Shanghai as an International Financial Centre

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Hui Mei Wong

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University of Queensland

Abstract

In 1949 Shanghai was the leading financial centre in Asia. Recently the transformation of Shanghai into an international financial centre (IFC) has once again been placed on the policy agenda. This paper first draws upon the IFC literature to derive the factors that are considered to be important in determining the potential of a city to emerge as an IFC. Shanghai’s progress is then measured against these criteria and is also placed in a comparative perspective, with data not only being collected for Shanghai but also for Hong Kong and Singapore. The findings show that Shanghai’s strengths include its high growth rate and international orientation, along with its access to important markets and cheap business input costs. Areas of weakness include most relevant microeconomic factors, financial market inefficiencies and the political reality that policy makers in Beijing will ultimately decide Shanghai’s IFC fortunes. These findings suggest that Shanghai’s emergence as an IFC needs to be rated a long term proposition. It is also noted that Shanghai’s emergence need not necessarily represent a zero-sum game for Hong Kong and Singapore, and that an Asian region featuring a strong and dynamic China may well be able to support three IFCs.

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1. Introduction

In 1949 Shanghai was the leading financial centre in Asia. The Banker (March 2003) magazine recounts that at this time there were 24 state banks, over 200 private lenders, trust companies and other financial institutions based in Shanghai. It also hosted the world’s third largest stock market, following only New York and London. Now, over 50 years on and more than 20 years after China began its open door policy, Shanghai is once again seeking to transform itself into an international financial centre (IFC). In doing so it is attempting to make up the ground lost to neighbouring Tokyo, Hong Kong, SAR (hereafter abbreviated as “Hong Kong”) and Singapore. According to Shanghai’s mayor the goal is to reach IFC status within 10 to 20 years (People's Daily 08/08/2002).

Financial sector development in Shanghai has been rapid over the past decade and according to Wong (2002) financial services accounted for 15.2% of Shanghai’s GDP in 2000. Shanghai has already established itself as the domestic financial hub of mainland China. The municipality’s stock market has developed rapidly since 1991 to become the third largest in Asia, following only Tokyo and Hong Kong (People's Daily 06/08/2002). Shanghai has also become the centre for many of the country’s other financial activities, including interbank lending, bond trading, foreign exchange trading and fledgling futures and commodity trading. It is also becoming increasingly clear that Shanghai is serving as the point of contact for China’s international financial integration at the expense of Shenzhen or even Hong Kong. Foreign banks in Shanghai now account for half of the deposits, loans and assets of all foreign banks in China (People's Daily 06/08/2002). The major foreign banks in China including Hong Kong and Shanghai Banking Corporation (HSBC), Citibank and Standard Chartered have all moved their China headquarters to Shanghai since the mid-1990s. HSBC has gone one step further and additionally made Shanghai its regional headquarters. Shanghai has also traditionally been used as the testing ground for China’s external financial liberalisation policy. For example, in December 1996, foreign banks located in Shanghai were amongst the first to be permitted to engage in local renminbi (RMB)-denominated financial services and now the majority of foreign banks licensed to trade in RMB are located in Shanghai.
While Shanghai’s drive to IFC status has been a hot topic in the financial press, little has been done by way of a systematic attempt to gauge its progress using a conceptual framework grounded in the IFC literature. In contrast, Tokyo, Hong Kong and Singapore have all been the subject of previous research (e.g. see Yong, Hung and Cheng 1999; Sassen 2001). Yet investigating Shanghai’s progress towards achieving IFC status is important for several reasons. Firstly, the pace of China’s international financial integration is now increasingly being pushed through external bodies such as the World Trade Organisation (WTO). For example, in a radical change from historical policy, five years after China’s WTO entry in 2001, all foreign banks throughout China will be afforded full national treatment (Lardy 2002, p.79). Given that Shanghai will be the initial contact point and hub of China’s external financial liberalisation, the degree to which it can successfully transform itself into an IFC will go a long way to determining whether China’s global integration proceeds smoothly. Secondly, if Shanghai can transform itself into a successful IFC, this could have significant economic implications not only for China but also for its regional competitors such as Hong Kong and Singapore. The fact that an IFC can potentially bring economic benefits to a host economy has been well discussed in the literature (Kaufman 2001: 366). Therefore, gauging the extent to which Shanghai is along the path to emerging as a genuine competitor is of significant importance for other regional economies.

This paper analyses Shanghai’s progress in the following manner. Section 2 lays out the conceptual framework for the analysis by highlighting those factors that are regarded as being the driving forces behind IFC development. Section 3 then compares the current state of play in Shanghai against these criteria. Conditions in Shanghai are also contrasted wherever possible with those in Hong Kong and Singapore. This is done for two reasons. Firstly, given that Hong Kong and Singapore are already regarded as having reached IFC status, much can be learned about Shanghai’s current situation by placing it in a comparative context. Second, Hong Kong and Singapore are the two regional IFCs that will most directly face competitive pressure from Shanghai’s emergence and, hence, gauging their current degree of superiority will have implications for the time frame in which their ascendency may begin to be questioned. Section 4 summarises the findings.
2. Conceptual Framework

A financial centre is an area, normally a city or even a spot within a city’s boundaries, in which a vast amount of financial activities are concentrated. O’Brian (1992, p.73) puts it eloquently in stating that “finance is like the Olympic Games…it tends to be the city not the nation that competes for the activity”. While the formation of financial centres is powerfully shaped by the forces of agglomeration and is thus path dependent, history demonstrates that established IFCs are not immune to decline due to competition from new challengers. Examples include Sydney surpassing Melbourne, Toronto surpassing Montreal, Johannesburg surpassing Cape Town, and Sao Paulo surpassing Rio de Janeiro during the post war period (Porteous 1995). Such a shift of comparative advantage between competing cities should not come as a surprise, considering that financial production is increasingly footloose thanks to the advancement of information and telecommunication technology. Such technological advances when combined with global deregulation of financial industries have prompted some to cast doubts on the need for the centralisation of financial activities and, thus, for the future of IFCs (e.g. see O'Brien 1992). However, others counter that location still matters (e.g. see Sassen 1999; Tschoegl 2000) and there has certainly been no observable decline in their prominence. If anything, the race amongst cities to establish themselves as IFCs has intensified (The Economist 09/05/1998).

