia	203.33	452.11	477.61	395.23	1,838.28
Germany	128.74	76.72	238.66	183.41	845.50
Republic of Korea	588.82	27.32	56.67	96.91	850.34
Bahamas	22.95	2.72	38.99	-55.91	60
Sudan	91.13	50.79	65.40	-63.14	528.25

Source: National Bureau of Statistics of China 2009, 2008, 2007.

Officials in the government of Hong Kong SAR undertook an exercise to remove round-trip capital from the economic data it collected and reported. Their study was premised on the idea that "it would be useful to analyze the DI [direct investment] situation of Hong Kong if this type of DI is excluded from both inward and outward DI statistics" (Census and Statistics Department 2007: 35). This analysis was achieved by identifying investment received from "non-operating companies" created by Hong Kong SAR companies in an OFC and any investment capital sent to those IBCs. Naturally the result was a reduction in both inward and outbound direct investment for Hong Kong SAR, and most of the difference was attributed to the British Virgin Islands (Census and Statistics Department 2007: 39-42). The problematic aspect to the approach taken in this exercise was the singular consideration for IBCs created by a Hong Kong SAR-registered firm. While relevant to the Hong Kong SAR economy in itself, it failed to address the capital channelled through IBCs created by firms registered in other jurisdictions, represented by direct

investment from Bermuda and the Cayman Islands, for example, whose data were not substantially changed by the exercise yet may also represent investments originating in Mainland China or Taiwan. Consequently, it is likely that this official analysis did not incorporate all potential round-trip capital actually present in the Hong Kong SAR economy.

Beyond these prominently recognised OFCs in Hong Kong SAR and the Caribbean, there are a number of other OFCs in Europe, Africa, and Asia that are involved in the transfer of investment capital to China. On a global league table for offshore finance, the latter jurisdictions may not appear as significant as the Caribbean jurisdictions, yet several are quite conspicuous on the list of major sources of capital for China. For example, the data in Table 2 show that the Cook Islands, with a population of 21,750, was the source for 20.3 million USD in FDI to China for 2008. Somewhat more substantial is the Marshall Islands with 63,174 citizens and the source for 94.6 million USD in investment capital to China. Neither of these two small island economies compare with Samoa, however – with 217,083 citizens, these latter islands contributed 80.4 per cent of all FDI to China in the *China Statistical Yearbook* category for Oceanic and Pacific Islands. This category includes the significantly larger economies of Australia and New Zealand, yet Samoa provided 2,549.8 million USD out of a total 3,169.9 million USD from the region in 2008.

The preceding review of FDI flows to China indicates that there are a number of possible reasons for FDI to arrive in China from an OFC. The first reason suggested here was that it consists of domestic capital from China returning as FDI having successfully circumvented capital controls to exit China (one example is through over-/ under-invoicing practices). A second source could be that it represents the profits acquired from other investments previously made outside of China that are then reinvested as FDI in China rather than being repatriated (and taxed) as foreign profits – essentially a variant of the round-trip activity. A third alternative is that it represents investments from other locations (e.g. North America, Europe or Japan) which are using the OFC in order to minimise their corporate income tax at home; this is the reason preferred by the IMF (Prasad and Wei 2005). A fourth is that these inflows conceal corruption by serving as "a conduit through which well-connected party cadres receive huge payoffs and kickbacks from host-country bankers, underwriters, and joint-venture partners" (Yeung and Liu 2008: 79). Alternatively, one study of global migrant remittance flows suggested

that FDI originating with "overseas Chinese" may instead represent the private capital that in other developing states are remittances. Pointing out the fact that investment in real estate is a frequent use for migrant remittances, Devesh Kapur noted that a large percentage ("about a quarter") of Chinese FDI is invested in real estate. Kapur suspected that the source for this FDI consisted of remittances from emigrant citizens (Kapur 2004). Then there is the structural argument made by Yasheng Huang to explain the high levels of FDI in China, which I refer to below.

