SHANGHAI AND HONG KONG AS INTERNATIONAL FINANCIAL CENTRES: HISTORICAL PERSPECTIVE AND CONTEMPORARY ANALYSIS

Y. C. Jao*
School of Economics and Finance
University of Hong Kong

Ever since Shanghai announced in April 1990 its plan to develop the Pudong New Area, and its ambition to re-emerge as a major international financial, commercial and shipping centre by 2010, the traditional "Tale of Two Cities" about the rivalry, real or imagined, between Hong Kong and Singapore has gradually given way to a new one featuring "Shanghai vs. Hong Kong". Shanghai's recent successful bid for the 2010 World Expo, in contrast to Hong Kong's failure to capture even the 2006 Asian Olympics, is regarded by many as pregnant with symbolic significance.

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This paper is more narrowly focused on the comparison and evaluation of Shanghai and Hong Kong as international financial centres (IFCs). It is organized as follows. Section 1 presents a typology of financial centres in order to make the meaning of IFC more exact, thus avoiding the confusion and misunderstanding rampant in popular and journalistic discussions. Section 2 gives a broad historical overview of the vicissitudes of the two cities as background information for understanding their present positions as IFCs. Section 3 then provides a macroeconomic profile and a financial centre profile of the two cities in quantitative terms for comparison and evaluation. Section 4 analyzes the salient features of and essential conditions for an IFC. Section 5 evaluates the relative strengths and weaknesses of the two cities. Section 6 is devoted to a discussion of competition, complementarity and cooperation between the two cities. Section 7 deals with the problem of "trilemma" or the "Impossible Trinity theorem" as applied to the economics of IFCs. The final section ends the paper with some concluding remarks.

I. Typologies of Financial Centre

Some years ago, in a book on Hong Kong as an IFC, I noted three typologies of financial centres from different perspectives (Jao, 1997a). Since the conceptual framework still seems useful, it is reproduced here as Fig. 1.

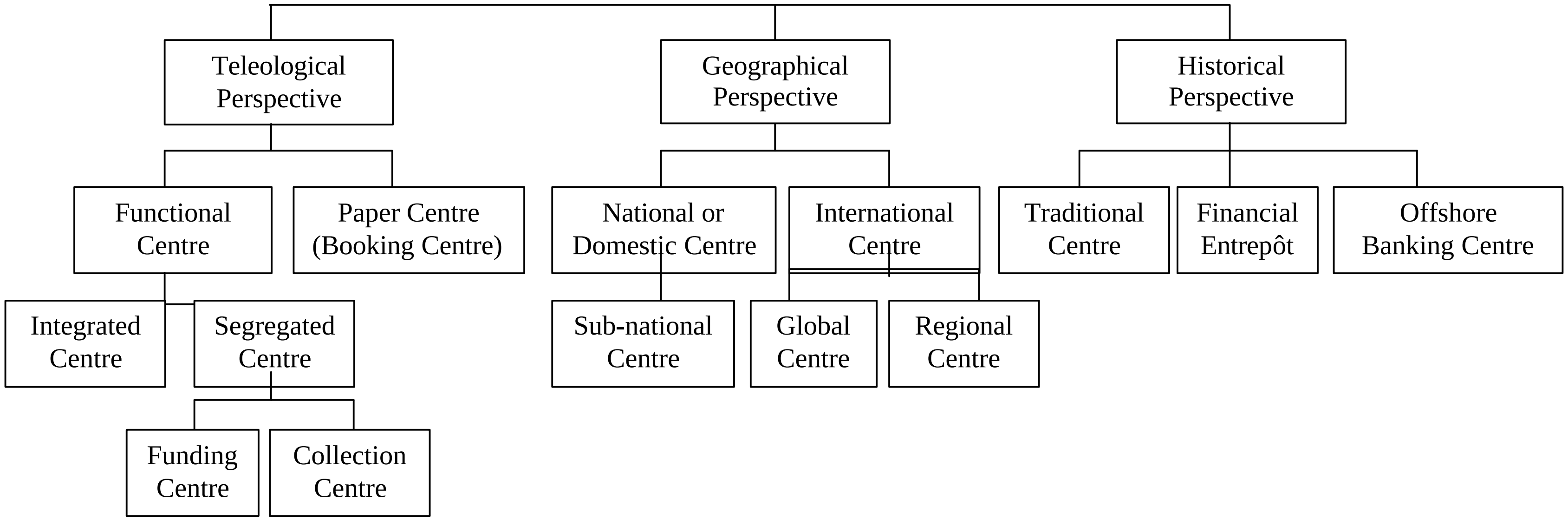
As shown in the figure, from a geographical standpoint, financial centres can be classified according to the scope, or at least the main focus, of their activities. Proceeding from the bottom, the smallest centre is the sub-national centre, such as Shenzhen in South China. For the country as a whole, we then have the national or domestic centre. Once a financial centre outgrows its national boundary, it then becomes a regional centre. Some well-defined regions readily come to mind: Europe, America, the Middle East, Asia-Pacific etc.

The apex is, of course, the global centre, whose activities extend all over the globe. It should be noted that the concept of an IFC encompasses both regional and global financial centres, though the geographical domain of the latter is, of course, the largest. There are some metropolises which serve simultaneously as domestic, regional, and global financial centres. The best current examples are London, New York, and Tokyo.

From a teleological point of view, McCarthy (1979) makes a useful distinction between a paper centre and a functional centre. A paper centre acts as a

Fig. 1

Typologies of Financial Centre



Source: Jao (1997a), p.15

location for recording financial transactions only, but little or no actual banking or financial business is carried out there. Many transnational financial institutions find it convenient, for example, to keep "shell" offices in jurisdictions where taxes and prudential regulations are nonexistent or nominal, in order to minimize their overall costs. They include, for example, Anguilla, the Bahamas, Bahrain, the Cayman Islands, Jersey, and the Netherlands Antilles. For this reason, centres with offices in such locations are also called "brass plate" centres. A functional centre, on the other hand, is one in which financial services and transactions of all kinds, notably deposit-taking, lending, forex dealings, and buying and selling of securities, are actually provided and executed, thereby generating both income and employment for the host country.

Within the category of functional centre, Jao (1980, 1988) distinguishes between an integrated and a segregated centre. An integrated centre refers to one in which no artificial barriers exist between onshore and offshore markets, so that once a financial institution is established, it can engage in both onshore and offshore business, whether denominated in home or foreign currencies, without restriction. In contrast, a segregated centre is one in which the authorities make clear distinctions between onshore and offshore markets, or between domestic- currency-denominated and foreign-currency-denominated businesses. Non-domestic institutions are mostly confined to the offshore sector; they are either barred from, or severely restricted in, the onshore sector. Some financial centres, however, combine the features of both, so that a limited number of authorized institutions can engage fully in both onshore and offshore businesses. A segregated centre is more often called an offshore financial centre (OFC). The term offshore banking centre is also used, implying that only the banking sector is internationalized.

Dufey and Giddy (1978) classify financial centres into three major types according to the services they provide and their stages of development. The first type is the traditional centre, which serves as a net creditor to the world through bank lending and securities market activities such as flotation, underwriting, and placements. The classic examples are London before World War II and New York afterwards, though in recent decade Tokyo has increasingly been playing this role. The second type is the financial entrepôt. It is defined as a centre that offers the services of its domestic financial institutions, money markets, and securities markets to both domestic and foreign residents. It is not, however, a net capital exporter. London since the end of the World War II, and especially since the rise of the Euro-currency market in the late fifties, and New York since the late seventies, are the prime examples. The third type is the offshore banking centre. This is a centre in which financial intermediation is performed primarily for non-resident borrowers and depositors. Although there can occasionally be some domestic resident participation in the offshore sector, the domestic financial sector is typically insulated from the offshore sector by an array of controls or restrictions.

Park (1982) combines functional and geographical criteria and classifies offshore financial centres into four types: primary, booking, funding, and collection. A primary centre is one whose sources and uses of funds are worldwide; London and New York are his examples. A booking centre, which corresponds to McCarthy's paper centre, is only a location for booking Euro-currency deposits and loans. Nassau (the Bahamas) and the Cayman Islands are the representatives. A funding centre plays the role of inward financial intermediation, channelling offshore funds from abroad towards local uses. Park offers (somewhat questionably, in my opinion) Singapore and Panama as examples. In contrast, a collection centre engages in outward intermediation by channelling excess domestic funds to external users. The sole example given is Bahrain.

With the above typologies in mind, we can definitely characterize both Shanghai and Hong Kong as functional centres, not paper centres, because real financial business is done in both cities that do generate income and employment. Shanghai however is a segregated centre, because it allows foreign banks to undertake only limited *renminbi* (RMB) business in Pudong, while Hong Kong is a fully integrated centre, as it allows foreign banks and other financial institutions unlimited freedom in transacting all kinds of financial business, whether denominated in Hong Kong dollar or foreign currencies.

From the geographical standpoint, Shanghai is only a national centre, not an IFC, for reasons that will become clear in subsequent sections. Hong Kong, by all accounts, is already an IFC, but is only a regional centre, not a global centre, the region in question being the Asian-Pacific region. Neither Shanghai nor Hong Kong has a formal offshore sector, but both, especially Hong Kong, perform the role of financial entrepôt. In recent years, Hong Kong has also been playing the role of a capital-exporter.

