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Shanghai  
*Building an  
International  
Financial Center with  
Chinese Characteristics*



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## EXECUTIVE SUMMARY

*The Chinese government's State Council has announced a clear goal for Shanghai to become an international financial center by 2020. That said, no one, including the Chinese government, can yet predict what this financial center will look like and how it will go about its business. Much will depend on the nature of China's economy—and its place in the global economy—10 years from now. In addition, the evolution of financial centers, post-recession, and the extent of the internationalization of the renminbi will play a critical role in Shanghai's development. All of these factors will define the ways in which the financial center in Shanghai can truly be termed "international" and whether it is ultimately respected around the world.*

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## CHINA'S SHANGHAI AMBITIONS

The decision by the Chinese government, announced in early 2009, to make Shanghai an international financial center by 2020 marks a new and defining phase in Shanghai's development. But that announcement by itself means little; instead, how China's economy and the nation's economic policies evolve during the next 10 years will determine whether this very ambitious goal for Shanghai is achieved. In fact, perhaps the most instructive way to assess Shanghai's chances of becoming a major international financial center and to explore what this term will actually mean in the context of China is by examining two qualifying comments made by the State Council in describing China's vision for the city:

- *First, the aim is to make Shanghai an international financial center in accordance with China's economic strength (in 2020).* No one could be accused of going too far out on a limb by predicting that 10 years hence, China's economy will be

radically different than it is today—that is, bigger and more powerful in the global scheme of things. And that growth will redound to the benefit of Shanghai in its effort to become an international financial center.

- *Second, Shanghai's role needs to be in accordance with the international status of the renminbi (in 2020).* That is less easy to predict. It is quite likely, though, that liberalization of the Chinese currency and the convertibility of the renminbi will be a gradual process. How far along that process will be by 2020 remains uncertain. But while the status of the renminbi will play an important role in shaping Shanghai's development as a financial center, the city's future need not be completely tied to full liberalization of the currency. Atypical approaches to becoming a financial center without a free-floating local currency will likely be adopted by Chinese officials and enterprises.

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## CHINA'S ECONOMIC STRENGTH IN 2020

Think back to 1998 and reflect on the striking economic changes that have occurred in China since then: the ever-stronger role of the market economy; the wide and deep penetration of mobile phones and the Internet; the range and influence of evolving consumer demands and habits; the growth of multinationals building integrated businesses in China; the rise of Chinese companies and their significance around the world; the increasing innovation in Chinese management capabilities; and the outsized growth of China's foreign exchange reserves. There has been a similarly stunning transformation in the Chinese financial sector, especially in the size and institutional capabilities of the country's leading banks and financial institutions, as well as in the emergence of strong capital markets, including equities—a transformation that, while impressive, still has a ways to go.

The changes in China over the next 10 years are likely to be just as dramatic—and as much as anything

else, they will shape the requirements and opportunities for Shanghai as a financial center. To start with the most obvious, China's economy in 2020 will be much larger in both absolute and relative terms and clearly established as the world's second largest in terms of GDP, a position that it will likely attain this year. Barring a massive, sustained increase in economic nationalism in one or more of the world's major economies, China will be even more integrated into the world economy in 2020 than it is today, representing the largest single market for many or even most of the world's multinationals in consumer products, automotive, industrials, healthcare, and many other sectors. Moreover, Chinese companies will rank among the world's largest multinationals and many will have established large and profitable businesses around the world, in both mature and emerging markets. This will create new financing needs at home and abroad.

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As the world's second largest economy, with a relatively high savings rate, China will have massive domestic funds available that will require an effective financial system to support allocation of capital to the right investment opportunities. Similarly, maintaining high growth rates will require substantial and continuing investments in infrastructure and productive capacity—with an increased premium on attracting foreign funds (which have played such a big role in China's growth up to now) and putting capital to work efficaciously.

By 2020, China will enjoy a growing reputation as an innovation leader, especially in the commercialization and practical application of new

technologies. Continued urbanization and the reinvention of rural areas into more productive economic regions will provide the opportunity to embed new technologies into day-to-day life much more rapidly than in more mature economies, where legacy infrastructure is a constraint to adopting new approaches in renewable energy and smart transportation—two areas in which the Chinese are likely to excel.

Still, though the future is clearly rosy for China, there are concerns that must be considered when examining the nation's future economy. Given its vast population, China in 2020 will still be at best a moderately well-off economy, with wide wealth and income disparities between the most

prosperous cities and the rural areas. As a result, China will have a very different set of financing needs—for example, required investments in rural development, including infrastructure and social services—than smaller, richer countries. In addition, China will be an older society in 2020 than it is today, as its one-child policy will rapidly result in an imbalance between its vast pool of aging residents and the far smaller cohort of young people. Pensions and healthcare benefits, currently quite meager, will likely be improved in 10 years and will involve the private sector. This in turn will mean that domestic institutional investors will be larger and more capable than they are today and will seek more sophisticated investment options.

