# Shifting Capital
## The Rise of Financial Centres in Greater China

A Chatham House Report

Paola Subacchi, Helena Huang, Alberta Molajoni and Richard Varghese

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The cut-off date for information in this report is 31 March 2012.

# List of Abbreviations and Acronyms

| | |
|---|---|
| ABC | Agricultural Bank of China |
| ADBC | Agricultural Development Bank of China |
| AMC | Asset Management Company |
| AUM | Assets under Management |
| BOC | Bank of China |
| CBRC | China Banking Regulatory Commission |
| CCB | China Construction Bank |
| CDB | China Development Bank |
| CEPA | Closer Economic Partnership Agreement |
| CIRC | China Insurance Regulatory Commission |
| CNH | Chinese Offshore Yuan |
| CNY | Chinese Yuan* |
| CSRC | China Securities Regulatory Commission |
| ECFA | Economic Cooperation Framework Agreement |
| ETFs | Exchange Traded Funds |
| FDI | Financial Development Index |
| FMCs | Fund Management Companies |
| FSC | Financial Supervisory Commission |
| GFCI | Global Financial Centres Index |
| HKEx | Hong Kong Exchange and Clearing Limited |
| ICBC | Industrial and Commercial Bank of China |
| IFC | International Financial Centre |
| IMF | International Monetary Fund |
| IPO | Initial Public Offering |
| LSE | London Stock Exchange |
| MoF | Ministry of Finance |
| NDRC | National Development and Reform Commission |
| NHMPE | Non-H-Share Mainland Private Enterprises |
| NYSE | New York Stock Exchange |
| OBU | Offshore Banking Unit |
| ODI | Overseas Direct Investment |
| OTC | Over the Counter |
| PBoC | People's Bank of China |
| QDII | Qualified Domestic Institutional Investor |
| QFII | Qualified Foreign Institutional Investor |
| REIT | Real Estate Investment Trust |
| RMB | Renminbi |
| RQFII | RMB Qualified Foreign Institutional Investors |
| SAFE | State Administration of Foreign Exchange |
| SAR | Special Administrative Region |
| SICs | Systemically Important Countries |
| SEZ | Special Economic Zone |
| SFC | Security and Futures Commission |
| SHIBOR | Shanghai Interbank Offered Rate |
| SMEs | Small and Medium-sized Enterprises |
| SOEs | State-owned Enterprises |
| SSE | Shanghai Stock Exchange |
| SZSE | Shenzhen Stock Exchange |
| TSE | Tokyo Stock Exchange |
| TSEC | Taipei Stock Exchange Corporation |
| WEF | World Economic Forum |
| WFE | World Federation of Exchanges |
| WTO | World Trade Organization |

* In this report, RMB, CNY and the Chinese yuan refer to China's fiat currency – the renminbi – in circulation.

# Executive Summary

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 intermediated 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.

# 报告概要

纵观21世纪全球经济局势，中国的崛起当属世人瞩目之焦点；这对当今国际经济格局的重整亦造成了深远的影响。作为目前全球第二大经济体，中国经济的崛起主要归功于市场经济改革初期所倡导的出口导向型经济增长模式，以及该国极具优势的劳动密集型制造业。中国具有卓越的产能，其在全球市场中也有广泛的贸易网络；然而，该国的金融市场却仍缺乏市场深度，其本国货币（人民币）在国际贸易及国际融资中的使用也极为有限。以中国国际融资头寸占国际间融资总量的数据为例，中国的外汇储备资产约占30%的全球总量；相比之下，该国对外投资的程度却显得微不足道，其海外投资全球占比尚且不足3%（包含对外直接投资与证券投资）。

为彰显其经济实力，北京方面认识到深化本土金融市场以及拓展人民币于国际间贸易结算的应用，两者实属必需。回顾中国经济改革初期，邓小平先生所倡导的“摸着石头过河”经济改革方略曾获得广泛认可。持此理念，中国将采取相似的审慎原则，逐步开放国内金融市场并推动人民币国际化进程，从而使得两者进一步融入国际金融市场与全球货币体系 。

恰如中国在过去二十余年来贸易全球化的进程，其金融全球化的启航亦将在今后数十年内促使全球经济格局发生本质变革。本次中国金融改革重点旨在实现中国资本项目的全面开放以及人民币完全可兑换。如若改革成功，此举有助于促进调衡全球经济，并最终改变国际货币体系的面貌。因此，各界政要应当对于此次中国金融改革及其进程投以密切关注；对于系统重要性国家 (systemically important countries) 的政策制定者，其意义尤为深远。

本报告重点关注中国通过促进大中华区各大金融中心的发展，从而以此推进金融服务业改革所采纳的重大举措。作为资本市场中资金交易的重要枢纽，大中华区的各大金融中心则构成了反映中国金融改革进程及其影响成效的整体缩影。为分析大中华地区资本市场的宏观演变，本报告立足于分析该地区内四大各具千秋的金融中心－上海、深圳、香港、台北，试图通过呈现两岸四城之间相互竞争、合作融通的发展关系，为读者梳理并解析这一错综复杂的国家金融改革进程和整体发展趋势。

随着此次中国金融改革的推进，尤其是旨在实现货币完全可兑的人民币国际化进程，大中华区四大金融中心之间的联系将因此日益紧密、呈整体化发展；与此同时，此次改革也将深刻影响到该四大金融中心各自在亚洲乃至全球资本市场中的定位与发展。譬如，自2009年北京启动一系列人民币国际化政策以来不过数年，香港金融业便因此而发生格局转变。继美元和港元之后，人民币如今已成为香港第三大广泛使用的币种，其银行间存款占据了全港近10%的银行存款总量。具体而言，自2009年7月至2011年12月，香港人民币存款总额由560亿元增长至5885亿元；香港人民币借贷业务也扩张迅速，在2010年至2011年间由原先的20亿元增长至308亿元。与此同时，香港人民币点心债券市场增长之势尤为迅速：截止至2011年年末，香港累计发行人民币离岸债券规模达到2000亿元；其2011年年度点心债券发行量为1040亿元，较2010年年末356亿元的发行量翻了近三倍。

大中华地区四大金融中心之间的发展勾勒出一幅错综复杂的中国金融改革图景。而在这场政策驱动下的改革中，将上演一场政府与市场之间的权衡角力。2012年1月，在北京召开的第四次全国金融工作会议中，扩大金融对外开放、加强金融基础建设以及加强资本市场和保险市场建设等金融改革规划被明确列为中国今后五年内所须执行八项金融改革部署。

根据北京的政策规划，上海和香港两大金融中心在此次中国金融改革中分别被赋予了不同角色。对于致力于成为国际金融中心的上海而言，上海向这一目标迈进的过程将是中国金融市场逐步深入参与全球资本市场的写照；对于已成为国际金融中心的香港而言，其主要任务则旨在巩固自身国际资本市场间领跑者的地位。为扩大中国资本在大中华地区（乃至全球）的市场影响力，北京方面将推动大中华地区金融中心与国际资本市场之间的深入互动，以实现这一目标。

本报告指出，香港作为目前国际金融中心的领先地位，在中短期内将难以被撼动。这归功于香港完善的法制体系、亚洲自由金融中心的美誉及其相较纽约伦

敦等其他金融中心所独有的“中国元素”。尽管北京方面计划于2020年扶持上海成为其最大的人民币在岸国际金融中心，该愿景曾一度引发舆论产生对香港是否能维持其国际金融中心地位的诸多疑虑，然而就长期发展而言，无论北京方面的政策如何转变，香港所独具的各类竞争优势并不会因此而受到削弱；香港也将继续保持其国际金融中心的领导地位。

然而，即便上海在短期内迅速取代香港作为地区国际金融中心的可能性较为渺茫，但是从长远看来，中国庞大的经济实体仍有能力为两大国际金融中心未来的共存互惠提供足够的发展空间。此外，国务院于2009年计划扶植上海成为大陆第一国际金融中心的政策决议，也进一步表明了上海与香港之间现有的差距将在其后十年内（至2020年）大为缩短。

报告认为，深圳金融中心未来的发展仍将以服务大陆市场为主，致力为广东地区受银行融资所困的各大中小型及创业型企业提供资本市场融资服务。而台北借助于其长年为亚洲地区高科技中小企业提供金融服务的经验，则在这一方面独有所长：在服务大陆高端中小企业的市场中，台北金融中心将更具优势。尽管与亚洲地区其他各大金融中心相比较而言，台湾资本市场目前的发展规模依然不足，但随着海峡两岸金融合作的逐渐深化以及大陆金融改革进程的演变，这将为台北作为亚洲地区金融中心错位互补的定位发展带来崭新机遇。

在大中华区四大金融中心崛起之际，两岸间三大金融体系（中国大陆、香港、台湾）亦将在今后十年内呈现渐趋交融之势。纵观全局，作为人民币离岸金融中心，香港与大陆金融业界的合作已因此日益深化。鉴于该进程势在必续，香港与大陆间的两大金融体系最终将走向更具系统性的深层融合。基于人民币国际化的框架，上海、香港、深圳三地之间的合作互动也将逐步得到深化发展。本报告指出，无论从技术层面抑或是政策层面而言，未来数年内，该三大金融中心均可能在大中华地区整合成一个多层次金融交易平台，并拓展出更深更广的资本市场。与此同时，作为人民币在岸离岸市场的桥梁，境内外人民币的回流机制亦在沪港两地之间逐渐形成。

北京方面认为，该四大金融中心在大中华区乃至全球范围内，应当各司其职、各展所长。然而，待到中国全面开放其资本项目之时，该四大中心是否仍能依此布画渐进发展，恐怕不容乐观。一旦阻碍资本自由流动的政策限制逐一松动，市场将成为左右资本、贸易及人才等资源流动的重要推力，并最终将上述资源引向最具市场效率、低廉融资成本以及最宜居住的金融中心城市。对于各大金融中心而言，届时，唯有具备上述各项无从被北京方面政策所影响的市场竞争优势，方可成为真正意义上的国际金融中心并在国际资本舞台上保持领先地位。

中国金融改革是一场盘根交错的政策驱动型改革进程。其改革范围之广覆盖早期的银行系统改革以及如今的债券市场发展，并将最终涉及利率、汇率自由化改革。在该国资本项目尚未完全自由化的前提下，这场金融改革将以人民币国际化作为支点，并围绕其发展。究其根本，这是政策理念与市场选择之间的角力均衡。而中国所面对的真正挑战，则在于如何就金融市场化需求与维持传统经济增长模式两者之间作出恰当协调。

如若这项改革如期兑现，中国终将在国际资本舞台上展现出金融大国的实力，并作为国际主要储备货币发行国在国际货币体系中担当重任；大中华区各大金融中心也将与国际资本市场建立更为紧密的联系，真正起到作为国际金融枢纽自由支配内外资本，以服务海内外企业融资需求的桥梁作用。而此次金融改革一旦成功，将有助于解开目前困扰全球经济及货币体系的症结：即作为世界第二大经济体及第一大出口国，中国实施的汇率政策却有欠弹性，以至于该国出现经常项目常年盈余以及外汇储备巨幅累积（两大不利于全球经济平衡的现象）。

在当前这场金融改革中，中国所采取的举措，无论对于大中华地区抑或是全球经济的前景发展，都将是至关重要的；然而，这一进程毫无前路可循。这固然将为中国金融改革提供充分自由的政策试验空间，但也会使其面临重重挑战。毕竟，这是首个试图在推进全面金融改革、强化金融服务业的同时一并推动本国货币国际化进程的新兴经济体国家。

总而言之，中国金融改革是一个循序渐进的过程。欲见其效，尚需时日。鉴于目前仅有几项政策目标以供参考、具体细节尚待明确，我们预期本次中国金融改革的全面影响将在五年至十年以后才能逐一显现。对于目前在短期内亟待调衡的全球经济而言，中国的改革步伐则显得过于缓慢，较为差强人意。然而，确保中国谨慎实现转型并成功建立起一个现代金融体系其则更为关键。毕竟，中国的任何一场金融危机抑或是持续的金融不稳定，均将对全球经济体系造成系统的灾难性后果。

## 政策建言

展望将来，大中华地区国际金融中心的建设与大陆金融体系的深化改革都将难免面临诸多挑战。四大金融中心究竟会如何演变也尚难定论。为应对挑战，本报告为大中华区各决策者提供以下数点建言，以兹参考。

- **调度政府干预力度** —— 逐步减弱政府在金融服务业的干预；允予包括国有银行在内的金融机构拥有更为独立的经营权。这将有助于为银行业的商业化和金融资源的有效配置提供良好的市场环境。
- **加速银行业内改革** —— 尽快推进当前银行业市场化改革；促进银行业遵循国际标准及行业规范。免除该国银行所承担的福利宗旨、实现利率自由化，从而消除市场扭曲现象、减少受信息误导而产生的错误投资决策；建立正确效性机制以强化市场激励、增进资本资源配置效率。
- **发展资本市场，减轻实体经济对银行融资的过度依赖** —— 鼓励多类金融机构平等竞争，以实现金融部门间的均衡发展；完善金融基础设施及法制体系建设，从而鼓励民间资本进入资本市场（尤其是债券市场）进行融资操作。减少阻碍资本市场深化的各类行政管制；培育资产管理行业，拓宽各类风险收益组合的金融投资产品种类，从而鼓励企业家精神并吸引各类投资风险偏好者。
- **加强香港对金砖五国（BRICS）及新兴市场的影响力** —— 提升香港在国际资本市场中的地位，由此增强其与伦敦、纽约之间的竞争优势。
- **深化沪港两地合作** —— 采取有效措施以确保香港和上海发挥各自比较优势；通过两者市场之间的有效合作，配合实现中国金融改革中的诸项宏观目标。
- **定位深圳为区域型金融中心** —— 鼓励深圳重点为大陆日益增长的各类中小型企业提供融资服务，进而纾解其匮乏银行信贷支持的融资压力；同时，以此鼓励创业家精神，并间接起到多元化、深化资本市场的作用。
- **对应北京政策规划，台北需另觅新径** —— 台北应当充分利用大陆金融市场与全球资本市场一体化进程中所派生的崭新机遇，以巩固其作为区域型金融中心的地位。相较于其他三大金融中心，台北在本次中国金融改革中的角色尚难明确。因此，台北有必要充分理解并积极把握此次金融改革的政策动向。台湾各界则可适时通过两岸政经协商往来，积极推动与大陆之间的各类金融合作。

# Introduction

Beijing has embarked on a cautious journey to open up its financial system and integrate it into the international financial system, in line with the incremental reform process championed by Deng Xiaoping – 'touching stones to cross the river'. Albeit gradual and almost unnoticed by non-specialists in financial affairs, the reform is critical for China's ability to create a financial sector that is congruous with the size, and relevance, of the country's economy and to shift its economic growth model towards domestic demand. Currently, China's financial sector is small compared with the size of the real economy and is mainly domestic because of its limited integration in the international financial system. Moreover, the Chinese currency, the renminbi (RMB), is not yet fully convertible and has very limited use beyond the country's borders. If China wishes to play a greater international role, it needs a currency that reflects such a role. The reform of the currency and of the exchange rate regime requires the development of liquid and diversified capital markets.

The process of financial reform will eventually allow China to fully open its capital account[1] and make its currency fully convertible. Hence it represents a key step in rebalancing the global economy. This is why what China is doing is of global importance, and policy-makers around the world, especially in systemically important countries,[2] should pay close attention to it. Global financial stability is essential for the framework of 'strong, sustainable and balanced growth' to which the G20 committed at the Pittsburgh meeting in September 2009. The global financial crisis of 2008 demonstrated how fast financial shocks can travel across the international financial and banking system and how vulnerable domestic economies are to these shocks. At the same time it is vital to reduce the imbalances between deficit countries and surplus countries, of which China is the most prominent. Having a fully convertible currency will help China to reduce its surplus, and hence its holding of foreign reserves, and eventually produce a (small) deficit.

Financial reform is of course a complex process in which 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. Another challenge is to reduce the country's reliance on the banking sector. The dominance of the banks in China's financial sector is the consequence of the role historically played by the main banks as policy facilitators and a source of funding for the country's development objectives.

In this report we assess the steps that China is taking to reform its financial services sector and discuss the outlook for such a sector in the years to come. In doing so, we take an innovative approach by looking at the development of financial centres in the region. These are the physical places where the main financial transactions take place and are clusters of activities and services that connect several different operators and so facilitate financial transactions among them. As such they are deeply affected when measures to reform the whole financial system are implemented. At the same time they reflect the features and strategies that underpin the reform process itself. In other words, the financial centres are where the reform measures are seen in action and where their impact can be assessed and gauged.

1 Using the IMF definition of categories of capital controls, Gao and Yu (2009: 8–9) show that at the end of 2007 half of the transactions under capital account were subject to controls, and half of cross-border capital transactions were available for non-residents and residents.

2 In this report, we refer to the broadly used concept of 'Systemically Important Countries' (SICs), or countries of systemic significance to the world economy, to identify countries that are so large and integrated into the global economic system that any changes or shocks in one or more of them could have significant spillover effects on the rest of the world through direct or indirect channels. The IMF, in its spillover reports, classifies China as one of the five systemically important economies, together with euro area, Japan, the United Kingdom and the United States (IMF, 2011c).

In the report we also make a distinction between domestic or regional centres and international financial centres (IFCs). The latter are centres with a critical mass of business and capital transactions and where global firms raise capital and invest. IFCs have become important clusters for the world economy in the last two decades as the result of the process of integration of international capital markets.

Rather than just focusing on mainland China, the report takes a broader regional approach and so considers the main financial centres in Greater China[3] – Shanghai, Shenzhen, Hong Kong and Taipei. This allows us to address the key research question of whether China's financial reform will have an impact on the Greater China region, rather than just on the domestic economy. Looking at the whole region, therefore, offers a wider perspective on the effects of China's financial reform.

The links between these four cities are historically very tight, and are strengthened by geographic and cultural proximity. Shanghai and Shenzhen, the two major financial centres of mainland China, have been shaped by the reform process since its very beginning. Hong Kong, one of the world's leading IFCs, is the main actor in China's financial opening-up thanks to the 'one-country, two-systems' arrangements. Taipei is the most relevant example of the way in which China's financial expansion broadly affects financial centres in the Greater China region and how this influence can be exploited for business.

China's financial reform is the 'glue' that links these four financial centres together. In the report we look at the development of each centre within the framework of reforms, the impact of the reform process on this development, and the way in which each centre interacts with the others. How is each centre evolving in terms of the markets that it serves and its links with the international financial markets? We regard the internationalization of the RMB as the most important reform measure and the one that, to varying extents, binds the financial centres in Greater China together. In particular, Shanghai as the RMB onshore centre aiming to expand its international influence, and Hong Kong as the RMB offshore centre aiming to keep its competitive position as one of the world's leading financial centres are the two cities most affected by China's RMB strategy. A fully convertible RMB brings challenges as well as opportunities. By offering a comprehensive view on how the four centres are positioning themselves with respect to the internationalization of the RMB, this report brings to light the major dynamics that are shaping and will shape the four cities during this process.

One aim of the report is to develop a deeper analysis of the transformation of the different financial sectors under the reform process in mainland China. The transformation implies that the whole financial industry is currently in the process of shifting from a system dominated by big banks to one that is more focused on capital markets. It provides significant potential for growth for Shanghai and Shenzhen as new business opportunities arise from the development of the bond market and the asset management industry. Also, the growth of the real economy is expected to push the demand for financial services and products in the country. China's growing middle class and rising number of SMEs, for example, offer new opportunities for the financial services industry.

The report also asks how quickly Shanghai will catch up with a major IFC such as Hong Kong in terms of size and market capitalization. At the same time it explores whether size is enough for Shanghai to be acknowledged as an IFC. What other policy measures, other than developing a fully convertible RMB, would Shanghai need in order to gain such recognition?

Another critical question is how each of these cities fits into the bigger picture of Beijing's overall strategy for mainland China's financial development. Beijing was deliberately excluded from our analysis. We are conscious that this decision may be controversial. As China's political capital, Beijing is where the majority of financial and non-financial institutions maintain their headquarters in order to be close to the centre of power. However, we see Beijing as the source and the promoter

3 Greater China includes mainland China, Hong Kong SAR (Special Administrative Region), Macau SAR and Taiwan. In this report, 'mainland China' and 'the Mainland' are used interchangeably as they both refer to the two geopolitical Chinese terms, namely Dalu (大陆) and Neidi (内地), which mean 'continent' and 'inner land' respectively.

of the financial reform rather than as a financial centre where reform measures become operational and where market activities are run.[4]

If Shanghai is China's designated international financial centre, to be developed by 2020, and this is one of the key objectives of the central government's policy, it is in Beijing that every single step in the process of financial reform originates. It starts with the internationalization of the RMB and its eventual full convertibility, and it is on this that the future of Shanghai as an international financial centre depends. As a result, we constantly need to refer to Beijing to understand where China is going, even if it does not feature directly in our analysis of financial centres in Greater China.