II. Historical Overview

To fully understand how and why Shanghai and Hong Kong have become what they are today, a brief overview of their financial development is necessary. Modern Western-style banking and finance was introduced into the two cities at approximately the same time after the end of the First Opium War, when Hong Kong was ceded to Britain, and Shanghai was declared a "treaty port". The British-owned bank, The Oriental Banking Corporation, was the first to arrive: it set up a branch in Hong Kong in 1845 and an office in Shanghai in 1847. The Hongkong and Shanghai Banking Corporation (now the multinational giant HSBC Holdings) was founded with its head office in Hong Kong in 1864. It opened for business in 1865, and established an office in Shanghai in the same year. Other British, European, American and Japanese banks then followed. Modern Chinese banks also began to appear towards the end of the 19th century. The first modern Chinese bank, the Commercial Bank of China, was established in 1897 with its head office in Shanghai. The first stock exchange was formed in Hong Kong in 1891 and in Shanghai in 1904. Insurance companies also began to appear in both cities from the middle of the 19th century onwards.[1]

By 1936, Shanghai had 47 foreign banks, of which 33 came from UK, US, and Europe, 4 from Hong Kong, 3 from Singapore and Malaya, and one from the Philippines.[2] According to the *Chinese Banks Yearbook*, in 1936, of the 164 domestic banks in China, 6 government owned banks or financial institutions, namely, the

Central Bank, the Bank of China, the Bank of Communications, the Farmers Bank, the Central Trust, and Postal Remittances and Savings Bank, and 54 other private banks, all had their head offices in Shanghai. In addition, Shanghai had 72 traditional *qianzhuangs* (native banks).[3] It accounted for no less than 40% of the nation's total bank deposits.[4] However, apart from being the nation's banking centre, Shanghai was also the place where modern financial markets were concentrated: securities market, gold market, foreign exchange market, silver bullion market, internal remittances market, and inter-bank market.[5] It was also an insurance centre, with 166 foreign insurance companies and 48 domestic insurance companies.[6] According to two Chinese economic historians, Hong and Zhang, although Shanghai bore the marks of a semi-colonial and semi-feudal city, its financial sophistication compared favourably with that of Tokyo and Osaka. "Shanghai at that time was not only the largest financial centre inside China, but was also an international financial centre in the Far East".[7]

In his work on financial centres in Asia, Middle East, and Australia, the British economic historian Geoffrey Jones proposes a 3-fold classification: Type A is the sub-regional centre, which is somewhere between a national centre and a regional centre, the term "region" here denoting a territorial area larger than a country, such as Asia, but not an area within a country; Type B is the regional centre; and Type C is the global centre. For the period 1919-39, Shanghai, Hong Kong and Singapore were the Type A centres, but Shanghai was the largest, with Hong Kong "being essentially a smaller version of Shanghai throughout the interwar years"[8]. For the period 1945-65, Shanghai dropped out, and Hong Kong, Singapore and Beirut were the three Type B centres. For the subsequent period 1965-75, Beirut dropped out due to its civil war, and Bahrain, Hong Kong, Singapore and Sydney became the four Type B centres. For some obscure reasons, Jones does not include Tokyo in his classification.

There can be no doubt that Japan's aggression against China was the immediate and most important cause of Shanghai's decline as a financial centre. Japan began its aggression as early as September 1931, when its army suddenly seized China's Northeast Provinces (Manchuria). In January 1932, Shanghai itself became a combat zone, as Japanese army and navy launched a ferocious attack on the Chinese section of the city, but the major powers arranged an armistice after a month's fieree fighting. In July 1937, full-scale war broke out between China and Japan after the Marco Polo Incident, and again Shanghai was the scene of heavy fighting for three months during August-November 1937.

There was to be no peace for Shanghai for a long time. Simultaneously with the attack on Pearl Harbour in December 1941, the Japanese Army also marched into the International Settlement. Earlier, Japan took over the French Concession through its puppet regime after the fall of France in 1940. The end of World War II was soon followed by the revolutionary civil war of 1946-49.

After the establishment of the People's Republic of China (PRC), there were hopes for a gradual re-emergence of Shanghai as a regional financial centre. But China's involvement in the Korean War, and the subsequent UN and US embargoes against China, dashed completely such hopes. After the Korean Armistice, one would have thought that Shanghai could finally begin to regain its prewar eminence. However, Beijing at that time chose to turn its back on Shanghai as an IFC, for various reasons. First, the ideologues, then in ascendancy in Beijing, regarded Shanghai's financial services industry as a hotbed of speculation and other capitalist iniquities and vices, that needed to be curbed rather than promoted. Second, Marxist economics and ideology tend to downgrade and neglect the role of the service sector, especially financial services. Third, China had already enthusiastically embraced the Soviet model of planned economy, and the associated development strategy of inward-looking industrialization, with special preference to the heavy industries.

From 1949 to 1979, the Chinese Government pursued what can only be described as "financial repression": foreign banks and financial institutions were in effect driven out of China; private Chinese banks were first reorganized into "joint public-private banks" and later nationalized by merging them with the People's Bank; other non-bank financial institutions were either nationalized or closed; all financial markets, such as securities markets, forex markets, inter-bank market, gold and silver markets etc. were closed.[9] Shanghai was of course hard hit: it lost not only its IFC status, but also its “national financial centre” status. Like other cities, Shanghai had had to endure some catastrophic political movements, especially the “Great Leap Forward” of 1958-60 and the Cultural Revolution of 1966-76.[10]

Indeed, at the height of the Cultural Revolution, even some Government banks were downgraded, merged, or closed, the idea being to form, according to Lenin’s prescription, an all-embracing monobank.[11]

The economic reform and opening to the world policies launched in 1979 gave a new lease of life to Shanghai. However, initially, Shanghai was relatively neglected compared to the special economic zones in Guangdong and Fujian. The architect of the new policies, Deng Xiaoping, himself acknowledged: “Shanghai has obvious advantages in respect of human resources, technology, and management. It has a very broad radiation range. My big mistake was to leave out Shanghai when we established the four economic zones. Otherwise, the situation of the Changjiang Delta, the whole Changjiang Basin, or even the prospects of the reform and open door policies of the whole country, would have been very different.”[12]

Although the normalization of the financial sector during the 1980s, such as the restoration of the original functions of the Agricultural Bank, the Bank of China, and the Bank of Communications, the establishment of new banks such as the Industrial and Commercial Bank, the transformation of the People’s Bank from a monobank into a Central Bank, the reopening of insurance companies etc.,[13] were also beneficial to Shanghai, it was not until 1990 that a real impetus was given to Shanghai’s re-emergence as a financial centre. In that year the Chinese Government formally announced the policy of developing the Pudong New Area, within which preferential treatment of foreign investors broadly similar to that in the special economic zones and the development zones would be applied. The Pudong New Area, a 350 square kilometre triangular area east of the Huangpu River, is itself divided into several sub-areas, of which the Liujiazui-Huamu sub-area, opposite the famous Bund, is earmarked for the broadly defined financial sector, namely banking and finance, real estate, and business services. Others measures to boost Shanghai's financial status soon followed. In the same year, the securities exchange reopened, and commodity exchanges were established. Shanghai was selected by the Central Government as one of the first few major cities to allow the entry of foreign banks and other financial institutions. The Bank of Communications moved its headquarters from Beijing to Shanghai. In April 1994, following the exchange rate reform, the China Foreign Exchange Trading Centre was located in Shanghai to unify forex trading for the whole nation. Then, in January 1996, a nationwide inter-bank market was launched in Shanghai, with nine banks and thirty-five regional capital centres as its members. Beijing also gradually eased Shanghai's fiscal burden in the form of revenue contribution to the Central Government.[14]

The stated objective of the Chinese government is to develop Shanghai into a leading international industrial, financial, and commercial centre by the year 2010. Specifically, Shanghai is to catch up with Hong Kong and Singapore as an IFC by the same year. This marked a radical shift from the policy stance during the pre-Reform era, when the role of banking and finance in economic development was not understood and appreciated, let alone the concept of IFC. It was only after the reform and opening-up policies began that decisions-makers and the economics profession realized gradually the importance of not only banking and finance, but also other service sectors such as tourism.

Hong Kong was occupied by Japanese forces from December 1941 to August 1945, and during that period, all banks and other financial institutions owned by nationals of the Allies and the Chinese Government were closed, so were financial markets. Only a few local ethnic Chinese banks were allowed to operate, subject to severe limitations. After Japan's surrender, Hong Kong was able to enjoy a prolonged period of relative peace and stability. To be sure, both China's civil war and the Korean War also indirectly affected Hong Kong, but the adverse effect was far less than that suffered by Shanghai. Hong Kong also did not experience any domestic political or social upheavals similar to the Great Leap Forward and the Cultural Revolution, except for a brief period in 1967 when the Cultural Revolution spilled over in the form of violent disturbances organized by local extreme leftists. Nor had Hong Kong undergone any extended period of "financial repression" as Shanghai had. Indeed, the Hong Kong authorities were renowned for their *laissez-faire* policies. Finally, Hong Kong, unlike Shanghai, did not have to bear an onerous burden by sharing its fiscal revenue with the Central Government. It was true that under the Defence Costs Agreements with Britain, Hong Kong had to bear the foreign exchange costs of the British Garrison. But the amount involved was small: it decreased from HK$1.47 million (US$189 million) in fiscal year 1994-95, or 0.8% of total revenue, to HK$344 million (US$44 million) in fiscal year 1997-98, or 0.15% of total revenue.[15] In short, Hong Kong's initial conditions for developing into an IFC were much more favourable than those of Shanghai's.