In his study, Huang pointed out that rather than major capital investments by large multinational corporations (MNCs), the situation anticipated in most of the FDI literature, individual FDI projects in China were once small, particularly when compared to similar projects in other Asian economies. This point supported his overall argument that FDI in China was structurally different from that expected for FDI in a developing economy (Huang 2003: 32-35). Huang's argument involved the institutional structures for economic development and finance in China, the nature of which reflected the political structure and its approach to economic planning and development – in other words, the preferential treatment that privileged foreign investment capital over existing domestic investment capital. Huang's argument points towards more recent analysis that makes the case that these FDI flows represent capital investment raised in foreign markets by the Chinese firms. Dylan Sutherland, Ahmad El-Gohari and Ben Mathews situated the use of the Caribbean OFCs as "capital augmenting". Analysing the corporate statements required from firms listed on US stock exchanges, they found that Chinese firms used ODI in an IBC to raise additional capital to support corporate expansion (Sutherland, El-Gohari, and Mathews 2009). In a further paper, Sutherland considered Chinese private firms listed on the Hong Kong Stock Exchange in addition to a sample of firms listed on US stock exchanges, highlighting the use of a Caribbean IBC by Chinese private firms to "internationalise" operations and to establish a global production network (Sutherland 2009).

The presence of round-trip capital in FDI flows in and out of China continues to distort the complete picture of business investment, both by foreign firms in China and by Chinese firms in the global economy. Certainly, if some Chinese government officials believe that as much as two-thirds of all FDI is in actuality domestic capital disguised as foreign capital, that belief will influence government policy and action (US-China

Business Council 2008: 2). Regulatory changes at the national level to address some of the reasons behind round-tripping could reduce the level of activity, but may not eliminate the motivations completely. Arguably, the Enterprise Income Tax was motivated in part by this perception, in addition to an assessment that the Chinese economy is sufficiently mature that across-the-board preferential tax treatment of foreign investment is no longer required. The difficulty behind efforts to determine the true measure of round-trip capital rests in the desire of the owners to keep their practices clandestine, and only a few policy changes are not likely to address all aspects for that desire. And the reduction in round-trip activity will not necessarily bring an end to the use of OFCs to channel FDI in and out of China. The motivations for the use of an IBC by a multinational corporation from a developed state economy to invest in China are equally relevant to a Chinese firm investing abroad – including tax-planning, risk mitigation, and regulatory arbitrage. Furthermore, the Chinese firm may utilise an IBC to intermediate with domestic institutional constraints as well as to protect against prejudices held toward Chinese investment in foreign states (Sutherland 2009: 14).

Financial Liberalisation and Future Vectors to the Offshore

Attempts to stem the flow of illicit capital out of China are but one part of the challenge facing the process to liberalise its financial sector. This sector is one of several that China agreed to liberalise (opening itself up to foreign investment) as part of joining the World Trade Organization (WTO), but it is expected to take longer than was scheduled at the time of China's accession. One reason is the desire to maintain control over the banking sector and another is the level of bureaucratic resistance to liberalisation that exists across the many levels of China's regulatory agencies (Mertha and Zeng 2005). The desire to maintain control over the banking sector then combines with worries over pent-up domestic demand for opportunities to invest beyond a simple savings account in a state bank. In 2004, for example, the informal banking sector's interest rate for loans stood at 15.4 per cent, well over the official rate of 2.25 per cent, and it made money-lending an attractive investment opportunity because the difficulties faced by small and medium enterprises to secure a loan from a state bank encouraged them to seek other sources of capital (Bradsher 2004). The problem confronting the Chinese government is

