Financial Statism as an Alternative Interventionist Approach in Developing International Financial Centres (IFCs): The Case of Shanghai since the 1990s

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Declaration

I, Dafeng Xu, confirm that the work presented in this thesis is my own. Where information has been derived from other sources, I confirm that this has been indicated in the thesis.

Abstract

As increasing numbers of developing countries seek to build their own international financial centres, it is critical to take account of this new phenomenon in the realm of development studies. Previous development theories have devoted a great deal of attention to the analysis of industrialisation in the manufacturing sector, but insufficient attention to this new subject. At odds with neoliberal laissez-faire evolution, the financial statism identified in this thesis as (a) state ownership in the financial sector; (b) financial restraint policies; and (c) state control over capital mobility and currency convertibility, suggests an alternative approach adopted by the Chinese state to develop Shanghai into an international financial centre from the 1990s.

It is argued that IFCs' development is multi-faceted and can only be addressed in a country-specific context. The study demonstrates that due to the imperfection of institutions and infrastructure in China as a transitional economy in the 1990s, financial statism has played an active role in maintaining socio-economic stability at macro level, creating market institutions and urban infrastructure at meso-level and precluding exogenous financial risks at meta-level. Despite the observation of several disadvantages and deficiencies, financial statism has successfully transformed Shanghai into a domestic financial centre at the nascent stage of China's financial development.

Utilizing a process-tracing method, it was also discovered that given recent contextual changes, the Chinese state has started to withdraw its financial statist regime, paving the way for a more open and liberalised market system to further transform Shanghai into an international financial centre. The thesis concludes that market-driven and state-led development can be complementary and financial statism might serve as invisible scaffolding in the development of an IFC, particularly in large, fast-growing emerging economies.

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List of Abbreviations and Acronyms

ABC	Agricultural Bank of China
AMCs	Asset Management Companies
BOC	Bank of China
CAR	Capital Adequacy Ratio
CBD	Central Business District
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CFETS	China Foreign Exchange Trading System
CFFE	China Financial Futures Exchange
CIRC	China Insurance Regulatory Commission
CPC	Communist Party of China
CSRC	China Securities Regulatory Commission
DCs	Developed Countries
DFC	Domestic Financial Centre
ETFs	Exchange Traded Funds
FDI	Foreign Direct Investment
FX	Foreign Exchange
GFCI	Global Financial Centers Index
ICBC	Industrial and Commercial Bank of China
IFCs	International Financial Centres
IFCD	International Financial Centre Development
IMF	International Monetary Fund
IPO	Initial Public Offering
LDCs	Late-developing-countries
LNG	Liquid Natural Gas
LOF	Listed Open-end Fund
LPG	Liquid Petroleum Gas
LSB	Large State-owned Bank

MNC	Multi-national Corporations
NBFIs	Non-Bank Financial Institutions
NDRC	National Development and Reform Commission
NPLs	Non-performing Loans
OTC	Over the Counter
PBoC	People's Bank of China
PWC	Price Waterhouse Cooper
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
QFLP	Qualified Foreign Limited Partner
RBS	Royal Bank of Scotland
RCCs	Rural Credit Cooperatives
REITs	Real Estate Investment Trusts
RMB	Renminbi
RQFII	Renminbi Qualified Foreign Institutional Investor
SAFE	State Administration of Foreign Exchange
SDRC	Shanghai Development Research Centre
SEZ	Special Economic Zone
SFIs	State-owned Financial Institutions
SFSO	Shanghai Financial Services Office
SHIBOR	Shanghai Interbank Offered Rate
SIFC	Shanghai International Financial Centre
SOEs	State-owned Enterprises
SMEs	Small and medium- sized Enterprises
SPFI	Shanghai Financial Prosperity Index
SSB	Securities Supervisory Board
SSE	Shanghai Stock Exchange
WEF	World Economic Forum
WFE	World Federation of Stock Exchange
WTO	Word Trade Organization

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1. Introduction

When one is about to take an inspiration, he is sure to make a (previous) expiration; when he is going to weaken another, he will first strengthen him; when he is going to overthrow another, he will first have raised him up; when he is going to despoil another, he will first have made gifts to him.

--Lao-Tzu,[1]
Tao Te Ching

We are living in a globalizing world. Economies and people have become more inter-connected than ever before. Outstripping increased cross-border flows of goods and services, the recent wave of economic globalisation since the 1980s has been marked by a surge in financial flows among advanced economies and more notably, between advanced economies and emerging economies (Roxburgh et al. 2011). Meanwhile, with advances in telecommunications and information technologies, international financial centres (IFCs) have been conceived as the nodes of a global network of cities that control financial flows (Poon 2003; Taylor 2005; Friedmann 1986). Over the past few decades we have witnessed the phenomenon of an increasing number of cities in large, fast-growing emerging economies beginning to build up their own international financial centres (see section 2.1).

Indeed, the surge of emerging economies has changed the landscape of global finance.

[1] Lao-Tzu was a philosopher and poet of ancient China. He is best known as the reputed author of the *Tao Te Ching* and the founder of Taoism.

According to IMF (2014), emerging economies have contributed 82 percent to the world economic growth in 2013. Even though they still remain relatively lowly ranked in terms of national income per capita, they are playing an increasingly important role in international finance. Some commentators have noted the global economic regime is shifting from control by several developed economies towards more developed and developing economies, particularly BRIC[2] countries (Yeung 2010; Rottier and Veron 2010).

Among the most striking issues related to such seismic changes are how these late-developing economies will be able to build their own IFCs. While there is a vast and rapidly growing literature on the IFCs' development in advanced economies (e.g. Kindleberger 1974; Cassis and Bussiere 2005; Faulconbridge 2004; Kendrick 1980; Reed 1980; Roberts 2004; Shirai 2007; Schenk 2007), the literature on the development of IFCs in emerging economies is rather inadequate. Since the 1980s, neo-liberalism has become the mainstay of economics while neo-classical analysis has been applied to traditionally non-economic subject matters such as political science, urban development and new public management (Wade 2009). This philosophy has inevitably influenced development studies in recent years. As recognised by Kindleberger (1974), the evolution of international financial centres such as London and New York was a long-term, self-sustaining and spontaneous process. The laissez-faire approach thus suggests that an IFC is gradually built up over time and transition from one phase to another occurs over a relatively long timeframe. According to neo-liberal logic, state intervention rarely determines the destinies of international financial centres in a lasting or fundamental way (see Cassis 2006).

The thesis emphasizes that a well-functioning international financial centre is based on a wide range of essential, coherent institutions, such as various financial firms (banks; security firms; insurance companies), markets (e.g. foreign and stock exchanges), associations and cooperatives. These will be accompanied by rules, norms and

[2] In 2001, Goldman Sachs's research report identified BRICs (Brazil, Russian, India and China) as a group of countries with the potential to catch up with the G-7 (see Wilson and Purushothaman, 2003). In 2010, South Africa joined the grouping.

regulations.

However, the laissez-faire approach advocated by neo-classical economists and neo-liberals often neglects the significance of institutional structures in developing countries. Therefore, the prescription they offer to LDCs is to follow the path of so-called Anglo-American model and to adopt neo-liberal policies of privatisation, deregulation, financial openness and liberalisation.

The thesis demonstrates that financial sectors in late-developing countries were significantly inferior to those in advanced economies. Hitherto, many developing countries lacked market institutions and there was little reason to presume that markets would develop on their own (Reinert 1999; Chang 2000). They were not only confronted by endogenous problems such as institutional weaknesses, market incompleteness and knowledge gaps, but also faced intense external competition from established foreign counterparts in this increasingly globalised world (see section 4.3.2).

Moreover, developing countries have less capacity for financial regulation and greater vulnerability to shocks (de la Torre et al 2007). When a market system is not established and the private sector is still in its incipient stage, the privatisation of a financial sector poses great risks, jeopardising the stability of the society and its economic development. Based on this, simply using neoliberal/laissez-faire approach advocated by the current advanced economies to develop IFCs in LDCs would retard and even block development.

Inasmuch as institutional development is crucial to the building of IFCs in developing countries, new institutional economics (NIE) provides some inputs for the role of the state in this process. Although the NIE is a neoclassical-inspired approach, it rejects the orthodox assumption of perfect information and costless transaction by adding institutions to the process of economic change (Menard and Shirley 2008). In this way, it has changed neo-classical economics from a static to a dynamic theory. Douglass North (1981, 1990a) has been leading the movement to study the broader institutional framework (including the role of the state) in shaping how markets and institutions function. To neo-institutionalists, the state has a dual role. On the one hand, it can specify rules to maximize societal outputs and play a developmental role. On the other hand, it can also drive off resources to the governing elites or class and become predatory (North 1979, 1981). Yet most of them maintain a faith in private ownership and argue that private property rights should be enforced by the state in order to encourage development (North 1981, p.21).

Since the 1990s, the various strands of liberal and neo-classical development approaches have been criticised by many scholars, analysts and commentators (Nolan and Wang 1999; Chang 2002; Brohman 1995; Evans 1995; Marois 2012). Drawing upon the East Asian Miracle, the so-called 'developmental state view' is the antithesis of neo-liberalism. The critics argue that late-developing countries face different problems than advanced economies and state intervention in industrial policies is necessary (Johnson 1982; Amsden 1989；Wade 1990). The state can be an important substitute for market failure that often occurs at the developmental stage of an economy. Yet it should also be mentioned that the limitations of a developmental state, e.g. soft-budget constraints and conflicts of interest, are consistently challenged by other commentators (e.g. Krueger 1990; Lardy 1998, 2012).

In the 1990s, Aoki et al. (1998) shifted the problem of state-versus-market dichotomy to a market-enhancing view, emphasising the state's role as the facilitator of private-sector coordination. This new emerging view recognises market forces in the allocation of resources but contends that there might be room for well-designed, restricted state intervention in collaboration with the private sector to foster economic development. However, studies of the development of IFCs have not drawn as much attention as other literature in this area, which has mainly focused on manufacturing, exports and industrialisation.

Based on the cited changing intellectual contexts, this thesis seeks to explore the changing role of the state in the development of IFCs, particularly in large, fast-growing emerging economies. This task is an important one as the debate on the "market-driven" and "state-led" for IFCs' development has created polarisation in both academic and policy circles (e.g. HPEC 2007; Pan et al 2010). The first step of our efforts is to explore an alternative interventionist approach adopted by the Chinese state in developing Shanghai into an IFC since the 1990s.

The thesis demonstrates that well-designed state intervention at early stage of IFCs development is necessary due to widespread endogenous institutional failures and external competitions in late-developing countries. In this thesis, this alternative approach termed as "financial statism" refers to a composite of state-owned financial institutions (SFIs)[3], financial restraint policies and a capital control regime. Conceptually grounded in the recently articulated market-enhancing perspective, it emphasizes that at a certain stage, financial statism approach can be helpful to reinforce market institutions and improve related infrastructure necessary to the development of IFCs in a large emerging economy like China. Chapter 4 introduces the conceptual model of financial statism while Chapter 9 presents a further discussion on the limitations and evolution of financial statism following the SIFC case study.

In addition to constructing a conceptual model, we adopt a broader and more inclusive perspective on the formation of an IFC. More particularly, the thesis develops an analytical framework that distinguishes four levels of development:

(1) The micro-level of financial markets and institutions agglomeration
(2) The meso-level of urban and business environment in a host city
(3) The macro-level of political and macro-economic conditions for the hinterland
(4) Meta-level connectivity to a global network (see section 3.5).

This analytical framework allows the development of a schema to understand what can be done to facilitate the formation of an IFC in LDCs and what cannot be achieved, at least not in the short term.

In the case of Shanghai, we examine the impact of Chinese's financial statism on IFC development at macro-, meso- and meta- levels (see Chapter 6). Utterly conflicted with the Anglo-American model of financial liberalisation, the case study shows that the Chinese state has masterminded a huge transformation in Shanghai International

[3] State-owned financial institutions (SFIs) include a wide variety of institutions, such as commercial banks, development banks, postal banks, insurance companies, credit guarantee funds, leasing firms, etc (Luna-Martinez and Vicente, 2012).

Financial Centre (SIFC) development under financial statism. The research project enables an understanding how financial statism as alternative approach may - or may not - promote the development of SIFC.

The findings of the case study suggest that at the early stages of market development, China's state banks and its interest rate control policies are successful in mobilising deposits from the household to the strategic sector, championing SOEs' market reforms and stimulating economic take-off. Hence financial statism has a significant impact on macro-economic conditions of a host country, and thus the progress of financial centre development. In addition, financial statism policies have also been effective in modernising infrastructure and improving the investment environment, which has boosted the agglomeration of various financial institutions and markets in Shanghai. It is evident that financial statism has been successful in developing Shanghai into a domestic financial centre in the 1990s. Yet the study also shows that this approach has its limitations and constraints, which have impeded Shanghai transforming from a domestic financial centre into an international one (see chapter 7). Given recent contextual changes, it is also discovered that the Chinese state has started to withdraw its financial statism policies, paving the way for a more open and liberalised market system to further transform Shanghai into an IFC (see chapter 8).

The central argument employed is that an approach that determines the evolution of IFCs' development is shaped by constraints derived from the past and the consequences of innumerable incremental choices of a state authority that continually modify such constraints. In this way, this thesis extends further the market-enhancing view. Therein we suggest that financial statism is likened to "invisible scaffolding". Just as scaffolding is necessary to provide temporary assistance when erecting a building, financial statism is also a supportive aid in the shaping of international financial centres, particularly in late-developing countries. The scaffolding metaphor offers a better understanding of both the changing role of the state in IFCs' development and an explanation for the differences between developing and advanced economies with regard to financial development. We conclude that financial statism is better to be withdrawn or dismantled after functional, competitive market institutions have been established in LDCs.

The quotation at the beginning of this chapter from Lao-Tzu, an ancient Chinese philosopher and Taoist, is consistent with this broad, dialectic and necessarily complex view of the financial statism approach. According to Taoism, *yin* and *yang* are two universal concepts used to describe how apparently opposite and contrary forces are actually complementary, interconnected and interdependent in the natural world (Porkert 1974), e.g. male and female, light and dark, active and passive, motion and stillness. In the process of IFCs' development, market institutions (structure) and state managers (agency) are considered symbiotic. Financial statism postulates that market structures constrain but do not determine the outcome of IFCs' development. Rather, state managers are able to configure and reconfigure market structures through deliberate policy efforts, which may lead to the success of an IFC in late-developing countries. Financial statism as scaffolding represents a similar philosophy in the context of IFCs' development where two opposites (market-driven versus state-led) co-exist in harmony and are able to cross-pollinate, thereby destroying the duality.

This thesis seeks to avoid simplistic, ideological views, instead aiming to develop a more nuanced approach to IFCs' development based on a synthesis of current research and operational experience. The building blocks of the theoretical framework can be described as threefold:

(1) The theory related to the formation of IFCs, particularly contributory factors to their development
(2) A focus on the perspectives of the role of the state on economic development
(3) The theory of international finance, with an emphasis on financial restraint policies, capital control regimes and their impact on IFCs' development.

Meanwhile, several theoretical deductions draw upon insights from new institutional economics and interventionist perspectives in development theories. It is hoped that this study would shed some lights about the changing role of the state, the IFC evolution in late-developing countries as well as conditions underlying this dynamism.

Outline of the Dissertation

After the introduction, chapter 2 presents the research context of the dissertation. It starts with a brief discussion of the IFCs evolution in an era of globalization and goes on to review the key issues faced by IFCs in large, fast-growing developing countries. Moreover, the contextual background of the case study is presented – why China needs to build Shanghai into an international financial centre?

Chapter 3 provides a systematic literature review of concepts, mechanisms and contributory factors of IFCs' development. Three sets of different theoretical perspectives are examined; the neoclassical economic perspective, the socio-geographical perspective and the financial-growth perspective. Based on this, I have created an integrated multi-layer framework of IFCs' development, which provides a sound foundation for further study on the role of state.

Chapter 4 focuses on the role of the state in various discourses on development approaches, from laissez-faire development views to various state interventionist views. Based on critical analyses and characteristics of IFCs' development, an alternative interventionist approach - financial statism - is developed.

Chapter 5 addresses methodological issues, particularly the strengths and weaknesses of a single case study as a method in the study. The research question and hypothesis of the dissertation is also presented.

Chapter 6 investigates China's financial statism and its impact on SIFC development at macro, meso and meta levels. The research findings provide a counter-example to the conventional wisdom in the Anglo-American model of IFCs' development. The study shows that financial statism provided a "helping hand" to SIFC development particularly during China's economic transition in the 1990s. Three main positive outcomes of financial statism are presented: (a) the maintenance of economic development and social stability at a macro-level; (b) the fostering of market mechanisms and infrastructure at a meso-level and; (c) the reduction of external risks at a meta-level.

Chapter 7 provides a micro-level evaluation of the performance of SIFC since the 1990s, focusing on the evolution of financial markets, institutions, services and human capital in Shanghai. Meanwhile, a comparative analysis is made between the status of SIFC and other IFCs in the major developed and emerging economies. The study suggests that despite of some deficiencies and disadvantages, Shanghai made remarkable progress to become a financial centre enabled by a regimen of financial statism.

Chapter 8 discusses the recent changes to financial statism following China's accession into the World Trade Organization (WTO), including diversification of ownership in the banking sector, the liberalisation of interest rates and the internationalisation of the Renminbi. The underlying reasons behind these changes are anatomised. The case of Shanghai shows that Chinese financial sector is leaning towards a greater emphasis on market mechanisms and away from administrative rule.

Chapter 9 offers a metaphor of scaffolding to explain the changing role of Chinese state in SIFC development. It is suggested that financial statism might be regarded as invisible "scaffolding" – a deliberate development strategy designed by the Chinese state in the process of transforming Shanghai into an international one.

Chapter 10 provides concluding remarks on the role of the state in developing international financial centres. It summarises the research findings and analyses the strengths and limitations of the scaffolding metaphor. Some policy recommendations regarding the role of the state in IFCs' development for late-developing-countries are provided at the end. It emphasises that LDCs should find an approach based on their own contextual setting, rather than replicating the practices of developed countries.

2. Research Contexts

> *Who controls the food supply controls the people; who controls the energy can control whole continents; who controls money can control the world.*

------ Henry Kissinger

This thesis mainly deals with the changing role of the state in IFCs development for large, fast-growing emerging economies. This chapter describes the contextual background of this study. The first section presents a brief history of IFCs evolution as well as their new characteristics in the recent wave of financial globalisation. Next, I identify several key issues that are faced by IFCs development, notably in large, fast-growing developing countries. The section 2.3 introduces the contexts of the case study– Shanghai's re-emergence as an international financial centre since the 1990s.

2.1 IFCs Evolution in a Globalizing World

The financial centres are not new in economic terms. In ancient times, Samarkand[4], Marrakech[5], Babylon, Timbuktu[6] and Constantinople all functioned as major financial centres, providing "brokerage, credit and allied services" to the trade (Mainelli 2006). During the Renaissance, the city states of Venice, Florence, Naples and Genoa became

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4 Samarkand is currently the second-largest city in Uzbekistan and is most famous for its central position on the Silk Road between China and the West in Ancient times.

5 In the 12th century, Marrakech was the most important city in former imperial Morocco and a cultural, religious, and trading centre for sub-Saharan Africa.

6 Timbuktu flourished from the trade in salt, gold, ivory and slaves and was part of the Mali Empire early in the 14th century.

mercantile centres that dominated trade between Europe and the Orient from the 14th to 16th Centuries. Nevertheless, the modern financial centres only emerged in the 18th and 19th Centuries with the ascendancy of the Anglo-American centres. London and New York have still maintained their pre-eminent positions to the present (see Fratianni 2008; Cassis 2006).

At the end of World War II, the United States consolidated its power as the supreme political and economic leader of the World and the US dollar became the dominant currency for international settlement and reserve. From then on, the world entered an era of stability in international financial system terms until the collapse of Bretton Woods in the 1970s. Since then the world has witnessed oil crises, the expansion of multinational companies, the rise of Euro-dollar and Asia-dollar markets and the unleashing of control over capital movements by many governments. Contemporaneously, there have been periods of fluctuation in the money and capital markets and changes in the patterns of the international financial system.

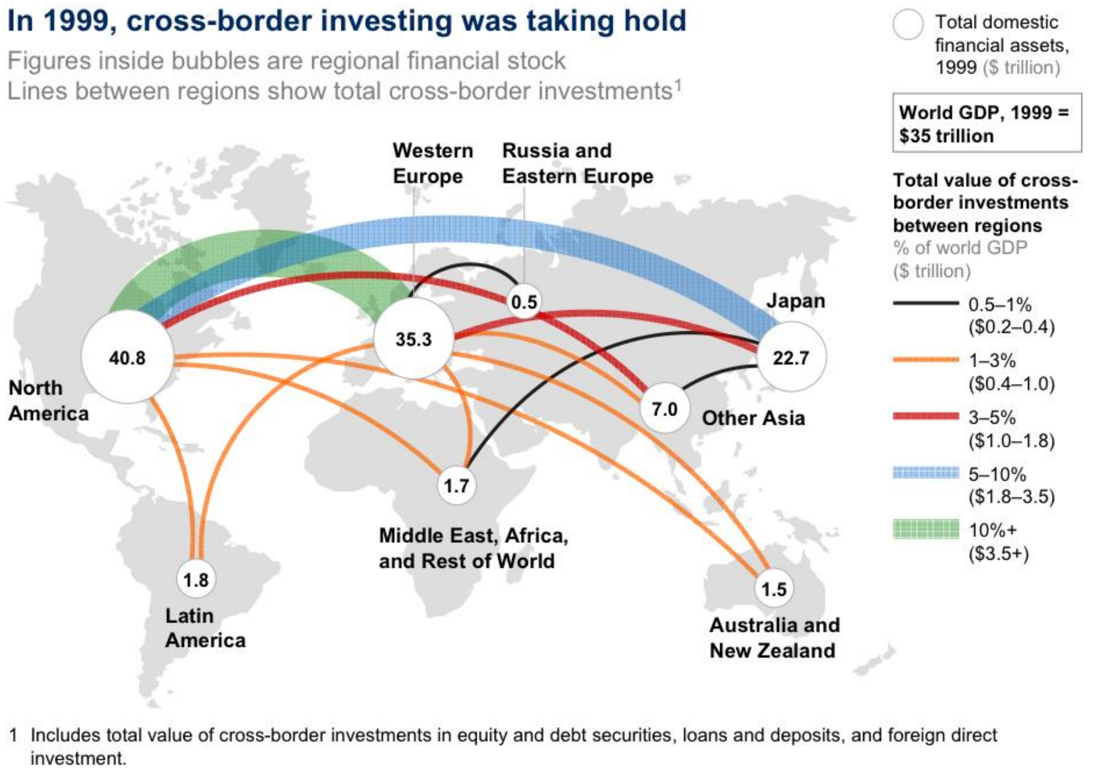
Since the 1970s, financial centres have started to spread into small developing countries and regions such as the Caribbean, Panama, Singapore, Hong Kong, Bahrain, Beirut and the Channel Islands, most of which were former colonies of Western powers. Unlike New York and London, in the main these financial centres have no direct link with the real economies in their own countries. They mainly deal in foreign currencies and primarily provided services for non-resident clients, facilitated by freedom from regulation, taxes and exchange controls (Park, 1982; IMF 2000). These centres were thus able to offer favourable environments that were able to obviate the various constraints that might arise in onshore financial centres. They were variously termed “offshore centres”, “paper centres”, or “tax havens”. However, after the 1990s, most of these centres have declined, with the exception of Singapore and Hong Kong.

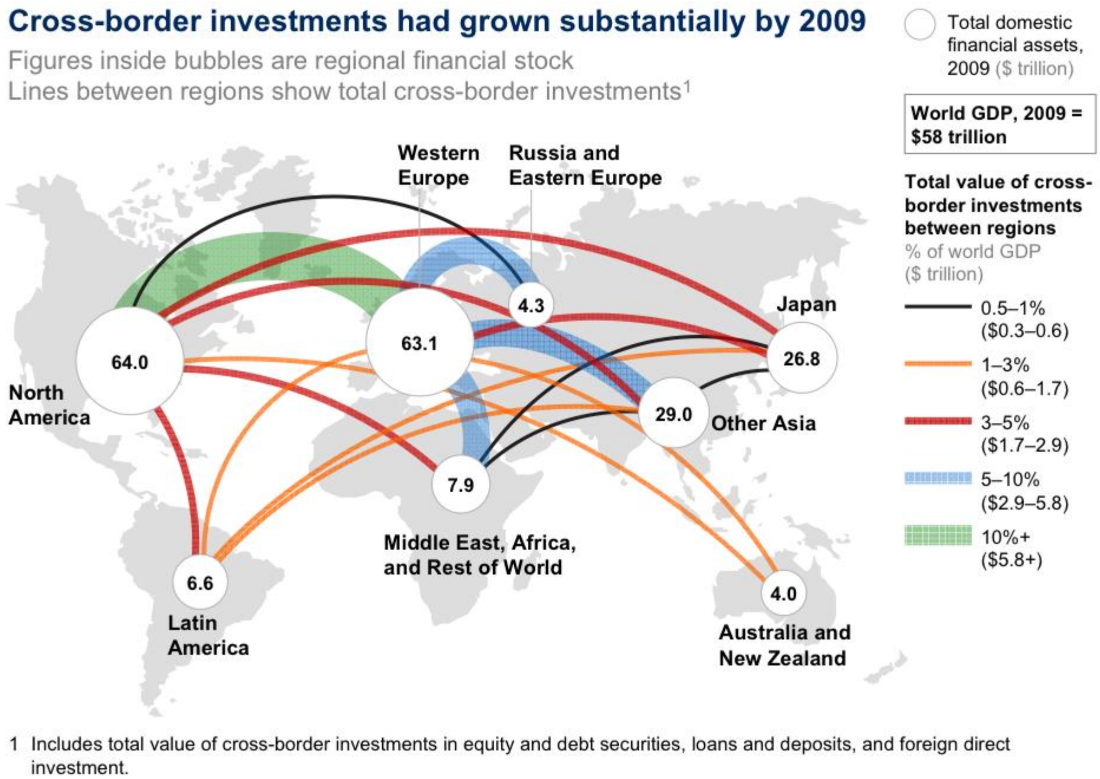
In recent years, economic globalisation has enhanced integration of world economic activity through increased cross-border flows of a greater variety of goods and services. In the past two decades, the world has seen resources, especially capital, shifted more speedily from West to East – and from North to South. In particular, financial flows have experienced exponential growth. According to a survey from McKinsey Global Institute, global financial stock has increased sharply from USD 12 trillion in 1980 to

USD 212 trillion in 2010. The increase of capital flows increased dramatically in the last two decades, particularly among developing and undeveloped countries. Since 1995, cross-border capital flows have tripled and peaked at USD10.9 trillion in 2007. Although they declined sharply in 2008 and 2009 due to the global financial crisis, there was a rebound in 2010 with capital flows totalling USD 4.4 trillion (Roxburgh et al 2011). Figure 2.1 depicts the total domestic financial assets and their cross-border movement in 1999 and 2009 respectively. As we can see, capital movements across borders in 1999 were mainly taking place between developed countries, such as the United States, Western Europe and Japan; while financial assets in developing economies were relatively small. In 2009, domestic financial assets in emerging economies increased dramatically and cross-border investment became more frequent among developing countries. Such large capital flows require international financial centres that are able to process large volumes and international transaction.

Moreover, it is also notable that in the past few decades, a new direction of global capital flows has emerged. In the conventional central-periphery model, the centre controls and influences the periphery and exports financial capital and high-value industrial goods to the periphery (Subacchi 2008). Since the late 1970s, OPEC countries have accumulated a large amount of capital through oil trade surpluses. In 2008, some 40% of global foreign currency reserves were held in the Middle East. Since the global financial crisis in 2008, the world's geopolitical arena has been undergoing major adjustment, which has been bringing about a rebalancing of economic power between developed and developing countries (Yeung 2010).The emerging economies have achieved strong economic growth amid recovery and are playing an increasingly important role in international finance. A report from The World Economic Forum states that capital has recently flown from emerging economies, such as China and the Middle East, to developed markets, such as the United States (WEF, 2010a). Following the East-Asia miracle, China and other countries in south-eastern Asia also hold large foreign currency reserves generated by trade surpluses. This has greatly altered the landscape of the global economy and has a direct bearing on the necessity of IFCs' development for developing countries.

Figure 2.1 A comparative analysis of cross-border investment between 1999 and 2009





Source: Roxburgh et al (2011)

In an increasingly globalized world, international financial centres are substantially different from their historical counterparts. To a certain degree, international financial centres have been transformed from a geographic concept to a functional one. One might say that financial centres, rather than banks, have become the key apparatus for financial intermediation. Poon (2003) described international financial centres as one of the "control centres of global financial flows". As argued by Castells (2000a), international financial centres in the Information Age cannot be reduced to a small number of cities at the top of a hierarchy. Beyond the main global cities, other continental, national, and regional economies have their own nodes that connect to the global network (p.443). He also points out that the hierarchy in the network is neither assured nor stable, but is subject to fierce inter-city competition. His argument has at least two implications. Firstly, IFCs are the nodes or hubs of capital flows in the global network and; secondly, developing countries should also establish linkages to the global network through the creation of IFCs.

In the past two decades, the development of international financial centres (IFCs) in large, fast-growing developing countries has become increasingly noteworthy and prevalent. Cities such as Shanghai, Mumbai, Sao Paulo, Moscow, Seoul and Istanbul are all vying for becoming international financial centres (see Table 2.1). The new phenomenon has been driven by the rapid pace of economic globalisation, coupled with tremendous advances in telecommunications and electronic networks. Rottier and Veron (2010) describe the new context of financial integration "financial multi-polarity", and suggest that the geography of global finance is rapidly evolving from a mainly North Atlantic focus towards a much broader territory. Nasser Saidi, Chief Economist of the Dubai International Financial Centre, claims that the rise of the emerging world will inevitably force the global financial system to change from a "hub-and-spoke model" (with London and New York as the hubs) to a spider's-web model of many interconnected hubs (The Economist 2012). Lu Hongjun, the president of Shanghai Institute of Finance, also asserts: "The global layout of financial centres will become pluralistic with both developed nations (such as the United States, the United Kingdom and Japan) and new economies such as the BRIC nations playing key roles" (Ma, 2009).

