SHANGHAI AS AN INTERNATIONAL FINANCIAL CENTRE: PROBLEMS AND PROSPECTS

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Executive Summary

1. The 2008-09 financial crises prompted China to reflect on its economic policies. It is concerned with the shrinking value of its dollar reserves, and plans to move step-by-step to turn the *yuan* into an international currency.

2. To do so, China wants to grow and liberalise its financial market and transform Shanghai into a major international financial centre by 2020. The plan was announced by China's State Council in March 2009.

3. The decision was timely as it came at a time when China was assuming a leading role in global economic matters and becoming bolder in internationalising its currency as well as exploring means to reduce its dependency on the US dollar.

4. Historically, Shanghai has been an important centre for trade and commerce. It has demonstrated its ability to revive its financial sector after Deng Xiaoping's *nanxun*, which enhances its case to become an international financial hub.

5. Shanghai has a relatively complete financial platform and hosts the Shanghai stock exchange, the 6th largest stock exchange in terms of market capitalisation in the world in 2007. The city has become the de facto financial centre of Mainland China.

6. In 2008, Shanghai's financial industry generated an added value of about 144 billion *yuan* (US$21 billion) which was about 10% of Shanghai's total GDP in 2008. The city has nearly 700 financial institutions.

7. There are a number of hurdles before Shanghai can become an international financial centre. First are the two big issues of *yuan* convertibility and control of capital flow.

8. Second, Shanghai faces contention from Beijing which hosts major international banks and financial institutions.

9. Third, Chinese financial firms need to offer a bigger range of financial products and services with greater sophistication.

10. Fourth, China has to adopt international accounting standards and offer more transparent and independent legal framework for business. Shanghai still has a lot to do in order shore up its current financial infrastructure.

11. In 2009, Shanghai was ranked 10th based on Global Financial Centres Index (GFCI, a measure of competitiveness of global financial centres), ahead of Sydney, Toronto and Frankfurt. Shanghai can learn much from Hong Kong which ranks fourth in the GFCI.

12. Given these hurdles, Shanghai is likely to go through a bumpy and uncertain journey before it can fulfil its ambition. Meanwhile Hong Kong will remain as the premier international financial centre of China.

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Background and Rationale

1.1 In March 2009, China's State Council announced an ambitious plan to transform Shanghai into a major international financial centre, on par with Hong Kong, Singapore, New York and London by 2020.

1.2 The State Council's announcement was timely as it came at a time when, in the wake of the 2008-09 financial crisis, China was assuming a leading role in global economic affairs. Indeed, China is set to replace Japan as the second largest economy in the world in the near future. It is also the world's largest manufacturing base and the biggest commodity importer. Besides, China holds 40 percent (or around US$2 trillion) of the world's foreign exchange reserves and is also the world's largest holder of US treasury bills.

1.3 In addition, the country has the world's top three banks in terms of market capitalisation (see Table 1 in Appendix). In 2009, China (including Macau) accounted for 47.8% of total value of IPOs worldwide (that of the USA was 14.6%) – another indication of the growing importance of the Chinese financial market.[1] More importantly, China is becoming bolder in the internationalisation of its currency and is actively exploring means to reduce its dependency on the US dollar.

1.4 The emergency actions taken by various countries, particularly those of the United States, to free credit markets and boost demands are likely to cause

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[1] Equity firms target CICC, *The Wall Street Journal*, 23 February 2010, p. 1, 16

inflation.[2] In fact, signs of inflationary pressure could be seen in the spike of oil prices from about US$40 per barrel in March 2009 to over US$60 per barrel by the end of June 2009 as well as the 20 percent increase of raw material prices and the surge of gold futures to over US$1,000 during the same period.

1.5 Inflation is no good news for the US dollar. Signs of a weakening dollar can already be seen in the yields of the ten-year Treasury bill jumping from around two percent at the end of 2008 to almost four percent by early June 2009.[3] As the global economy shows signs of life, there will be even more downward pressure on the US dollar as investors become less risk averse and do not need the dollar's security.

