Barbarians at the Gate: The Populist Attack on Globalisation and its Threat to Smaller IFCs

**By Marcus Killick OBE,
Chief Executive Officer, Isolas, Gibraltar**

THE NEXT PARAGRAPH WILL BE CONTROVERSIAL. The purpose of this is twofold. First, you are more likely to read the article in full, if only to utterly disagree with it. Second, it is not going to be easy to explain how protectionism, as espoused by the leaders of Venezuela and the United States, alongside the leader of the opposition in the UK (and various other wannabe populists), is going to be harmful to small international finance centres (IFCs).

A recent, extensive survey by Gary Lewis and Timothy Bates, psychologists at Royal Holloway University of London, has shown a significant link between a high IQ in childhood and economic conservatism in adulthood. There you have it; free marketeers are brighter than protectionists. They are less likely to blame foreigners and big business for their troubles, or to want government to wantonly redistribute income. Indeed, as other studies have shown, they are also more socially liberal.

For those of you who have now reached this paragraph rather than stopping at the end of the last to troll me on the internet, what I am saying is that most intelligent people are horrified at the prospect of tearing down metaphoric bridges, to build (in some instances) real walls between nations. Yet, there is a populist movement that seems to believe that the creation of such divides actually helps a country's economy.

Those of us who have, for decades, complacently comforted ourselves with the notion that being bright somehow meant that our social and economic outlook would hold sway in perpetuity are feeling sorely disappointed. We have been rejected by the very democracies we believe in and uphold. The people have spoken, but for us, they were the wrong people. The barbarians are indeed at the gate.

Yet, these barbarians, like the creation of Mary Shelley's doctor, are of our own making. Last year, 40 per cent of young Greeks remained unemployed, long after the country's national financial meltdown began. Between 2008 and 2016, four per cent of Greece's population emigrated, many of them young, creating a long-term structural crisis. The coal miners of West Virginia saw their communities collapse whilst watching the national economy bloom. Is it any wonder they listened to the siren calls of the populists?

It is difficult to see that something is for the good of your country when your family is suffering. History may understand our lack of responsibility in causing this pain, but it will harshly judge our lack of empathy in dealing with it, or our failure to be seen to work to alleviate it.

So the barbarians are here. We didn't see it coming. Being bright isn't the same as being clever it seems, so what next?

The two results of greatest impact to IFCs will be controls on international capital flows and the imposition of tariffs. Both will harm international commerce and consequently IFCs.

Let me explain.

The first threat comes from the traditional hard left who regarded the restriction of free capital flows as a legitimate economic tool. The inevitable result of this is restricted investment inflows into their countries, as the inability to recover capital invested is a major disincentive to external investors. Capital moves in search of the highest risk-adjusted return at a global level. The risk of loss of capital (through restricted capital movement and possibly asset nationalisation), effectively excludes a nation from such valuable investment. One only has to look at the spiraling collapse of the Venezuelan economy to evidence this.

Whilst destabilising, the introduction of controls on capital flows tends to be localised (often to a single jurisdiction) and short term. The ultimate crippling economic effect, as well as the inevitable increase in other controls on freedom, with the resultant loss of individual liberty, and growing despotism in the regime applying them, can have only one result. However, that result can take time.

In the past, capital flight from a despotic or economically mad regime tended to be through the small IFCs. People took the view that it was better to move liquid assets out of harm's way before the regime stops printing its own money and starts stealing yours. IFCs are stable, have an established and applied rule of law and have (traditionally) strong confidentiality obligations.

The ability to transfer assets has now become far less easy due to higher levels of transparency and cooperation. IFCs have been at the forefront of this cooperation. Indeed much of it, whilst bureaucratic, such as FATCA, has closed the door to the tax evaders who have historically tarnished the reputation of IFCs as legitimate business centres. Such changes are, in principle, laudable.

However, the most recent anti-money laundering and automatic disclosure requirements have come into existence at a time when few people are experiencing the direct risk of asset confiscation by their own governments. They are based on the premise of benign regimes simply wishing to ensure citizens cannot evade their tax obligations. They are not designed to protect the property rights of a person fearful of a regime seeking to deprive them of that property. Indeed, under the myriad of tax information exchange agreements, an individual may even end up having their attempted transfer reported to their own tax authorities.

Also, anyone caught carrying over US$10,000 in cash or a single €200 note (nicknamed the Bin Laden) across a border is liable to have the whole stash seized.

Whilst IFCs of the past may have been safe havens for the worried wealthy, they have evolved from this role. Their adherence to tax transparency and disclosure, in many cases to a greater extent than larger jurisdictions, means they now focus on being an intermediary in international trade and globalisation (as a whole). Future capital flight is far less likely to be through them, than through larger jurisdictions less concerned with playing by the new rules of the game.

Worried individuals could try bitcoin or one of the other 'anonymous' pseudo currencies to get their money out. However, given the volatility of cryptocurrencies they represent a poor store of value. Additionally, as the intermediation of an IFC is unnecessary, even if they are used, IFCs will not benefit.

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The second and far more disturbing threat to IFCs comes from the other populist mantra – that expounded by President Trump and others of his ilk. Whether under the guise of 'America First', #mefirst, or some other spurious slogan, the raising of tariff barriers will always lead to a subsequent reduction in global trade. IFCs are now tied into a full role in future globalisation, therefore, as globalisation is now under threat, so are IFCs.