Table 2.1: Development of IFCs in large, fast-growing developing countries

- **Seoul, South Korea.** The South Korean government launched its Northeast Asian Financial Hub for Seoul in 2003 and published a detailed action plan aimed at achieving this goal in July 2005 (Yeung 2010).
- **Mumbai, India.** In 2007, the Indian Ministry of Finance published a report on Making Mumbai an International Financial Centre, written by the High Powered Expert Committee (HPEC 2007).
- **Istanbul, Turkey.** The Turkish Government aims to make Istanbul "a regional and global financial centre", and included this aspiration in its Ninth Development Plan covering 2007-2013(IFC-Istanbul 2008).
- **Moscow, Russia.** In May 2008, Russia announced it would build Moscow into an international financial centre by 2025. Dmitry Medvedev, the then Russian President, delivered a thesis at the 12th International Economic Forum in Saint-Petersburg, stating: "Converting Moscow into a strong financial centre, and converting the rouble into a leading regional reserve currency, are the key components to secure competitiveness of our financial system" (GOM, 2008).
- **Shanghai, China.** On April 29, 2009, the Chinese central government formally stated that Shanghai would become an international financial centre compatible with the country's economic strength and the Renminbi's international status by 2020.

Source: compiled by author.

In short, as increasing numbers of developing countries seek to build their own international financial centres, it is critical to take account of this new phenomenon in the sphere of development studies. An efficient financial services sector has direct consequences for economic growth. The promotion of financial and other relevant services is significant for developing countries as it enables them to use financial resources from home and abroad more efficiently. The big questions now are；

- How will these late-developing economies be able to build their own IFCs?
- What will this mean for the developed countries that have dominated this arena?

2.2 Key Issues Faced by IFCs in Large, Fast-growing Developing Countries

Traditionally, IFCs have been connected with advanced economies. The literature on IFCs' development in emerging economies is rather sparse. Despite this there are some discussions in extant literature regarding relevant topics in large, fast-growing developing countries, including India, Russia, Nigeria and China. This thesis now aims to highlight three key issues faced by IFCs in these countries: Internal challenges, external competition, and policy options.

Internal Challenges

The major internal challenges faced by IFCs in developing countries include institutional weaknesses, market deficiencies, and urban environment unattractiveness. For example, HPEC (2007, p.xxi) report identifies two key deficiencies in financial markets in India that have impeded Mumbai's emergence as an IFC. Firstly, the absence of a 'properly functioning bond market, a currency market and a derivatives market for currencies and interest rates', and secondly, the absence of 'institutional investors (e.g. mutual funds, banks, insurance companies and pension funds) that have the size, visibility and capability of those in established IFCs'.

In Russia, Moscow also faces a wide range of challenges in its attempts to build an IFC. Ogloblina (2012) demonstrates that the business environment in the Russian capital does not appeal to foreign investors. Poor infrastructure, e.g. transport, communications networks, etc., are other negative factors. In Nigeria, despite the aspiration of the federal government to become Africa's major international financial centre (FGN 2007), Olaseni and Alade (2012) cite infrastructural weaknesses for thwarting this ambition.

To counter these challenges, some cities (e.g. Moscow, Bangalore) have adopted a new paradigm, so-called "entrepreneurial urban management" (Kolossov and O'Loughlin 2004). The key feature of this approach is to introduce private sector and market forces in the creation of an IFC in developing countries. This approach is also questioned by some commentators. For example, Goldman (2011) observes that hot money - US hedge and derivative funds in particular - flooded Bangalore and other Indian cities after the

2008 global financial crisis, pursuing high returns in the name of “world-city” making. He termed this phenomenon “speculative urbanism”, as competing cities have leveraged their infrastructure and lands to attract foreign and private capitals to improve city life. The large-scale re-capitalisation cities in emerging economies has given rise to new problem of social justice, as numerous residents are displaced and the poor people have often suffered the most (Goldman 2011).

External Competition

In the meantime, the race among cities either in developing countries or in the developed world to establish themselves as IFCs has intensified (Jarvis, 2011; Young et al., 2009). In the Asia Pacific region, aside from well-established IFCs – Tokyo, Hong Kong and Singapore - cities such as Sydney, Shanghai, Wellington, Seoul and Taipei have all launched new initiatives since the 1990s aimed at becoming international financial centres. Yeung (2010) was optimistic about the prospect and opportunities for financial centres in Asia Pacific. In a vision of emerging Asia, he claimed Asia’s major financial centres were poised to gain even greater prominence as hubs of business and creation in the post-crisis era of increased globalisation.

However, competition among IFCs can be a double-edged sword. On the one hand, competition among IFCs breeds efficiencies in financing and increases returns on investment. On the other, it may also bring new risks, such as increased market volatility, financial risk contagion, and harmful tax and subsidy competition (Young et al. 2009). In particular, Young et al. (2009) warned that intense competition among IFCs in the Asia Pacific area may lead to greater regional fragmentation instead of integration. They discovered an interesting phenomenon whereby funds in surplus countries were not moving in very large amounts to countries within the region that were looking for such fund but to the global financial centres, such as New York and London. Similarly, the City of London remains sceptical about the future of IFCs in Asia, citing an important structural weakness. While the United States and European markets are built upon single currencies and unified regulatory environments, IFCs in the Asia Pacific region are hampered by fragmented financial structures due to a range of different currencies and regulatory environments[7] (City of London 2008).

To cope with unbridled competition, Young et al. (2009) suggest IFCs in the region should co-operate more and establish an integrated Asia-Pacific IFC network. However, this seems to be a wishful thinking as geo-political situation in this region is much more complicated (see Smith 2009).

Policy Options

Faced with both internal problems and external competition, IFCs have increasingly become components in a deliberate strategy designed by policy makers or market participants (Lannoo 2007).To some extent, IFCs competition is a function of global competition among policy regimes in terms of capability and effectiveness (Young et al. 2009; HPEC 2007). Although there are some pioneering studies on the state-led/agency-driven global city formation (e.g. Zhang 2014; Amen et al 2006), inquiries into the role of the state in IFCs' development are rather inadequate. In particular, investigations into the theoretical paradigm of the "state-led approach" in the evolution of international financial centres are relatively rare.

There is a gap in studies concerning the role of the state in the development of IFCs: How and why financial clustering and agglomeration occur and to what extent the nation-state is able to facilitate the concentration of markets, firms and people into one place. In particular, this thesis identifies three open policy questions associated with IFC development in developing countries.

Firstly, to what extent state-ownership in a financial sector has affected the IFCs' development in LDCs? There have been heated debates on whether the state should

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[7] One might question that the UK is not part of the Eurozone , but London remains preeminent in the IFCs hierarchy. Thus the lack of unitary currency does not seem to be an obstacle to IFCs development. Yet it is the fact that European economic integration is much more advanced than that in Asia Pacific Region.

maintain a privileged position over other economic agents in terms of access to financial resources (see HPEC 2007, pp.188-189). La Porta et al. (2002) claim that the competitive weakness of the financial sector in developing countries is due to the nature of state ownership, asserting that state-owned banks are less innovative and efficient than private ones, handicapped by corrupt politicians and incompetent employees. According to neo-liberal theorists, the only efficient and complete way to improve the financial sector in developing countries is to transfer property rights from the state sector to private ones (see Shirley 1997, 1999; Shirley and Walsh 2000). Privatisation and the free market would quickly enhance the allocative efficiency of economic and financial resources, thus contributing to high-quality growth (Kolodko 1999).

In the contemporary developing world, state ownership in financial system is quite commonly seen. La Porta et al. (2002) observed that state ownership of banks remained prevalent: in an average country, 42 percent of the equity in the 10 largest banks was still state-owned in 1995 after many countries had undertaken privatisation. In some developing countries such as Algeria, Belarus, China, Egypt, India and Syria, the asset market share of state banks still exceeded half the assets of the banking system in 2010 (World Bank 2012). At odds with developing countries, most advanced economies such as United States, the United Kingdom and Japan hold lower percentages of state ownership in financial sectors.

One particular issue related to this question is whether late-developing countries should privatise their financial industries, such as their banking sectors, to promote IFCs' development. Some economists argue state ownership has caused competitive weakness, low efficiency and lack of innovation (e.g. La Porta et al., 2002) in LDCs. In India, a HPEC (2007, p. 195) report recommended the reduction of "the state's present shareholding in all types of financial firms to below 49 percent by end-2008, below 26 percent by end-2010, and toward a full exit by 2015" in order to enhance its competitiveness and allow Mumbai to emerge as an IFC. However, the World Bank (2001) notes that in those countries (e.g. Thailand, South Korea and Indonesia) with rapid privatisation and liberalisation of their banking industries, these states paid a huge price and had to re-nationalise the banking sector amid the financial crisis. For example, in South Korea state ownership in the banking sector increased from 20 percent to 40 percent, and such ownership hit 80 percent in Indonesia (it was 40 percent before the crisis).

Secondly, should deregulation and free market forces be the catalysts for late-developing countries to establish an IFC? Neo-liberal economists highlight the significance of financial development on economic development in developing countries (e.g. Goldsmith, 1969; Shaw, 1973; Obstfeld, 2007). Most of them argue financial repression is a substantial barrier to successful economic development, particularly for late-developing countries. They have advocated that the financial sector in developing countries should be more liberal and open to the developed world. In contrast to the neo-liberal view, Gerschenkron (1962) argues that the state should become directly involved in organising financial markets in order to kick-start a developmental process, so as to compete with already-industrialised countries. Some developing countries also employ financial restraint policies, such as deposit rate controls, restricting competition in the financial market and adopting policies to curb asset substitutability (Hellman et al., 1998). Nevertheless, research into the financial restraint policies on the IFCs' development in developing countries is ambiguous and unverified.

Thirdly, how significant it is to have free capital flows and full currency convertibility in the development of an IFC in late-developing countries? As the defining feature of an IFC, full access to international market and currency convertibility are critical to success. Therefore, is it appropriate for developing countries to lift their capital control regimes as early as possible as a way to promote IFCs' development? Yet in the real world, most of developing countries still impose stringent capital controls across borders, such as China, Brazil and India. Is this in conflict with their goals and what are the implications of capital control policies to IFCs' development in LDCs? These are the interesting questions we would like to address in this thesis.

The investigation of the role of the state on IFCs development is a challenging task, since it is closely associated with the relationship between the state and the market, which has been a controversial topic in the academic arena for many years (see Brett 2009; Martinussen, 1997; Rueschemeyer and Evans 1985). Given different political, cultural and historical contexts, there is arguably no uniform model that can be applied to all the LDCs in terms of IFCs' development. Therefore, to get to grip with these problems, it would be more feasible to address them only in the context of country-specific circumstances and institutional features.

2.3 The Re-emergence of Shanghai as an IFC: A Case in Point

In this thesis, I use Shanghai as a case study to examine the role of the Chinese state in developing its own international financial centre. Shanghai used to be a leading financial centre in East Asia in the early 20th Century. As early as 1847, a British-Indian Joint Venture, the Oriental Banking Corporation opened its branch office in Shanghai as the first foreign bank in the city (Kuilman 2005, p.12). Three years later, the Imperial Bank of China began operating in Shanghai (Cheng 2003, p. 25). In 1936, Shanghai was the seventh largest city in the world with a population of 3.81 million (Yatsko 2001, p.56). At that time, the turnover of the Shanghai Stock Exchange was the third largest in the world after New York and London. About 90 percent of the country's financial assets and over half its foreign trade were concentrated in Shanghai. However, the city's progress as an economic and financial hub was disrupted by the second Sino-Japanese War (1937-1945) and the following civil war (1947-1949). A large number of entrepreneurs and bankers fled to Hong Kong and Shanghai was eclipsed by Hong Kong thereafter (Yang, et al. 2010, p.4).

When the Chinese Communist Party won the civil war, they embraced the Soviet socialist model of economic development. According to Chinese traditional version of socialist political economy, financial services were "non-productive labour" and a hotbed of speculation and exploitation (Wu 2007, p.298). The centrally-planned economy thus focused its attention on the growth of material production. After 1949, Shanghai turned into an industrial city and the largest manufacturing base in the country. In the 1960s and 1970s, Shanghai was the bridgehead of the centrally-planned economy with the proportion of State-owned Enterprises (SOEs) in excess of 85 percent. These SOEs, primarily manufacturing companies, were able to source cheap raw materials and low interest loans, from which they could make profits and then remit these to the central government. During that period, Shanghai was perceived as the "cash cow" of the country (Han 2000). In 1978 Shanghai's population represented only one percent of China's total and its land area constituted only 0.06 percent of the country but it contributed 10 percent of overall GDP, 33 percent of foreign export trade and 16 percent of fiscal revenue. As Logan (2010, p.5) notes:

> With the reunification of the country under the Communist Party after 1949, China maintained a defensive posture toward the West and had tense relations with the Soviet Union…during the period of the Cultural Revolution policy was aimed at creating self-reliant domestic development. The government pursued an anti-urban agenda, seeking to decentralize production and reduce inter-regional and rural-urban inequalities, with a large share of the cost financed by transfers from historically more productive centres like Shanghai.

From the late 1970s, China began carrying out top-down market reform. However, Shanghai played a "rear guard"[8] action as the central government was concerned the risks that reform would bring might undermine its fiscal revenue and economic stability. Nevertheless, Shanghai's SOEs lost the exclusive privileges they enjoyed under a central planned economy. Access to cheap energy and raw materials was no longer its preserve. However, Shanghai still needed to remit a fixed proportion of its tax revenue to the central government. Consequently, financial conditions in Shanghai deteriorated and little was invested in the built environment during the 1980s. The city suffered from "a lack of transportation facilities, a housing shortage and a crisis of environmental pollution" (Newman and Thornley, 2005, p.238) and lost its capacity for further development. During that period, its economic growth was relatively slow compared with other provinces in the country.

In order to reinvigorate the city's economy, the Shanghai Municipal Government (SMG) conducted a strategic review of the city's developmental master plan – with a view to uncovering new engines to power the city's growth. Between 1984 and 1987, a large number of scholars, senior officials and practitioners were brought together to provide recommendations for the city's future development. Wang Zhan, the Director of the Shanghai Development Research Centre (SDRC), made the following comments

[8] For reasons of stability and safety, Shanghai was not be included as the Special Economic Zone (SEZ) in the early 1980s with other four SEZs in South China (namely Shenzhen, Zhuhai, Shantou and Zhuhai) that enjoyed favorable policies for their economic development.

regarding the threats faced by Shanghai in the 1980s and the opportunities for it.

> First, the main advantage of the city in the 1980s was sizable state-owned manufacturing sector, which was linked to revenue remittance to the central government. Following that model, the city could hardly obtain enough revenue for its regeneration and was thus unsustainable. Second, to break this vicious circle, what Shanghai could do was to generate a stronger tertiary sector, through lobbying the central government for more preferential financial policies. More specifically, Shanghai desperately wanted to have greater latitude for raising capital from financial markets to fund a new wave of urban regeneration[9].

As a result, a blueprint was mapped out in the consultative report *Shanghai: going forward to the 21st Century* to rejuvenate the city as an international economic, financial and trading hub. From the outset the Shanghai International Financial Centre (SIFC) was a local initiative by the municipal government to regenerate its vapid economy and dilapidated urban environment.

Shanghai's IFC development was finally endorsed by the central government. The pre-eminent Chinese politician, Deng Xiaoping stated:

> Shanghai used to be a financial centre, a place where the currency was freely convertible, and in the future, Shanghai should continue to serve as a financial centre…If we want to have a seat in the world of finance, we need to rely on Shanghai (Deng 1993).

In 1992, the 14th National Congress of the Communist Party passed a resolution to build Shanghai as "the dragon head and one of the international economic, financial and trading centres to drive the growth of the Yangtze River Delta and in turn the take-off of the whole economic region" (quoted in Wu 2003, p.1684). Since then, SIFC development has been boosted by the endorsement of the central government. Although Shanghai was a leading financial centre in the 1930s, China's financial industry was seriously restrained afterwards and its financial markets were closed over the 40 years of the planned economy. Therefore, the bid to rebuild Shanghai into an IFC was doomed to be a journey full of perplexity and exploration.

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[9] These two points were made by Wang Zhan in a meeting, when the author was a research fellow in SDRC.

Table2.2: Shanghai's ranking in global financial markets (2010)

Financial Markets	**Parameters**	**2010**	**Global Ranking**
Stock Market	Market capitalisation (USD billion)	2,644	5
	Market turnover(USD billion)	4,495	2
	Capital raised by share(USD billion)	82	4
Bond Market	Market outstanding (RMB trillion)	20.3	5
	Market turnover (RMB trillion)	64.5	N.A.
Financial Futures Market	Turnover (RMB trillion)	82.1	N.A.
	Volume (10,000 hands)	9,175	29
Gold Market	Market turnover (RMB trillion)	1.6	1
Foreign Exchange Market	Daily Average turnover (USD billion)	19.77	22
Interest Rate derivative market	Daily Average turnover (USD billion)	1.52	22

Source: World Federation of Exchange, SFPI (2011)

Transforming the SIFC development from a local initiative to a national strategy was a significant step towards gaining political support from the central government. From 1990, the Chinese state played an active role in the process of SIFC development. Shanghai thus shifted its role from "rear guard" to "spearhead" when it came to market reform in China. From 1992 to 2007, Shanghai experienced 16 consecutive years of double digit growth (see Table A3 in Appendix 2). By 2010 Shanghai had become the centre for many of the country's financial activities, including stock exchange trading, inter-bank lending, bond trading, foreign exchange trading, futures and commodity trading. A broad variety of financial products and instruments were also introduced to the market; including A shares[10], B shares[11], Treasury bonds, corporate bonds, convertible bonds, repos， outright forward contracts, interest rate swaps, margin buying and short selling, exchange traded funds (ETFs), listed open-ended funds (LOF) and

[10] A-shares: denominated in RMB and available to domestic investors and OFII.

[11] B-shares: traded in USD or Hong Kong dollars, were available originally to foreign investors only. Since 2001, domestic investors have been allowed to use foreign currency to invest in B shares.

warrants etc. There is also ample evidence that Shanghai’s financial markets made extraordinary advances in their breadth and depth as well as in the agglomeration of financial institutions (see chapter 8 for details). Table 2.2 shows several indicators that Shanghai’s financial market had risen to the top 10 worldwide by 2010.

The case of Shanghai and its unique context make it significant for the study for IFCs’ development in LDCs. Experiencing tremendous economic growth during the past 30 years, China has become the world’s locomotive of economic development and the key provider of surplus investment capital for the global economy. By 2010, China’s GDP had surpassed Japan’s and it had become the second-largest economic entity in the world. China’s market socialism in its concept and substance has sparked widespread interest among academics. Furthermore, China is still a developing country: its GDP per capita ranking was only 83rd in the world in 2013. As the business capital of China, Shanghai offers both positive and negative examples of how IFCs’ development can be promoted in a late-developing-country and how the state can keep a strong hand in an economic transition in a post-socialist era. It is also hoped that China, together with other BRICs’ countries, could become the bellwether of Global South, providing exemplary guidance of IFCs’ development for the developing world.

3. The Formation of IFCs: Concept, Mechanism and Different Perspectives

> *Tomorrow's financial centre will reveal a different face, which will require new efforts of adaptation; but as the nerve centres of international financial activity, they remain hard to replace.*
>
> ---Youssef Cassis (2006, p.287)

This chapter provides a theoretical literature review of different perspectives on international financial centres. The following questions are discussed: What is an international financial centre? What is its relevance in the world economy? Why does an international financial centre come into being? Why does this happen in a particular place, as opposed to others? How important is it for a developing country to have an IFC? What are the key factors that determine the formation of an international financial centre? This chapter helps to understand the characteristics and contributory factors of IFCs in a comprehensive fashion and lays the groundwork for exploring the role of the state in IFCs' development in LDCs.

3.1 Concept and Typology

Generally, a financial centre is depicted as a geographic concept. Laurenceson et al. (2009) view it as "an area, normally a city or even a spot within a city's boundaries where a wide range of financial activities are concentrated", e.g. Wall Street in New York and The City/Canary Wharf in London. This definition is ostensibly correct but it overlooks some underlying characteristics of a financial centre. According to Kindleberger (1974, p.6), financial centres perform "a medium-of-exchange function and an interspatial store-of-value function". From this, we can see that an international financial centre is a place where financial institutions from many different countries come together to carry out financial intermediation across borders. Financial centres are not merely an agglomeration of institutions physically, but rather a system, a network and an economic complex with peculiar functions, including raising capital, clearing transactions, setting prices and diversifying risks.

The first and most important function of a financial centre is to aggregate or disaggregate financial resources across borders or regions. International financial centres provide a platform to bridge the providers and the users of capital and transfer the money across time, space and sectors, so that both large and small projects can be financed. They are conceived as the “capitals of capital” (Cassis 2006), as they concentrate large pools of financial intermediaries and capital in one place, thereby increasing the efficiency of financial transactions (McGahey et al., 1990). In one sense, an IFC is not only a place where multinational financial institutions service clients, but also a haven for international savings and pools of liquidity seeking profits (Park 1982).

Secondly, financial centres are places where financial transactions are cleared and coordinated across borders. At the turn of the 19th Century, the main function of a financial centre was to underpin international trade, along with the complementary activities of currency exchange, insurance and shipping (Cassis 2006, p.8). Gradually, financial centres were able to effect payment and settlement by acting as clearing houses - not only for trading companies, but also for financial intermediaries. They created a system of interregional payments to facilitate trade and commerce and make transactions in diverse markets more efficient (McGahey et al 1990). In this respect, financial centres can be defined as the places where intermediaries coordinate financial transactions and arrange for payments to be settled (Cassis 2006, p.2).

Thirdly, financial centres are capable of setting asset prices. Just as with real goods, financial products require a pricing mechanism to facilitate resource allocation across different areas. For example, interest and exchange rates, securities pricing etc. These prices provide important signals to managers of firms in their selection of investment projects and financing. An international financial centre is in essence a high-volume, cross-border financial market with a large number of broker-dealers, market makers[12] and other participants, all of whom are imperative to an effective and efficient pricing mechanism and a liquid market.

The fourth basic function of financial centres is to diversify the risks wrought by uncertainty. Financial centres provide risk-pooling and risk-sharing opportunities for both households and business, such as various financial derivatives and hedging tools. In a well-functioning financial centre, investors are able to reset their portfolios conveniently in tandem with any changes in future expectations. More importantly, the concentration of financial services' firms and employment in the financial centre leads to a frequent exchange of information and ideas that can reduce the risks from financial activities. In this sense, the financial centres provide effective mechanisms for managing uncertainty and controlling risks in financial markets, e.g. price hedging. Yet it is worth mentioning that diversifying risks do not inevitably lead to minimizing risks as a whole. For instance, financial centres could also give rise to new risks, such as market volatility, financial risk contagion and so on, which is particularly challenging in weak institutional environments (Young et al 2009).

What are the differences between domestic financial centres and international financial centres? This primarily depends on their geographic coverage. A domestic financial centre is mainly confined to internal state boundaries; an IFC operates across borders. A more comprehensive definition of an IFC is presented by the International Monetary Fund (IMF 2000),

> International financial centres are large international full-service centres with advanced settlement and payments systems, supporting large domestic economies, with deep and liquid markets where both the sources and uses of funds are diverse and where legal and regulatory framework are adequate to safeguard the integrity of principal-agent relationships and supervisory functions.

[12] Market maker refers to a company, or an individual, that quotes both a buy and a sell price in a financial instrument or commodity held in inventory, hoping to make a profit (Radcliffe 1997, p.134).

Reed (1981) demonstrates a five-stage evolutionary hierarchy in which a financial centre serves (Table 3.1).

Table 3.1: Five-stage evolutionary hierarchy of a financial centre

Stage	**Geographic Coverage**	**Types of Financial Centre**
I	Immediate surroundings	Domestic
II	An area wider than the local one	Domestic
III	National space	Domestic
IV	Contiguous countries and political dependencies	International (Regional)
V	Financial centres worldwide	International (Global)

Source: Adapted from Reed (1981, p.57)

It is obvious that a financial centre from stage I to stage III belongs to domestic financial centres while it emerges as an IFC at stage IV and V. An international financial centre is distinctive from other financial centres "in the sense that the facilities which it offers are far more extensive than elsewhere" (Wasseman et al. 1963, quoted in Reed 1981, p.283).

As seen from Reed's stage IV, a regional financial centre serves its regional economy beyond its national frontiers. Examples of such financial centres are Hong Kong, Singapore, Dubai and Frankfurt. When an international financial centre moves up to the apex of the hierarchy and serves worldwide, it becomes a global financial centre (Stage V). A global financial centre is the nexus between that country's wealth and the global market and between foreign investors and that country's investment opportunities (Sassen 2006, p.136).

Reed's categorisation does not mention another type of international financial centre - the offshore financial centre. Offshore financial centres are mainly tax havens for wealth management, rather than providing full financial services, e.g. Panama and the Cayman Islands. They seek to attract business by offering facilities to help individuals or firms get round the rules, laws and regulations elsewhere (see IMF 2000; Roberts 1994d).

Most offshore financial centres are booking centres, corresponding to McCarthy's paper centres, and are only for booking deposits and loans (Park 1982). They are often regarded as "fake" financial centres, as there are no real transactions taking place. In view of this, we have excluded offshore financial centres in this study.

Reed's discourse of five-stage evolution can be understood as a linear progression of IFC development into a hierarchy. In the real world, financial centres at different hierarchical stages coexist at certain points with horizontal as well as vertical linkages, constituting a network of financial centres (Lai 2011). For example, in the United States, it is widely acknowledged that New York is a global financial centre, and several other cities such as Washington DC, Chicago, Boston, Houston, Los Angeles, and San Francisco act as domestic and regional financial centres[13]. These financial centres usually cooperate as well as compete with one another. Undoubtedly, the global financial centre is at the centrepiece of an IFC network.

In a nutshell, international financial centres can be understood physically and functionally. The agglomeration of different financial institutions and markets into one place is the most fundamental process of IFCs' development. Nevertheless, its various functions of fundraising, settlement, pricing and risk diversification need be considered as the ultimate aim for their development, given that a successful IFC is not merely contingent on the number of financial institutions concentrated in one place.

3.2 The Analyses of IFCs from a Neo-classical Economic Perspective

What are the underlying reasons for an IFC's ability to attract an agglomeration of financial institutions? In other words, what are the benefits that these IFC participants

[13] Washington D.C. hosts the Federal Reserve and is the policy-making and financial management centre; Chicago is the eastern financial centre and futures transaction centre; Boston is one of the fund management centres; Houston is a regional financial centre for central America; Los Angeles is a financial centre for the country and Pacific Basin; San Francisco is a regional financial centre for Western America as well as venture capital investment.

gain from concentrating in a central place? There is no widely accepted definition of how international financial centres came about (Reed 1981, p3; Laulajainen, 2003). Economists provide their answers based on comparative advantages (e.g. cost of land, capital, labour etc.), economies of scale and agglomeration economies (or externalities).

The first serious discussions and analyses of financial centres were published in 1974 with Kindleberger's seminal work *The Formation of Financial Centres: a Study in Comparative Economic History*. In his book, Kindleberger (1974) makes an analogy of the financial centres' efficiency as mediums of exchange with that of money (pp. 5-11). He notes a considerable reduction in transaction costs when dealing with a single centre rather than dealing with many locations. These gains are proportional to the shift from N (N-1)/2 to N-1, where N is the number of locations. Davis (1990) employs industrial location theory as an analytical framework to explain the rise and fall of financial centres. He identified a range of factors that might influence the formation of financial centres by focusing on behavioural principles of major financial and business intermediaries. According to him, the main consideration of banks and financial intermediaries when choosing a location is mainly based on the supply of factors of production (e.g. availability of capital, staffing, premises, equipment and machinery, regulation and tax regimes etc.), the demand for the product (e.g. level of economic activity, income, trading etc.) and external economies.

It is evident concentration of financial firms in one place can provide efficiencies and liquidity. The scale of a financial market is conducive to collaboration and teamwork among banks and other financial firms, such as arranging loan syndication, credit transaction and risk sharing. This also reduces the costs of developing important infrastructure such as clearing offices, courier services and other advanced telecommunication facilities. For example, an active inter-bank lending market provides an efficient channelling of financial resources among banks. In this regard, the IFC is often conceptualised as the intermediary of financial intermediaries.

The geographical proximity of different financial markets can bring economies of scale, since there are close ties with one another. For example, a Treasury bond market, commercial paper market and inter-bank lending market are all inextricably connected to one other. Inefficiency will be caused if they are segregated and located in different places. Grilli et al. (1989) labelled these “thick market externalities”, highlighting the relationship between productivity and market size. When the productivity of individual firms can benefit from the proximity of competitors or other firms, concentration arises. It is an appealing way of explaining the growth and agglomeration of financial markets, both physical and non-tangible.

Moreover, the agglomeration of different firms and institutions in one location also facilitates the sharing of various resources. They not only have more convenient and cheaper access to the specialist services of lawyers, accountants, actuaries, computer programmers and consultants; the can also share facilities and organisations that serve groups of financial firms, such as clearing houses, organised exchanges and professional associations (McGahey et al., 1990). Meanwhile, the proximity of business contact, particularly face-to-face communication with their clients from multinational enterprises or regulatory bodies, is considered essential to promoting rapid dissemination and quick responses, which favour ongoing innovation and technological spillover[14] (Meyer 1991).

Recently, industry clustering thesis has also been used to explain the evolution of IFCs. A cluster is a “geographically proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and complementarities” (Porter 2008)[15] . Firms in a cluster can reduce their direct input costs by sharing a large labour pool and suppliers that serve the cluster. Other benefits to clustering include access to institutional and public goods, such as trade conferences, local business journals, and extensive software and hardware training opportunities (Yee 2006). Some researchers in the field of urban economics also argue the balance of centripetal and centrifugal forces determines the agglomeration of financial clustering (e.g. Gehrig 1998; Reszat 1998). The centripetal forces include economies of scale, information spillover, liquid markets and labour markets. Centrifugal forces include

[14] This coincides with the information hinterland theory from socio-geographers (See section 3.3.1).

[15] For example, Poon (2003) has used clustering analysis to examine the spatial organization and evolution of capital markets in 43 cities from 1980 to 1998.

market access costs, traffic congestion, high business costs and localised information.

Is there a self-sustaining mechanism in the development of an IFC? Davis (1990) analyses the impact of "sunk costs" and concludes that once an IFC had been identified, it could sustain itself for some time unless major economic and political changes occur, which he labelled "cumulative causation". Finally, for multinational enterprises, factors such as tariff barriers, political stability and strategic considerations are also important.

Economists have sought to explain why financial firms and markets tend to concentrate on one particular location and to develop it into a financial centre. Kindleberger (1974) characterises the process of IFC development as an "evolutionary and time-consuming process". His theory is specifically tailored to the explanation for an international financial centre such as London and New York. However, this perspective is unable to explain why a financial centre would be located in one place rather than another. Another weakness of this approach centres on its failure to examine the factors that shape how the role of the state evolves over time. Neo-classical economists presume that IFCs' development only happens in advanced economies with developed financial markets. The theoretical gap is obvious when applying it to emerging economies, particularly those in the process of economic transition.

