

## **PECC International Conference**

### ***Competition among Financial Centers in the Asia-Pacific: Prospects, Benefits, and Costs – Stumbling Blocks or Building Blocks towards a Regional Financial Community?***

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**DAY 1.** Case Study Reports: Vision, Strategies, Roadmap, and Progress

**SESSION III.** Shanghai, Wellington, and Seoul

### **Building Shanghai International Financial Center: Strategic Target, Challenges and Opportunities**

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Challenges and Opportunities**

**Paper for PECC Conference on Competition among Financial Centers in the  
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# **Building Shanghai International Financial Center: Strategic Target, Challenges and Opportunities**

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When Deng Xiao Ping made inspection tour in Southern China in 1991 he pointed out to Shanghai officials that Shanghai was an important international financial center where currency was convertible. He hoped Shanghai could regain its financial center status in the future. The next year, CPC 14<sup>th</sup> congress made a resolution to build Shanghai into international financial center and stressed that it is the national strategy to do so. Since then, 15 years has passed and what has been achieved and what is the specific target of Shanghai international financial center? This paper is trying to discuss these issues and give you a clear prospect of Shanghai international financial center.

## **1. Strategic Target Evolution of Shanghai International Financial Center**

Although the strategy to build Shanghai into an international financial center was set up as earlier as in 1992, the concrete target and when and how to achieve the target was not clear in the early time and yet it is evolving gradually. The following table 1 gives you a chronological events that gradually shaping the strategic target of Shanghai international financial center.

Table 1. strategic evolution of Shanghai International Financial Center

1991	In early 1991, Deng Xiaoping put forward the idea to build Shanghai into international center as he said: “Shanghai was the financial center in the past and was the place where currency was convertible. In the future Shanghai should still be the same.”
1992	CPC 14 <sup>th</sup> congress adopted the strategy of building Shanghai into a Dragon Head and Three Centers (International Economic Center, International Financial Center and International Trade Center )

1994	In April 1994, Central Government set up unified Foreign Exchange Trading Center in Shanghai and in 1996, Shanghai inter-bank loan center was also set up in Shanghai.
2001	State Council approved the municipal development plan of Shanghai and International Economic Center, International Financial Center, International Trade Center and Sea Transportation Center were reiterated.
2001	Shanghai municipal government made a blueprints of Tenth Five Year Plan in which contain a section of building Shanghai into International Center.
2002	Shanghai municipal government put forward a target of Four Basic Implementations to realized Four Centers and preferable policy was adopted by Shanghai towards financial institutions setting up branches and subsidiaries in Shanghai.
2004	Shanghai municipal government announced the Action Plan to Promote Shanghai International Financial Center. A strategy target of Five years for foundation building, Ten years for framework construction and twenty years to achieve the basic aim was formulated.
2005	Pudong New Area district government announced the Action Plan for 2005-2007 Modern Service Industry Development in which it put forward concrete target to have 450 financial institutions in Pudong by the end of 2007. In the same year, the state council approved Pudong as one of three trial area for comprehensive reforms and financial center function was reiterated.
2005	POC, China's central bank set up second headquarter in Shanghai
2005	MNCs in Pudong were allowed to carry out reform of autonomous handling of their foreign exchange funds.
2006	Shanghai municipal government announced the blueprints of Eleventh Five year Plan of Building Shanghai International financial center..

From what mentioned above, we could see that the strategic target of Shanghai international financial center is gradually becoming concrete and clear. By now Shanghai is already the most important financial center in China and basic elements for a financial center have been already established. According to the 11<sup>th</sup> Five Years Plan, the overall construction of Shanghai international Financial Center can be divided by three stages. The first stage is to set up and consolidate the national financial center status. The second stage is to become Asian regional financial center and third stage is to emerge as global financial center. We could see form the table 2 that from 1992 to 2001, the first stage target has been fulfilled and Shanghai already emerged as the most important domestic financial center in China. The market foundation has been improved step by step. Now it is in the second stage to become

Asian regional financial center.

Table 2. Financial Market element concentration in Shanghai since 1990

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

## **2. The obstacles and challenges that Shanghai is facing in building into an international financial center**

There are lot of comparative advantages and policy preference for Shanghai to emerge as an international financial center. Shanghai is the biggest economic metropolis and culturally the most open city in China as it was the biggest foreign concession city before communist party took power in china. It has a long history of international trade and finance and was the biggest city in Far East in 1930s. It is situated in the

mouth of Yangtze River and connects directly to the most developed Yangtze River delta area. Until now, Shanghai port handles one fourth international trade of China and contributes about 15% fiscal revenue of whole China. I believe that it is because of these elements, Chinese government made the building of Shanghai international financial center a national strategy of. As China is growing and the aggregate economy ranks 4<sup>th</sup> in the world, the financial strength is also becoming one of the largest in the world. Under this background, Shanghai is bound to play an important role in China's financial system and represent China to compete with other countries in the international financial market and it will inevitably become an important financial center in the Asia Pacific region in the future.