the fact that a large and vibrant informal banking sector developed in reaction to strict government control of the financial sector (Tsai 2006, 2002). Furthermore, domestic stock exchanges experienced ever-rising share prices that generated a fear among government agencies that "irrational exuberance" had consumed the domestic investor and another stock market bubble burst was imminent. Initially, the government reacted by relaxing regulations, limiting retail investment to these domestic markets (*China Daily* 2006). Following a proposal to permit retail investment by Mainland citizens on the Hong Kong Stock Exchange, the Central Bank announced its intentions to permit citizens to invest directly on the stock exchanges of London, Tokyo and Singapore. This latter proposal, however, remained subject to bureaucratic resistance; the *Financial Times* reported that previous plans to permit direct share purchases via Hong Kong were "quickly suspended after fierce opposition from other government departments, including the banking and securities regulators" (Anderlini 2008: 42). The anxiety over this latest move to open legitimate foreign investment opportunities to ordinary citizens is that it could bring about a rapid deflation in current domestic share prices as capital shifts out of domestic markets and into foreign markets. Events subsequent to the Central Bank's public announcement bore out the validity for this concern, as Chinese stocks declined by 4 per cent on 18 April 2008. That precipitous decline underscored the reduction in the domestic stock market's valuation by close to 50 per cent over the preceding six months, following a peak in the fall of 2007. In monetary terms, the impact from this six-month period was a loss that equated to approximately 2.5 trillion USD, affecting millions of individual small investors that had been caught up in the frenzy of ever-rising share prices over the previous couple of years (Areddy and Karmin 2008: A1).

The Chinese historical experience has led to different financial market practices from those in other states, and the extensive informal financial sector represents only one aspect of difference. Another difference is individual retail investor logic – practices followed by mutual fund investors in the mature stock markets of Europe and North America are not an appropriate model. Market research by McKinsey & Company described retail investors in China as possessing "only a rudimentary understanding of the [mutual fund] industry" (Binder, Ngai, and Wang 2007: 6). Chinese market participants believed that high mutual fund share values represented an "expensive" fund and consequently sold their shares when a fund had appreciated in value to the point that it

was perceived as expensive. In response to this local investment strategy, the high-performing funds in the Chinese market began to make large dividend distributions in order to keep mutual fund share prices down and thereby retain existing investors. Due to the potential capacity for retail investment in the domestic Chinese stock market, it remains very attractive to foreign financial firms, even though the present pace of liberalisation continues to restrain their market penetration. For example, an article in the *International Herald Tribune* in 2006 indicated that European banks were establishing private banking operations in China to service more than 320,000 millionaires (in US dollars), while *Forbes* magazine's list of "The World's Billionaires" included 42 Chinese citizens in 2008, a number that grew to 64 in 2010 (Jun 2006; *Forbes* 2008; Kroll and Miller 2010). One intermediate business strategy employed by foreign banks is to establish substantial operations in Asia in close proximity to the potential customer base in China – Singapore is a popular location (Li 2008; Brown 2010).

The difficulties the Chinese government has had in maintaining strict control over the financial sector of the economy have arisen in part due to the substantial investment potential represented by these growing numbers of increasingly wealthy individual citizens. One liberalisation plan proposed permitting investors to freely convert up to 50,000 USD annually from CNY to a foreign currency. Supposing that there were 10 million Chinese citizens with sufficient legal assets to take advantage of this proposal, as much as 500 billion USD (25 per cent of total household savings) could be shifted to foreign-denominated (and potentially foreign-domiciled) assets annually (Ma and McCauley 2007: 21). Consequently, China could find itself in a position very similar to that of the OECD states – unable to collect taxes on the foreign income of citizens if that income is located/ concealed in a foreign jurisdiction (Vlcek 2004). The significant presence of OFCs in the flow of direct investment will provide an example for their use by individuals to avoid domestic regulations and taxes and facilitate the transfer of assets to one's heir, for example, via a trust or corporate vehicle registered in an OFC (Kolesnikov-Jessop 2010). As that knowledge permeates through the ranks of the newly wealthy Chinese citizens, it holds the potential to hamper government efforts to control the national economy through taxation, interest rates and domestic investment. One example promoting this possibility is an article found in the July 2008 issue of *Benchmark* explaining the use of an OFC for retirement planning; this issue was