## Methodology

The research undertaken for this report was informed and supported by in-depth research roundtables and discussions held with senior policy-makers, academics and market participants in Hong Kong, Shanghai, Taipei and London throughout 2011. These first-hand research sources are complemented by analysis of publicly available data, policy documents and literature, and the report aims to provide a comprehensive, independent assessment of current policy developments as well as some policy recommendations.

Given the breadth of the topic, there are some inevitable omissions in themes and approaches in the report. For instance, we refer only cursorily to China's legal and regulatory system even though we recognize its essential role in the development of financial centres. We agree with many market practitioners we talked to during the course of this research that mainland China's legal system needs to be reformed in order to develop Shanghai, or any other city, as an IFC. Since IFCs are where global firms can raise money and global investors are welcome, regulations that prevent Shanghai from doing offshore business, thus constraining the number of global firms and participation of international investors, could hinder the development of Shanghai's international dimension. Corporate governance, transparency and an accounting system aligned with that used in many other countries not only supply the necessary infrastructure but also give confidence to foreign companies that do business in the Mainland. Despite the relatively small size of its domestic market, Hong Kong has the advantage over Shanghai of operating a legal and regulatory system that international investors trust.[5]

Similarly, our analysis does not consider the impact of the evolution of the international regulatory framework, in particular the gradual implementation of Basel III, on Greater China's financial centres. Nor do we discuss the importance of a robust professional framework and key services, such as accountancy, for the development of an international financial centre.

Nevertheless we are confident that our approach offers a valuable contribution to the debate on China's financial reform and its interaction with the development of financial centres in the region. Most of all we hope to shed light on what China is doing to develop and open up its capital markets, thereby eventually contributing to the rebalancing of the world economy.

4 For instance, Beijing does not have a stock exchange.

5 Unlike other developing countries such as Brazil and India that are comfortable in drafting contracts with international partners under Western law (e.g. English or New York law), China prefers to use Chinese law.

# 1. Setting the Scene: China's Financial Landscape

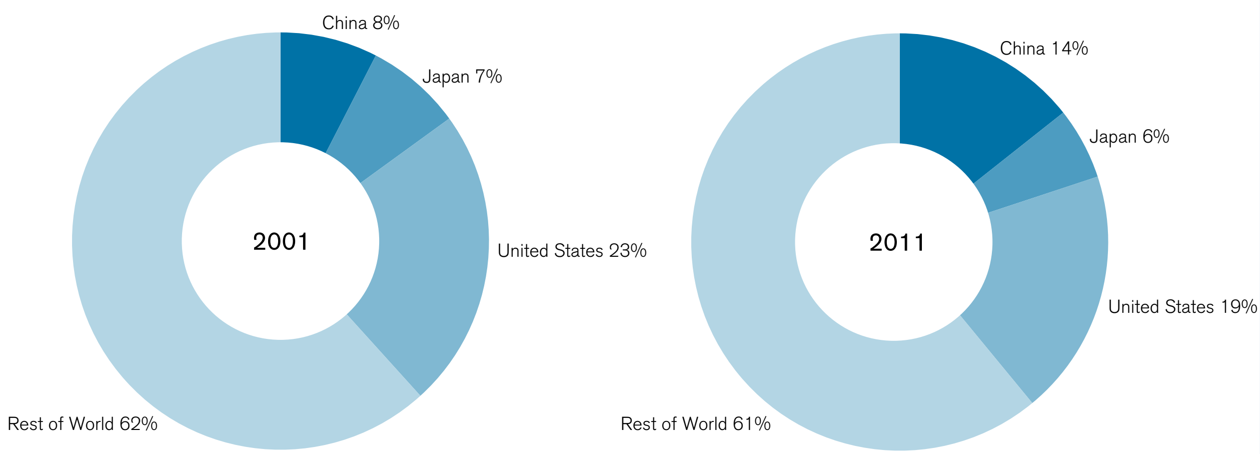
## 1.1 An internationally integrated economy, but a less integrated financial sector

The rise of China as an economic superpower and its integration with the rest of the world have been among the most remarkable stories of the 21st century and have come to define modern international economic relations (Subacchi, 2008). While remaining a low-income country where about 254 million people still live on less than one dollar a day, China is also of systemic significance to the world economy (Subacchi and Jenkins, 2011; O'Neill, 2011).

China's development has been driven by its integration in global markets, while at the same time globalization has been furthered by its rapid economic growth. The Chinese economy expanded from $59 billion (RMB364.5 billion) in 1978 to $7.7 trillion (RMB47.15 trillion) in 2011, at an annual growth rate of about 10% for the past thirty years. It now contributes about 14% of the world's GDP (see Figure 1). In 2010 China overtook Japan to become the world's second largest economy. It has also become the world's largest exporter, having overtaken Germany in 2009 when its annual exports were over $1.2 trillion.

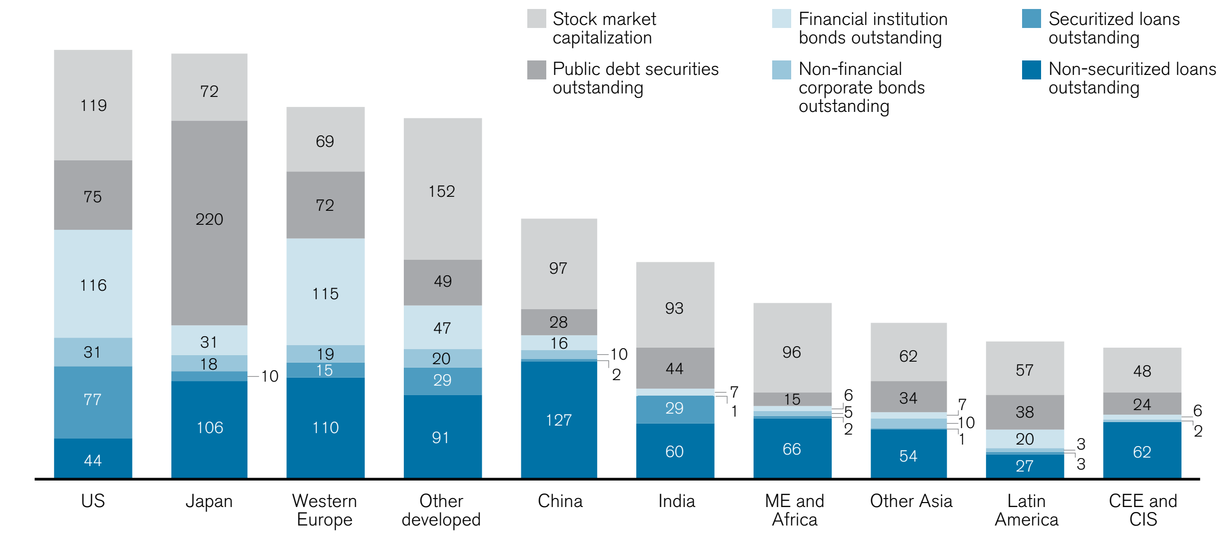
Since the opening up of China's economy in 1978, its development has been driven by exports; the country's abundant workforce has supplied the world market with cheap products. Through trade China has become more integrated in the world economy. A major step in this process was its accession to the World Trade Organization (WTO) in December 2001. By joining the WTO, China could exploit new markets for its goods and expand its exports, which rose from $299.4 billion in 2001 to a high of $1.6 trillion in 2008. Although it is at the lower end of the world's production chain in terms of value added, China has built a very successful labour-intensive manufacturing sector.

Figure 1: Share of total world economy, 2001, 2011 (GDP, PPP)




Source: IMF (2011a).

Figure 2: Financial depth, year-end 2010 (% of regional/country GDP)

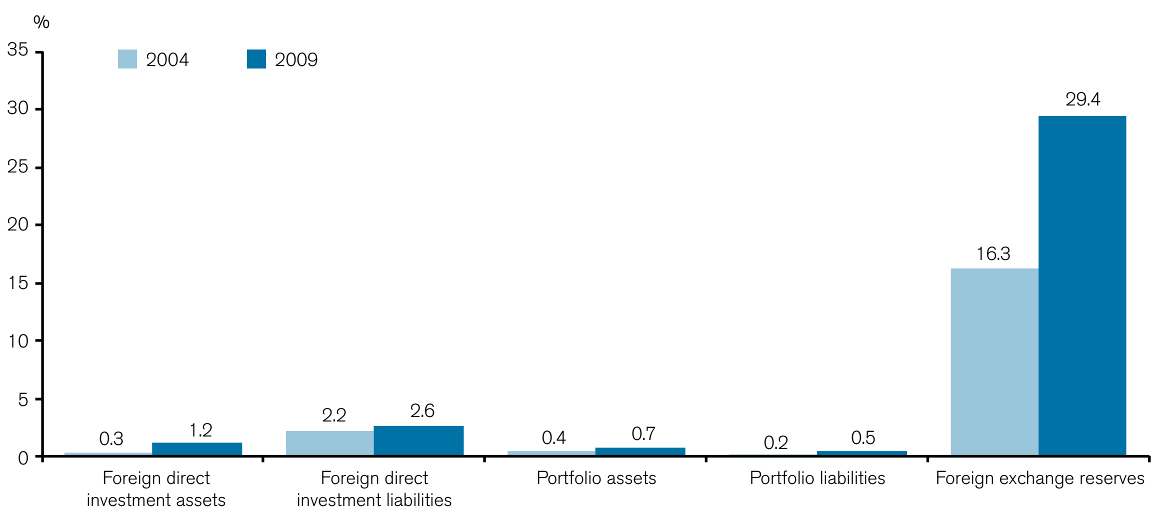



Sources: BIS, Dealogic, SIFMA, S&P's, McKinsey Global Banking Pools, McKinsey Global Institute Analysis.

Despite China's large production capacity and trade links with the rest of the world, its financial sector lacks depth and has little connectivity with the international financial system (Figure 2). Underdeveloped financial markets are not unusual among emerging-market economies, and indeed China fares well on different indicators of financial depth when compared with other emerging markets, especially with Latin America and the Middle East and North Africa (Figure 2). Considering China's 30-year history of reform, this is hardly surprising.

However, China's domestic financial depth does not match its global economic significance, nor that of the developed economies whose contributions to global economic growth it already rivals. Furthermore, despite being the world's second largest economy it does not have a currency that can be used in international transactions, owing to restrictions on its capital account. Its financial integration is largely restricted to accumulation of reserve assets, while its capital assets abroad, in particular portfolio assets, remain underdeveloped (Figure 3).

Figure 3: China's international investment position (% of global stocks)




Sources: SAFE, UNCTAD, IMF CPIS, DB Research Institute Analysis.

### Box 1: Eight key areas for financial reform (Fourth National Financial Work Conference, Beijing, January 2012)

- **Financial services:** Improve the overall quality of financial services to support economic and social development; particular attention is given to providing financial services for the rural sector, small enterprises and government-supported sectors such as environmental protection projects and green energy.
- **Financial institutions:** Deepen institutional reforms to reinforce corporate governance and effective decision-making. Encourage private capital to enter the financial service industry. Policy banks are to continue to serve the policy-based projects, while the China Development Bank will continue with its reform to become a commercial bank.
- **Financial regulation:** This needs to be strengthened to prevent systemic financial risks. The banking industry should institute comprehensive risk management systems. The security industry should improve the market system, strengthen regulation of market participants and protect investor rights.
- **Risks arising from local government debts:** Though China's overall public debt liability is safe and manageable, it is important to manage outstanding debt properly and to control the debt-issuing mechanism of local governments. Revenue and expenditure related to local government debt should be incorporated into the budgeting system. Monitor the size of overall local government debt and establish a risk-monitoring and early-warning system.
- **Capital market and insurance market:** Enhance overall financial market coordination for the healthy development of stock and futures markets, and encourage the development of a well-regulated and unified bond market.
- **Macroeconomic policy:** Strengthen the coordination of monetary and fiscal policies and that of regulatory and industrial policies. Improve the RMB exchange rate mechanism by allowing a wider float.
- **Allocation of financial resources:** Gradually relax the RMB capital account controls to improve capital allocation and enhance the management of foreign reserves. Promote closer financial cooperation with Hong Kong, Macau and Taiwan, support Hong Kong's development as an international financial centre, and speed up Shanghai's development into an IFC. Actively participate in the dialogue and reform of the governance of global economic and financial systems.
- **Financial infrastructure:** Set up a unified credit information system, improve registration, depository, settlement and clearance systems and enhance consumer protection.

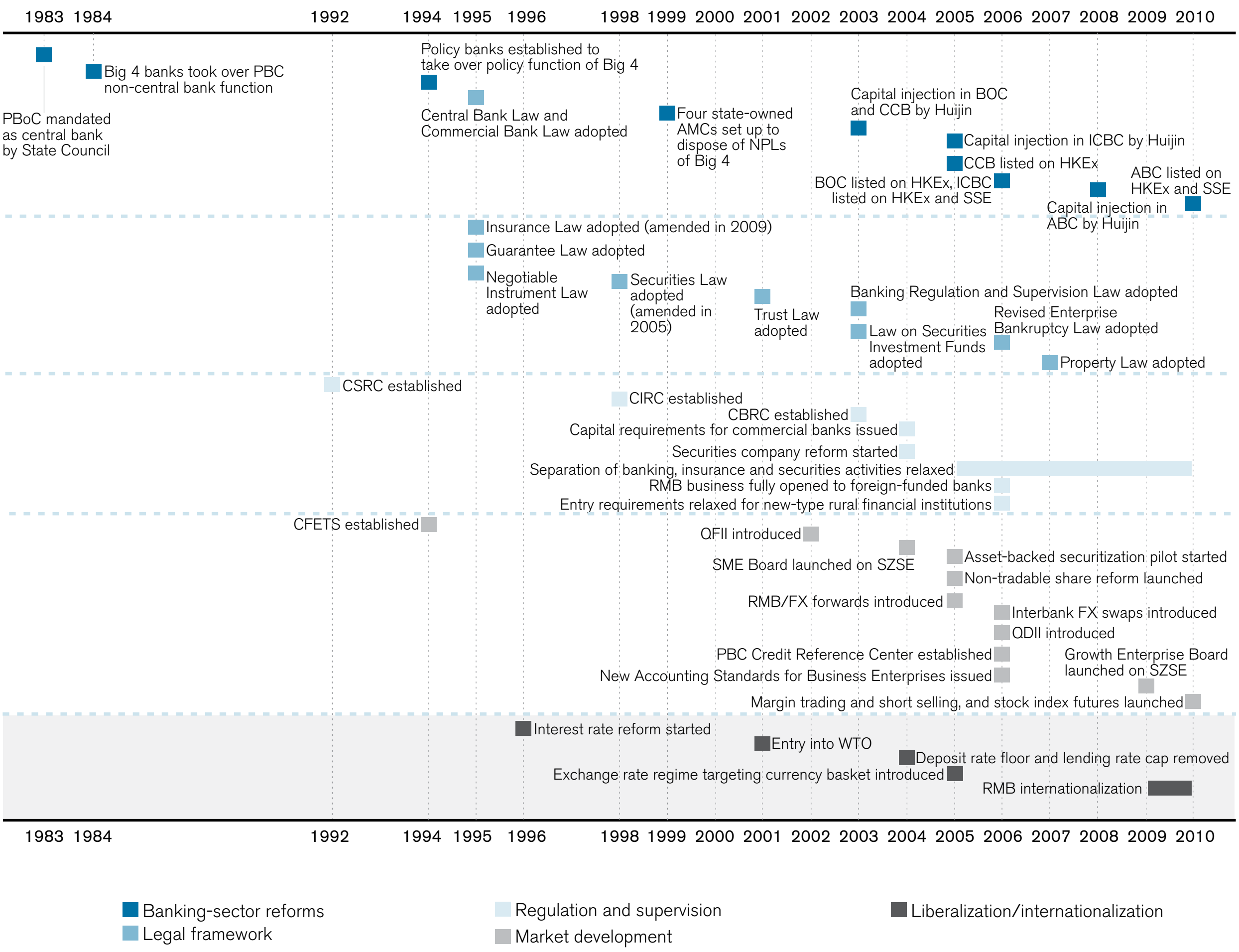
Source: Government of the People's Republic of China.

China now needs to develop a deeper and diversified financial sector that reflects the size and the international integration of its real economy to ensure the efficient allocation of capital. There is scope to enhance domestic financial depth by improving financial infrastructure, developing financial segments and instruments (such as insurance) that are much needed to help expand the retail sector, for instance, and establishing credit-rating agencies for Chinese companies. The corporate bond and securitization markets are particularly underdeveloped (Figure 2), while financial services need to reach the rural sector and private capital needs to be encouraged to feed into financial services. These are key areas of financial-sector reform in the next decade, as stated in the Fourth National Financial Work Conference (Box 1).

## 1.2 The financial system in mainland China: a work in progress

Reforms of mainland China's financial system began in earnest in the 1990s and accelerated over the next decade, following the opening-up of the Chinese economy in the 1980s. As shown in Figure 4, 30 years ago neither capital markets nor the insurance sector existed in mainland China. In this 'mono-bank period', the People's Bank of China (PBoC) and the rural credit cooperatives served the entire nation's commercial banking needs. However, with the implementation of the economic reforms championed by Deng Xiaoping, the PBoC's role as the supreme controller of the banking system was gradually decentralized. In the 1980s four specialized banks ('the Big Four'[6]) were established to take over the PBoC's policy and commercial functions.[7] While China's rural credit cooperatives were merged in 1979 to establish the Agricultural Bank of China (ABC), both the Industrial and Commercial Bank of China (ICBC) and the Bank of China (BOC) were carved out of the PBoC's commercial and foreign exchange businesses. The China Construction Bank (CCB), jointly established by the PBoC and the Ministry of Finance, was created to facilitate major national infrastructure projects. Thus during the 1980s the financial market in mainland China became dominated by the PBoC and the Big Four.

Figure 4: Financial-sector reforms in mainland China – selected benchmarks




Source: IMF (2001b).

6 The phrase 'Big Four' refers to the four largest commercial banks in China, namely the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC) and the China Construction Bank (CCB).

7 Before the reform of the financial system in the 1980s, the PBoC served as deposit and lending bank, payment system and cash agent for the government and the entire nation. It functioned as a commercial bank – responsible for deposit-taking and credit-lending for domestic customers and enterprises – a policy bank providing financial resources to meet fiscal objectives and government projects, and a central bank. In the 1980s, to alleviate its burden and to decentralize China's banking sector, the bank's commercial functions were allocated to the Big Four according to their industry sectors, as were its policy functions. Among the four banks, the CCB and ABC were established with a greater focus on providing financial services for government projects, whereas the ICBC and BOC emphasis was on developing commercial businesses.

In 1994 'the three policy banks'[8] were created to take over policy functions from the Big Four. Meanwhile, the nation's equity market, instituted in 1990 with the Shanghai and Shenzhen stock exchanges, required a new set of regulatory institutions – the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC) – to support the financial sector. With accession to the WTO, financial reforms accelerated, while a better legal and regulatory framework was established. For example, regulations on securities investment funds were first introduced in 2003, and banking regulation and supervision measures were also adopted in the same year.[9] In 2006, bankruptcy rules were revised after the five-year buffer period following China's accession to the WTO in 2001 (Figure 4). Between 2005 and 2010 there was a massive growth in China's equity market. Driven by more than 500 initial public offerings (IPOs) and some huge listings, including those of China's largest banks, in 2010 the IPO boom contributed US$131 billion to the rapidly expanding equity market, a dramatic increase from $25.6 billion in 2005 (PwC, 2011). At the end of 2011, China's total stock market capitalization was estimated at about US$3.7 trillion.[10] This was nearly ten times the level in 2005 ($401 billion).

