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## Shanghai's Future as an International Financial Centre

- The Mainland government's plan to transform Shanghai into an international financial centre by 2020 is part of a bigger plan to internationalise the Chinese renminbi (RMB). The Mainland wants the RMB to play a bigger role in the world market, especially after the global financial crisis which saw the US dollar tumble under the weight of massive government debt. A bigger, deeper and more developed financial market will facilitate the internationalisation of the RMB.
- Shanghai is already a national financial centre of mainland China by most measures, but it is still some way behind the world's leading financial centres in terms of market openness, market size and the variety and sophistication of products available.
- However, Shanghai has clear advantages over many of its regional competitors to becoming an international financial centre, including the back up of one of the world's most dynamic economies and favourable government policies. How far it can close the gap with the world's leading financial centres will depend on how fast the Mainland will remove the constraints that presently restrict the city from becoming a world financial centre, including capital control and the inconvertibility of the RMB. That, in turn, will depend on how the authorities weigh the benefits and risks associated with the internationalisation of the RMB, and how fast the country can build up the necessary infrastructure for defending against any such risks.

The Mainland government unveiled on 29 April a plan (hereafter the "Plan") for establishing Shanghai as an international financial and shipping hub by 2020. Not surprisingly, the Plan has aroused widespread interest and discussion on the Mainland and Hong Kong, especially regarding the implication of the Plan for the convertibility and the international role of the Chinese renminbi (RMB).

### The blueprint

Under the Plan, Shanghai will be an international financial centre by 2020 compatible with the economic strength of the country and the international status of the RMB (Exhibit 1). By 2020, the government hopes that Shanghai will have a multi-functional and highly internationalised financial market that comprises internationally competitive financial institutions and professionals, and will be equipped with the necessary taxation, credit, regulatory and legal systems.





## Exhibit 1: The framework for developing Shanghai into an international financial centre

The government's main targets:

1. Establishing Shanghai, by 2020, as an international financial centre compatible with the country's economic strength and the RMB's international status
2. By 2020, Shanghai should have
  - a multi-functional and highly internationalised financial market system
  - a pool of internationally competitive financial institutions
  - a pool of financial professionals
  - a compatible system of taxation, credit, regulation and law

Source: 《国务院推进上海建设国际金融中心和国际航运中心》，Xinhuanet; Hang Seng Bank

In a broad sense, the government's vision for Shanghai by 2020 fits with what generally constitutes an international financial centre. According to the International Monetary Fund, "international financial centres are large international full-service centres with advanced settlement and payments systems, supporting large domestic economies, with deep and liquid markets where both the sources and uses of funds are diverse, and where legal and regulatory frameworks are adequate to safeguard the integrity of principal-agent relationships and supervisory functions" <sup>(1)</sup>.

According to the Plan, the authorities will introduce more financial products, derivatives and futures trading to Shanghai in the years ahead (Exhibit 2). International development organisations will be encouraged to issue more RMB-denominated bonds. Over time, other foreign companies will be permitted to do the same, and will also be allowed to list shares on the city's stock exchange. In particular, Shanghai will try to develop a reinsurance market by encouraging international reinsurance companies to open business in the city, and setting up domestic and Sino-foreign joint venture reinsurance companies.

In building up a pool of internationally competitive financial institutions, the Plan puts special emphasis on the development of investment banks, fund and asset management companies, and leasing and financing companies. Various kinds of equity investment and venture capital funds will be developed, and a wide variety of financial business will be encouraged, including private banking, offshore finance, car financing, and commercial bank financing for merger and acquisitions.

In short, the Plan has laid down the framework and the steps to be taken for strengthening Shanghai's financial infrastructure in the city's run up to becoming an international financial centre. With respect to the internationalisation of business, new financial institutions, services and products will be developed, and markets will be opened. With respect to the running and regulation of the financial system, international legal and regulatory practices will be introduced, and the necessary professionals will be trained.