Montes (1999) classifies financial markets according the type of intermediation they perform (Table 1). Type 1 is considered the least sophisticated and for a given financial market to be considered an IFC, it must at least display some features relating to Types 2 - 4. According to this classification, despite Shanghai’s financial market being the most dynamic one on the mainland, it is still predominantly a Type 1 market and it’s IFC drive must therefore largely be discussed in terms of potential rather than achievements to date. This is exemplified by the fact that foreign intermediaries continue to play only a marginal role in Shanghai’s financial sector. For example, at year-end 2002 outstanding loans in domestic and foreign currencies at both Chinese and foreign financial institutions in Shanghai amounted to US$127.12 billion (People's Daily 10/01/2003). However, as of November 2002, total loans from
foreign financial institutions amounted to only USD9.5 billion and the bulk of this business was denominated in foreign currencies (People's Daily 03/01/2003). Beijing’s ongoing reluctance to make the RMB convertible for capital account transactions also necessarily constrains the ability of Shanghai to achieve higher degrees of financial sophistication.

Table 1: Types of Financial Systems

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type 1</td>
<td>Intermediaries between domestic providers of capital and domestic users of capital.</td>
</tr>
<tr>
<td>Type 2</td>
<td>Intermediaries between foreign providers of capital and domestic users of capital.</td>
</tr>
<tr>
<td>Type 3</td>
<td>Intermediaries between domestic providers of capital and foreign users of capital.</td>
</tr>
<tr>
<td>Type 4</td>
<td>Intermediaries between foreign providers of capital and foreign users of capital.</td>
</tr>
</tbody>
</table>

Source: Montes (1999, p.154)

In evaluating whether a city’s financial sector can potentially emerge as an IFC, a mix of macroeconomic and microeconomic factors, in conjunction with the efficiency of the financial sector itself, are usually taken to be important. These factors are summarised in Table 2. In terms of macroeconomic conditions, the income level and growth rate are important to the formation of an IFC in several aspects. Firstly, an IFC is typically founded on the basis of a vibrant domestic financial market. Schenk (2002), for example, points out that it was the vibrant traditional local banking system and laissez-faire economic policies that catapulted Hong Kong to stand out amongst regional and global financial centres in the 1950s and 1960s and laid the foundation for its later emergence as an IFC. The domestic demand for sophisticated financial products and services is closely related to domestic savings per capita and, hence, GDP per capita. Secondly, the larger an economy is, the more investment

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2 An exception is those IFCs that attract international capital mainly by serving as a tax and regulation haven. Most of these IFCs are island states with virtually no other industries.
opportunities it affords to foreign investors. Related to this point is that the GDP growth rate not only reflects the short-term dynamism of an economy but also determines the long-term income level. Therefore, an economy with a higher growth rate, other things equal, will be more attractive to foreign investors. Apart from the income level and growth, other important macroeconomic factors include the international trade and investment intensity of a city. A city is more likely to emerge as an IFC when the real sector is both dynamic and internationally orientated. An IFC is essentially an “exporter” of financial and related services. Trade in merchandise goods and direct investment activities make use of these services also. In particular, exports and imports provide opportunities for the financial sector to underwrite trade through the provision of credit, and, if domestic firms expand into other countries via foreign direct investment, then financiers can follow firms with the provision of financial products services (Meyer 1998). This provides a foundation for the agglomeration of financial, accounting, legal or other related services in the economy. The importance of maintaining sound macroeconomic policies to promote an IFCs development is self-explanatory. Assuming that macroeconomic factors are sufficiently satisfied, the various microeconomic considerations listed in Table 2 then become important. All of these microeconomic factors influence the opportunity cost of doing business in one city versus another. The idea behind including the efficiency of the financial sector as a catalyst for IFC development is simple. At the most basic level, the driving force underlying the formation of financial markets and institutions is a desire to reduce the costs of acquiring information and undertaking transactions (Levine 1997, p.690). Therefore, if a financial sector does not perform this task efficiently, there is little reason to expect that it will flourish. There are a number of studies that have attempted to rank the factors that are important to the formation of IFCs. Appendix A provides details regarding one such recent attempt by Bindemann (1999).
Table 2.: Factors influencing IFC development

<table>
<thead>
<tr>
<th>Factor</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Macroeconomic environment</td>
<td>• High GDP per capita and growth</td>
</tr>
<tr>
<td></td>
<td>• High trade and investment intensity</td>
</tr>
<tr>
<td></td>
<td>• Sound macroeconomic policy</td>
</tr>
<tr>
<td>b. Microeconomic business environment</td>
<td>• Low business costs (office rental, corporate taxes, wages, etc)</td>
</tr>
<tr>
<td></td>
<td>• Significant domestic market and growth potential</td>
</tr>
<tr>
<td></td>
<td>• Rule of law and the absence of corruption and red tape</td>
</tr>
<tr>
<td></td>
<td>• Highly developed physical infrastructure (communications, transportation, etc)</td>
</tr>
<tr>
<td></td>
<td>• Adequate human capital (availability of finance, accounting and legal professionals, etc)</td>
</tr>
<tr>
<td></td>
<td>• Liveability (low pollution, affordable housing, access to high quality health, education, entertainment and cultural events)</td>
</tr>
<tr>
<td></td>
<td>• Political and economic freedom</td>
</tr>
<tr>
<td>c. Financial market efficiency</td>
<td>• Low transaction costs (taxes, brokerage fees, etc)</td>
</tr>
<tr>
<td></td>
<td>• International standards of accounting, legal and supervisory practices</td>
</tr>
<tr>
<td></td>
<td>• Large variety of financial products and services</td>
</tr>
</tbody>
</table>
3. Shanghai’s Development as an IFC