Along with its financial system, China's financial regulatory framework has gone through a long period of structural reforms. It is currently based on the 'One-Bank, Three-Commissions' model, with the PBoC playing the central role (Figure 5).[11] The PBoC serves as the country's central bank and its primary function includes the formulation of monetary policy, the maintenance of financial stability and the provision of financial services. The 'Three Commissions' – the CBRC, the CSRC and the CIRC – oversee their respective financial sectors. These institutions and the PBoC report directly to the State Council, where regulatory and monetary policies are formulated and approved and, most importantly, where the nation's financial reform strategy is implemented.

Although much has been achieved since the early 1980s, China's financial reform is still a work in progress. For instance, throughout the whole reform process little flexibility was granted to the two essential pricing tools – interest rate and exchange rate – to be determined by market forces. Consequently, the country does not have an efficient capital allocation system – in particular, an effective price-signalling mechanism. The interest rate and exchange rate fail to reveal the relevant information that would assist market participants to adjust their behaviour. Similarly, domestic financial institutions, notably the banks, are still heavily reliant on their policy-driven business model, which puts their respective political objectives ahead of profit maximization as their business priority. Such a system has resulted in significant capital misallocation in China, where large state-owned enterprises (SOEs) hold excessive funds and small and medium-sized enterprises (SMEs) find it difficult to raise capital for their activities.

The current state of China's reform process, and the major weaknesses of its financial system, are captured in the Financial Development Index (FDI) compiled by the World Economic Forum in its annual *Financial Development Report*. The FDI ranks nation-states according to the level of financial development: 'the factors, policies, and institutions that lead to effective financial intermediation

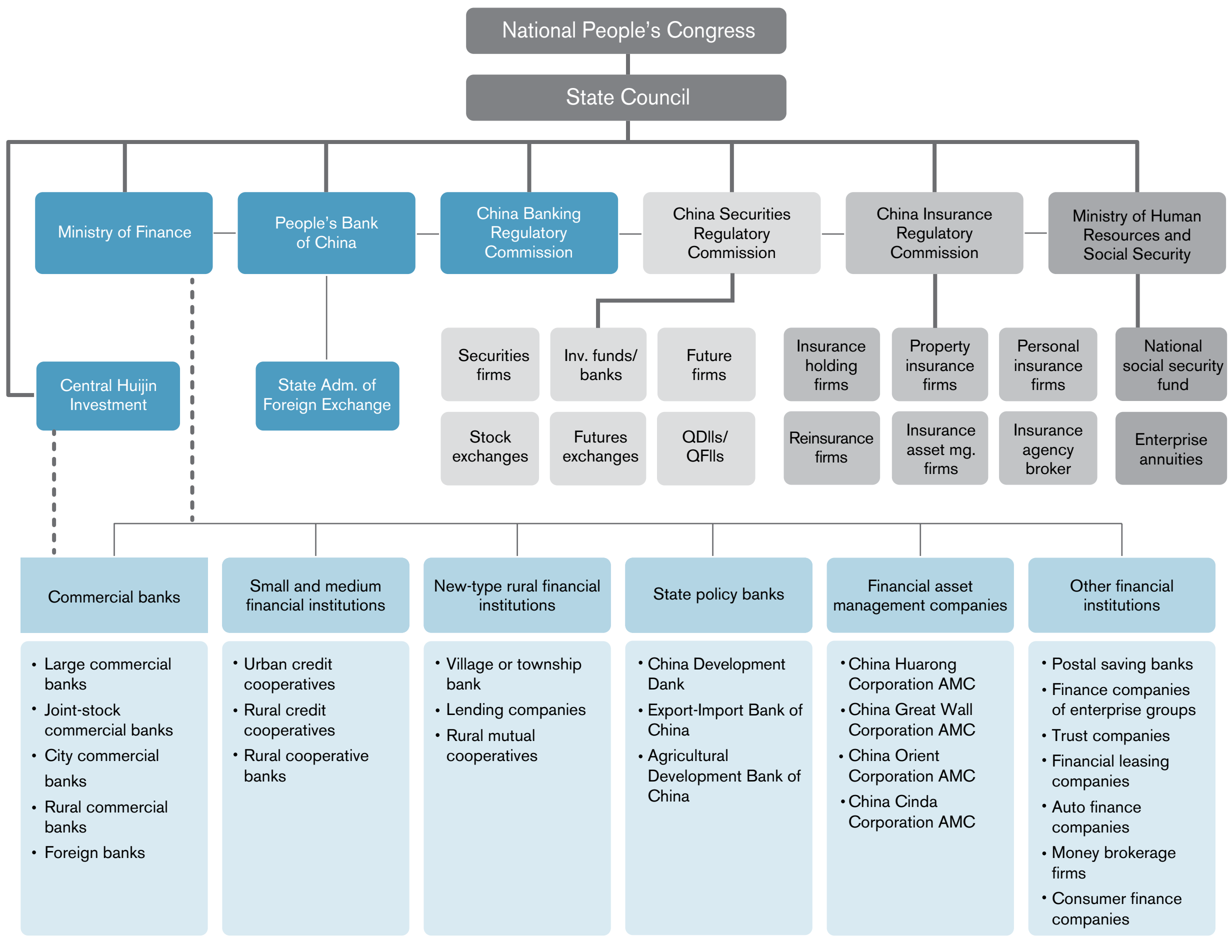
8 The expression 'the three policy banks' used in this report denotes the China Development Bank (CDB), the Agricultural Development Bank of China (ADBC), and the Export-Import Bank of China (China Exim Bank). In the Mainland, however, the term 'policy banks' refers specifically to the ADBC and China Exim bank but not to the CDB. In 2008, the CDB was converted from a policy bank into a commercial bank jointly owned by the Ministry of Finance and Central Huijin Corporation, but it is still regarded as the most influential policy bank in China.

9 On 28 October 2003, the Law of the People's Republic of China on Funds for Investment in Securities was promulgated and went into effect as of 1 June 2004. Under the Securities Investment Fund Law, a securities investment fund may thereby be established as either a closed-end fund or an open-end fund, which was a significant breakthrough in the development of the fund management industry in China. Details are available at http://english.gov.cn/laws/2005-09/07/content_29992.htm. The Law of the People's Republic of China on Banking Regulation and Supervision, adopted on 27 December 2003, was the first law promulgated after the establishment of the new banking supervisory institution, the China Banking Regulatory Commission, in the same year. Details of the clause can be found at http://www.pbc.gov.cn/publish/english/964/1956/19566/19566_.html.

10 The total stock market capitalization of US$3.7 trillion is composed of the year-end data for market capitalization of the SSE and SZSE, but excluding HKEx and TSEC.

11 The phrase 'One Bank, Three Commissions' is used by the Chinese authorities to refer to the PBoC and the three regulatory institutions overseeing the three major financial sectors in China, namely the China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC).

Figure 5: Financial system architecture in mainland China



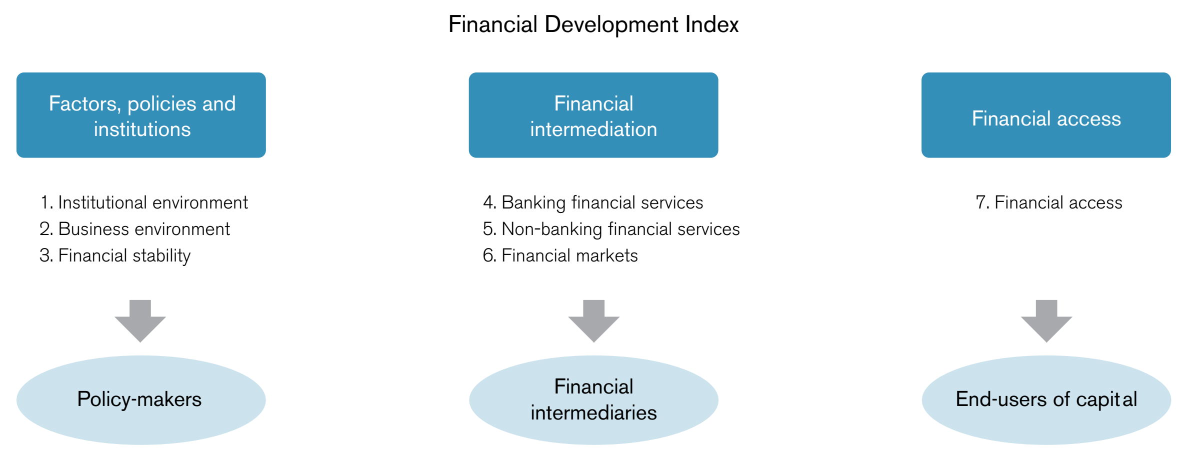

Source: IMF (2011b).

and markets, as well as deep and broad access to capital and financial services' (WEF, 2011: 6). The index assesses 60 of the world's leading economies and is based on seven parameters of financial development organized under three main categories (Figure 6).[12] China is ranked 19th while Hong Kong (considered separately from the Mainland) is first, followed by the US and the UK (Table 1).

The FDI shows that China performs well in terms of 'Non-banking financial services' and 'Financial stability'. However, stressing that China's financial and regulatory reform is still a work in progress, the 2011 edition of the FDI report observes that China needs to enhance its macro-prudential oversight of financial systems, and the laws and regulations that facilitate the development of deep and efficient financial intermediaries, markets and services to improve its performance on the 'Institutional environment' pillar (WEF, 2011: 6). The 'Business environment' pillar also shows considerable weakness, mainly owing to the tax regime, poor infrastructure and cost of doing business. More importantly, the FDI report highlights that China also needs to develop its 'Financial markets' – an allusion to its underdeveloped corporate bond markets.

12 The three categories are: 1) 'Factors, policies and institutions', relating to the local business and institutional environment; 2) 'Financial intermediation', which refers to the efficiency of banking services, non-banking services and financial market accessibility for the intermediaries themselves; and 3) 'Financial access', which relates to the ease of access to financial markets for the end-users of capital (investors). The FDI is based on a system of weighted variables, with data drawn from a variety of sources. A principal source is the Executive Opinion Survey indicators (drawn from the World Economic Forum's Executive Opinion Survey). Each pillar is sub-divided into variables. The computation of the FDI is based on the aggregation of weighted scores from the variable level to the overall FDI level. More details on the methodology of the IFC can be found in WEF (2011), Appendix A.

Figure 6: Composition of the Financial Development Index




Source: WEF (2011).

Table 1: FDI ranking, 2011 and 2010

| Exchanges/city | 2011 rank | 2010 rank | Country/Economy | 2011 rank | 2010 rank |
|---|---|---|---|---|---|
| Hong Kong SAR | 1 | 4 | Germany | 14 | 13 |
| United States | 2 | 1 | Denmark | 15 | 16 |
| United Kingdom | 3 | 2 | Malaysia | 16 | 17 |
| Singapore | 4 | 3 | Spain | 17 | 14 |
| Australia | 5 | 5 | Korea, Rep. | 18 | 24 |
| Canada | 6 | 6 | China | 19 | 22 |
| Netherlands | 7 | 7 | Austria | 20 | 19 |
| Japan | 8 | 9 | Finland | 21 | 20 |
| Switzerland | 9 | 8 | Ireland | 22 | 18 |
| Norway | 10 | 15 | Saudi Arabia | 23 | 26 |
| Sweden | 11 | 12 | Bahrain | 24 | 23 |
| France | 12 | 11 | United Arab Emirates | 25 | 21 |
| Belgium | 13 | 10 | | | |

Source: WEF Financial Development Index (2012, 2011).

## 1.3 The financial centres in Greater China

The financial centres in mainland China are expected to play a significant role in the country's efforts to build a modern financial system that reflects the size and the international integration of its real economy. It is hardly surprising that the central government places much emphasis on the Mainland's financial centres, notably Shanghai. The Fourth National Financial Work Conference held in January 2012 and the State Council's report on establishing Shanghai as an international financial centre reiterated the need both to develop Shanghai and to introduce policies to consolidate and strengthen Hong Kong's position as one of the world's leading financial centres. China not only welcomes the economic benefits that IFCs bring to the local economy, but also considers its national development plan to be incomplete without reputable financial centres in the region. In fact, the authorities in Beijing see IFCs as a symbol of international recognition of a nation's global influence.[13]

A cursory analysis of the financial sector in mainland China shows that Shanghai and Shenzhen, the two leading financial centres within its domestic market, are the two cities that have attracted most capital as well as the largest number of financial intermediaries, both domestic and foreign. Shanghai is mainland China's leading financial centre with well-developed insurance and fund-management sectors, but existing regulations constrain its ability to offer access to international investors. Shenzhen too has a blossoming financial industry, though smaller than Shanghai's; it mainly focuses on serving the needs of SMEs in the prosperous region of Guangdong.

Hong Kong, an international city that is now part of China but with a separate legal and institutional system, and a recognized centre of international financial intermediation, plays a crucial role in China's 'Go Global' strategy (see Box 2). Its well-developed equity market, banking sector and fund-management industry have made it one of the leading global financial centres (Seade, 2007). The city also serves a broad and international set of investors and clients, allowing them exposure to global capital markets.

The Mainland's plan to make the RMB a more international currency implies greater cooperation in future between its financial centres and those of Hong Kong SAR, Macau SAR and Taiwan. Taipei, for instance, with its diversified financial services and better links to international capital markets, is expected to play an important complementary role.

### Box 2: China's 'Go Global' strategy

Officially launched in 1999, the 'Go Global' strategy aims to support Chinese enterprises and investment outside China. There are three clear motivations for the adoption of this strategy. First, in the late 1990s the national authorities started to realize that the domestic market was not large enough to sustain China's strong growth and thus promoted investments abroad to secure new markets as well as resources. Secondly, the government was very keen for large SOEs to become multinational and expand their influence in the international economy. Finally, it was a way to relieve upward pressure on the RMB. As a consequence, China gradually shifted from being a major recipient of foreign direct investment to an important global investor.

The 'Go Global' strategy progressively exposed the Chinese financial sector to international markets. Furthermore, as Chinese enterprises gain a heightened international presence through investments abroad and greater participation in the global economy, Chinese financial institutions, mainly banks, are increasingly expanding abroad in order to provide services for them. In line with the reforms of the financial system, financial institutions were also encouraged to seek greater exposure to international financial markets. In particular, the big state-owned banks such as the ICBC and the ABC chose the Hong Kong Stock Exchange for their IPOs in 2006 and 2010 respectively. Being the gateway for Chinese companies to the rest of the world and the place where they seek access to foreign capital markets, Hong Kong is the market where a growing number of Mainland companies double-list when they go public. Both these outward investments and joint IPOs have contributed to the development of an offshore RMB centre and the internationalization of the RMB, and indeed the latter can be considered the latest development of the 'Go Global' strategy.

Source: Government of the People's Republic of China.

13 The Chinese authorities set out their ambitious plan to establish an international financial centre in the 12th Five-Year Plan (2011–15). The establishment of an IFC, further domestic reform in financial markets and the internationalization of RMB are the three main themes of China's medium-term financial strategy. Expansion of its financial periphery is also treated as an essential component of enhancing China's soft power. Detailed targets for realizing this goal have been set out in China's Fourth National Financial Work Conference, as detailed in Box 1.

## Table 2: Overall GFCI rankings of major cities

| Country/Economy | GFCI 11 Rank | GFCI 10 Rank | GFCI 9 Rank |
|---|---|---|---|
| London | 1 | 1 | 1 |
| New York | 2 | 2 | 2 |
| **Hong Kong** | 3 | 3 | 3 |
| Singapore | 4 | 4 | 4 |
| **Shanghai** | 8 | 5 | 5 |
| Beijing | 26 | 19 | 17 |
| **Taipei** | 27 | 23 | 19 |
| **Shenzhen** | 32 | 25 | 15 |

Sources: GFCI 11 (2012), GFCI 10 (2011), GFCI 9 (2011).

In the Global Financial Centres Index (GFCI) published by the Z/Yen Group,[14] Hong Kong is ranked third worldwide as an IFC and Shanghai eighth, whereas Taipei and Shenzhen are ranked 27th and 32nd respectively (see Table 2).

*Connectivity*, *Diversity* and *Speciality* are the three elements adopted in the GFCI rankings to measure the financial integration level of each financial centre.[15] *Connectivity* is key in showing the level of global integration of the cities considered and provides the criterion for their classification as Global, Transnational or Local Financial Centres. The wider the global network a financial centre has, the greater its potential international exposure, and thus the more international it is. The other variable used to classify centres with the same level of *Connectivity* is the level of financial depth, which is determined by the two other categories, *Diversity* and *Speciality*, shown in Table 3.

Hong Kong is classified as a *Global Leader* (Table 3) along with London and New York. Consistently ranked among the top five in GFCI reports, London, New York and Hong Kong are likely to retain their leading positions in the near future as they control a large proportion of financial transactions (approximately 70% of equity trading). Shanghai has comparable levels of market depth and breadth to those of the Global Leaders, but because it is not integrated in the international financial markets, it is classified as a *Global Diversified Centre*. Indeed, the city has a growing market that taps into China's domestic development and plays a critical role in the 'Go Global' strategy; it also has a mature and broad financial sector. As for Shenzhen and Taipei, these cities are viewed more as niche centres. The former, in particular, is classified as a *Transnational Specialist* with a slightly lower level of connectivity with Shanghai, which is classified as an *Evolving Centre* at the local level.

Since the publication of the first GFCI report in March 2007, financial centres in emerging Asia, particularly those perceived as 'strong', having improved their ratings (GFCI, 2011). Shanghai, in particular, rose into the top 5 list for the first time in 2011. However, perceptions on the rise of those financial centres in the Greater China region have recently changed as the result of concerns about the convertibility of the Chinese yuan (GFCI, 2012). Consequently, this is reflected in the 2012 GFCI's lower

14 The GFCI provides a useful and systematic framework, albeit with some methodological limitations. The index, which has been compiled by the Z/Yen Group since 2007, ranks financial centres using a 'factor assessment model', i.e. using two different types of input: instrumental factors and financial centre assessments (responses to an online survey). Instrumental factors are defined as 'external indices that contribute to competitiveness': these indices come from surveys and other sources and are combined in order to measure the so-called competitiveness factors for each financial centre (the four main competitiveness factors are the availability of skilled personnel, the regulatory environment, access to international financial markets and the availability of business infrastructure). Financial centre assessments are collected from 1,887 respondents via online questionnaires. See GFCI (2011), Methodology, p. 32.

15 In the GFCI report, 1) *Connectivity* is defined as the centre's level of interaction with other financial centres, or the depth of the network as perceived by investors; 2) *Diversity* is defined as 'the breadth of industry sectors that flourish in a financial centre' or 'richness of business environment'; 3) *Speciality* refers to the depth of each sector that makes the whole industry, including asset management, investment banking, insurance, professional services and wealth management.

ranking for Shanghai. On the other hand, Hong Kong kept its position as the third leading IFC, despite concerns about the RMB currency issue.

There is a clear distinction in the classification adopted by the GFCI between defining a financial centre's position in the global context and the level of financial development of a country and its economy. The latter carries far greater weight for the institutional environment, whereas the former focuses on the centre's financial network, emphasizing market accessibility and market integration.

### Table 3: Financial centres by 'Connectivity' and 'Diversity and Speciality'

| | **Broad and deep** | **Relatively broad** | **Relatively deep** | **Emerging** |
|---|---|---|---|---|
| ***Global*** | *Global leaders* | *Global diversified* | *Global specialists* | *Global contenders* |
| | Chicago | Amsterdam | Beijing | Luxembourg |
| | Frankfurt | Dublin | | Moscow |
| | **Hong Kong** | Seoul | | |
| | London | **Shanghai** | | |
| | New York | Singapore | | |
| | Paris | | | |
| | Tokyo | | | |
| | Toronto | | | |
| | Zurich | | | |
| **Transnational** | *Established transnational* | *Transnational diversified* | *Transnational specialists* | *Transnational contenders* |
| | Copenhagen | Boston | Athens | Bahrain |
| | Geneva | Istanbul | Dubai | British Virgin Islands |
| | Madrid | Kuala Lumpur | Edinburgh | Cayman Islands |
| | Montreal | Washington DC | Glasgow | Gibraltar |
| | **Munich** | | Mumbai | Guernsey |
| | Sydney | | Doha | Isle of Man |
| | Vancouver | | **Shenzhen** | Jersey |
| **Local** | *Established players* | *Local diversified* | *Local specialists* | *Evolving centres* |
| | Brussels | Bangkok | Abu Dhabi | Buenos Aires |
| | Calgary | Warsaw | Bahamas | Jakarta |
| | Helsinki | | Budapest | Johannesburg |
| | Lisbon | | Hamilton | Manila |
| | Melbourne | | Malta | Mauritius |
| | Mexico City | | Monaco | Osaka |
| | Milan | | Oslo | **Taipei** |
| | Prague | | Reykjavik | Wellington |
| | Rome | | Rio de Janeiro | |
| | San Francisco | | Riyadh | |
| | São Paulo | | St Petersburg | |
| | Stockholm | | Tallinn | |
| | Vienna | | | |

Note: Diversity and Speciality are combined to create a two-dimensional table showing financial depth.
Source: The GFCI 11 Report, March 2012.