<sup>1</sup> "Offshore financial centres", IMF Background Paper, IMF, 23 June 2000





## Exhibit 2: Steps to be taken for building up a multi-functional and internationalised financial system

New market instruments and measures to be developed or taken in establishing a multi-functional and internationalised financial system:

1. Develop corporate bonds, asset backed securities, foreign currency bonds, etc
2. Develop derivative products based on stock indices, FX, interest rates, stocks, bonds, bank loans, etc
3. Introduce commodity futures trading for energy and metals
4. Expand the industry coverage and scale of listed companies
5. Nurture all kinds of institutional investors such as securities investment funds and insurance funds
6. Allow, gradually, foreign investors to participate in Shanghai's financial market, expand the issuance of RMB-denominated bonds by international development organisations, and allow foreign companies to issue RMB-denominated bonds
7. Develop a reinsurance market. Domestic and joint venture reinsurance companies will be introduced; international reinsurance companies will be encouraged to open business in Shanghai, and the possibility of opening offshore reinsurance business will be studied
8. Strengthen financial cooperation between the Mainland and Hong Kong

Financial institutions and business systems to be developed

1. Various kinds of financial institutions, particularly investment banks, fund and asset management companies, money brokerages, leasing and financing companies, etc
2. Various kinds of equity investment funds, venture capital funds, etc
3. Private banking business, offshore finance, trust and financing business, car loans, etc
4. Commercial bank financing for merger and acquisitions
5. Bigger opening of the financial market

Source: 《国务院推进上海建设国际金融中心和国际航运中心》，Xinhuanet; Hang Seng Bank

## The internationalisation of the RMB

The Mainland government has a long-held ambition of developing Shanghai into an international financial centre. As early as 1991, the late patriarch Deng Xiaoping already had the idea of rehabilitating Shanghai's former role as a financial centre. The idea was later adopted as a policy objective during the 14<sup>th</sup> Party Congress of the Communist Party of China in 1992<sup>(2)</sup>.

The Mainland government's latest plan to transform Shanghai into an international financial centre by 2020 is part of a bigger plan to internationalise the Chinese renminbi (RMB). The Mainland wants the RMB to play a bigger role in the world market, especially after the global financial crisis which saw the US dollar tumble under the weight of massive government debt. A bigger, deeper and more developed financial market will facilitate the internationalisation of the RMB.

## Shanghai is already a national financial centre

Over the years, numerous works have been done to revitalise Shanghai's role as a financial centre. The result is the Liujiazui financial district in Pudong, Shanghai, the Wall Street of Mainland China. It houses the Mainland's most important financial institutions, including the second headquarters of the People's Bank of China after Beijing's, the national foreign exchange trading centre and the national bond trading centre (Exhibit 3).

<sup>2</sup> The Party Congress adopted the strategy of building Shanghai into Three Centres: an international economic centre, an international financial centre and an international trade centre.





### Exhibit 3: Major financial institutions in Shanghai

Institutions	Set up
The 2nd headquarters of the People's Bank of China	2005
The Shanghai stock exchange	1990
The National FX trading centre	1994
The National interbank borrowing centre	1996
The National bond trading centre	1997
The gold exchange	2002
The petroleum futures market	2006
The China Financial Futures Exchange	2006
The Credit Reference Centre of the People's Bank of China	2008

Sources: "Building Shanghai international financial centre: strategic target, challenges and opportunities", Xu Mingqi, Shanghai Academy of Social Science, 2007; Hang Seng Bank.

Today, Shanghai is indisputably the national financial centre of mainland China. The city has the country's biggest stock market in terms of market capitalisation, turnover and capital raised (Exhibit 4). It also has the biggest bond market (in terms of trading value) and the only gold market on the Mainland, and the highest concentration of domestically-incorporated foreign banks (in terms of numbers and assets).

### Exhibit 4: Shanghai's dominance in mainland China's financial market

Market/industry	Parameters	End-2008	National share, %
Stock market	Market capitalisation (RMB billion)	9,725.2	82.2
	Market turnover (RMB billion)	18,043.0	67.5
	Capital raised (IPO + secondary issues, RMB billion)	191.8	61.3
Bond market	Spot trading (RMB billion)	207.6	97.8
	Repo trading (RMB billion)	2,426.9	100.0
Gold market	Spot trading (tons)	4,457.6	100.0
Insurance market	Assets managed (RMB billion)	1,000 (approx)	46 (approx)
Fund management	Number of fund management companies (Sino-foreign JV)	30 (19)	49.2 (57.6)
	Fund managed (Sino-foreign JV) (RMB billion)	721.0 (500.0)	37.1 (58.2)
Banking sector	Domestically incorporated foreign banks	number	17
		total assets (RMB billion)	845.1
Insurance sector	Foreign property insurance companies	number	7
	Sino-foreign JV life insurance companies	number	12