Although the Hong Kong colonial government adopted a permissive attitude towards the financial sector, it also did not pursue an active IFC policy, at least in the 1950s and 1960s. Two events can illustrate this point. In 1966, after a banking crisis rocked the whole financial system, the Hong Kong Government took the view that the territory was over-banked, and imposed a moratorium on new licences to foreign banks. This was, of course, a serious setback to Hong Kong's development as an IFC. Fortunately, it was not fatal, for foreign banks which wished to enter the market could still do so through one of the following channels: acquisition of equity interests in existing local banks, up to 100%, or to set up wholly or partly owned deposit-taking companies. Then, in the late sixties, several multinational American banks intended to set up an Asian-dollar market, which was basically an extension of the Euro-dollar market to a different time zone, in Hong Kong. The major stumbling block to this proposal was the Hong Kong Government's refusal to abolish the interest withholding tax on foreign currency deposits. Singapore, on the other hand, was only too glad to accommodate the US banks by tax breaks and other incentives. As a result, the status and prestige associated with the hosting of the Asian-dollar market went to Singapore.[16] Though serious, this setback to Hong Kong was fortunately again not fatal. For Singapore's economy was too small to utilize all the US dollars deposited there. In effect, multinational banks tapped the Singapore market, and on-lent them to larger economies in the region, including Hong Kong. Because there were already a number of internationally active banks in Hong Kong, the territory naturally became a syndication centre, despite the moratorium. Moreover, thanks to its favourable business climate and tax regime, it also became a fund management centre for the whole region.

By the mid-1970s, many multinational banks had become increasingly frustrated by their inability to open full-service branches in Hong Kong. Confronted with growing pressure from such banks, and with intense competition from Singapore, the Hong Kong Government announced in March 1978 that it was ready to issue new bank licences again provided that the following requirements were met. First, the applicant banks must be incorporated in jurisdictions where there were effective prudential supervision. Second, they must have assets, net of contra items, exceeding US$3 billion (subsequently raised to US$16 billion in several steps). Third, some form of reciprocity was available to Hong Kong banks in the jurisdiction concerned. The effect of this measure was dramatic: before 1978, there were 40 foreign-incorporated banks in Hong Kong, but by the end of 1995, the number had increased to 154.

Other liberalization measures soon followed. In February 1982, the interest withholding tax on foreign currency deposits was abolished. In 1989, all forms of tax on interest, including those paid by non-financial firms to depositors/lenders, was abolished. At the same time, the lending and borrowing of share scripts for settlement purposes was also exempted from stamp duty.[17] Even after the Asian Financial Crisis erupted, liberalization continued: the total asset rule was relaxed for smaller banks which had high international reputation, and foreign banks could open three offices in stead of only one.[18]

With the government becoming more proactive in its policy, Hong Kong also made rapid progress in its IFC status. Jao (1997) was able to document that, by 1995-96, Hong Kong had become the second largest IFC in the Asia-Pacific region, and between the 6th and 7th largest IFC in the world. Since the Asian Financial Crisis, however, Hong Kong’s world ranking has slipped to between the 7th and 8th.[19]

Scholars like Jao (1979, 1980, 1997a, 1997b), Ho (1991, 1997), Hui (1992, 2003), Mak (1993), and Jones (1992) in their writings generally took the line that Hong Kong's metamorphosis into an IFC did not begin seriously until the late 1960s or early 1970s. This view may be called the "mainstream view". It has the advantage that, with the exception of the work by Jones, it is backed by solid statistical evidence. The alternative view, represented by Reed (1981, 1983), Schenk (2001), and Meyer (2000), may be called the "early-start view" which argues that Hong Kong became an IFC much earlier. Reeds finds that, in every 5-year interval during the period 1900-1980, Hong Kong was among the 10 largest international banking centres of the world except 1970 and 1980. But later, using a 4-tier hierarchy of IFCs, he places Hong Kong among the 3rd tier, on a par with such cities as Bombay and Brussels. This result not only underestimates Hong Kong's importance, but seems inconsistent with his earlier finding that Hong Kong was among the ten largest banking centres. Reed's methodology is also flawed because he relies almost exclusively on banking variables, ignoring completely other financial markets variables, which have become much more important due to the rise of capital market finance, securitization, and other innovations. Schenk's main contribution is that, using recently released British Government archives, she shows how the Hong Kong Government resisted strenuously, and apparently successfully, the intermittent efforts of the UK Treasury and the Bank of England to close down Hong Kong's gold market and free foreign exchange (US$) market, which London regarded as loopholes in the world sterling system. However, the statistical data supporting her arguments that Hong Kong's career as an IFC began during the period 1945-65 are rather sketchy. As an urban sociologist, Meyer writes on Hong Kong as a global metropolis (GM) rather strictly as an IFC, but in so far a GM implies an IFC, one supposes that his work belongs in the same genre. He goes much further than others in arguing that Hong Kong became a GM already in the latter part of the 19th century. However, he relies heavily on secondary sources and trade data, without any reference to financial data, except some vague and imprecise discourse on "social networks of capital".

III. Shanghai and Hong Kong: Macroeconomic and Financial Centre Profiles

This section presents a macroeconomic profile and a financial centre profile, in order to provide statistical data for the evaluation of the two cities as IFCs. Before we do this, some preliminary remarks are called for.

Shanghai's statistical collection, compilation, and dissemination system, like those in other parts of the country, was severely disrupted and discredited during the Great Leap Forward and the Cultural Revolution. It was revived towards the end of 1970s, and since then considerable progress has been made, though much remains to be desired in both quantity and quality. Hong Kong's statistical system did not experience such disastrous events, and over the last four decades have improved beyond recognition in both quantity and quality. It is safe to say that Hong Kong's data are much more accurate, reliable, comprehensive, detailed, and conformant with international standards. In both tables, the data refer to the end of 2002, (unless otherwise stated), the latest year for which information is reasonably complete for both cities. Notice that the abbreviation n.a. can mean either "not applicable" or "not available". There are more n.a.'s for Shanghai, implying either that there are more lacunae in the city's economy or financial system, or that its statistical coverage is less comprehensive or detailed.

As shown in Table 1, at the end of 2001, Shanghai was twice as populous as Hong Kong, but its Gross Domestic Product (GDP) was only 40% that of Hong Kong, while its *per capita* GDP was only about 20% that of Hong Kong. One may presume that after adjusting for purchasing power parity (PPP), the differential will be narrowed, but not eliminated.[20] However, Shanghai had much higher rate of growth for its GDP and *per capita* GDP: nearly 3 times as much for the former, and more than 4 times as much for the latter, than Hong Kong's during the period 1990-2001. Three ratios are used to measure "financial deepening": the ratio of the broadest money to GDP, the ratio of stock market turnover to GDP, and the ratio of the stock market capitalization to GDP.[21] Shanghai's M3/GDP was somewhat lower than Hong Kong's, but its SMT/GDP and SMC/GDP were much higher than Hong Kong's.

As to foreign trade, Shanghai's exports were about 36% of Hong Kong's while its imports of goods were about 26% of Hong Kong's, but again, Shanghai's growth rates of exports and imports were much higher than Hong Kong's. Hong Kong had considerable exports and imports of services, a sign of its importance as an IFC, but unfortunately corresponding figures are not available for Shanghai. Hong Kong had very high inflow and outflow of foreign direct investment (FDI), another sure sign of a financial entrepôt, but outward FDI data are not available for Shanghai. Shanghai's unemployment rate, at 4.8%, was much lower than Hong Kong's, but it is widely believed that China's "registered urban unemployment rate" under-estimates the true rate. Shanghai's average monthly wage was only about 16% of Hong Kong's. Shanghai had a much larger population, so it is unsurprising that it also had a much larger number of tertiary-level students. But surprisingly, it also had a much higher ratio of college/university students to total population than Hong Kong: 2.5% vs. 1.7%. Finally, Shanghai's receipts from incoming tourists, US$1.8 billion, was much smaller than Hong Kong's, US$8 billion.

Table 1

Shanghai and Hong Kong: A Macroeconomic Profile, End of 2002

	Shanghai	Hong Kong
Population	13,342,300	6,787,000 (mid-year)
GDP (US$ billion)	65.35	163.00
GDP *per capita* (US$)	4,911	24,017
Average annual real GDP growth, 1990-2002	11.9%	4.1%
Average annual *per capita* GDP growth, 1990-2002	11.6%	2.6%
Financial Deepening Ratios:		
M3/GDP	1.8	2.8
SMT/GDP	9.0	1.3
SMC/GDP	4.7	2.8
Foreign Trade :		
Exports of Goods (US$ billion)	81.8	200.1
Average annual growth rate 1990-2002	21.6%	8.0%
Imports of Goods (US$ billion)	60.7	207.7
Average annual growth rate 1990-2002	18.6%	8.0%
Exports of Services (US$ billion)	n.a.	45.2
Imports of Services (US$ billion)	n.a.	24.2
Foreign Direct Investment (US$ billion)		
Inward FDI	10.6	23.8 (for year 2001)
Outward FDI	0.13	11.4 (for year 2001)
Unemployment	4.8%	7.3%
Consumer Price Index Change	0.5%	-3%
Average monthly wage (US$)	241	1,467

Table 1 (contd.)