1.6 With this developing trend, China would like to avoid the "US dollar trap". Coined by Nobel laureate Paul Krugman in his *New York Times* article, the term refers to the massive value loss on foreign reserve due to a depreciated US dollar.[4]

1.7 Beijing has come out with a number of ways to address the dollar trap. In March 2009, Zhou Xiaochuan, governor of the People's Bank of China, called for the establishment of a super-sovereign reserve currency based on existing special drawing rights to replace the US dollar.[5] Furthermore, since December 2008, Beijing has concluded a series of swap currency agreements with its trading partners and has been experimenting with the idea of conducting trade and investment activities using *yuan* and the respective partners' currency. To date, the People's Bank of China has arranged six bilateral currency swaps, totalling more than 650 billion *yuan* (US$95 billion),

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2 "The Biggest Bill in History", *The Economist*, 13 June 2009.

3 "This Way Out", *The Economist*, 6 June 2009.

4 Paul Krugman, "China's Dollar Trap", *The New York Times*, 2 April 2009, Accessed at http://www.nytimes.com/2009/04/03/opinion/03krugman.html, 1 June 2009

5 Yang Mu and Chen Shaofeng "Can China Reduce Foreign Reserve Risks?", *China Daily*, 20 May 2009.

with countries including Japan, South Korea, Malaysia, Hong Kong, Brazil and Argentina.[6]

1.8 The swap currency could be used for trade settlements between China and its trading partners. As a start, Shanghai, Shenzhen, Zhuhai, Dongguang and Nanning were chosen by the Chinese government to use *Reminbi* for trade settlements. The first swap currency agreement between China and Hong Kong which involved more than 440 companies took effect in June 2009.[7] The Chinese government is also planning to include the purchase of *Reminbi* financial products in the currency swap agreements.

Shanghai as an International Financial Centre

2.1 The State Council's announcement is significant as it marked for the first time a concrete national-level backing and recognition of Shanghai's status as a global financial hub. Prior to that, it was only functioning as China's de facto financial hub and has recently been jostling this position with Beijing. According to Liu Tienan, Vice Minister of the National Development and Reform Commission (NDRC), the State Council gave its official blessing to Shanghai simply because the city is the "most qualified metropolitan city on the Chinese mainland to pursue the ambition".

2.2 As stated in the guidelines of the State Council's decision, the process to build Shanghai into an international financial hub encompasses features such as using the *yuan* for international trade settlement, developing private equity and developing a re-insurance market, and encouraging overseas enterprises to issue *yuan*-denominated bonds in China (Table 1).

2.3 The Chinese authorities need to introduce a more transparent and independent legal system and promulgate favourable tax policies to attract financial companies. The State Council also asks the city to step up efforts to shore up

6 "BIS-China, Brazil Working on Trade FX Deal-cenbanks", *Reuters*, 28 June 2009.

7 *The Straits Times*, 3 July 2009, Singapore. *Xin Bao*, 30 June 2009, Hong Kong.

its soft infrastructure. These include incentives and measures to attract and train financial talents. Banks in China are urged to provide sophisticated investment products.