3.3 The Analyses of IFCs from a Socio-geographic Perspective

Socio-geographers highlight the interaction of financial deregulation, technological advancement in telecommunications and globalisation in the development of IFCs (Porteous 1995; Thrift 1994; Zhao et al 2004; Sassen 2001). In this section, I will introduce two important strands from the socio-geographic perspective: the Information Hinterland theory and the World City thesis.

3.3.1 The Information Hinterland Theory

Porteous (1995) gives considerable emphasis to the relationship between financial information and transactions as well as their impact on physical locales. He proposes a theoretical framework to explain why financial activities tend to be concentrated in one particular location over another. In this framework, he identifies two key concepts:

information hinterland and information asymmetry. The information hinterland is defined as "the region that provides the best access point for the profitable exploitation of valuable information flows" (p. 113). Financial firms who are closer to the information hinterland are therefore able to act earlier at lower cost. Information asymmetry, according to Porteous, is caused by two kinds of information; standardised and non-standardised. Standardised information is generally able to be codified and transmitted electronically. However, non-standardised information is, in most cases, difficult to codify and has to be transmitted in person. Consequently, local firms, foreign firms and the government have different abilities when it comes to accessing local information, which creates the problem of "information asymmetry" (Zhao et al. 2005, p.311). According to Porteous (1995), in order to access, collect and interpret huge amount of non-standardised information correctly, financial firms tend to locate near the information hinterland of an international city, i.e. an IFC (Zhao et al, 2004).

One contribution of information hinterland theory is that it considers financial services as 'high-value-added' information services. Therefore, financial centres are also conceived as hubs that transform dispersed information into an organic one. Therefore, an IFC is an information collector and user whose existence is contingent on its ability to add new value to information (Zhao 2003). Laulajainen (2003, p. 332) argues that the ability to "collect, exchange, rearrange and interpret" information is the most persistent characteristic of an IFC, surpassing other factors, such as capital exports and regulation. In order to obtain international pre-eminence, only a handful of cities can have the gateway function for a region (information hinterland). He then postulates that three interlinked time zones centring on North America, Europe and Asia Pacific underpin the supremacy of New York, London and Tokyo as three global financial centres.

Information hinterland theory has also sought to explore whether international financial centres would continue to exist in the digital era. O'Brien (1992) argues that advanced information and telecommunications technology have brought about "the end of geography" in banking and finance, and thus financial institutions will no longer have to be in financial centres. Computer networks mean some financial services can be provided electronically, rendering redundant the need for personal contact. Carincross (1997) declares the "death of distance"; since distance will not determine the cost of communications electronically. It is evident such these arguments will be challenged heavily by information hinterland theory. As noted earlier, the effects of information asymmetry tend to push financial firms closer to an information source in order to interpret the non-standardised information necessary to maximise profit. This type of information is far more difficult to obtain: it requires technical conditions as well as social infrastructure. This type of social infrastructure is critical to the success of financial centres. Sanyal (2007b) also highlights that informal human interaction and lifestyle are critical to the competitiveness of financial centres, since activities such as innovation, creativity and the diffusion of ideas need a constant exchange of ideas and "fuzzy information". This all demonstrates that international financial centre will continue to exist because improved telecommunications allows the decentralisation of some activities involving standardized and routine transactions, but facilitates the centralisation of others involving innovative and customized transactions (Tschoegl 2000).

3.3.2 The World City Thesis

The world city thesis explains the formation, spatial and hierarchical distribution of international financial centres. Friedmann (1986) argues that "the new division of labour" is organised through "world cities" and points out that cities rather than states have become the most fundamental geographic units. In his hypothesis his emphasis is on world cities as "basing points" for the concentration and accumulation of international capital. Sassen (2001) reinforces the world city hypothesis by claiming that globalisation and information industry development mean that spatial dispersion of production have created new forms of centralisation of producer services (including financial services) in order to manage the global network of production sites. These centralised locales, which Sassen coins "global cities" thus act as nerve centres of the world economy. According to Sassen (2006, p.7), today's global cities are：

- Command points in the organisation of the world economy
- Key locations and marketplaces for the leading industries of the current period – finance and specialised services for firms
- Major sites of production, including the production of innovations, for these industries

Sassen's view highlights that these new forms of centralised place entail a marketplace with a multitude of advanced corporate service firms and financial institutions (2001, p.330). It is generally acceded that global cities and international financial centres have similar characteristics. New York, London and Tokyo, for example, all contain large numbers of corporate headquarters, financial services firms and high-paid professional jobs. While a financial centre is seen as the pivot of a financial network, a global city is the strategic control point in the organisation of the world economy and in a multinational corporate network (Zhao et al, 2004, p.579).

According to the world city thesis, the current network of financial centres differs sharply from earlier versions. Traditionally, international financial services were directly linked to international trade. The larger the volume of imports and exports by a country in international trade, the larger the scale of its international financial sector. Over the past 30 years however the global manufacturing and financial system has become more complex, with a dramatic expansion of multinational companies and a concomitant expansion of transnational banks. Meanwhile, the flow of economic resources beyond national borders has increased massively. As such, a cross-border network of financial centres has also been generated to ensure the management, control, and servicing of this new organisation of production and finance (Sassen 2001, p.24) . Therefore, the importance of an IFC is not merely determined by the scale of international trade, but also by the level of connectivity with the "world city network". As HPEC (2007, p.43) notes,

> What is significant is that all significant IFCs start to constitute an integrated web of global finance. In that sense, the specific financially-based linkages among global IFCs may supersede the importance of more general linkages among their national and regional economies.

Another point of note in the world city thesis is that globalisation processes have produced not only a few leading cities, but a "world city network" with many more cities from emerging economies having different nodal characteristics (Taylor 2005). Cities with different sizes are more connected with each other within the new context of globalisation and digitalisation. In recent years, cities in late-developing-countries have successively connected to this network and become important nodes within it. As more nodes are added to the network its value increases exponentially. Castells (1996) suggests the current network society comprises a "space of flows" rather than a "space of places", which is a good way of understanding the IFCs' hierarchical development across the world. He says the space of flows constitutes "electronic circuits and information systems", but it is also made of "territories, physical places, whose fundamental or symbolic meaning depends on their connection to a network" (Castells 2000b, p. 696).

3.4 The Analyses of IFCs from a Financial-Growth Perspective

In this section, I will analyse how important it is for developing countries to strive for financial development and thereafter the formation of international financial centres. In both the practical and academic arenas, there are two contradictory strands of thought on the IFCs' development. Some argue IFCs' development in developing countries helps these countries to integrate with the world economy and the globalisation process. They see IFCs as an important development strategy for economic development. Others argue IFCs' development in developing countries is a new instrument of imperialist control imposed by Western developed countries.

3.4.1 IFCs as Developmental Strategy

The discourse over the creation of IFCs as a part of a developmental strategy in developing countries is closely linked to the relationship between financial development and economic growth. The financial sector is reckoned to be "the brain of the entire economic system, the central locus of decision-making" (Stiglitz et al. 1993). To policy makers in emerging economies, the primary purpose of the IFCs development is to channel capital from developed countries to late-developing-countries and to help the latter upgrade their industrial structures (see HPEC 2007; FGN 2007).

Patrick (1966) has made an instrumental contribution to this issue by identifying two discourses - "demand-following" and "supply-leading". According to Patrick, "demand-following" means the creation of modern financial institutions and financial services are shaped by development demand in the real economy. "Supply-leading"[16]

[16] The supply-leading discourse highlights three connotations: (1) the pro-activity of a financial

refers to the creation of financial institutions and the supply of related services before the real sector has a demand for them. Patrick illustrates that the supply-leading approach is able to stimulate real growth, particularly in modern, innovative sectors. Supply-leading theory posits that financial development can take place earlier than economic development. Accordingly, the formation of financial centres is not just the natural evolution of economic development but the consequence of state intervention and promotion.

Economists such as Goldsmith (1969), McKinnon (1973) and Shaw (1973) have highlighted the connection “between a country’s financial superstructure and its real infrastructure”. According to Goldsmith (1969, p.400), the financial superstructure of an economy “accelerates economic growth and improves economic performance to the extent that it facilitates the migration of funds to the best user, i.e. to the place in the economic system where the funds will yield the highest social return”. In his seminal work-*Money and Capital in economic Development* (1973) McKinnon argues that “financial repression” is a substantial barrier to successful economic development, particularly in late-developing-countries. He argues that the development of financial intermediation is considered vital to the economic development process. Levine (2003, 2005) made a comprehensive study of the links between financial development, liberalisation and economic growth. He demonstrated that financial development crucially affects the speed and pattern of overall economic development. The expansion of financial markets can increase the efficiency of capital allocation, boosting saving and consumption, both of which are critical to economic development. King and Levine (1993) use cross-country regressions and case studies to show that a well-developed financial system promotes growth by channelling credit to its most productive uses. Although still far from conclusive, many empirical studies have shown that a well-developed financial system is useful to channel capital to its most-productive sectors (see Nabi and Suliman 2009).

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system in motivating saving and investment; (2) the antecedence of a financial system to economic growth; (3) the role of the state in financial and economic development (Patrick 1966).

To assess the relationship between international finance and growth, it is necessary to explore the topic within a much broader context. The current global economy has become both real and a fictitious. The fictitious economy generally refers to the invention of many new financial instruments such as securitisation, which liquefy capital and allow it to circulate globally. During the past decades, the increased capital inflows to the emerging economies, both FDI and portfolio flows, appears to be important in achieving growth in these countries (Sandar Kyaw and Macdonald 2009). Meanwhile, with this vigorous economic growth, the emerging economies are required to increase their responsibilities and influence in international financial organisations. By concentrating financial institutions and services in a certain place, the international financial centres could not only reduce transaction and information costs, but also promote a more complete, better-regulated and resilient financial system (Obstfeld 2007). Financial integration can help countries build more robust and efficient financial systems by introducing international practices and standards; by improving the quality, efficiency and breadth of financial services; and by introducing stable inflows of international funds (Claessens 2000). The prosperity of financial markets can create a large pool of technological know-how and a range of products within the country's economy that both improve efficiency and the size of the market for the benefit of both the producer and the consumer. Greenwood and Smith (1997） argue that financial markets will make a considerable contribution to economic development, which in turn will lead to the formation of new markets. More importantly, the IFCs' development implies that the financial system in individual countries can be more aligned with global standards, so as to establish better and more collaborative financial governance in line with global trends.

From the perspective of new structural economics, each level of economic development is a point along the continuum from a low-income agrarian economy to a high-income post-industrialised one. The journey requires continuous diversification and upgrading from existing industries to new, more capital-intensive ones (Lin 2011). For large developing countries, development might be unbalanced: some areas (cities) will likely develop much faster than more rural areas. These cities with advantages in the domestic economy has aspired to become IFCs and acted as the gateway to the global financial network.

Yet some commentators continue to cast doubt on the necessity of developing international financial centres in late-developing countries. Cassimon et al. (2012) argue that the finance-growth nexus is not linear; the relationship is at its weakest in the poorest countries due to the backwardness of their institutions. Kaufman (2001) posits that this does not appear to be "an opportune time" for developing countries to devote considerable public resources into developing their own IFCs, even if the countries could satisfy the requirements. He puts forward two points: firstly, technological advancement enables financial transactions using the internet; secondly, the locality of an IFC is much easier to transfer than before.

3.4.2 IFCs as new Instruments of Imperialist Control

In contrast to the preceding perspective that IFCs are favourable for developing countries, some commentators hold more cautious views. Gorostiaga (1984) interprets the IFCs' development in underdeveloped countries as new instruments of dependency and imperialist control. Using the case of Panama, he demonstrates that IFCs in the developing world entail new forms of dependency for the peripheral countries in their economic relations with the centre. According to him, the IFCs are strategic mechanisms that reinforce the globalisation of production and serve as tax havens and non-regulated financial platforms for the generation of global profits by transnational corporations and banks. Moreover, the historical and geographical backgrounds of these host cities/states make them suitable as operation platforms for these IFCs, such as Hong Kong, Singapore, the Bahamas, Beirut and Panama. As he puts it:

> The new articulation of the capitalist system is the collusion of the transnational finance capital of the various blocs within a global strategy of control and maximization of profits on a world scale (Gorostiaga 1984, p. 66).

As Huntington (1996) pointed out in his book - *Clash of Civilizations and the Remaking of World Order*, the Western countries dominate the world in 14 ways, three of which are associated with finance: they "own and operate the international banking system, control all hard currencies, and dominate international capital markets". According to Scholey (1987), international financial centres are "the hub of a global network of trading, financing and broking businesses with tentacles reaching deep into market places of other countries". It is apparent that traditional IFCs are the places where Western powers are able to exercise their power and maintain their dominance.

Nicolas Shaxon is a recent scholar who purports to identify the mechanics of the modern monetary system and claims developing nations are paying the cost. In his book "*Treasure islands: Tax Havens and the men who stole the world*", Shaxon (2011) argues that the British Empire has been replaced by a new form of financial empire centred in the City of London. The financial centres, particularly "tax havens" are new type of "colonialism" through secret jurisdictions, tax evasion and escaping regulation at home. As he describes it, "they (the colonists) went out of the front door, and came back in through a side window". He sees the worldwide offshore financial network as a "spider's web" and claims the objective of the network is to feed capitalists in the City of London (the global financial centre), thereby redistributing wealth upwards and risks downwards with the poorest countries losing most.

More commentators have criticised IFCs in the wake of the global financial crisis in 2008. They argue that the current international financial system is inappropriate and incurs deep exploitation of the developing nations. In the words of Mahathir Mohammad (2012), the former Prime Minister of Malaysia: "The financial market spins off no real businesses, creates hardly any jobs and gives rise to no trade. Getting greedy, they abused the system, manipulating the market for greater profits." Bankers botch up economies; creating house price surges and other speculative bubbles while paying themselves excessively for engendering economic crises. The recent protests, such as Occupy Wall Street in New York and other financial centres around the world echo Susan Strange's famous remark from 1986 that we are living in an age of "casino capitalism".

Some neo-Marxist theorists hold the same view but from a different angle. They maintain that not only imperialism and colonialism from a previous era but also contemporary forms of economic imperialism have impeded progress in the late-developing-countries (Martinussen 1997). For them, national financial autonomy in developing countries is being controlled by a small number of capitalists from developed countries, while the capacity of the state to influence financial services has diminished. Moreover, the standards and rules set by the financial centres in the developed countries force everyone else to apply them even if they are unsuitable for their own economic development. Over a long time period, developing countries were connected to traditional agricultural and manufacturing industries. They provided wealthy developed countries with low-value-added products based on natural resources and cheap labour. The development of service industries such as finance lagged behind in the developing world. For them, transaction costs have increased as a direct consequence of the expansion of economic activity brought by globalisation. And yet, in the absence of functioning financial markets, allocation of capital and economic resources are low-efficient. The peripheral countries are now trying to upgrade their industrial structures and develop service industries, particularly in their large cities. The development of IFCs in developing countries signals the "gaining of real national independence and self-centred economic progress"(Martinussen 1997).

The consideration of the IFCs as a new mechanism of imperialist domination and a new form of control over the periphery is certainly a wake-up call for the emerging economies. The IFCs can provide their host countries with important benefits such as seigniorage[17], employment, foreign exchange earnings, tax income, and funding for current account and fiscal deficits (Kaufman 2001). The policies of IFCs contribute to investment, employment, and the efficient functioning of markets and government policies in developing countries (Hine 2009, p.3). On the other hand, externality is not always positive; sometimes it can engender adverse effects, such as congestion externalities (Davis 1990). Negative externalities can outweigh economies of scale. They can thus bring about diseconomies such as rising business costs and an imbalance in regional development. These debates demonstrate that an IFC is arguably a mixed blessing for developing countries (Table 3.2).

[17] Seigniorage from having one's currency used by others as an international currency, so that the government can raise funds at a lower interest cost, is often considered one of the advantage of an IFC

Table 3.2 Benefits and costs of an international financial centre

Benefits	Costs
• Raising capital	• Rising salaries and housing rents
• Reduce transaction costs	• Imbalance of regional development
• Optimise financial resource allocation	• Smaller IFCs may surrender some control over their domestic economy
• Integrate into the world financial system	• Relatively large investment in human capital and human capital is highly mobile
• Seigniorage	• Susceptible to fraud and corruption
• More efficient financial firms through competition from foreign banks	• Financial risk contagion
• High-paid employment opportunities	

Source: compiled by author

For late-developing countries, it is important to recognise that the ultimate purpose of IFCs' development is not to create new financial hegemony and privilege, but to buttress economic restructuring and upgrading. As most developing countries are typically characterised by agrarian or labour-intensive economies and developed countries tend to have competitive advantage in capital-intensive economies, they have a different endowment structure (Lin 2010). Therefore, late-developing countries should maximise the strengths and benefits in the creation of an IFC whilst eliminating or decreasing the costs and drawbacks. In this process, the role of the state should play an active part, which I spell out in the Chapter 6.

The review on a body of IFCs' literature demonstrates that all these perspectives look at the development of IFCs but each approaches it from a different angle with a different set of beliefs and values. However the vast majority of studies tend to view the IFCs' development as single, linear and one-dimensional and have overlooked the role of the state and particularly the ownership structure in the IFCs' development.

In particular, current analyses of IFCs' development are mainly segregated and isolated within a particular discipline. The neo-classical theorists' work on IFCs' development is largely based on micro-level analysis (e.g. financial markets, institutions, services and professionals) or geographic distribution of finance. In fact, the IFCs' development is multi-faceted. Further, most studies are tailored for matured economies (primarily in the Anglo-sphere) rather than large, fast-growing emerging economies (e.g. BRICS). As well as this, most inquiries are static, rather than dynamic. All of these approaches are practical in explaining certain points, but most of them are static analyses. There has been extensive literature on the studies of international financial centres, largely focusing on their evolution, competitiveness and hierarchy in the world economy (e.g. Reed, 1980; Davis, 1990; Roberts, 1994a, b, c, d; Leyshon, 1997; Poon, 2003). Nevertheless, the research on the dynamics of IFCs' development is relatively insufficient. Major theories on IFCs' development overstate the power of the markets while the active role of the state is to a large extent overlooked. Further discussion will be conducted in the next chapter.

3.5 Multi-layered Analytical Framework for the Emergence of an IFC

How can the rise and decline of the international financial centres be explained? The existing literature details a broad set of attributes that give rise to the prosperity of international financial centres (see Nadler et al. 1955; Reed 1980; McGahey et al. 1990; Huat et al. 2004; Poon 2003; Jao 2003; Sagaram and Wickramnayake 2005; Cassis 2006; Walter 1998; Laulajainen 2003). It also makes sense to measure the success of IFCs using various financial variables as benchmarking. For example, Reed[18] (1980) uses a

[18] The variable measures adopted by Reed (1980, pp. 225-6) are: 1. Capital/deposit ratio of the large internationally active banks headquartered in the centre. 2. Capital/asset ratio of the large internationally active banks headquartered in the centre. 3. Pre-tax earnings/capital ratio of the large internationally active banks headquartered in the centre. 4. Pre-tax earnings/assets ratio of the large internationally active banks headquartered in the centre. 5. Revenue/asset ratio of the large internationally active banks headquartered in the centre. 6. Total international currency clearings of the centre. 7. Size (liabilities) of the centre's Eurocurrency market. 8. Total amount of international bonds issued in the centre during the year. 9. Foreign financial assets held in the centre. 10. Foreign financial liabilities held in the centre. 11. The daily average of the centre's stock exchange activity.

data-set of sixteen variables and concludes that the hierarchy of financial centres is determined primarily by the ability of international currency clearing, the size of Eurocurrency market, the portfolio of international financial assets and the number of the large, internationally active commercial banks. Jao (2003) claims that a city cannot be a genuine IFC unless it satisfies six conditions, such as a foreign exchange turnover of no less than USD 10 billion, the concentration of over 100 foreign banks and so on. His arguments have taken some flak as such static data could be invalid depending on time and conditions[19].

Based on the literature review of different perspectives on IFCs' development, it is suggested that it is systematic, multi-dimensional and dynamic. In view of this, I have developed a more comprehensive multi-layered framework to encompass IFCs' development; notably macro, meso, micro and meta levels. Each of these plays a significant role in any successful IFC (Figure 3.1). The macro-level is concerned with the general environment of the country/hinterland that an IFC serves and includes components such as political stability, economic power, legislative systems etc. The meso-level refers to the business environment for the host city of an IFC, such as infrastructure, the tax regime and urban amenities. The micro-level is related to the agglomeration of financial markets, financial institutions, financial services, human capital etc. The meta-level considers the connectivity of the IFC to the global network.

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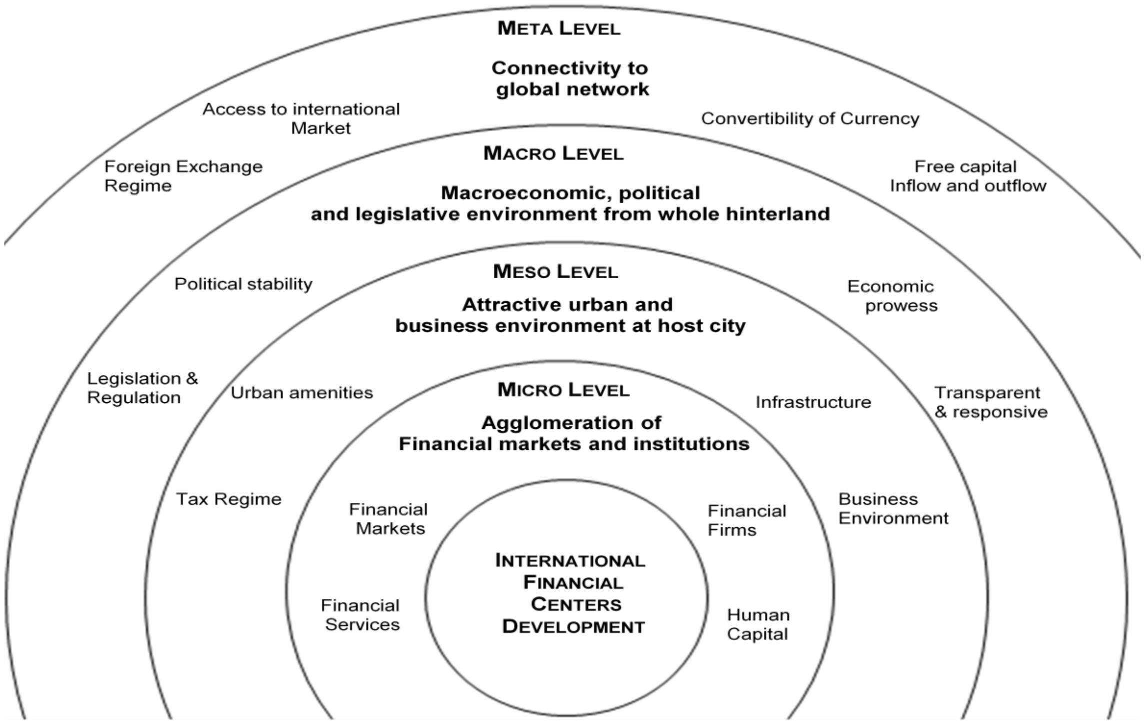
12. The number of large internationally active commercial banks headquartered in the centre. 13. The number of large internationally active foreign banks with offices in the centre. 14. The number of foreign financial centres with direct links, provided by the foreign internationally active banks, to the local centre. 15. The centre's airline passenger traffic. 16. The centre's airmail/airfreight volume.

[19] According to Jao (2003), the six indicators of a genuine IFC are: (1)It has a daily forex turnover of not less than USD10 billion; (2) It has a presence of foreign banks, net of representative offices, of not less than 100; (3) It has a presence of foreign non-bank financial intermediaries, net of representative offices, of not less 200; (4) It has cross-border inter-bank claims and liabilities of not less than USD100 billion each day; (5) It has total bank lending abroad of not less than US$20 billion; (6) It is chosen as the location for regional headquarters by not less than 200 foreign companies (including banks and financial institutions).

Figure3.1: The comprehensive multi-layered framework of IFCs development



Source: Author

Macro Level: Macro-economic, political and legislative environment

The development of an IFC is closely concerned with the macro-level environment. At this level, three ingredients are particularly important in the evolution of an IFC: political stability, economic prowess and a well-designed legislative environment.

More than anything, a successful IFC should have a politically stable environment. It is hard to imagine the survival of an international financial centre amid enduring violence, conflicts or even wars. Historically, a large number of international financial centres lost their positions due to political unrest or military catastrophe. For example, Shanghai lost its position as an East-Asian financial centre in the 1930s due to the invasion of the Japanese and subsequent domestic wars. Beirut used to be an international financial centre in the Middle East until the 1982 Lebanon invasion.

A buoyant international financial centre is reliant on a buoyant and diversified economic hinterland. Economic activity and stability within the centre are seen as imperative. In his book *Capitals of Capita*, Cassis (2006) explored the IFCs' evolution from 18th Century to the present. Through long-term historical analysis, he attributed the rise of major financial centres to the economic power of the country that hosts them (p.281). Cassis notes:

> The rise or decline of an international financial centre cannot be understood independently from the economic and social environment of the country in which it operates; from the weight carried by the financial sector in this economy; from the preference given to it compared with other activities, especially industrial, by the political authorities; and from the political influence that the financial elites are able to exert. (Cassis 2006, p.5)

The rise of an IFC was closely linked with the economic prowess of its hinterland. Fratianni (2007) reviews the historical record of seven IFCs – Florence, Venice, Genoa, Antwerp, Amsterdam, London and New York- from the 14th Century to the 19th Century. Apart from financial innovations and institutional change driven by market expansion, the evolution of IFCs was largely determined by the transformation of the economic centre from continental Europe to Maritime Anglo-American.

Sagaram and Wickramanayake (2005) contend that a centre complemented with a strong economic base will have the advantage of economies of agglomeration, with more efficient resources at its disposal. To function optimally, an IFC should have sufficient levels of economic activity to underpin it. With regard to IFCs' development in large developing countries, the ability of a city to become a regional international financial centre or global financial centre depends hugely on its host country's economic power.

The third equally-important element at the macro-level is a reliable, resilient and transparent legal and regulatory system. The regulatory mechanism is more delicate to an IFCs development. On the one hand, it is important that the financial industry is placed under sound supervision for the sake of risk containment. On the other hand, avoidance of over-regulation is also important for financial innovation and competitive advantage. Therefore, governments often face the dilemma of weighing the stability and flexibility of a regulatory climate. IFCs favour predictability when it comes to government regulation and change is often viewed as unwelcome. It is not easy to benefit from financial innovation when there is uncertainty over the approval of a new product or service by the legal authority (Young et al 2009, p.23). Abundant empirical evidence has established the fact that a country's financial development is related to its institutional characteristics, e.g. prudential regulation and supervision, contract enforcement and more broadly the rule of law (e.g. Levine 1997; Beck et al. 2000;Andrianova et al 2008). Meanwhile, regulations need to be administered with sufficient flexibility to adjust quickly to a changing environment (Dufey and Giddy 1978, p40).

Different legal systems in a host country would also have a profound impact on the distribution of IFCs (La Porta et al. 2008). Zhao (2010) claims the Anglo-American system, or common-law system, is superior to the continental European legal system on the grounds that the former is more flexible and resilient. In the common law tradition (negative-list regulation rules) such as operates in the United Kingdom and the United States, it is very easy to introduce new products and services on condition they are not prohibited by law. Under the legal framework of the civil law tradition, the so-called positive-list regulation holds sway: regulations do not allow anything new unless it is specifically listed in written statute beforehand.

Another important factor for ensuring market functionality is transparency. Participants in financial markets have different motives. Investors purchase securities for better returns; businesses issue stocks for financing; and security firms supply professional services for profit. All of them need free information flows and transparency to achieve their specific targets. Otherwise, financial resources cannot be allocated efficiently or fairly.

Meso Level: Urban and business environment in a host city

In the development of an IFC, high-quality urban infrastructure is crucial for attracting investment and supporting international financial business. In addition to necessities such as clean air and water, modern office space, an efficient transport system, widespread air links and robust telecommunications are all important aspects of an attractive infrastructure. Indeed, almost all of the leading IFCs have state-of-art physical and financial infrastructure that allows them to maximise the benefits of telecommunications and to organise and govern the new conditions for operating globally (Sassen 2006, p.140). In this regard, not only is it important to understand the characteristics of financial centres' historical development but also to consider the impact of modern-day IT to enable an understanding of the kind of financial services, institutions and markets that will likely comprise future financial centres.

The taxation regime is also important in any IFC development as it is difficult to provide uniform taxation to financial firms around the world. A business-friendly tax regime has a direct impact on the distribution of IFCs, since it can attract corporate investors as well as high-skilled professionals. This will cause regulatory arbitrage, which implies that a state can influence the IFCs' development by using favourable tax regimes. For example, in the British-ruled Cayman Islands, the favourable regulatory environment has absolved firms from income tax, corporate tax and capital gains tax. Some might argue that a tax regime is often determined by a central government and should be regarded as part of macro-economic policies at macro-level. I believe a favourable tax regime could be established at city level, rather than country level, e.g. a free-trade zone or a special economic zone. A favourable tax regime at city level can better channel financial resources to a certain place, although it is often blamed for its lack of taxation equality.

A successful international financial centre should also provide various urban amenities so as to attract and retain talent pools. In the words of Sanyal (2007a, pp.7-8):

> The creation of an international financial centre has to look at the wider eco-system rather than just the financial sector. First, it must be an attractive place to live for the talented. Second, every effort must be made to ensure that the city's human capital does not decluster. Third, tertiary educational facilities are needed both inside the city and within easy reach. "Attractiveness' is not just about physical aesthetics but about the "soft" factors that encourage the talented to converge and interact.

Therefore, the urban amenities mentioned here are not just modern infrastructure and hard facilities, but also various social-cultural elements, including entertainment, education, health care, arts and culture, etc.

Urban policies can also influence the formation of an IFC. Sagaram and Wickramanayake (2005) conducted an empirical investigation into a wide range of factors on IFCs' development in Hong Kong, Singapore and Japan. Their study shows that in the cases of Hong Kong and Singapore, government policies are positive and significant for their IFCs' development. Hong Kong's policy architecture reflects a position of "positive non-interventionism . . . [as] a deliberate policy choice rather than merely an absence of policy" (Schenk, 2002, p.322; Jarvis, 2011). Singapore has deliberately focused its efforts on clustering international expertise. Thus the city-state concentrated on improving the quality of immigration, tertiary education, entertainment facilities and global linkages. Interestingly, Japanese government policies were negative to its financial centre growth and sustainability. The inappropriate policies were mainly due to resistance coming from the banking, securities, and insurance industries (Shirai 2007).