IFCs are vital intermediaries in global trade as they facilitate the efficient movement of capital. This is mainly because they mitigate, in an entirely legitimate way, instances of double and triple taxation. As a result they boost aggregate investment on a global basis. This facilitates growth in all jurisdictions as it encourages capital to be invested internationally rather than simply domestically. IFCs do this without adversely affecting the tax revenue raising ability in other countries. Without them, there would be less trade and less international economic growth.

The idea propagated by some – that the money arriving in IFCs remains there in some enormous vault – is farcical. IFCs act as intermediaries. Investment flows through them and is put to productive use elsewhere. For example, 98 per cent of wealth managed by Jersey is merely in transit, on its way to be invested, and therefore creates economic benefit somewhere else.

However, the relationship is symbiotic. If countries stop trading with each other and erect trade barriers or, as stated above, impose capital flow controls, then the need for intermediation decreases, harming IFCs. Their integration into globalisation has had the twin effects of providing legitimacy, but creating dependency. IFCs are no longer a safe harbour, they are part of the convoy.

Last year, the value of goods and services traded globally amounted to US$20 trillion. There are tens of thousands of transnational corporations. By transnational, I mean they buy and sell goods and services in jurisdictions where they do not physically reside. As such they can sometimes become subject to taxation for the same activity in more than one jurisdiction. This is an unintended result of the way many national tax systems operate. If unchecked, this acts as a drain on the returns for such an activity, possibly making it uneconomic.

The role of IFCs in resolving this issue is set out in greater detail in an excellent IEA discussion paper called Offshore Bet, authored by Diego Zuluaga, which was published in July 2018.

Within the UK, at least the genuine aim (however misguided) of those seeking Britain's exit from the EU, is for trade deals to be concluded with numerous countries around the world. It is not a retreat to isolationism. At present, the only group seeking an isolationist future is Jeremy Corbyn, the leader of the opposition Labour Party and his supporters. In August, Corbyn launched a 'Build it in Britain' campaign and confirmed his opposition to elements of certain trade deals. They are against the drive to trade deals on ideological grounds, but, to be fair, they have also expressed support and admiration for the Venezuelan regime. Therefore, their views on the 'general prosperity, versus political purity' debate are pretty clear.

The United States, in its use of trade tariffs and sanctions as a weapon of economic warfare, is different. Trade wars, according to President Trump, are easy to win. Sanctions tend to have a wider agenda, such as those imposed on Iran and North Korea. Some use of tariffs, such as those against Turkey, are done to achieve narrow political goals (the freedom of a US citizen). The majority are allegedly to correct a perceived unfairness (or, bizarrely, national security concerns). Free trade must indeed be fair to prevent structural instability, but it can be questioned as to whether a tit-for-tat imposition of tariffs is a rational response to such a grievance.

Fortunately, not all countries share this view. One has yet to see Swedish politicians decrying Volvos new US$1.2 billion plant in South Carolina as robbing Swedish workers of their jobs.

It is not the role of this article to comment in detail on the merits of such actions, simply their effect. As action leads to reaction and escalation, transnational trade becomes more difficult. The intermediation role of IFCs is reduced in parallel with this fall in cross border trade. A retrenchment in the flow of global capital investment follows, again harming IFCs.

IFCs prosper when globalisation prospers. Undoubtedly, the benefits of globalisation, particularly for the poorer nations who stand to lose the most from trade barriers and tariffs, will ultimately overcome narrow protectionist agendas. But it will take considerable time for the damage to be repaired or for new global alliances to be formed.

The other problem with protectionist agendas is that they encourage xenophobia. We live in a time when the threats we face require international cooperation, not insular nationalism. Climate change is not known for its respect for national boundaries. Denying the poorest nations the opportunity of economic growth that free trade brings will increase migration, not restrain it. China has not lifted over a billion of its citizens from extreme poverty in 1978 by looking in on itself. Yet populism is on the rise, from the Philippines to Poland.

Populism also has some other unpleasant side effects. In the Philippines, President Rodrigo Duterte has harnessed the power of social media trolls and fake news. He has described both Pope Francis and Barack Obama as "the son of a whore" and even God as "stupid." Yet he has an approval rating of 65 per cent. Preliminary investigation launched by the International Criminal Court into killings since he took office indicates that his war on drugs is alleged to have killed over 12,000 people. In democracies, sometimes nasty people get elected.

Take all these factors and the likelihood of a global slowdown and you have a perfect storm, one which IFCs will not be insulated from.

IFCs, driven by, and reacting to events, can do little to alter this new populist agenda. Our world is about to change, possibly for good. The retreat of the United States from global economic leadership will open room for other nations, most likely the Chinese, to assume a more dominant role. Indeed, according to the WHO, Chinese babies born today can already expect longer, "healthier lifespans" than those born in the United States.

There is always hope that, ultimately, the threats and counter threats provoke a step back from the edge. Deals may be forthcoming from threats and insults. The populist agenda does not follow conventional rules. Consensus will be lost and trust damaged.

IFCs which were well positioned under the old power structure, may well find themselves overtaken by other, now better-placed competitors, with stronger links to the new dominant players. To continue to prosper, individual IFCs must again show their ability to adapt, but this time to support very different markets and trade flows, not just new services for existing ones.

The world's economy will continue to need the role of IFCs. The intermediation they provide cannot be replaced or replicated. The question is, which IFCs will be the ones providing it?