OFFSHORE IN PRACTICE: CHINA

China's Belt and Road: Offshore Involvement

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There are a number of key economic and demographic factors currently at play which are likely to increase the development of new business in Asia for offshore financial centres (OFCs) such as Bermuda, the British Virgin Islands and the Cayman Islands. In particular, the Chinese government is seeking to engineer a policy shift away from an economy fuelled by non-financial sector debt, such as corporate debt and government stimulus, towards a more sustained, quality growth derived from a consumer-driven economy. This rebalancing is also intended to mitigate the volatility of recent years.

In order to effect this planned economic shift, the Chinese government has been implementing measures to encourage investment in sectors including healthcare, insurance, education, social services, utilities and entertainment. These are the fastest growing areas of the Chinese economy, a growth which chimes with the view that China's burgeoning middle class will be a key economic driver.

Another factor will be the Belt and Road initiative, which the Chinese government intends to use to improve the infrastructure of overland and maritime routes between East and West in order to drive the flow of capital, goods and services. The Belt and Road concept reflects the ancient Silk Road, which transformed international trade and cultural exchanges along a number of intercontinental trade routes. The 'Belt' is the land route from China across Central-Asia into Europe and the 'Road' will be the maritime route out of China, encompassing South-East Asia, the Indian Sub-Continent, East Africa and the Middle-East and into the Mediterranean. The Belt and Road will give China access to over 65 countries representing more than 60 per cent of the world's population and around 30 per cent of global GDP. Not only will China gain new markets but it will also be in a position to secure key commodities, minerals and energy resources.

A core aim is to make it easier for businesses operating in and out of China to reach the middle classes along the Belt and Road. If the infrastructure development leads to urbanisation in developing countries along the routes – from that increased concentration of population in urban areas, the domestic economies will also develop. The corollary to this for China and other countries along the Belt and Road is that, as domestic demand drives activity across the region, the economic landscape will move away from debt-fuelled investments and reliance on exports.

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The major markets for China's export-led economy have been the United States and Europe. However, the development of markets along the Belt and Road will create new opportunities for China and will release over-capacity pressure should China's traditional markets not be able to continue to absorb its available exports.

Whilst the Belt and Road investments are initially expected to concentrate on building the infrastructure necessary to promote trade flows, including roads, rail, port and maritime logistics, power and communications networks, the end-game is to create opportunities for Chinese companies by generating demand for their goods and services. At both ends of that spectrum, in addition to financing provided by governmental sources such as the Asian Infrastructure Investment Bank, private sector funding from both inside and outside of China will be required. Whilst at present the Belt and Road is a China-led initiative, the size of the infrastructure projects will, by necessity, require a consortium of banks and other institutions, including international banks, to finance them.

In particular, the financing of the anticipated US$5 trillion needed over the next five years for the Belt and Road through loans and capital-raising will require the investment of a variety of financial institutions and firms. The Chinese government and the Chinese commercial banks will not be able to meet this by themselves. Some international banks have already

indicated they have been re-aligning and allocating resources specifically to address such financing needs which will arise from the Belt and Road, both in terms of increased global trade, as well a significant investment projects. Thus, those with existing global networks and cross-border expertise are likely to be in an advantageous position.

It remains to be seen whether the successful implementation of large-scale infrastructure development projects, which has already occurred in China, can be replicated along the Belt and Road. Such success has been aided in part from the support provided by public financing and the Chinese government's ability to steer resources within the economy into specific geographical areas and industry sectors. However, if government subsidies, whether through taxation or otherwise, are to be a component of the measures implemented in order to ensure profitability of the infrastructure projects, more thought will be required to determine how the costs of such subsidies will be shared across the relevant governments involved in a cross-border project and whether the subsidiaries need to recognise the country or countries which are to receive most benefits from such projects.

OFCs stand to gain from these initiatives, not only from the use of offshore holding companies but also from the need for investment funds and financing vehicles. Bermuda, the British Virgin Islands and the Cayman Islands in particular are no strangers to Asian investment and have been oiling the wheels of cross-border deals, including infrastructure projects, for several decades. OFCs are proven connectors in China joint-ventures arrangements and have provided a global link for Chinese enterprises seeking to transact business in international markets. Cayman Islands' vehicles are already being used to form investment funds and for project finance transactions to invest in Belt and Road projects.

The success of OFCs in Asia has been driven by the onshore need to conduct business on a stable, tax-neutral platform in jurisdictions which have sound but flexible laws and regulations. The intercontinental or cross-border nature of the Belt and Road projects will therefore present opportunities for vehicles which can manage the variables arising from conducting business across different legal and tax systems. OFCs have historically been used for foreign direct investment and merger and acquisition transactions in Asia. In addition, companies incorporated in OFCs are the home to a significant number of Asian initial public offering and capital markets transactions, with companies from Bermuda, the British Virgin Islands and the Cayman Islands accounting for approximately 75 per cent of all companies listed on the Stock Exchange of Hong Kong (SEHK). From the beginning of 2017 to date alone, over 85 Cayman Islands companies were listed on the SEHK.

OFC vehicles have been an integral part of the development and financing of Asian infrastructure projects and cross-border deals for over 30 years and, with the flexibility afforded by the available structures for debt and equity financing, whether as investment funds, capital market offerings or bond issues, OFCs are ideally position to continue that relationship for the Belt and Road. IFC