TABLE 1 KEY MEASURES TO SUPPORT SHANGHAI'S DEVELOPMENT AS A FINANCIAL HUB

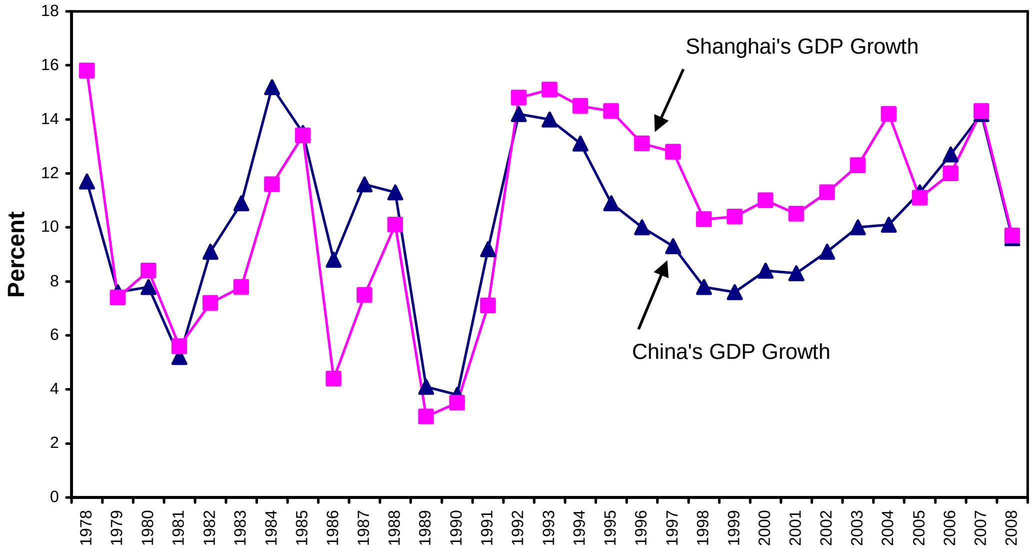
	Key Measures
1	Conduct trade settlement in *yuan* on a trial basis
2	Fully tap the financial market in Shanghai in terms of clearing in *yuan*
3	Develop over-the-counter (OTC) markets for non-listed companies in the Yangtze River Delta
4	Formulate a mechanism to help companies trading on the OTC markets to be transferred to the main stock boards
5	Develop pension products that offer tax breaks to encourage people to pay into pensions
6	Encourage more international development institutions to issue *yuan*-denominated bonds
7	Study plans to allow overseas enterprises issue *yuan*-denominated bonds in China
8	To allow qualified overseas companies issue *yuan*-denominated shares
9	Step up development of the re-insurance market
10	Give priority in terms of business expansion to securities and fund-management joint ventures
11	Encourage financial institutions to cover a wider range of businesses
12	Encourage the development of private equity and venture capital companies

Source: *China Daily*

2.4 Historically, Shanghai has been a centre for trade and commerce especially after its establishment as a treaty port in the mid-19th century. By the 1920s and 1930s, the city had flourished to become one of the world's major cities and an important entrepot. Consequently, this also led to the growth of Shanghai's financial sector. However, the city's progress as an economic and financial hub was interrupted by political events and it was overshadowed by Hong Kong after 1949.

2.5 Since China's open-door policy in 1978, Shanghai has been striving to regain its status as the premier economic and financial hub of China. This process was consolidated and gathered speed following the Pudong New Area Project initiated by Deng Xiaoping after his *nanxun* in 1992. Thereafter, Shanghai has experienced spectacular economic growth that lasts until now. As Chart 1 shows, Shanghai's GDP has been growing at double-digit rate for most years since 1992.

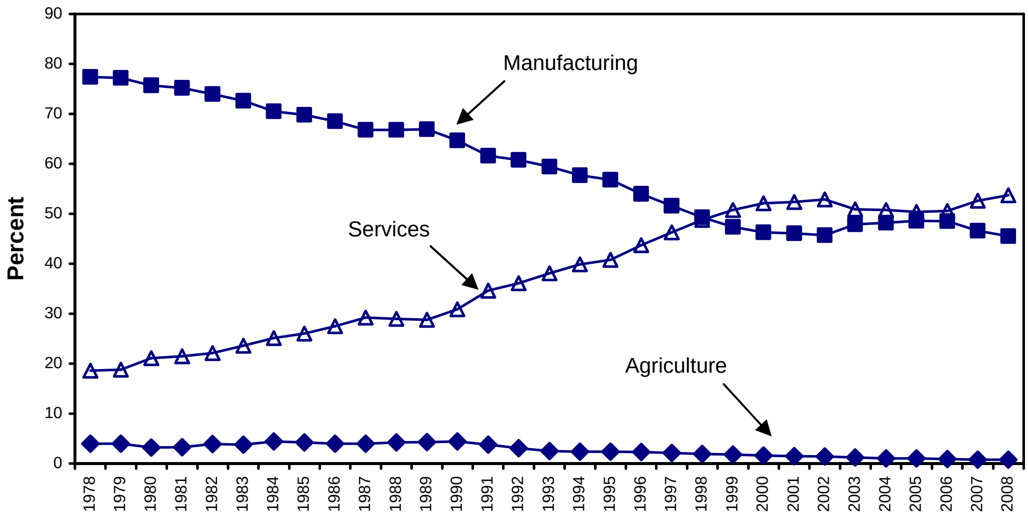
CHART 1 SHANGHAI'S AND CHINA'S GDP GROWTH (1978-2008)



Source: Shanghai Statistical Yearbook (2009)

2.6 Shanghai's revival also took place on a course that is different from that of most Chinese cities. Instead of focusing on the growth of the manufacturing sector as seen in cities such as Shenzhen, Tianjin, and Beijing, Shanghai's economy was powered by the service sector. As seen in Chart 2, Shanghai's service sector contributed nearly 54 percent of the city's GDP in 2008. It also absorbed about 54 percent of the city's labour force in the same year.