However, Shanghai international financial center is meeting a lot of Challenges and there are still some obstacles ahead.

The first, administrative control and lack of market mechanism in financial resources allocation made financial center difficult to play its function into full scale. Until now, Chinese financial system is still under market oriented reform and comparatively speaking, financial sector is lagging behind the other sectors' reform. China remains a strong government control over financial activities and transactions. State own commercial banks allocate credit not only according to market principals. Government orientation still plays a role in loan making. Big four banks vertically organized according to administrative layers and managed according to each branch's administrative ranking. Thus cross regional flow of funds and capital are constrained to limited scale. Even after three of Big Four Banks being listed in the capital market and invested by foreign strategic investors, these four banks' operation mechanism still remain the almost same. Capital market IPO and re-issuance are controlled directly by China Securities Regulatory Commission. Under this malfunctioned financial market condition, financial center could only play very limited role in resources allocation and its function as the hub of funds accumulation and channeling are limited. This is the most important reason that many people believe Beijing is a

more important financial center in China than Shanghai as they think big four state banks headquarters are located in Beijing and all headquarters of regulatory commissions and important securities companies are located in Beijing too. Beijing is the center of administrative financial resources allocation in China until now. All these lead to some unhealthy competition among Chinese big cities for the status of international financial center. Not only Beijing, cities such as Tianjin, Shenzhen, even Dalian, Guangzhou put forward the blueprints to be international financial center and ask for preferable policy treatment from the central government. People still believe that the administrative measures and policy undertakings could decide the most things that a financial center needs. Actually, market mechanism in financial resources allocation is the most important thing for a city with comparative advantage to emerge into a financial center.

The second, low degree of internationalization of the financial market made Shanghai has little influence in Asian and Pacific region. Although Shanghai is the most important financial center in China and the market volume of some financial activities is big enough to compete with other financial centers in the region, Shanghai has little direct influences on other markets. The most important reason for this is the capital account control and limited convertibility of Chinese RMB. Rather strict nominal control measures constrain the cross border financial transactions and capital flows. If a financial market could not accumulate capital worldwide and channel funds to where needs them worldwide, or at least in the Asian Pacific region, it is hard to say it is an internationalized market. This is the main reason for the weakness of Shanghai as international financial center in comparison with many other Asian Pacific cities trying also to become international financial center. Right now, there 100 foreign banks operating business in Shanghai. The absolute number is not smaller as compared to many other cities in the region But the assets owned by foreign banks only make 14% of total banks assets in Shanghai. This ratio is 69% in New York and 50% in London. The foreign banks assets share in total banks assets in Singapore is 75%. So the role played by foreign banks is quite different and we could see the gap

between Shanghai and other important international financial centers. Another example is that Shanghai Securities Exchange is already the seventh largest in the world in terms of listed companies' capitalization volume. It has already reached to some 15 trillion RMB as it grows rapidly since last year and capitalization value doubled. Yet, there is not any foreign company being listed in the market and it is not yet open fully to foreign investors. This made Shanghai Securities Exchange a closed market and has very limited influence on the world capital market. Shanghai capital market only passively absorb external shocks at present. The last but not least example is the foreign exchange market. Daily trading volume of important international financial center is very impressive. London is 1.2 trillion USD, New York is 565 billion USD. Singapore and Tokyo are all more than 200 billion USD. Shanghai is the center for foreign exchange transaction but the daily turnover is on 4.4 billion US dollars. Without opening the market to foreign financial institutions, the market has very limited international influence. So to me, internationalization is the most important element that Shanghai develops into an international financial center. Thus, speed up the pace of capital account liberalization and RMB full convertibility would be the most important step for building Shanghai international financial center.

The third, legal system and other soft infrastructure need to be improved to host international financial transactions. That only have the willingness and hope to become international financial center and tries to enjoy the benefit of international financial center is not the way going ahead. You should provide enough infrastructures from hard to soft. Shanghai has been trying hard to construct enough so called hard infrastructure from building first class office space to transportation and telecommunication facilities. However, in terms of so called soft infrastructure is not yet good enough to attract international financial transactions to be initiated and carried out in Shanghai. Usually, international banks would initiate a cross border transaction in Shanghai and move to Hong Kong or Singapore to execute it with the contract governed by Anglo-Saxon legal terms. If we could not establish suitable legal frameworks for international finance and strictly implement them in practice, it would



be really difficult for Shanghai to emerge into an international financial center. Broadly speaking, well established culture of credit worthiness and legal structure of international standard are more important infrastructure for international financial center. In this regard, only Shanghai municipal government's efforts is far from enough and we need central government efforts as well as whole nation's efforts too.