Micro Level: Agglomeration of Financial Markets, Institutions and Human Capital

The depth and breadth of financial markets is the keystone of an IFC. As previously mentioned, neo-classical economists have contributed much to illustrate why financial firms tend to concentrate their business in a certain place. Economies of scale, comparative advantage and the externalities are valid in interpreting the agglomeration of financial firms and markets at micro-level. A pre-eminent financial centre not only has a well-established market system, it also takes a leading position in the global or regional financial market. For instance, London has the largest foreign exchange market, bond market and insurance market in the world and New York hosts the largest stock market, mutual funds market and private equity market. Most other leading international financial centres have a premier position in niche markets, e.g. Chicago (derivatives), Zurich (asset management), Hong Kong (IPO) and Singapore (Asia-US dollar market).

It is thus understandable that an international financial centre is the central place for the clustering of various financial services. Apart from the conventional services of financing services, such as fundraising, money transfer, currency exchange, clearing and settlement, a leading international financial centre will also provide all kinds of adjunct services, such as logistics, insurance, brokerage, accounting and legal services. These services are clustered in one place to create an agglomeration economy and reduce transaction costs.

At a micro-level, financial firms have been the participants in financial markets as well as service providers. A successful international financial centre also hosts various financial firms from across the world.

Last but not least, human capital is crucial to the success of an international financial centre. With the development of information and communications technology, there is an increasing requirement for highly skilled professionals to interpret various data. Meanwhile, financial instruments and tools have become increasing complicated and require talented labour. Furthermore, there is also a high demand for lawyers, accountants, consultants and IT technicians who are able to provide other ancillary services.

Meta Level: Connectivity to Global Network

The meta-level is primarily concerned with the linkages to other countries, i.e. free capital flow across borders and full currency convertibility (both current account and capital account), which is critical in differentiating a domestic financial centre from an international one. An open, fuctional market makes it possible for individuals and corporations from home and abroad to compete on an equal footing. The full convertibility of currency allows all investors - foreign and domestic - to convert the domestic currency into the currency of their choice. Most developed countries lifted their capital controls in the 1980s, such as the United Kingdom and United States.

Consideration of all these ingredients is necessary for a full picture of an IFC's development. Here it is important to note that for late-developing countries, these factors were not always naturally endowed. Instead, the state might have had to step in to deliberately create or improve them. This is the central issue that we want to explore in the following chapters.

3.6 Summary

This chapter introduces the definition of the IFC and reviews different perspectives of IFCs in literature. The work that focused on IFCs has been divided into three sets: the economic, the socio-geographical and the financial-growth. The economic perspective mainly attributes the growth of IFCs to economies of scale, externalities and comparative advantage (e.g. cost of land, capital and labour). Within the socio-geographic literature, attention has been paid to the importance of information flows (Porteous, 1995), with emphasis on geographic distance to valuable information and access to non-standardised information. Another strand of the socio-geographic perspective is the world-city thesis, which explains the formation, spatial and hierarchical distribution of international financial centres and their connection to the "world city network" (Sassen, 2001; Taylor, 2005). The financial-growth theorists provide two main conflicting viewpoints: one sees the IFCs' development as a development strategy and the other considers that IFCs' development in the developing countries is a "new instrument of imperialist control" (Gorostiaga, 1984) imposed by advanced capitalist states.

It is argued that the IFCs' development is a multi-faceted matter and their success requires a broad set of factors ranging from political stability, macro-economic growth (macro-level), to urban and business environment in a host city (meso-level) and connectivity to a global network (meta-level). However, in current research, these contributory factors are segmented and segregated. The literature survey finds that the role of the state in IFCs' development has been understated, although it demonstrates many elements of IFCs' development and competitiveness are directly linked to public policies and the role of the state. In the next chapter, I will review different perspectives of development theory and try to explain why the state needs to play a more active role in IFCs' development, particularly in late-developing-countries.

4. The Role of the State in IFCs' Development: An Alternative Approach

> *I sincerely believe that banking establishments are more dangerous than standing armies…*
>
> --- Thomas Jefferson

As mentioned in the previous chapter, IFCs' development is not purely a financial issue and should be viewed in a multidimensional way encompassing different players at different levels. Among others, the state is one of the most significant stakeholders in the IFCs' development. In this chapter, I try to explore the role of the state in IFCs' development. This chapter is organised as follows. Firstly, I examine the concept and intrinsic nature of the state. Next, I discuss different perspectives regarding the role of the state in development, from the laissez-faire to various interventionist views. The primary purpose of this brief review of literature is to point out areas of agreement and disagreement over the role of the state in different theoretical perspectives and to identify the gaps in the role of the state in IFCs' development for late-developing countries. Finally, I set forth an alternative approach for the IFCs' development, particularly in late-developing countries.

4.1 The Definition of the State and its Dual Nature

The concept of the state is notoriously difficult to define, as Dunleavy and O'Leary (1987, p.1) put it, "the state is not a material object, but a conceptual abstraction". States are compulsory associations claiming control over territories and the people within them (Skocpol 1985, p.7) . According to Weber (1978, p.54),

> A compulsory political organization with continuous operations will be called a "state" insofar as its administrative staff successfully upholds the claim to the monopoly of the legitimate use of physical force in the enforcement of its order.

Weber also identifies several primary formal characteristics of the modern state, which include: an administrative and legal order subject to change by legislation and the administrative staff whose activities have to be oriented by legislation and regulations (Weber 1978, p. 56). Two aspects of this definition are particularly noteworthy. First, the Weberian state is a set of institutions with dedicated, meritocratic administrative staff (bureaucracy) that strictly follow the legitimate order. Second, Weber regards the modern state as a compulsory organisation with instruments of authoritative rule-making and enforcement within a bounded territory and thus the activities of administrative staff inevitably involve coercive force.

However, in the real world, the bureaucratic machinery defined in the Weberian state appears too idealistic. The complexity of the state lies in the different interests it represents and the conflicts among these interests. Rueschemeyer and Evans (1985, p.48) point out that the state tends to have four connotations: (i) an expression of pacts of domination, which represent a governing class' interests, (ii) the ability to act coherently as a corporate unit, representing bureaucracy's interests; (iii) openness to becoming an arena of social conflict; and (iv) the presentation of itself as the guardian of universal interests. As O'Donnell (1979, p.290) puts it,

> Tension between the underlying reality of the state as guarantor and organizer of social domination on the one hand, and as agent of a general interest which, though particularized and limited… is characteristic of any state.

From the perspective of institutionalism, the state has a dual nature (Dugger 1989). On the one hand, the state is a parasitic institution that drains off public resources for the interests of a governing elite and dominates the bulk of the population through force and fraud. On the other hand, the state is also a productive institution that creates resources for the common good and for peaceful development. It is also one that establishes an administrative and legal order for protecting the rights of every citizen. Therefore, the state can be both predatory and productive and play a "grabbing hand" as well as a "helping hand". This means the role of the state should be studied in its political, economic, social and historical contexts.

It is also necessary to distinguish the state from the government. After the Second World War, political scientists in the United States tended to relegate the concept of the state and focus instead on the government, the political system and political behaviour. It was not until the 1980s that academics began once more to revisit the importance of the state in any significant way. Theoretically, the state is the collection of administrative, legal, and political institutions that together monopolise legitimate force and territorial sovereignty within a country's borders (Grieco and Ikenberry 2003). Therefore, the state is considered as more than the "government". In most circumstances government plays the major administrative and bureaucratic role in fulfilling the functions of the state. When we consider the role of the state, it definitely entails the role of the government as well.

4.2 The Role of the State in Different Perspectives of Development

4.2.1 The Laissez-faire Approach and its Critiques

The laissez-faire approach in development can be traced back to Adam Smith (1776)'s *Wealth of Nations* in the18th Century, in which he stresses the economic benefits from the "invisible hand". In the following two centuries, this basic idea of an unfettered market has evolved into neo-classical economics, modernisation theory and recent neo-liberalism. All of them insist that markets are efficient per se and competition is effective (Todaro and Smith 2011).

The neo-classical economists are not only sceptical of developmental intervention but also show a deep mistrust of all forms of state intervention in all kinds of economic activities (Lund 2010). They believe the state is unnecessary, ineffective and generally decreases societal welfare. One particular strand of the "grabbing hand" view (Shleifer and Vishny 2002) holds that government interventions are predatory pursuits for the benefit of politicians and bureaucrats. They argue the state should not interfere with economic development unless necessary. The essential state is a minimal state, whose function is limited to maintaining law and order. The state should refrain from direct intervention and take a back seat as a "night watchman".

In developmental studies, the theory of modernisation (Rostow 1960; Martinussen 1997), which espouses neo-classical economics, views developed countries as modern and developing countries as traditional. The role of the state is to remove the obstacles to competition to enable free market competition. According to Pye (1966), the development is “a process whereby the traditional and backward Third World countries developed towards greater similarity with the Western, or rather, the North-Western world”. In the 1950s and 1960s, modernisation theory was used by some Western scholars to guide development in developing countries.

Neo-liberalism is defined by neo-classical economic ideas about the nature of markets and economic growth (Robison and Hewison 2010).The rise of neoliberalism in the 1970s and 1980s coincided with the breakdown of the Keynesian welfare state in the United States and the United Kingdom. Neoliberalism in essence blames “everything that does not work on the works of the state and credits everything that works to the free market” (Yeung 2000, p. 138). It argues that both economic efficiency and economic growth will be stimulated by “permitting competitive free market to flourish, privatising state-owned enterprises, promoting free trade and export expansion, welcoming investors from developed countries, and eliminating the government regulations and price distortions in financial markets” (Todaro and Smith 2011). Neo-liberals argue that poor resource allocation and too much state intervention prevents markets from functioning properly and it has hampered growth (Skinner 2007).

By the 1980s, neoliberalism had become a mainstream social, political and economic movement that effectively held sway in most parts of the world. International organisations such as the World Bank[20] and the IMF were promoting and enforcing neoliberal policies throughout the capitalist world, especially in the 1980s (Taylor 1997;

[20] It should also be noted that after global financial crisis 2008, the World Bank (2012) has reconfigured the role of the state in financial development. In the Global Financial Development Report 2013, the World Bank provides new insights on the role of the state in financial systems, from regulation and supervision of financial institutions and markets, to competition policy, to state guarantees and state ownership of banks, and to enchantments in financial infrastructure.

Yeung 2000, p.137). Thus it has become a political project that was "primarily concerned to promote a market-led transition towards the new economic regime" (Jessop 1993, p. 29; Yeung 2000, p.136).For example, the IMF and the World Bank conducted a Structural Adjustment Program (SAP) through which these international financial institutions granted loans to developing countries but with conditions of structural reforms attached, known as "conditionality" (Chant and Mcllwaine 2009). These conditions included currency devaluations, reductions in public spending, price reforms, trade liberalisation, the reduction and removal of subsidies, privatisation of public enterprises and institutional reforms (Potter et al. 1999). In 1989, the economist John Williamson coined the term "Washington Consensus" [21] to describe ten neo-liberal policy instruments he identified as standard in any package to developing countries.

Pursuant to neo-liberal logic, the evolution of international financial centres (e.g. New York, London) in Western advanced economies is generally an evolutionary, self-sustaining and spontaneous process (Kindleberger 1974; Reszat 1998). For instance, Kindleberger (1974) describes the evolution of banking business in his staple theory:

> …banking starts out to serve the needs of sovereigns and nobles; develops in connection with commerce; then…with governmental finance; next with transport…; then with industry; and finally with intermediation in insurance, mortgages, consumer finance, factoring, pension funds, and the like.

Overall, Kindleberger attributes the formation of financial centre primarily to private forces and casts doubt on governmental policy as a catalyst. He argues that governmental policy "can accelerate or slow down" the emergence of given city as a financial centre but "it can probably not change the outcome" (Kindleberger 1974). He asserts that private forces in many cases will resist the concentration efforts by government if this does not conform to their profit motives (ibid. p.70) .

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[21] The original ten points of the Washington Consensus include: 1. fiscal discipline, 2. Reordering public expenditure priorities, 3. Tax reform, 4. Liberalising interest rates, 5. A competitive exchange rate, 6. Trade liberalisation, 7. Liberalisation of inward foreign direct investment, 8. Privatisation, 9. Deregulation, 10. Property rights (Williamson 2004).

For neo-liberals, government interference suffocates financial competitiveness through tight control and misguided policies. Cassis (2006) maintains state intervention rarely determines the destinies of international financial centres in a lasting or fundamental way.

> There are countless examples showing that state interference harms financial markets' competitiveness, even without take wars, when economic activities everywhere were subject to far tighter control, or interventionist measures, such as credit control or nationalisations, into account. One only need think of the various measures intended to channel or limit international movements of capital: the need for a green light from the political authorities to list a foreign security on the Paris and Berlin stock exchanges before 1914; the embargo on foreign issues in London in the early 1920s; exchange controls in post-war Europe; the introduction of the Interest Equalization Tax in the United States in 1963; measures aimed at curbing the development of Euromark etc in continental Europe in the 1960s, and so on. (Cassis 2006, p.284)

Therefore, neo-liberals argue that state intervention in financial development must be reduced to a minimum, except where private interests of financial market participants do not align with public interests and for reasons of competitive fairness. Following this logic, the development of IFCs in the developing countries is achievable by following the processes that were used by developed countries.

Critiques

This laissez-faire view has been criticised by a number of commentators. The critics, mainly taking the experiences of Japan and the Asian Tigers, have countered that the developmental state works for developing countries. Hitherto, many developing countries lacked market institutions and there was little reason to presume that markets would develop on their own. Scholars point out that in almost every one of the East Asian cases, the state played a far more active role than that stated in the Washington Consensus. In practice, all cases of successful economic development have involved state intervention and improvisation of an industrial strategy (Shapiro and Taylor, 1990; Wang 2000).

From a historical perspective, every rising power has relied on the state to kick-start growth or at least to protect fragile infant industries. For example, as early as 1791, Alexander Hamilton, America's first treasury secretary, called for the protection of the country's fledgling industries through tariffs. For almost two centuries, US tariffs were rarely below 30 percent, and often much higher (Nolan and Wang 1999). Even Great Britain, the initiator of free-trade thinking, created a giant national champion in the form of the East India Company (The Economist 2012). In this respect, Alexander Gerschenkron, a Russian-born American economic historian, has made a significant contribution to the analyses of the relationship between development and capital. In his view, late-developing countries are characterised by a disconnect between the scale of economic activity required for development and the effective scope of their private economic network (Gerschenkron 1962). The economies of developing countries are segregated and their markets do not function optimally. As a consequence, goods prices and capital gain are distorted. Furthermore, local entrepreneurs in LDCs are unable to accumulate sufficient capital to compete with already-industrialised countries. To figure out these problems, the state should directly involve itself in financial markets. He also points out that the later the state embarks on a development process, the more cost it will incur to satisfy the increasingly minimum efficient scale of production.

Reinert (1999) concurs that in now-developed countries, national markets did not occur spontaneously. In effect, well-functioning markets in now-developed countries have been created by the state since the Renaissance through the provision of a legal framework, standards, credits, physical infrastructure and the state has even functioned temporarily as an entrepreneur of last resort. In particular, Helleiner (1995, p. 319) has cited the Euro-dollar market centred in the City of London, which he says was not a "stateless" market. Rather, its existence rested on state support from the outset. When the United States supported London in this new Euro-dollar activity, the Bank of England quickly gave its full support through a number of regulatory initiatives, seeing it as a way to offset Britain's diminished political influence with a more powerful economic role for its capital city.

A similar argument is put forward by Ha-Joon Chang (2002) in his book - *Kicking Away the Ladder*. He claims that now-developed-countries had not exactly enacted laissez-faire policies when they themselves were in the process of development He argues that the developed countries are now attempting to "kick away the ladder" by which they have climbed to the summit of greatness, thereby preventing developing countries from adopting policies and institutions that they themselves used. Britain replaced mercantilism with economic liberalism after industrial revolution but it is important to note its willingness to transfer to the free trade model only after it had become the most powerful player in the world with no rivals. In the case of England, Polanyi (1944, p.76) notes: “the road to the free market was opened and kept open by an enormous increase in continuous, centrally organised and controlled interventionism”.

A more fundamental criticism of neo-liberalism is that it is based on the faulty assumption that all economic activities are alike. However, developing countries have their own historical and cultural backgrounds and this cannot be underestimated and dismissed in favour of a uniform model. In his studies of developing countries, Jacobs (2003) found that variations in national embeddedness have resulted in dissimilar development outcomes among nation-states. Another difference between developed and developing countries lies in the fact that the latter have often suffered problems from deficient institutions and unsatisfactory legislative systems. The development of legal and regulatory institutions took hundreds of years in the advanced countries of the West (Mishkin 2007). Yet in most developing countries, the institutional weaknesses and market incompleteness are widespread (see Brett 2009). All of these suggest that the extent of state intervention varies from country to country, and the developing countries often experience greater direct state intervention in the market than developed countries (Wee 2002). Brohman (1995, p.122) also casts doubt on the concept of modernisation and expresses discontent over the construction of a single model of modernity based on the experience of a few industrial countries. He argues that modernisation theory is “too simplistic and too vague to be taken seriously as comprehensive theory of development” (p. 125), which ignores much of the richness and diversity of societies that produce different trajectories of development.

> In large part, the new institutions created by modernisation have failed to find roots in the indigenous social and cultural traditions of Third World societies… (Brohman 1995, p.130)

In summary, the market fundamentalists overestimate the wisdom of the marketplace. On the one hand, they ignore the fact that their states did intervene when they kick-started their own economic development; on the other, they fail to understand the different social settings between developed and developing countries. The financial sectors in late-developing countries is not only confronted by endogenous problems such as institutional weakness, market ineffectiveness and brain drain, but also face intense external competition from foreign counterparts in an increasingly globalised world. In such circumstances, if they were to follow the path suggested by neo-liberals, relying only on spontaneous market evolution, it would be doomed to failure. Therefore, for IFCs' development in developing countries, the laissez-faire approach seems highly improbable.

4.2.2 New Institutional Economics (NIE) and the "North Paradox"

Institutions and organization are critical to IFCs development because of the support they provide for various services and exchange. The study of institutions changed dramatically when Oliver Williamson (1975) set out to investigate the firm as an institution based on the earlier work of Ronald Coase (1937, 1960). A similar pioneering work conducted by Douglass North (1981, 1990a) argues it is institutional change that laid the foundations for industrial revolution. Along with these seminal works, the academic arena has seen the emergence of the new institutional economics (NIE) in the last quarter of 20^{th} Century. Since then, institutions have become one of the heated topics in social science, including economics and political science (March and Olsen 1984). The state also became an object of institutional analysis (see Hodgson 2006; North 1981).

NIE casts some lights on the role of the state in IFCs' development. It is worth noting that NIE does not abandon neoclassical economic theory. While neo-institutionalists accept orthodox assumption – the scarcity of resource and competition (Menard and Shirley 2008, p.2), they criticised neo-classical theory for ignoring the costs of information, uncertainty and transactions. In particular, neo-institutionalists underline the significance of institutional structures such as property rights, rules and regulations, the role of the state and even private enterprise. Unlike neo-classical economists, they stress that aside from market failure, "institutional failures" are widely existed; thus economic, financial and even urban development need to be examined in a comparative-institutional way (Coase 1960; Williamson 1973).

One of NIE's main inputs to economics has been to understand how institutions emerge, operate and change, thereby transforming neoclassical economics from a static to a dynamic theory (Menard and Shirley 2008). According to neo-institutionalists, institution is defined as a set of rules, norms and constraints, formal or informal, that actors generally follow to reduce uncertainty and control their environment, and organizations as durable entities with formally recognized members, whose rules also contribute to support production and exchange and to achieve other objectives[22](North 1990a, Menard and Shirley 2008). In his paper *The Problem of Social Cost*, Ronald Coase (1960) points out that "only in the absence of transaction costs did the neoclassical paradigm yield the implied results; with positive transaction costs, resource allocations are altered by property rights structures". North (1990a) contends that the expansion of market scale lead to specialisation and the division of labour, which created an increase in transaction costs. The increase in transaction cost thus implies allocative inefficiency. Increasing returns is among the important forces shaping the path of institutional change and it has a countervailing effect on the increase of transaction costs. Therefore, economic institutions adapt according to the new contexts of social and economic change and these changes paved the way for technical advances in the economic revolution.

North (1990a) mentions that institutional change evolved with the expansion of financial markets and an increase in capital flows. He suggests the institutional innovation in the financial sector that lowered transaction costs can occur at three cost margins (North, 1990a, p. 125):

- those that increased the mobility of capital
- those that lowered information costs
- those that spread risk

Within the context of economic globalisation, the enlargement of market scale causes rising transaction and funding costs. This requires institutional change and innovation and IFCs' development in developing countries can be understood as one of the results

[22] Note that we refer loosely to the "institutions" to refer to both the organizations and institutions related to IFCs development, from time to time, in this thesis.

of such efforts. In this regard, to investigate IFCs development from neoclassical economics to NIE is an attempt to understand the evolution of IFCs in a more dynamic way.

Meanwhile, neo-institutionalists clarify the dual nature of the state in economic and social development. In his book, *Structure and Change in Economic History*, North (1981) presents a model of the state as both a contract and a predatory regime. He argues that the state has two paradoxical objectives (hereafter labelled as the "North Paradox"): Firstly, to specify rules and enforcements which will provide a structure of property rights for maximising the rents[23] accruing to the ruler; secondly, to reduce transaction costs in order to maximise output of the societal well-being and hence increase tax revenues accruing to the state.

To North (1990a, p.51), the ruler is not confined to a single absolute ruler but could be the whole ruling group or class that a democratic government represents. In modern representative democracy, the ruler might also gain rents in exchange for providing certain services or by enacting particular rules for certain constituent groups. With multiple interest groups, the ownership structure is a result of ongoing tensions between the desires of the rulers on the one hand, and the efforts of the parties in the exchange to reduce transaction costs on the other. The North Paradox suggests not only is the state crucial for economic growth, but it is also the source of "man-made economic decline" (North 1981, p.20). Moreover, the discourse of NIE provides a hint towards understanding ownership structure in the financial sector. North's model of the state is consistent with rational choice institutionalism, which suggests that the state is a rational actor pursuing the "logic of interest" (see Schmidt 2005; Hall and Taylor 1996).

[23] In economics, rent has two meanings. Firstly, it is described in terms of "excess returns" above "the resource owner's opportunity cost" that take place in competitive markets (Tollison 1982). In this instance, rent is short-lived, as competition will drive it to market levels. Here rent-seeking is equivalent to profit-seeking. Secondly, rent can be contrived artificially through state intervention or government regulation of a market, e.g. monopoly rents arising from government control of bank charters, returns from patents or copyrights etc. It is our belief that the kind of rent accruing from government actions is what is meant in the "North Paradox".

It is also notable that state managers devised property ownership structure in their own interests, which sometime leads to inefficient property rights (North 1979, 1981). As North (1990b, p.360-361) contends,

> Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interest of those with bargaining power to create new rules.

However, there are also several limitations. Firstly, North's model of the state is based on a capitalist state and does not explore the various forms of state ownership in depth. North argues that property rights and the ownership structure play a significant role in institutional evolution. Yet his argument is developed through perpetuating the assumption that private ownership is more efficient than public ownership (North 1981, p.21). Besides, the NIE approach has maintained the primacy of the legal and private ownership over all other social, economic and political factors in development (Przeworsk 2004; Marois 2012).

Secondly, despite the fact that rents can be contrived artificially, it does not mean they are always negative in terms of societal welfare. Rents can sometimes be taken by corrupt bureaucrats for self interest (Buchanan et al 1980), but in many cases, they flow to strategic SOEs or innovative private firms. We should therefore differentiate a legitimate function of a state from a common-law crime of bureaucracy such as fraud, embezzlement and theft (Pasour 1987). For instance, lobbyists from particular interest groups will help create the transfer of public resources to particular sectors. In this regard, the justification of the rationale for rents is closely connected to the appropriate role of the state. If we assume economic development is one of the defining roles of the state, we would be hard pressed to argue that the government's investment in infrastructure is an entirely negative rent-seeking phenomenon. For example, Hellmann et al. (1998) demonstrated that giving rents to financial intermediaries and production firms has promoted financial deepening, particularly in a number of high-performing East Asian Countries (see section 4.3.1). However, North (1981, 1990a) fails to elaborate the differences between these two rents.

4.2.3 The Developmental-state View Versus the Market-enhancing View

Since the 1980s, with the rise of the newly industrialised economies in East Asia, a number of economists have put forward a new approach - the developmental state theory to explain why they have been able to catch up the developed economies (see Johnson 1982; Wade 1990; Amsden 1989). The developmental-state view regards market failures to be more pervasive in developing economies (for example, due to the lack of liquid capital markets) and thus looks to state intervention as an important substitute for market coordination. According to Amsden (1989, p.143), the allocation of subsidies is one of the features of state intervention. The incentive enables the state to entice a set of entrepreneurial groups to undergo industrial transformation. This has not only rendered the government a banker, but an entrepreneur. Hence, the state and nascent industrial groups are conceived to be in a symbiotic relationship. Unlike structuralists who downplayed the key role of markets in the industrialisation process, the East Asia developmental state view emphasises the "synergy" between the state and the market (Onis 1991). In his work, Wade (1990) demonstrates the advantages of bank-based, interest-rate-controlled financial systems in East Asia countries. He argues that Taiwan's industrial success lay in the "governed market", a series of policies that "enabled the government to guide – or govern – market processes of resource allocation so as to produce different production and investment outcomes than would have occurred with either free market or simulated free market policies" (pp. 26-27) . Nevertheless, he also points out that state intervention will set off complex relationships among the state, private sector businesses and the banking sector, resulting in low efficiency and malpractice in the financial sector.

As opposed to the neoliberal's discourse of the "grabbing hand", the role of the developmental state has been called the "helping hand". From the perspective of the developmental state, the appropriate question for the role of the state is not "how much" but "what kind" (Evans 1995, p.10) . In other words, the crucial role of the state is not fading away, but it needs to be redefined. Peter Evans identifies four particular roles that provide the underlying structural basis for successful state involvement in industrial transformation (Table 4.1). The first two - "custodian" and "demiurge" - can be construed as variations on the tradition roles of regulator and producer. The second pair, which he calls “midwifery” and “husbandry”, focuses more on the relation between bureaucracy and the private sector. Midwifery refers to inducing private sectors to enter areas that they are not willing to enter. Husbandry means providing the support and stimulation to private sectors when they are already in situ.

Table 4.1: Roles of the state in industrial transformation

Roles of the State	**Functions**
Custodian(regulator)	Prevent private sector from doing anything illegal, as protection and policing
Demiurge(producer)	Replacing/competing with private sectors, such as SOEs
Midwifery	Inducing private sectors to enter the areas that they are not willing to enter
Husbandry	Provide support and prodding to private sectors when they already in situ

Source: Author adapted from Peter Evans (1995)

How can state-led development not be captured by a few interest groups? Peter Evans’ discourse of embedded autonomy illustrates a delicately balanced combination of capable meritocratic bureaucracies and industrialising elites. He argues that an insulated, meritocratic bureaucracy keeps developmental states from degenerating into predatory states. For him, the autonomy of the state requires the insulation of the bureaucracy from private economic interests. However, insulation does not mean isolation. Bureaucrats need to have a close relationship with business but they also have to formulate and implement policies autonomously. The success of industrialisation in these countries is associated with the close relationship between the bureaucrats and private industrial elites. Through frequent contact and information exchange, the bureaucrats are able to understand the needs of private entrepreneurs and thus to formulate and implement more effective industrial policies. One of the confusions of embedded autonomy is how to achieve it in any particular developing country. In his work, Evans (1995) mentions the role of SOEs in supporting industrial transformation when private capital is inadequate. However, he does not delve into the significance of state-owned banks and other financial institutions.

The market-enhancing view is the new emerging variant on the state as an interventionist for development. It was primarily developed by Aoki et al. (1998), who suggest the state uses policies to facilitate or complement private-sector coordination. Unlike the developmental state view, the market-enhancing view suggests the role of the state is not to be a substitute for but facilitator for private-sector coordination. The importance of the market-enhancing view is made clear firstly by recognising the ability of the private sector to coordinate a large fraction of economic activity, while at the same time recognising the potential for the state to facilitate the development of private-sector institutions. Thus the state and the private sector are not rivals in competing for control over economic activity. In this view public policy is not aimed at introducing a substitute mechanism for resolving market failures, but rather at increasing the capabilities of private-sector institutions to do so. Although this view has been criticised for lacking clear operational guidelines, it should be noted that a more nuanced approach to development policies may be necessary to fit individual country specifics (de la Torre et al 2007).

Table 4.2: Roles of the state in different perspectives of development theories

	Neo-liberal Development view	**Market-enhancing view**	**Developmental-state view**
State's position	An exogenous player	An endogenous player (part of market system)	An exogenous player
Neutrality of the state	Neutral	Not neutral	Neutral
State capacity	Not omnipotent	Not omnipotent	Omnipotent
Relationship between state and market	Market system is the best mechanism to solve coordination problems	Market has advantages to access local information	State can solve the coordination problem and overcome market failure
The role of state	Gatekeeper, minimise the government	Not a substitute, but facilitates, complements and enhances the private sector.	Synergy of market and state, links between public and private sector, embedded autonomy

Source: Author compiled from Aoki et al (1998)

The differences between the developmental state view and the market-enhancing view are at least threefold. Firstly, the former considers the state as a neutral, omnipotent agent exogenously attached to the economic system with a mission to resolve its coordination failures. The latter views the state as an integral part of the market system, i.e. an endogenous player. Secondly, unlike the developmental state view, which considers the state to have better information and judgment than the private sector, the market-enhancing view recognises that private-sector institutions have important comparative advantages vis-à-vis the state, in particular the ability to provide appropriate incentives and to access local information. Thirdly, the developmental state view highlights the direct intervention of government departments, such as a ministry of commerce. The market-enhancing view postulates that the role of the state is to facilitate the development of private-sector institutions (Aoki et al 1998). The private sector is the engine of growth while the public sector plays the role of a facilitator of development and ensures that the socio-economic objectives of the nation are achieved (Wee 2002). Table 4.2 lists the role of the state in different perspectives of development theories.

In general, the role of the state has oscillated between laissez-faire and state interventionist in development theories (Brett 2009). At one end of the scale, state interventionism calls for large-scale state interventions to solve problems of market failure; at the other end, neoliberalism calls for the unfettering of the market, with the invisible hand spontaneously leading to growth and prosperity.

These differences can be understood by variations in the structures of different states. According to Evans (1995), states vary dramatically in their internal structures and relationships to society. Different kinds of state structure create different capacities for action, which has a direct impact on the range of roles of the state. As Brett (2009) put it, the outcome of interventionist or neo-liberal policies depend on contextual circumstances and produce changes in the social, economic and political capital in each country that will determine the success or failure of policies.

