Executive Summary

Shifting Capital
The Rise of Financial Centres in Greater China
A Chatham House Report
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China's rise as an economy of systemic significance is among the most remarkable stories of the 21st century, and has come to define modern international economic relations. With its strategic emphasis on export-oriented growth, China has transformed itself within a couple of decades into the world's second largest economy, powered by a labour-intensive manufacturing sector. However, despite its vast production capacity and trade links with global markets, China lacks depth in its financial sector, and its currency, the renminbi (RMB), has very limited use in international trade and finance. For example, a close look at China's international investment position as a percentage of global stocks shows that China's foreign direct investment and international portfolio assets and liabilities are a tiny percentage – less than 3% – of total global stocks. Compare this with its foreign exchange reserves, which account for about 30% of global stocks.

Beijing acknowledges the need to develop a deeper financial sector and a currency that is widely used to settle international trade, thereby reflecting the significance of China's economic power. Deng Xiaoping championed a policy of incremental economic reform that he called 'touching stones to cross the river'. It is in this spirit that China is embarking on a cautious journey to reform and open up its financial market and its currency, integrating them into the international financial and monetary system.

Much like its trade integration over the last twenty years, China's financial integration will trigger fundamental changes in the global economy in the coming decades. Financial reform will eventually allow Beijing to open China's capital account fully and to make its currency fully convertible. In turn, this will help in rebalancing the global economy and eventually alter the international monetary system. This is why policy-makers around the world, and particularly those from other systemically important countries, should pay close attention to the changing financial landscape in China.

This report focuses on the steps that China is taking to reform its financial services sector through the incremental development of the financial centres in the Greater China region. As clusters of activities and services that connect different operators and facilitate financial transactions among them, financial centres are where China's reform measures are seen in action and where their impact can be assessed and measured. Thus they are the report's main unit of analysis.

The report takes a broad regional approach, and so includes the four financial centres in Greater China – Shanghai, Shenzhen, Hong Kong and Taipei. These are centres that, in different ways and with different competitive advantages, both rival and complement one another in serving Greater China's large regional economy, as well as helping it become more integrated in the world economy.

China's financial reform, and in particular the process of internationalizing its currency and eventually making it fully convertible, binds these financial centres together and shapes their future development. For instance, in the few years since its launch in 2009, Beijing's RMB strategy has helped redefine Hong Kong's financial sector. The RMB is now the third most used currency in the special administrative region, after the Hong Kong dollar and the US dollar, and accounts for about 10% of total banking deposits. The volume of RMB deposits accumulated in Hong Kong has steadily increased from RMB56 billion in July 2009 to RMB588.5 billion at the end of 2011. The RMB lending business in Hong Kong has also experienced rapid growth, rising from RMB2 billion in 2010 to RMB30.8 billion in 2011. Similarly, the market for RMB-denominated bonds has grown at a rapid pace since its inception in 2007. The volume of new issuances in 2011 was almost RMB104 billion, tripling from RMB35.8 billion in 2010. The total outstanding bonds were worth about RMB200 billion at the end of 2011.
The development of these four financial centres provides a picture of the complex evolution of China's financial reform, which is a policy-driven process where political considerations directly interact with market forces. The Fourth National Financial Work Conference that was held in Beijing in January 2012 clearly identifies eight key areas of financial reform over the next five years, including measures to strengthen financial regulation and financial infrastructure.

The reform policies decided by Beijing will, for example, shape both the development of Shanghai as an international financial centre (IFC) and its eventual integration into international capital markets, and the consolidation of Hong Kong's position as one of the world's leading international financial centres. By integrating China's financial sector into international financial markets, Beijing will also assert and expand its financial influence in the region while becoming a more significant player on the international financial stage.

The report argues that Hong Kong will remain the dominant IFC in the region because of its well-developed regulatory system, its existing reputation as the most liberalized financial centre in Asia and its unique competitive advantage over other IFCs such as New York or London – i.e. the 'China dimension.' Despite concerns that Mainland authorities may expect it to make way for Shanghai eventually to become the largest RMB onshore IFC in mainland China by 2020, Hong Kong is likely to maintain its competitive edge for a long time to come, irrespective of policy shifts or decisions made in Beijing.

Even if Shanghai is unlikely to supplant Hong Kong as the region's dominant IFC in the next few years, the size of mainland China's real economy indicates that the country has ample capacity to accommodate two major international financial centres in the longer term. Moreover the decision by China's State Council in 2009 to develop Shanghai as an international financial centre by 2020 suggests that by the beginning of the next decade Shanghai may have considerably narrowed the gap that now exists with Hong Kong.

For its part, Shenzhen will mainly serve as a domestic financial centre, focused on the needs of small and medium-sized enterprises (SMEs) and start-ups located in Guangdong that currently have difficulty in obtaining credit through the banking sector. Taipei, on the other hand, can benefit from its experience with high-tech SMEs in the broader Asia region to target Chinese SMEs at a relatively advanced stage of growth. Although the capital markets in Taiwan remain small relative to other centres in the region at present, further cross-strait cooperation in the financial sector, along with mainland China's financial reform process, will provide Taipei with new opportunities as a complementary regional financial centre.