This section reviews Shanghai’s development as an IFC according to the conceptual framework presented in Table 2. Having noted the importance of a vibrant and internationally orientated business sector in the conceptual discussion above, by way of a general empirical introduction it is useful to consider the degree of success Shanghai has had with respect to attracting the resources of foreign multinational companies (MNCs). This is because in making its investment and locational decisions, an MNC is effectively required to make a summary judgement regarding many of the factors listed in Table 2. When the actual investment and location decisions made by MNCs are examined, two important points emerge. Firstly, the economic attractiveness of Shanghai has improved markedly over time. For example, Table 3, column 1 presents the level of FDI in Shanghai in level form and as a percentage of the national total in parentheses. Column 2 shows the number of registered firms with foreign capital in Shanghai, again with the percentage of the national total in parentheses. It is clear that since the mid-1990s Shanghai has not only passively benefited from China’s overall rising prominence as an FDI host but has actively began absorbing a larger share of the national total.

<table>
<thead>
<tr>
<th>Year</th>
<th>FDI ($US10000)</th>
<th>Number of registered firms with foreign capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>10754 (5.50)</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>17401 (4.99)</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>49361 (4.37)</td>
<td>3635 (4.31)</td>
</tr>
<tr>
<td>1995</td>
<td>289261 (7.65)</td>
<td>14487 (6.20)</td>
</tr>
<tr>
<td>2000</td>
<td>316014 (7.76)</td>
<td>15930 (7.83)</td>
</tr>
<tr>
<td>2001</td>
<td>429159 (9.15)</td>
<td>18160 (8.98)</td>
</tr>
</tbody>
</table>

Source: China Statistical Yearbook, various years.

Secondly, despite this rapid growth, Shanghai still trails Hong Kong and Singapore by a large margin, particularly in terms of attracting key decision-making and high value-added units of MNCs such as regional headquarters. For example, a two-year long
study published in the Economist Intelligence Unit’s publication Business Asia (11/12/2000) surveyed over 8000 North American, European and Japanese firms in the region and found that 35 per cent of companies based their regional headquarters in Hong Kong, followed closely by 30 per cent in Singapore. Shanghai remained a distant competitor with only 3 per cent. According to a recent report, in 2002 there were 948 foreign companies that had set up their regional headquarters in Hong Kong (Hong Kong Government 2002). This compared with just 79 in Shanghai (SinoCast China Business Daily News 28/03/2003). While Shanghai’s share of regional headquarters remains small, it should be noted that in the period immediately prior to and since WTO entry, a growing band of MNCs have moved all or part of their regional headquarters to Shanghai, and in most cases these business units were transferred from Hong Kong or Singapore. These include well-known Fortune listed companies such as Alcatel, Allied Signal, Citibank, General Motors, Johnson & Johnson, Kodak, Roche, Rhodia Chemicals, Sharpe, HSBC, UPS, Standard Chartered, Mckinsey and Honeywell. Attracting the regional headquarters of MNCs became official Shanghai government policy in July 2002 with the release of the Encouragement for Foreign Multinational Companies Establishing Regional Headquarters Tentative Provisions.

3.1 Macroeconomic Environment

Income Level and Growth

Table 4 summarises the real rate of GDP growth and per capita GDP for Shanghai, Hong Kong and Singapore in the last two years. The much smaller growth figures of Hong Kong and Singapore reflect their ongoing struggle to recover from the Asian crisis of 1997. However, given that these two economies have had several decades of head start, it is no surprise that their per capita income levels are 4 to 5 times that of Shanghai. If it is supposed that the three economies maintain their growth rates in 2002 unchanged, that is, Shanghai will continue to grow over 4 times as fast as Hong Kong and Singapore do, it will still take Shanghai 20 years to catch up in terms of per capita GDP. This simple calculation indicates that, as far as the income level is concerned, Hong Kong and Singapore have at least 10 to 15 years’ time to prepare themselves for the challenge of Shanghai.
Table 4.: GDP Growth in Shanghai, Hong Kong and Singapore

<table>
<thead>
<tr>
<th></th>
<th>Shanghai</th>
<th>Hong Kong</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2001</td>
<td>2002</td>
<td>2001</td>
</tr>
<tr>
<td>Real GDP Growth</td>
<td>10.2</td>
<td>10.7</td>
<td>0.5</td>
</tr>
<tr>
<td>(%)</td>
<td></td>
<td></td>
<td>2.3</td>
</tr>
<tr>
<td>Per Capita GDP</td>
<td>4,500</td>
<td>4,909</td>
<td>25,400</td>
</tr>
<tr>
<td>(USD)</td>
<td></td>
<td></td>
<td>24,011</td>
</tr>
</tbody>
</table>
| Source:          | Hong Kong Census and Statistic Department; Singapore Department of Statistics; National Bureau of Statistics of China

The above calculation is also likely to overestimate the growth advantage of Shanghai compared with Hong Kong and Singapore. This is because, firstly, the latter two economies are currently at a trough in their business cycles and, secondly, Shanghai can grow quickly for a time as it catches up with the richer economies. The Growth Competitiveness Index compiled annually by the World Economic Forum is instructive here even though it only compares countries rather than cities. This index aims to measure the capacity of the national economy to achieve sustainable economic growth over the medium term, controlling for the current level of development and short run business cycle fluctuations (Cornelius, Schwab and Porter 2003: 8). Such adjustments have a considerable impact on China as although it had the highest growth rate amongst the 80 surveyed economies in 2002, it’s overall ranking was 33rd, compared with Hong Kong which ranked 17th and Singapore which ranked 4th.