CHART 2 COMPONENTS OF SHANGHAI'S GDP (1978 to 2008)



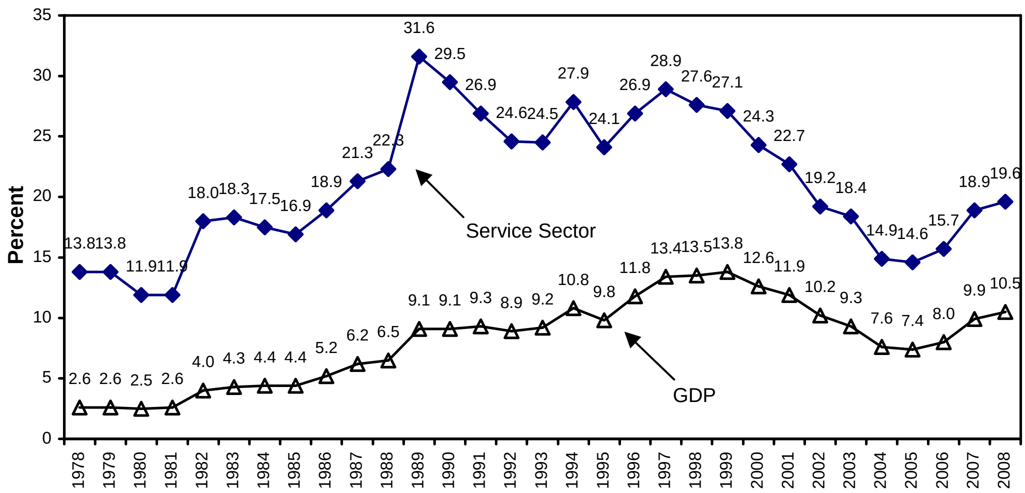
Source: Shanghai Statistical Yearbook (various issues).

2.7 In this sense, Shanghai has a relatively complete financial sector. In 2008, Shanghai's financial industry generated an added value of about 144 billion *yuan* (US$21 billion). This is an increase of about 15 percent from the previous year and about 10 percent of Shanghai's total GDP in 2008 (Chart 3). By the end of 2008, there were a total of 689 financial institutions in the city. Of that, 124 were commercial banks, 291 were insurance companies and the remaining 94 were securities companies. Of the total, 165 were foreign banks.[8]

2.8 Shanghai is also home to the Shanghai Stock Exchange (SSE). As at the end of 2007, the SSE had 860 listed companies with a combined capitalisation of US$3.7 trillion. This made the SSE the world's sixth largest stock exchange in terms of market capitalisation.

8 Lan Xinzhen, "Rebranding Shanghai", *Beijing Review* (14 May 2009).

CHART 3 PERCENTAGE SHARE OF FINANCIAL SECTOR IN SHANGHAI'S TOTAL GDP AND SERVICE SECTOR (1978 to 2008)



Source: Shanghai Statistical Yearbook (various issues)

2.9 Since its set up in 1990, trading within the SSE has gradually been liberalised to allow the inflow of foreign funds and *yuan*-denominated trading. For instance, the SSE introduced the Qualified Foreign Institution Investor (QFII) programme in 2003 and the Qualified Domestic Institutional Investor (QDII) programme in 2006.[9] The QFII allowed foreign investors to buy *yuan*-denominated shares in the SSE, while the QDII allowed domestic financial institutions to invest in shares in offshore markets. These measures are seen as milestones because China's capital market has always been heavily regulated by the central government since it adopted the open-door policy.

2.10 In addition to the stock exchange, Shanghai has also introduced a number of financial institutions since 1990. These include a foreign exchange market, RMB bond trading centre, gold exchange, futures exchange for commodities and derivatives market (See Table 2).