Along with the development of the four financial centres in Greater China, the three financial systems in the region – those of mainland China, Hong Kong and Taiwan – are expected to undergo a certain degree of integration over the next ten years. The development of Hong Kong as an RMB offshore centre has reinforced the financial linkages with the Mainland, and this process is set to continue, leading to more systemic integration. Within this framework, closer cooperation and coordination among Shanghai, Hong Kong and Shenzhen should develop gradually. For example, the report shows that it will be both technically and politically feasible to form a multi-tiered trading platform as well as a broader equity market in the Greater China region over the coming years. Meanwhile, a currency repatriation scheme, bridging the RMB onshore and offshore market, is also shaping up between Shanghai and Hong Kong.

From Beijing's point of view, the degree of cooperation among the four financial centres implies the emergence of a 'division of labour' between them, each with its own designated role. But it is hard to see this as a sustainable arrangement, particularly once the Chinese capital account is fully liberalized. If and when the policy barriers are relaxed, market forces will ultimately lead capital resources, business and talent to cities where the market is most efficient, cost-effective and profitable, and where it is most pleasant to live. By that time, only those financial centres with a strong competitive edge that cannot be eroded by policy decisions from Beijing will find themselves at the top of the league table of international financial centres.

China's financial and monetary reform is a complex policy-driven process with several overlapping levels and related goals. It has a broad span, from the reform of the
banking system and the development of the bond market to the interest rate and exchange rate reforms. It revolves around and at the same time is supported by the strategy of developing the RMB as an international currency without making it fully convertible yet. Most of all, it is where political considerations and market preferences meet. Thus China faces the difficult challenge of reconciling the need for an efficient and market-driven financial sector with its policy-driven growth strategy.

If all goes according to plan, China will eventually emerge on the international scene as a major financial power, the issuer of one of the key reserve currencies within a multi-currency international monetary system, with deeply connected international financial centres where domestic and international capital is mediated by domestic and international firms. All this will correct the fundamental problem that currently afflicts the international economic and monetary system – where the world’s second largest economy and the first exporter is managing its exchange rate, resulting in a large current account surplus and a very large accumulation of foreign reserves.

What China is doing is critically important not only for the development of the Greater China region, but for the world as well. It is also historically unprecedented. Thus there is ample scope for policy experimentation, and the challenges are enormous. Possibly the most difficult of these challenges is that China has no roadmap or past experience to rely on. Indeed it is the first emerging country to seek a comprehensive reform and expansion of its financial services sector and to establish a truly international currency.

Most of all, China’s financial reform is a gradual process that will take time to deliver the expected results. As there is no official timetable beyond a few goalposts, the full impact of China’s measures is likely to be noticeable in five to ten years. This may sound far too slow given the current urgency of rebalancing the world economy, and disappointing in the short term. But it is critical that China carefully manages its transition to a modern financial system. A financial crisis, or protracted financial instability in China, would have a systemically devastating effect on the rest of the world.

Policy recommendations

Building modern financial centres and an efficient national financial system in Greater China will be fraught with challenges, and the future of these four cities is yet to be determined. In order to address some of these challenges the report offers the following ideas to Chinese decision-makers:

- **Moderate government intervention**: Steadily reduce government intervention in the financial services sector and provide greater operational independence to the financial institutions, including state-owned banks. This could promote a favourable environment to implement full commercialization of the banks and efficient allocation of financial resources.

- **Accelerate the reform of the banking sector**: Expedite the ongoing reform to develop a market-driven banking sector that adheres to international standards and regulations. Free the country’s banks from welfare goals and liberalize interest rates to remove market distortions and minimize misguided investment decisions, as well as creating and reinforcing appropriate incentives and capital allocation mechanisms.

- **Develop capital markets and reduce reliance on the banking sector for the financing requirements of the economy**: Rebalance the financial sector by creating a level playing field for various types of financial institutions. Develop the necessary financial infrastructure and a rigorous legal regime to encourage greater private-sector presence in the market and fundraising through capital markets, particularly in bond markets. Reduce the administrative controls that prevent the further deepening of capital markets. Nurture the asset management industry to develop a broad range of financial products with different risk/return profiles to promote entrepreneurship and meet the risk preferences of investors.

- **Increase Hong Kong’s exposure to the financial systems of the BRICs and other emerging-market economies**: Improve Hong Kong’s international market influence in these markets and achieve a greater competitive advantage vis-à-vis London and New York.
• **Promote greater cooperation and coordination between Hong Kong and Shanghai:** Take steps to ensure that the competitive advantage of both cities is managed through effective cooperation and coordination to achieve the macro goals of China’s financial reform process.

• **Develop Shenzhen as a regional financial centre:** Encourage Shenzhen to serve the demand stemming from the growing number of SMEs that lack adequate credit facilities, enabling it to support entrepreneurship and indirectly contribute to the deepening of capital markets.

• **Carve out a niche for Taipei in response to Beijing’s strategies:** Taipei should take advantage of the new opportunity provided by mainland China’s integration with the global financial system to redefine itself as a regional financial centre. To this end, it needs to understand and anticipate Beijing’s strategies, given its role as an ‘outsider’ in relation to the Mainland’s financial reform strategy. It is therefore in the interest of the Taiwanese government to engage proactively with the Mainland and respond strategically to its policies.