**Trade and Investment Intensity**

Table 5 show the 3-year average ratios of imports to GDP, exports to GDP and total trade to GDP over the period of 1994-2002. We divide the period of 1994 to 2002 into three sub-periods, corresponding to before, during, and after the Asian crisis. It can be seen that during the Asian crisis, trade intensities for all three economies fell, but the fall for Shanghai was only marginal. By 2000-2002, Hong Kong and Singapore had resumed their pre-crisis trade intensities, whereas Shanghai had progressed to raising its trade intensity by around one third. Shanghai’s trade intensity in this comparative
perspective is particularly impressive given that Hong Kong and Singapore, being small island cities, would expectedly have a higher trade dependency than Shanghai, which is geographically part of a larger and more resource abundant domestic economy.

Table 5: International Trade Intensity \[^a]\n
<table>
<thead>
<tr>
<th></th>
<th>Import/ GDP</th>
<th>Export/GDP</th>
<th>Total Trade/ GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>0.40 0.37</td>
<td>0.57 0.39</td>
<td>0.47 0.79 0.75</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1.42 1.28</td>
<td>1.41 1.41</td>
<td>1.47 2.82 2.57</td>
</tr>
<tr>
<td>Singapore</td>
<td>1.43 1.35</td>
<td>1.46 1.36</td>
<td>1.39 2.79 2.70</td>
</tr>
</tbody>
</table>

\[^a]\] The figures for Shanghai cover only trade in merchandise goods, while those for Hong Kong and Singapore cover both goods and services.

**Sources:** China Statistical Yearbook; Yearbook of Statistics Singapore; Hong Kong data are from the World Development Indicators database.

Table 6 shows the annual average value of FDI inflows and outflows as a proportion of GDP for the three economies over the period of 1990-2001. This period is divided into three sub-periods: 1990-95, 1996-98 and 1999-2001. Shanghai’s openness in terms of hosting FDI inflows appears to compare well with both Hong Kong and Singapore and has consistently averaged above 10% of GDP.\(^3\) Also, largely not shown in Table 6 is the jump in FDI into Shanghai following China’s WTO accession. In 2002, the contracted value of FDI flowing into Shanghai increased by 43.4 per cent to USD105.76 billion as compared to US$73.73 billion in 2001 (data source: Shanghai Statistical Yearbook). The services sector (which includes the financial sector) was the big winner in 2002 with contracted FDI increasing by 93.6 per cent to US$35.73 billion (data source: Shanghai Statistical Yearbook). The latest

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\(^3\) The 1999-2001 FDI figures for Hong Kong are much larger than during previous periods and this is due to a noticeable jump in FDI inflows and outflows during 2000. We suspect a lot of these capital inflows make use of Hong Kong as a detour towards mainland China and that is why capital outflows were equally large in magnitude.
statistics reported by the Shanghai Foreign Economic Relations and Trade Commission reported that foreign investment rose 31.7 per cent during the first two months of 2003. The emerging service sector alone received 346 projects worth a total of US$800 million. Unfortunately, data regarding outward FDI from Shanghai are not available although such capital outflows are expected to be small when compared to Hong Kong and Singapore. Shanghai faces particularly strong competition from Hong Kong in attracting FDI. Worldwide recognition of Hong Kong as an investment destination can be found in the World Investment Report 2002 published by the United Nations Conference on Trade and Development (UNCTAD). This source showed Hong Kong as the second largest FDI recipient in Asia in 2001 following only China. The report also named Hong Kong as the best-performing host economy for FDI in Asia and second in the world after Belgium/Luxembourg.

Table 6: International Investment Intensity [a] [b]

<table>
<thead>
<tr>
<th></th>
<th>FDI Inflow/ GDP</th>
<th>FDI Outflow/GDP</th>
<th>Total FDI Flow/ GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>0.113</td>
<td>0.143</td>
<td>0.108</td>
</tr>
<tr>
<td></td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>0.044</td>
<td>0.074</td>
<td>0.226</td>
</tr>
<tr>
<td></td>
<td>0.118</td>
<td>0.137</td>
<td>0.184</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.101</td>
<td>0.100</td>
<td>0.100</td>
</tr>
<tr>
<td></td>
<td>0.041</td>
<td>0.063</td>
<td>0.076</td>
</tr>
<tr>
<td></td>
<td>0.142</td>
<td>0.159</td>
<td>0.176</td>
</tr>
</tbody>
</table>

[a] The figures are annual averages.

[b] Foreign investment data for Shanghai are contracted values. Historically, actually utilised values are about two-thirds of the contracted values.

Source: For Hong Kong and Singapore, 1990-95 figures are from World Investment Report 2002 published by the UNCTAD; 1996-2001 figures are from International Financial Statistics published by the IMF. Figures for Shanghai are from Shanghai Statistical Yearbook.
Sound Macroeconomic Policy

There are two major hurdles in comparing economic policy between the three cities. Firstly, as far as macroeconomic policies are concerned, such as the money supply and the exchange rate, Shanghai is part of mainland China and hence has no independent macroeconomic policy to speak of. As a consequence, we can only look at the macroeconomic policy of China as a whole. Secondly, since there is a wide range of macroeconomic policies that could affect business operations, a summary measure is needed in order to undertake a tractable commentary. To achieve this aim, we make use of the Macroeconomic Environment Index compiled by the World Economic Forum. It is necessary to emphasise first that this index and its composite subindexes not only measure macroeconomic policies, but also a country’s performance in a number of related aspects, such as its credit rating. In other words, the index measures both the “input” and “output” of macroeconomic policies. Table 7 summarises the ranking of China, Hong Kong and Singapore over the past two years. In terms of the Macroeconomic Environment Index, China ranks 8th in 2002 while Hong Kong ranks 3rd and Singapore tops the list. Perhaps the most important observation flowing from these figures is not that Singapore and Hong Kong are high on the list, but the fact that China has been within the top 10 countries over the past two years. In fact, China ranks even higher than Hong Kong in terms of macroeconomic stability in 2002. What drags China’s overall ranking down is its credit rating, which highlights the continuing uncertainty residing in its economy. A caveat here is that the above index was first constructed in 2001. However, a country’s ranking can be greatly affected by short-term fluctuations in its macroeconomic conditions. This is reflected in the large change of ranking in the Government Expenditure Subindex over the two years for all of the three economies, as well as that of the Macroeconomic Stability Subindex for China and Hong Kong.
Table 7: Macroeconomic Environment Index

