Global Finance

Shanghai and Hong Kong: China’s Emerging Global Financial Hubs

By Dan Steinbock | Tuesday, March 23, 2010

Since the early 2000s, Shanghai and Hong Kong have increasingly been seen as rivals for the economic center of the Greater China region. Dan Steinbock explores how the two cities have contributed profoundly to China's economic progress and financial development, albeit in different ways.

Until the 1990s, Hong Kong thrived and benefited from the postwar globalization. However, since the late 1990s, Shanghai has been booming, while Hong Kong, despite its historical wealth and capabilities, has been haunted by doubt over the future.

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Fluctuating fortunes

In the 1920s, Shanghai was the major center of international trade and finance in East Asia. The position of the “Pearl of the Orient” eroded with the turmoil of the 1930s, starting with the currency crisis and the Sino-Japanese War.

After World War II and the Civil War, most foreign firms in 1949 moved their offices from Shanghai to Hong Kong, as part of an exodus of foreign investment.

As a British Crown Colony, Hong Kong was spared from the Civil War in the mainland and experienced an inflow of capital and labor, as well as Shanghai’s entrepreneurial elite. After the civil war, a new wave of migrants fled to Hong Kong, along with many corporations in Shanghai and Guangzhou.

As textile and manufacturing grew with low-cost labor and population growth, Hong Kong industrialized. The export-led growth model boosted living standards rapidly.

During the 1950s and 1960s, Shanghai was transformed into an industrial center. In comparison with other Chinese provinces and municipalities, it was the largest contributor of tax revenue to the central government, but at the
cost of crippling its own infrastructure and capital development. As Shanghai fell into a historical oblivion, Hong Kong thrived.

At first, Shanghai was sidelined by economic liberalizations that were launched in China’s southern provinces in the mid-1980s. In 1992, when Deng Xiaoping declared that Shanghai would be "the head of the dragon" pulling the country into the future, the development of Pudong was designed to restore Shanghai’s historical role for the Yangtze River Delta and, more broadly, to China.

Shanghai’s economic reforms resulted in huge development and the birth of Lujiazui, the great financial and commercial hub in the Pudong New Area, across Shanghai’s historical Bund and the Huangpu River. Today, Shanghai’s position is rapidly rising as a major destination for corporate headquarters, fueling demand for a highly educated and modernized workforce.

"Shanghai has laid a solid foundation for making itself an international financial center. But it is still a big step away from the objective," China Banking Regulatory Commission (CBRC) Chairman Liu Mingkang told the first Lujiazui Forum in May 2008. “Shanghai's financial sector only has about 100,000 professionals, compared with some 400,000 on Wall Street and more than 250,000 in London.”

**Hong Kong and Shanghai compared**

How do Hong Kong and Shanghai compare as financial hubs? First, Hong Kong has a deeper pool of financial services than Shanghai, with established insurance, law, accounting and other professional service firms.

With its market capitalization of $2.7 trillion, Shanghai's stock market is worth more than Hong Kong’s, but it has fewer listed companies. For now, retail investors dominate trading in Shanghai, which translates to higher volatility.

In addition, Hong Kong is far more active in global bonds than Shanghai. It also has a mature and active financial futures market, but recently China’s State Council approved the launch of stock index futures in Shanghai.
Domestic currency trading in Shanghai far surpasses that in Hong Kong, which is pegged to the U.S. dollar, but imposes no capital controls — whereas the renminbi is not fully convertible and exchange controls restrict foreign investment flows (for now).

While Hong Kong’s financial markets regulator is an independent statutory body, Shanghai’s regulator is part of the government’s State Council. True to its British origins, Hong Kong has an independent legal system, and English continues to be the only medium in which the majority of overseas judgments are reported.

In Hong Kong, English is regularly spoken in the business environment, along with Cantonese. Mandarin is standard for business dealings in Shanghai.

Finally, financial professionals may be most attracted by Hong Kong’s income tax rate, which is a flat 15%, compared with some 45% in Shanghai. Compared with the rest of China, Shanghai has lower taxes for foreign-invested companies. Hong Kong tax rates are low by OECD standards, and there are no capital gains taxes. Taxes are also only levied on income made in Hong Kong.

**Three scenarios**

As the world’s factory, greatest commodity importer and largest holder of foreign exchange reserves, China needs an international financial platform to serve its growing needs and increasing voice in global financial markets. Due to the tarnished credibility of the dollar, the great global recession is accelerating these needs. In the future, China’s global financial hubs may evolve according to three generic scenarios:

- **One financial center.** Some observers expect China to have a single financial center. The scenario is based on the assumption that big is beautiful. Due to economies of scale and network effects, a nation can, or at least should, have only one major stock exchange.

  The implication is that since there can be only one major financial center, it has to be Shanghai or Hong Kong. The UK has its City. The United States has its Wall Street. So China should also have its single global financial hub.

- **Two or more financial centers.** Other observers share the assumption that greater muscle means greater clout, but they also believe that, precisely due to its extraordinary size, China could develop two or perhaps even more financial centers. The assumption is that China’s scale and level of development differs significantly from the United States’ and the UK’s.

  In the short- and medium-term, the U.S. experiences may provide some benchmarks to assess the prospects of China’s financial centers, but in the long-term, China will set benchmarks of its own.

- **Transitional stage.** The third scenario is a variation of the second. In the
short- to medium-term, China will be supported by two major financial hubs. In the long-term, one major financial hub may be supported by multiple smaller hubs that may be more focused regionally or in terms of markets.

Although financial centers compete with one another, the competition is not a "zero sum" game, and global centers can play many different roles (including domestic, niche, regional, international or global). In this scenario, the Pearl River Delta could evolve into China’s entrepreneurial innovation economy, with a Nasdaq-like market.

Currently, however, the basic assumption is that, in the long-term, Shanghai will become China’s international financial center.