

## **OFFSHORE FINANCIAL CENTRES: BENEFITS OUTWEIGH COSTS FOR NEIGHBOURING ECONOMIES**

Offshore financial centres might encourage bad behaviour, such as tax evasion and money laundering. But according to new research by Professor **Andrew Rose** and Dr **Mark Spiegel**, published in the October 2007 issue of the *Economic Journal*, their net impact on neighbouring economies is positive.

By providing competition for domestic banks, offshore banks also (inadvertently) lower the costs for anyone using the domestic financial system. For example, simply by being close to Andorra and Monaco, France has a more competitive banking system, which provides more credit at lower interest rate spreads. Such indirect competitive benefits of offshore financial centres more than offset their costs.

Offshore financial centres – such as the Cayman Islands or Panama – are jurisdictions that oversee a disproportionate level of financial activity by non-residents. Financial activity in them is usually dominated by the provision of intermediation services for larger neighbouring countries.

In this study, the authors ask two distinct questions about the causes and consequences of offshore financial centres:

- First, why do some countries become offshore financial centres?
- Second, what are the consequences of offshore financial centres for their neighbours?

Offshore financial centres are often accused of facilitating tax evasion, money laundering and any number of nefarious activities. Prominent offshore centres have reputations for facilitating all manner of these unsavoury practices, though ample opportunities for such activities may also exist for local banks with branches in Gibraltar, Guernsey, Jersey and the Isle of Man.

All told, there are 40 offshore financial centres spread around the world, mostly in Europe and the Caribbean (see the list below). There is widespread suspicion that most of them reduce the costs of illicit activity in their neighbours, leading many to characterise offshore financial centres as parasites. This study suggests that they are more accurately viewed as symbionts than parasites.

### **What makes a country likely to become an offshore financial centre?**

The authors approach this question using a number of different data sets. Unsurprisingly, countries that are tax havens and money launderers host more assets and are more likely to be offshore financial centres. These results are intuitive; one attraction of moving assets offshore is the ability to pursue activities that are prohibited in source countries.

### **Do offshore financial centres make bad neighbours?**

One might expect proximity to an offshore financial centre to be bad for the neighbourhood, since they may encourage tax evasion and other illegal activities. But the presence of nearby offshore financial centres also has the beneficial effect of increasing the competitiveness of a source country's banking sector. The trade-off between the positive and negative externalities of offshore financial centres lies at the heart of this research.

To analyse this trade-off, the authors develop a theoretical model where offshore financial centres have the benign effect of encouraging competition in the domestic banking sector. They then take the predictions of the model to the data, and examine the impact of offshore financial centres' proximity on banking sector competitiveness and financial depth.

The prediction that offshore financial centres have a pro-competitive impact on their neighbours is robustly confirmed. Simply by being close to Andorra and Monaco, France has a more competitive banking system, which provides more credit at lower interest rate spreads.

To summarise, Rose and Spiegel find that countries identified as tax havens and money launderers are likely to be offshore financial centres, encouraging tax evasion and nefarious activity in neighbouring countries.

Nevertheless, offshore financial centres still provide substantial offsetting benefits in the form of competitive stimulus for their neighbours' financial sectors. This benign impact on local banking conditions tends to mitigate the adverse effects of offshore financial centres on tax evasion and illegal activity.

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**Notes for editors:** 'Offshore Financial Centres: Parasites or Symbionts?' by Andrew K Rose and Mark M Spiegel is published in the October 2007 issue of the *Economic Journal*.

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## Offshore financial centres

### ***Caribbean***

Aruba	Bahamas	Barbados	Belize
Bermuda	British Virgin Islands	Cayman Islands	Costa Rica
Dominica	Netherland Antilles	St. Kitts & Nevis	Turks and Caicos Islands

### ***Europe***

Andorra	Cyprus	Gibraltar	Guernsey
Isle of Man	Jersey	Liechtenstein	Malta
Monaco			

### ***East Asia***

Hong Kong	Macau	Malaysia	Marshall Islands
Philippines	Singapore	Thailand	

### ***Middle East***

Bahrain	Israel	Kuwait	Lebanon
Oman	United Arab Emirates		

### ***Other***

Liberia	Mauritius	Morocco	Panama
Russia	Uruguay		