On the basis of the GFCI's *Connectivity* criteria, we can infer that Hong Kong is an IFC as it presents a strong base comprising functioning intermediaries and infrastructure that connect international financiers and capital markets. Shanghai, on the other hand, lacks a deep enough financial market and therefore, as noted above, offers limited access and products to international investors. In this report, therefore, we still classify Shanghai as a Domestic Financial Centre, notwithstanding the classification followed by the GFCI. But its tremendous market size and fairly well-developed financial market, especially in the banking and insurance sectors, give it the potential to extend its influence regionally and internationally as the liberalization of the RMB progresses. Meanwhile, Shenzhen will remain a niche financial centre serving the SMEs in mainland China. Though not comparable to Shanghai in terms of market size or financial infrastructure, it will be at the forefront of Beijing's experiments with its internationalization strategy for the RMB. As for Taipei, this is classified by the GFCI as a Local Centre. However, as discussed in Chapter 3, with its vast network of Taiwanese business throughout Asia and its competitive advantage in terms of connectivity, Taipei could gain relevance as a complementary regional financial centre as China opens up and reforms its financial system.

# 2. A Tale of Two Cities: Shanghai and Shenzhen

## 2.1 Building financial centres in mainland China

As China reforms and opens its financial sector, its financial centres will support the implementation of these policies. Conversely, the process of financial reform is an important determinant in shaping these centres. In particular, both Shanghai and Shenzhen have played and are still playing a critical role in China's long-term economic reforms. Backed by a successful history as the city where financial activities were concentrated before 1949, Shanghai, as noted, has been designated to become the IFC in mainland China. The government's commitment to this has been made evident several times: in the 11th Five-Year Plan in 2006 (NDRC, 2006), in the State Council declaration in 2009[16] and in the 12th Five-Year Plan in 2011.

Like Shanghai, Shenzhen has been a frontrunner in China's reform process. Since the early 1980s it has served as a testing ground for the process of financial liberalization through the development of the very first Special Economic Zone (SEZ).[17] The establishment of the Shanghai Stock Exchange (SSE) and then of the Shenzhen Stock Exchange (SZSE) were the first signal that the central government was planning to develop these two cities as China's main financial centres. Shenzhen has now become China's second most important financial centre, serving the local economy of the Guangdong region where many innovative companies, many of which are SMEs, are based.

## 2.2 Shanghai and China's domestic financial reform

According to China's 12th Five-Year Plan (2011–15), Shanghai is set to become an IFC by 2020. In January 2012 the National Development and Reform Commission (NDRC) and the Shanghai government announced a plan to develop the city as a global hub of RMB trading by 2015. This could be a significant announcement as it reveals that China's RMB strategy is essential to the process of building an international financial centre in Shanghai – and the pace at which its capital account is opened up to make the RMB a fully convertible currency will therefore ultimately determine Shanghai's evolution towards this goal. The announcement not only demonstrates the strong strategic preference of the Chinese authorities to pursue more vigorous financial development in Shanghai, but also sets out a list of ambitious yet pragmatic goals to achieve within a set timeframe (see Box 3 and Table 4).

The goals set for Shanghai raise two questions. First, is it feasible for Shanghai to achieve these targets within the proposed timeframe? For any financial centre, the financial depth and liquidity of its capital markets, both equity and debt markets, are at the core of its competitiveness. In this regard, measurable parameters such as market capitalization, IPOs, turnover, size of derivatives and exchange markets are fundamental to quantifying a financial centre's potential for developing a deep and liquid market.

16 On 25 March 2009, China's State Council issued detailed guidelines for the promotion of Shanghai to become an international financial centre by 2020. This seminal policy document cemented Shanghai's position as Beijing's preferred choice as an IFC.

17 Special Economic Zones (SEZs) are selected geographical areas with rules and regulations that are different from the rest of the country, aimed at encouraging foreign direct investment. The companies operating in SEZs often receive tax and tariff incentives. In China, the term was chosen after considerable semantic discussion and intellectual debate, with SEZs being conceptualized as a complex of related economic activities and services rather than as uni-functional entities. SEZs in China, therefore, differed from free-trade zones and similar special areas in Asia by being more functionally diverse and covering much larger land areas (Yeung et al., 2009).

### Box 3: Shanghai as a global centre for RMB trade by 2015

According to the plan by the National Development and Reform Commission, Shanghai is set to become a global RMB trade centre by 2015. This is a major milestone on the city's path to becoming an international financial centre. The plan, the first detailed follow-up since the State Council's 2009 announcement that Shanghai would become an international financial hub by 2020, envisages the city becoming a leading international financial hub and global centre for RMB trading, clearing and pricing by 2015. The document lists ambitious goals that Shanghai is expected to achieve by that date:

- Financial market transactions (excluding foreign exchange transactions) to almost triple to RMB1,000 trillion (US$158 trillion), and comprehensive expansion of market size and market depth (see Table 4).
- The Shanghai Interbank Offered Rate (SHIBOR) and the RMB central parity rate to become major benchmarks for RMB asset pricing and transactions, both domestically and internationally.
- Infrastructure construction to be speeded up to build a cross-border RMB payment and clearing network that will eventually support international demand; a cross-border RMB investment and financing centre is also to be established in Shanghai.
- Sufficient provision of financial services to be ensured, to facilitate the needs stemming from the real economy of the whole of China, with a focus on the development of assets under management (AUM), ship financing, reinsurance and private equity and venture capital industry.
- Greater communication and cooperation between Shanghai and Hong Kong in areas such as financial markets, institutions, products, businesses and talents.

### Table 4: Goals for Shanghai's financial sector during the 12th Five-Year Plan period (2011–15)

| | Item | 2010 | 2015 |
|---|---|---|---|
| **Size of financial markets** | Total transaction volume of Shanghai's financial markets (excluding foreign exchange market) | RMB386.2 trillion | RMB1,000 trillion |
| | Total volume of the balance of securities deposit | Global No. 5 | Global top 3 |
| | Total transaction volume of Gold Spot Trading | Global No. 1 | Global No.1 |
| | Total transaction volume of financial derivatives | N/A | Global top 5 |
| | Total insurance premium | RMB69.5 billion | RMB140 billion |
| | Total interbank card transaction | RMB10 trillion | RMB25 trillion |
| **Market connectivity and diversity** | Overseas investor | Limited market participation | Significant market participation |
| | Global influence | Limited overseas market influence | Promote international market influence through listing major indices in Shanghai Stock Exchange and developing RMB-denominated commodity future prices |
| **Market depth** | Direct financing as % of total financial markets | 16.70% | 22% |
| | Financial Assets Under Management (AUM) | RMB15 trillion | RMB30 trillion |
| **Financial environment** | Total no. of professional financiers | 245,000 | 320,000 |
| | Global competitiveness | National No. 1 | Adopt international standards for stable legal and regulatory financial environment |

Source: NDRC (2012).

To develop as an international financial centre Shanghai also needs to develop its international exposure and connectivity, to use the GFCI terminology. It also needs to establish a sound regulatory framework, a transparent supervisory environment, a stable legal system, a fair tax regime, modern financial infrastructure and a good standard of living, all of which would help in attracting and retaining a skilled workforce (GFCI, 2011).

This leads to the second question: will Shanghai be able to develop greater international 'connectivity' and improve these qualitative facets within the proposed timeframe? If purely judged on the quantitative aspects, the performance of Shanghai's capital markets appears very promising. Looking at the equity market alone, the domestic stock market capitalization stood at $2.36 trillion, exceeding Hong Kong's $2.26 trillion at the end of 2011 (WFE, 2012). The stock market in Shanghai experienced a rapid boom in the 2000s, with market capitalization growing at an average annual rate of 60% between 2000 and 2010, while market turnover in 2010 was almost tenfold that in 2005.[18] By the end of 2011, the SSE's trading volume reached $3.67 trillion, and it was ranked as the third largest in the world (Hong Kong achieved only $1.49 trillion). If such a growth rate is sustained, even at a slower pace, Shanghai's equity market will be able to compete with London, Tokyo and even New York in the near future.[19]

These figures and their growth rate trend once again suggest the potential for Shanghai to achieve the targets by volume set by the 12th Five-Year Plan in the proposed timeframe. Moreover, the role of China's vibrant real economy cannot be ignored. Its strong growth in the last two decades, if it continues, provides Shanghai with a very solid platform to build an international financial centre. Major state-owned enterprises such as the energy companies Petro China and Sinopec, large commercial banks and financial institutions, and China's rapidly growing private sector would rely on the Mainland's principal exchange, the Shanghai Stock Exchange, to raise funds and manage financial risks. Shanghai is also a major seaport, which overtook Singapore in 2010 to become the world's largest container port.

All these factors provide foreign financial institutions with enough business potential to make Shanghai one of the most attractive cities in the Mainland: 68% of the foreign banks have their head offices there, as well as 44% of non-life foreign insurance companies and 31% of life-insurance joint enterprises (PBoC, 2011a).

At the end of 2010, the city was also home to 45% of joint-stock securities companies and 63% of joint-stock asset management companies in China. Shanghai is attractive not only for private foreign banks and insurance companies, but also as the centre with the most important financial institutions. A growing number of key financial exchange houses have been established in the city since the SSE's inception in 1990.

Table 5: Chronology of major financial institutions in Shanghai

| Inception date | Financial institution |
|---|---|
| 1990 | Shanghai Stock Exchange |
| 1994 | China Foreign Exchange Trade System (CFETS) |
| 1997 | National Interbank Funding Centre (NIFC) |
| 1997 | National Bond Trading Centre |
| 2002 | Shanghai Gold Exchange |
| 2005 | 2nd Headquarters of the People's Bank of China |
| 2006 | China Petroleum Futures Market |
| 2006 | China Financial Futures Exchange |
| 2007 | Shanghai Financial Arbitration Court |
| 2009 | Shanghai Clearing House |

Source: Chatham House.

This agglomeration of private foreign financial institutions and public authorities provides a sound basis for Shanghai's development as an IFC. However, compared with Hong Kong, it still lacks a sound supervisory

18 In 2010, its equity market turnover was RMB416 trillion (in 2005 it was approximately RMB40 trillion).

19 By the end of 2011, the domestic equity market capitalization of LSE, TSE, NASDAQ and NYSE was US$3.27 trillion, $3.33 trillion, $3.85 trillion and $11.8 trillion respectively, according to WFE 2011 data (WFE, 2012).

### Box 4: Qualified Foreign Institutional Investors (QFII)

The Qualified Foreign Institutional Investors (QFII) scheme refers to the programme by which selected foreign investors are allowed to participate in China's domestic managed fund market. The scheme allows authorized institutional investors to invest in and trade on the Chinese securities market, namely the Shanghai and Shenzhen stock exchanges. Launched in November 2002, the QFII scheme has allowed China to maintain strict controls over its currency and capital flows, while its economy has become integrated with the rest of the world. The national authorities have controlled the inflow of international funds into the country by using the licences issued by the Fund Supervision Department of the China Securities Regulatory Commission (CSRC) and the quota set by the Reserve Management Bureau of the State Administration of Foreign Exchange (SAFE).

framework, investor protection laws and a favourable tax regime – all necessary for such development.

In terms of connectivity too, Shanghai falls short as a potential IFC. The restrictions on the convertibility of the RMB and the free movement of capital make it difficult for the city to build a deep financial sector in terms of products and services, especially one that involves cross-border and cross-currency financial transactions. The direct tradable foreign currencies in the Shanghai foreign exchange market, for example, are mainly the US dollar, the Japanese yen, the Hong Kong dollar, the euro, the British pound and the Australian dollar (SAFE, 2011). Additionally, the bond market is mainly confined to the interbank market, where bond dealers require licences for access. Despite figures showing an increase in the activities conducted within the SSE, its exposure to foreign capital and investors is still very limited. Foreign companies are not allowed to list on the SSE and the securities market is heavily regulated. Programmes such as the recently introduced QFII scheme (Box 4) are important in terms of allowing foreign investors to participate in China's capital markets. These schemes give the SSE much-needed international exposure, but the volumes that they generate are limited. Much more has to be done for Shanghai to attain the level of connectivity deemed necessary for an IFC and currently enjoyed by cities such as London and New York. This leads us to conclude that Shanghai's current ranking in the GFCI report is not entirely appropriate. While it clearly shows the *potential* to become one of the world's leading IFCs, it is not there yet.

## 2.3 Shenzhen and the development of SMEs

In the sixth edition of the GFCI in 2009, Shenzhen ranked fifth, mainly because of the positive assessments by the respondents based in Asia, but it had poor assessments by those outside Asia. However, since then Shenzhen has lost its high rankings and is ranked 32nd in the latest GFCI report. Though it is classified as a 'Transnational' and 'Relatively Deep' financial centre, its development remains very closely linked to that of the Guangdong region. Moreover, relative to Shanghai's, Shenzhen's financial infrastructure is not highly developed and lacks connectivity with other international centres. However, it has the potential to evolve into a niche centre serving the SMEs based in the Guangdong region and to complement Shanghai's international role as China opens up and reforms its financial system.

There are two elements that suggest how Shenzhen could or should evolve as a financial centre focusing on the development of capital markets and services needed to support SMEs at a local or regional level.

First, the effort to develop Shenzhen as a Special Economic Zone is set to continue. Shenzhen was allowed to develop as an SEZ and was used as a platform to 'experiment' with financial liberalization that was eventually implemented elsewhere. When the city began its transformation into a financial centre by becoming China's first SEZ in 1980, it was chosen for its proximity to Hong Kong and the links between the two cities, with Shenzhen working as the manufacturing 'backyard' for Hong Kong. Furthermore, the whole of Guangdong Province has a long tradition of trade and entrepreneurship, making Shenzhen an ideal ground for economic reforms. In fact, Guangdong's liberal and outward-looking leaders were the first to ask for the domestic market to be opened. The success of this scheme led Beijing to persist with the opening-up. Thus Shenzhen became the 'pilot city' for reforms that were later implemented on a larger scale in Shanghai. Indeed, when the Shenzhen Stock Exchange was established in 1991, investors in southern China were far more enthusiastic than in other regions in mainland China. At that time, Shenzhen enjoyed light policy intervention and relatively loose regulation on market activities. However, the fast pace at which speculative activities on the SZSE increased led to Beijing imposing strict regulations on futures trading transactions and almost freezing the expansion of capital markets after the Asian financial crisis in 1997.

The second reason for expecting Shenzhen to develop as an SEZ is its close links with the manufacturing industry embedded in Guangdong, one of the world's largest manufacturing centres – production in 2011 was worth RMB2.6 trillion (US$ 469 billion), accounting for about 56% of the province's GDP. In 2011 Guangdong's GDP was RMB1.15 trillion, making Shenzhen the largest and richest metropolis in the Pearl River Delta region and the fourth in the Mainland. Manufacturing industry contributed over 46% (RMB522.8 billion) to the municipal GDP and service industries accounted for around 53% of the city's economic growth, of which 13.6% was contributed by its financial sector (PBoC, 2011b).[20]

Powered by a strong export-oriented manufacturing industry, Shenzhen is now a point of reference for SMEs that are seeking business opportunities and capital. The central government is encouraging Shenzhen to be the financial centre for SMEs and innovative start-ups. It made this clear with the opening of the SME Board on the SZSE in June 2004 and the ChiNext Board in October 2009. The establishment of the SME Board was a defining moment for Shenzhen's capital market, considering that the applications for new IPO issuances on the SZSE Main Board[21] had been suspended for the previous four years.[22] This was also intended to provide SMEs with better access to capital resources via the primary capital market, in particular the equity market, reducing their dependence on commercial banks as the only means of corporate financing,[23] and ultimately to develop a multi-tier financial system – which is not only composed of banks – to create diversified financing channels for the domestic economy. Thus the SME Board has made available vital resources for SMEs while also reviving the market activity of the entire SZSE. The ChiNext Board specifically facilitates fund-raising for start-up enterprises. The goal is to expand as the next Nasdaq-style board with equivalent importance for Chinese companies to the Main Board, where major SOEs and large financial institutions and enterprises are listed.

Since its inception, ChiNext has grown strongly, with 117 IPOs in 2010, raising US$14.6 billion in total. As shown in Figure 7, the SME Board remains the most important of the SZSE boards with the highest numbers of IPOs, while all the SZSE boards show a clear preference for the manufacturing industry. However, its future is uncertain. Guo Shuqing, appointed Chairman of the CSRC in October 2011, announced that securities regulation on stock issuance and delisting would be introduced within the next five years and meanwhile, in a bid to encourage standard industry practice in China's equity market, tougher legal penalties would be imposed for deliberate illegal speculation.

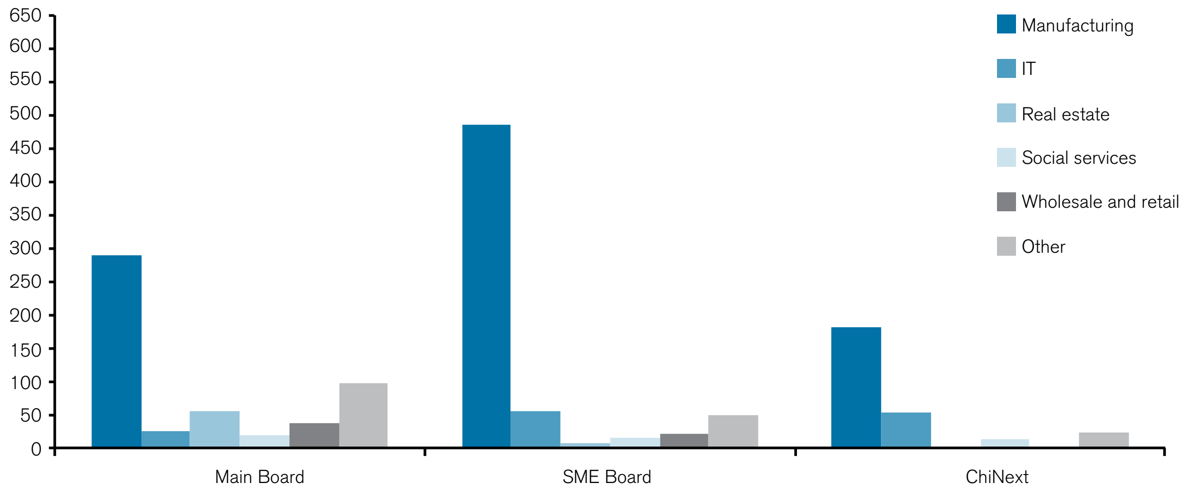
20 PBoC's data on China's domestic GDP are organized according to three levels – municipal, provincial and regional. For the municipal level, financial data on the four Chinese direct municipalities (Beijing, Shanghai, Tianjing and Chongqing) and Shenzhen are available from PBoC publications. Provincial statistics provide the aggregated data for the 31 provinces in mainland China, and regional reports cover a much broader geographical area, offering aggregated data on, for example, the Pearl River Delta region and Yangtze River Delta region.

21 China's equity market comprises the SSE and SZSE Main Board markets, SME Board market, ChiNext market and OTC market. The Main Board was originally established for the reform of state-owned enterprises and later expanded to serve the real economy. Over the past two decades, the Main Board markets have become the vital financing channel for major enterprises.

22 In September 2000, IPO activity in Shenzhen Stock Exchange was suspended as the Chinese government decided to merge its bourses into a single exchange in Shanghai and prepared to launch a second board in Shenzhen for private and technology companies.

23 In the Mainland market, direct credit from commercial banks is the major channel for SMEs to finance business. However, with their strong lending preference for SOEs (which are regarded as much creditworthy), commercial banks tend to impose stricter conditions for providing credits to SMEs. Owing to these banks' market dominance, it is generally very difficult for Mainland's SMEs to acquire adequate capital resources through them.

Figure 7: Number of SZSE-listed companies by board and sector




Source: SZSE, 2011.