[9] See Lu Ding and Li Ning, "China's Capital Market Reform: Problems and Prospects", in John Wong and Liu Wei (eds.), *China's Surging Economy: Adjusting for More Balanced Development* (Singapore: World Scientific, 2007), pp. 282-283 for more details on reforms carried out in the Shanghai Stock Exchange.

TABLE 2 FINANCIAL INSTITUTIONS IN SHANGHAI SINCE 1990

Institutions	Content	Founding Year	Status or Scale
Shanghai Securities Exchange	Main, capital market (equity, bonds)	1990	80 percent of total trading turnover in China
Foreign exchange trading centre	Foreign exchange	1994	Head office of national trading market
Inter-bank loan centre	Money market	1996	National centre for interbank trading
RMB bond trading centre	Money market	1997	National centre for bond trading
Shanghai Futures Exchange	Rubber, copper, aluminium and fuel oil	1999	60 percent of futures trading volume of all China
Shanghai Gold Exchange	Gold market	2002	The only gold market
Note market service centre	Provide note transaction information and service	2003	Principal note pricing system in China
Shanghai Petroleum market	Futures transactions	2006	The only petroleum market in China
China Financial Futures Exchange	Financial derivative transactions	2006	The only derivative market in China

Source: Soogil Young, Dosoung Choi, et. al. (eds). *Competition Among Financial Centres in Asia-Pacific: Prospects, Benefits, Risks and Policy Changes* (ISEAS: Singapore, 2009), p. 234.

Challenges Ahead

3.1 Shanghai has to overcome a number of hurdles before it can become a full fledged international financial centre. First are the issues of inconvertibility of the Chinese *yuan* and ban on capital flow. All major international financial centres do not face these issues, which puts Shanghai at a disadvantage. As the two issues come under the jurisdiction of the central government, there is nothing Shanghai can do about them.

3.2 Non-convertibility of the *yuan* is part of the macroeconomic policy of promoting export as a means of generating economic growth and creating employment. Beijing policies strongly suggest that the finance sector must serve the economy, which means that financial policies must be subsumed under economic policies. The prospects for currency convertibility are good if China continues to upgrade its economy to higher value adding activities and solve its unemployment problem. Judging from past government behaviour, Beijing is likely to adopt a gradualist approach and to do so on its own terms.

3.3 As part of this gradualist approach, the government is using swap currency to settle trade between China and some of its trading partners. This is a win-win situation for both China and its major trading partners, though on balance it benefits China more. The arrangement is a half-way house on the route to final stage of floating exchange rate for the *yuan*. As China is moving in this direction, it is also relaxing its control on capital flow.

3.4 China is very cautious about capital control for good reasons. In the 1997 Asian financial crisis, free currency flow allowed currency speculators to wreak havoc in Hong Kong, South Korea and the ASEAN countries.[10] This caution is further buttressed by the 2008 financial crisis. Both China and India, with their control of capital flow, need not worry about the danger of currency crisis. A number of eminent pro-market economists have strongly argued for control of short-term speculative capital flow.[11] Even the International Monetary Fund, which has a history of advocating free capital flow, has modified its position.[12]

3.5 Capital control consists of a range of measures targeted at different capital flow. In fact, China does not impose a blanket ban on capital flow. Since its economic reform, China has welcomed manufacturing FDI and allowed repatriation of legitimate profits. It also allows remittance of funds for overseas study as well as for corporate investment and trade. Chinese tourists going abroad and foreign tourists entering China are allowed to bring with them a reasonable amount of money.

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10 Paul Krugman (2009) *The Return of Depression Economics and the Crisis of 2008,* New York: W W Norton

11 Michael Lim Mah Hui and Lim Chin (2010) *Nowhere to Hide: Global Financial Crisis – its Origin, Iimpact and Challenges Ahead,* Singapore: ISEAS

12 Fundamental questions, *The Economist*, 20 February 2010

3.6 In June 2009, China approved the listing of foreign companies in the SSE.[13] This is an unprecedented move and a huge step forward in liberalising China's capital market as the policy will not only set the stage for the inflow of more foreign funds, but also allow foreign companies to raise capital in China. Shanghai also permits locally incorporated foreign banks to issue *yuan*-denominated bonds and to allow China-based foreign companies to be listed in the Shanghai Stock Exchange. These are signs that the government is gradually liberalising its financial market.