<table>
<thead>
<tr>
<th>Index and subindex</th>
<th>Ranking</th>
<th>China</th>
<th>Hong Kong</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macroeconomic Environment (2002)</td>
<td>8</td>
<td>3</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Macroeconomic Stability</td>
<td>5</td>
<td>9</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Country Credit Rating</td>
<td>32</td>
<td>25</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Government Expenditure</td>
<td>16</td>
<td>15</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>Macroeconomic Environment (2001)</td>
<td>6</td>
<td>2</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Macroeconomic Stability</td>
<td>15</td>
<td>17</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Country Credit Rating</td>
<td>34</td>
<td>25</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Government Expenditure</td>
<td>4</td>
<td>7</td>
<td>20</td>
<td></td>
</tr>
</tbody>
</table>


[b] 80 and 75 countries were ranked in 2002 and 2001, respectively.

3.2 Microeconomic Business Environment
Comparing city-level microeconomic data relating to the various criteria listed in Table 2 are both limited and potentially cumbersome. Thus, in this section we predominantly make use of summary measures. One important source with relevance to the present study is a survey conducted in 1998 by Enright and Thompson from the University of Hong Kong. It asked MNCs to rank the attractiveness of Shanghai versus Hong Kong as a location for regional headquarters in the future according to numerous criteria that were broadly similar to those presented in Table 2. The results are summarised in Table 8. The overall conclusion was that Hong Kong was rated a significantly more attractive location for a regional headquarters than Shanghai. Shanghai’s sole advantage related to the costs of doing business. This is likely to largely reflect relatively low office rental costs in Shanghai. For example, according to the real estate services company Cushman and Wakefield, in September 2002 rental costs of Prime and Grade A office space in Shanghai was US$28.18 / sq-f / yr, compared with US$48.27 in Hong Kong and US$37.85 in Singapore. The only other criteria that Shanghai came close to matching Hong Kong in was related to its centrality to important markets. This is one factor that is likely to have grown in importance since China’s WTO entry and it would not be surprising if Shanghai has since eclipsed Hong Kong in this respect. Indeed, an examination of the press releases issued by companies that have relocated their China and regional headquarters to Shanghai in the most recent years suggests that improved access to China’s large and rapidly expanding domestic market, as opposed to lower business input costs, has been the driving force behind their relocation. Nevertheless, according to Table 8, Shanghai continues to lag significantly in areas relating to infrastructure, human capital, liveability and the broader category of political and economic freedom and the rule of law.
Table 8: Attractiveness of Hong Kong versus Shanghai for Regional Headquarters \[^{[a]}\]

<table>
<thead>
<tr>
<th></th>
<th>Hong Kong (mean)</th>
<th>Shanghai (mean)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centrality to important markets</td>
<td>4.2</td>
<td>3.7</td>
</tr>
<tr>
<td>High quality local managers</td>
<td>4.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Financial services</td>
<td>4.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Supporting and supply industries</td>
<td>3.6</td>
<td>2.9</td>
</tr>
<tr>
<td>Transportation infrastructure</td>
<td>4.2</td>
<td>2.9</td>
</tr>
<tr>
<td>Communications infrastructure</td>
<td>4.4</td>
<td>3.0</td>
</tr>
<tr>
<td>Technological environment</td>
<td>3.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Cost of doing business</td>
<td>2.4</td>
<td>2.9</td>
</tr>
<tr>
<td>Government economic policy</td>
<td>3.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Political cleanliness</td>
<td>3.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Rule of law</td>
<td>3.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Quality of life for executives</td>
<td>3.8</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Overall attractiveness for RHQs</strong></td>
<td><strong>4.0</strong></td>
<td><strong>2.8</strong></td>
</tr>
</tbody>
</table>

\[^{[a]}\] Respondents were asked to rank according to the following scores: 1=Very important; 2=Slightly unimportant; 3 = Neutral; 4=Slightly unimportant; 5=Very important.


There are numerous other summary measures that lend credence to the above conclusions. Apart from compiling a Macroeconomic Environment Index, the World Economic Forum also formulates a Business Competitiveness Index (Table 9, column 1) that attempts to quantify the degree of company sophistication and the quality of the business environment in a given country. Another source that relates to political and economic freedom is the Heritage Council’s *Index of Economic Freedom*. (Table 9, column 2). This index ranks economic freedom according to ten factors including trade policy, fiscal burden, government intervention, monetary policy, foreign investment, banking and finance, wages and prices, property rights, regulation and the black market, with 1 being “free” and 5 being “repressed”. The Fraser Institute’s
publication *Economic Freedom of the World* (Table 9, column 3) similarly compiles data relating to the size of the government, legal structure and security of property rights, access to sound monetary policy, freedom to exchange with foreigners and regulation of credit, labour and business. Transparency International’s well-known *Corruption Perceptions Index* (Table 9, column 4) is also worth mentioning in this discussion. This index asks business leaders and country analysts to rate countries in terms of their perceptions regarding the prevalence of corruption with 10 being “highly clean” and 0 being “highly corrupted”. China’s performance in these indices is presented in Table 9, along with the comparative data relating to Hong Kong and Singapore.