In Shenzhen, the financial sector contributed about 13% of the local (municipal) GDP in 2011, slightly lower than that of Hong Kong at 15%.[24] This is quite remarkable considering that apart from the SZSE, Shenzhen does not have any other exchange (such as a commodity or futures exchange) of national significance that would help attract financial activities to the city. In addition Hong Kong absorbs the bulk of capital from the Mainland and overseas, and has distinct advantages such as the most liquid financial markets, an advanced legal system and world-class financial talent.

The only other centre that can compete with Shenzhen in serving the SME market is Taipei. This has rich experience in addressing SMEs' financial needs at their different stages of growth, and a broader SME customer profile across the Asia region, not just across mainland China (APEC, 2003).

Nevertheless, the ongoing financial reform and RMB internationalization strategy have been providing new opportunities for Shenzhen. The newly proposed scheme allows Qianhai region autonomy in setting preferential policies to attract financial institutions and to act as the experimental region for cross-border RMB transactions. Though the details of the proposal are unclear, Beijing hinted at the possibility of a low tax regime and free convertibility of the RMB in Qianhai. In addition, it has repeatedly emphasized the importance of Qianhai's role in the process of setting up a cross-border RMB settlement scheme.

24 In London, the world's leading financial centre, the financial sector contributed 10% of the local GDP in 2011.

# 3. Beyond Borders: Hong Kong and Taipei

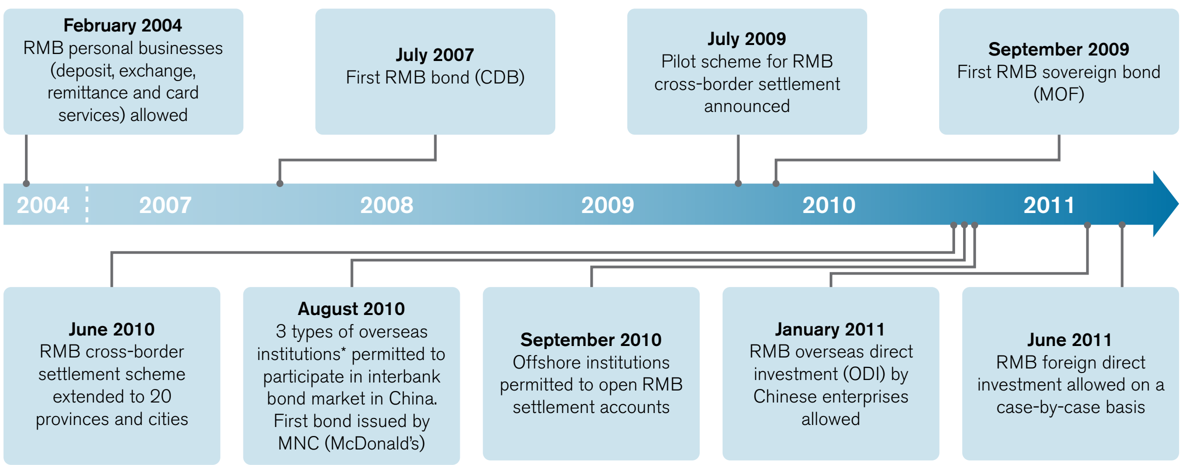
## 3.1 Internationalization of the RMB

The integration of financial centres in Greater China is an important step in Beijing's strategy to develop the Mainland's financial system and to expand the country's economic and financial influence beyond its national borders towards its financial periphery. In doing so, China will directly shape the future of Hong Kong's financial sector, and to some extent, and indirectly, also that of Taipei. Consequently, cooperation and coordination among the financial centres in Greater China are expected to grow as mainland China strengthens its presence in the regional financial network. The scope and pace of financial reforms, both domestic and international, set by Beijing will ultimately determine the exact nature of this process of integration. The RMB and its internationalization lie at the heart of this process.

China's strategy of internationalizing the RMB without fully opening its capital account is proceeding along two parallel tracks. The first track aims to increase the regional use of the RMB, with policies focused on its use as a currency for invoicing cross-border trade. The second track aims to develop Hong Kong as an offshore RMB centre, with policies focused on providing instruments for hedging the currency risk and making RMB holdings more attractive to non-residents (Subacchi, 2010). This two-track strategy is likely to draw the financial centres in Greater China into the Mainland's financial sphere and will bind them together as the RMB and the RMB-denominated assets become more sought out in the region.

This is already evident in the rapidly evolving relationship between Hong Kong and Shanghai. On the one hand, Hong Kong, the main offshore centre for the Chinese currency, is increasingly dependent on China's RMB internationalization policies for future opportunities (Figure 8). On the other hand, as Shanghai, the main onshore centre for RMB, aims to develop into an IFC over the next decade it will gradually gain greater significance in the international RMB market. These developments suggest that over time Hong Kong and Shanghai are expected to forge deeper financial ties and converge in terms of the services offered to market players.

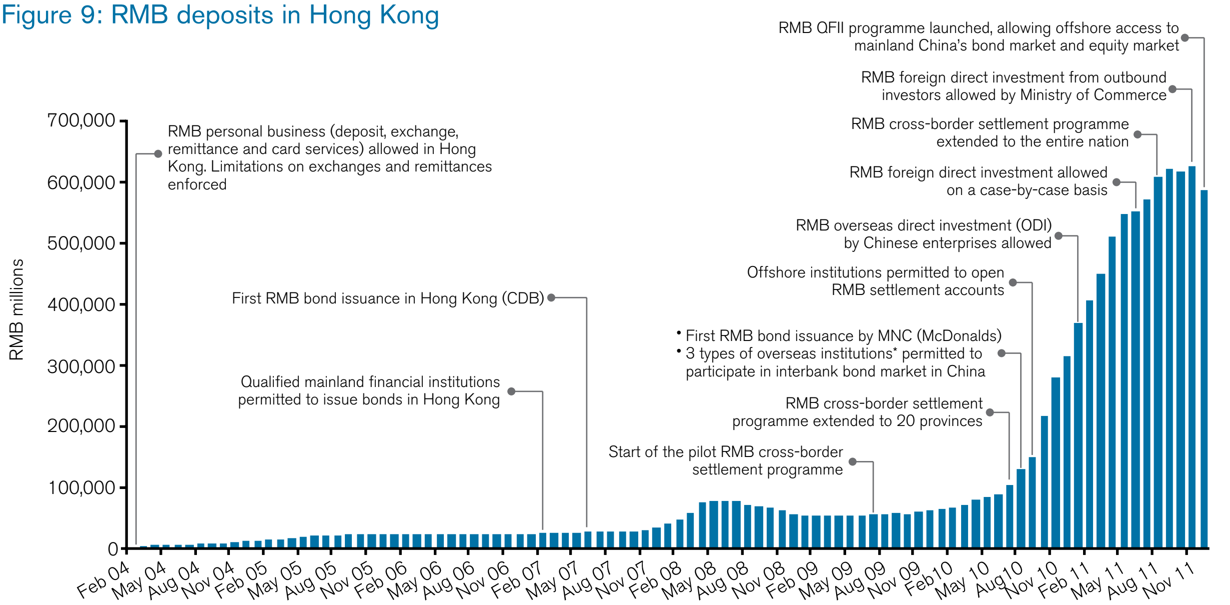
Figure 8: Milestones of offshore RMB liberalization




*Includes foreign central banks and monetary authorities, RMB business clearing banks in Hong Kong and Macau, and offshore authorized participating banks for cross-border RMB settlement.

Source: HKEx, 2011.

## Figure 9: RMB deposits in Hong Kong

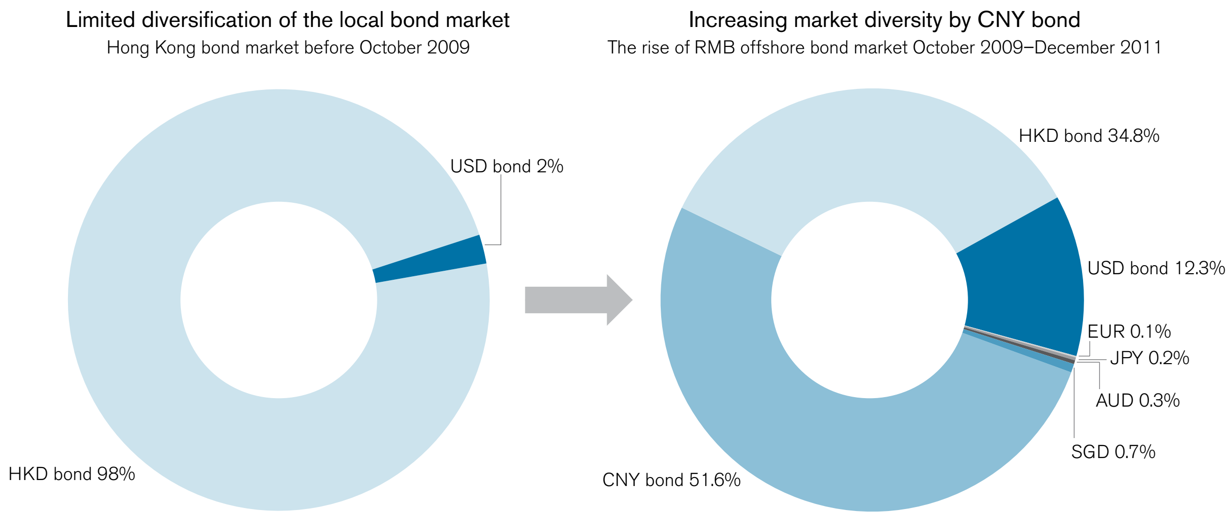



*Includes foreign central banks and monetary authorities, RMB business clearing banks in Hong Kong and Macau, and offshore authorized participating banks for cross-border RMB settlement.

Source: HKMA, 2011.

Hong Kong remains the most important centre in China's RMB internationalization strategy and the RMB market in the city has come long way since July 2009 when the pilot scheme for RMB cross-border settlement was announced. The introduction of new policy measures – the expansion of cross-border settlement to twenty new provinces and permission for offshore institutions to open RMB settlement accounts – in mid-2010 led to a strong growth of RMB deposits in Hong Kong (Figure 9). The even stronger growth of the RMB-denominated bonds issued – the so-called dim sum bonds[25] – and the rising significance of RMB IPOs in Hong Kong, as well as the introduction of the RMB Qualified Foreign Institutional Investors (RQFII) scheme (Box 5), are fuelling the growth of the RMB offshore market, as indicated in Figure 10.

## Figure 10: Growing RMB offshore bond market




Source: HKMA, 2011.

25 These RMB-denominated bonds issued in the offshore market are called 'dim sum bonds'. The other type of RMB bond is called a Panda Bond. These are RMB-denominated bonds issued by non-Chinese institutions and sold in mainland China's onshore interbank bond market. See Chapter 4 for more discussion of this topic.

Though RMB-denominated bonds issuance has been operational in Hong Kong since 2007, it was not until August 2010 that the first foreign private company, McDonald's, issued RMB bonds, attracting significant attention from the international investor community.[26] Previously the Chinese government had only allowed financial entities incorporated in the Mainland to issue such bonds in Hong Kong. The growth of the RMB offshore bond market in Hong Kong has been very strong (Figure 10). In 2011, 84 financial institutions and corporates issued US$14 billion worth of dim sum bonds in Hong Kong, triple the amount in 2010 (US$5.4 billion), and six times the level in 2009 (US$2.3 billion). By the end of 2011, RMB-denominated bonds represented 51.6% of Hong Kong's bond market.

The equity market is another area of expansion for RMB-denominated securities. The first RMB IPO was in April 2011 when the Beijing-based Hui Xian real-estate investment trust raised up to RMB11.2 billion (US$1.7 billion) in Hong Kong. The RMB listing of the REIT (Real Estate Investment Trust) was a critical step that consolidates Hong Kong's market status as the first and most important RMB offshore centre.

There are at least three main competitive advantages that give reason to believe that the market for RMB-denominated products will flourish in Hong Kong. First, the city has the technical and operational capabilities to deal with trading and clearing businesses of RMB products. Secondly, there is growing and positive market demand for RMB-denominated products in Hong Kong. Partly because of expectations of the yuan's appreciation and partly owing to the growing profitability of RMB-denominated products, the market has so far reacted extremely positively to the issuance of dim sum bonds. In particular, it welcomed the announcement of exclusive RMB repatriation schemes to be sited in Hong Kong, made immediately after Vice Premier Li's visit to Hong Kong in August 2011. Finally, the city offers ample RMB liquidity because of its huge deposits (Figure 9). Hong Kong is so far arguably the only RMB offshore centre where the three elements of RMB trade settlement, RMB financing and RMB wealth management have reinforced its market status as the foremost RMB offshore centre (Yue, 2011).

More recently, the RQFII scheme (Box 5) was introduced as a means of repatriating a portion of the accumulated offshore RMB (CNH)[27] back to Mainland capital markets. The scheme permits registered foreign investors to invest in the Chinese securities markets by using RMB raised from offshore, with an initial limit of RMB20 billion (US$3.1 billion) in total as the maximum volume. More importantly, the RQFII scheme is the first channel that allows smooth circulation of the RMB between the offshore market in Hong Kong and the Mainland. This scheme provides incentives for foreign investors to hold on to CNH as they can access the onshore RMB market. The scheme also promotes the innovation and development of Hong Kong's offshore RMB financial products while turning the city into a gateway to mainland China.

### Box 5: RMB Qualified Foreign Institutional Investors (RQFII)

Introduced in August 2011, the RMB Qualified Foreign Institutional Investors (RQFII) scheme allows foreign investors to invest RMB raised in offshore centres into the Mainland; 80% of the funds brought into mainland China under the scheme must be invested in the bond market. The first batch of licences has been allocated to Hong Kong branches of Mainland companies.

The development of an offshore RMB market is expected to cement Hong Kong's position as the IFC for China in the medium term as well as to draw it closer to Shanghai through the gradual merging of the RMB onshore and offshore markets. Measures to deepen ties between the two stock exchanges are encouraged. In October 2008, the Hong Kong Stock Exchange (HKEx) Information Services Limited and SSE Infonet Limited (the information

26 In August 2010, McDonald's Corporation issued an RMB corporate bond. This issuance is seen as an important milestone in the development of an offshore RMB bond market and also a new channel for international companies seeking to raise capital.

27 CNH is the currency code given to the RMB traded on the offshore market in Hong Kong. The onshore-traded RMB is generally referred to as CNY.

business subsidiaries of the HKEx and SSE) signed a two-year agreement to support investors with an interest in shares of issuers dual-listed in Hong Kong and Shanghai by raising the transparency of the issuer in both markets. The agreement, the Mainland Market Data Collaboration Programme (HKEx Information Services Limited, 2010), was renewed in November 2011 and is set to remain in place until the end of 2013.

Furthermore, in January 2009 the Hong Kong Stock Exchange and the Shanghai Stock Exchange signed a Closer Cooperation Agreement, which was renewed in January 2010. This agreement commits the two exchanges to work even more closely together 'towards the common goals of meeting the domestic and international fund-raising needs of Chinese enterprises for their continued development, and contributing to the greater development of China's economy' (HKEx News Release, 2009). In addition, the presence of Mainland companies in the HKEx is significant in terms of the IPOs, market capitalization and sheer number of listed companies. The cooperation between the stock exchanges suggests that companies would have advantages in expanding their exposure to both markets. As already discussed, Shanghai serves the national market, and companies would aim to list on the SSE to be closer to domestic investors. The advantages of listing in Hong Kong include its international exposure and the great range of opportunities it offers to market participants in terms of connectivity, quality of service and diversification of products.

Although Shenzhen does not seem to have an evident role in this story, recent developments suggest that the Chinese authorities are exploring the possibility of allowing a cross-border RMB lending scheme in Qianhai, a coastal region geographically close to Hong Kong.[28] Adopting the broad philosophy of China's economic reform process set out by Deng Xiaoping – the initiation of pilot programmes in the south China region before any major reform is implemented nationwide – Qianhai is to be developed into an experimental ground for further RMB cross-border development.

As for Taipei, it is less likely to become an RMB offshore centre in the near future or play any significant role in the RMB internationalization process. The primary obstacles lie in the lack of policy cooperation that is necessary for building an RMB offshore centre and linking it with the RMB onshore. Although cross-strait cooperation and business ties are growing, they are as yet far from strong enough to support the establishment of another RMB offshore centre in Taipei.

Integration between Taipei and the other financial centres in the region seems confined to cross-strait trading businesses. Financial cooperation between the two markets is still in its infancy, at a stage where political consensus plays a very dominant role in the process. Yet as Beijing's RMB strategy unfolds, Taiwan would embrace greater business opportunities in the area of cross-strait financial cooperation as well as in trade. For instance, Taiwanese banks would be able to expand their offshore banking business (or so called OBU – Offshore Banking Unit) in the Mainland market, enjoying exclusive benefits to provide Taiwanese firms with the local currency (RMB) services. Nevertheless, further financial integration between the two markets is still constrained by cross-strait political dialogue.

## 3.2 Hong Kong: springboard for the Mainland and gateway for the RMB

Hong Kong, as noted, has an internationally integrated financial sector and a sound regulatory framework that make it one of the world's leading international financial centres. Under the influence of the British rule, the city was able to develop as a financial centre for two main reasons. First, it adopted a regulatory system based on the rule of law that is reflected in the current financial institutional environment. Secondly, following the Anglo-Saxon model, Hong Kong embraced an open market regime characterized by the free movement of people, goods, services and

28 On 12 April 2012, a set of measures including the pilot reform programmes in bond, private equity and RMB cross-border lending schemes were approved by Shenzhen's local authorities. Although detailed policies are yet to be clarified, media reports on the 'Project Qianhai' zone reveal several measures to be taken in 2012, including: 1) preferential policies for foreign firms to establish global settlement centres in the Qianhai Zone; 2) the legalization of direct yuan lending business between onshore and offshore markets.

capital. These factors make Hong Kong similar to London and New York, whose open environment to trade and investment was an indispensable condition for their development into global centres.

A government report (Hong Kong Information Services Department, 2011) describes the performance and the international dimension of the city by looking at its banking sector. At the end of July 2010, Hong Kong counted 146 licensed banks, 22 restricted-licence banks and 27 deposit-taking companies, together with 70 local representative offices of foreign banking institutions.[29] These institutions come from 34 countries and include 70 of the world's largest 100 banks. However, the attractiveness of Hong Kong for international investors is not limited to the banking sector, but comes from having deep financial markets. For example, the foreign exchange market, which has been supported by the absence of exchange controls and its favourable location in terms of its time-zone, is a well-established market. Moreover, not only does the Hong Kong stock market rank as the sixth largest in the world (as of end 2011), but its bond market has also developed as one of the most liquid in the region. The city is also a major asset and portfolio management centre in Asia, offering a wide range of services (including unit trusts, mutual funds and institutional fund management) to overseas investors willing to explore opportunities in the region.

Since the handover of Hong Kong to mainland China in 1997, the Hong Kong SAR has maintained its high degree of autonomy in developing its economic system under the Basic Law,[30] a different legal system from that of the Mainland. However, as it is part of China, it is impossible to analyse Hong Kong's status as an IFC without considering the nature and evolution of its relationship with the Mainland. In the past, commercial activities were essential to Hong Kong's prosperity, as it was the only port linking the Mainland and the West, particularly at the beginning

### Box 6: Regulatory evolution in Hong Kong

Under the British administration, Hong Kong built an institutional and regulatory architecture based on English Common Law. Since the 1960s, its financial sector has undergone several reforms that culminated in the establishment of a prudential supervisory authority to support financial stability. The institution in charge of monitoring this system is the Hong Kong Monetary Authority, founded in 1993.

Another important supervisory body for the securities, futures and equity markets is the Security and Futures Commission (SFC), an independent non-governmental body created in 1989 in response to the stock market crash of 1987 and further improved after the Asian financial crisis in 1997. The SFC's goal is to create a secure business environment for financial transactions, where investors will feel comfortable in following the decision-making processes of financial institutions and more willing to take advantage of the financial services offered by Hong Kong. A transparent financial environment is known to build trust among market players and can result in a relevant competitive advantage for the financial centre itself.

Linked to the regulatory regime, the tax policy in Hong Kong is another element in its success as a financial centre. Low taxes attract capital and professionals, from all over the world. In recent years the largest group of professionals relocating to Hong Kong has been from mainland China. Hong Kong offers a competitive individual income tax rate capped at 17%, compared with the 45% rate in the Mainland. Hong Kong's low tax rate also makes it a preferred option for personnel looking to locate in the Greater China region.

