SHANGHAI: GLOBAL FINANCIAL CENTER? ASPIRATIONS AND REALITY, AND IMPLICATIONS FOR HONG KONG

By Scott Tong

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Shanghai's newest trophy skyscraper provides a glimpse into the city's global aspirations. On the way up to the world's tallest observation tower, each visitor is shepherded through a 3-D kaleidoscopic light exhibit and a futuristic elevator with space-age music piped in. The not-so-subtle suggestion: Shanghai = The Future. The building's name, by the way, is the Shanghai World Financial Center.

Shanghai has long aspired to become Asia's top money-handler, and in the process challenge Asian rivals Hong Kong, Tokyo and Singapore. Locals—not known for their modesty or lack of ambition—cheered in March 2009 when China's central government endorsed a blueprint to transform Shanghai into a global shipping and finance hub by the year 2020. Regular state media coverage of developments often carries a tone of inevitability.

But for all the headlines, there remains a sizeable gap between ambition and reality, between now and then. And Shanghai's economic elite know it. In general, they agree: (1) Shanghai has a long road ahead, (2) Beijing controls the speed limit, and (3) even if reforms go well, it's far from certain Shanghai will eclipse international financial powerhouses like Hong Kong. Economist Xu Xiaonian of Shanghai's China Europe International Business School has gone so far as to declare "Shanghai forever cannot catch up with Hong Kong."[1]

What motivates Shanghai? Perhaps the most obvious rationale for crafting a financial sector is jobs; hundreds of thousands of high-paying, respectable jobs that won't further pollute the city's already smoggy skies. Both locals and outsiders think business and finance play to the city's strengths. It's historically a place where smooth operators seek their fortunes: Chinese merchants fleeing regional war and instability, opportunity-seeking migrant workers, opportunists. Perhaps more than any other place, Shanghai is where a person who can negotiates the lowest price for a good or service is rendered a superior human being.

The Shanghai of the future also wants to meet the demand for financial services today. A lot of money sloshes around this city. Shanghai's port is the world's busiest, measured by cargo tonnage [2] (Hong Kong ranks 9th). By container throughput it ranks second to Singapore (with Hong Kong third). Shanghai, which literally means "on the sea," sits at the mouth of the Yangtze River, a key conduit toward the mainland's interior, and it's closer than Hong Kong to key cities in China and North Asia. Add in manufacturing, logistics, and a budding entrepreneurial culture in neighboring Jiangsu and Zhejiang provinces, and greater Shanghai —officially the Yangtze River Delta Economic Region—accounts for 19% of China's GDP, 37% of its exports and 49% of foreign investment.[3] Shanghai hosts the mainland's key trading markets for futures, gold and foreign exchange. It's a fashion capital for young people with large cameras and small cell phones. All this economic activity creates demand for credit, insurance, trade finance, and stock and bond markets.

"Financial markets are, basically, pretty simple things," investment bank S.G. Warburg chairman David Scholey told a group of Swiss bankers in 1987. "All they require is a surplus of capital … a roughly offsetting deficit of capital … and an intermediator.".[4] Simply put, Shanghai wants to become a convenient place for global savers of money to bump into global spenders of money. Previously, few places in the world fit that description. Not long ago, Shanghai did.

Shanghai: A Historic International Financial Center

In the 1930s, Shanghai stood as the Asia Pacific's undisputed financial hub. The "Paris of the East" hosted not just opium dens and cabarets, but also the world's third-largest stock market by capitalization. In 1934, 33 foreign banks operated branches in Shanghai, more than in Hong Kong (21) or Singapore (17).[5] International bankers exchanged foreign currency. They lent money to British property investors and Japanese cotton factory owners. They financed government railways, and military campaigns by the then-ruling Kuomintang (KMT). At the time, the neo-classical, domed headquarters of the Hong Kong & Shanghai Bank (since renamed HSBC) stood out as the most visible presence of the foreign bankers. The ionic-columned structure anchored Shanghai's riverfront boulevard, the Bund, and was the world's second-largest bank building, after the Bank of Scotland in London.[6]

Shanghai's fall came quickly. Global currency crisis, wartime inflation, Japanese invasion and, finally, the communist takeover in 1949 pushed

entrepreneurs, bankers and capital out of the mainland. Mao Zedong's government sealed off China from the outside world, and many bankers fled to Hong Kong. Today, Hong Kong by one measure ranks as the world's fourth most competitive financial center, behind London, New York and Singapore.[7] Shanghai, meanwhile, sits down at 35th, according to the 2009 Global Financial Centres Index compiled by the City of London. The index compares cities on dozens of metrics, including MBA rankings, taxes, availability of capital, infrastructure, corruption, safety, even the weather. The index does note that Shanghai, along with Singapore and Dubai, is likely to become "more significant in the next few years."[8]