3.7 Second, Shanghai has to strengthen its position vis-à-vis Beijing, which enjoys comparable financial prowess. In 2007, Beijing's financial sector was worth 112.7 billion *yuan* (US$16.1 billion), making up about 12.5 percent of the city's GDP while that of Shanghai was worth around 119.6 billion *yuan* (US$17.1 billion) or about 10 percent of its GDP.[14] In addition, Beijing is home to 677 financial institutions (compared to Shanghai's 604) and most of the headquarters of China's national and foreign banks. In 2007, the savings-to-GDP ratio in Shanghai was 249%, and the loan-to-GDP ratio was 178%. These figures are much higher than the national average (156% and 105%), but they are only about half of Beijing's (429% and 230%).[15]

3.8 Beijing's strength is based on the fact that the Chinese government still plays a very important role in the economy. Government investment is the most important driving force for China's economy, the main source of bank deposit and the largest loan issuer. In addition, IPOs and the reissuing of shares are controlled by the China Securities Regulatory Commission in Beijing. As a result, most of the headquarters of China's national and foreign banks as well as MNCs and local enterprises prefer to reside there. However, unlike Shanghai, Beijing does not have an institutionalised stock market, money market, currency market and futures market. Its financial infrastructure is less established.

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13 "Shanghai Stock Market Opens to Foreign Firms", *Telegraph*, 1 May 2009.

14 "Beijing's Financial Dream", *Beijing Review*, 24 May 2008.

15 Shahid Yusuf and Kaoru Nabeshima: Two Dragon Heads: Contrasting Development Paths for Beijing and Shanghai, the World Bank, 2010, Washington, pp. 89-94.

3.9 Given the nature of political system and interest groups lobbying, it would not be easy for Shanghai to gain mileage over Beijing. However, Shanghai hosts the county's leading stock market, is more commercially oriented and has a vast industrial base in the Yangtze River Delta and an economically dynamic hinterland. The deepening of the marketisation of the Chinese economy is likely to weaken the role of Beijing as a financial centre relative to Shanghai. In most of the big countries the financial centre is not the political centre (such as the USA, Germany, Brazil and India).

3.10 Third, China can allow more financial products to be made available to investors, e.g. futures markets and markets for bonds, derivatives and currency trade. At the same time, an international financial centre needs to have effective supervision and regulation. The importance of this point is amply demonstrated in the 2008 financial crisis. These activities require a million well trained and experienced finance professionals, especially those in senior positions.[16]

3.11 Shanghai has responded to this shortage of human resources with a two-pronged approach. It has sent a number of delegations to New York, Hong Kong and Singapore to recruit highly qualified professionals, and this task is made easier by the big numbers of them being laid off during the financial crisis. The city has also allocated 320 million *yuan* to set up Shanghai Institute of Advanced Finance (上海高级金融学院) at Jiaotong University (ranked fourth in China), with the aim of turning it into a world-class research and teaching institute. The institute has an exchange educational programme with the NUS Business School. Moreover, Shanghai has Fudan University (ranked third in China) and Shanghai University of Finance and Economics (上海财经大学).

3.12 Fourth, Shanghai still has a lot to do to bring its current financial infrastructure up to international standards. China has to improve accounting standards, legal framework for business, corporate governance and other soft

[16] http://news.xinhuanet.com/fortune/2009-05/04/content_11306348.htm

infrastructure. As an indication of inadequate legal frameworks, international banks usually bring cross border transactions initiated in Shanghai to Hong Kong or Singapore in order to execute them there with the contracts governed by Anglo-Saxon legal terms.[17]

3.13 According to the latest Global Financial Centres Index (GFCI) which ranks the competitiveness of global financial centres, Shanghai is ranked 11th out of a total of 75 centres in 2010, one place down from its 10th position in the previous year (Table 3). On the other hand, the financial cities that Shanghai wants to emulate, namely London, New York, Hong Kong and Singapore, are among the top four.[18]

TABLE 3 THE GLOBAL FINANCIAL CENTRES INDEX: 2009 AND 2010 RANKING

Financial Centre	**GFCI 2010 Ranking**	**GFCI 2009 Ranking**
London	1	1
New York	2	2
Hong Kong	3	3
Singapore	4	4
Tokyo	5	7
Chicago	6	8
Zurich	7	6
Geneva	8	9
Shenzhen	9	5
Sydney	10	11
Shanghai	**11**	**10**
Toronto	12	13
Frankfurt	13	12
Boston	14	17
Beijing	**15**	**23**
Taipei	21	25

Source: *The Global Financial Centres Index 5*

17 Xu Mingqi (2009) Building the Shanghai International Financial Centre: strategic targets, challenges and opportunities, in Soogil Young, Dosoung Choi, Jesus Seade and Sayuri Shirai (ed.) Competition among Financial Centres in Asia-Pacific, Singapore: ISEAS

18 *The Straits Times*, 13 March 2010.