29 Hong Kong maintains a three-tier system of deposit-taking institutions, including licensed banks, restricted-licence banks and deposit-taking companies. The first may operate current and savings accounts and accept deposits of any size and maturity from the public. Restricted-licence banks are principally engaged in commercial banking and capital market activities. Deposit-taking companies are mostly owned by or associated with banks and engage in a range of specialized activities. All three types are known as authorized institutions.

30 For detailed information on Hong Kong's economic history, see Schenk (2008).

of the colonial period and during the planned economy in the Mao era (Schenk, 2008). In 2003, Hong Kong and the Mainland signed the Closer Economic Partnership Agreement (CEPA), aimed at promoting trade and investment by progressively reducing or eliminating tariffs and non-tariff barriers on virtually all reciprocal trade in goods. Liberalization of trade in services followed, through the reduction or elimination of virtually all discriminatory measures, resulting in greatly facilitated trade and investment opportunities. Its links with the Mainland also enabled Hong Kong to become the investment gateway into and out of China. The consequences for Hong Kong's financial sector have been very positive. Indeed, after the opening of the investment regime in mainland China in the 1990s, and since the introduction of the 'Go Global' strategy, Hong Kong has become a major springboard for business from the Mainland (Brown and Steel, 2010).

The importance of the relationship between Hong Kong and Beijing is reflected in the structure of the HKEx. In terms of listed companies this includes domestic and foreign listings plus two types of Chinese-controlled shares: 'H-shares' and 'Red-chips',[31] introduced for Chinese companies with Mainland majority control in order to overcome the infrastructural inadequacy of the Mainland stock exchanges. Table 6 shows the 'mainland China dimension' as at August 2011. H-shares and Red-chips together form a high proportion of the total market capitalization (40.43%). Approximately 40% of companies listed on the HKEx are Mainland companies. The importance of Mainland companies is even more evident in Table 7, which shows the major IPOs in the history of the HKEx: China's four big state-owned banks appear in the top ten. Hong Kong receives very high volumes of business from Mainland companies listed in the HKEx; at the same time, companies in the Mainland gain exposure to international capital markets and foreign investors by listing in Hong Kong.

Hong Kong's financial links to Beijing are becoming even more significant owing to its role in the RMB offshore market. As an already well-developed IFC, it fits into Beijing's strategy as the springboard for the RMB to become an international currency. Indeed, working closely with Beijing, Hong Kong is now becoming recognized for providing the most sophisticated RMB products and services to the world. Its ability to exploit its financial structure and respond to the demand for financial services from Beijing to support the internationalization of the Chinese currency constitutes a great competitive advantage for the city. Vice Premier Li's visit in August 2011 reconfirmed Beijing's firm will and policy support to establish Hong Kong's position as the most prominent RMB offshore market. The internationalization of the RMB is the principal policy that will shape the future of Hong Kong as an international financial centre.

### Table 6: Mainland companies' market presence in the HKEx

| (HKD, billions) | 2011 end | 2010 end | No. of | 2011 end | 2010 end |
|---|---|---|---|---|---|
| Market capitalization of H-shares | 4,101.27 | 5,230.48 | Issuers of H-shares | 168 | 163 |
| Market capitalization of Red Chips | 4,002.52 | 4,385.97 | Issuers of Red-Chip stocks | 107 | 102 |
| Market capitalization of NHMPE | 1,619.95 | 2,319.32 | Issuers of NHMPE | 365 | 327 |
| Total market capitalization of Mainland enterprises | 9,723.75 | 11,935.77 | Total issuers of Mainland enterprises | 640 | 592 |
| Mainland enterprises as % of total market capitalization | 55% | 57% | Mainland enterprises as % of total market capitalization | 43% | 42% |

Note: NHMPE refers to non-H-share Mainland private enterprises.
Sources: HKEx, Market Statistics 2011.

31 H-shares come from Mainland-incorporated state-owned companies but are traded on the HKEx. Red-chip shares come from Mainland companies incorporated outside the Mainland and listed in Hong Kong.

### Table 7: Top 10 largest IPOs in Hong Kong (1986 to end 2011)

| Rank | Company | IPO funds raised (HKD, billions) | Year listed |
|---|---|---|---|
| 1 | AIA Group Ltd. | 159.08 | 2010 |
| 2 | Industrial and Commercial Bank of China Ltd. (H shares) | 124.95 | 2006 |
| 3 | Agricultural Bank of China Ltd. – H shares | 93.52 | 2010 |
| 4 | Bank of China Ltd. (H shares) | 86.74 | 2006 |
| 5 | Glencore International plc | 77.75 | 2011 |
| 6 | China Construction Bank Corporation (H shares) | 71.58 | 2005 |
| 7 | China Unicom Ltd. | 43.61 | 2000 |
| 8 | China CITIC Bank Corporation Ltd. (H shares) | 32.92 | 2007 |
| 9 | China Mobile Ltd. | 32.67 | 1997 |
| 10 | China Minsheng Banking Corp., Ltd. (H shares) | 31.23 | 2009 |

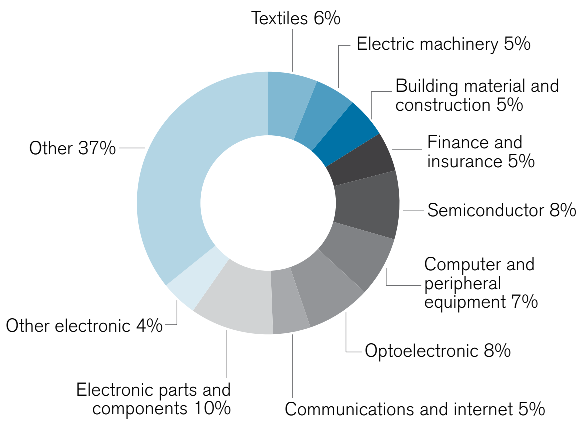
Sources: HKEx, Market Statistics 2011.

## 3.3 Taipei: a niche regional centre

Centred in Taipei, Taiwan's financial markets serve local businesses, especially those engaged in high-tech manufacturing activities. As shown in Figure 11, this is reflected in the activities of the Taipei Stock Exchange Corporation (TSEC). The sectoral breakdown of listed companies shows that it is dominated by technology-oriented SMEs. This is partly because the TSEC, like the Shenzhen Stock Exchange, offers preferential treatment to technology-based companies. For example, high-tech start-ups without track records but with a certain amount of paid-in capital asset and projected net worth are allowed to list on the market with no extra requirements. The focus on high-tech SME businesses is definitely a source of competitive advantage for Taipei to grow as a niche financial centre. Even so, capital markets in Taiwan are likely to remain small relative to other centres in Greater China.

Deep cross-strait trade links with mainland China were established as a result of the Economic Cooperation Framework Agreement (ECFA, see Box 7) signed in June 2010. This preferential trade agreement between Taiwan and mainland China is regarded as the most significant accord between them since 1949 and marks the start of a new phase in cross-strait relations, but political differences remain. For instance, although the agreement is expected to bring substantial economic benefits for local companies, the political debate in Taiwan often focuses on the dangers of becoming economically too dependent on the Mainland's market. The fear is that this might lead to a situation that could jeopardize Taiwan's manufacturing sector and put Taipei in a 'weaker' position *vis-à-vis* Beijing in setting its own economic strategy.[32]

### Figure 11: Taiwan Stock Exchange listed companies by sector




Source: TSEC, 2010.

32 The Democratic Progressive Party (DPP) and other pro-independence groups believe that the ECFA is a cover for political unification with mainland China.

### Box 7: Cross-Strait Economic Cooperation Framework Agreement (ECFA)

The Cross-Strait Economic Cooperation Framework Agreement (ECFA) agreed by the Straits Exchange Foundation and the Association for Relations Across the Taiwan Straits is intended to gradually reduce or eliminate barriers to trade and investment between mainland China and Taiwan. It was initially called the Comprehensive Economic Cooperation Agreement when proposed in early 2009 by Ma Ying-jeou, the President of the Republic of China (Taiwan). But the agreement faced strong objections from the Taiwanese opposition, who thought the name was too similar to the Closer Economic Partnership Arrangement (CEPA) signed between the Mainland and its two special administrative regions, Hong Kong and Macau. The agreement, signed on 29 June 2010, hopes to:

- strengthen and advance economic, trade and investment cooperation between mainland China and Taiwan;
- promote further liberalization of reciprocal trade in goods and services and gradually establish fair, transparent and facilitative investment and investment protection mechanisms;
- expand areas of economic cooperation and establish a mutual cooperation mechanism.

In terms of trade in goods, the ECFA allows for a reduction in the Mainland tariffs on 539 Taiwanese products, valued at 16.1% of Taiwan's exports, and lowers tariffs on 267 Chinese goods, accounting for 10.5% of the Mainland's exports by value. With regard to trade in services, the agreement allows for the establishment of branches by Taiwanese banks in the Mainland if any such branch has been operational for more than a year and is profitable. More importantly, branches will also be allowed to conduct RMB business for Taiwanese firms in mainland China.

Before signing the ECFA neither Taiwan nor mainland China had allowed overseas banks to operate locally. Without sufficient financing support from home banks, the Taiwanese firms in the Mainland often struggled to expand beyond their current market domain, which is mainly located in the Pearl River Delta and Yangtze River Delta regions. In addition, Taiwan, unlike Hong Kong or other advanced economies, still imposes controls over its capital account and the convertibility of the Taiwanese dollar. Cross-border capital transactions between the two economies, both with limited freedom of local currency convertibility, have therefore resulted in increased costs and inefficiencies.

### Table 8: Cross-strait financial cooperation

| Date | Event |
|---|---|
| 2009 April 26 | Association for Relations Across the Taiwan Straits (ARATS) and the Straits Exchange Foundation (SEF) signed the 'Cross-Strait Financial Cooperation Agreement' and reached a consensus on cross-strait financial supervision and monetary cooperation. |
| 2009 November16 | China Banking Regulation Commission (CBRC) and Taiwan's Financial Supervisory Commission (FSC) signed MOU on cross-strait interbank supervision. |
| 2010 March 16 | Taiwan announces guidelines for the MOU. |
| 2010 June 29 | Signing of Economic Cooperation Framework Agreement (ECFA). |
| 2011 April | CBRC and FSC jointly host the First Cross-Strait Summit on Banking Cooperation in Taipei. |
| 2011 November 23 | CBRC and FSC hold Second Cross-Strait Summit on Banking Cooperation in Beijing. |

Sources: CBRC, FSC, Chatham House.

### Table 9: Taiwan banks in mainland China

| Company name | Branch office location | Inception date representative office | Upgrade approval date branch office |
|---|---|---|---|
| Cathay United Bank Co. | Shanghai | 2002 May | 2010 December |
| First Commercial Bank of Taiwan | Shanghai | 2003 March | 2010 November |
| Land Bank of Taiwan | Shanghai | 2003 April | 2010 November |
| Taiwan Cooperative Bank | Suzhou (Jiangsu Province) | 2002 November | 2010 November |
| Hua Nan Commercial Bank | Shenzhen | 2002 November | 2011 November |
| Chang Hwa Commercial Bank | Kunshan (Jiangsu Province) | 2002 November | 2010 November |

Sources: *Wall Street Journal*, Chatham House.

### Table 10: Mainland banks in Taiwan

| Company name | Representative office location | Inception date representative office | Upgrade approval date branch office |
|---|---|---|---|
| Bank of China | Taipei | 2010 October | N/A |
| Bank of Communication | Taipei | 2010 September | 2011 December |
| China Merchants Bank Co. | Taipei | 2011 March | N/A |
| China Construction Bank | Taipei | 2011 March | 2011 December |

Sources: *Wall Street Journal*, Chatham House.

Some measures to foster cooperation in the financial sector predate the ECFA. A Memorandum of Understanding (MoU) on cross-strait interbank supervision was signed in the run-up to the ECFA. This removed the barriers for banks on both sides to establish representative offices and conduct cross-border local currency business. In order to foster cross-strait cooperation in the banking sector, after the ECFA was officially signed, both sides' regulatory commissions for the banking sector agreed to jointly host a cross-strait banking summit every six months in April and November on a one-year rotating basis (Table 8).

The reopening of the cross-strait dialogue led to an increase in business between the two sides. The high-level political dialogues, in particular, significantly eased the difficulties encountered by Taiwanese enterprises in the Mainland. Likewise, Taiwanese banks operating in the Mainland now enjoy the same benefits there as their Mainland counterparts do in Taiwan. They are allowed to practise local banking businesses and serve a broad clientele. By the end of 2011, six Taiwanese banks had been granted licences by the CBRC to establish branches, and ten other banks have set up representative offices in the Mainland (Tables 9 and 10).

The question for Taipei now is how to exploit this rapprochement so as to bolster its position as a regional financial centre. The economic interdependencies, common cultural roots and privileged channel into the Mainland all provide a strong foundation for Taiwan to rebuild its financial sector. However, it will have to pay close attention to Beijing's reform policies and strategies, in particular the process of RMB internationalization. Mainland China's integration with the global financial system provides Taipei with a new opportunity to redefine itself as a regional financial centre. It could utilize the current transition in the Mainland's financial markets to carve a niche role for itself. To this end, Taipei needs to understand and adapt to Beijing's strategies within the region itself. The Taiwanese government should therefore proactively engage with the Mainland and respond strategically to its policies in order to exploit this opportunity to the full.

reaffirmed Beijing's will to gradually liberalize China's financial sector and transfer some power from the banking system to the capital market.

# 4. From Banks to Capital Markets

Financial reforms in mainland China are ultimately intended to create a more liquid and diversified financial system where capital can be more efficiently channelled through the banking sector and capital markets. Having more channels for financial intermediation would improve capital allocation and provide more options to investors. A deep and efficient capital market would support China's next stage of economic development and contribute to domestic rebalancing between the banking sector and capital markets. Recent policy measures, in particular the Fourth National Financial Work Conference, have

## 4.1 The 'all-mighty' banks

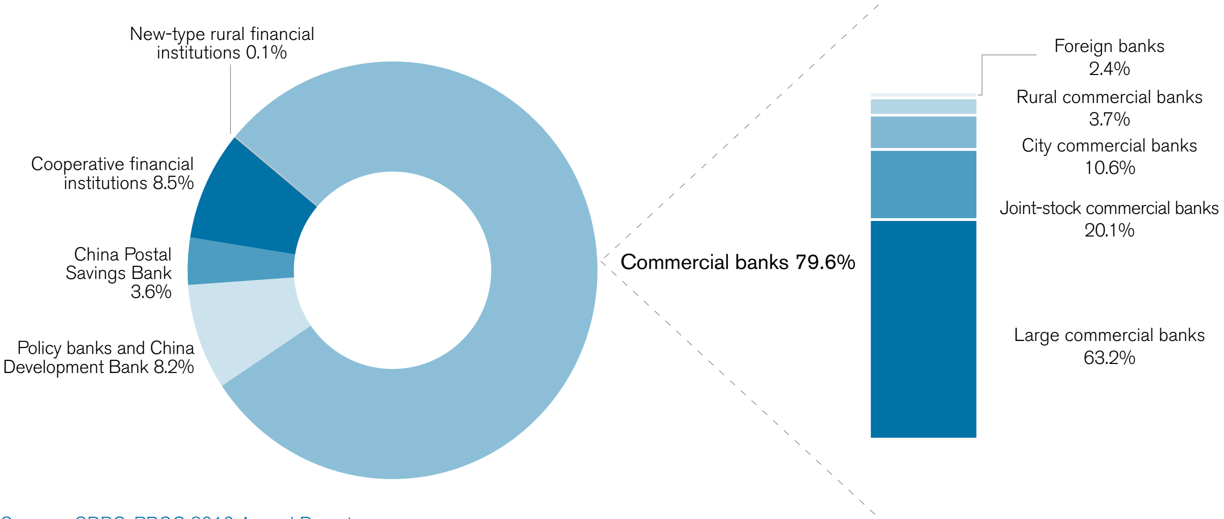
The banking sector is at the core of the financial system in mainland China. The challenge for the authorities is to reform it and make it more market-driven, while leaving room for the capital market to develop. In contrast to its manufacturing industry, which is 'capable of meeting the demands of the world's most sophisticated markets and open to intense on-shore competition' (Goodstadt, 2012: 2) from foreign enterprises, the banking industry in mainland China lacks a competitive market structure and noteworthy foreign participation. Even though banking reform has been a well-known priority for the Chinese government for over two decades, China has not yet been able to create a market-driven banking sector and adopt international standards and regulations. More importantly, the country's banks are still saddled with welfare goals, which put political objectives instead of profit maximization as their business priority (Hale and Long, 2010). Consequently, the

### Box 8: The banking sector in China

The banks in China, currently classified into five categories – commercial banks (including the so-called Big Four commercial banks); policy banks and China Development Bank; China Postal Savings Banks; cooperative financial institutions; and new-type rural financial institutions – remain the primary source of capital for local businesses and enterprises, and account for the bulk of capital resources in the country. At the end of 2010, total assets in the sector stood at RMB95.2 trillion (US$14.2 trillion), making it the third largest banking sector in the world by assets.

The banking structure in the country is characterized by the dominant state-owned banks and a few foreign institutions. Given their size and the continued support from Beijing that they enjoy, the state-owned banks play a major role not only in the domestic banking sector but also in China's whole financial system. Commercial banks account for nearly 80% of the total assets in China's banking sector. By contrast, the three policy banks, which specialize in lending to national infrastructure projects, export and import business from SOEs and economic development in the agricultural sector, account for just 8% of assets (Figure 12). Among the commercial banks, nearly 85% of the total assets are held by the large commercial banks and the joint-stock commercial banks, whereas foreign banks hold a mere 2.5%. Moreover, as shown in Table 11, since the onset of the global financial crisis, the large Chinese commercial banks now figure among the global top ten banks by pre-tax profit.

## Figure 12: Banking structure in mainland China by % of total banking assets




Sources: CBRC, PBOC 2010 Annual Report.

## Table 11: Global top 10 banks by pre-tax profit, 2007–2010

| 2007 | Bank | Country | $US million | 2008 | Bank | Country | $US million |
|---|---|---|---|---|---|---|---|
| 1 | Bank of America | USA | 31,973 | 1 | ICBC | China | 21,260 |
| 2 | Citigroup | USA | 29,639 | 2 | CCB | China | 17,520 |
| 3 | HSBC Holdings | UK | 22,086 | 3 | Banco Santander | Spain | 15,825 |
| 4 | JP Morgan Chase & Co | USA | 19,886 | 4 | BOC | China | 12,620 |
| 5 | Royal Bank of Scotland | UK | 18,033 | 5 | BBVA | Spain | 9,640 |
| 6 | Crédit Agricole | France | 14,060 | 6 | HSBC Holdings | UK | 9,307 |
| 7 | Barclays Bank | UK | 14,009 | 7 | Barclays Bank | UK | 8,859 |
| 8 | BNP Paribas | France | 13,921 | 8 | ABC | China | 7,659 |
| 9 | Mitsubishi UFJ Financial Group | Japan | 12,824 | 9 | UniCredit | Italy | 6,952 |
| 10 | Wells Fargo & Co. | USA | 12,745 | 10 | Royal Bank of Canada | Canada | 6,077 |

| 2009 | Bank | Country | $US million | 2010 | Bank | Country | $US million |
|---|---|---|---|---|---|---|---|
| 1 | ICBC | China | 24,494 | 1 | ICBC | China | 32,528 |
| 2 | CCB | China | 20,316 | 2 | CCB | China | 26,448 |
| 3 | Goldman Sachs | USA | 19,826 | 3 | JP Morgan Chase & Co | USA | 24,859 |
| 4 | Barclays Bank | UK | 18,869 | 4 | BOC | China | 21,463 |
| 5 | Wells Fargo & Co | USA | 17,606 | 5 | HSBC Holdings | UK | 19,037 |
| 6 | Banco Santander | Spain | 16,951 | 6 | Wells Fargo & Co | USA | 18,700 |
| 7 | BOC | China | 16,319 | 7 | ABC | China | 18,230 |
| 8 | JP Morgan Chase & Co | USA | 16,143 | 8 | BNP Paribas | France | 17,406 |
| 9 | BNP Paribas | France | 12,222 | 9 | Banco Santander | Spain | 16,079 |
| 10 | Itau Unibanco Holding SA | Brazil | 11,521 | 10 | Goldman Sachs | USA | 12,892 |

Source: *The Banker*, 2011.

government has allowed the inefficiencies in the system to continue despite the 'multiple rounds of reforms to help transform the old financial institutions into authentic commercial banks' since the 1990s (Goodstadt, 2012: 2).