Table 9: Indices relating to the Microeconomic Business Environment

<table>
<thead>
<tr>
<th></th>
<th>WEF [a]</th>
<th>HC [b]</th>
<th>FI [c]</th>
<th>TI [d]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rank</td>
<td>Mean</td>
<td>Rank</td>
<td>Rank</td>
<td>Mean</td>
</tr>
<tr>
<td>Rank</td>
<td>Mean</td>
<td>Rank</td>
<td>Mean</td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>46</td>
<td>3.55</td>
<td>127</td>
<td>100</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>19</td>
<td>1.45</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Singapore</td>
<td>8</td>
<td>1.5</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

[a] This data is taken from the 2003-2004 edition of the World Economic Forum’s *Global Competitiveness Report*. This source compiled data relating to 100 countries. Information about this index can be obtained from the World Economic Forum’s website: http://www.weforum.org/

[b] This data is taken from the 2003 edition of the Heritage Council’s *Index of Economic Freedom*. This source compiled data relating to 161 countries. Information about the Index can be obtained from the Heritage Council’s website: http://www.heritage.org/research/features/index/.

[c] This data is taken from the 2003 edition of the Fraser Institute’s *Economic Freedom the World*. This source compiled data relating to 123 countries. Information about the Index can be obtained from the Fraser Institute’s website: http://www.freetheworld.com/release.html.

[d] This data is taken from the 2003 edition of Transparency International’s Corruption Perceptions Index. This source compiled data relating to 133 countries.
Information about the Index can be obtained from the Transparency International’s website: ttp://www.transparency.org/cpi/index.html#cpi

In all of the above indices, two points are notable. Firstly, China lags both Hong Kong and Singapore significantly. Secondly, both Hong Kong and Singapore perform not only well in relation to Shanghai but are also amongst the best performers internationally. Of course it needs to be recognised that the use of such national average scores is likely to bias the results against Shanghai because it is one of China’s more progressive cities. For example, according to the 2000 Marketization Index of China’s Provinces published by National Economic Research Institute in Beijing, Shanghai ranks 6th in terms of its progress towards achieving a free market economy (Fang, Wang and Zhang 2000). Nevertheless, in comparative terms, Guangdong province, the number one ranking province, leads Shanghai by some 25% and there is little doubt that Hong Kong and Singapore would receive a higher ranking than Guangdong.

Apart from summary measures, it is also useful to consider more disaggregated microeconomic data and this paper makes a contribution towards this endeavour in the form of Table 10, which compares various aspects of the communications and transportation infrastructure in Shanghai, Hong Kong and Singapore. According to Table 8, these are two areas in which MNCs perceived Shanghai to lag considerably behind Hong Kong and Singapore in 1998. On balance, while the data do suggest that Shanghai continues to lag Hong Kong and Singapore through 2002, the gap is closing rapidly. For example, per capita telephony and Internet usage figures appear to be converging. According to Bindemann’s study presented in Appendix 1, infrastructure ranks the 7th most important factor out of the list of 21 surveyed factors that together determine the IFC potential of a city. Thus, Shanghai’s progress in this area bodes well for its IFC aspirations. Extending the data collection process to encompass other relevant microeconomic factors such as human capital is left for future research.
Table 10: Communications and Transportation Infrastructure

<table>
<thead>
<tr>
<th>Year 2002</th>
<th>Shanghai</th>
<th>Hong Kong</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Telephone lines &amp; cellular subscribers (per capita) [a]</td>
<td>1.19</td>
<td>1.49</td>
<td>1.24</td>
</tr>
<tr>
<td>Internet users (per capita)</td>
<td>0.34</td>
<td>0.43</td>
<td>0.48</td>
</tr>
<tr>
<td>Cargo handled (million tones)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Railway</td>
<td>58.36</td>
<td>0.385</td>
<td>N/A</td>
</tr>
<tr>
<td>Road</td>
<td>297.59</td>
<td>39.61</td>
<td>N/A</td>
</tr>
<tr>
<td>Sea</td>
<td>231.74</td>
<td>192</td>
<td>335.2</td>
</tr>
<tr>
<td>Air</td>
<td>1.32</td>
<td>2.48</td>
<td>1.64</td>
</tr>
<tr>
<td>Port container throughput (million TEU)</td>
<td>8.61</td>
<td>18.65</td>
<td>16.94</td>
</tr>
<tr>
<td>Post articles and parcels handled (billion)</td>
<td>2.81</td>
<td>1.27</td>
<td>1.59</td>
</tr>
</tbody>
</table>

[a] Population figures for Shanghai and Hong Kong are year-end figures, while that for Singapore is mid-year.

Source: Census & Statistics Department of Hong Kong; Yearbook of Statistics Singapore; Shanghai Statistical Yearbook.

3.3 Financial Market Efficiency

Efficiency in the context of Shanghai’s equity markets can be discussed in terms of informational efficiency and fundamental valuation efficiency. Testing for the informational efficiency of equity markets typically revolves around examining whether stock prices behave in a manner implied by the Efficient Market Hypothesis (EMH). The EMH contends that if stock prices are efficient, they will rapidly adjust to new information and that current prices will fully absorb and reflect all available information. Numerous studies of stock prices and returns in China have been conducted and on balance the evidence suggests that for much of their short history they have not been efficient (Song, Liu and Romilly 1998; Su and Fleisher 1998; Mookerjee and Yu 1999; Liu 2003). Fundamental valuation efficiency refers to whether stock prices accurately reflect the economic fundamentals underlying the
listed firm. This is a more difficult concept to measure empirically. However, price / earning (P/E) ratios and the degree of stock price volatility can serve as useful guides. That is, if stock prices are driven by speculative activity, herding behaviour and / or illegal activities (such as insider trading) rather than economic fundamentals, P / E ratios will be excessively high / low and prices will be highly volatile and represent inefficient signals for capital flows in the economy. Currently, shares in Shanghai are traded at an extremely high P / E ratio. For example, at year-end 2002, the average P / E ratio in Shanghai was 34.4 per cent (which was down from over 40% several years earlier). The comparative figure in Hong Kong and Singapore was 14.9 per cent and 21.2 per cent (source: Hong Kong Stock Exchange[kk1]). Thus, P / E ratios do provide some suggestion of fundamental valuation inefficiency in Shanghai’s stock market. Table 11 places stock price fluctuations in Shanghai in a comparative perspective. It shows the monthly, average percentage change (in absolute terms) of the Shanghai A-share composite index, the Hong Kong Hang Seng Index and the Singapore Straits Times index over the years 1995 – 2002. The findings are interesting. On the one hand, there is evidence that Shanghai’s stock markets were initially relatively volatile. On the other hand since 1997, Shanghai’s stock market appears to have been no more volatile than Hong Kong or Singapore’s.