## WHAT IT MEANS FOR SHANGHAI

What does this forecast of China in 2020 tell us about how Shanghai can develop into an international financial center? First, with so much economic growth expected to occur inside the country—for example, in consumer market and infrastructure projects—Shanghai will need to maintain close and seamless integration with the domestic economy. As such, it can play a clear role as a financial center that brings together within China those with money and those who need money for investments.

Second, Shanghai as a financial center will need to be able to attract and retain the right individuals and institutions to form a vibrant, local financial ecosystem that reaches out into the Chinese economy but is physically situated in Shanghai. This is a matter of offering the opportunity to earn a good financial return (both to companies and to individuals) and access to Chinese leadership in business, finance, and politics. Essentially, as a financial center, Shanghai will be competing against alternative locations: Do I have to be in Shanghai to do this type of business, or do regulations and practice allow me to do it from Tianjin or Hong Kong?

And if so, which of these is the better business location? Where do people want to work?

Shanghai can answer these questions in its favor by touting the benefits of face-to-face communication and informal networking in commercial transactions, joint venture formation, and the signing of partnerships and large investments. Doing business in person can eliminate a lot of misunderstandings later on. Moreover, experience shows again and again that the prospect of attractive financial returns outweighs ease or comfort in attracting business. If there is a financial prize to be won, investors and multinational executives will make do with poor restaurants and inefficient air-conditioning in frontier markets. In short, Shanghai cannot rely on superior infrastructure alone to establish its position against other Chinese cities, but neither can more established financial centers like Hong Kong and Singapore.

Of course, the ability to earn acceptable profits in a financial center depends on being able to develop distinctive product offerings that meet the needs of investors or those who seek capital in a trusted regulatory environment. If everyone offers the same product, the only route to sustainable profit is through regulated pricing, which allows financial institutions to earn a profit in the absence of a competitive advantage

but is not a favored option for free-market companies. The challenge for regulators is to ensure that companies in a financial center have the breathing room to innovate without producing unwarranted systemic risks. That's a very difficult balance to get right, but it is critical if Shanghai is to emerge as a financial center.

And while Shanghai surely will want to encourage the presence of as many financial services firms in the new center as possible, the city should not ignore the potential of reaching out beyond its physical location through social networking, e-mail, and videoconferencing, among other burgeoning technologies. Just as stock exchanges around the world have moved into the digital world, with little or no need for a physical “floor” anymore, so electronic communications will be increasingly important for a financial center. The application of advanced technologies will let Shanghai project its “virtual” presence as a financial center more widely—across China and to the rest of the world. This would potentially allow people and companies to access many of the benefits of trading and doing business in Shanghai even if they are not actually there—though, in turn, this may raise questions of legal jurisdiction and regulatory control as the physical and online worlds evolve together.

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## BUT IS THIS “INTERNATIONAL”?

If Shanghai is so firmly connected to the domestic economy, in response to the expected continuing rapid growth of China’s companies, investment needs, and consumer markets, are the city’s ambitions of becoming an *international* financial center placed at risk? In a word, no. Indeed, there are many reasons why this should not be a prohibitive hurdle. And it all rests on what an “international” financial center truly is.

First, almost as a prerequisite, there is a strong need to upgrade Shanghai’s financial sector capabilities to an international level. Just as many leading Chinese institutions wish to “become globalized” (国际化) while—in the near term, at least—operating only in China, Shanghai can gain many aspects of an international financial center simply by offering more sophisticated investment and commercial opportunities. This would mean, for example, deeper and more liquid bond and equity markets, the greater use of derivatives, greater information transparency and compliance to improve the quality of market information, creation of a larger and more diversified

institutional investor base, a more market-based approach to IPO timings, and so on. By building the regulatory and market infrastructure for Shanghai financial services firms to enjoy these benefits, the Chinese government would make a major contribution toward Shanghai’s emergence as an international financial center and simultaneously better support the needs of China in 2020 by improving the effectiveness of the nation’s capital markets.

Shanghai can also internationalize its financial center by using its domestic expertise to take the lead globally in driving financial innovation in areas relevant to major new economies, such as India and Brazil. Examples could include new approaches in rural financing (e.g., the securitization of rural loans), new approaches to infrastructure financing and leasing that combine the strengths of industrial and financial institutions more effectively, and the creation of new financial linkages among China, Africa, the Middle East, and Latin America as trade and commodity flows shift.

# THE RENMINBI IN 2020

The State Council's second goal for Shanghai—that the city's role as an international financial center be in accordance with the international status of the renminbi in 2020—is at least to some commentators the biggest obstacle to Shanghai's emergence as a true *international* center. Without liberalization of capital flows and convertibility of the renminbi, they argue, Shanghai will not be integrated into global capital markets and will never be able to rival Hong Kong in supporting the renminbi's offshore market; Hong Kong's trade settlement infrastructure, liquidity, and integration in global financial markets are too strong and well developed for Shanghai to compete against without less restrictive capital and currency policies.