Shanghai's plan to get back in the game focuses not on the historic Bund, but the new Pudong district directly across the Huangpu River. Pudong's modern skyline features bank buildings, the Shanghai stock exchange, the Pearl Tower tourist attraction and the trophy World Financial Center. Yet hardware alone does not a financial eco-system make. A big missing piece: sufficient skilled workers to fill those fancy offices. At a May 2008 forum, China's top bank regulator, Liu Mingkang, said New York employs 400,000 financial professionals, London nearly 300,000, and Shanghai a mere 100,000. (Hong Kong's financial workforce is 192,000 strong, says its government.) Liu bemoaned that Shanghai's financial professionals "lack in experience and have a long way to go in many aspects such as professional quality, degree of globalization, and dedication."

In effect, Shanghai—which pushed out foreign bankers 60 years ago—wants them back. In May 2009, two months after Beijing endorsed Shanghai's Project 2020, city officials pledged housing and healthcare benefits to entice financial professionals. They suggested foreign firms will be allowed to list shares on the mainland in as early as 2010. Among the first in line: The historic Hong Kong & Shanghai Bank (which, however, as HSBC has just decided to move its chief executive back to Hong Kong from his present London office). And to lure global funds and managers, regulators in August eased restrictions on foreign private-equity firms raising domestic currency from Chinese investors.

The upshot of these reforms: Shanghai Inc. has obtained a degree of parental permission to cut through mainland China's corporate red tape. The central government has given Shanghai "license to be a little more adventurous, to create conditions to encourage foreign investors to do things in different ways than in the past," says Arthur Kroeber of the Beijing consultancy Dragonomics. And yet, relative to the world's most

open, deregulated economies like Hong Kong, mainland China still has a gargantuan amount of government to move out of the way. Shanghai's personal income tax rate tops out at 45%, compared to 17% in Hong Kong. Most significant Chinese banks—the locus of corporate finance—remain state-owned. Stock market regulators pick which companies go public, and when. "The market doesn't have much say in who gets capital; the government does," says independent economist and Morgan Stanley alum Andy Xie. For now, he says, Shanghai's notion of becoming a free-market, international financial center "is still a concept."

Chinese regulators also control the rollout of new financial products and exchanges. For now, Shanghai the aspiring financial supermarket has shelves that are relatively bare—especially compared to what's on offer in Hong Kong. In July 2009, Fang Xinghai, director-general of the Shanghai's municipal office of financial services, told a J.P. Morgan conference that "imminent" reforms will include the introduction of stock index-tracking exchange-traded funds, foreign company listings in Shanghai, financial futures and additional commodity futures products. A brand new stock market patterned after Nasdaq—the Growth Enterprise Board—opens for business in the fall of 2009.

As optimists see it, the new stock exchange holds great promise for the Chinese economy. The world's workshop, as the saying goes, wants to graduate from made-in-China to created-in-China. It wants to nurture an innovation economy, China 2.0. But on the mainland, it's hard "for new knowledge to be commercialized," according to securities attorney Scott Guan of Jade & Fountain PRC Lawyers in Shanghai. Inventors often are turned away by banks, and thus chase high interest-rate options, aka family, friends and loan sharks. The Growth Enterprise Board aims to nurture venture capital and private-equity investment by providing a viable alternative.

Tracking all the changes in Shanghai is no easy feat: the new stock boards and products, subsidies, incentives and recruitment programs. But it's not just what's happening, it's when. The 2009 global financial crisis could have shaken China's faith in the free market. After all, policymakers reform the economy by way of trial-and-error, by "crossing the river by feeling for the stones" as the saying goes. And yet the mainland has not retreated from reforms. "To the contrary they have accelerated," says international finance specialist Zhang Bin of the Chinese Academy for Social Sciences in Beijing. Dragonomics consultant Arthur Kroeber figures Chinese leaders realized the global recession meant "the old export

engine was not going to come back." Thus it was high time to stoke the domestic economy, including financial market reform.

