Reaffirmation and Reinforcement of Shanghai's Future as an International Financial Center

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I. Announcement of five-year plan to make Shanghai an international financial center

1. Shanghai still on track to becoming an international financial center

On 30 January, China's National Development and Reform Commission (NDRC) published its *Blueprint for the Construction of Shanghai International Financial Center during the 12th Five-Year Plan Period* ("the blueprint").

China's State Council first gave its official blessing to the creation of an international financial center in Shanghai when, in April 2009, at the height of the global financial crisis, it approved a joint proposal by the NDRC and the Shanghai Municipal Government to transform Shanghai into an "international financial and shipping center" by 2020[1].[2] The blueprint is therefore a reaffirmation of this proposal, confirming the commitment of the State Council and the NDRC to oversee Shanghai's continuing transformation during the latest (12th) five-year plan (for 2011–15).

Our view is that the backing of the NDRC, a powerful government department responsible for managing China's micro and macro economies (hence its unofficial name of "mini-State Council"), is an important indication of this continuing commitment.

2. Challenges facing the blueprint

In its introduction the blueprint points out what was achieved by the 11th Five-Year Plan (for 2006–10). In particular, in the international league tables Shanghai ranked No. 3 in the world in terms of the value of the shares traded on its stock exchange in 2010, No. 6 in terms of its stock exchange's market capitalization, No. 5 in terms of the bonds outstanding on its bond market (China's interbank bond market), both at the

1 For further details of this proposal, see Sekine, Eiichi, "Chuuou Seifu no Shounin o Uke Ugokidashita Shanghai Kokusai Kin'yuu Sentaa Kousou" (Central Government Gives the Go-ahead to a Proposal to Turn Shanghai into an International Financial Center), Kikan Chuugoku Shihon Shijou Kenkyuu, 2009 Summer edition, Tokyo Club Foundation for Global Studies (in Japanese).

end of 2010, No. 2 in terms of the number of transactions on its futures exchange, and No. 1 in terms of the volume of spot transactions on its gold exchange, both in 2010.

However, Shanghai faces a challenge in that there are still gaps between its actual progress towards becoming an international financial center and the degree of progress that would match China's economic and social development. The first gap is a shortage in both the number and range of institutional investors as well as a shortage of financial products and vehicles. To bridge this gap, Shanghai's financial markets will have to further improve how they allocate resources. The second gap is in the competitiveness and clout of its financial institutions. The third is in the degree of internationalization of its financial services. And the fourth is the need for improvements in financial legislation, taxation, credit ratings, regulation, and the availability of skilled staff.

II. Blueprint's distinguishing features

What distinguishes the blueprint from previous such plans is the following.

1. Setting numerical targets

When, in 2009, it was proposed to transform Shanghai into an international financial and shipping center, the focus of attention in the short term was on easing monetary conditions in order to weather the global financial crisis. What distinguishes the blueprint, however, is, first and foremost, the numerical targets it sets for 2015 in order to ensure that the goal of transforming Shanghai into an international financial center by 2020 is achieved (Figure 1). This reflects the progress that has been made in

Figure 1: Blueprint's objectives

Type	No.	Target	2010	2015
Market size	1	Transaction value	RMB386.2trn	RMB1,000trn
	2	Bonds outstanding	World No. 5	World No. 3 or better
	3	Spot gold volume	World No. 1	Maintain position as world No. 1
	4	Derivative volume		World No. 5 or better
	5	Insurance premium revenue	RMB69.5bn	RMB140.0bn
	6	Bankcard transaction volume	RMB10trn	Approx. RMB25trn
Degree of internationalization	7	Participation of non-Chinese investors	Relatively small	Increase significantly
	8	International clout of Shanghai's financial markets	On the whole, limited	Significantly increase importance of main securities indices and commodity futures prices
Financial service function	9	Proportion of direct financing	16.7%	Approx. 22%
	10	Assets under management	RMB15trn	Approx. RMB30trn
Infrastructure	11	Number of people employed in financial services	245,000	Approx. 320,000
	12	International clout of financial infrastructure	Leading domestic market	Markedly increase international clout and raise legal, tax, and regulatory standards to near international level

Note: "Transaction value" ("1" in second column) does not include foreign exchange market transaction value.
Source: Nomura Institute of Capital Markets Research, from NDRC data

the use of the renminbi as an international currency (e.g., for settling trade transactions).