Other than those important elements, some seemed less important elements also need to be improved such as human resources, business cost and government service efficiency. Shanghai is considered the pool of national human resources and many talented people work in Shanghai. Multinational financial institutions will not be very difficult to find their middle range management employees in the local labor market. But high ranking managers usually are in a kind of short supply and need to be found in the international market. This sometime leads to extra-cost for new comers in Shanghai. We need to enhance our own educational system and improve the policy to attract back those university graduates in the western countries to work for Shanghai financial centers. However, the quantity of English speaking qualified young graduates in Shanghai is not so satisfied and foreign financial institutions are complaining not having enough qualified employees. As for those return backs form abroad, HUKOU and some other domestic problems such as international traveling, next generation education etc. also become obstacles for their settle-down in Shanghai. So there are lots of rooms for improvement in this regard.

As for business cost escalating, Shanghai is also meeting big challenges. Real estate price hiking and rent rising made Shanghai's business cost already world metropolitan level. Comparative advantage of low labor cost is diminishing. Government on a whole is supportive and friendly toward foreign investment, but bureaucratic measures are sometime very annoyed and regarded by foreign institutions as extra-cost of their business. If Shanghai is to compete with other cities in the region for international financial center, it must be in the position to solve these problems as soon as possible. Otherwise, it may lose it comparative advantage and momentum as

the most potential candidate of international financial center in the Asian and Pacific region.

### **3. The measures that Chinese Central and Shanghai governments are going to take in the future**

Consensus has been reached gradually among central government officials and Shanghai government. All have aware that Shanghai international financial center is the national strategy and neither Shanghai government nor central government efforts alone will be enough. Both level efforts and policy orientation should put together. Recently, Shanghai municipal government set up a Leadership Committee of Shanghai International Financial Center. The members of the committee are mostly the heads of state financial regulatory commissions, from CSRC, CIRC, CBRC to POC and with two Beijing based think tanks leaders. Shanghai mayor is the Chair. This committee is aimed to mobilize all efforts both from Beijing and Shanghai to promote Shanghai International Financial Center. This move shows clearly the awareness of importance of Beijing support by Shanghai municipal government. Hopefully, the committee will make real contribution toward this end. In his recent inspection to Shanghai, Premier Wen Jiabao reassured central government support to build Shanghai international financial center and promised to give full policy backing. He urged Shanghai official to work hard to realize the target of Four Centers, especially international financial center.

Shanghai municipal government gradually realized that the biggest obstacle in the road to international financial center is the lack of market mechanism and internationalization of financial market in China. Shanghai financial center could not become international center without real progress in above key aspects. So now Shanghai government is trying hard towards a correct direction. In the previous plans drawn by Shanghai government, most efforts were put on infrastructure building and pure market scale enlargement. For instance, in the 11<sup>th</sup> Five Years Plan for Shanghai Financial Center Development, one of the target is that capitalization volume of listed

companies in Shanghai Securities Exchange is to reach 7 trillion RMB by the end of 2010. Now only in the middle of 2007, this volume already exceeds over 15 trillion RMB. So even if all the targets set forth in the 11<sup>th</sup> Five Years Plan had been fulfilled by the end of 2010, nobody could really be sure that Shanghai is an international financial center by then. The following targets are drawn in the 11<sup>th</sup> Five Years Plan for Shanghai Financial Center and the key indicators of market mechanism and internationalization were carefully avoided. The reason for this omission is clear. Reform and policy measures in further marketization and internationalization are not in the hands of municipal government and Shanghai could not really make the plan under its own capacity.

Table 3. Main Targets in 11<sup>th</sup> Five year Plan for Shanghai Financial Center

Indicators linked with market volume	Indicators concerning financial institutions business scale
Direct financial transaction takes up to 25% of all China	The Assets of financial institutions take 10% of all China financial institutions.
The total financial transaction reach to 80 trillion RMB	Deposits stock value reach to 4.5trillion RMB
Money market trade volume reach to 40 trillion RMB	loan stock value made by Shanghai Banks reach to 3.2 trillion RMB
Shanghai Securities Exchange listed companies worth 7 trillion RMB	Commercial entities acceptance ratio on credit cards reach to 70% and above
Shanghai Futures Exchange enter the top ten ranks of world futures exchanges	Card usage in consumption reach to 40% and above.
Shanghai gold market become one of the important international gold market	Insurance deepening ration reach to 5% (insurance premium / GDP )
Non-listed equity market in Shanghai become nationwide market	Insurance density ratio (insured value per capita) reach to 4000 RMB

With the reiterated support from Premier Wen Jiabao and central government officials, Shanghai municipal government realized the important elements of international financial center and tried to revise the 11<sup>th</sup> Five Year plan for Shanghai Financial center. At present, new plans are under drawing and think tanks such as our institute are involved in the policy recommendation. I can imagine that China's financial market is going to open more widely and quickly so as to meet new challenges in the new international condition. In the process of opening and liberalization of Chinese

capital market, the speed of Shanghai emerging as an international financial center is go to accelerate.