3.14 As one of the world's leading financial centres, Hong Kong is able to provide invaluable insights for Shanghai especially in areas such as liberalising its capital market. Hong Kong could also help Shanghai improve the latter's corporate and commercial infrastructure such as corporate governance and business legal system (See Appendix Table 2 for SWOT analysis of Hong Kong and Shanghai as international financial centre).

3.15 Contrary to the buzz that Hong Kong could become a has-been,[19] Hong Kong is emerging as a viable alternative to New York and London, particularly for large companies in emerging markets which do not have easy access to Mainland China. Hong Kong led a consortium consisting of Shanghai Stock Exchange and Shenzhen Stock Exchange to raise a combined US$52 billion in IPO proceeds in 2009. That is much more than the US$27 billion raised at NYSE and Nasdaq, and US$2 billion in London.[20] While Shanghai is on its bumpy journey to fulfil its ambition, Hong Kong will continue to function as the main international financial centre for China.

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19 *Newsweek*, 15 June 2009.

20 "Taking Stock of Hong Kong", *The Wall Street Journal*, 5-7 February 2010.

APPENDIX

TABLE 1 TOP 10 BIGGEST BANKS IN 2004 AND 2009

Ranking	**2004 Ranking**		**2008 Ranking**	
	Banks	**Market Value (USD Billion)**	**Banks**	**Market Value (USD Billion)**
1	Citigroup	259	Ind. & Com. Bank of China	252
2	HSBC	163	China Con. Bank	180
3	Bank of America	118	Bank of China	151
4	Wells Fargo	97	HSBC	140
5	RBS	89	JP Morgan Chase	125
6	UBS	86	Wells Fargo	110
7	JP Morgan Chase	85	Banco Santander	95
8	Mitsubishi Tokyo	63	Bank of America	85
9	Wachovia	61	Mitsubishi UFJ Financial	75
10	Bank One	60	BNP Paribas	74

Source: Soogil Young, Dosoung Choi, et. al. (eds). *Competition Among Financial Centres in Asia-Pacific: Prospects, Benefits, Risks and Policy Changes* (ISEAS: Singapore, 2009), p.xlvii.

TABLE 2 SWOT ANALYSIS OF HONG KONG AND SHANGHAI AS INTERNATIONAL FINANCIAL CENTRE

HONG KONG	SHANGHAI
Strengths	**Strengths**
o High level of transparency of the government and its policies o Political and social stability o Equitable treatment of foreigners o Foreign exchange stability and abundant liquidity o Superb financial infrastructure o Minimal interference by financial supervisory/regulatory authority o Predictable legal environment o Workforce with good financial expertise and international experiences o English-speaking population o Regional headquarters for many global financial institutions, including investment banks	o Very large economic power and abundant human resources o Large domestic capital market o Very good potential for continuation of high growth o Possess a large amount of domestic savings
Weaknesses	**Weaknesses**
o Limited local market size o Serious air pollution	o Regulations hindering efficient functioning of the market mechanism o Limited openness to foreign investment o Slow internationalisation of the capital markets o Soft financial infrastructure development lagging behind hard infrastructure development o Limited command of the English language among the local population
Opportunities	**Opportunities**
o Physical proximity with China o A bridge connecting foreign companies to investors in China	o Opening of the market to foreign firms and investors
Threats	**Threats**
o Competition with Shanghai as a financial centre	o Competition with Hong Kong to become the main financial centre in China

Source: Soogil Young, Dosoung Choi, et. al. (eds). *Competition Among Financial Centres in Asia-Pacific: Prospects, Benefits, Risks and Policy Changes* (ISEAS: Singapore, 2009), pp. 7 and 15.