freely available to the users of the MTR Airport Express train station at Hong Kong Airport (Annells 2008). According to the *New York Times*, there has been an increase, for example, in "high-end real estate" purchases in London involving Mainland Chinese, from 1 per cent of all purchasers in 2009 to 5 per cent in 2010. The article further states that "many wealthy Chinese elude the restrictions [limiting overseas investments to 50,000 USD annually] with help from trust funds and foreign bank accounts, real estate brokers say" (Werdigier and Wassener 2010). Increasing the dissemination of this investment methodology, the article was reprinted in a subsequent edition of the *South China Morning Post* (*The New York Times* 2010).

In addition to the consistent annual increase in FDI attracted to China up until 2009, official flows of Chinese outbound investment have also increased in recent years. As seen in Table 5, however, it is clear that – headline investments notwithstanding – a significant quantity of Chinese direct investment is first going to an OFC before it moves on to its final destination. Yeung and Liu (2008) imply that these flows represent round-tripping, with the outbound direct investment returning to China as FDI, which would also imply official negligence in maintaining capital controls, if not official complicity, as these figures represent officially approved direct investment projects and not the clandestine capital seen by many observers as the source of round-trip FDI. The low-tax or no-tax environment of the OFCs means that "they have become quite attractive locations for many Mainland Chinese firms that register there and subsequently invest back into China" (Yeung and Liu 2008: 66). These authors also suggest that the creation of a foreign affiliate, such as an IBC, would help to counter any accusation of capital flight that might be made against these firms (Yeung and Liu 2008: 75). Fundamentally, however, the business management practice to keep a mainland firm's capital "offshore" provides it with flexibility for investment supporting the firm's growth as well as reducing interactions with "the mainland's strait-jacket regulatory regime" (Yam 2010).

All that said, Chinese ODI, whether or not it is routed through an OFC, is viewed as a security threat by some commentators. In particular, some concerns have been raised over Chinese sovereign wealth funds (SWFs); for example, the French oil firm Total SA publicly acknowledged that a "Chinese public fund" had established an investment position in the company. The Chinese fund was not named, but joined several other SWFs with investments in Total, including a Norwegian one

(Mitchell 2008). As a point of comparison, China's SWF ranked sixth in size among the major SWFs at an estimated 200 billion USD in 2008 (*The Economist* 2008: 70). Nevertheless, concern over the increased presence of Chinese ODI in natural-resource extraction remains high, as reflected in mainstream business publications as much as at US-based think tanks (Scissors 2010a, 2010b). It is important to view the size of China's ODI in the context of the size of global flows of direct investment: Compare, for example, 65 billion USD for China with 680 billion USD for Japan, 3,162 billion USD for the United States and 8,087 billion USD for the European Union (Nolan and Zhang 2010). Chinese ODI needs significant growth before it can be comparable with the ODI of these other large economies.

Conclusion

The connections between China and the offshore world are varied and deep. It must be recognised that the OFCs serve purposes beyond tax avoidance. The offshore financial centre located in the Caribbean, the Pacific or Africa provides a measure of economic development for these small jurisdictions while at the same time providing a pivotal financial intermediation service in support of China's economic development. This fact must be acknowledged by the outside observer attempting to understand the presence of small island developing economies in the league table for FDI flows to China and subsequently China's direct investment outward to other regions of the world. The critical point to take away from this analysis involving the use of OFCs to channel FDI to China is their use to support various forms of arbitrage – that is, *tax* arbitrage for investors, *risk* arbitrage for owners (especially from Taiwan and potentially from other politically sensitive locations) and *identity* arbitrage to conceal beneficial ownership. These uses are equally applicable for Chinese direct investment as Chinese firms seek to invest in politically sensitive locations in Africa (Sudan and Zimbabwe) and Asia (Vietnam, Indonesia, and Malaysia).