	Shanghai	Hong Kong
Number of tertiary level students	331,600	117,500
Ratio of tertiary level students to population	2.5%	1.7%
No. of overseas visitors (million persons – times)	2.7	16.6
Receipts from overseas visitors (US$ billion)	2.3	9.9

Notes: n.a. = not applicable or not available.
M3 = broadest money or currency in circulation plus all bank deposits
GDP = Gross Domestic Product
SMT = stock market turnover
SMC = stock market capitalization

Sources: Shanghai: *Shanghai Statistical Yearbook* 2003;
Shanghai Economy Yearbook 2003;
China Statistical Yearbook 2003;
China Securities and Futures Statistical Yearbook, 2003

Hong Kong: *Hong Kong Monthly Digest of Statistics*, 2002;
Hong Kong Annual Digest of Statistics, 2002;
Hong Kong Annual Report, 2002;
Hong Kong Stock Exchange Fact Book, 2003;
2002 Gross Domestic Product

Table 2, a financial centre profile of both cities, begins with a summary review of banking, which is the cornerstone of a financial centre. Here, all indicators show that Shanghai was dwarfed by Hong Kong. Moreover, for certain items which are important indicators of an IFC, such as loans abroad, balances due to and due from banks abroad, and clearing house daily turnover, data are not available for Shanghai. For insurance, the total number of insurance companies and premium income were again much smaller, though there were more registered insurance agents in Shanghai. Fund management was still in its early phase of development in Shanghai, and data are scanty. By contrast, Hong Kong, being an acknowledged centre of fund management in Asia-Pacific, was exceptionally strong under this heading.

With regard to the various financial markets, Shanghai's stock market was smaller than Hong Kong's on all counts except for average daily turnover. Shanghai had no derivatives market (mainly for stock options and warrants), while Hong Kong had a sizeable one. As to the much more important forex market, Shanghai's daily forex turnover of US$0.3 billion was pitifully small compared to Hong Kong's US$67 billion. This is a reflection of the fact that the *Renminbi* (RMB) is still not convertible, and that there still is a whole panoply of exchange controls on capital account. Hong Kong, on the other hand, has no exchange control of any kind, and the Hong Kong dollar is a fully convertible hard currency. Shanghai, however, had a much larger debt market, due no doubt to the Chinese Government's pro-active fiscal policy in recent years. Hong Kong, however, used to pursue, until quite recently, a very conservative fiscal policy, and whatever debt the government had issued in the past had already been paid off long ago. Corporate bonds are also very small in size and inactive in trading. Most of the existing debt instruments consist of Exchange Fund Notes and Bonds, which are issued by the Hong Kong Monetary Authority for monetary policy purposes, not for fiscal reasons.[22] Finally, as regards the futures market, Shanghai had a fairly active commodity futures market for copper, aluminum, and rubber, but no financial futures market for stock index and interest rate futures. By contrast, Hong Kong had no commodity futures market, but had a reasonably active financial futures market. This phenomenon reflects the different economic structures of the two cities. Shanghai has a well-diversified industrial complex and a sizeable primary sector, particularly in the suburbs and the hinterland. There is therefore a real demand for industrial raw materials futures market. Hong Kong's primary sector has virtually disappeared, and its manufacturing industries have steadily relocated to the Pearl River Delta during the past two decades. Actually, Hong Kong used to have commodity futures markets for cotton, sugar, soyabeans, and gold in the late 1970s and early 1980s, but none of these took off, due to lack of demand, and ceased operations one by one later. Finally, Hong Kong's international investment position (IIP) shows enormous amounts of external assets and liabilities, reflecting Hong Kong's importance as an IFC. After netting out liabilities, Hong Kong still had net external assets of US$339.2 billion, showing that Hong Kong is an IIP creditor. Similar data are not available however for Shanghai.

Table 2

Shanghai and Hong Kong: Financial Centre Profile, 2002

Indicators	Shanghai	Hong Kong
Banking		
Deposits (US$ billion)	169.6	425.5
Foreign currency deposits (US$ billion)	20.7	191.5
Loans (US$ billion)	127.5	266.4
Foreign currency loans (US$ billion)	14.3	59.1
Loans Abroad (US$ billion)	n.a.	31.2
Balances due to banks abroad (US$ billion)	n.a.	178.8
Balances due from banks abroad (US$ billion)	n.a.	246.0
Clearing House daily turnover (US$ billion)	n.a.	39.5
Interbank market daily turnover (US$ billion)	3.9	20.6
No. of banks and depository institutions:		
Domestic	18	28
Foreign	54	196
Insurance		
No. of insurance companies:		
Domestic	21	96
Foreign	15	99
Premium income (US$ billion)	2.9	11.4
Registered insurance agents	51,300	31,484
Fund Management		
No. of unit trusts or mutual funds:		
Domestic	25	91
Foreign	n.a.	1,874
Net asset value of authorized funds (US$ billion)	n.a.	342.1
Registered intermediaries	n.a.	26,411

Table 2 (contd.)

Indicators	Shanghai	Hong Kong
Stock Market		
No. of listed companies:		
Domestic	715	802
Foreign	n.a.	10
Market capitalization (US$ billion)	306.4	456.4
Average daily turnover (US$ billion)	0.84	0.83
Equity funds raised (US$ billion)	0.67	13.0
Derivatives Market		
Total no. of stock option contracts	n.a.	3,724,705
Daily average	n.a.	15,203
Total no. of warrants	n.a.	414
Daily average warrant trading (US$ billion)	n.a.	0.06
Foreign Exchange Market		
Average daily forex turnover (US$ billion)	0.34	67 (end-2001)
Average daily forex derivatives turnover (US$ billion)	n.a.	4 (end-2001)
Debt Market		
Total outstanding debt instruments (US$ billion)	366.3 (national figure)	68.3
Average daily turnover (US$ billion)	15.5	2.9
Futures Market		
Commodity futures daily turnover (US$ billion)	1.98	nil
Financial Futures (index and interest rate futures)		
No. of contracts	nil	7,304,699
Daily average	nil	29,815

Table 2 (contd.)

Indicators	Shanghai	Hong Kong
International Investment Position		
External Assets (US$ billion)	n.a.	1,028.8
External Liabilities (US$ billion)	n.a.	689.6
Net External Assets (US$ billion)	n.a.	339.2

Note: Only full service banks and other financial institutions are included in this table. Representative offices are not included. Hong Kong's stock market includes the Main Board and the Growth Enterprises Market (GEM).

* National figure

Sources: Shanghai: *Shanghai Statistical Yearbook* 2003; *Shanghai Economy Yearbook* 2003; *China Statistical Yearbook* 2003; *China Securities and Futures Statistical Yearbook*, 2003

Hong Kong: Hong Kong Monetary Authority (HKMA) *Annual Report*, *Quarterly Bulletin*, and *Monthly Statistical Bulletin*, 2003; *Hong Kong Monthly Digest of Statistics*, 2003; *Hong Kong Annual Report*, 2002; *Hong Kong Stock Exchange Fact Book*, 2003; Hong Kong Commissioner of Insurance *Annual Report*, 2002; Hong Kong Securities and Futures Commission *Annual Report*, 2002

IV. What Makes an IFC?

The data in Tables 1 and 2 clearly show that, despite its rapid growth since 1990, Shanghai still lags considerably behind Hong Kong, both economically and financially. This generally accepted fact, however, does not in itself prove that Shanghai is not yet a fully-fledged IFC. We need to ask two major questions. First, what are the salient characteristics, in quantitative terms, of an IFC? Second, what are the necessary conditions, or prerequisites, for a city to become a genuine IFC?

To answer the first question, we note that an IFC is basically about cross-border and cross-currency financial transactions. A large and active forex market is therefore an unmistable hallmark of a genuine IFC. A forex market is, in turn, basically an inter-bank market for wholesale currency transactions. A critical mass of internationally active banks is therefore essential for generating the economies of scale of forex transactions characteristic of an IFC, as well as achieving the economies of scale and of scope for other financial activities like loan syndication, underwriting, mergers and acquisitions etc.

To derive some meaningful quantitative benchmarks for an IFC, I first checked the survey of daily forex turnover in 2001 sponsored by the Bank for International Settlements (BIS).[23] Hong Kong ranked 7th with a daily turnover of US$67 billion. Belgium (ranked 17) and other countries below it, Austria, Ireland, Spain etc. are not known to have any significant IFC. I therefore took the figure for Belgium, US$10 billion, as the cut-off point. Similarly, I checked the table on the presence of foreign banks in my book (Jao, 1997, p. 31) and the tables on cross-border inter-bank claims and liabilities) (Jao, 1997, pp. 35-36). Using the same line of reasoning, it may be concluded that a city cannot be a genuine IFC unless:

- It has a daily forex turnover of not less than US$10 billion;
- It has a presence of foreign banks, net of representative offices, of not less than 100;
- It has a presence of foreign non-bank financial intermediaries (NBFIs), again net of representative offices, of not less 200;
- It has cross-border inter-bank claims and liabilities of not less than U$100 billion each way;
- It has a total bank lending abroad of not less than US$20 billion;
- It is chosen as the location for their regional headquarters by not less than 200 foreign companies (including banks and financial institutions).