Sources: 《2008年上海金融市场交易总额超167万亿元》，Xinhua News, 3 January 2009; "China Financial Market Development Report, 2008", People's Bank of China; People's Bank of China; Shanghai Government website





## But not yet an international financial centre

Despite Shanghai's dominance in the Mainland's financial arena, the city is still some way behind the world's major financial centres such as London or New York in terms of market size and the availability and sophistication of financial products and services. Foreign exchange trading on the Mainland, for example, was less than 1% of those in London (Exhibit 5). And while the Shanghai Stock Exchange was ahead of that of London in terms of market capitalisation, it was less than ¼ of the latter in terms of the amount of capital raised and less than 1/10 of New York in terms of turnover.

**Exhibit 5: Shanghai's position in the world financial markets**

		Shanghai	Hong Kong	Tokyo	New York	London
Stock market	capitalisation (Mar 2009, USD billion)	1,863	1,307	2,611	7,946	1,676
	turnover (2008, USD billion)	2,587	1,629	5,586	33,639	6,474
	capital raised (2008, IPO plus secondary issues, USD billion)	28	52	11	151	125
Bond outstanding (domestic, end 2008, USD billion) *		2,210	50	11,077	24,622	1,223
FX market turnover (Apr 2007, daily average, USD billion)		9	175	238	664	1,359
Banks' external assets (end 2008, USD billion)		NA	789	2,575	2,600	5,639

\* for the whole country/ territory, not individual cities

Sources: World Federation of Exchanges; Bank for International Settlement

Quantitative measures apart, Shanghai also lags behind other leading financial centres on qualitative counts. According to the latest Global Financial Centre Index (GFCI) published by the City of London, Shanghai ranked 35 among the world's 62 financial centres in 2009 (Exhibit 6), putting it in the rank of Brussels (32) and Copenhagen (38). The GFCI ranks 62 of the world's financial centres on the basis of qualitative assessment by financial services professionals of such factors as the availability of skilled personnel, the tax, legal and regulatory environment, access to information, customers and international financial markets, etc.

To be sure, Shanghai does lead the other financial centres in some areas. In 2008, for example, Shanghai ranked the world's first in the futures trading of rubber and second in that of copper, aluminium and zinc after London Metal Exchange. It was also the world's number one in the spot trading of gold. But overall, Shanghai has a lot to catch up if it is to become an international financial centre. The question is how far it can close the gap between itself and the world's leading financial centres by 2020.





## Exhibit 6: Global Financial Centre Index

Cities	Ranking	Score	Key factors for consideration
London	1	781	<ul style="list-style-type: none"> <li>• <b>People:</b> availability of skilled personnel, flexibility of the labour market, business education and the development of 'human capital'</li> <li>• <b>Business environment:</b> regulation, tax rates, levels of corruption, economic freedom and the ease of doing business</li> <li>• <b>Market access:</b> levels of securitisation, volume and value of trading in equities and bonds, and the clustering effect of having many firms involved in the financial services sector together in one centre</li> <li>• <b>Infrastructure:</b> cost and availability of buildings and office space, other infrastructure factors such as transport</li> <li>• <b>General competitiveness:</b> overall competitiveness in terms of more general economic factors such as price levels, economic sentiment and how centres are perceived as places to live in</li> </ul>
New York	2	768	
Singapore	3	687	
Hong Kong	4	684	
Zurich	5	659	
Tokyo	15	611	
Shanghai	35	538	
Beijing	51	478	

Source: Global Financial Centre Index, March 2009, City of London

## Shanghai's competitive edge and constraints

In the city's run-up to becoming an international financial centre, Shanghai has clear advantages over many of its competitors. It has the back up of one of the world's most dynamic economies. Between 1998 and 2008, mainland's China's economic growth averaged 9.6% a year, which was among the fastest in the world. Although economic growth for the country will slow in the coming decade, the Mainland is still expected to surpass Japan in a few years' time to become the world's second largest economy after the US (Exhibit 7).