Table 11: Average Monthly Percentage Change in Stock Indices

<table>
<thead>
<tr>
<th>Year</th>
<th>Shanghai</th>
<th>Hong Kong</th>
<th>Singapore</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>9.15</td>
<td>4.94</td>
<td>2.79</td>
</tr>
<tr>
<td>1996</td>
<td>8.34</td>
<td>4.01</td>
<td>3.21</td>
</tr>
<tr>
<td>1997</td>
<td>7.29</td>
<td>7.35</td>
<td>5.46</td>
</tr>
<tr>
<td>1998</td>
<td>5.08</td>
<td>10.40</td>
<td>13.59</td>
</tr>
<tr>
<td>1999</td>
<td>7.05</td>
<td>8.58</td>
<td>6.55</td>
</tr>
<tr>
<td>2000</td>
<td>4.09</td>
<td>6.36</td>
<td>5.29</td>
</tr>
<tr>
<td>2001</td>
<td>4.47</td>
<td>6.68</td>
<td>6.33</td>
</tr>
<tr>
<td>2002</td>
<td>5.81</td>
<td>5.01</td>
<td>5.21</td>
</tr>
</tbody>
</table>

Source: Emerging Stock Markets Factbook published by International Finance Corporation (various issues), Hong Kong Stock Exchange, Singapore Exchange.
Any relative inefficiency in Shanghai’s stock markets can be explained by several factors. First, and in clear contrast with Hong Kong and Singapore, the state is the major player in Shanghai’s stock market. The majority of the shares of companies listed on Shanghai’s stock market are state-owned and not freely tradeable. When only a small proportion of a company's total shares are available for trading, share prices cannot reflect the market's view of the fundamental value of a listed firm (Spencer 1995, p.30; Yao 1998, p.22). The negative implications of non-tradeable state-owned shares for corporate governance and the financial performance of listed companies have also already been discussed at length in the literature (Tam 1999).

Second, there is evidence that equity-trading costs in Shanghai are higher than in other stock exchanges, including those in Hong Kong and Singapore. Explicit costs of trading in Shanghai’s stock market, such as taxes and stamp duties, remain significant although they have been falling in recent years. After a reduction in November 2001, stamp duty levied on A- and B-share trading is currently fixed at 0.4 per cent, shared equally between the buyer and the seller (source: Hong Kong Stock Exchange). The comparative rate in Hong Kong is 0.225 per cent and in Singapore 0.2 per cent. The global trend is towards the abolition of such taxes with the U.S., Japan and Australia, amongst others, having already undertaken such action. It was also only recently that brokerage fees in Shanghai were no longer completely determined by the government. Until May 2002 brokerage fees in Shanghai were administratively fixed at 0.35 per cent. After this date, brokerage fees became flexible up to a maximum of 0.3 per cent (People's Daily 05/04/2002). Hong Kong and Singapore have also been relatively slow in a global perspective in this respect. Singapore liberalized its brokerage commissions as of October 2000. Prior to this date it was fixed at 0.75 per cent. By year-end 2000, 13 of the world’s 15 largest stock exchanges had already adopted freely negotiable commissions with the exceptions being Hong Kong and Taiwan (South China Morning Post 09/03/2000). Hong Kong’s broking commissions were not deregulated until April 2002 and before that a minimum charge of 0.25 per cent was in place.

Third, there is little doubt that the regulatory framework governing the trading of shares in Shanghai, along with the corporate governance standards of the listed companies themselves, lags international standards. For example, in measuring the
pervasiveness of insider trading, the Global Competitiveness Report 2002-2003 ranked China the 70th amongst the 80 surveyed countries, with a score of 3.5 on a 1-7 scale (1 = pervasive, 7 = extremely rare). In comparison, Singapore ranked 8th with a score of 5.5 and Hong Kong ranked 35th with a score of 4.4. Fourth, the governance structure of Shanghai’s stock exchange continues to be traditional in the sense that it is based on a non-profit, cooperative model. Meanwhile, the global trend is towards demutualisation, with controlling companies in Hong Kong and Singapore, amongst others, even listing themselves on the domestic exchange. The benefits of demutualisation are several and have been summarised by (Wei 2002). Finally, Shanghai’s equity markets continue to be segmented with respect to domestic and foreign participants.

Inefficiencies in China’s credit market have already been well documented and so only need to be briefly mentioned here. Lardy (1998, p.76-127) provides a detailed description of how the financial performance of China’s major banks and the corporate governance structures surrounding them lag well behind international standards. Interestingly however, recent official data indicate that banks located in Shanghai have performed far better than national average figures. For example, nationally state banks in 2002 had non-performing loans (NPLs) worth around 25 per cent of total outstanding loans (People's Daily 02/06/2002). Meanwhile, the People’s Bank of China Shanghai branch reported that state banks in Shanghai had an NPL ratio of just 8.14 per cent at year-end 2002. The average NPL ratio of all banks in Shanghai stood at 6.81 per cent (People's Daily 10/01/2003). This level is not far off comparative figures in Hong Kong and Singapore. The Banker (July 2002) magazine shows that NPLs in Hong Kong and Singapore’s largest commercial banks ranged from 2.07 per cent - 6.8 per cent and 4.00 per cent - 9.30 per cent respectively.