While developed countries have “kicked away the ladder” (Chang 2002), late-developing countries need to put the ladder back up. Considering that the financial industries in developing countries are lagging far behind those in Western industrial countries, it is critical that the state plays an active role in the promotion of growth and transformation. It is also notable that the literature on development studies is primarily concerned with the industrialisation and structural reform in developing countries. They are either general propositions or confined to manufacturing industries. After all, we should acknowledge that there are stark differences between the financial and manufacturing industries.

The Speciality of Financial Sector

First of all, the financial sector not only creates high-valued output by itself, but also provides capital and financial services to support other industries, e.g. manufacturing industry. In any economy, almost all individuals, enterprises and governments need finance and the ubiquity of finance places it in a central role in the allocation of scarce resources (Lawrence 2001). In one sense, the financial industry is connected with every aspect of social and economic activity.

In addition, the financial sector requires different endowments to develop. In contrast to manufacturing industry, which is often dependent on hard infrastructure (e.g. raw materials, energy and equipment facilities), the financial industry is more concerned with soft infrastructure (e.g. regulation, culture, urban amenities) and human capital. Therefore, the role of the state in improving the quality of immigration, tertiary education, entertainment facilities and global linkage should be examined.

Furthermore, financial services are more mobile than manufacturing activities in terms of technologies and business characteristics. This implies that the financial sector is more volatile, risky and difficult to manage, particularly for late-developing countries, where all of the important institutions are underdeveloped. According to Shin (2005, p.382),

> The possibility that large amounts of money can move across borders at a touch of button is threatening the management of national economies. Therefore, financial industry, in many developing countries remained principally as a domestic industry under heavy government regulation.

After considering the differences between financial and manufacturing industries, it turns out that the current literature on the role of the state is insufficient to explain the IFCs' development in late-developing countries. Given that IFCs' development is a very complicated, multi-faceted subject, there is a need for an alternative interventionist approach to explain the role of the state.

4.3 Conceptualizing Financial Statism Approach

4.3.1 Conceptual Model

Financial statism mainly draws on certain insights from the recently emerging market-enhancing approach[24] (Aoki et al. 1998; Hellmann et al. 1998; de la Torre et al. 2007). It encompasses a broad set of policies and measures deliberately applied by central and local governments to govern the market at various stages of an IFC's development. The key components of financial statism policies are:

- The state's ownership within the financial system, e.g. state banks
- Financial restraint policies, including interest rate controls, restricting competition in the financial markets etc (Hellmann et al., 1998)
- State control over capital mobility across borders

It is also notable that financial statism approach points to large, fast-growing emerging economies rather than entrepot ones (e.g. Dubai and Singapore). Figure 4.1 describes a conceptual model of financial statism and its mechanisms in the development of IFCs in late-developing countries. This model has the following three defining features:

1. Financial statism is a market-enhancing approach. While this thesis is conceptually grounded in the recently articulated market-enhancing perspective (Aoki et al. 1998; Hellmann et al. 1998), there is an analytical focus on a broad set of interventionist policies and measures applied by state or city managers to promote IFCs at an early stage of development. Financial statism approach acknowledges the primacy of market forces at their economic best but also

[24] The market-enhancing view is also referred to as "Pro-market activism" (de la Torre et al 2007)

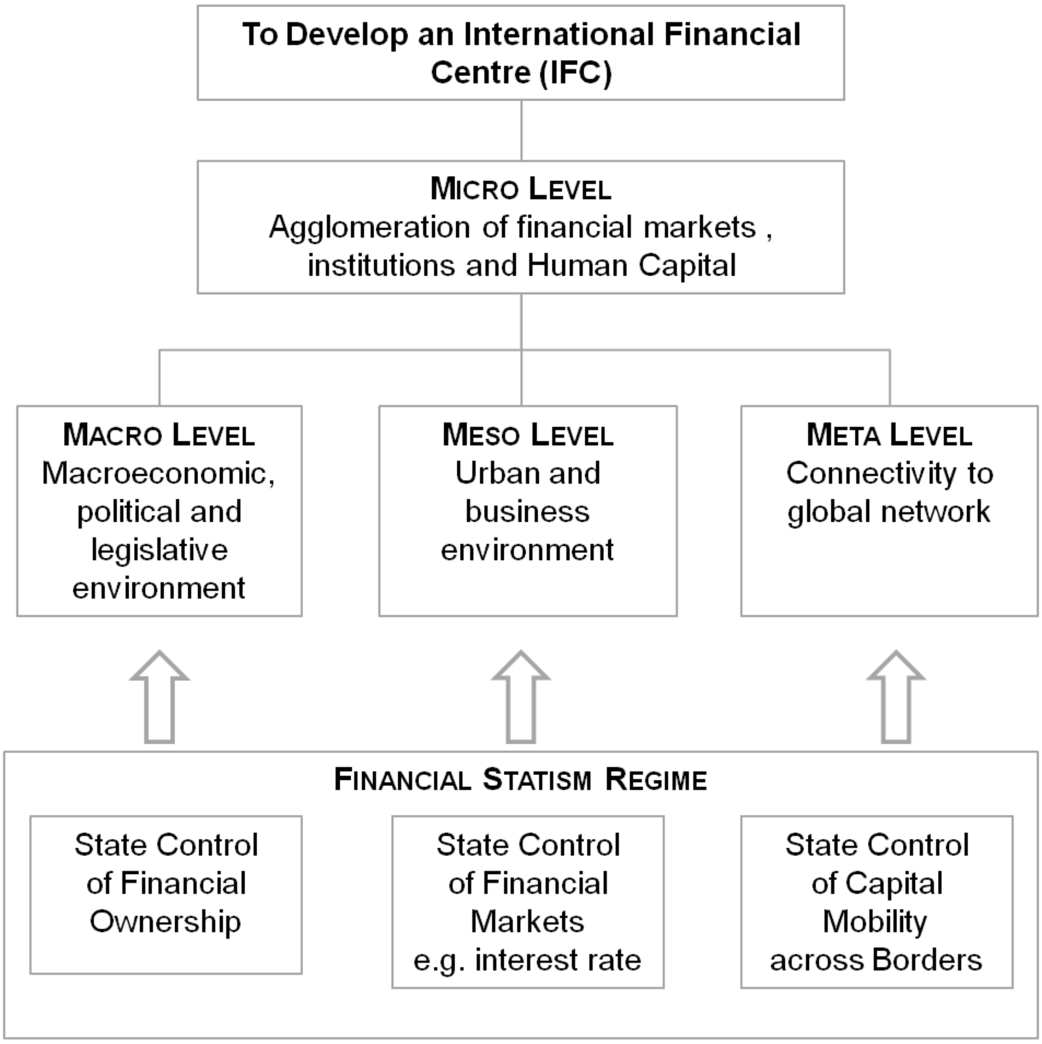
recognises the institutional weaknesses and market deficiencies in late-developing countries. Therefore, it contends that well-designed direct state intervention might be necessary to facilitate the formation of market institutions at an early stage of IFC development, e.g. state-ownership in commercial banks, contingent rents[25] or capital controls. In this way, the state managers employ financial statism policies to accelerate structural reforms; to support physical infrastructure development; and to facilitate the fostering of market institutions that lay the necessary foundations for long-term IFC development.

2. Financial statism is often a sub-optimal approach. In the real world, the state managers need to strike a balance among the different policy objectives of social stability, political sovereignty and economic efficiency. Due to the institutional weakness and market deficiencies, socially efficient does not in most cases equate to Pareto Optimal (see Barth et al 2006). When these objectives conflict, state managers often choose well-designed direct intervention as a suboptimal approach and prioritise social stability and political sovereignty over economic efficiency. To put it another way, financial statism is not always an economically efficient approach.

3. Financial statism is a dynamic approach. Its policy design differs from previous counterparts (e.g. developmental-state view) with regard to sustainability, time limits, governance and mechanics. Furthermore, it is more open and transparent. It emphasises that the approach that determines the evolution of IFCs' development is shaped by constraints derived from the past and the consequences of innumerable incremental choices of state authorities, which continually modify those constraints. This will be discussed further in Chapter 9.

[25] Aoki et al. (1998) introduced the concept of "contingent rents", which are different from direct state subsidies since they are not fixed. Rather, they are performance-based, often through productivity-enhancing contests.

Figure 4.1: The conceptual model of financial statism in IFCs development for LDCs



Source: Author

State-ownership in Financial System[26]

The naive belief that all that is required for developing countries to boost their financial sectors is to change ownership structures is specious. According to Farazmand (1999), the pervasive wave of privatisation in developing countries under neoliberalism is not considered economic policy but rather a "global ideological strategy of capitalism". He

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[26] The main focus of this paper is on state-owned banks rather than nonbank financial institutions. The choice to focus primarily on state banks is driven by the dominance of banking sector in developing world and greater availability of data on banking rather than nonbanking institutions.

points out that one of the probable consequences of privatisation for developing countries would be the erosion of national territorial sovereignty and the total dependence on foreign capital. This would reduce the capacity of their leaders to make independent policy decisions, bringing the consequent risks of further eroding competitiveness in the world economy (Farazmand 1999, p.555).

Nolan and Wang (1999) argue that privatisation in many cases has caused more problems than it has solved. In Eastern Europe and Latin America, bank privatisation gave rise to government bailouts or outright re-nationalisation, which were then followed by another round of privatisation (Feldstein 2003; Ocampo 2001). For late-developing-countries, privatisation has become a major setback for states in guiding their economies and destroyed the indigenous basis of their economic systems (Farazmand 1999, p.564). Andrianova et al. (2008) also provide a theoretical model as well as empirical evidence that show privatising state-owned banks when institutional quality is at relatively low levels is at best unnecessary and at worst detrimental.

Some might argue that state-owned financial institutions (SFIs) do not have any direct links to the IFC, since an IFC hosts various banks, securities firms, insurances companies, etc. regardless of their ownership. In Singapore and Hong Kong, we can see a large number of banks and financial firms – whether state-owned or privately-owned - carrying out business that has little impact on the status of these two cities as international financial centres. However, this is not the case for a developing country where financial markets are underdeveloped.

At certain stage, state banks could be an effective substitute for weak institutions. First of all, state banks could play an active role in development intervention, i.e. with targeted efforts to catch-up with advanced economies in strategic industries. Marois (2013) argues that state banks could facilitate the mobilization of savings and the allocation of those savings toward strategic sectors with long-term beneficial effects on an economy. In addition, state banks may also enjoy an advantage over private counterparts in terms of coordinating externality-rich activities because a private bank might not identify or internalize the benefits (see Barth et al 2006, p.207).

These justifications are coupled with arguments that state-ownership facilitates economic sovereignty and planned development. For late-developing countries, state ownership in financial system is a necessary counterweight to foreign ownership to maintain economic sovereignty. It could also allow the state to obtain valuable information on the financial industry and a way for direct government participation via state-owned financial institutions. In these ways, the state control of financial ownership can have a significant impact on macro-economic conditions of a host country, and thus the progress of IFCs' development in late-developing countries.

State banks could also do a better job in improving the infrastructure necessary for financial development, facilitating the agglomeration of financial institutions and maximizing social justice. Moreover, the recent global financial crisis underscored the countercyclical role of the state banks in countervailing the credit crunch from private banks (World Bank 2012).

Although state-owned financial institutions have many merits for LDCs particularly at the early stage of development, widespread evidence in practice shows that they have generally been very inefficient in allocating credit (World Bank 2012). Among other things, special attention should be paid to reforming the governance of SFIs to ensure that adequate risk management processes are in place.

Financial Restraint Policies

In the framework of financial statism, I borrow "financial restraint" from Hellmann et al. (1998) to specify a set of interventionist policies over financial markets to promote IFCs' development. According to Hellmann et al., financial restraint can provide some incentives for financial deepening through state intervention in most developing countries, or those in transition, where fully functioning financial institutions are either nonexistent or in their infancy. These policies include deposit rate controls, restricting competition in the financial markets and adopting policies to curb asset substitutability. By using these financial policies, the state aims to create "rent opportunities", which may provide incentives for banks to monitor private firms and promote economic development. This is particularly important, as these "rent opportunities" are contingent on the performance of financial intermediaries.

Financial restraint provides incentives for financial deepening in the following ways: Firstly, financial restraint can reduce costs, allowing banks to absorb more savings. Capital inadequacy can undermine the franchise value of banks and entices moral hazard among banking managers. Moreover, dearth of capital can greatly jeopardise the functions of financial systems as drivers of economic growth. Financial restraint policies are able to bring down the costs of deposit absorption and provide banks with more capital and profits. The increased cash-flow can thus help to accumulate capital and edge up its franchise value.

Secondly, financial restraint can foster a system dominated by financial intermediaries. It is noteworthy that financial restraint co-exists with limited market competition. Under financial restraint, banks can acquire more rents provided that they obtain more deposits, provide more loans and open more branches and subsidiaries. Meanwhile, the state also establishes barriers to entry to help those early entrants enjoy temporary monopolistic power to gain rents to offset start-up costs. This could increase capital efficiency and develop a virtuous circle between households and banks. However, if market competition is too intense, the "contingent rents" obtained by the banks would be diminished and incentives to expand their business would also be weakened. For example, a foreign Bank A is introduced into a certain area with the potential to be an IFC. Bank A has to invest in office space, training staff, cultivating new clients etc. If other similar banks B, C, D, and E were also permitted to enter this market within a short period, Bank A would lose incentives because its franchise value would not cover its costs. Andersen & Tarp (2003) advocated the adoption of a more cautious approach to financial sector reform. They believe increased competition in the banking sector after financial liberalisation is likely to erode franchise values, which may in turn generate an unstable banking environment. These problems can be aggravated before appropriate regulation to curb bad banking behaviour has been established.

Moreover, in the early stage of financial development, restricting bond and stock markets might prove to be an efficient policy, especially when a banking system is still at an early stage of development. During this time, the stock market will compete with the banking sector for deposits, which will deprive it of some of its more profitable potential business and cause the loss of franchise values and rents for banks. Augier & Soedarmono (2010) suggest that developing countries should develop financial intermediation (e.g. a bank-based financial system) before developing a market-based financial system, because a bank-based financial system is less costly than a financial market-based system. In short, the role of the state should focus on the framework of broad macroeconomic policies as well as active intervention in nurturing mechanisms that enable the funnelling of savings into high value-added industries. Policy objectives such as IFCs' development could be effectively implemented because a central state administration controls credit and could intervene in industrial sectors (see Chapter 6).

Capital Control

One of famous theoretical approaches to explain capital control is the Mundell-Fleming paradigm (Mundell 1962, 1963, 1964; Fleming 1962). It basically argues that three key policy objectives cannot be achieved simultaneously: exchange rate stability, private capital mobility and domestic monetary independence. As a result, many developing countries seeking to develop international financial centres still exercise stringent controls on capital mobility and currency convertibility so as to maintain monetary sovereignty and economic stability. These courses of action seemingly conflict with the neo-liberal model of IFCs, which advocates deregulation, liberalisation and the free flow of capital across borders. In effect, capital and the state do have conflicting goals that cannot be achieved simultaneously (Block 1994, quoted in Yeung 2000, p.139). The lifting of capital controls and full convertibility of currency should not be based on ideological commitment to an idealised conception of markets.

For late-developing countries, capital-account convertibility can incur massive risks. A hasty opening up of the capital account and overdependence on private capital inflows imposes a number of constraints on the autonomy of developing countries in the conduct of macroeconomic policies (UNCTAD 2012). When the prospects for a domestic economy are positive, the influx of hot money will give rise to an economic bubble. Conversely, when the economic situation is poor, speculative money will decamp and cause problems for the international balance of payments, particularly in large, fast-growing emerging economies. Since the 1980s, the developed world has put considerable pressure on developing economies to open up their financial markets to foreign competition. Financial liberalisation usually leads to "speculation-led development" which in turn almost invariably ends in currency and banking crises

(Chang and Grabel 2014). Developing countries should thus be wary of financial liberalisation when its institutions are underdeveloped. The financial system has the capability of self-adjustment, but it has its limitations. Unrestricted currency convertibility creates the potential for currency depreciation and collapse, capital flight and financial instability. Conversely, restriction of convertibility ameliorates the problems (Chang and Grabel 2014). When external forces are exceeding their limitations, the financial system will be ruined. Instead, state control over capital mobility can often consolidate state capacity, build up financial markets and institutions gradually and eventually sharpen the competitive advantage of domestic players in the global market.

Meanwhile, developing countries should be beware of the assertion that efficient financial intermediaries automatically lead to the rise in societal welfare after capital liberalisation. Alessandria and Qian (2005) use a model of endogenous financial intermediation and demonstrate that a welfare loss may occur in an open economy when a country accesses global capital markets at high interest rates. It is argued that the entry of foreign institutions has mixed results. The foreign capital may help to raise welfare through low interest rates and the introduction of increased competition but simultaneously it could also generate more risky behaviour through lower lending rates, which will lessen welfare. Furthermore, the presence of foreign banks may decrease the government's control of the economy. Weiss (1999, p. 127) observes the tensions of openness:

> On the one hand, countries are often told they must open up to the world for fear of being left behind. On the other, opponents of openness urge putting up the shutters -- re-imposing capital controls and trade protection -- for fear of letting in a socially and economically destructive virus.

Therefore, different countries, in different situations, should balance these considerations differently (see Stiglitz et al 1993). Only when a financial market is deep enough can the LDCs resist the impact of volatile capital flows. As a matter of fact, most of the world's industrialised countries did not maintain unrestricted currency convertibility until their economies were strong and stable and hence could withstand the pressures of currency volatility. Therefore, in the early stage of transition, when deposit mobilisation is essential to economic transition, imposing restrictions on speculation and capital mobility is a sensible option. This is the reason why capital-account convertibility is viable in Western, mature economies, while it jeopardises financial stability in emerging economies.

4.3.2 Motives and Benefits

In this section I try to illustrate why financial statism might be helpful for developing countries in facilitating IFCs' development. To understand financial statism as an approach in IFCs' development, the underlying characteristics of a financial sector in late-developing-countries need to be taken into consideration. Herein I would argue that the financial sector in late-developing countries has its idiosyncrasies, notably institutional weaknesses, market incompleteness (i.e. threshold effects), vulnerability to crises and lacking of expertise.

Firstly, financial development in developing countries is characterised by lack of proper market institutions. Financial markets cannot exist without effective legal, administrative, regulatory and other institutions. These variegated institutions provide the certainty and predictability necessary for facilitating efficient financial intermediation. von Mettenheim (2009, p.120) argues that there are stark differences between developing and advanced economies with respect to the maturity of markets and institutions. Developing countries usually suffer from institutional weaknesses, market imperfections and volatility due to lack of well-established institutions and a mature private sector necessary for the effective running of a market economy (Wee 2002; HPEC 2007). Those neo-liberals who claim the market is everything ignore the background highlighted by the literature on developing countries: many, if not all of them, lack sound institutions for financial development. For those developing countries in transition, market mechanisms are all the more deficient because of central-planning economic traditions. Conversely, advanced economies have longstanding consolidated institutions and deeply embedded and effective markets. Mishkin (2006) writes,

> Good institutions, however, need to be home grown…The development of good institution in the advanced countries took hundreds of years as they grew and adapted to local conditions. Poor countries must ultimately develop their own institutions, and the citizens

> of these nations must feel they have ownership of those institutions or else the institutions will be ineffective and short-lived (2006, p.13).

The mainstream laissez-faire approaches such as neo-liberalism fail in developing countries owing to institutional failure. When a market system is not established and the private sector is still not competitive at world stage, the privatisation of a financial sector poses great risks, jeopardising the stability of the society and its economic development. Developing countries with weak institutions would lapse into a "financial globalisation trap" if they inappropriately promoted capital account openness and mobility (Cassimon et al 2012, p.75). In a situation in which there are many deficiencies to prevent the fulfilment of market mechanisms, financial statism may help to deal with institutional weaknesses, lessening the risks of the financial industry in a globalised world. Djankov et al. (2003) have claimed that a fundamental issue of institutional design is to reach a trade-off between a controlling dictatorship and disorder. The general point is that financial liberalisation should be considered in light of its own institutional possibilities, rather than as some dogmatic views of a few rich capitalist countries.

The second issue of financial sector in developing countries is that the financial development is often thwarted by the threshold effect, which is instrumental to the finance-growth nexus. Recent findings in academia establish that any level of financial development can produce a threshold effect (Augier and Soedarmono, 2010). Financial development cannot support economic growth unless its initial stage exceeds this threshold value. Consequently, if income levels are lower than the threshold value it means people cannot afford financial services and financial intermediaries and markets will not emerge. The threshold effect suggests a nexus between market formation and economic development.

Greenwood and Smith (1997) highlight that market formation is endogenous, which suggests it must follow some period of real development. Markets open when an economy is wealthy enough to support them. Meanwhile, there are important fixed costs associated with opening and operating markets (Greenwood and Smith 1997, p.149). The formation and growth of financial markets are not free of cost. Investment in institutions and infrastructures is also costly. For this reason, those who want to use specialist and sophisticated financial services have to pay a portion of fixed cost (i.e. "threshold value"). If capital stock is not large enough to meet the threshold value, financial institutions will not emerge.

There is some evidence of various kinds of "threshold effect". For instance, it is stated that the glaring deficiencies in Mumbai's urban infrastructure have impeded IFCs development (HPEC 2007). As the report describes, Mumbai's deficiencies include:

> [C]rumbling housing in dilapidated buildings pervading the city; poor road/rail mass transit … poor quality of airports, airlines and air-linked connections domestically and internationally; poor provision of power, water, sewerage, waste disposal, as well as a paucity of high-quality residential, commercial, shopping and recreational space that meets global standards of construction, finish and maintenance (HPEC 2007, p.xxi).

Financial statism provides a useful approach to overcoming the threshold effect, particularly for developing countries. For example, the state (either central or local) could make a lump-sum payment to upgrade infrastructure and create financial institutions and markets in one fell swoop. Financial statism would allow the LDCs to accumulate physical and human capital more rapidly. In other words, financial markets could emerge before the income level reaches the threshold value. As such, the financial sectors in developing countries should thrash out a way either to reduce certain thresholds or resort to raising capital elsewhere to spur economic growth. This can take place when the ownership of major financial institutions is dominated by the state.

The third point that justifies financial statism is that LDCs are more vulnerable to economic crisis and financial shocks. The financial sector is a strategic industry which is closely associated with national interests. Taking the banking sector as an example, it attracts deposits from households and corporations. However, the homogeneity of banking business is vulnerable to the chain effect of a run on banks spreading from one individual bank to others (World Bank 2012). Bank A's problem can quickly become that of Bank B and Bank C. Financial meltdown can propagate very quickly in developing countries if confidence is lost in these privately held banks. When a large number of such banks suffer runs at the same time, a financial crisis will occur with potentially devastating consequences for the national - or even the greater regional – economy. In such cases, state banks are effective in bolstering confidence for the depositors as the government is the last resort and credit guarantor, especially when effective market institutions (e.g. deposit insurance system) are not established in late-developing countries.

Moreover, the risks and uncertainty in an economy arise due to the volatility of financial markets. In the new context of economic globalisation, the developing countries with deficient and underdeveloped financial systems are deeply vulnerable to international money speculators (Chang et al 1998). The Asian financial crisis in 1997, for example, was caused by hedge funds whose strategy was to attack loopholes within the financial and economic system in developing countries. Since the 1990s, developing countries have frequently suffered huge losses in these attacks, such as Mexico in 1994, Russia in 1998, Brazil in 1999 etc. Nevertheless, developing countries would be able to set a firewall to guard against these attacks through financial statism so as to maintain the stability of their domestic economies. China was unscathed in the Asian financial crisis in 1997, which is largely attributable to its capital control regime (see section 6.2.3).

Financial statism could also play an active role in maintaining economic stability in the downturn of a business cycle. When a country's economy is on the way to recession or depression, or affected by unusual incidents, private capital or foreign capital will lose the incentive to stay as it battles with pessimistic expectations on returns or declines in investment capability. By the time this happened, financial statism would be able to maintain economic stability and kick-start private capital investment. Following economic revival or a return to prosperity, the private sector would boom and foreign capital would flood back in; denationalisation could occur and the state sector could then exit. Von Mettenheim (2009, p.131) suggests that state banks were the critical agents in the provision of counter-cyclical credit to help Brazil get out of its economic slump in 1999-2000. During global financial crisis, the state banks are also able to lend counter-cyclically to offset the credit contraction from private banks (World Bank 2012; Marois 2013).

Therefore, to maintain macroeconomic stability and social welfare, a strong state is fundamental to efficient intervention. In his book - *State-building: governance and world order in the 21st century*, Francis Fukuyama (2004) states that the root cause of many serious problems in the contemporary world is a weak or failed state. He thus calls for a re-engineering of the concept of state-building. Wang (1991) defines state capacity as an indicator to measure the effectiveness of state intervention. In practice, the concept has interpreted as the capability of the state to mobilize and guide social and economic resources toward the ends identified by the political leaders. Financial statism suggests that plentiful financial resources in the hands of the state are one of the key ingredients of state capacity.

Last but not least, it is worth noting that IFCs development in developing countries is confronted with intense competition not only from advanced economies, but also among emerging economies (e.g. Jarvis 2011; Young et al 2009; Lannoo 2007). Financial statism would allow late-developing countries to learn from the rest of the world. Chang (2006) uses the Gerschenkronian "catching-up" framework in exploring institutional development in the developing countries. In his view, they could emulate similar institutional models from the developed countries without incurring the same set-up costs. This coincides with the "advantage of backwardness", suggested by Lin (2004) [27]. In essence, developing IFCs in developing countries is a "catch-up" process. The phenomenon of "catch-up" should be understood as a process in which the state plays a strategic role in taming domestic and international market forces and harnessing them to national ends (Onis, 1991 p.110).

It is acknowledged that the development of IFCs in late-developing countries should learn from advanced countries in terms of advanced technology and management skills. During this process, financial statism would enable state investment in the cost of learning that is too expensive for the private sectors to withstand. Financial statism would thus be able to develop some "national champions" through various adaption, imitation and trial-and-error behaviour. Apart from this, financial statism could also help to develop a modern financial market and introduce effective financial services and a management structure. It is also worth mentioning that the learning process should be subject to buy in by late-developing countries, rather than being imposed upon them by

[27] Lin (2004) suggests that developing countries can borrow advanced technology and management skills from the developed countries.

developed countries.

In sum, financial sectors in late-developing countries were significantly inferior to those in advanced economies.The LDCs are confronted with various problems, such as institutional failure, the threshold effect, multiple risks and knowledge gaps. All of these suggest that IFCs' development in developing countries cannot duplicate the laissez-faire models advocated by the current advanced economies. Conversely, financial statism approach could reinforce national sovereignty, promote financial deepening and preclude exogenous risks in LDCs, at least at early stages of IFCs development.

4.3.3 Limitations and Challenges

While financial statism presents some opportunities in IFCs' development, it also involves some limitations and challenges. As a matter of fact, financial statism, specifically dominant state-ownership in banking, state intervention in financial markets and capital control policies, has long been criticized by commentators in Western academia.

Some commentators believe state ownership tends to politicize resource allocation, soften budget constraints, and otherwise hinder economic efficiency (Kaufman 1999; La Porta et al. 2002). These defects are theoretically ascribed to the principal-agent problem and soft budget constraints. In the public ownership scenario, since it was hard to discriminate whether losses are derived from policy loans or operational costs, management have no incentive to improve its performance. In particular, a number of conflicts-of-interests arise between the role of the state as the regulator, owner and/or borrower of financial system (World Bank 2012). Besides, it is also claimed that the state-ownership may generate perverse incentives for government to diminish competition, through protecting the survival and profitability of state banks at any costs (HPEC 2007).

In a similar manner, interest rate controls also lead to a distortion in resource allocation and drive down the efficiency of investment. Moreover, guaranteed interest rate margins give rise to excessive investment in capital-intensive industries. With the underpriced capital, the profitability of projects would be distorted by these implicit subsidies from the state.

Critics also cast doubt on entrepreneurship by the state-owned financial institutions – “creative destruction”. It is argued that the state sector is possessed with monopoly powers and therefore has little incentive for innovation crucial to the competitiveness of IFCs’ development. Rather, monopolistic interest groups are prone to resist market reform, competition and opening up (Lien and Chen 2009).

Perhaps the biggest challenge to financial statism lies in the fact that in certain respects its main practices conflict with the key factors of IFCs’ development identified in Chapter 3. In particular, figure 3.1 shows that, at a meta-level, an IFC should have free capital flows across borders and full convertibility of currency in order to link to the global network. However, the capital control regime defined in financial statism entirely contradicts this. So, how can late-developing countries develop an IFC using financial statism? To address these questions, let us first investigate the case of Shanghai in the development of IFC since the 1990s and then we will have a further discussion in chapter 9 on the validity of financial statism approach.

5. Methodology

5.1 Epistemological Stance

5.1.1 Realism as Research Epistemology

It is vitally important to introduce the epistemological stance prior to the empirical study on the development of an IFC. Epistemology is basically a theory of knowledge, which reflects one's view of what one can know about the world and how one can know it. Marsh and Furlong (2002) classified epistemological approaches into three categories: positivist, realist and interpretivist. Positivists contend that the world exists independently of our knowledge of it. They argue that natural science and social science are similar and the world is not socially constructed. Therefore direct observation can serve as an independent test of the validity of a theory. Interpretists argue the direct opposite. They contend the world is socially or discursively constructed, which means social phenomena are affected by our interpretation or understanding. One corollary of the interpretivist position is that objective analysis is impossible and the proposition of the research is heavily affected by the researcher's subjectivity, comprising cultural, ideological, political, religious or ethnological bias. Realism shares the views of positivism and contends that the world exists independently of our knowledge of it. However, realists disagree with positivists that all social phenomena are directly observable. They maintain there are subliminal structures that cannot be observed and what can be observed may offer a false picture of these phenomena/structures and their effects (Marsh and Furlong 2002). In this way, they have more in common with interpretists.

In development studies, realism is instrumental in helping us to distinguish between reality and appearance. In order to reveal underlying structures of reality, we need to look below the surface. In fact, underlying structures are more durable than the appearance they create. Realists argue that underlying structures can sometimes conflict with appearances (Collier 1994). Hence, we need to identify and understand both the external 'reality' and the social construction of that 'reality' if we are to explain the relationship between social phenomena (Marsh and Furlong 2002).

Realism has clear methodological implications. It suggests there is a real world "out there", but emphasises that outcomes are shaped by the way in which this world is socially constructed (Marsh and Furlong 2002). As such, it would acknowledge methodological pluralism, i.e. the adoption of both quantitative and qualitative methods.