The first key numerical target is to increase the value of transactions on Shanghai's financial markets (excluding its foreign exchange market) from RMB386 trillion in 2010 to RMB1,000 trillion in 2015. The second is to increase the proportion of direct financing (using equities and bonds) from 16.7% to around 22% during the same period. The third is to increase assets under management from roughly RMB15 trillion to around RMB30 trillion. And the fourth is to increase the number of people working in financial services in Shanghai from 245,000 to around 320,000.

2. Shanghai's future as a renminbi trading center

The second feature that distinguishes the blueprint from previous such plans is its aim of creating by 2015 a global center for developing, trading, pricing and settling transactions in renminbi financial products that would reflect the growing internationalization of the renminbi and complement Hong Kong's role in this process. Hence, the goal of establishing, first, a center for the payment and settlement of cross-border renminbi transactions and, second, a center for cross-border renminbi finance and investments.

With regard to the former, the blueprint includes a plan to establish a commercial banking payment settlement center. Consistent with this was the decision this March by Bank of China, the largest bank for the settlement of cross-border renminbi transactions, to locate its second head office in Shanghai. Although the People's Bank of China located its second head office in Shanghai in 2005 ("Shanghai Head Office") and subsequently moved its market supervision departments from Beijing to Shanghai, Bank of China's decision to locate its second head office in Shanghai was the first such decision by a commercial bank. If Bank of China does locate its second head office in Shanghai, its departments (and staff) responsible for renminbi market transactions will presumably also relocate to Shanghai.

3. Significance for non-Chinese financial institutions and investors

With regard to the creation of a center for cross-border renminbi finance and investments (see 2. above), the blueprint outlines a program for opening up China to non-Chinese financial institutions and investors. Its main points are as follows.

1) Opening up Chinese financial markets in a positive and orderly way

First, the blueprint recommends that an international board should be set up on the Shanghai Stock Exchange and that non-Chinese companies that meet the criteria should be helped to issue renminbi shares. Although there is apparently no specific timetable for setting up an international board, the blueprint confirms that the Chinese authorities will continue to discuss the matter.

Second, it recommends that the eligibility criteria for non-residents wishing to issue renminbi bonds on the mainland and the limits on the size of such issues should gradually be eased. Eligibility might be extended from the international development organizations that are currently allowed to issue renminbi bonds on the mainland (Asian Development Bank and International Finance Corporation).

Third, it recommends that qualified foreign institutional investors (QFIIs) should be allowed to invest larger amounts in a wider range of investments and that non-Chinese investors should have the option of investing in futures and derivatives. This raises the possibility that non-Chinese investors may be allowed to invest in financial products other than equities.

Fourth, it recommends that restrictions on the participation of non-Chinese financial institutions in the mainland's foreign exchange market should gradually be lifted. This may lead to the development of instruments for hedging foreign exchange risk.

Fifth, it recommends that non-Chinese financial institutions should be encouraged, where appropriate, to invest in mainland Chinese securities at the same time as channels are created to enable offshore renminbi funds to be repatriated. The initial investment quota for the renminbi qualified foreign institutional investor (RQFII) program may be increased from the current limit of RMB20 billion.

2) Opening up China’s financial services industry in a positive way

First, the blueprint recommends that strategic capital and business tie-ups between Chinese and non-Chinese financial institutions should be encouraged. In addition, it recommends that efforts to open up China’s banking and insurance industries should continue.

Second, it recommends that China’s securities and futures industries should be gradually opened up and that joint-venture securities companies registered in Shanghai that meet the criteria should be encouraged to engage in a wider range of activities. Since joint-venture securities companies are initially only eligible for an underwriting license (and are therefore not entitled to engage in trading or brokerage), it will be interesting to see what criteria they will have to meet before they are allowed to engage in a wider range of activities.