These quantitative benchmarks raise in turn another question: why are some cities able to achieve these benchmarks, while others are not? To answer this question, one must specify the essential conditions, or prerequisites, for an IFC.

It is widely agreed in the literature that these prerequisites are:

- Political and social stability;
- Central and convenient geographical location;
- Full capital mobility, implying absence of any exchange rate controls;
- “National Treatment” to foreign banks and NBFIs;[24]
- A liberal, non-interventionist policy towards business, especially banking and finance;
- A sound framework for prudential supervision to ensure systemic stability and to protect the legitimate interests of consumers, depositors and investors;
- A tradition of the “Rule of Law”, and a sound, comprehensive system of financial law;
- A modernized physical infrastructure;
- A modernized financial infrastructure, and developed financial sector;
- Free flow of information without any restrictions;
- A business-friendly tax regime;
- Widespread use of English;
- Good quality of life.

V. Relative Strengths and Weaknesses

We are now in a position to evaluate Shanghai and Hong Kong in accordance with the quantitative benchmarks of and essential conditions for, an IFC, as outlined in the previous section.

In respect of the quantitative benchmarks – number of foreign banks and NBFIs, forex market turnover, cross-border interbank claims and liabilities, bank loans abroad – Shanghai either falls far short of them, or does not have the required data, possibly because the relevant activities simply do not exist. Hong Kong has, however, long crossed such thresholds.

Shanghai also fails the regional headquarters test. Some multinational banks, such as Citibank and HSBC, have, it is true, set up their China headquarters in Shanghai, but this is very different from headquarters for the whole Asia-Pacific region. Apart from some anecdotal stories, there are no systematic statistics showing that Shanghai has been chosen as regional headquarters. Hong Kong, on the other hand, has hundreds of multinational corporations (including banks and other NBFIs) using it as regional headquarters, and there are systematic data to support such a claim. Table 3 presents the numbers of regional headquarters and regional offices set up by overseas companies (including those from Mainland China) in Hong Kong. A regional headquarters (RHQ) is an office that has control over the operations of offices in the region (i.e. Hong Kong plus one or more other places), and manages the business without frequent referrals to its parent company. A regional office (RO) is an office that coordinates operations in the region, and manages the business but with frequent referrals to its parent company.[25]

Table 3

Number of Overseas Companies with RHQs and ROs in Hong Kong, 2000-2003

	2000	2001	2002	2003
RHQs	855	944	948	966
ROs	2,146	2,293	2,171	2,241

Source: Business Expectations Statistics Section, Census and Statistics Department, Hong Kong Special Administrative Region Government

In respect of the essential conditions for an IFC, Shanghai either has not yet fulfilled them, or is only beginning to fulfill them, whereas Hong Kong has already fulfilled them all. The first two conditions, political and social stability and central and convenient geographical location, need not detain us too long. War and civil strife are the chief enemies of an IFC. As mentioned in Section II, Shanghai itself and

Beirut are the two prime examples of how war and civil strife can ruin an IFC. Hong Kong mercifully has enjoyed a long period of relative stability since 1945, even though it is always sensitive to events in China. Since the reform-and-open policies began, political mass movements with "class struggle" themes have ceased in China, and this has created an internal condition conducive to Shanghai's re-emergence as an IFC, though it must be stressed that authoritarian measures alone cannot guarantee long-term stability. Both Shanghai and Hong Kong are centrally located in the Asia-Pacific region, and since they are in the same time zone, there is little to choose between them, geographically speaking.

Much greater differences exist for other conditions. Full capital mobility is still a distant goal for Shanghai, as there are still extensive controls over capital movement in China. Given China's obsession with the fear of massive capital flight, full convertibility of the RMB is unlikely in the near future. Even if it should decide in favour of full convertibility, it would do so slowly and in a piece-meal manner. Hong Kong has however a long history of full convertibility and capital mobility, except for the period when sterling was under strict exchange control, which was imposed however by the British Government. Shanghai is still unable to give "national treatment" to foreign banks and NBFIs, though under the terms of accession to the World Trade Organization (WTO), China has pledged to do so by 2006. Hong Kong, on the other hand, has always granted "national treatment", if only in the *de facto* sense. Indeed, Hong Kong's status as a free port since 1841 already implies there are no systematic protective barriers against foreign firms.

While Shanghai since 1990 has liberalized its bureaucratic controls and restrictions, the vestiges of an interventionist mentality still remain. In any case, it cannot match Hong Kong, which has been renowed for its "positive non-interventionism". Indeed, Hong Kong has been named by think tanks like Heritage Foundation, Cato Institute, and Fraser Institute as the world's freest economy for many years.[26]

A sound framework for prudential supervision is by no means inconsistent with freedom and non-interventionism, for its purpose is to protect the legitimate interests of consumers, depositors and investors. A planned economy, as experience shows convincingly, often entails lax prudential supervision and lack of "banking culture"[27] That China's banking system is crippled by non-performing loans (NPLs) is an open secret. While the official figure of national average NPL-ratio was about 24%, private sector estimates of this ratio are much higher, generally over 40%.[28] Recently, Yi Gang, Secretary-General of the Monetary Policy Committee of the People's Bank of China, argued that NPLs varied with economic performance and stage of development of various geographical areas. The economically advanced regions around Shanghai, including Jiangsu and Zhejiang provinces, had the lowest NPLs, averaging 7% to 12%.[29] Whatever the case may be, it is indisputable that China's banking system as a whole is unable to comply with the minimum capital adequacy ratio (CAR) of 8% agreed under the Basel Accord.

Hong Kong also used to have a serious problem of banking fragility, but after the banking crises of the 1960s and 1980s, a determined reform effort has yielded the result that Hong Kong's banking system is now one of the best managed and supervised in the world. Even at the height of the Asian crisis, not one single bank failed. During the period 1997-2002, locally incorporated banks maintained an average CAR of about 16%, one of the highest in the world, certainly much higher than the Basel ratio.[30] Its NPL-ratio at the end of 2002 was 5.05%.[31] Moreover, due to Hong Kong's higher standards of disclosure and transparency, its CAR and NPL figures are far more credible than China's.

Shanghai also faces a "credibility gap" in another crucial prerequisite for an IFC, namely the rule of law. Although efforts have been made to rebuild the legal system after the lawlessness during the Cultural Revolution, and a series of national banking law, companies law, securities law etc. have recently been enacted, their effective enforcement remains to be seen. In contrast, Hong Kong has a long tradition of the rule of law dating back to the 19th century. Its legal system, based on common law and equity law, is internationally well-known and understood, and enforceable by an independent judiciary without any political or ideological interference. Laws most relevant to an IFC, such as companies law, banking law, and securities law etc., are being regularly updated and revised in response to the changing needs of the times.

Shanghai is also no match for Hong Kong on the criterion of free flow of information. While controls on economic and financial information have greatly eased in China, censorship over sensitive political and social news still exists. Moreover, nearly all mass media are government-owned. In Hong Kong, however, there is free flow of information comparable to any world class financial centre, and there is no censorship over any news except for obscene and pornographic materials. Nearly all mass media are owned and managed by the private sector. Given that most decisions in modern banking and finance have to be taken on a real-time basis, the importance of free information for an IFC can hardly be over-emphasized.

During the period 1949-79, there was little improvement of the existing physical infrastructure, and indeed there were very few new buildings in Shanghai, giving the city a dreary and dilapidated outward appearance. When foreign banks and business firms were again welcomed back in the early 1980s, they found that even basic facilities, such as office buildings and telephones, were lacking. Beginning from the late 1980s, Shanghai, with the apparent blessing of the Central Government, mobilized huge resources into renovating the existing infrastructure, and constructing new commercial and residential buildings, so that during the past 15 years or so, Shanghai has been undergoing a tremendous face-lift. The city recently even hit world headlines by launching the ultra-modern, German-built “magnetic levitation (maglev)” train. Hong Kong, on the other hand, has been continuously improving and upgrading its infrastructure, without any prolonged disruption. Its new airport at Chap Lap Kok, despite initial mishap, has now been recognized world-wide as one of the most efficient high-tech airports of the world. For many years the busiest container terminal of the world, Hong Kong is now considering the 10th container terminal. But given Shanghai’s current construction boom, the gap in physical infrastructure is not that great now.

By re-opening the gold market last year, Shanghai seems to have completed the initial stage of building up financial markets and institutions, except for derivatives market and financial futures market. However, the range of financial products and services available to consumers, depositors and investors is still very limited. A glaring example is that even today, individuals in Shanghai and elsewhere in China still cannot use cheques for payment purposes. This is an retrogression compared to the pre-1949 era, when cheques were widely used in Shanghai by individuals and households.