5.1.2 A Dialectic Approach to "Structure-Agency" Relationship

A closely related issue in epistemology is the debate on the "structure-agency" relationship. In effect, the relationship between structure and agency is one of the most important issues affecting the way we undertake development studies. In this study, we often ask the following question: "Which one is more important in the process of IFCs' development, market-driven or state-led?" Essentially, this question is associated with the "structure-agency" relationship.

> Fundamentally, the [structure-agency] debate concerns the issue of to what extent we as actors have the ability to shape our destiny as against the extent to which our lives are structured in ways out of our control; the degree to which our fate is determined by external forces.(McAnulla 2002, p.271)

Here agency is conceptualised as "conscious, reflexive and strategic" (Hay 2001). Agency generally refers to individuals or groups that can affect their environment. Structure usually refers to contexts and material conditions which define the range of actions available to them (McAnulla 2002, p.271). As regards the "structure-agency" debate, there are two positions at opposite ends of the spectrum. One prioritises structure (the "structure-centred approach") and the other prioritises agency (the "agency-centred approach"). I prefer a position which gives crucial roles to both structure and agency; a dialectical approach.

The reason why I favour a dialectical approach is that the "structure-agency" relationship is essentially determined by the ontological and epistemological stances. In other words, there are different solutions to structure-agency problems when the researcher holds different epistemological assumptions (Hay, 2001). Modern critical realism acknowledges two points. Firstly, although social phenomena exist independently of our interpretation of them, our interpretation/understanding of them affects the outcomes. Therefore structures do not determine; rather they constrain and facilitate. Social science involves the study of reflexive agents who interpret and change structures. Secondly, our knowledge of the world is likely to make errors, since our interpretation of social phenomena can only be understood within the context of a specific theory (Marsh and Furlong 2002).

A dialectical approach is perfectly consistent with the perspective of modern critical realism. In the work of Colin Hay (1996) and Bob Jessop (1990), they suggest a dialectical approach towards the structure-agency relationship. In this approach, structures do not determine outcomes and agents are not simply “bearers” of structures. Rather, structures constrain and facilitate agents whose actions configure and reconfigure the structures. As such, actions take place within a pre-existing structured context that is strategically selective; one that favours certain strategies over others (McAnulla, 2002). For example, the existence of the interest groups who are able to benefit from industrial transformation give rise to the state managers and bureaucrats who advocate industrial policies. In parallel, these state officials and their policies can also make the industrial transformation successful and generate new interest groups. Meanwhile, Jessop (1990) also stresses the ability of agents to alter structural circumstances through an active process of strategic learning: “agents are reflexive, capable of reformulating within limits their own identities and interests, and able to engage in strategic calculation about their current situation” (quoted in McAnulla, 2002, p. 281).

This could be also true when we explore the evolution of international financial centres. In this thesis, I intend to explore the IFCs’ development by analysing the interplay between structure (e.g. market institutions) and agency (e.g. state managers). In the process of interplay, the agential force represented by various actors is often active, intentional and reflexive. Most of the time these actors may behave deliberately in an attempt to realise their attentions and preferences. They are also presumed to be capable of monitoring the longer-term consequences of their actions. Furthermore, the agential force is also dynamic; it responds to changing contexts. These actors can also reform their preferences and perceived interests and determine their course of action over time given changes in structure and material circumstance (Hay 2001). Taking account of the "structure-agency" relationship in a dialectical way helps us understand that the role of the state in IFCs' development is not a straightforward matter.

It is also important to identify different levels of analysis when we look at the role of the state in the IFCs' development. For instance, in the domestic market, the individuals and the state can be conceived as a set of structure-agency relationship; while in the global market, the individual state and the rest of the states across the world be another set of structure-agency relationship. At the different level of analysis, the state might play a different role, either agency or structure. In that sense, the state is essentially an amalgamation of agencies (i.e. state managers) and institutional structures (Skocpol 1985, p.28). Therefore, we should not fall into the trap of focusing solely on one level of analysis. Moreover, we should also keep in mind that the structure-agency debate is more suitable for consideration as an analytical device rather than an empirical generality (Hay 2001).

5.2 Research Method: Single Case-Study

Creswell (1994, p.12) provides a good account of case study definition:

> [Case studies] explore a single entity or phenomenon (the case) bounded by time and activity (a program, event, process, institutions, or social group) and collects detailed information by using a variety of data collection procedures during a sustained period of time.

Indeed, the case study is a valuable method of research, with distinctive characteristics that make it ideal for many types of investigations, including exploratory, explanatory and descriptive research (Tellis 1997). Exploratory case studies are suitable for theoretical development. This type of study often involves fieldwork and a survey prior to a definition of the research question and hypothesis. Explanatory case studies are used for causal inferences to help identify a causal chain between different social phenomena or events. Descriptive cases are capable of testing a well-formulated theory. Under these circumstances, a case study that can confirm all of the conditions is also able to challenge and expand the theory.

There is a clear distinction between case studies and statistical studies. The latter often neglect all of the contextual factors and intervening variables, except those selected for measurement (George and Bennett 2005). In contrast, case study method is better suited to investigating complex social phenomena when boundaries between phenomena and contexts are often blurred (Yin, 2008). As previously noted, IFCs' development is influenced by a broad set of factors such as institutional, structural and ideological legacies from the past. The role of the state on IFCs' development should be examined based on the contextual settings. The capabilities and incentives of the state are greatly influenced by the initial conditions as well as the external circumstance in which they are embedded (Lau 1998). Brett (2009) notes that the models of "best practice" in developed countries are constantly evolving in response to new political, economic and environmental crises. The developing countries should adapt these theories in relation to their own settings, since the prescription of the "neo-liberal model" has played a crucial but ambiguous role in producing both success and failure.

Using case study methodology, we can look at a large number of intervening variables and inductively observe any unexpected aspects of the development mechanism for an IFC. George and Bennett (2005, p.45) identify four strengths of case study methods: their potential for achieving high conceptual validity (to define a concept in a specific context); their strong procedures for fostering new hypotheses (revision of hypothesis during a survey); their value as a useful means to closely examine the hypothesised role of causal mechanisms in the contexts of individual cases (considering the specialty of an individual case); and their capacity for addressing causal complexity.

A frequent criticism of case study methodology is that its dependence on small number of cases renders it incapable of providing a generalising conclusion (Tellis 1997). Yin (2008) stresses that we need to discriminate "analytic generalisation" from "statistical generalisation". Case studies conducted under certain contexts with all sorts of variables and conditions may not be representative. However, the case study method is valuable for expanding and generalising theories, which implies that it is applicable to a theoretical proposition. That is to say, the goal of a case study is to generalise an analysis rather than a particular object or event (Gomm et al. 2000; Yin 2008).

Generalisations do matter but are best understood if careful attention is paid to their setting and scope. In other words, we cannot generate nomothetic laws that are always universally applicable (Byrne & Ragin 2009, p.9). Lincoln and Guba (1985) have reconceptualised the notion of generalisability. They argue the contribution of a case study is more about transferability than generalisability.

> [T]he degree of transferability is a direct function of the similarity between the two contexts, what we shall call ‘fittingness’. Fittingness is defined as the degree of congruence between sending and receiving context. If context A and Context B are ‘sufficiently’ congruent, then working hypotheses from the sending originating context may be applicable in the receiving context. (Lincoln and Guba, 1985, p.124; cited by Donmoyer 2000)

In this thesis, I employ the single-case study method to develop theories (hypotheses). I am not attempting to develop a grand theory that can be used in all types of countries. Rather, I expect to identify the conditions under which a range of variables interacted with each other to promote IFC development in China. As David Dessler (cited in George and Bennett 2005, p.147) has argued, there are two approaches to the explanation of events: a generalising strategy (to show the event as an instance of certain type of events) and particularisation (detailing the sequence of happenings leading up to an event, without necessarily placing it in a larger class). For the current study, I have chosen particularisation. John Friedman’s (2005) recent overview of “China’s urban transition” reflects a common reluctance on the part of China scholars to generalise. He provides a good account of particularity with regard to China.

> China cannot be fitted neatly into the narrative of any grand theory, whether that be the narrative of modernization or globalization, urbanization or national integration – certainly not yet (because the future is so rapidly being made) and perhaps never (because China is not just another country, but a civilization that deserves to be understood on its own terms). (see Logan 2008, p.2)

Therefore, in this thesis I concentrate on searching for necessary condition or intervening variables for IFCs’ development in China instead of duplicating the same conditions in other countries.

Another common critique of case study methodologies is that they are inclined to “selection bias” (George and Bennett 2005). Selection bias refers to studies that appear to show researchers deliberately choosing their samples based on the values of their dependent variables. This can be a severe problem in statistical studies, since it always understates the strength of the relationship between independent and dependent variables. The selection of cases on the basis of the value of their dependent variables is sometimes appropriate as this can help identify sufficient conditions for the selected outcome (George and Bennett 2005). This is understandable since case study researchers are keen to find the specific conditions that underlie a given phenomenon, rather than the frequency of occurrence of a given outcome (Bennett, 1997). However, in some circumstances this selection bias can understate or overstate the relationship. To some degree, this could be considered a primary weakness in qualitative single-case studies such as mine. Despite this, a solid analytical framework such as process-tracing is helpful in safeguarding against selection bias.

5.3 Research Questions, Analytical Framework and Hypothesis

The core issue of this thesis is to investigate the inter-relationship between financial statism in China and the development of an international financial centre in Shanghai. The main research question is:

> Has China’s financial statism (notably dominant state-ownership in the financial sector, financial restraint policies and capital controls) promoted or hampered Shanghai’s IFC development since the 1990s?

The study also identified three sub-questions:

a) What was the impact of China’s financial statism on Shanghai’s IFC development at macro, meso and meta levels?

b) How successful has Shanghai been in developing into an IFC under financial statism since the 1990s?

c) Were there any changes taking place in China's financial statism given the new contextual conditions? If so, what were the underlying reasons for these changes?

For the case study method, there are different analytical techniques linking data to propositions. Process-tracing is particularly useful for uncovering the evidence of causal mechanisms and obtaining an explanation for deviant cases; those that have outcomes not predicted or explained inadequately by existing theories (George and Bennett, 2005). One of the most common patterns of process-tracing takes the form of a detailed narrative or story presented in the form of historical chronicle. In this thesis, the financial system is not static, but variable. The evolution of a financial system is a dynamic process. Hence, process-tracing is a useful mode of analysis in exploring SIFC development. As a means of examining complexity in detail, case studies also require substantial process-tracing evidence to document complex interactions. The analytical framework of the study is divided into three phases.

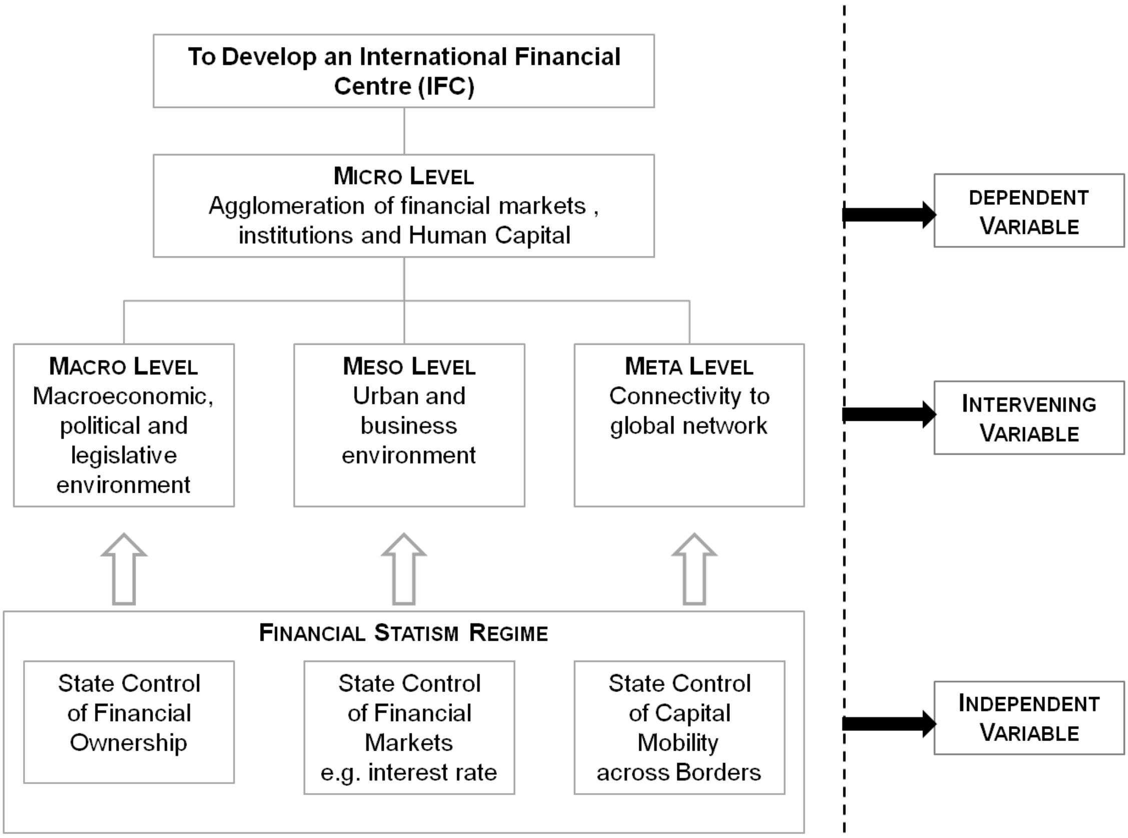
Phase One: Identifying different variables

At the onset, we need to identify a range of variables that were correlative in the process of SIFC development. The independent variable in this thesis is obviously direct state intervention in IFCs' development, which I have labelled financial statism. This means the independent variables include the scale of state control in financial ownership, the extent of financial restraint policies and the degree of state constraints on capital mobility.

The dependent variables are certainly the outcome of IFC development in Shanghai. As stated in the preceding chapter, an IFC is an agglomeration of various financial markets and institutions in a certain place. This can thus be measured through the breadth and depth of financial markets and institutions at the micro-level. Furthermore, the efficiency and innovativeness of the IFC need to be examined. Although the dependent variables can be observed and assessed, there seems no theoretical link that directly connects the dependent and independent variables.

To facilitate a better understanding between the dependent and independent variables, I have introduced a set of intervening variables (Figure 5.1). As previous discussed in Chapter 3, the agglomeration of financial markets and institutions (the micro-level) are subject to other factors, such as the urban and business environment (the meso-level), macro-economic conditions (the macro-level) and connectivity to the global network (the meta-level). Meanwhile, these variables have direct causal relationship with financial statism (see Chapter 4). In this thesis, those factors with regard to meso, macro and meta levels are chosen as the intervening variables affecting the formation of an IFC.

Figure 5.1: The analytical framework of the study



Source: author

Phase Two: Examining causal Relationships

The analytical model of process-tracing is primarily applied in this phase. I retrace and document the key measures or policies that were taken by China's central and local governments to promote Shanghai's IFC development over the past 20 years in chronological order. Then I analyse to what extent these interventions have affected the

SIFC's development. Moreover, I also consider how the state converted financial statism following changes in contextual factors, such as the occurrence of financial crises and China's accession to the World Trade Organization in 2001. From these, I seek to demonstrate the ways financial statism affected SIFC development and to look into the causal relationships between independent and dependent variables.

Phase Three: Refining hypotheses and the summation

It is possible evidence from the empirical study would not be consistent with the hypotheses delineated at the outset. At this stage, it is desirable that new hypotheses can be generated on the basis of events observed inductively in case studies. It is also crucial to identify other factors such as historical analysis to underpin the research findings, as the formation of an IFC is also path-dependent.

George and Bennett (2005) also identify two key constraints on process-tracing. Firstly, process-tracing requires a continuous, uninterrupted causal path linking putative causes. When data is unavailable, process-tracing can only draw provisional conclusions. Secondly, there may be more than one hypothesised causal mechanism consistent with any given set of process-tracing evidence. In that case, "parallax" may arise due to different interpretations.

Based upon the above analytical framework, the thesis seeks to examine the following hypotheses.

(1) Financial statism policies generally boosted the promotion of Shanghai into a domestic financial centre (agglomeration of financial markets, services and human capital) during the early stages of SIFC's development, while the country enjoyed a high degree of state intervention at macro, meso and meta-levels during its economic transition.

(2) However, financial statism restricted Shanghai's connectivity to the global network, which impaired its transformation into a genuine international financial centre. Given the enhanced institutional strength of the market system, the state managers needed to withdraw financial statism during the latter stages of the SIFC's development.

(3) Overall, China's financial statism can be viewed as "invisible scaffolding" in the SIFC's development.

5.4 Fieldwork and Data Collection

Before carrying out this PhD study, I had served as a research fellow in the Shanghai Development Research Centre (SDRC) for nine years. The SDRC is a think-tank funded by the Shanghai Municipal Government, whose mission is to conduct policy studies on Shanghai's development in partnership with other government departments, universities and research institutions. One distinct function of the organisation is that most of the research projects undertaken were commissioned by the mayor of Shanghai and other city leaders, and thus have a heavy influence on policy making. While working at SDRC, I participated in a number of projects related to Shanghai's IFC development. The Table 5.1 lists part of relevant research projects carried out at SDRC between 1997 and 2006.

The experience of participating in these project studies has provided invaluable information and resources for this study. More importantly, as an active participant-observer in this process, I was in a better position to understand the policy-making mechanisms in the city's government and their interaction with the central government in various reforms and policy initiatives regarding the IFC's development.

It is also notable that Shanghai's IFC development is an ongoing project. I conducted several field trips to Shanghai from 2008 to 2013 while I was carrying out this PhD study. The most important goal of the fieldwork was to obtain information regarding updated policies and contextual conditions. This involved the collection and review of relevant documentation on the study. Relevant data includes unpublished reports/ records, published reports (research studies/ case studies and so on), newspaper articles, other media coverage, information accessed through the internet, academic research papers, official records and government dossiers from key government agencies, e.g. Shanghai Financial Service Office (SFSO), Shanghai Development Research Centre (SDRC), and any other authentic available documented sources of information.

Table 5.1: Relevant research projects sponsored by the SDRC

Year	Project Partners	Project Topics
1998	Shanghai University of Finance and Economics	The Study on Shanghai's Fund Market Development
2000	PBoC, Shanghai Branch	Comparative Study of IFCs between Tokyo, Hong Kong, Singapore and Shanghai
2001	Fudan University	The Feasibility Study of Developing Privately-owned Financial Intermediaries in Shanghai
2002	Development and Reform Commission, SMG	The Development of SIFC as a National Strategy
2003	Shanghai Institute of International Finance	Using Commodity Futures Market as a Strategic Initiative to Promote SIFC Development
2003	Shanghai University of Finance and Economics	The Study of Corporate Governance on China's Security Holding Companies
2003	Shanghai Financial Service Office	The Action Plan on the Development of SIFC
2004	Shanghai Pudong District Government	The Study on Industrial Clustering Development in Pudong
2004	Shanghai Jiaotong University	The Study on Key Policy Initiatives to Promote SIFC
2004	Shanghai Institute of Pudong Economic Development	The Study on CBD Development in Pudong, Shanghai

Source: Author, SDRC reports

Furthermore, China's economic transition and development have been analysed in depth by both Chinese and foreign scholars. The literature on China's economic growth is voluminous. I also draw heavily on this literature in describing the role of the state and transformation. These documents serve to corroborate the evidence from other sources. In the evaluation of the IFC development in Shanghai, I also examined several competitive rankings and indices produced by several prestigious institutions and consultancy companies, such as the City of London Corporation, the Chicago Mercantile Exchange Group and Roland Berger Consulting Co. Ltd. etc (see Section 7.3

for details).

According to Yin (2008), triangulation is helpful in improving reliability in single case studies. This involves the use of two or more different methods in studying the same phenomena on the grounds that no single method is infallible (Rose 1982). I began my research with "secondary evidence", supplemented by a variety of government documents and statistical evidence. In the meantime, I have also used anecdotal evidence to analyse tendencies and trends. I have examined histories, archival documents, interview transcripts, and other sources to see whether the causal process the study hypothesises or implies is in fact evident in the sequence and values of intervening variables.

Apart from that, I also acknowledge that primary information is significant to the case study. I conducted dozens of interviews with experts, scholars and senior executives in person or by telephone via semi-structured questionnaires (see Appendix 6 & 7 for details). The interviewees are chosen from the central bank, local government and other relevant organisations, including The People's Bank of China (Shanghai Headquarters Shanghai Stock Exchange (SSE)，Shanghai Financial Service Office (SFSO), Shanghai Development Research Centre, Shanghai Academy of Social Sciences and Shanghai Jiaotong University.

6. China's Financial Statism: The Underlying Impact on SIFC Development

> If large institutions live globally but die nationally, can we afford to bail out big banks that dwarf national treasuries and private sector savings, as happened in Iceland and Ireland?

---Mainelli and Giffords (2009, p. 27).

Financial statism is one of the defining features of China under its massive economic transition during past decades. In this chapter, I intend to address the following question: What has been the impact of China's financial statism on SIFC development at macro, meso and meta levels? This chapter is organised as follows: firstly, I briefly introduce the key characteristics of China's financial statism; then I anatomise the impact of financial statism at macro, meso and meta levels; finally, I discuss several risks and challenges facing China's financial statism.

6.1 A Glimpse of China's Financial Statism

Dominant Financial Ownership

There were two manifest features in the Chinese financial system during the early 1990s. Firstly, a large banking sector played a major part and secondly, the dominance of state ownership (Allen et al 2011). Since the foundation of the People's Republic of China in 1949, the country had embraced the Soviet model of central planning and virtually all the private companies and institutions were nationalised until 1956. Between 1956 and 1978, China had a very limited banking system because of the deficiencies of market competition. Without a frontier between central and commercial banks, the whole banking system in the country was composed of a mono-bank, The People's Bank of China (PBoC), which handled almost all financial transactions. In the 1980s, this unitary banking system was transformed by the establishment of the four specialist banks - the “Big Four”, notably the Industrial and Commercial Bank of China (ICBC)[28], the Agricultural Bank of China (ABC)[29], China Construction Bank (CCB)[30] and Bank of China (BOC)[31]. During that period, the “Big Four” were state-owned.

Table 6.1: Market share of banking sector assets by types of bank (1983-2000)

Year	Total RMB billion	SOB RMB billion	Share %	JSB RMB billion	Share %	UCB RMB billion	Share %	FB RMB billion	Share %
1983	397	397	100	0	0	0	0	0	0
1990	2,896	2,789	96	107	4	0	0	N.A.	0
1995	6,422	4,436	69	485	8	65	1	159	3
1996	7,903	5,227	66	662	8	214	3	248	3
1997	95,01	5,890	62	688	7	274	3	312	3
1998	11,042	7,041	64	1,185	11	372	3	284	3
1999	12,323	7,926	64	1,461	12	452	4	264	2
2000	13,548	9,296	69	1,513	11	N.A.	N.A.	288	3

Note:
SOB: State-Owned Banks
JSB: Joint Stock Banks
UCB: Urban Commercial Banks
FB: Foreign Banks
Source: China Financial Statistical Yearbook, Wang (2008)

In the early 1980s, China started to carry out top-down market reform. Despite the substantial growth of the private sector in other industry sectors, China’s financial sector was still dominated by the SFIs. As shown in Table 6.1, from 1990 to 2000, the total assets of state banks increased substantially from RMB2.8 trillion to RMB9.3 trillion while the share of state bank assets declined from 96 percent to 69 percent. This

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[28] The Industrial and Commercial Bank of China was formed in 1984, which was primarily responsible for urban industrial and commercial credit.

[29] The Agricultural Bank of China was set up in 1979 to deal with all banking business in rural areas

[30] The China Construction Bank was established in 1954. It was responsible for fixed investment credit in the medium and long term. However, under the planned economy in the 1960s and 1970s, all the sources of its credit came from government appropriation. It was not able to accept household deposits until 1980.

[31] The Bank of China was originally established in 1912 as a private bank and nationalized after 1949. It specialised in foreign currency related transactions. It was given the mandate to specialize in transactions relating to foreign trade and investment.

suggests that the falling share of state banks was not due to shrinkage but to the growth of new types of banks, such as joint-stock banks, urban commercial banks, foreign banks etc. In particular, it should be noted that the share of foreign banks' assets levelled off at three percent during that period so the money was not channelled in that particular direction.

Table 6.2 Financial firms overseen by Shanghai municipal government

Banks
1. Shanghai Pudong Development Bank
2. Bank of Shanghai
3. Shanghai Municipal Union of Rural Credit Cooperatives
Comprehensive Financial Companies
4. Shanghai International Trust and Investment Co.
5. Shanghai Aijian (AJ) Trust & Investment Co.
Securities Companies
6. Guotai Junan Securities
7. Haitong Securities
8. Shenyin & Wanguo Securities
9. Orient (Dongfang) Securities
10. Shanghai Aijian (AJ) Securities
11. Shanghai Securities
12. Shanghai Evergreen (Jiulian) Securities
Fund Management Companies
13. Hua An Fund Management
14. Guotai Asset Management
15. Fullgoal (Fuguo) Fund Management
Insurance Companies
16. China Pacific (Taipingyang) Insurance
17. China Pacific Property Insurance
18. China Pacific Life Insurance
19. Da Zhong Insurance

Source: Adapted from Heilmann (2005, p.658)

The expansion of state banks at central level coincided with the growth of state-owned financial assets at local level. In early 1990s, under the banner of SIFC development, the Shanghai Municipal Government lobbied the central government for the green light for new licences for banks and non-bank financial institutions (NBFIs)[32]. In 1993, when

[32] Before the 1990s, banks and financial firms were generally not allowed to be owned by local government directly.

Shanghai's first local bank - Shanghai Pudong Development Bank (SPDB) - officially opened, the municipal government was so pleased it even presented the new bank an office building in Bund for its headquarters[33]. Since then, Shanghai's Municipal Government has established 19 new financial entities, including three banks, two comprehensive financial companies (similar to conglomerates), seven securities companies, three fund management companies and four insurance companies (see Table 6.2). As of 2007, the total assets of these banks and NBFIs reached RMB 2.07 trillion and delivered RMB 61.4 billion of pre-tax income（Fang 2013, p. 213）.

Financial Restraint Policies

Apart from dominant financial ownership, the Chinese state also took control of financial markets. Hellmann et al. (1998) postulated that financial restraint policies can provide incentives for financial deepening, especially for developing countries. In China, financial restraints are generally in the form of directed credit and aggregate credit ceilings, floors for loan rates and caps on deposit rates as well as limited access for the private sector (Shi and Ye 2003). Among other financial mechanisms, directed credit and aggregate credit ceilings were largely directed for state-owned banks in the 1990s.

China's interest rate system is basically composed of three categories: central bank rates (e.g. reserve rate[34], refinancing rate[35], etc.), wholesale market rates (e.g. inter-bank lending rate[36]) and retail market rates[37]. Since 1990, wholesale markets rates have been

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[33] The Bund is a waterfront area in central Shanghai, which housed the headquarters of the major financial institutions operating in China before the 1940s. After 1949, the buildings on the Bund were mainly for government use. They were returned to financial use by the government in the early 1990s, motivated by the SIFC development.

[34] Reserve rate refers to the rate institutions receive for deposits at the central bank.

[35] Refinancing rate refers to the rate institutions can borrow at from the central bank. Sometimes, it is also called the discount rate.

[36] The inter-bank lending market rate refers to the rates at which commercial banks and NBFIs offer to each other in the wholesale (inter-bank) market, such as SHIBOR.

[37] The retail market rate is the rate at which commercial banks offer to their consumers for

gradually liberalised (see section 8.1.2 for details). The retail market rate, particularly the deposit and lending rates, is still under the guidance of the state rather than the market. In other words, the interest margins of the banks are still determined by the PBoC.

Limited access to deposit markets accompanies these interest rate controls. As noted above, the state bank plays a dominant role in the deposit and credit markets. Compared to more mature economies, the competition in China's banking sector is relatively unimportant. According to Federal Reserve Economic Data (FRED)[38], in the early 1990s, there were around 12,000 commercial banks in the United States, although the number has reduced sharply to around 6,000 in 2010 due to the financial crisis. In China, there were far fewer due to tight regulation governing licensing. According to the Commercial Bank Law of China, the setting up of a new commercial bank should not only meet the minimal capital requirement[39], it also requires approval from the central bank. In other words, the law has allowed the central bank to prevent private investors from entering the deposit market.

Capital Control

Another important aspect of financial statism is the control of the state over capital flows across borders and currency convertibility. In 1996, China successfully realised current account convertibility, but the Renminbi is still practically inconvertible for the bulk of capital accounts in China. As China's control over capital transactions has been continuously altered over the past 20 years, table 6.3 chose December 31, 1996 as one particular point in time to illustrate the status of capital controls.

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deposits and lending.

[38] See http://research.stlouisfed.org/fred2/series/USNUM, accessed on November 5, 2013

[39] According to Commercial Bank Law, the minimal capital requirement is RMB1 billion for a nationwide commercial bank, RMB100 million for an urban commercial bank and RMB50 million for a rural commercial bank.

Table 6.3 Controls on capital transactions as of December 31, 1996

Controls on Capital and Money Market Instruments				
Capital Transactions	Non-residents		Residents	
	Purchase/Sale locally	Issue locally	Purchase/Sale abroad	Issue abroad
Capital Market Securities	B Share only	Not permitted	Needs approval by SAFE	Needs approval by PBoC, SAFE or SSB
Money Market Instruments	Not permitted	Not permitted	Needs approval by SAFE	Needs approval by PBoC and SAFE
Collective Investment Securities	Not permitted	Needs approval by SSB	Needs approval by SAFE	Needs approval by PBoC and SAFE
Derivatives and Other Instruments	Not permitted	Not Permitted	Prior review and limits applied	Prior review and limits applied
Controls on Credit Operation				
Credit	Resident to Non-residents		To Residents from Non-residents	
Commercial/Financial Credits	Needs approval by SAFE		Needs approval by SAFE	
Guarantees, sureties and financial back up facilities	Needs authorisation		N.A.	
Controls on Direct Investment				
Direct Investment	Non-Residents		Residents	
Outward Direct Investment	Permitted		Needs Approval by MOFTEC and SAFE	
Inward Direct Investment	Needs approval by MOFTEC		Permitted	

Source: Adapted from Prasad and Wei (2007)

As shown in the table 6.3, non-residents were generally prohibited from issuing securities in the domestic Chinese marketplace, other than being allowed to purchase B shares[40]. Residents other than financial institutions permitted to engage in foreign borrowing and authorised enterprises or groups, were not permitted to purchase securities abroad. And yet, inward FDI was generally permitted except in several strategic sectors. Therefore, China had a distinctive feature of selective opening, i.e. it was heavily in favour of foreign direct investment (FDI) yet it restricted its flows of portfolio investment across borders (Xiao and Kimball 2004; Prasad and Wei 2007). It is also notable that since 2002, capital controls have somewhat eased with the introduction of Qualified Foreign Institute Investors (QFII) and Qualified Domestic Institute Investors (QDII) initiatives. These are schemes to empower qualified institutions, residents or non-residents, to access restrictive portfolio investments on the basis of quotas (see also section 7.2).