## Exhibit 7: Mainland China's economy is already the third largest in the world and looks set to overtake Japan's no.2 spot in a few years

	Share of world GDP in 2008 (%)	
	At market exchange rates	At PPP exchange rates
USA	23.5	20.7
Japan	8.1	6.3
China	7.3	11.5
Germany	6.0	4.2

Source: International Monetary Fund

Mainland China was also the world's third largest foreign trader in 2007 after the US and Germany, and the world's sixth biggest recipient of foreign direct investment (Exhibit 8). With Shanghai being situated at the heart of the Yangtze River Delta, the most dynamic and prosperous region of the Mainland, and the country's dominant position in world trade and investment, the future volume of business and financial flows for the city is guaranteed. A city with substantial business and financial flows of its own will not only generate its own momentum of growth but will also act as a magnet for overseas investors.





## Exhibit 8: Mainland China's position in world trade and investment

Merchandise exports plus imports, 2007			Foreign direct investment inflow, 2007		
	USD billion	Share, %		USD billion	Share, %
USA	3182.9	11.3	USA	232.8	12.7
Germany	2385.0	8.5	UK	224.0	12.2
China	2173.7	7.7	France	158.0	8.6
Japan	1333.9	4.7	Canada	108.7	5.9
France	1168.6	4.1	Netherlands	99.4	5.4
UK	1057.4	3.8	China	83.5	4.6
<b>Sub-total</b>	<b>11301.5</b>	<b>40.1</b>	<b>Sub-total</b>	<b>906.4</b>	<b>49.4</b>
Other	16892.5	59.9	Other	926.9	50.6
<b>World total</b>	<b>28194.0</b>	<b>100.0</b>	<b>World total</b>	<b>1833.3</b>	<b>100.0</b>

Sources: World Trade Organisation; UNCTD World Investment 2008.

Note: According to UNCTD, FDI inward flows comprise capital provided (either directly or through other related enterprises) by a foreign direct investor to an FDI enterprise, or capital received by a foreign direct investor from an FDI enterprise. FDI includes the three following components: equity capital, reinvested earnings and intra-company loans.

But the Mainland also has its constraints and weaknesses. Most obvious is capital control, the presence of which inevitably limits the business volume of the Mainland's financial market (Exhibit 9). The inconvertibility of the RMB further restricts the business volume in areas such as FX trading and IPO listing. Other constraints include the control on information and foreign participation. How far the Mainland can or is willing to remove those constraints will be the key to how far Shanghai can catch up with the world's leading financial centres by 2020.

## Exhibit 9: Some of Mainland China's constraints and weaknesses

Constraints	Weaknesses
<ul style="list-style-type: none"> <li>• Capital control</li> <li>• RMB convertibility</li> <li>• Information control</li> <li>• Limited foreign participation</li> <li>• Control on interest rates and loans</li> </ul>	<ul style="list-style-type: none"> <li>• Availability of skilled personnel</li> <li>• Risk management</li> <li>• Corporate governance</li> <li>• International competitiveness</li> <li>• Financial infrastructure</li> </ul>

Source: Hang Seng Bank

Some of the weaknesses, such as the lack of skilled personnel are easier to overcome, given the right incentives. Nor will inadequate legal and regulatory environment be a hindrance to foreign participants, as witnessed by the phenomenal inflow of foreign direct investment to the Mainland in the 1990s. Other constraints, however, will need more time to remove.

Capital control, for example, is imposed to limit the impact of any external shocks on the domestic economy, as is the inconvertibility of the RMB on the capital account. The Mainland authorities are unlikely to relax any such controls hurriedly after the present global financial crisis.

# ECONOMIC FOCUS

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The presence of an international financial centre will provide the Mainland with much greater capacity to increase the efficiency of capital utilisation, and hence will be conducive to the sustainable growth of the economy. It will provide better investment opportunities for the ever growing wealth of the country, and will be better able to serve the needs of domestic and foreign companies. In the process, it will help facilitate the internationalisation of the RMB.

How far Shanghai can match the other international financial centres by 2020 will depend on the pace of liberalisation of the constraints mentioned above. This, in turn, will depend on how the authorities weigh the benefits and risks associated with the internationalisation of the RMB, and how fast the country can build up the necessary infrastructure for defending against any such risks.

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