Hong Kong has no such problems. It already has a comprehensive range of financial markets and institutions, offering a wide variety of financial products and services comparable to any other IFCs. Hong Kong may not be very good at financial innovations – though it has innovations of its own, such as “covered warrants” –, but it is very good at adopting innovations from abroad. One important innovation in recent years has been the securitization of mortgages. The Hong Kong Mortgage Corporation was established in 1997 to specialize in buying residential mortgages from the banks, and securitize them and re-sell them to individual or institutional investors. This innovation can help solve the mismatch and liquidity problems of the banking system, while promoting at the same time the growth of securities market. Hong Kong also has one of the most modern and sophisticated payments and settlement systems in the world. The Hong Kong Monetary Authority (HKMA) set up a Central Moneymarkets Unit (CMU) in 1992, which serves as a central custodian and clearing agent for Hong Kong dollar debt instruments issued by the private sector. Then, it introduced Real Time Gross Settlement (RTGS) in December 1996, for large interbank payments, marking Hong Kong as one of the earliest economies to do so. In December 2000, it inaugurated a US dollar clearing system, enabling payment versus payment (PvP) settlement for US$/HK$ foreign exchange transactions. A link-up with the Euro clearing system is being planned. These measures have consolidated Hong Kong’s position as a leading IFC in the Asian time zone.

With regard to the tax regime, Shanghai offers tax breaks and preferential treatment in the Pudong New Area, similar to those offered by the development zones in the 14 open coastal cities. Foreign banks and foreign financial institutions are granted income tax reductions. In the bonded areas, goods produced for export are exempt from export tax and value-added tax, while imported goods used as inputs are exempt from customs duties and value-added tax. Special tax breaks and tariff cuts are also available for the high-tech sector, such as the IT, telecommunications and internet industries.[32]

Outside the Pudong and high-tech sector, China's tax system, which is also applicable to Shanghai, can be quite onerous and complex. Corporation income tax (inclusive of local income tax) is 33%, while individual income tax is subject to a sliding scale ranging from 5% to 45%. There are a variety of direct and indirect taxes such as property tax, inheritance tax, land premium tax, agricultural tax, husbandry tax, resource tax, value-added tax, sales tax, consumption tax, stamp duty, automobile tax etc.[33]

Hong Kong does not provide any tax breaks or incentives. Instead, as an integrated IFC, it relies on low tax rates and a simple tax system for attracting foreign investors and MNCs. As of March 31, 2003, the standard tax rate was 16%, while the corporation profit tax rate was $17\frac{1}{2}$%. There was also a sliding scale of rising marginal rates for salary tax, but the average effective rate was capped by the standard rate, i.e., 16%. There were no taxes on capital gains, interest, and dividend, nor were there any value-added tax or sales tax. Two features of Hong Kong's tax system are especially attractive for multinational entities. One is the "schedular system", under which taxes are levied on separate sources of income, in lieu of a comprehensive income tax. Another is the "territorial source principle", under which only income that originated in, or derived from, Hong Kong is subject to tax.[34] These features are regularly cited as a main factor in the annual survey of overseas companies which set up their regional headquarters in Hong Kong.

It is also noteworthy that Hong Kong receives more favourable fiscal treatment from the Central Government. Article 106 of Hong Kong's Basic Law clearly states that "The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region". Moreover, unlike Britain, China absorbs the costs of its garrison in Hong Kong. As already mentioned earlier, Shanghai used to be required to hand over a very large proportion of its revenue to the Central Government. Since 1990, however, this proportion has been greatly reduced. In 2002, Shanghai paid a *ding'e shangjie zhongyang* (lump-sum contribution to the Central Government) of RMB 12 billion, or 16.7% of fiscal revenue. But it also received refunds and grants of RMB 28.26 billion from the Central Government.[35]

The widespread use of English, the undisputed international language not only of banking, finance, and trade, but also of science, technology, and diplomacy, is also an obvious prerequisite. English is no longer regarded as a colonial relic, but as an indispensable tool in a highly competitive world of globalization. In Shanghai, English used to be dominant foreign language before 1949, but it was replaced by Russian during 1949-79. Since about 1980, English has regained its pre-eminance, though it is still not an official language, and is still not widely used in banking and finance (outside foreign banks and other NBFIs). In Hong Kong, however, English remains an official language after the 1997 handover, and has always been the dominant language in banking and finance.

Finally, an IFC cannot exist without a large congregation of multinational banks and financial institutions, as well as other non-bank MNCs. How to attract expatriate professionals and other talents to work and live in the aspiring city must always be an important task for the decision-makers. It is in this connection that a good quality of life, or at least improving quality of life, counts as a prerequisite, for an IFC. When Shanghai first re-opened, living condition were very harsh. Even decent housing was lacking, let alone other facilities and amenities such as super-markets, international schools, social clubs, cultural centres, concert halls etc. Since 1990, however, great strides have been made in making the living conditions more agreeable. Hong Kong's quality of life, on the other hand, gradually but continually improved with the growth of the economy without any prolonged period of disruption. Despite frequent complaints about pollution and other familiar urban problems, Hong Kong still has an edge over Shanghai in respect of the quality of life. This is confirmed by a recent survey, conducted by the Chinese University of Hong

Kong and the Shanghai Academy of Social Sciences, in which senior executives of MNCs in both cities were interviewed (Tuan and Ng, 2002). One of the measuring items of competitiveness is living conditions. For the year 2001, on a scale of one (worst) to 5 (best), Shanghai's score for "facilities" and "environmental protection" were 3.121 and 2.844 respectively, while Hong Kong's scores were 3.870 and 3.174 respectively.

Having enumerated Shanghai's weaknesses as an financial centre, it is only fair to evaluate its strengths. Shanghai had a much larger bond market and sizeable commodity markets. Its position as a national or domestic financial centre (NFC) is undisputed and unchallenged. Shanghai monopolizes the forex market and the inter-bank market. With only 1% of Mainland China's population, Shanghai nevertheless accounted for 8.2% of total bank deposits in 2002. It also had the largest number of foreign banks and NBFIs. Its stock market was much larger than Shenzhen's, the only other stock market in Mainland China. Even when, in a few years' time, *Renminbi* business is open to all foreign banks and NBFIs without geographical restrictions, they will still probably flock to Shanghai, and choose it as their Mainland headquarters. Shanghai is not only a magnet for foreign direct investment, but also one for domestic direct investment as well.[36]

However, it is in the real economy that Shanghai's strengths lay. It had a well-diversified industrial structure, which included heavy industries, as well as IT and other high-tech industries. It had a larger pool of science and technology talents, and had more research and development (R & D) activities. The competitiveness survey which we have just cited (Tuan and Ng, 2002) reports that, for the year 2001, Shanghai's score for science and technology was 3.294, while Hong Kong's was 3.226.[37] But Shanghai's trump card was its much higher GDP and foreign trade growth rates. Given that Shanghai's average wage rate was still very low, it is likely that the robust growth will continue for some time. If Shanghai can maintain its growth differential, it will catch up with, and surpass Hong Kong, in about 15 years (on an absolute size basis, not on *per capita* basis).

Hong Kong's weaknesses lay mainly in the real economy. Its trend growth rate of real GDP declined from nearly 9% in the 1960s and 1970s to 6% in the 1980s, and further to 5% during 1990-97. As the economy grows and becomes more mature, the growth rate tends to fall, and this in itself need not be alarming. But the Asian Financial Crisis dealt a severe blow to the economy, which shrank by 5.3% in 1998, the worst performance since 1961.[38] The recovery during 1999-2000 proved to be ephemeral, and the economy again plunged into recession in 2001-2002. During 1998-2002, the average growth rate of real GDP fell sharply to only 2%. Nominal GDP has in fact been falling, but real GDP managed to rise only because prices have been falling even more. Since 2001, Hong Kong has been in the throes of deflation and stagnation, attributable to deep cyclical, structural, and monetary causes, an analysis of which is, however, beyond the scope of this paper.

Both Shanghai and Hong Kong have been affected by the outbreak of the SARS epidemic in the spring of 2003. But Hong Kong has reported a much larger number of cases and a much higher mortality rate. Its economy has suffered more than Shanghai's.

VI. Competition, Complementarity, and Cooperation

Shanghai's stated intention to re-emerge as a major IFC in the Asian Pacific Region has inevitably posed the question of actual or potential competition with Hong Kong. China's official line, as embodied in one of "Chen's Seven Principles", is that "Shanghai and Hong Kong will have complementary and mutually reinforcing relationship as financial centres".[39] These principles governing monetary relationships between Mainland China and Hong Kong after July 1, 1997 were proclaimed by Chen Yuan, then Deputy Governor of the People's Bank of China, in September 1996 in London at an international seminar sponsored by the Bank of England. These were obviously meant to reassure Hong Kong that its IFC status would not be taken over by Shanghai. The denial of any competition between the two, however, is unconvincing. For example, some multinational banks have already chosen Shanghai as their regional headquarters for Mainland China, and given the present wage-cost differential, it is likely that they will also move at least some of their operations there. As another example, Shanghai in 2002 ranked fourth busiest container port of the world, next only to Hong Kong, Singapore, and Pusan. It has started work on what may become the world's largest port at Yangshan, an offshore island just south of the city.[40] Many other examples of competition can be given. But competition, provided it is not the cut-throat type, can be healthy and beneficial by encouraging greater efficiency and productivity.