3) Stepping up efforts by Chinese financial institutions to offer better global services

First, the blueprint recommends that Chinese financial institutions should become more engaged in the settlement of cross-border renminbi trade and investment transactions. It also recommends that financial institutions registered in Shanghai should be encouraged to engage in trade finance (outward loans and guarantees in renminbi) and that domestic banks should be encouraged to offer renminbi loans for overseas projects (either directly, via overseas branches, or in the form of entrustment loans). Such activities would promote the use of the renminbi overseas.

Second, it recommends that financial institutions registered in Shanghai should be encouraged to become more involved as qualified domestic institutional investors (QDIIs). It also argues that China needs a wider range of QDIIs and that more channels should be made available to domestic investors, both institutional and retail, to enable them to participate in overseas financial markets. These efforts, together with those to encourage QFIIs and RQFIIs (see above), are likely to boost cross-border securities transactions.

Third, it recommends that financial institutions registered in Shanghai should be encouraged to improve the services their overseas branches offer non-Chinese investors.

Fourth, it recommends that outlets accepting bank credit cards registered in Shanghai should be encouraged to offer a wider range of services, including better cross-border services. This would stimulate consumption by mainland Chinese tourists and businesspeople when they travel overseas, including to Japan.

4) Increasing financial cooperation at home and abroad

First, the blueprint recommends that Shanghai and Hong Kong should continue to develop their complementary relationship in the field of financial services within a common national framework and that they should be encouraged to strengthen their ties, increase their cooperation in financial markets, institutions, products, services and human resources, and trade each other's financial products on each other's markets. The Chinese government committed itself to encouraging the development of a renminbi offshore market in Hong Kong during the 12th Five-Year Plan when Vice Premier Li Keqiang gave his speech in Hong Kong in August 2011[2].[3] We expect the development of financial services using the renminbi to continue in parallel on the mainland and in Hong Kong for the time being.

Second, it recommends that the mainland should continue to develop its cooperation with Taiwan in the field of financial services and that Shanghai should become a center for Taiwanese financial institutions on the mainland. This might give non-Chinese financial institutions operating in Taiwan the opportunity to use Taiwan as a springboard from which to expand onto the mainland.

Third, it recommends that Shanghai should increase its cooperation with international financial centers such as New York, London and Singapore, and seek to develop new forms of cooperation. It is unfortunate that the blueprint makes no

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2 For further details of the outlook for Hong Kong's offshore renminbi market, see Sekine, Eiichi, "Honkon Kin'yuu Saabisugyou no Shinkou o Hakaru Chuugoku Kokumuin Li Kokkyou Fukusouri no Honkon Supiichi" (Vice Premier Li Keqiang's Hong Kong Speech as a Move to Stimulate Hong Kong's Financial Services Industry), Kikan Chuugoku Shihon Shijou Kenkyuu, 2011 Autumn edition, Tokyo Club Foundation for Global Studies (in Japanese).

mention of Tokyo as a financial market, perhaps because it was drawn up before the leaders of China and Japan reached an agreement on financial cooperation at their summit on 25 December 2011.

Fourth, it recommends that Shanghai should consider becoming involved in mergers and acquisitions involving non-Chinese stock exchanges. Since the Shanghai and Shenzhen stock exchanges are currently mutually owned, they would need to become joint-stock companies for this to happen. However, the first thing that is likely to happen is that China's Securities Law is amended and related legislation passed.

Fifth, it recommends that Shanghai, with the help of government departments involved, should seek to attract international development organizations or their local offices. One possibility, for example, if financial cooperation among the BRICS increases, would be for the BRICS to have their own secretariat in Shanghai.

4. Continuing rivalry with other parts of China

Shanghai's strength vis-à-vis other parts of China lies in its combined strength with neighboring provinces such as Jiangsu and Zhejiang. In terms of financial indicators such as deposit balances, listed companies, market value of tradable A shares, trading accounts, securities companies, and offices of foreign securities companies, the combined strength of the Yangtze River Delta region (i.e., Shanghai, Jiangsu, and Zhejiang) is second to none in all of China (Figure 2). One of the blueprint's key aims is to persuade financial institutions to locate their head offices in Shanghai. In the case of non-Chinese financial institutions, for example, it would appear that the authorities in Shanghai are prepared to offer unparalleled incentives to persuade them to locate either their global or regional headquarters and, in addition, either their Asia-Pacific administrative or operational headquarters there.