There are many plans and policy measures are under discussion and will be taken in the future as regard to building Shanghai International Financial Center especially those to promote internationalization of Shanghai financial market. Owing to some reason, I can not tell you when and how the policy measures are going to be introduced and implemented. What I can tell is that some of the policy measure are under discussion and hopefully will be adopted in the future.

The first, further opening Shanghai securities market to both investors and fund raisers. Until now, China's capital market only opens its B share to foreign investors and through QFII. No foreign companies are yet allowed to be listed in both Shanghai Securities Exchange and Shenzhen Securities Exchange. In the future, the number of QFII will be expended and more investment volume will be granted to them. Some special investment fund will be allowed to investing to China's stock. More importantly, foreign companies will be allowed to list in Shanghai Securities Exchange. By doing so, Shanghai capital market will enter a real stage of internationalization.

The second, foreign government entities and international organizations will be allowed to issue bonds and other debts in Shanghai. Some big companies are under discussion to be allowed to issue bonds in Shanghai either denominated in RMB or foreign currencies.

The third, some foreign securities companies will be granted with license to do the intermediate business conducting Chinese people's portfolio investment abroad. Of course, foreign company's entry to domestic intermediate or underwritings business will still be under some control in the near future.

The fourth, expand the scope of QDII and allow domestic citizen to invest foreign financial assets directly. Opening to Hong Kong stock market is the first step. In the future, channels to invest in the US or European market will also be introduced. By doing so, Shanghai financial market will play more important role in provide the service to channel the investment.

The fifth, unified the A and B share market and allowed B share holder being converted to A share holder so as to open the A share market to foreign investor. Of course, this is only a kind of proposal at present and the principle may be correct while the way to handle it could very different in the future. However, under the process of opening the financial market, the problem of separation of A and B share market will be solved sooner or later. If this measure has been adopted, as the biggest capital market in China, Shanghai Securities Exchange will become competitive in the East Asian region in terms of scale and liquidity.

The sixth, in the process of RMB currency full convertibility, Shanghai will be the hub of RMB denominated transaction center. China is going to promote more denomination of RMB in international trade and banks in Shanghai will be asked to conduct RMB clearing and settlement business for foreign trade transactions. If the internationalization of RMB is developing together with RMB full convertibility, more financial transactions denominated in RMB will take place. Then Shanghai will have the possibility to be the ideal place to center all these transactions pricing and clearing.

The seventh, open Shanghai Foreign Exchange Trading Center to more foreign financial institutions. Until now, only Chinese financial institutions and foreign subsidiaries registered in China are allowed to participate the market. In the future, foreign entities with equivalent account in China will be allowed to participate the market. By doing so, Shanghai foreign exchange market will enter into a real international market stage and will joint into the integrated world foreign exchange

market. Of course, this may not be happen in the near future as the process of lifting all measures of foreign exchange control is gradual and RMB full convertibility is only marching step by step.

The last but not least, improve the infrastructures especially the so called soft infrastructure. These include improvement of legal system and implementation behavior of all regulations and laws, building a good culture of credit worthiness by establishing a region-wide credit record for all economic entities and every citizen, and suitable living and working conditions for foreign financial institutions and their employees. Shanghai municipal government and Pudong Government are trying to introduce some local legislation and regulation according to international standard concerning financial contracts and implementation of the contracts. The central government already granted Pudong with comprehensive reform rights that could make trial anything according to international standard. Yangtze delta regional credit worth net is under construction and it will cover all entities and individual's credit record of 15 cities in the region. It will provide the inquiry service to goodwill customer. As business cost controlling, Shanghai municipal government is trying cut more licensing procedure as more as possible in order to reduce the cost connected to the administrative measures. For other cost such as rent and labor, the government cannot do anything directly. But lowering the income tax and other fees is in under discussion. For the transportation cost and convenience of international traveling, Shanghai municipal government is also discussing with central government departments to find a way to resolve some of the inconvenience.

On a whole, Shanghai is now marching toward a right direction to an international financial center. Right now Shanghai is not yet an international financial center and does not really joint the competition with other cities in the Asian Pacific region, but its potential is enormous. By 2020, I believe, Shanghai could become one of the most important financial centers in this region.