The Great Financial Wall

One of Shanghai's biggest regulatory hurdles is actually a wall, the Great Financial Wall. Chinese currency controls, to a great degree, lock foreign money out and trap domestic money in. Chinese investors have few options to invest outside the mainland and, with few exceptions, foreign investors can't buy shares on the Shanghai and Shenzhen stock markets. The obvious point of the wall is to protect China from global financial storms offshore, such as the 1997 Asian financial crisis that battered currency and stock prices in more open economies like Hong Kong, Indonesia and Thailand. The mainland government is piloting programs to internationalize the RMB—via currency swaps with other countries' central banks and settling trade deals with Chinese money instead of dollars or euros. But Beijing controls currency policy and by most accounts it will take years, even decades, for full convertibility. Until then, global investors will be on the outside looking in, and Shanghai will remain a domestic financial center.

"There's an old saying, capital goes where it's invited, and stays where it's treated nicely," says Jim Angel, former visiting economist at the Shanghai stock exchange and finance professor at Georgetown University in Washington, DC. "And part of treating capital nicely is letting people move it in and out." Obviously, international currency moves freely in and out of Hong Kong. Until Shanghai offers the same service, "it can't even talk about being an international center," said Pan Yingli, who researches financial centers at Shanghai's Jiaotong University.

Rule of Law a Necessity

If currency is the main policy challenge, the challenging ethical leap forward is establishing a credible rule of law. Ask a financial professional in Shanghai about laws and enforcement and the rhetorical question frequently comes back: "Would you trust a Chinese court?" Securities regulators acknowledge insider trading is rampant, particularly the scheme known as front-running: a fund manager in-the-know purchases shares before the fund does, then rides the price up as the fund makes it hefty purchase. "Insider trading is becoming more sophisticated and price manipulation is taking on many more forms," Fan Fuchun, then-vice chairman of the China Securities Regulatory Commission, said in a 2007

interview.[9] The CSRC itself faces criticism lacking in enforcement staff, and for overlooking alleged abuses by the politically connected. The one grand exception: Shanghai's former party secretary in 2008 was sentenced to 18 years in prison, for his part in a string of scandals that siphoned $4.8 billion from the city's pension fund.

Certainly Shanghai holds no monopoly over financial fraud. Hong Kong, New York and London have witnessed their own high-profile cases. The difference, though, for those who have lived on the mainland, is the general presumption in any business sphere that rules are for someone else. Every day, office faxes and mobile phones hum with offers of fake receipts, for workers to pad expense reports and companies to conceal taxable revenue. One particularly snarky commentator suggests tax evasion is China's official sport. At the very least, Shanghai business leaders know the mainland has a perception problem. Market participants by and large do not trust the system is transparent and nonpolitical, enforced by dependable umpires.

Whither Hong Kong?

As Shanghai pursues Project 2020, many locals are outspoken about their city's desire to leapfrog Hong Kong. There's a resurgence of "our buildings are nicer than yours" sentiment. The most voluble and optimistic reckon the RMB will go global and render the Hong Kong dollar obsolete. Perhaps. But for the record, mainland officials tread cautiously. Xia Bin of the central government's State Council Development Research Center told the China Economic Times in August that, while Shanghai's RMB financial transactions "will inevitably surpass" those of Hong Kong by 2020, Hong Kong will remain a center for offshore transactions and channeling Chinese RMB investments overseas.[10] Shanghai municipal official Fang Xinghai adds: "China's strategic decision to turn Shanghai into a global financial center doesn't preclude the roles of other cities."

That carries a whiff of PR, but it may be more than that. Financial veterans in Shanghai talk of Hong Kong retaining its considerable edge for the foreseeable future. In the near term, if Shanghai poaches financial business from Hong Kong it would be of the vanilla category. International economist Xu Mingqi of the Shanghai Academy of Social Sciences thinks that, in the future, more mainland companies will choose to go public in Shanghai than Hong Kong. Or they may be told to. More foreign investment may come into the mainland via Shanghai. Indeed, mainland financial centers stand to dominate most RMB activity.

Yet it will be difficult to dislodge Hong Kong in areas where it has vastly superior human capital, experience and credibility. These include asset allocation, derivatives, low-tax offshore business, legal services and arbitration, and foreign currency transactions—that is, those which involve dollars, euros and yen moving in and out. In his new book *"Capitals of Capital",* University of Geneva economic historian Youssef Cassis argues that financial centers gain and lose influence at a glacial pace. "Given the transformations in the world economy," he writes, "their number has remained remarkably stable."[11]

So as Shanghai rises, or tries to, it may well continue to serve a role complementary to those of Hong Kong and other mainland financial cities. It may be instructive to think of New York and Chicago, one hub for domestic business, another for international deals. Certainly the mainland Chinese pie is big enough, as China prepares to surpass Japan as the world's second-largest economy. In the early 1990s, Chinese policymakers talked officially of Shanghai as the financial "head of the dragon." However, the dragon could grow two heads, or more.

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