The efficiency of Shanghai’s financial markets is also affected by a lack of diversity in terms of products and services offered. This is of course to be expected given Shanghai’s relatively short modern history of diversifying away from a bank-based financial system to one that also includes markets for equity, commodities and risk. For example, stock futures and options are not traded in Shanghai in contrast with Hong Kong and Singapore. Shanghai also lags behind Hong Kong and Singapore in terms of diversifying into markets for debt. At year-end 2002, the market value of the
total 27 bonds listed in Shanghai was USD43.97 million, up from USD29.04 million of the previous year (World Federation of Exchanges 2002). This compared with 165 bonds of USD66.22 million in Hong Kong and 414 bonds of USD259.10 million in Singapore (World Federation of Exchanges 2002). Furthermore, all of the debt traded in Shanghai was domestic public debt and this contrasts considerably with Hong Kong and Singapore where private, and often foreign, debt is significant.

4. Conclusion

Shanghai’s political leadership has set 10 to 20 years as the timeframe for achieving IFC status. Using the broader IFC literature as a conceptual framework, this paper reviewed Shanghai’s progress towards achieving this goal to date. A number of important findings emerge. Firstly, Shanghai’s apparent strengths include its macroeconomic environment, in particular, its high rate of growth and international orientation. Shanghai’s strategic access to important markets and relatively cheap business input costs are also points of strength and it has been the combination of these factors that has been driving its rapid development over the past decade, albeit growing from a small base. Furthermore, all indications point to WTO entry being a boon for Shanghai.

Equally important however is that the findings revealed numerous factors that make Shanghai’s transition to an IFC a problematic one. Firstly, most microeconomic factors important to the formation of an IFC continue to be areas of weaknesses for Shanghai. These include perceptions relating to the availability of human capital, the relative lack of political and economic freedom and shortcomings in the rule of law. The perceptions of foreign firms and financial institutions towards Shanghai are also necessarily affected by the fact that Shanghai is part of the mainland and as such is ultimately controlled by Beijing. Despite Shanghai being one of China’s most progressive cities, it will continue to be hampered by “national average” evaluations and a high intrinsic locational risk compared with other IFCs such as Hong Kong and Singapore. This means that statements by Shanghai’s political leadership regarding timeframes are ultimately misplaced because they do not have the decision-making
authority to effect even the most basic changes necessary, such as full RMB convertibility. Thus, Shanghai’s greatest challenge is to secure the consensus and commitment of policy makers in Beijing.

In terms of implications for Hong Kong and Singapore, the findings of this paper indicate that Shanghai will not be in a position to challenge their pre-eminence in the foreseeable future. Also of note is that the findings indicate that the strengths of Hong Kong and Singapore appear to cut across the whole range of macroeconomic, microeconomic and financial market efficiency factors that are important to a city functioning as an IFC. Thus, their long-term viability as IFCs appears credible, even if Shanghai is able to address the factors that currently constrain it. Singapore in particular benefits from the fact that its geographical location vis-à-vis Shanghai means that it will always hold a locational advantage in terms of meeting the financial needs of South-East Asia. Shanghai’s potential emergence as an IFC in the long term also need not necessarily represent a zero-game for Hong Kong given that it is in an ideal position to service southern China and provide the high value added consulting services that Shanghai will require. While Shanghai is likely to continue to attract a steady stream of MNCs away from Hong Kong and Singapore in the coming years, ultimately Shanghai’s emergence need not come predominantly at their cost. There is already some evidence to support this conclusion in the Hong Kong government (2002) report cited earlier which showed that the number of foreign companies setting up regional headquarters in the autonomous region continued to increase through 2002, despite the rising prominence of Shanghai in recent years. Thus, it may well be that an Asian region which features a large and dynamic China can accommodate three fully-fledged IFCs.
Appendix A

Using survey methods, Bindemann (1999) constructs a list of ranked criteria that are perceived to be important to the formation of an IFC. The list is based on the responses from 19 stock and derivatives exchanges; 72 banks, investment firms, and financial consultancies in five countries with their headquarters in eight countries; 5 central banks; 1 national government; and 31 academics, financial journalists and other researchers in seven countries. The response rate was 46 percent. The ranking of criteria is listed in Table A.

Table A.: Ranking of Criteria

<table>
<thead>
<tr>
<th>Rank</th>
<th>Criterion</th>
<th>Rank</th>
<th>Criterion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Human resource</td>
<td>13</td>
<td>Settlement of transactions</td>
</tr>
<tr>
<td>2</td>
<td>Diversity size of markets</td>
<td>14</td>
<td>Circulation of information</td>
</tr>
<tr>
<td>3</td>
<td>Diversity of financial products</td>
<td>15</td>
<td>Strength of currency</td>
</tr>
<tr>
<td>4</td>
<td>Presence of international banks</td>
<td>16</td>
<td>Language</td>
</tr>
<tr>
<td>5</td>
<td>Volume of transactions</td>
<td>17</td>
<td>Innovation</td>
</tr>
<tr>
<td>6</td>
<td>Market regulation</td>
<td>18</td>
<td>Commissions</td>
</tr>
<tr>
<td>7</td>
<td>Infrastructure</td>
<td>19</td>
<td>Fiscal regulation</td>
</tr>
<tr>
<td>8</td>
<td>Operation costs</td>
<td>20</td>
<td>Automatic continuous system for transactions</td>
</tr>
<tr>
<td>9</td>
<td>Availability of capital</td>
<td>21</td>
<td>Bank secrecy</td>
</tr>
<tr>
<td>10</td>
<td>Financial tradition</td>
<td>22</td>
<td>Economic growth of host country</td>
</tr>
<tr>
<td>11</td>
<td>Political Stability</td>
<td>23</td>
<td>Independence of central bank</td>
</tr>
<tr>
<td>12</td>
<td>Banking sector</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Table 3.5 of Bindemann (1999).
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