Current indications are that the liberalization and internationalization of the renminbi will advance in a gradual way—another example of crossing the river while feeling for stones, a phrase made popular by China's former leader Deng Xiaoping in describing the country's attempts to embed capitalism in a socialist state. When complete liberalization will occur is unclear. However, even without the full internationalization of the renminbi and capital flow policies, Shanghai's financial center can still become more international in several important ways:

## *1. Supporting deregulation of foreign ownership in China*

For some, an international financial center is where “foreign” financial institutions have a strong presence, claim a sizable market share, and, quite often, compete on fully equal terms with the local players. In China, many foreign commercial banks have already incorporated locally and leading

global investment banks are keen to continue to develop as regulations allow. Government policies that supported further deregulation and investment by foreign firms would bring a much more “international” feel to Shanghai's financial center even without any changes in capital controls. Benefits would include an increased two-way flow of information, capabilities, and innovation, as well as competitive pressure on domestic institutions to continue upgrading.

## *2. Encouraging foreign employees to work in the Shanghai financial sector*

Employees from foreign companies could bring much-needed new capabilities and different perspectives to local institutions in Shanghai. When foreign and domestic companies in China work together in either joint ventures or other types of partnerships, there are often significant cultural challenges to integrating and operating effectively, but those challenges are a reflection at an individual level of the difficulties of international integration between China and other countries. To encourage more foreign employees to work in Shanghai, promotional campaigns will have to play up ongoing “success stories” of both individuals and companies that have settled there, as well as the attractive financial benefits, lifestyle, and career experiences that are possible in the city's financial center.

## *3. Accessing Chinese financing for global companies*

In 2020, China will be the largest market in the world for many global firms. Consequently, financing expansion in China will be a priority, but it could also be a difficult undertaking, full of regulatory

complications and exchange rate risk for multinationals funding this growth from sources outside China. The good news, though, is that in 2020, China will likely be the biggest source of domestic savings in the world. This presents the perfect opportunity for Shanghai's financial center to provide intermediation between international companies (and Chinese companies) and domestic money. Shanghai firms could serve as underwriters in deals that tap debt and equity markets, if the terms are right. Indeed, a Shanghai stock market listing could be an important sign to Chinese customers that a company is committed to being in the country. Multinationals such as HSBC, Standard Chartered, and Siemens are already considering making such moves when the regulations permit.

In fact, because Shanghai will be rightly viewed as an insider in the Chinese business community, it is

possible to imagine that the role of the city in financing multinationals would be greater in the presence of capital controls than without them. With capital controls eased, Shanghai's role in helping to fund non-Chinese companies could change, as the city would be in active competition with other financial centers around the world. Chinese savings would then flow into the global economy, and multinationals could choose to raise funds in London, New York, Hong Kong, or Shanghai. In that larger—and more competitive—environment, Shanghai's advantage would rest on its ability to support financial institutions in accessing Chinese investors, as well as in structuring and marketing products that meet the needs of both investors and those raising capital.

**4. Accessing global financing for Chinese companies**  
Paradoxically, helping Chinese

companies gain financing internationally will be the toughest challenge for Shanghai. Hong Kong has already made great inroads in establishing itself in this activity. While capital controls remain, Shanghai would need to gain permission to create what would effectively be an offshore market in the city—and then encourage institutions to join together to make transactions there rather than in Hong Kong or other global financial centers. Given the tremendous advantages in established capabilities, networks, and reputation that Hong Kong enjoys, this is a formidable challenge indeed; Shanghai would offer little or no differentiation. As capital controls are lifted, Shanghai will be able to compete more freely but will still face the disadvantages vis-à-vis Hong Kong. The challenge will be to innovate and provide something new, while remaining closer than Hong Kong to the needs of mainland companies.

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### *About the Author*

**Andrew Caine** is a Booz & Company partner and also the firm's managing director for Greater China. He has over 20 years of management consulting experience in Asia and Europe, and has been working in Asia since 1997. He advises local and multinational financial institutions on all aspects of strategy, organization, and capability building in China, Korea, and the rest of Asia.

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## CONCLUSION

A look beneath the surface shows that Shanghai has in fact many possible paths to becoming an international financial center by 2020, though following any of them will require vision, persistence, and flexibility. China wants Shanghai to be a financial center operating at international standards. Foreign individual investors, companies, and financial institutions, as well as Chinese domestic institutions, will have to make important contributions if this goal is to be met.

Regardless of the international status of the renminbi and the state of capital controls, there will be a substantial role for Shanghai to play in helping to meet the needs of multinational companies. Innovation provides the opportunity for Shanghai to stake out a position as a new, respected financial center within a changing global financial system. As China's financial integration into the world economy continues, Shanghai has a unique opportunity to shape a new kind of international financial center—one with Chinese characteristics; a deep connection to Chinese companies, wealth, and markets; and a global perspective attractive to the rest of the world.

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