In their present respective roles as NFC and IFC, Shanghai and Hong Kong do have a great deal of complementarity. Some people argue that, as Shanghai's immediate hinterland is the Yangzi Valley, while Hong Kong's is the Pearl River Delta, there is a natural geographical complementarity between the two. While this argument seems to be reasonable, on closer examination it is not very meaningful. Shanghai is an aspiring IFC, and Hong Kong is an established IFC. No IFC worthy of its name is willing to have its activities confined to a sub-national region.

A more meaningful approach is to look at the "functional" complementarity. First, due to long-standing political schism, neither Mainland China nor Taiwan allows banks or NBFIs from the other side to operate full-service branches in its territory. Hong Kong, because of its special status, hosts banks and other NBFIs from both sides of the Taiwan Strait, on an equal footing. As at the end of 2002, there were 18 authorized institutions (comprising licensed banks, restricted licence banks, and deposit-taking companies under Hong Kong's 3-tier banking system) from Mainland China, and 12 from Taiwan.[41] Hong Kong's banking system had also substantial dealings with those of Mainland China, Taiwan and Macau, as shown in Table 4.

Table 4

Net External Claims (Liabilities) of Hong Kong's Authorized Institutions
End-2002
(US$ billion)

	Net Claims on/ (liabilities to) banks	Net Claims on/ (liabilities to) Non-banks	Total Net Claims/ (liabilities)
Mainland China	(16)	(4.5)	(20.6)
Taiwan	0.9	(4.6)	(3.7)
Macau	(4.9)	(0.6)	(5.5)

Grand Total	(20.0)	(9.7)	(29.7)
	====	===	====

Source: Hong Kong Monetary Authority *Annual Report 2002*.

Mainland China's stakes in Hong Kong's banking sector in 2002 were very substantial: 16.9% of total assets, 22.7% of customers' deposits, 21.7% of loans to customers, 23.3% of loans to customers inside Hong Kong, and 9.9% of loans to customers outside Hong Kong.[42] As I have noted in an earlier work (Jao 1997b), due to its unrivalled economic freedom, political neutrality, and superior record of "national treatment" and reciprocity, Hong Kong is the only Chinese city which can serve simultaneously as the financial centre of Greater China as well as an IFC in the Asian-Pacific region.

Second, as RMB is still inconvertible, Hong Kong-based banks, including those owned by China, cannot take deposits or make loans denominated in RMB. They can only engage in RMB retail money-changing. If they wish to access RMB business, they have to turn to cities on the Mainland, of which the dominant centre is Shanghai. That is why Hong Kong-based banks, especially the larger multinational ones, are so keen in acquiring stakes in Shanghai's banks. Thus, the HSBC and Citibank have recently bought minority stakes (both around 8%) of the Bank of Shanghai and Shanghai Pudong Development Bank respectively.

Third, Hong Kong is also the largest hard-currency capital-raising centre for Mainland China. From July 1993, when the first H-shares (shares of Chinese enterprises, both state-owned and non-state owned), were listed on the Hong Kong Stock Exchange, to the end of 2002, a cumulative total of US$92.3 billion was raised.[43] To be sure, Chinese enterprises can also raise funds on the Shanghai stock market, but in RMB only. For those which wish to raise capital denominated in hard currencies, they have to turn to Hong Kong, New York, Singapore, or London, but Hong Kong remains the largest and most convenient source.

In short, Shanghai as an NFC and a RMB centre, and Hong Kong as an IFC and a hard currency (HK$) centre, have a lot of mutually beneficial complementarities.

Whatever the status of Shanghai and Hong Kong as financial centres, however, there are plenty of opportunities for cooperation. The two cities have increasingly close economic relationships. In 2002, Shanghai's 2-way merchandise trade with Hong Kong amounted to US$8.15 billion, up by 115.6% compared to 1995. Hong Kong was Shanghai's third largest trade partner, after Japan and US.[44] Hong Kong also topped the list of foreign direct investment in Shanghai, the cumulative total at the end of 2002 being US$12.1 billion.[45] China has, of course, also invested heavily in Hong Kong, the cumulative total at the end of 2002 being US$75.9 billion, though there is no separate figure for Shanghai.[46]

We will first discuss cooperation possibilities which have not been realized. Now that Hong Kong has successfully launched a RTGS US dollar clearing system during the Asian business hours, the next logical step is to develop a similar RMB clearing system. Here, cooperation with Shanghai is clearly essential. Shanghai's payments and settlement system is anyway badly in need of modernization, and cooperation with Hong Kong, which has the state-of-the-arts technology, will be highly beneficial to Shanghai. Hong Kong has been trying hard to persuade Mainland China to issue bonds in US dollar in the territory, in order to boost its rather small bond market. However, it has grave reservations about China issuing debt denominated in Hong Kong dollar, for fear that this might adversely affect the linked exchange rate. Hong Kong has also been lobbying China to allow an offshore RMB market to be set up in Hong Kong, i.e., to permit Hong Kong-based banks to take RMB deposits and lend them out. In November 2003, China announced that Hong Kong banks can, effective from January 1, 2004, take deposits, remit money, and transact credit card business denominated in RMB, but lending is still not allowed.

Other than these unexploited opportunities, cooperation has been routinely going on at different levels between the monetary and regulatory authorities, financial markets and intermediaries, educational institutions and professional bodies, in the two cities, which in the long run, benefit both as financial centres. Space does not permit any elaboration. To give just a few examples, it is well known that the regulations, organization, and listing rules of the Shanghai Stock Exchange were largely modelled after those of the Stock Exchange of Hong Kong. Hong Kong accounting and legal firms regularly advise Chinese enterprises on how to bring their accounting practices up to international standard, and Hong Kong-based commercial and investment banks regularly underwrite them in their initial public offerings (IPOs) in Hong Kong or elsewhere. In 1993, Hong Kong's Securities and Futures Commission (SFC) and its counterpart in China signed a memorandum agreement for mutual cooperation and exchange of information and personnel. Very recently, the Hong Kong Exchanges and Clearing has signed an agreement with Shanghai's futures market to develop energy futures.[47] While these activities are undoubtedly useful, they are of secondary importance. The most challenging and difficult task of cooperation is the resolution of Shanghai's (and hopefully, the whole China's) banking fragility problem. Apart from the "demonstration effect" of its successful banking reform experience, Hong Kong can help by practical advice, not only from the regulatory authorities, but also from the banks themselves, including China-owned banks based in Hong Kong, to their counterparts in Shanghai. Hong Kong, on its part should learn, with due humility, from Shanghai's rapid economic growth since 1990.

VII. The "Trilemma" or the "Impossible Trinity"

There is a well-known "trilemma" in monetary economics, which is also called the "impossible trinity" (Frankel, 1999 p. 7). The proposition may be simply stated as follows: of the three desirable goals of monetary policy, namely, monetary independence, fixed exchange rate, (or at least a high degree of exchange rate stability), and full capital mobility (implying absence of exchange controls), the monetary authorities can at most achieve two, but not all three, simultaneously. They must, in other words, give up one in order to attain the other two.

At first glance, this seems to be an esoteric theorem that has nothing to do with the subject of this paper. On reflection, however, one realizes that it lies at the heart of the economics of IFCs.

This can be illustrated by the examples of China (Shanghai) and Hong Kong. China is very jealous of its monetary independence. At the same time, it also values exchange rate stability, the RMB being pegged *de facto* to the US dollar since 1997 at US$1 = RMB8.28. Therefore, it must give up full capital mobility, which is another way of saying that the RMB is inconvertible, and that there is a panoply of capital controls. But since full capital mobility is the *sine qua non* of an IFC, this means that Shanghai will remain an NFC as long as exchange controls are not lifted.

The Hong Kong dollar has been pegged to the US dollar since October 15, 1983 at the rate of US$1 = HK$7.8. This regime, officially called the linked exchange rate, is a variant of the currency board arrangement (CBA), under which the legal tender currency is more than fully backed by US dollar assets. It saved Hong Kong from financial collapse during the Sino-British negotiations on the territory's future.[48] The Hong Kong authorities therefore always insist that this regime is the best for Hong Kong despite its defects. At the same time, Hong Kong also sets great store by its status as an IFC, and capital controls are widely regarded as an anathema. According to the ineluctable logic of the "trilemma", Hong Kong has no choice but to give up monetary independence, meaning that it has to follow the Fed's decisions all the way, sometimes to the detriment of its real economy.

Take the examples of Singapore and Malaysia as further illustrations. Singapore, as a sovereign state, values monetary independence. But it also wants to be an IFC in keen competition with Hong Kong. Ergo, it has to forego fixed exchange rate. Actually, Singapore, like Hong Kong, used to be on the sterling exchange standard, the classic form of CBA. In 1972, following the demise of the sterling area, it exited from this regime, and gradually adopted a managed floating system that pegged the value of the Singapore dollar to a basket of currencies within an undisclosed band. During the Asian crisis, Singapore allowed its dollar to depreciate significantly. Malaysia devalued its currency sharply soon after the Asian crisis, but in September 1998, it repegged its currency to the US dollar at the depreciated level, and reimposed capital controls. Since it valued monetary independence, but had no ambitions of building up an IFC, it had also no qualms about giving up capital mobility.