Recent developments suggest that the reform process is still in progress, and new targets have been set. According to the 12th Five-Year Plan, the government's goal is to complete the commercialization of its three policy banks by 2015. Meanwhile, commercial banks will face increased market competition from small and medium-sized domestic financial institutions, as they will no longer be able to benefit from the fixed interest rate spread between the deposit and lending rate that is currently determined by the government. Finally, with Beijing's 'Go Global' strategy, large commercial banks will inevitably need to adopt international standards and regulations and to develop business models to compete on international markets.

Yet the banking sector will continue to dominate China's financial landscape in the medium term and the reform process of creating a market-oriented banking sector that meets international standards will be gradual. This partly reflects the implicit acknowledgment by the national authorities that in the medium term the financial sector will continue to bear the burden of welfare goals.

## 4.2 Capital markets in Greater China: the equity market

In Greater China, as in many other economies in the region, development of the financial sector has lagged behind the performance of its real economy.[33] This is evident from the size of its equity markets, a proxy for the size of its capital markets. Market capitalization figures for Shanghai (45%) and Shenzhen (22%) show a much lower level of

### Table 12: Comparison of market capitalization and GDP

| | | 2008 | | | 2009 | | | 2010 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Exchange/city** | | **Market capitalization** | **GDP** | **Market capitalization to GDP (%)** | **Market capitalization** | **GDP** | **Market capitalization to GDP (%)** | **Market capitalization** | **GDP** | **Market capitalization to GDP (%)** |
| Hong Kong | Hong Kong | 1,329 | 217 | 612 | 2,305 | 211 | 1092 | 2,712 | 225 | 1205 |
| Shanghai | China | 1,425 | 4,405 | 32 | 2,705 | 4,912 | 55 | 2,717 | 6,039 | 45 |
| Shenzhen | China | 353 | 4,405 | 8 | 868 | 4,912 | 18 | 1,312 | 6,039 | 22 |
| Taipei | Taiwan | 357 | 392 | 91 | 641 | 379 | 169 | 817 | 467 | 175 |
| ***Greater China total*** | ***Greater China*** | ***3,464*** | ***5,014*** | ***69*** | ***6,519*** | ***5,502*** | ***118*** | ***7,557*** | ***6,731*** | ***112*** |
| NYSE | US | 9,209 | 14,265 | 65 | 11,838 | 14,258 | 83 | 13,394 | 14,660 | 91 |
| NASDAQ | US | 2,249 | 14,265 | 16 | 3,239 | 14,258 | 23 | 3,889 | 14,660 | 27 |
| **NYSE+ NASDAQ Total** | **US** | **11,458** | **14,265** | **81** | **15,077** | **14,258** | **106** | **17,283** | **14,660** | **118** |
| ***London*** | ***UK*** | ***1,868*** | ***2,340*** | ***80*** | ***2,796*** | ***2,255*** | ***124*** | ***3,613*** | ***2,267*** | ***159*** |

Sources: World Federation of Exchanges 2011, Chatham House.

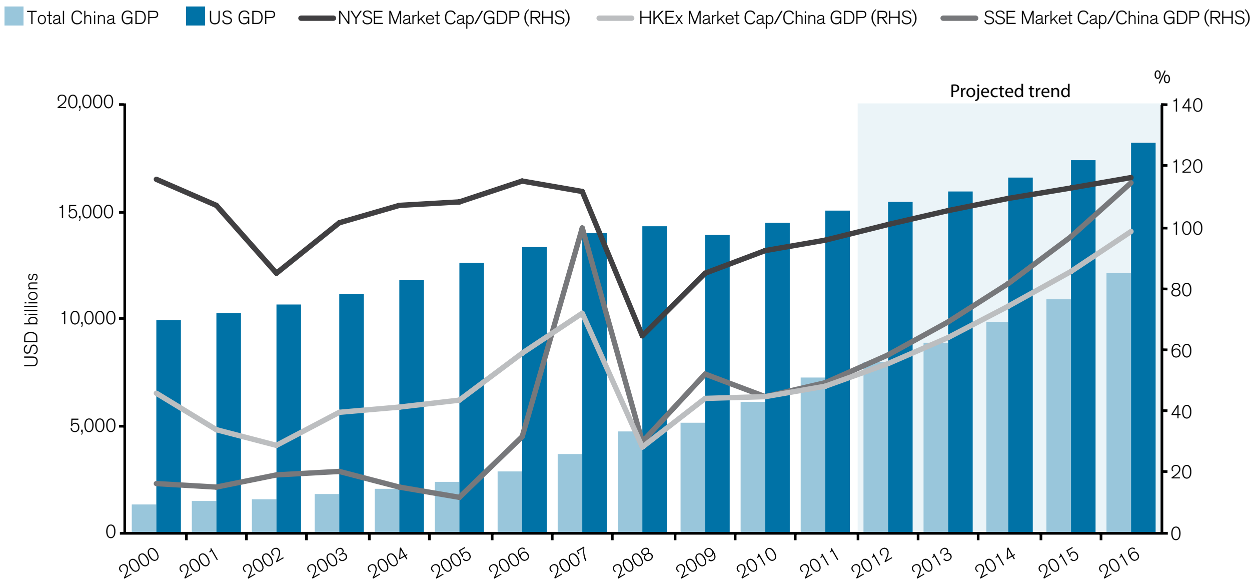
33 In Asia, broadly, the development of capital markets is a recent phenomenon that has taken different paths and evolved at different speeds in different countries. However, it is clear that in many Asian economies during the 10 years after the Asian financial crisis, financial-sector development has lagged behind the performance of their real economy (Madhur, 2008). The financial sector is still dominated by banks in most countries, and capital markets, especially bond markets, remain less developed. For detailed discussions on the evolution of capital markets in Asia, see Ghosh (2006), IMF (2006), Nakagawa (2007), Goswami and Sharma (2011) and BIS (2012).

capitalization as a share of China's GDP than other financial centres in the region, let alone international financial centres such as London and New York (see Table 12). However, Hong Kong, comparable to Shanghai in terms of absolute market capitalization, remains an outlier with a high ratio to GDP. This anomaly is partly explained by the influence of the Mainland in Hong Kong's equity markets. But as China gradually integrates with the rest of the world, the potential for both Shanghai and Shenzhen to expand their stock markets, and by implication their capital markets, is actually higher than that of Hong Kong.

At 91%, New York's market capitalization-to-GDP ratio shows that a country with a large economy should be able to develop an equity market whose value is almost equivalent to that of its domestic economy. Moreover, the size of New York's stock exchange provides a benchmark for Shanghai's potential development. The projections of market capitalization to GDP ratio over the next five years (Figure 13) suggest that if the consistent and strong growth in market capitalization in Shanghai between 2000 and 2010 continues, the city's potential as a financial centre over the next decade is very high.[34]

Hong Kong, despite having a longer history of well-developed equity markets, shows a strong positive growth trend (mainly owing to the presence of Mainland companies), but it is not comparable to that of Shanghai. If the Hong Kong market capitalization is weighted with the total Chinese GDP (including Hong Kong GDP), its ratio to GDP drops from 1205% (Table 12) in 2010 to 46% (Figure 13). Figure 13 suggests that Hong Kong, being part of China but not as plugged in to the Chinese economy as Shanghai, will not quite achieve the level of capitalization of the other two leading IFCs, New York and London. It benefits from being part of the Mainland's 'Go Global' strategy, with its equity markets strengthened by some big Mainland companies double-listing on the SSE and the HKEx. However, it is hard to say that the double-listing strategy will guarantee Hong Kong an advantage in tackling the Mainland's domestic market, where local businesses may still find Shanghai more convenient as their main point of reference. Competitive advantages for Hong Kong's capital market are more likely to come, as already argued, from the offshore RMB market and the issuance of RMB-denominated financial products.

Figure 13: Market capitalization/GDP projections (NYSE, SSE, HKEx)




Note: The figure uses GDP at current prices.
Sources: IMF, WFE, Chatham House.

34 The GDP projections are taken from the IMF's World Economic Outlook, whereas the market capitalization has been projected using the average growth rate for the 10-year period 2000–10, based on WFE data.

Table 13: 2010 Global IPOS, by stock exchanges

| Top 10 by number of deals | | | Top 10 by capital raised | | |
|---|---|---|---|---|---|
| Exchange | No. of deals | % of global total | Exchange | Capital raised (USD, million) | % of global total |
| Shenzhen* | 321 | 23.0 | Hong Kong | 57,383 | 20.2 |
| Sydney | 92 | 6.6 | Shenzhen* | 44,295 | 15.6 |
| Hong Kong | 87 | 6.2 | New York | 34,717 | 12.2 |
| New York | 82 | 5.9 | Shanghai | 27,879 | 9.8 |
| NASDAQ | 76 | 5.5 | Tokyo | 14,268 | 5.0 |
| Warsaw – New Connect | 71 | 5.1 | London | 8,861 | 3.1 |
| Bombay | 62 | 4.4 | NASDAQ | 8,726 | 3.1 |
| KOSDAQ | 56 | 4.0 | Bombay | 8,304 | 2.9 |
| Toronto Venture | 42 | 3.0 | Australia | 7,905 | 2.8 |
| London AIM | 40 | 2.9 | Korea | 7,750 | 2.7 |
| All other exchanges | 464 | 33.4 | All other exchanges | 64,506 | 22.7 |

*Shenzhen Stock Exchange includes listings on Mainboard (SME) and ChiNext.
Sources: Dealogic, Thomson Financial, Ernst & Young, Global IPO Trends 2010.

Over the last twenty years, since the opening of the Shanghai and Shenzhen Stock Exchanges, the equity market has become increasingly relevant in providing an alternative source of capital for local businesses. The SSE has expanded remarkably since it was reopened in 1990.[35] The main challenge then was to rebuild the whole infrastructure and regulatory system, which was outdated and inadequate for China's growing economy. Today, the activity of the SSE is also becoming more relevant at an international level; it is now ranked 4th in the top financial centres by capital raised in 2010 (Table 13). Also, according to a recent KPMG study (2011), the mix of investors is becoming more diversified, showing that equity markets are evolving into a more appealing destination for investments. Institutional investors (such as pension funds, investment funds, insurance companies and corporate investors) are overtaking retail investors and looking to increase their allocations in the Chinese equity market. By the end of 2010, institutional investors owned about 60% of China's tradable shares by value (KPMG, 2011).

However, foreign companies are not allowed to list on the SSE and non-resident investors are allowed to buy stocks only through controlled channels (B-Shares). These restrictions limit the expansion of the SSE and Shanghai's appeal as an attractive business environment for foreign investors, and hence its international dimension. In addition, the regulatory authorities remain very cautious about excessive deregulation of the equity market. Tight controls over trading operations and limited innovation in financial products are currently still the main policy stance. It will take time for mainland China to reach the level of development of the Hong Kong or even Taipei equity markets – despite the latter's small relative size on the global financial markets, it has still achieved a good level of capitalization.[36]

35 In his paper 'Shanghai and Hong Kong as International Financial Centres: Historical Perspective and Contemporary Analysis' (2003) Y.C. Jao asserts: 'From 1949 to 1979, the Chinese Government pursued what can only be described as "financial repression"': foreign banks and financial institutions were in effect driven out of China; private Chinese banks were first reorganized into 'joint public-private banks' and later nationalized by merging them with the PBoC; other non-bank financial institutions were either nationalized or closed; all financial markets, such as securities markets, forex markets, inter-bank market, gold and silver markets etc were closed.'

36 By the end of 2011, Taipei's market capitalization was US$635.5 billion. Its market capitalization-to-GDP ratio in 2010 was around 175% (see Table 12).

The central government aims to develop Shenzhen as a financial centre to serve SMEs that are deprived of credit relative to large state-owned enterprises. As already discussed in section 2.3, one of Shenzhen's main features as a financial centre is its focus on local SMEs operating in the manufacturing and high-tech industries. Given the dominance of the policy banks that favour large state-owned enterprises and an underdeveloped equity market in the Mainland, the creation of a multi-tier structure for the SZSE is an important step towards the opening of equity markets to a broader set of participants, and in turn develops it as another pillar in the Chinese financial system.

## 4.3 Developing the bond market

Developing the bond market is another priority for the national authorities in their attempt to reduce reliance on the banking sector. Efforts to open up mainland China's interbank market have become visible in recent years. Since 2010, international investors have been allowed to enter Mainland's interbank bond market. Government bonds and corporate bonds are made available for foreign central banks as part of their foreign exchange reserves and for large-scale international financial institutions as part of their global asset portfolios.

Recent developments in mainland China's bond market were driven by the RMB offshore bond market in Hong Kong, which acted as the 'bridge' linking the Mainland to Hong Kong. The availability and nature of debt products issued in RMB in Hong Kong are strictly linked to the convertibility of the Chinese currency. In the past few years, Beijing's main goal was to expand the bond market beyond the national market with adequate restrictions on capital flows. Crucial market reforms were implemented as part of the 'Go Global' strategy, and Beijing chose Hong Kong to become the first offshore market for bonds to be issued in RMB.

According to Beijing's strategy, the Chinese bond market is expected to evolve in two ways: by increasing market access for international investors to conduct inward investments into the Mainland and by growing RMB bond issuance in the offshore market in Hong Kong. Within this framework, Shanghai could become the onshore centre for the issuance of RMB Panda Bonds by foreign governments and international institutions in the Mainland market.[37] Meanwhile, Hong Kong will continue to grow as the major offshore RMB bond market, generating great potential for it to expand, provided Beijing's policy support continues.

The main challenge that China is facing in developing its bond market is once again the dominance of the banking system on the debt market. The interbank market is currently the major trading platform for the Mainland's bond market, accounting for over 90% of national bond issuance volume and trading volume (Table 14).

### Table 14: Fixed-income business in mainland China

| Market | Major securities | Outstanding amount (RMB billion) | Regulatory institution |
|---|---|---|---|
| Interbank Bond Market | Treasuries, Policy Financial Bonds, PBoC Bills, Financial Bonds, Enterprise Bonds, Medium-term notes, Commercial Paper Asset-backed Securities, Bond forwards, Bond repurchases, Interest rate swaps | 18,879 | PBoC |
| SSE and SZSE | Treasuries, Enterprise Bonds, Corporate Bonds, Convertible Bonds, Bond Repurchases | 288 | CSRC |
| OTC Bond Market | Treasuries | 172 | CSRC |

Sources: Chinabond, Chatham House.

37 As noted, Panda Bonds are RMB-denominated bonds issued by non-Chinese institutions and sold within mainland China.

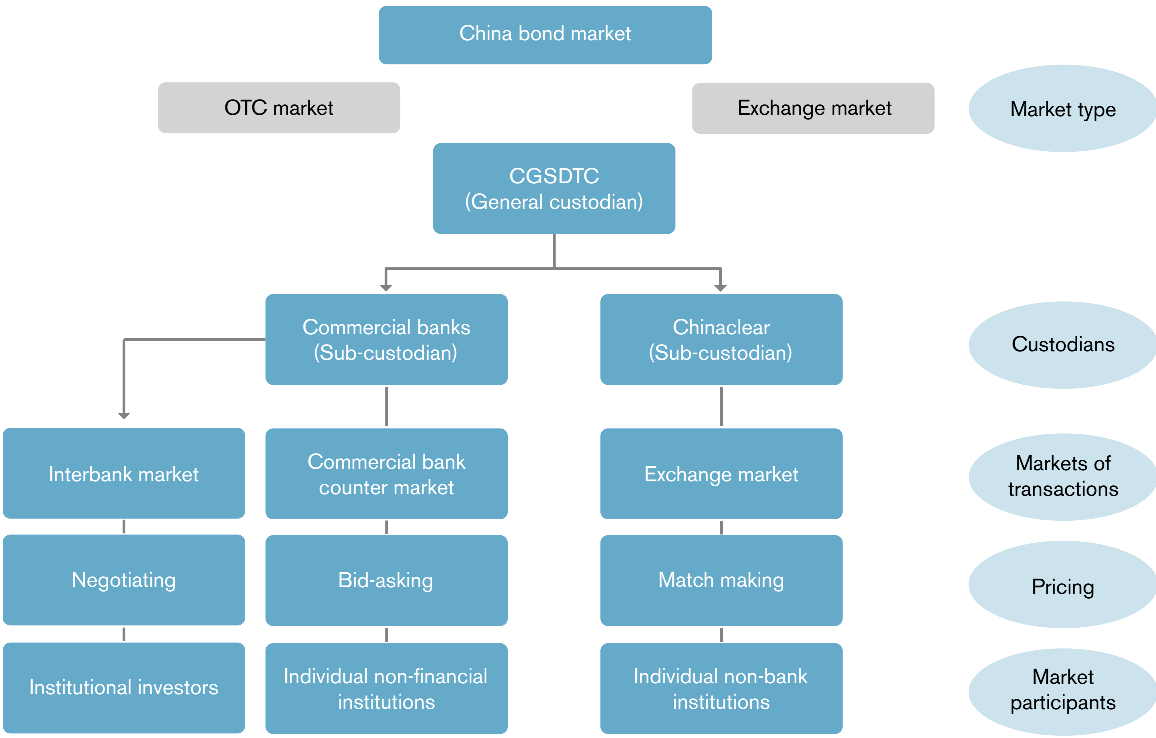
As shown in Figure 14, the banks in China play a triple role as the key issuers of bonds, the largest investors and the intermediary institutions in the bond market. Only institutional investors are allowed to participate in the interbank bond market, which is a wholesale quote-driven market; for non-banking institutions or individual investors tight restrictions are in place.[38]

There are three major bond issuers on the Chinese market: the Ministry of Finance (MoF), the PBoC and the three policy banks (including the China Development Bank). Together these three institutions hold 78% of the total issuance of bonds, with the majority being traded on the interbank market. As policy banks do not have commercial banking functions and are not allowed to hold any private deposits,[39] bond issuance becomes the only way for them to collect sufficient capital to accomplish their task. On the investors' side, large commercial banks are the major players, benefiting from their evident market dominance and from being the first authorized institutions to enter the interbank market. Chinese commercial banks hold about 68% of the total outstanding bonds; the three major issuers combined hold about 10%, fund managers approximately 7% and other market players 14.5%. Individual investors, who are affected by regulatory limitations in accessing the major bond markets, account for a mere 1%. Finally, banks act as intermediary institutions with almost complete control of the bond market itself.

## 4.4 Asset management

China's asset management industry has also been consistently promoted and guided by the government over the past fifteen years. Immediately after the Asian financial

Figure 14: Bond market in mainland China




Sources: Chinabond, Chatham House.

38 In the interbank market, institutional investors include commercial banks, securities companies, trust and investment companies, finance companies affiliated with corporations, insurance companies, fund management companies etc. For non-banking institutions, investors can only conduct transactions through authorized agents (NAFMII, 2012).

39 See footnotes 9 and 10 in Chapter 1 above.

crisis, when market conditions were highly unfavourable, the industry adopted the 'Provisional Measures for Securities Investment Fund Management' promulgated in November 1997 by the State Council, which provided detailed regulations on the establishment of fund management companies (FMCs). During its preliminary stage in 1998, only five fund management companies were approved by the CSRC to operate as closed-end funds. Each fund at that time was assigned to a different commercial bank as the qualified custodian. Though closely overseen by the regulator, these five closed-end funds ushered in a new era in China's asset management industry.