As such, we can see that financial statism has been one of the defining characteristics of China's economic and financial system during its economic transition. These three components of financial statism are inextricably connected. Financial ownership of the state lies at the centre of the regime, which is significant to strengthen state capacity and influence financial reform and policies at the macro, meso and meta levels.

6.2 Implicit Contributions of Financial Statism to SIFC Development

The financial sector is the lifeblood of any modern economy. According to the neo-classical literature, it is generally argued that the bid for an IFC is synonymous with deregulating, liberalising and globalising a financial system (see HPEC 2007). However, Shanghai's experience followed a radically different route. One distinctive feature of SIFC's development since the 1990s is that China has tenaciously held on to its

[40] B share are shares issued by Chinese companies that are listed and traded in the Shanghai or Shenzhen Stock Exchanges. These shares are sold to and held by foreign investors. Starting in 2001, Chinese investors could also trade these shares.

financial statism to promote such a development. What is the underlying motivation for this? Is this a policy failure or viable strategy? To grapple with these questions, we will look into context of financial statism and its impact on the different levels - notably the macro, meso and meta levels - of SIFC's development.

6.2.1 Macro-Level

As noted in section 3.5, the rise and decline of an international financial centre rests on the economic growth and political stability of the country that hosts it. Therefore, the relationship between financial statism and its macro-level impact should be carefully examined.

Mobilising Deposits

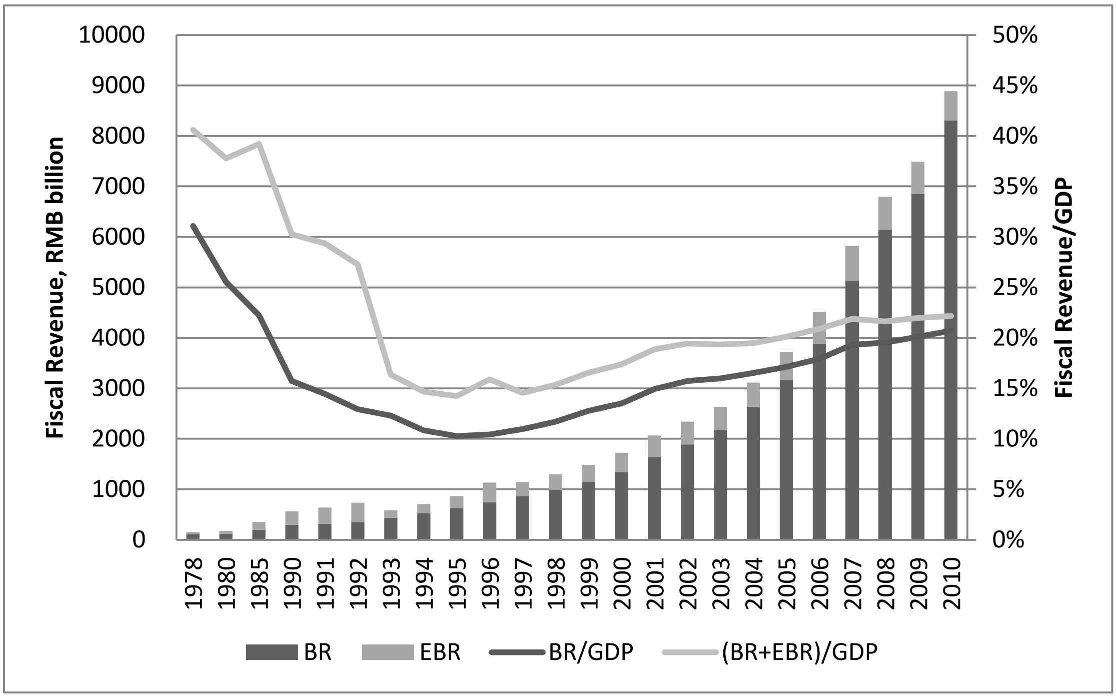
To advance our understanding of the impact of financial statism, we should put SIFC's development in the context of China's economic transition in the 1990s. During that period, China simultaneously confronted two significant changes.. The first was how to transform a conventional agricultural economy into a modern industrial economy. The second was how to shift from a planned to a market economy. The former required huge investment and the latter involved huge transitional costs.

Prior to 1980, the state sector was the key depositor and investor in China. Following market reforms, the competition from the non-state sector and price decontrol lowered the monopoly rents of SOEs, thereby reducing the tax and profit remittances to the government (Hofman 1998). At the same time, the household sector gradually replaced the state sector as the primary depositor. As shown in Figure 6.1, the ratio of budgeted revenue to GDP dropped radically from 31.1 percent in 1978 to 10.3 percent in 1995. One might argue that apart from budgeted revenues, the Chinese government could also obtain extra-budgetary revenues from various administration fees and public funds before 2011[41]. Yet even if extra-budgetary revenue is taken into account, it does not

[41] In 2011, Chinese Ministry of Finance abolished extra-budgetary revenues and put all the government revenues under budgeted management.

affect the fact that the total fiscal revenue to GDP ratio fell from 40.6 percent in 1978 to 14.2 percent in 1995 (Figure 6.1). During economic transition, the fall of fiscal revenue was prevalent. In central and eastern European countries, the huge fiscal deficits have given rise to deep, and in some cases, long-lasting recessions (Kotz 2004). In Russia, the state lost control of its financial sector and suffered severe hyperinflation in the 1990s (Wang et al. 2008, p. 113). It seemed inconceivable that the Chinese government would not fall apart given the substantial decrease in fiscal revenues. Instead, China successfully contained inflation and kept price stability, which McKinnon (1993) terms the "Chinese puzzle".

Figure 6.1: China's fiscal revenue and its ratio to GDP (1978-2010)

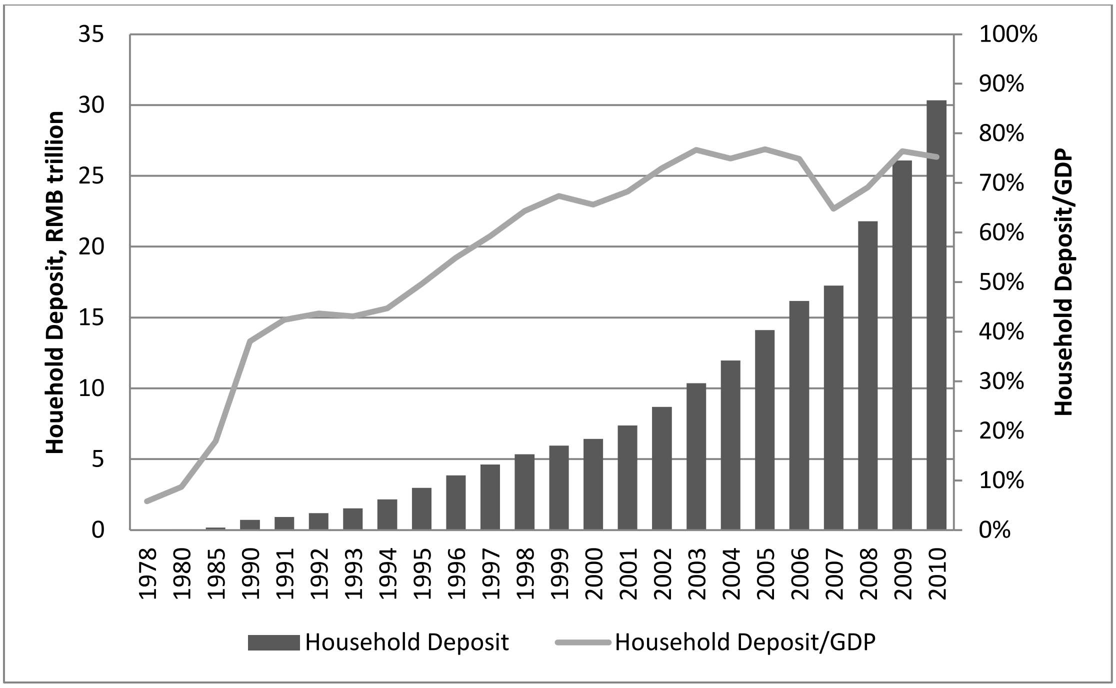


Note:
BR: Budgeted Revenue
EBR: Extra-budgetary Revenue
BR/GDP: Budgeted-Revenue-to-GDP Ratio
Source: China Statistical Yearbook 1996-2011, the Ministry of Finance website

What was the magic formula? McKinnon (1993, pp.194-5) attributes China's success to its dual-track pricing system and gradual marketization. He is correct to highlight the "gradualist" approach, but understates the significance of China's dominant state-ownership of its financial sector. In effect, financial statism has played a significant role in mobilising savings from the household sector to the state sector, thereby avoiding financing government debts through printing bank notes.

A number of reasons can explain the effectiveness of the state bank in deposit mobilisation. Firstly, China's household saving rate soared throughout the reform period. The rate of household saving to GDP increased from six percent to 45 percent from 1978 to 1994, and further grew to 66 percent in 2000 (Figure 6.2). As of 2010, the rate increased to 75 percent and household deposits arrived at a total of some RMB 30 trillion. Secondly, the constraints on the deposit markets and the ban on investing abroad suggest that household depositors have few options but to deposit in state banks. Moreover, by means of controlling interest rates and prohibiting the entry of new private banks, state banks retain a dominant position in creating "franchise value". In this way, they have been able to capture new deposits by expanding their businesses through establishing new branches, e.g. in rural areas favourable to deposit mobilisation. This also partly explains the reason why the total assets of state banks surged in the 1990s.

Figure 6.2: China's household deposit and its ratio to GDP (1978-2010)



Source: China Statistical Yearbook 1996-2011

Has financial statism policies sacrificed ordinary depositors for the sake of enhancing profit? Some might argue that private banks would be able to provide a more competitive interest return if there were no controls over interest rates and market entry. This might well be the case but it does not take account of the contextual setting of China during that period. Firstly, due to institutional weakness, the moral hazard in the private banks was extremely high. In that case, ordinary depositors would risk losing their entire deposits rather than gaining interest on them. Secondly, ordinary depositors were willing to deposit their savings in the state banks since the state acted as the implicit guarantor.

Patronising SOEs' Reform

SOEs' reform is one of the most significant factors in China's economic transition. In 1995, there were some 88,000 industrial SOEs with "independent accounting systems" in China, of which 5,000 were classified as large SOEs, 11,000 were medium-sized SOEs and 72,000 were small SOEs (NSB 1996). The aim of SOEs' reform is to establish a "modern enterprises system" (MES), characterised by "clearly established property rights, well-defined powers and responsibilities, separation of the enterprise from the government and scientific management" (Zhang 2006). This included a broad set of reform programmes, including IPOs of SOEs, management buyouts of small SOEs, and ownership diversification etc (Hofman and Wu 2009). In response to the criticism from neo-liberalism[42], market socialists argue that the introduction of competition and management reform is a primary recipe rather than privatisation. In particular, they believe the joint-stock system is an ideal institutional arrangement for modern enterprise systems. As Wang (1994) argues,

> [E]nterprise managers could have sufficient autonomy to take whatever actions necessary for profit maximization, but at the same time their behaviours could be monitored by the state so that they would not be able to abuse their power for pursuing other goals.(p.16)

[42] Neo-liberals argue that the state sector is less efficient than the private sector because of soft budget constraints, principal-agent problems, the monopolistic nature of the public sector and issues of corruption and nepotism. For a detailed introduction to China's SOEs' reforms see Hassard et al.(2007), Zhang, L. (2006)

The guidelines for SOE reform were laid out by Zhu Rongji, the premier from 1998-2002 “to restructure the major enterprises and relax control over the small ones” (i.e. “*Zhua Da Fang Xiao”*). Zhu believed the state should concentrate control on a group of 1,000 large SOEs and release control over on some 90,000 small and medium SOEs. The reforms intended to relieve the burden of social services provision on SOEs, since during that period the employment and related social welfare system such as housing, healthcare, schooling and pensions were attached to them. However, employees in these SOEs could no longer enjoy an “iron rice bowl” after reform, which meant their jobs were no longer guaranteed. .

However, one of the biggest challenges for SOE reform was that market institutions, such as unemployment insurance, housing public fund[43], pension plan and social insurance, were still not in place at that period. This meant that the state had to carry out market reform on the one hand and rebuild the social safety net on the other. Since 1997, the SOEs’ reforms have led to millions of workers being laid off every year (Hassard et al. 2007). If there was no immediate action taken by the government, social unrest and political upheaval would have ensued.

In order to maintain social stability, the state had to bear the huge costs of reform through various explicit or implicit subsidies. For example, in 1997, the central government made a special policy arrangement for the closure of insolvent SOEs: the proceeds from liquidation were used to settle down the laid-off employees[44], prior to paying off the loans of state banks. Until 2007, this policy was applied to 4,251 bankrupt SOEs and benefited 8.37 million people who had been made redundant (Li 2007). In 1999, the central government announced the “two guarantees” policy:

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[43] Housing public fund is statutory deductions to which both employees and employers contribute. Since the 1990s, the welfare-based housing distribution has been replaced by pay-for-housing in China. Under the new system, employees can withdraw the balance of account or apply for credit loans from housing public fund when they purchase a property.

[44] To settle down the lay-offs means to provide them with basic pensions, unemployment benefits and a subsistence allowance.

guaranteeing that laid-off employees receive basic living allowances and that SOE pensioners receive their pensions in full and on time (Huang 2013). Meanwhile, state banks became the treasury agents for SOE reform. They were required by the government to provide policy loans to those SOEs in financial distress. Such loans are conceptually equivalent to government funding, and are usually labelled as quasi-fiscal activities (Hofman 1998).

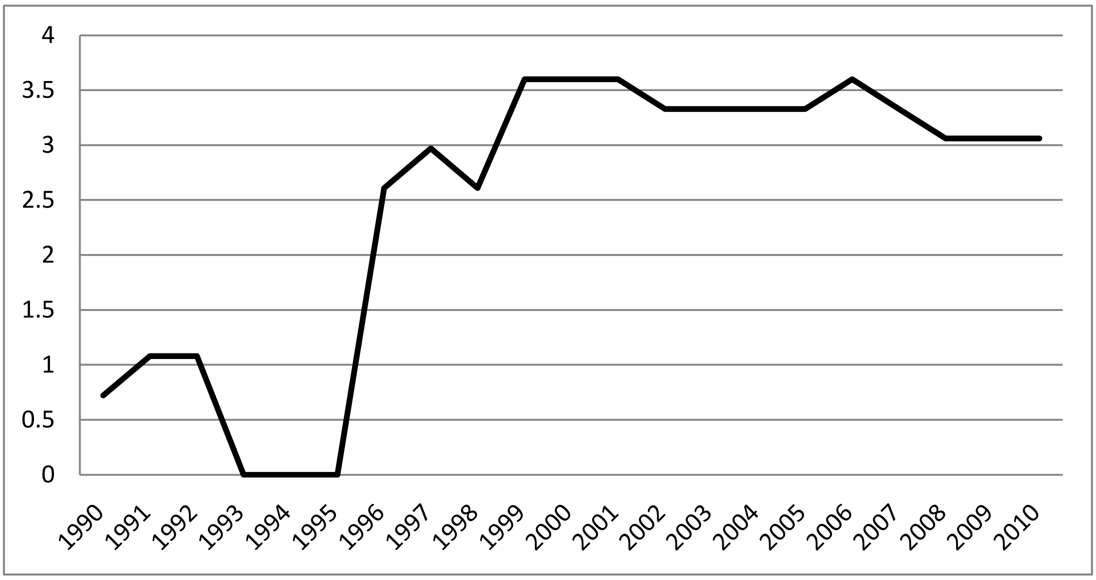
Interest rate control is another important supportive policy for SOEs' reform under a regime of financial statism. In the early 1990s, China was experiencing an inflationary period. Although the typical monetary policy used to contain inflation was to increase interest rates, the state was reluctant to increase the burden on SOEs in the process of reform, since the SOEs were absorbing approximately 75 percent of bank credit. The central bank thus chose to keep the lending rate relatively low and increase deposit rates to prevent deposit withdrawals and illegal capital flight (Herr and Priewe 1999). As a result, it can be seen that the interest margin for one-year loans between 1990 and 1995 was close to zero (Figure 6.3). In this manner, the state bank provided the SOEs with substantial low-cost funding even when the lending rates were lower than the Walrasian interest rate[45], which means it was not economic efficient. Yet this sort of arrangement enabled state banks to finance the SOEs with cheap loans during the economic transition.

From 1996, the interest margin expanded as the base rate for deposits had been lowered further than that for lending and stood at 3.6 percent a year by 1999. According to Hellmann et al. (1997), financial restraint enabled the creation of rents for the banking sector through state control over the deposit and lending rates. In China, the rent incentives created from the controlled interest margins were actually being transferred to the SOEs in order to carry forward the SOEs' reform (see Hassard et al 2007). In this way, China's approach was different to that of Japan and South Korea, whose governments has intensively supported big private enterprises such as Keiretsu and

[45] In neoclassical economics, Léon Walras develops a general equilibrium macroeconomic model, in which prices of capital goods are the same whether they appear as inputs or outputs and in which the same rate of profits is earned in all lines of industry.

Chaebol through loans and favourable industrial policies (Baek 2005, p. 494).

Figure 6.3: The evolution of interest margin set by the PBoC (1990-2010)



Note: The interest rate was calculated based on the one-year deposit and lending rate set by the PBoC.
Source: China Statistical Yearbook 1996-2011

The third approach to facilitating reform through financial statism was by giving SOEs priority when it came to raising funds in the capital markets. After the Shanghai Stock Exchange (SSE) was incorporated in 1990 it was employed as an instrument to support SOEs' reform. At that stage, stock market listings were subject to strict administrative quotas, which stipulated the number of companies to be listed and the amount of funds to be raised. In December 1996, the China Securities Regulatory Commission released the *Notice on Several Issues regarding Issuance of New Stocks*, which stated that the priority for listing should be given to 300 key SOEs and 100 enterprises experimenting with "modern enterprises system" and 56 enterprises that were experimenting with conglomerates (CSRC 1996). The notice also pinpointed priority sectors for stock issuance such as agriculture, energy, transportation, telecommunications, major raw materials and high-tech industries. Conversely, processing and commercial industries were categorised in unsupported sectors whilst the financial and real estate sectors were temporarily disregarded for the IPO. This implies, at that time, the stock market was used primarily to raise funds to support SOE reforms, particularly those SOEs in financial distress.

Table 6.4: The share of SOEs[46] in the annual IPOs (1997-2006)

	SOEs Share in numbers of IPOs (%)	**SOEs Share in stocks issuance of IPOs (%)**	**SOEs Share in fund raising through IPOs (%)**
1997	70.6	79.6	78.8
1998	81.0	87.4	88.3
1999	54.8	63.6	67.1
2000	60.9	63.0	69.2
2001	66.7	75.9	84.4
2002	67.2	85.3	92.1
2003	57.8	81.9	86.9
2004	46.5	53.2	61.6
2005	46.7	61.6	76.7
2006	50.0	93.7	97.0

Note: 1997- 2003: Shanghai Stock Exchange;
2004-2006: Shanghai Stock Exchange and Shenzhen Stock Exchange
Source: Wu (2008, p.456)

According to Table 6.4, SOEs retained a high share of stocks' issuance and fundraising between 1997 and 2006, even though a growing number of private companies were permitted to raise capital through the stock market. This table also shows that after joint stock reform, the performance of listed SOEs has markedly improved. In 2006, among all of the 753 companies listed on the SSE, the average return on equity (ROE) of SOEs was 8.46 percent and that of non-state company was 7.28 percent (Wu 2008). From this, we can see that the performance of listed SOEs is even better than those of non-state listed companies. It also suggests that the joint-stock reform has granted SOEs more autonomy and created a fairer playing field for them. The public list of SOEs thus provides sufficient information on managerial performance and "makes the managers' incentives compatible with those of the state" (Lin et al 1998, p.422). Furthermore, these SOEs were opened up to competition from the non-state sector and even companies outside the country. As such, the state could no longer be held accountable for the failures of SOEs and could thus impose heavier budgetary constraints on them.

[46] Provided that the largest shareholder (shareholder A) of the company is state-owned and the second and third largest shareholders (shareholder B and shareholder C) are private, if the total share of B and C is greater than that of A, we regard the company as a non-state company, and vice versa.

To some extent, these measures to champion SOEs matter. Financial statism has not only provided substantial investment in the process of industrialisation, but also shouldered much of the reform costs in China since the beginning of the reform era. China has now practically transformed the bulk of SOEs into independent economic entities and established a community-based social welfare system. The social welfare function was removed from the SOEs, and thus the government would no longer be entangled by policy-induced losses and operational losses in them.

Stimulating Economic Take-off

Since 1991, the Chinese economy has experienced unprecedented growth at an average annual rate of around 10 percent (Figure 6.4). Totalling RMB 40.12 trillion (USD 5.9 trillion) in 2010, China's GDP has overtaken that of Japan (USD 5.5 trillion) and risen to be the second largest in the world. In 2010, China's GDP comprised around 9.3 percent of the world economy against a mere three percent in 1980 (World Bank 2011[47]). According to the World Trade Organization China has risen to the top of the global league in terms of merchandise exports in 2010, accounting for 10.4 percent of world exports (WTO 2011). With respect to imports, China ranked second only to the United States. It is important to note that all of this stunning growth was made under financial statism, especially during the 1990s. So what was the logic underpinning this progress?

China has long been criticised for its lack of efficiency and transparency in its legal system (Xu 2009, p.238). Some commentators (e.g. Allen et al. 2005; Lu and Yao 2009) are puzzled by the fact that China's rapid economic growth is concomitant with an incomplete legal system and underdeveloped financial markets. Allen et al. (2005) argue that the most successful part of the Chinese financial system is not the state-owned banking sector or financial markets, but rather a sector of alternative financing channels, such as informal financial intermediaries, internal financing and trade credits etc. Lu and Yao (2009) suggest there is a "leaking effect" by which means financial resources in

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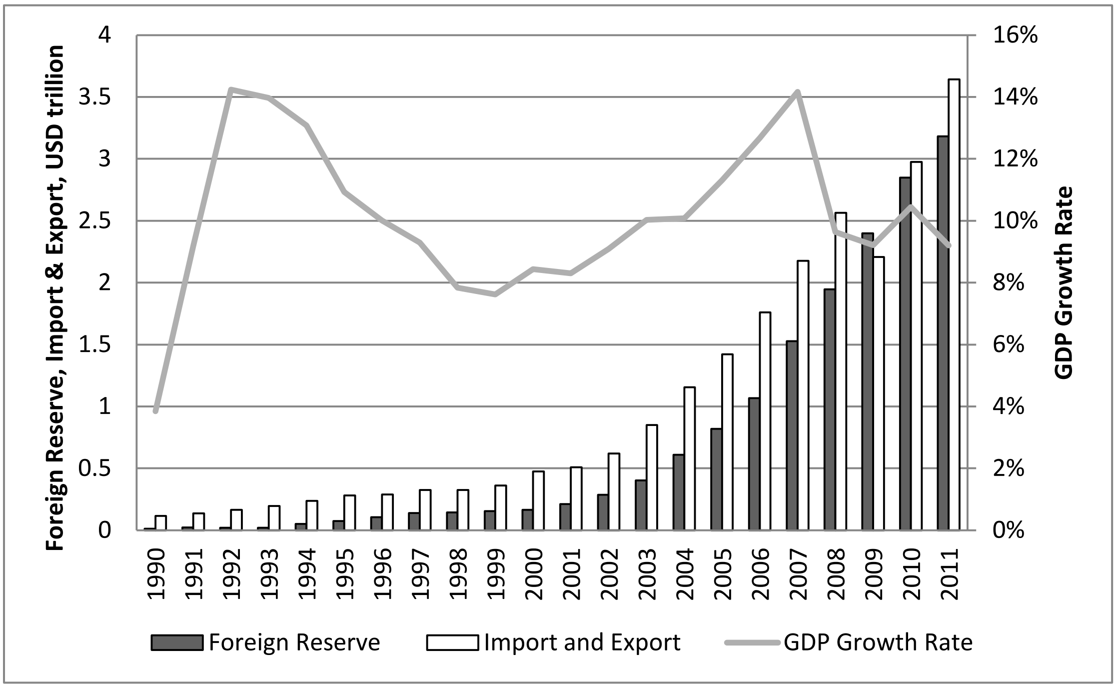
[47] See http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf, accessed on 19th June, 2014.

the state sector are channelled to the private sector. This mechanism allows for informal financing intermediaries to support private sector growth. There is probably some truth in these propositions, but in my opinion they do not identify the key reasons for economic growth in China.

Figure 6.4: China's foreign reserve, imports & export and GDP growth rate (1990-2011)



Source: State Administration of Foreign Exchange website, www.safe.gov.cn , Chinese Statistics Yearbook 2011

I would argue that growth in China has, in the first place, been driven by high investment and an export-oriented economy in which SFIs played a far more significant role than informal financial arrangements (also see Hofman and Wu 2011). Among large economies, China has made the largest proportion of investment in GDP and its investment growth rate has increased more than any other country since the 1980s. China's financial statism was effective in raising the substantial funds needed for its capital-intensive growth. Using a very large micro-database of 1.3 million observations covering the period 1999-2005, Demetriades et al. (2008) demonstrate that China's state-owned banking sector has supported the growth of both output and total factor productivity in manufacturing enterprises. Keidel et al. (2009, p.117) also provide evidence that China's financial system generates a reasonably good rate of return on investment and has succeeded in sustaining over 15 years of rapid growth, with capital investment efficiency roughly equivalent to India's[48]. On the face of it, this may not seem impressive but we need to remember that these large-scale investments funded by China's national development banks were primarily channelled to infrastructure, such as expressways, high speed rail links, airports, irrigation networks, grid systems etc. which private banks in the West might be reluctant to invest in. By the end of 2013, China had established the longest expressway network in the world, with a total length of 104,400 kilometres.[49] According to the International Union of Railways (UIC 2013), the length of China's high speed rail in operation reached 9,867 kilometres in 2013, accounting for 46 percent of the world's high speed rail lines. All of these are primary funded by the central government and state banks. In contrast, India had not developed a single high-speed railway by then. All of these infrastructural developments are critical to the sustainable growth of the Chinese economy.

The state-dominated financial system is also the main source of technological progress, productivity growth and structural change. Credit loans were granted to technological transformation projects, especially in large and medium-sized SOEs. The state also actively interfered with capital markets by directing loans or stock listings to certain promising industrial sectors such as high-tech, high value-added industries while discouraging others (Boyreau-Debray and Wei 2005). World Bank (2013, p.28) states,

> The current system, characterized by dominance of state-owned banks, strong state intervention, and remaining controls on interest rates, has been remarkably successful in mobilizing savings and allocating capital to strategic sectors during China's economic take-off.

In the eyes of some commentators, China's current economic achievements demonstrate the failure of the state-led development and success of "Washington Consensus"(Irwin

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[48] Keidel (2009, p.118) uses the incremental capital to output ratio (ICOR) as the indicator to measure investment effectiveness. For the 5-year period 2001-2005, China's ICOR is 3.9. For India, the ICOR is roughly 4.1 for 2001-2006.

[49] See http://www.moc.gov.cn/zfxxgk/bnssj/zhghs/201405/t20140513_1618277.html, accessed on 19th June 2014.

2004). However, they have confused state-led development with the previous centrally-planned, Soviet model. There is no denying that the non-state sector and market system have contributed to China's rapid economic growth in the past decades, which has made the whole economy more dynamic and innovative. Nevertheless, Western academics have often misinterpreted the role of the SFIs. As previously mentioned, the SFIs has served as an important stabilising force on the economy and society, particularly at the early stages of transitional development. For this reason, China did not privatise its sizeable state-bank sector along with SOEs' reform, which prevented rents moving to a few oligarchic money capitalists during China's economic transition (see Zhang 1998).

To summarise, financial statism has made China's economic transition a source of growth, namely mobilising deposits from the household to the strategic sector, championing SOEs' market reforms and stimulating economic take-off at the early stages of market development. Far from being a policy failure, China's financial statism has acted as an "unsung hero" in safeguarding economic transition and kick-starting its dramatic economic growth over recent decades. Based on these special policy arrangements, China successfully realised remarkable economic growth in the past decades, which has laid a solid groundwork for further financial development.

6.2.2 Meso-Level

In this section, I address the impact of financial statism at the city level and explore how it can modernise urban infrastructure and foster financial markets and institutional facilities in Shanghai.

Lump-sum Payment for Upgrading Infrastructure

To attract global financial institutions and to thrive in the financial industry, Shanghai should first improve its infrastructure to support international financial business. Before Shanghai's municipal government earmarked the Lujiazui area in Pudong ("East of Shanghai") as a new Central Business District in the early 1990s, it was an area full of shabby buildings or warehouses. No one could have imagined that this dilapidated place would house the headquarters of top banks and financial institutions from around the world. Nevertheless, within ten years, this area of 28 square kilometres was filled with state-of-the-art office buildings, advanced conference facilities, five-star hotels, brand-new shopping malls and a large number of green areas (see Figure 6.5).

How did this come about? In the early 1990s, most private and foreign investors were reluctant to participate in land development in the Lujiazui area due to the high risks. Chen (2007, p.113) comments:

> Uncertainty about the future of Pudong, the sizeable gap between plan and reality, the lack of adequate infrastructure and experience with collaboration between local public companies and development companies, all contributed to the risks considered in the feasibilities studies conducted by private sector organizations.

Financial statism was central to making lump-sum payments towards the infrastructural upgrades. In 1992, the Shanghai Lujiazui Development Company (SLDC) was established by the Shanghai Municipal Government (SMG). When the SDLC was set up, the SMG invested 93.7 percent of the total capital of this company. Although the initial capital investment from the municipal government was not enough to develop the entire area, financial statism also ensured the SLDC was given privileged access to low-interest loans from the “Big Four”. The building of the SIFC was considered part of a national strategy and so the loans were perceived as “more a political gesture than a matter of commercial calculation” (Chen 2007, p.202).

Furthermore, thanks to the central government’s preferential policy of allowing stocks to be issued to support the Pudong development, the SLDC was listed on the Shanghai Stock Exchange in both A-share and B-share markets in 1993 and 1994 respectively. The IPO helped the SLDC to raise much-needed capital to develop infrastructure in Lujiazui. Records show that by 2010, it had developed an area of 11.07 square kilometres, relocated 28,000 residential households and 750 business and enterprises to allow the creation of the Lujiazui Financial City.