However, Shanghai is not the only place in China that is seeking to promote its financial services industry or become a financial center. In the north, Beijing and, in the south, Guangdong and Shenzhen are either on a par with or even superior to Shanghai in terms of the aforementioned financial indicators. On 9 November 2011 Beijing published its own blueprint (*Blueprint for Developing Beijing's Financial Services Industry during the 12th Five-Year Plan Period*), while, on 1 December 2011, Guangdong published its *12th Five-Year Plan for Reforming and Developing Guangdong's Financial Services Industry*. In addition, Shenzhen and Hong Kong have offered incentives to financial service providers to set up shop in the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone they have been jointly developing in Shenzhen. Whether or not Shanghai succeeds in cementing its position as China's premier international financial center will depend, in our view, on whether it is the first to benefit from a dismantling of the country's foreign exchange and capital controls.

Figure 2: Financial indicators for different regions in mainland China (as of end-2010)

	Deposit balances (RMB100mn)	Listed companies (Number)	Market value of tradable A shares (RMB100mn)	Trading accounts (Number)	Securities companies (Number)	Offices of foreign securities companies (Number)
Beijing	66,585	163	73,501	26,869,989	17	62
Tianjin	16,499	34	1,308	2,688,933	1	–
Hebei Province	26,271	44	1,787	3,958,045	1	–
Shanxi Province	18,640	30	4,401	2,761,362	2	–
Inner Mongolia Autonomous Region	10,325	21	997	1,499,502	2	–
Liaoning Province	28,057	60	2,861	6,727,346	2	1
Jilin Province	9,703	35	1,049	2,670,535	2	–
Heilongjiang Province	12,924	30	1,676	3,729,031	1	–
Shanghai	52,190	180	43,636	30,862,651	14	79
Jiangsu Province	60,583	168	14,227	12,925,909	5	1
Zhejiang Province	54,482	185	10,184	9,186,566	3	–
Anhui Province	16,478	65	2,512	3,121,327	2	–
Fujian Province	18,753	74	4,911	5,636,514	2	–
Jiangxi Province	11,908	30	1,311	2,801,270	2	–
Shandong Province	41,654	126	6,881	9,335,536	1	–
Henan Province	23,247	51	2,600	5,910,163	1	–
Hubei Province	21,769	73	4,269	6,101,515	2	–
Hunan Province	16,643	62	2,076	4,949,238	4	–
Guangdong Province	82,019	294	14,770	15,334,509	5	2
Guangxi Autonomous Region	11,814	27	1,645	2,754,828	1	–
Hainan Province	4,217	22	451	1,215,094	2	–
Chongqing	13,614	35	2,595	2,574,620	1	–
Sichuan Province	30,504	82	3,488	7,001,489	4	1
Guizhou Province	7,388	19	587	1,004,436	1	–
Yunnan Province	13,476	29	1,965	1,787,963	2	–
Tibet Autonomous Region	1,297	9	0	80,329	1	–
Shanxi Province	16,591	36	1,683	3,237,888	3	–
Gansu Province	7,147	22	1,467	1,635,316	1	–
Qinghai Province	2,327	9	918	558,544	1	–
Ningxia Autonomous Region	2,587	12	404	664,970	–	–
Xinjiang Autonomous Region	8,899	36	1,673	2,175,331	1	–
Shenzhen	–	–	32,103	–	17	11
Xiamen	–	–	–	–	1	3
Ningbo	–	–	–	–	–	1
Qingdao	–	–	–	–	1	–
Other	–	–	19,407	–	–	–
Total	708,589	2,063	263,343	181,760,749	106	161

Note: The figures for the number of trading accounts are the total number of A share and mutual fund trading accounts on the Shanghai and Shenzhen stock exchanges.