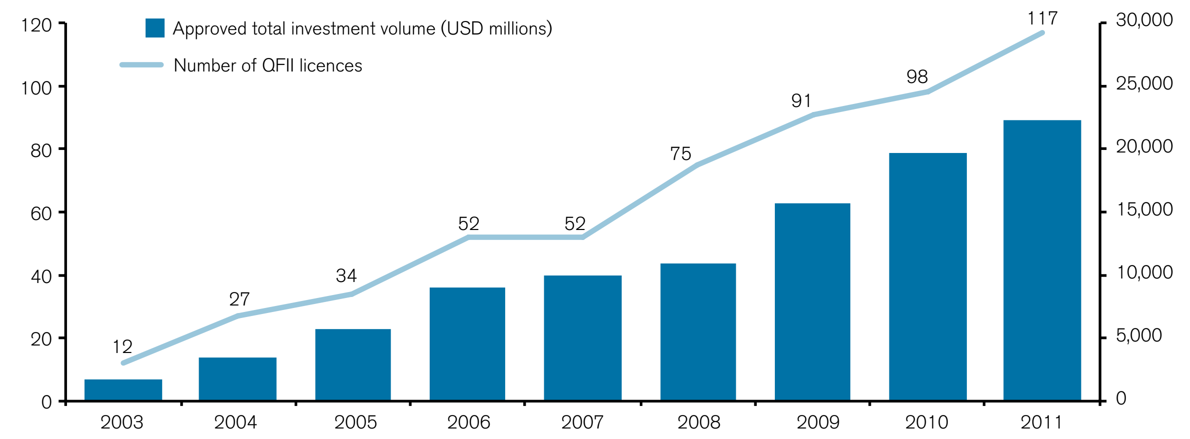
However, apart from the government's support in providing a sound legal framework, the FMCs faced extreme difficulties in building up their market reputation and finding efficient distribution channels outside the banking sector. At that time, neither individual investors nor Chinese banks were familiar with the concept of FMCs, and investors lacked trust in the financial services industry. Without the assistance of the Big Four, which closely follow Beijing's policy strategy, domestic FMCs could not have survived in the market and gradually built up their market share and presence to the current levels.

Despite their short history, FMCs have now become the most representative institutional investors in China's capital markets, with 75% of the market share. Since the approval of open-ended funds in 2001 and exchange traded funds (ETFs) in 2004, a number of funds have been gradually developed in China, covering stock funds, bond funds and currency funds. The QFII Fund (see Chapter 2) is a unique type that originated in the limitation of RMB currency convertibility. Despite the entry restrictions for foreign FMCs, the financial assets under management (AUM) grew rapidly. Excluding the assets held by the QFII Fund, it is now a market worth RMB2.13 trillion (US$320 billion) (CSRC, 2011).

Initially holding less than 1% of domestically issued shares in 1997, the fund industry had about 60% of domestically issued shares in 2011. In comparison, the Taiwan fund industry took 20 years, and the US 25 years, to reach the same level. In addition, led by the local FMCs, joint-venture FMCs entered the market and quickly became significant players along with the local FMCs. Nevertheless, as noted earlier, China's limited currency convertibility means the market is dominated by domestic investors. Aside from the authorities' cautious attitude towards liberalizing capital inflows, in recent years Beijing has speeded up approval procedures for QFII licences, in terms both of licence numbers and of trading quotas (Figure 15).

For Mainland FMCs, China's equity market and real estate markets are the two major investment markets. Fund managers dealing with either conventional AUM or alternative assets[40] therefore prefer to locate their business in places

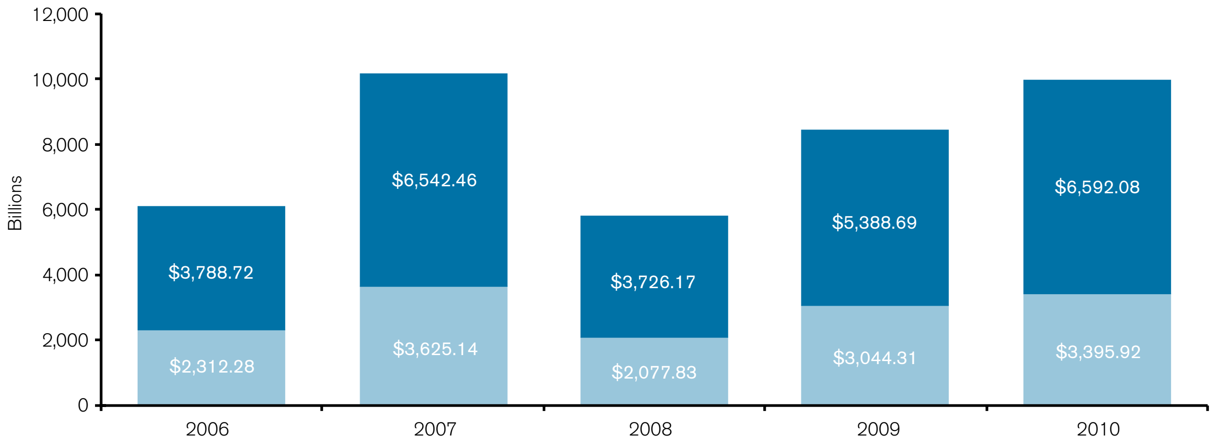
Figure 15: Increasing QFII licensing and investment volume




Sources: CSRC, 2011 Annual Report.

40 Conventional Assets Under Management (AUM) – pension funds, insurance funds and mutual funds; Alternative (Non-Conventional) Assets – sovereign wealth funds, hedge funds, private equity and ETFs.

Figure 16: Non-REIT fund management business in Hong Kong (HKD, billions)




Sources: Fund Management Activities Survey 2010, Securities and Futures Commission (SFC), Hong Kong, 2011 July.

close to the main stock exchanges and to wealthy clients. In this sense Shanghai is a favourite among fund management companies. It is home to 31 of the 67 FMCs registered in the Mainland – nearly 50% of the market (PBoC, 2011a).

With such a density of FMCs, Shanghai is set to become a leading player in the wealth management industry. Considering China's plan to relax capital market entry for international investors, its asset management industry still has significant scope for growth. Domestically, it is expected to witness greater diversification in its investor profile, with domestic pension funds, insurance funds and international FMCs gaining in importance. In addition, Chinese FMCs are anticipated to step out of the local market.

In contrast to the Mainland, Hong Kong not only attracts local and regional capital resources but also global capital resources and high net wealth clients. Moreover, its fund management industry is bigger and more international and diversified. It continues to be a preferred location for international investments (Figure 16). Of its total US$9,988 billion assets in the non-REIT fund management business in 2010, 66% originated from non-Hong Kong investors.

In terms of the gradual opening-up of the capital market in the Mainland, Hong Kong acts as a springboard to the international market for Chinese funds. Four years after the introduction of the QFII scheme, the Mainland's FMCs were first allowed to invest abroad through the Qualified Domestic Institutional Investor (QDII) scheme in 2006 (Box 9). Though still limited in scale and legally accessible overseas markets, the QDII investment overseas from the Mainland will in the long run strengthen Hong Kong's position as the bridge between the Mainland market and the global financial system.

### Box 9: Qualified Domestic Institutional Investors (QDII)

The Qualified Domestic Institutional Investors (QDII) scheme is designed to allow domestic financial institutions (including securities firms and insurance companies) which have been approved by CSRC to invest in offshore markets using locally raised funds. Private firms and individual investors are allowed to access overseas markets through Chinese banks. QDII can therefore be viewed as the reverse of QFII. Although the scheme, officially inaugurated in April 2006, is seen as means of diversifying investments, currently most QDII investments have been made in Hong Kong. More importantly, the scheme has also lost some steam as a result of the global financial crisis and the expected appreciation of the RMB.

# 5. Conclusion

This report has considered China's financial reform process and the consequent expansion of key financial centres in the region at a critical juncture in the country's economic development. The analysis has emphasized the significance of the coming decade in China's financial reform process and sheds light on the outlook for financial centres and integration of financial systems in the Greater China region in the medium term.

## 5.1 Outlook for the financial centres in Greater China

The growth of the region's four financial centres will be influenced by the policy process decided in Beijing. In fact, Beijing will set limits to the wider external use of the RMB and determine the pace of the capital account liberalization, consequently shaping the development of these financial centres. Looking ahead, Hong Kong is expected to remain the international financial centre in the region that could rival New York and London. This is not only because of its well-developed regulatory system and its reputation as the most liberalized financial centre in Asia but also because of its unique competitive advantage over London and New York, namely the 'China dimension'. More importantly, despite concerns that the Mainland's authorities may expect Hong Kong to provide traction to ultimately make Shanghai the largest RMB onshore IFC in mainland China by 2020, Hong Kong has its own competitive edge such as its legal system, abundant financial talent and liberal market environment, which no policy decisions can erode.

Shanghai is unlikely to be able to compete sufficiently with Hong Kong to emerge as the international financial centre in the region over the next few years. This situation could radically change, however, with the convertibility of the RMB and subsequent comprehensive liberalization of China's capital account.[41] Although there is no clear timetable for this process, the State Council's decision in 2009 to develop Shanghai as an international financial centre by 2020 suggests that it expects both these policies to be established by then. A convertible currency and an open capital account will help Shanghai compete with Hong Kong and other established international financial centres to attract global capital. In the meantime close cooperation between these two centres will enable Shanghai to benefit from Hong Kong's international exposure, and Hong Kong will further benefit from growth in mainland China. In addition, the size and growth of the real economy suggest that the country can accommodate two major financial centres. However, Shanghai remains the city chosen to be the international financial centre in China in the longer term. Finally, in terms of RMB-related business, Shanghai would still be the only financial centre in Beijing's strategy intended to become the largest international financial centre in the Greater China region.

Shenzhen and Taipei are expected to develop as regional financial centres. On the one hand, Shenzhen presents a strong case for developing as a regional financial centre serving the growing number of domestic SMEs based in the Guangdong region as well as from the Mainland market, and the Mainland authorities are encouraging it to grow by serving the domestic SMEs and start-ups in need of capital other than through bank financing. By opening the SME Board on the Shenzhen Stock Exchange in June 2004 and the ChiNext Board in October 2009, the authorities have made the direction of their policy evident.

41 In February 2012, the statistics department of the PBoC published a progress report on the liberalization of China's capital account, assessing the possibility of accelerating the pace. The report took a positive outlook, implying that the economic benefits from greater capital account freedom would outweigh the potential risks. It also delivered an agenda for gradual and sequential liberalization in the short term (1–3 years), medium term (3–5 years) and long term (5–10 years) (PBoC, 2012).

Taipei, on the other hand, is seeking greater access to the Mainland through the ECFA in its attempts to rebuild itself as a regional financial centre. Taipei's focus on high-tech SMEs in the Asia region offers it a competitive advantage for targeting SMEs at a relatively advanced stage of growth (compared with those in the Mainland). At present, the capital markets in Taiwan remain small relative to other centres in the region. Further cross-strait cooperation in the financial sector would provide Taipei with new opportunities. Should the development trajectory of Shenzhen's SMEs model work well, similar opportunities could be seized by Taipei to specialize as the financing centre for high-tech manufacturing enterprises in the Asia region. Nevertheless, to achieve this, it needs to strengthen its Mainland dimension. This could potentially be done by establishing itself as the next RMB offshore centre backed by Beijing. It is thereby critical for Taipei to carve out a niche role for itself in Beijing's strategy.

China's tremendous economic growth capacity, in terms of both volume and rate, suggests that the country will be quite capable of accommodating two major financial centres (Shanghai and Hong Kong), both at international level, and presumably also another two niche centres (Shenzhen and Taipei). Taking the United States as a benchmark economy, it is apparent that the financial system in a large economy does not necessarily gravitate towards a single financial centre. New York developed as the international financial centre, while other cities such as Chicago and San Francisco grew into regional financial centres by serving the local economy or by specializing in specific markets. The outlook for the four financial centres suggests a similar scenario is likely to emerge in Greater China.

## 5.2 Integration of the financial systems in Greater China

Along with the development of the 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 is set to continue, leading to more systemic integration. Within this framework, closer cooperation and coordination among Shanghai, Hong Kong and Shenzhen is expected to develop gradually. It is technically and politically feasible to form a multi-tiered trading platform as well as a broader equity market in the Greater China region. Such trends are illustrated by the closer cooperation among the three exchange houses discussed in this report. Meanwhile, a currency repatriation scheme, bridging the RMB onshore and offshore market, is also shaping up between Shanghai and Hong Kong.

The interaction among the three financial systems covers two main themes, China's domestic financial reform and internationalization of the RMB. As discussed in Chapter 1, China still has much to do to catch up to consolidate its domestic financial depth, and the three financial centres, Shanghai, Hong Kong and Shenzhen, sharing the same currency periphery, will play essential roles in this process. To establish broader and deeper capital markets (both equity and bond markets), a nationwide trading platform underpinned by the three cities is required. Domestically, China needs to deepen its financial services for SMEs. With its specialization in the SMEs market, Shenzhen could once again become a market pioneer in leading this reform. Unlike in the economic liberalization of the 1980s, Hong Kong could cooperate with Shenzhen to promote market-oriented reform in the Pearl River Delta region. At the same time, the other theme of RMB internationalization will help form closer links between Shanghai and Hong Kong, with one being the largest onshore RMB centre and the other the first offshore centre. Within this expanding RMB business, Shenzhen, though playing a relatively less important role because of the limited size of its local financial market, will become the testing ground in preparation for the opening of greater direct capital channels between these two major cities.

However, cross-strait cooperation in the financial sector presents a less compelling case for systemic integration between Taipei and the Mainland. Recent dialogues between the central banks from the two sides have in fact been driven by an improvement in the political environment, and the adoption of the ECFA in June 2010. Despite considerable systemic and regulatory similarities between the Mainland and Taiwan, the cross-strait relationship would be the key determinant of further integration in the financial sector, particularly the banking industry. There are lingering concerns regarding the political environment, but the re-election of Ma Ying-jeou as Taiwan's president points to the likelihood of greater cross-strait financial cooperation in the near term.

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 intermediated 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, we expect to see the full impact of China's measures 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.

## 5.3 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.

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# Appendix: Chatham House Research Roundtable Agendas

## Shifting Capital: The Rise of Financial Centres in Greater China

### Taipei's Development as a Financial Centre

*Strategies for Economic Development in the China Region: The Impact of Stronger Capital Market and Financial Networks on the Next Decade of Investment and Growth in Taiwan and China*

Friday 10 June 2011, Taipei

### Agenda

0930–0940 ***Opening remarks***
*Paola Subacchi*, Research Director, International Economics, Chatham House

0940–0950 ***Opening remarks***
Paul Hsu, Founder and President, Epoch Foundation

0950–1000 ***Leading contribution***
Lee Sush-Der, Former Minister of Finance, Taiwan

1020–1200 ***Session One: Performance and Ambitions in Taiwan***
**Chair:** *Robert Hodgkinson*, Executive Director, Technical Research, The Institute of Chartered Accountants in England and Wales
**Panellists:** *Chi Schive,* Chairman, Taiwan Stock Exchange
*Daniel M. Tsai,* Chairman, Fubon Financial
*Chien-Fu Jeff Lin*, Professor, Department of Economics, National Taiwan University

1200–1340 ***Lunch Speech: Cooperation or Competition, Shaping the Relationship between Taipei and its Neighbours***
**Speakers:** *C.Y Huang*, Chairman, Taiwan Mergers & Acquisitions and Private Equity Council; President, FCC Partners
*Jonathan Batten*, Adjunct Professor, Department of Finance, Hong Kong University of Science & Technology

1350–1530 ***Session Two: Recognizing the Risks and Opportunities for the Future for Taipei as a Financial Centre***

**Chair:** *Jesús Seade*, Vice-President, Sydney S.W. Leong Chair Professor of Economics, Lingnan University

**Panellists:** *Jane Hwang*, General Manager, State Street Bank – Taipei Branch

*Dar-Yeh Hwang,* Professor, Department of Finance, National Taiwan University and Director, Centre for the Study of Banking and Finance, NTU

*Paul Hsu*, Founder and President, Epoch Foundation

1545–1730 ***Research Roundtable Discussion: Openness, Opportunity and Threat – The Significance of Financial Reform in China for Taipei***

**Chair:** *Paola Subacchi,* Research Director, International Economics, Chatham House

**Presenters:** *Erh-Cheng Hwa,* Former Chief Economist of China Construction Bank

**Discussants:** *Chi Schive,* Chairman, Taiwan Stock Exchange

*Tony Phoo,* Economist, Standard Chartered Bank (Taiwan) Ltd.

*Guonan Ma,* Senior Economist, Bank of International Settlements (BIS)

## Chatham House Roundtable Event

*Shifting Capital: The Rise of Financial Centres in Greater China*

### East Asia Financial Centres: A Decade of Opportunity

*Hong Kong: The Pearl River Delta as a Financial Centre*

Monday 13 June 2011, Hong Kong

### Agenda

0900–0905 ***Welcome remarks***

*Anthony Wu*, Chairman, Bauhinia Foundation Research Centre

0905–0915 Introduction

*Paola Subacchi*, Research Director, International Economics, Chatham House

0915–1000 ***Leading contributions: Hong Kong and the sustainability of success***

Keynote: 1. Hong Kong's development as the Offshore RMB Business Centre

*Norman Chan*, Chief Executive, Hong Kong Monetary Authority

Keynote: 2. Hong Kong's unique role as an asset management and equity fund- raising centre

*K.C. Chan*, Secretary for Financial Services and the Treasury, HK SAR

1020–1135 ***Session One: How to Maintain Excellence in Hong Kong***

*(IPOs and Hong Kong's position as a hub for corporate fund-raising)*

**Chair:** *Lawrence Lee*, Director, Bauhinia Foundation Research Centre

**Panellists:** *Dong He*, Hong Kong Institute for Monetary Research

*Jesús Seade*, Vice-President, Sydney S.W. Leong Chair Professor of Economics, Lingnan University

*Robert Hodgkinson*, Executive Director, Technical Research, ICAEW

*Stephen Cheung*, Dean of School of Business, Hong Kong Baptist University

1135–1250 ***Session Two: Hong Kong and Shanghai – Whether Growth can be Collaborative, Cooperative or Competitive***

**Chair:** *Paola Subacchi*, Research Director, International Economics, Chatham House

**Panellists:** *Alicia Garcia-Herrero*, Chief Economist for Emerging Markets, Banco Bilbao Vizcaya Argentaria (BBVA)
*Gary Liu Shengjun*, Deputy Director of CEIBS Lujiazui International Finance Centre
*Jun Ma*, Chief Economist for Greater China, Deutsche Bank Hong Kong
*Nicholas Kwan*, Head of Research East, Standard Chartered

1400–1715 ***Afternoon research roundtable for selected researchers and experts***
(Meeting held under the Chatham House Rules)

## Chatham House Roundtable Event

*Shifting Capital: The Rise of Financial Centres in Greater China*

*Financial Centres in Greater China*
*Shanghai research conference*
Wednesday 9 November 2011, Shanghai

### Agenda

0920–0945 ***Welcome remarks***
*Zhu Xiaoming*, CEIBS Executive President, Chairman of CEIBS Lujiazui Institute of International Finance
*Paola Subacchi*, Research Director, International Economics, Chatham House

0945–1010 ***Opening remarks***
*Wu Xiaoling*, Deputy Director of the Financial and Economic Affairs Committee, National People's Congress; First Director, CEIBS Lujiazui Institute of International Finance (former Deputy Governor of the People's Bank of China)

1010–1200 ***Keynote and Panel: Vision for Shanghai's Future and China's Next Stage of Development***

**Chair:** Paola Subacchi, Research Director, International Economics, Chatham House

**Speaker:** *Fang Xinghai*, Director General, Shanghai Financial Services Office

**Panellists:** *Wang Wei*, General Secretary, China Association of Private Equity
*Chi Schive*, Chairman of Taiwan Stock Exchange

1300–1415 ***Session One: Strengthening Shanghai's Position as a Financial Centre: The Role of Municipal Government and the Role of Central Government in Beijing***

**Chair:** *Paul Hsu*, Founder and President of EPOCH Foundation

**Panellists:** *Geng Xiao*, Director of Research & Senior Fellow, Fung Global Institute
*Pan Yinli*, Professor and Dean of Department of Finance, Antai College of Economics and Management, Shanghai Jiao Tong University
*Dicky Yip*, Executive Vice President, Bank of Communications
*Vivian Jiang*, Managing Partner, Deloitte Touche Tohmatsu (Shanghai)

1415–1530 ***Session Two: Shanghai & Hong Kong Collaboration, Regional and International Dimensions to Shanghai's Growth and RMB Internationalization***

**Chair:** *Robert Hodgkinson*, ICAEW

**Panellists:** *Nicholas Kwan*, Head of Research, East, Standard Chartered Bank

*Michael Yang*, Head of Asia Global Corporate Client Group, New York Stock Exchange

*Jesús Seade,* Vice-President, Sydney S.W. Leong Chair Professor of Economics, Lingnan University

*Guo Wanda*, China Development Institute (CDI)

* All meetings were held under the Chatham House Rule

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