Turning to China and Hong Kong again, if Shanghai is content to remain an NFC, the present *status quo* can continue in the absence of any major financial crisis. Indeed, Shanghai as an NFC and Hong Kong as an IFC are highly complementary to each other, as pointed out in the last section. Problems arise if Shanghai insists on becoming an IFC, as China will be confronted inexorably with the trilemma. Given that China will never forego monetary independence, while full capital mobility is an indispensable condition for an IFC, something has to give, and this has to be the *de facto* peg to the US dollar. There are several possible scenarios. The first, being consistent with China's current policy stance, is to liberalize capital controls very slowly and cautiously. As a consequence, exchange rate flexibility will also be limited to a narrow band. While this strategy will entail minimum risk, and little impact on Hong Kong, it will also prolong Shanghai's time-table of attaining the IFC status. The second is a much quicker tempo of liberalization, resulting in a substantial appreciation of the RMB. This will have a beneficial effect on Hong Kong. The third is that a quick liberalization leads to substantial depreciation of the RMB. While this seems unlikely from the current perspective, its possibility can never be ruled out. The impact on Hong Kong will be severe, given the Hong Kong authorities' attachment to the linked exchange rate. A replay of the 1998 assault on the Hong Kong dollar, when speculators spread rumours about the RMB's imminent devaluation, will almost be a certainty. For this reason, many economists advocate that, when the RMB becomes fully convertible, Hong Kong should switch its peg from the US dollar to the RMB, since closer integration between the Mainland China and Hong Kong economies is an inexorable long-term trend.

VIII. Concluding Remarks

This paper argues that, owing to marked differences in historical circumstances and policy regimes, Shanghai and Hong Kong have followed very different paths of financial development. After more than three decades of international isolation and "financial repression", Shanghai has a long way to go before it can become a genuine IFC. It will remain an NFC for some time to come.

If Shanghai is not overly ambitious, its role as an NFC dovetails rather nicely with Hong Kong's role as an established IFC. However, if Shanghai insists on an accelerated drive towards the coveted IFC status, China will be confronted with the thorny problem of the proper timing of full RMB convertibility. One key lesson of the Asian Financial Crisis is that overly hasty capital account liberalization before a well-managed and solid banking system, and a sound framework of prudential supervision adopting international standards are in place, can be extremely risky. Shanghai would be well-advised, therefore, to tackle its NPL problem as a priority task, and to fulfill other essential conditions for an IFC, before attempting to catch up with Hong Kong or Singapore. Shanghai and Hong Kong should also cooperate closely to prevent any systemic crisis that might engulf both, and coordinate their financial centre strategies accordingly.

Notes

1. See Wang (1981), Chapter 3; Hong (1993), Chapter 3; Liu (2000), p. 50.

2. Tamagna (1942), pp. 96-97; King (1988), pp. 368-71;

3. The numbers are calculated from the tables of banks in *Quanguo Yinhang Nianjian* (Chinese Banks Yearbook). See Bank of China Economic Research Department (1937).

4. Liu (2000), p. 51.

5. For details, see Hong and Zhang (1989), Chapters 2-8; Tamagna (1942), Chapters 5-8.

6. Liu (2000), p. 50.

7. Hong and Zhang (1989), p. 22. The description of Shanghai as "semi-colonial", undoubtedly refers to the existence of the International Settlement and French Concession, administered by Britain and France respectively, and the fact that the big powers (UK, US, France and Japan) enjoyed extra-territoriality, and their banks could issue banknotes. The privilege of issuing banknotes ceased after the currency reform of 1935, while extra-territoriality was either renounced or effectively given up during and after the end of World War II.

8. Jones (1992), pp. 406-407.

9. The term "financial repression" was originally used by Shaw (1973) and McKinnon (1973) to denote the controls of interest rates at levels below inflation rate, and heavy taxation of financial intermediation etc., but it has been later expanded to cover government restrictions on and discriminations

against the financial sector. Surely the wholesale closure of financial institutions and markets is an extreme form of "financial repression". See Hanoshan (1993) for more discussions of the term.

10. For concrete examples of how these movements disrupted China's financial sector, see Hong (1993), Chapter 9.

11. See Li (1987), Chapter 7.

12. Quoted from Deng (1993), p. 376.

13. For more details on banking reforms in the 1980s, see Chen (1985), Chapters 2-3; Samansky (1981).

14. See Ho and Tsui (1996), Chapter 6; Tian (1996), Chapter 3; White (1989), *passim*.

15. See Jao (2000), p. 27.

16. See Hodjera (1978); Bryant (1989).

17. For fuller details, see Jao (1997a), Chapter 4.

18. Jao (2003), pp. 108-109.

19. Jao (2001), Chapter 6.

20. The World Bank has PPP-adjusted estimates of Gross National Income (GNI) for China, but not for Shanghai. See World Bank, *World Bank Atlas*, 2003.

21. The term "financial deepening" is due to Shaw (1973). It is vaguely defined as the growth of the financial sector relative to that of the economy. The three

ratios, M3/GDP, SMT/GDP, SMC/GDP, have been suggested respectively by Shaw (1973), Levine (1997) and BIS (1997).

22. Since 2001, Hong Kong has been facing a growing and increasingly serious fiscal deficit. Even so, the Government has been reluctant to issue bonds, preferring to run down its fiscal reserves instead.

23. The BIS-sponsored survey report is reported in “Turnover of Foreign Exchange and Derivatives Market in Hong Kong”, Hong Kong Monetary Authority *Quarterly Bulletin*, Nov. 2001, pp. 62-71.

24. The concept of “national treatment” forms part of the principle of nondiscrimination, one of the main pillars of the General Agreement on Tariffs and Trade, (GATT), codified in 1947. In Articles I and III of the GATT, the most favoured nation (MFN) clause requires that, subject to certain exceptions, imports from all sources face the same barriers, while “national treatment” requires that, once they have gone through the customs, foreign goods be subject to no taxes or regulations more onerous than those on equivalent domestic goods. Since then, the concept has been extended to direct investment and the financial sector. In other words, foreign banks and other financial institutions should be treated on an equal basis as domestic ones. GATT has now been succeeded by WTO.

25. Table 3 presents summary statistics only. For more detailed classifications, see Census and Statistics Department, *Annual Survey of Regional Offices Representing Overseas Companies in Hong Kong*, various years.

26. See Joseph Lo, “Hong Kong still the world’s freest economy”, *South China Morning Post*, July 10, 2003. Hong Kong has been ranked No. 1 each year since survey of economic freedom was first published in 1996 by Canada’s Fraser Institute, together with Cato Institute and the Economic Freedom Network.

27. By “banking culture”, I mean the general acceptance of the principle in market economies that bank loans are made on commercial terms, and must be repaid on schedule. In pre-Reform China, this culture was utterly lacking, as banks were regarded as merely cashiers of the Ministry of Finance, for handing out grants.

28. According to Liu Mingkang, newly appointed Chairman of the China Banking Regulatory Commission, the average NPL ratio of the big four state banks – Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agricultural Bank of China – was 24.13% at the end of March 2003. See “Bank tsar comes out fighting”, *South China Morning Post*, May 30, 2003. For private sector estimates, see Hu (2002).

29. As reported in “Economy a Greater Indicator for NPLs”, *South China Morning Post*, Jan. 9, 2003.

30. See HKMA Annual Report for those years.

31. HKMA Annual Report 2002, p. 49.

32. See Hong Kong Trade Development Council Research Department (1991, 1993, 2001).

33. See Liu (2001), *passim*, for details.

34. See Jao (1997), pp. 62-63, and Annells (2002), for the attractiveness of Hong Kong’s tax regime. In the government budget for 2003-2004, the standard rate was raised from 15% to 16%, while the corporation profit tax was raised from 16% to 17.5%. Despite these increases, Hong Kong’s tax rates are still low by international standards, if tax havens are excluded.

35. *Shanghai Jingji Nianjian* (Shanghai Economy Yearbook), 2003, p. 479.

36. See "Shanghai is luring its neighbours", *South China Morning Post*, January 28, 2003.

37. It should be noted that the survey results reported in Tuan and Ng (2002) were compiled from a business management perspective, not from an IFC perspective. Moreover, of the 32 measuring items (questions) in the questionnaire, none is related to banking and finance. Hence, the survey is not strictly relevant to an IFC study, but can be used as indirect reference or evidence.

38. For the impact of the Asian crisis on the Hong Kong economy, see Jao (2001), Chapter 7; Ho (2002); Sung (2002); and Jao (2002).

39. See Chen (1996); Jao (2001), pp. 35-36 and 175-178.

40. See "Shanghai rises in world port rankings", *South China Morning Post*, February 6, 2003.

41. Hong Kong Monetary Authority, *Annual Report* 2002, p. 147.

42. *Ibid*., p. 142.

43. Underlying data from the Stock Exchange of Hong Kong.

44. *Shanghai Statistical Yearbook 2003*, Chapter 8.

45. *Ibid*., p. 188.

46. Census and Statistics Department, *External Direct Investment Statistics of Hong Kong 2002*, Table 1.

47. See Enoch Yiu, “HKEx snubs international pacts to focus on China,” *South China Morning Post*, June 2, 2003.

48. For the working of the CBA in Hong Kong, see *inter alia*, Jao (2001), Chapter 3, and Yam (1998).

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