Source: Nomura Institute of Capital Markets Research, from *China Statistical Yearbook*, *China Securities and Futures Statistical Yearbook*, and China Securities Depository and Clearing Corporation

III. Spotlight on People's Bank of China report

1. Timetable for dismantling capital controls

Ever since the Asian Currency Crisis of 1997, the Chinese government's official stance has been that it has no timetable for dismantling the country's capital controls, which would be a prerequisite for an international financial center.

However, on 22 February of this year the Financial Survey and Statistics Department of the People's Bank of China published a report on this very subject. The

Figure 3: Mainland China: stages of dismantling capital controls

Three stages	Timing	Description
Stage 1	Next 1–3 years (2012–2014)	■Remove some of the restrictions on non-speculative outward investment and encourage Chinese companies to "go global." ■Factors influencing this include (1) the desire to vent surplus productive capacity via outward direct investment, (2) access to plentiful foreign exchange in the form of China's foreign exchange reserves, (3) the cost advantages granted by renminbi exchange rates, which are likely to be increased, and (4) the opportunity to plug the investment gap left by retreating US and European companies and financial institutions.
Stage 2	Next 3–5 years (2014–2016)	■Remove some of the restrictions on non-speculative trade finance in renminbi and encourage the wider use of the renminbi. ■Encourage Chinese imports/exports and provide more channels for offshore renminbi to be repatriated by means of either cross-border settlement in renminbi or Hong Kong's offshore renminbi market. Make Chinese banks more competitive and make more credit available to companies (especially, smaller companies).
Stage 3	Next 5–10 years (2016–2020)	■Do more to create financial markets. Report recommends that capital inflows should be encouraged first and then capital outflows, and that controls on investment in property, equities and bonds should be dismantled carefully and gradually. ■It also recommends that, in order to reduce the risks of dismantling controls, controls on primary markets should be removed before controls on secondary markets, and that trading in Chinese markets by non-residents should precede trading in non-Chinese markets by residents. Controls should be dismantled carefully, starting with quantitative controls and gradually shifting to price controls.
Thereafter	After next 10 years (2020 and thereafter)	■Capital controls would be considered to have been basically dismantled once these three stages were completed. Controls would then be dismantled in ascending order of risk, starting with (1) retail capital transactions, (2) loans unconnected with capital transactions, (3) money market instruments, (4) collective investment schemes, and (5) finance backed by collateral or guarantees in an effort to make these more convenient and then proceeding to derivatives and other asset markets. The last set of controls to be dismantled would be those on foreign exchange transactions, which are unconnected with capital transactions. ■However, controls on short-term foreign debt, which tends to be speculative, would not be dismantled, even in the longer term.

Source: Nomura Institute of Capital Markets Research, from *China Securities Journal*, 23 February 2012, and other sources.

report argues that China should dismantle its capital controls by 2020 in three stages. In the first stage (until 2014) controls on outward direct investment using renminbi would be dismantled, while in the second stage (until 2016) controls on renminbi bank loans would be dismantled, and in the third stage (until 2020) controls on property, equity and bond transactions would be dismantled (Figure 3).

The report also rec ommends that the dismantling of capital controls should proceed gradually, with (1) inflows followed by outflows, (2) long-term transactions followed by short-term transactions, (3) direct transactions followed by indirect transactions, and (4) institutional investors followed by retail investors. Furthermore, it suggests that the process should begin with capital flows and then proceed to capital stock.

Although the report does not represent the bank's official stance, its publication does suggest to us that there is growing support within the government for the dismantling of capital controls. As the head of the department that produced the report, Sheng Songcheng, is also a delegate to the National People's Congress, he may have wanted to sound out public opinion before the Congress met in March.

2. Conclusion

It would probably be uncontroversial to say that whether or not Shanghai succeeds in achieving its objectives for the period of the 12th Five-Year Plan will be decisive in whether it succeeds in its goal of becoming an international financial center by 2020. As we have already argued, however, the success or failure of the various programs that Shanghai has in train will ultimately depend on the extent to which the Chinese government is prepared to dismantle its capital controls and the privileges it is prepared to grant Shanghai. The creation of an international board in Shanghai would be one such privilege.

Now that China's capital controls have been questioned in public, it will be interesting to see the outcome of the debate on their future, a debate that will involve both central and local government.