Another point to consider is the fact that even using the pessimistic figure that 50 per cent of China's inbound FDI in actuality consists of round-trip capital, the remaining inbound FDI still amounts to between 18,903 million USD and 31,510 million USD over the period 1995-2006. According to the database of the United Nations Conference on Trade

and Development (UNCTAD), this figure still represents 10 per cent of FDI made to all developing economies in 2006 (UNCTAD 2010).

> From a statistical point of view, trans-shipping FDI via offshore financial centers makes it difficult to estimate the real size of outward FDI from specific economies and by specific companies. In some years, flows from these centers have been particularly large (UNCTAD 2006: xxiii).

The *World Investment Report 2006* also noted the prevalence of corporate vehicles (special purpose entities) in developed economies used for the trans-shipment of investment capital. In this role, the report highlighted Luxembourg, in which "an estimated 95% of FDI inflows during 2002-2005 were trans-shipped" (UNCTAD 2006: 12). Thus, attempting to extract round-trip capital from data on FDI flows to China reduces the scale of foreign capital invested in China, but not the total impact of investment (both domestic and foreign) in China. It merely highlights the economic and financial imbalances that are created by a government preference for one form of investment over other forms of investment. In doing so, the China case suggests yet another rationale for why efforts undertaken to attract FDI as part of an economic development plan may not be in the long-term economic interests of the state and its citizens. The preference for FDI constructed by the government has distorted the development of the Chinese economy, both through the prevalence of round-tripping and the design of (multiple) individual FDI projects in order to stay within local FDI approval levels (Jiang 2004: 170).

This line of thought also suggests an alternative explanation for China's resistance with regards to the "tax-haven blacklist" prepared by the OECD at the request of the G20. Media reports in April 2009 identified a rift between China and the other members of the G20 (specifically France and Germany) because of the prospective inclusion of Hong Kong SAR and Macau SAR on that list. The rationale promoted in the press for China's resistance was because the list and any future sanctions against the listed jurisdictions were guided by an organisation that did not include Chinese representation (Fidler and Batson 2009; Robbins 2009; Mitchell 2009). Additionally, there were statements in the Hong Kong SAR media emphasising that it is not a tax haven. The alternative argument arising from the preceding analysis is that China benefits greatly from the use of an OFC in flows of direct investment. Further, if the corruption argument for round-trip capital is accepted, then significant members of the ruling cadre in China may also benefit (directly or

indirectly via family members) from the operation of these OFCs as locations permitting them to conceal the beneficial ownership of assets related to bribery and grand corruption. In sum, the relationship between China and the offshore world is more complex than suggested either by news media analysis and commentary or by most academic research on FDI flows to China.

Following the transportation metaphor of the title of this paper, among the major routes for financial flows with China are those that pass through the British Virgin Islands, the Cayman Islands, Samoa and Mauritius, in addition to those transiting via Hong Kong SAR. The quieter, lesser-known routes (in terms of smaller quantities) for investment nonetheless continue to use the services provided by an OFC, such as Vanuatu, the Cook Islands, Panama, Barbados and the Marshall Islands. Thus the network of financial relations between China and the global political economy incorporates many of the acknowledged OFCs, in a fashion quite similar to that of the major OECD economies, the US, the UK and Japan (see for example, McGuire and Tarashev 2008). This activity establishes the fact that China's economy is as firmly integrated in global finance as those economies, justifying and explaining China's increased presence in global financial governance activities, such as the Financial Action Task Force (Financial Action Task Force 2007). At the same time, these investment flows contribute indirectly (through license fees and employment) to the economic development of these small jurisdictions, in the Caribbean and Pacific as much as in Hong Kong SAR. The issue left for government regulators to contend with is the parallel use of this financial infrastructure for criminal purposes, money laundering, tax evasion, capital flight and corporate fraud as argued by G20 statements and non-governmental organisations (NGOs), such as the Tax Justice Network, Christian Aid, Action Aid, and Global Witness (House of Commons 2009). In this challenge, China's experience with MNCs and their use of OFCs as part of their international business operations is little different from the experience of many developed economies.

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