Figure 6.5: The evolution of Lujiazui Financial City in the 1990s

(i) Overview

(ii) Central district of Lujiazui

(iii) Central green land

(iv) Lujiazui Downtown area

(v) Zhuyuan commercial neighbourhood

Source: Official website of Shanghai Lujiazui Financial and Trade Zone Development Ltd. [50]

[50] See http://www.ljz.com.cn/about_ljzImg.aspx, accessed on 12 November, 2013

In addition to the SLDC, the Shanghai City Development and Investment Company (SCDIC) was another example of corporate commissioning by the municipal government to develop the infrastructure for the city. Established in 1992, the SCDIC was designated to fund the city's basic infrastructure such as clean water, sewage disposal, tunnel and bridge building and environmental protection. Similar to the SLDC, the SCDIC also enjoyed huge support from the state-owned banking sector. In 2007, its credit lines from 16 state banks and two foreign banks totalled RMB 170 billion (Kong and Xin, 2009). Moreover, SCDIC also used various financing vehicles such as corporate bonds and short-term financial bills to fund infrastructural development. By 2010, SCDIC had raised RMB 18.8 billion by issuing Pudong Development Bonds, a special corporate bond based on favourable policies granted by central government (Kong and Xin 2009).

Did these massive investments on infrastructure through credit loans from state banks incur bad debts for the municipal government? My interview with an official from the Shanghai Financial Service Office (SFSO) suggests the opposite: these loans were profitable for state banks. As he commented:

> The municipal government has not forced them to provide loans through administrative command; state banks are keen to do this kind of business because the municipal government is buoyant and least likely to default. The land premium and housing prices have soared in recent years. In general, these banks are in favour of funding infrastructure projects, which are high-return and low-risk. Personally I think it is a win-win position – both for state banks and the municipal government (Interview 10, translated by author).

This suggests a new mechanism for raising capital and reinvestment for the city: massive state investment in infrastructure pushed up land values and in turn generated further premiums from land leases (see Wu 2000). With the improvement of the investment environment in the 1990s, there was a virtuous interaction between infrastructure investment and financial development.

As such, we can see that financial statism helped overcome the threshold effect through lump-sum investment from the state banks and capital markets. The threshold effect suggests financial markets will not emerge before income levels reach a particular threshold value. Under financial statism, the Shanghai municipal government invested in a large number of infrastructure development projects, such as public transport, office spaces, telecommunications and IT facilities, and even sea ports. In this process, SFIs have been in the forefront of infrastructure development, particularly after the SIFC development became part of the national strategy. It is also noteworthy that the lending supports allowed state banks to mobilise deposits from households at relatively low interest rates. In this regard, financial statism should be given credit for its pivotal role in the remarkable advancement of infrastructure in Shanghai within such a short period. Although government funding and credit loans from state banks are not the only reasons for the massive infrastructure investment, it is evident the state-led development was the catalyst for the thriving financial markets in Shanghai. The advances of infrastructure in the city prompted subsequent foreign direct investment and I will elaborate on this in the next section.

Nurturing Financial Markets and Institutions

Functional financial institutions are imperative for a successful international financial centre. This set of institutions embodies various financial firms (e.g. banks, security firms, insurance companies etc), markets (e.g. foreign exchange, stock exchange), associations, cooperatives, as well as rules, norms and regulations. In the case of Shanghai, it is evident financial statism was successful in adopting selective interventionist policies to boost the development of various financial institutions.

The most direct momentum of financial agglomeration derived from dominant state ownership. After the central government announced the strategic plan for the SIFC development in 1992, a number of state banks such as the Bank of China, the Industrial and Commercial Bank of China, the China Construction Bank, the China Investment Bank and other state-owned insurance companies took the lead in relocating their office buildings to Lujiazui. In 1995, the central bank also transferred its new branch to Pudong[51]. Four years later, the Shanghai Stock Exchange installed its new office

[51] In 2005, the Shanghai Branch, PBOC was upgraded to be the second headquarters of the central bank.

building in Lujiazui. In 2001, the Bank of Communication, the fifth largest bank in the country, relocated its headquarters to Pudong as well. Other newly-established exchanges and financial markets, including the Shanghai Futures Exchange, the China Financial Futures Exchange and bank regional headquarters are now also situated around this area. While the decision to invest may have been based on expected profits and calculated risks, there is no denying political pressure from the state also played a part.

Another important driving force was the privileged access to restricted financial markets. Although the state banks and financial institutions responded to government pressure to relocate their offices to Lujiazui, this would have been far less likely in the case of foreign institutions. In this case, financial restrictions played a significant role. In the 1990s, a broad set of preferential policies were granted by the central government to support the development of the SIFC. One of these was permission for foreign investors to buy into tertiary industries (including finance, retail and trading) in Pudong. This form of investment was banned in other parts of the country. In particular, only the foreign banks registered in Lujiazui were allowed to engage in Renminbi business. These policies appealed to foreign banks seeking to secure market share in the rapidly-growing Chinese market. In 1996, four foreign banks operated in Lujiazui: Citibank, HSBC, Bank of Tokyo-Mitsubishi, and The Industrial Bank of Japan. These were the first to receive approval to engage in Renminbi business, i.e. to open accounts, attract Renminbi deposits etc. Moreover, the central government also gave the green light to setting up Sino-foreign joint venture insurance companies in the Pudong Area. By doing so, these financial firms were able to generate profits to offset marketing costs and potential risks. This led to the successful agglomeration of foreign financial institutions in Pudong during the 1990s. As of 2004，at least 74 foreign financial institutions, including the five regional headquarters of foreign banks, were operated in Pudong. This demonstrates that selective intervention of financial restraint policy is effective in attracting foreign investment (Zeng and Si 2008).

Thirdly, Shanghai’s municipal government managed to promote financial agglomeration by awarding direct fiscal funds. In August 2009, Shanghai set up a financial development fund, which included preferential treatments for new entrants, such as office lease subsidies, tax refunds and executive training programmes. The special fund allowed the municipal government to provide one-off subsidies to overseas institutions that had locally incorporated their subsidiaries or set up their regional headquarters in Shanghai. For instance, multinational companies that established regional headquarters in Shanghai were granted RMB 5 million by the municipal government. If the annual turnover of these multinational companies exceeded RMB 1 billion, the grants would increase to RMB 10 million (SMG 2008). As of 2009, Shanghai was host to 707 regional headquarters of multinational companies, more than any other city in mainland China.

Apart from the agglomeration of financial firms, the legal and regulatory environment is considered vital for financial institutions. Under financial statism, the state endeavoured to build a legal infrastructure that met international standards. After continuous efforts over two decades, a legal framework had taken shape, including the Company Law, the Securities Law, and the Securities Investment Fund Law, Enterprises Bankruptcy Law, Property Law and Insurance Law (see Herd 2010). These were supplemented by a number of regulations and administrative rules, such as Provisional Regulations on Public Offering and Trading and Provisional Regulations on Futures Trading, as well as over 300 departmental rules, guidelines, and codes (Neftci et al. 2007, p. 31).

Meanwhile, Shanghai's municipal government also promulgated a series of regulations. The landmark legislation - *Provision on Promoting the Development of International Financial Centres in Shanghai* - was enacted on 1st August 2009, in an effort to create an internationally competitive environment. This is the first provincial-level legislation in the country with respect to financial centre development. Table 6.5 lists some major administrative rules and regulations developed by the SMC since 1990 concerning the development of the SIFC. These regulations (in conjunction with state-level laws) provide a comprehensive legislative framework to promote the SIFC's development. Furthermore, to ensure expeditious and effective resolution of disputes, a special court – *The Shanghai Court of Financial Arbitration*- was established in 2007.

Table 6.5: Administrative rules and regulations concerning the SIFC's development

Administrative Rules and Regulations	**Effective Date**	**Key Points**
Regulations on Foreign Debts	05/08/1990	Specifies approval procedures and management regarding the activities of borrowing foreign debts.
Interim Provisions of Shanghai Municipality on the Administration of the Lujiazui Finance and Trade Centre Zone	01/08/1998	Specifies comprehensive management of the Lujiazui zone covering transportation, road facilities, green land, building, construction etc.
Administrative Measures to Promote Financial Institutions to Develop in Shanghai	28/05/2002	Sets up Shanghai Development Fund; to provide tax exemptions for staff of newly-established financial firms etc.
Interim Provisions of Individual Credit Information Collection and Management	01/02/2004	Specifies investigation, collection and management of individual credit information
Measures of Reforming and Developing Capital Markets	01/07/2004	Specifies objectives and measures to speed up capital market development in Shanghai, covering securities markets, futures markets and equity markets etc.
Implementation of Administrative Measures for MNCs to Set up Regional Headquarters in Shanghai	15/11/ 2008	Provides rewards and subsidies to newly-established regional headquarters of MNCs; provides facilities to fund management, overseas expatriates and customs' clearance.
Provision of Promoting the Development of International Financial Centres in Shanghai	01/09/2009	The first local legislation to promote the SIFC's development.

Source: Compiled by Author

Consolidating Synergies among Different Parties

The development of an international financial centre involves a number of different parties. The central-local government relationship is one of the most important factors in any state-led IFC development. It is worth highlighting that China's reform and policy measures in further opening and marketization are not in the hands of the Shanghai Municipal Government and the city cannot take such initiatives on its own. On the other hand, a blueprint cannot turn into reality without the involvement of local government. Central and municipal governments might have different policy priorities and these sometimes conflict. This is one of the differences between Shanghai and other city-state financial centres like Singapore. For it to succeed, Shanghai needed to make extra efforts to coordinate with the central government and other neighbouring provinces to ensure the plan was widely accepted and was given national and regional support (Chen 2007).

Against this background, the coordination and incentive mechanism between central and local government were crucial. With dominant state ownership in financial assets, the bureaucrats from local and central government are not only able to collaborate for government goals, but also motivated by the appreciation of state-owned assets. In this way, financial statism is advantageous in coordinating central and local government in the course of SIFC's development. For instance, every five years, there was a development plan that clarified major objectives, policy measures and action plans for the SIFC's development. Planning for the SIFC entailed interaction between the central and municipal government, which usually involved regular and ongoing consultation with relevant stakeholders to facilitate a top-down and bottom-up process. This continues to this day. There are also various seminars, workshops or fieldwork surveys jointly held by government officials and financial practitioners from time to time. Some of these now enjoy a worldwide reputation, e.g. the Lujiazui Forum[52]. Such communication and dialogue have not only resolved problems and bottlenecks but also served to provide feedback on a wide range of issues.

One particular feature of financial statism is the preferential access the state managers have to financial information. This is useful when the state managers are responsible for

[52] The Lujiazui Forum was created in 2008 as a high-level global platform for influential government officials, world financial leaders and prestigious scholars to discuss and foster international financial cooperation. Named after the financial district of Shanghai, China's financial capital, the Forum also symbolises Shanghai's vision of becoming a leading IFC.

formulating industrial policies and promoting IFCs' development. This is at odds with some developed countries, such as the United Kingdom and United States, where the financial industry is primarily dominated by the private sector. In China, the central and local authorities own a large number of financial assets, including commercial banks, securities firms, insurance companies, fund management companies etc (see Table 6.2 for example). The government is therefore in a better position to collect information and formulate feasible plans and policies. Applying policy measures or development plans does not mean the government can override the decisions of individual banks and firms. These measures belong to the industrial sphere, which means they are accessible to all financial companies, whether state-owned or foreign. What I tend to emphasise here is that financial statism, to some extent, has strengthened the capacity of the Chinese state in managing the reform agenda.

In 2009, China's cabinet - the State Council - unveiled a landmark document - *Plan on promoting Shanghai to accelerate the development of modern service industry and advanced manufacturing industry through building an international financial centre and international shipping centre* (aka The Double Centre Plan). The State Council formally stated that by 2020 Shanghai would be built into an international financial centre compatible with the country's economic strength and the Renminbi's international status. In the document, the state pledges to transform Shanghai from a domestic financial centre to an international one, although the authority was still cautious in defining the date of full liberalisation for the Renminbi. According to the Double Centre Plan, Shanghai would establish an international financial centre by 2020, which must have:

- A multi-functional and highly internationalised financial market system
- A pool of internationally competitive financial institutions
- A pool of financial professionals
- A compatible system of taxation, credit, regulation and law

In response to the Double Centre plan, Shanghai's municipal government released *The Implementation Guideline to Develop an International Financial and Shipping Centre by 2020*, which includes a broad set of comprehensive measures to promote the SIFC's development (see Appendix 3 for details). The guidelines cover a wide range of issues including the expansion of the breadth of financial markets, promoting further opening up of financial markets, boosting the development of various financial institutions, improving modern financial support systems, accelerating financial innovation and business development etc.

Table 6.6 Key measures to support the SIFC's development by the municipal government

- Develop Shanghai into a national clearance centre for bills exchange.
- Introduce new futures products such as crude oil, gasoline, diesel oil and asphalt etc.
- Develop over-the-counter markets for non-listed companies in the Yangtze River
- Develop the re-insurance market
- Encourage the set-up of a qualified foreign limited partnership scheme
- Boost the development of various debt instruments, e.g. corporate bonds, asset-backed bonds, revenue bonds, foreign currency bonds, etc.
- Develop various financial derivatives, e.g. stock index futures, Treasury bond futures, foreign exchange futures, stock index options, and gold ETF etc.
- Pioneer pilot programmes for tax-deferred pension products.
- Expand the types of financial services, e.g. IPR pledge financing, insurance policy credit financing, SMEs network joint guarantee loans, etc.
- Establish a cross-border payment and clearance system for Renminbi-denominated trading
- Expand issuance of Renminbi-denominated bonds by international development agencies, foreign incorporated banks and other qualified overseas institutions
- Encourage the development of private equity and venture capital companies

Source: Adapted from Shanghai municipal government, SMG (2009)

Moreover, state-ownership of financial institutions provides an important linkage that binds the state banks to the municipal government. For example, a series of memoranda were signed between the Shanghai municipal government and the five largest national banks (notably ICBC, BOC, CCB, ABC and Bank of Communication) to establish strategic partnerships in promoting the SIFC's development. According to the memoranda, these state banks expressed an intention to strengthen collaborative relationships with Shanghai's municipal government and to foster financial markets and new institutions in Shanghai (interview 6).

In summary, financial statism has been effective in modernising infrastructure and improving the investment environment. It has boosted the agglomeration of various financial institutions and markets in Shanghai. Furthermore, financial statism has laid a sound foundation for collaboration between the central and local government in promoting the SIFC.

6.2.3 Meta-Level

At the meta-level, the relevant components of financial statism have been its restrictive measures on capital accounts and currency convertibility. It is widely recognised that capital controls are the underlying reason China remained unscathed amid two financial crises, notably the Asian financial crisis of 1997-1998 and the global financial crisis of 2008(e.g. Zhou 2000; Gu and Sheng 2005).

In the Asian financial crisis countries such as Thailand, The Philippines, South Korea and Malaysia were severely damaged and their currencies were considerably devalued, with a commensurate spread of bankruptcies and economic catastrophes. However, China's economy was barely touched by the crisis. Some commentators attributed this to China's capital controls and the absence of currency convertibility (Lardy, 2000; Baek 2005, p.486). In particular, Gu and Sheng (2005) describe capital controls as the "Great Wall of Chinese Economy" and summarise three merits for national economic interests:

- Capital controls preserve domestic savings for domestic use, facilitate the taxation of investment income, and block capital flight during economic recession, political turbulence or social turmoil
- Capital controls protect domestic underdeveloped industries from foreign competition before they grow to an efficient scale to compete in the world market
- Capital controls provide the least disadvantageous solution to the destabilising effect of capital flows on poorly regulated financial systems

The Asian financial crisis in 1997-98 had a profound impact on the development process of the SIFC. The crisis prompted the need for better regulatory and supervision systems in the financial sector across a globalising world. In Shanghai, government think tanks, such as the Shanghai Academy of Social Science and the Shanghai Development Research Centre (SDRC), carried out a range of studies on the origins of the Asian financial crisis and its impact on the SIFC (Zhou 2000). These studies reveal that undue capital liberalisation was one of the reasons behind the crash. In particular, some victim countries such as South Korea, introduced high-risk derivative products without prudential regulation and supervision. This led to huge market volatility and became a major source of the crisis.

Thereafter, there was a growing consensus that the pace of financial liberalisation in China should be aligned with the country's macroeconomic fundamentals and the strength of its financial system (Zhou 2000). Hasty capital account liberalisation can be extremely risky before a well-managed banking system and a prudential supervision framework are in place (Cooper 1999). In other words, the capital account can only be fully liberalised after achieving macroeconomic stability, ensuring that the banking system is strong and competitive. If a country gives up capital controls prematurely, financial liberalisation would harm rather than benefit the national economy. Thereafter, China's political leaders became more alert to the dangers of financial liberalisation and so continued their imposition of restrictions on foreign equity investments as well as portfolio investments. The mainland stock exchanges remain closed to foreign investors to preclude international speculation. As Prasad and Wei (2007) observed:

> The idea of capital account liberalisation by 2000 disappeared, and in its place rose the notion that the higher the level of foreign exchange reserves, the better the chance of avoiding painful crises (p.453).

Following China's entry to the WTO in 2001, its exports have increased rapidly and the country has experienced a massive surplus in its current account (Luo 2012). Its foreign reserves have also increased considerably. At the end of 2011, Chinese foreign reserves reached USD 3.18 trillion - China held the world's largest foreign reserves and was the US government's largest creditor. During the global financial crisis in 2008, the Chinese economy showed strong resilience and has been expanding at an impressive rate. Whereas the rest of the world economy shrank by 0.6 percent in 2009, China reported growth of 8.7 percent (Subacchi and Huang 2012).

Financial statism provided a unique situation for China's economy and the nation's economic policies. The study demonstrates that it played an active role in mobilising savings, streamlined structural change and averted carnage in the wake of the Asian financial crises over the past two decades. Under financial statism China has succeeded not only in avoiding a severe transitional crisis, but also managed to "make transition a source of growth" (Herr and Priewe 1999). This also suggests perhaps that our knowledge of transition processes should not be restricted to conventional theories and concepts.

6.3 The Disadvantages of Financial Statism

While financial statism presents many opportunities, it also involves some risks in the long run. Lardy (1998) claims China has suffered serious problems due to resource misallocation resulting from the dominant state ownership of the financial sector. He argues that credit loans from state banks were not determined by the profit generated from the project but the social benefits it created. Profit maximisation was replaced by societal welfare maximisation. If the SOEs could always obtain cheap funds from the state banks, it would be a disincentive for the former to improve performance and the latter would eventually collapse. In his own words: A high degree of state ownership is not only associated with poor lending decisions but also frequently is accompanied by overstaffing, overdevelopment of branch networks, and other practices that contribute to relatively high operating costs (Lardy 1998, pp.16-17). Given the scale and scope of political and economic interests involved, this would lead to costly bailouts by the state while the latter would act as the "last resort".

The state banks are keen to make loans to the SOEs. This has led to investment-driven development model – the preference to use capital rather than labour and technological innovation has produced excess demand for credit and over-investment, particularly in capital-intensive industries (Lardy 2012). In the long run, this will increase the liability of the SOEs, entailing high-risk exposure to asset bubbles and resource misallocation. Since commercial banks are able to obtain stable profits from interest margins, they have been reluctant to support riskier non-state sectors, especially SMEs and high-tech firms. The crowding-out effect makes it difficult for the non-state sector to access loans from state banks. Hence, the controlled interest rates have undermined the long-run competitiveness of the national economy. As part of the Global Competiveness Report 2010-11 published by the World Economic Forum, a questionnaire survey was undertaken, which found that access to finance was the most problematic factor in doing business in China (WEF 2010b, p.128).

In reality, the financial conditions of state banks have deteriorated due to the responsibility of making such “policy loans”. It is no exaggeration to say that China’s state banks were on the edge of bankruptcy in the late 1990s. In 2001, the “Big Four” were saddled with enormous non-performing loans (NPLs): 29.8 percent for the Industrial and Commercial Bank of China, 27.5 percent for the Bank of China, 42.1 percent for the Agricultural Bank of China and 19.4 percent for the China Construction Bank (Table 6.7). A People’s Bank of China survey on the causes of state banks’ non-performing loans estimated that 70 per cent fell into the categories of policy and relationship loans[53]. The capital asset ratio of these banks was below zero. According to Xie (2008), the capital-asset ratio for the Bank of China was -2.02 percent in 2003, which was still the best among the “Big Four”.

Table 6.7: The rate of non-performing loans in the “Big Four” (2001-2006)

Year	**ICBC %**	**BOC %**	**ABC %**	**CCB %**
2001	29.78	27.51	42.12	19.35
2002	25.52	22.37	30.07	15.36
2003	21.65	18.07	30.65	11.90
2004	21.16	5.12	25.61	3.92
2005	4.69	4.62	26.17	3.84
2006	3.79	4.04	23.55	3.29

Source: CBRC website, Annual Report of ICBC, BOC, ABC and CCB

Furthermore, interest rate controls had also created an unfair market environment. As the interest margins were specified by the central bank, state banks as well as newly-established joint-stock banks and even foreign banks could benefit from a free

53 According to the survey, 30 percent of the NPLs were the result of lending in response to state planning and administrative intervention; 30 percent resulted from defaults by state enterprises after state banks provided financing based on state policy; 10 percent were write-offs caused by structural adjustments that led to closures, the suspension of operations, mergers and relocation. ; 10 percent of delinquent loans stemmed from poor legal environment and weak law enforcement, while 20 percent was due to inappropriate internal management (Zhou 2004). This provided a basis for addressing the NPLs and designing the blueprint for state commercial bank reform.

ride – even though the latter two categories had never taken any responsibility for policy loans. Meanwhile, the guaranteed margin of interest rates to banks, which would make it difficult to evaluate bank performances, ran the risk of a new type of soft budget constraint problem. Besides this, under specified interest margins, household depositors were likely to lose interest earnings as they were precluded from choosing their favoured financial instruments based on their preferences for risks and profits because they had to deposit their savings in the state banks passively.

Lardy's (1998) points are well-taken in the sphere of neo-classical economics. When capital is allocated by administrative forces, market forces will be repressed. However, if we put it in a more comprehensive framework from an interventionist perspective, the conclusion might be different. In the early 1990s, when Shanghai proclaimed the development of the IFC, the country was confronted by a number of challenges amid economic transition, including institutional failure, market deficiency, infrastructure weakness and brain drain etc. In these circumstances, political stability and societal welfare were of paramount importance for social and economic transition in China. Zhang (2010, p.5) argues that the large policy loans from state banks should be regarded as a special form of long-term treasury bonds issued by the state. The interest rate margins were a designated policy devised by the state to compensate state banks, as the latter were funding the country's transitional reform (Zhang 2011, p.15). Therefore, non-performing loans in state banks were actually the costs that the state had to bear during this process. In this way, financial statism served as a mechanism for ensuring social stability and welfare.

In effect, China's political leaders persisted in their belief that political and social stability were paramount for economic growth in the course of market transition. In this regard, China's financial statism has parallels with North's verdict (1981, 1992a). He argued that the state usually specifies rules that provide a structure of property rights to maximise profits accruing to the ruler (or ruling class/party), even though this may lead to lower efficiency. Financial statism has sacrificed economic efficiency to a certain extent for the sake of maintaining high levels of political and social stability.

The conditioning at macro, meso and meta levels thus laid strong foundations for the SIFC's development at micro-level. Moreover, China's financial statism also led to the segmentation of home and foreign markets due to stringent capital controls. This has led to the financial market in Shanghai being isolated from the global market, which has had a profound impact on Shanghai's transformation into an IFC. I will elaborate this in more detail in the next chapter.

7. The Performance of the SIFC under Financial Statism: A Micro-level Assessment

The complete formulation of our economic policy is to give full play to the basic role of market forces in allocating resources under the macroeconomic guidance and regulation of the government. We have one important piece of experience from the past thirty years, which is to ensure that both the visible hand and invisible hand are given full play in regulating market forces.

--- Wen Jiabao[54]

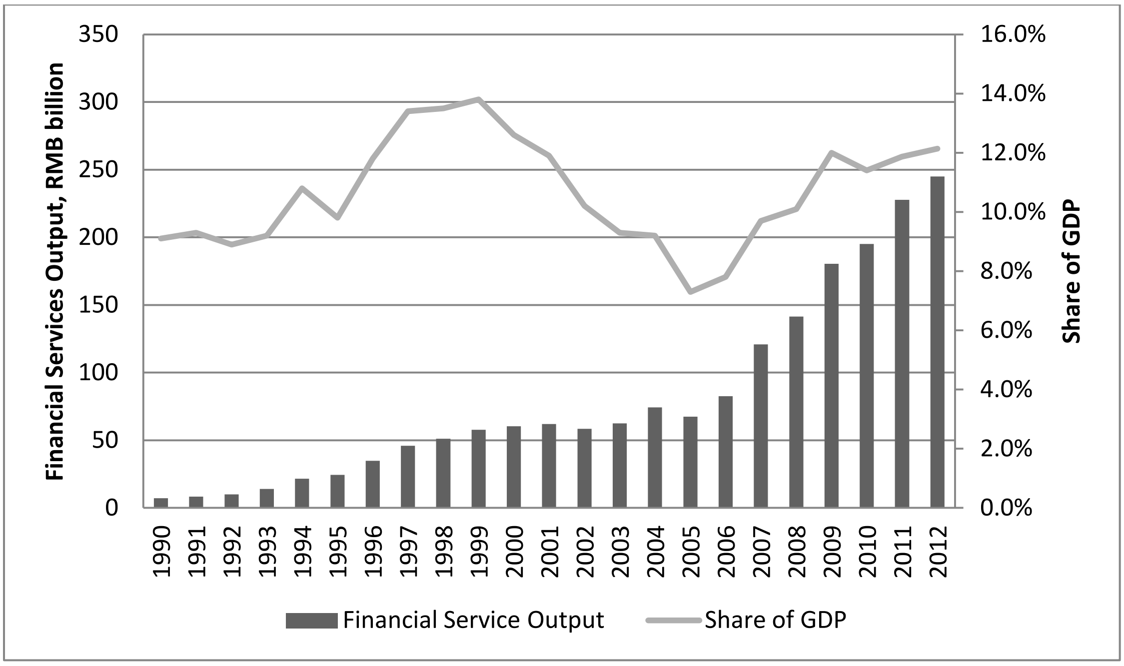
This chapter provides an assessment of Shanghai's IFC development at micro-level, focusing on the advancement of financial markets, institutions and professionals in Shanghai since the 1990s. Section 7.1 evaluates the depth and breadth of Shanghai's financial markets, covering the equity market, the fixed income market, the futures market, the foreign exchange market, derivatives and others. I will then discuss Shanghai's progress in the agglomeration of financial institutions, human capital and financial services and specify its strengths and weaknesses. Section 7.3 provides an overall picture of the competitiveness of the SIFC in comparison with other IFCs worldwide as well as several major peer-cities elsewhere in China, e.g. Beijing and Hong Kong. The final section will summarise these discussions.

[54] The quotation is taken from Wen Jiabao, Premier of P. R. China (2003-2013),when he was interviewed by CNN's Fareed Zakaria in September 2008

7.1 Development of Financial Markets: Depth and Breadth

The building of Shanghai as an international financial centre began in earnest in the 1990s. Since then, this city's financial sector has witnessed rapid progress. Figure 7.1 shows Shanghai's financial service output has maintained relatively stable growth since 1990. In 2012, Shanghai's financial service sector generated added value of RMB 245 billion, which was 35 times its 1990 total. The weight of financial services' output in total GDP terms also increased from nine percent in 1990 to 12 percent in 2012. Although the development of the financial industry was relatively slow between 1999 and 2005, with its weight declining from 13.8 percent to 7.3 percent[55], it recovered and experienced strong growth again after 2005.

Figure 7.1: Shanghai financial services output and its share of GDP (1990-2012)



Source: Shanghai Statistics Yearbook 2011

[55] There are two reasons that can explain the falling weight of financial services in total GDP terms between 1999 and 2005: Firstly, after the Asian financial crisis, Shanghai's municipal government stepped up its efforts to develop advanced manufacturing industry, fearing the city might suffer a "hollowing-out" effect without the support of a "real" economy. Secondly, the central government also tightened its regulation and management of the financial sector to reduce systematic risks and assets bubbles, calling for the establishment of "financial safety zone".

Indeed, it was a challenging task for the Shanghai municipal government to develop an international financial centre when the city was a bridgehead of planned economy in the early 1990s. One of Shanghai's tactics for IFC development was to become a gathering point for various financial markets in the country. Between 1990 and 2006, Shanghai developed a stock market, a bond market, a foreign exchange market, a commodity and financial futures market, a gold and diamond exchange and an equity over-the-counter (OTC) market (Table 7.1). This enabled the emergence of robust and integrated financial markets, which in turn became the catalyst for the agglomeration of a critical mass of financial institutions and professionals. Shanghai thus became the de facto domestic financial hub in mainland China.

Table 7.1: The development of major markets in Shanghai

Exchange	**Markets**	**Launching Year**	**Notes**
Shanghai Stock Exchange	Capital markets, including stocks and bonds	1990	National market share 69% in 2011 in terms of market capitalisation
China Foreign Exchange Trading Centre	Foreign Exchange Markets	1994	National headquarters
National Inter-bank lending centre	Money Market	1996	National headquarters
National Inter-bank Bond Trading Centre	Money Market	1997	National headquarters
Shanghai Futures Exchange	Commodity futures market include copper, zinc, rubber etc.	1999	National market share 54% in 2010
Shanghai Diamond Exchange	Diamonds	2000	The only diamond exchange in the country
Shanghai Gold Exchange	Spot market for gold, silver and platinum	2002	The only gold exchange in the mainland China
Shanghai Petroleum Exchange	Spot market for LPG, LNG	2006	The only petroleum spot market in the country
China Financial Futures Exchange	Financial derivatives market	2006	The only financial futures exchange in the country

Source: compiled by author

In addition, the market capitalisation, turnover and variety of products traded in Shanghai's financial markets have all increased substantially in recent years. As of 2010, the turnover of Shanghai's financial market totalled at RMB 386.2 trillion (excluding the foreign exchange market): the securities market turnover totalled RMB 39.8 trillion; the futures market RMB 123.4 trillion; the inter-bank market RMB 179.5 trillion[56]; and the gold market RMB 2.02 trillion (PBoC 2011). The growth of the financial markets has become the key strength in Shanghai's ascendance to an international financial centre.

Equity Market

The incorporation of the Shanghai Stock Exchange (SSE) in 1990 marked the start of equity markets in China. In one sense, it was also the launching pad for the SIFC's development. In 1992, the market capitalisation of the SSE only amounted to RMB 56 billion (see Table A8 in Appendix 2). Since then, we have witnessed momentous growth in Shanghai's equity market.

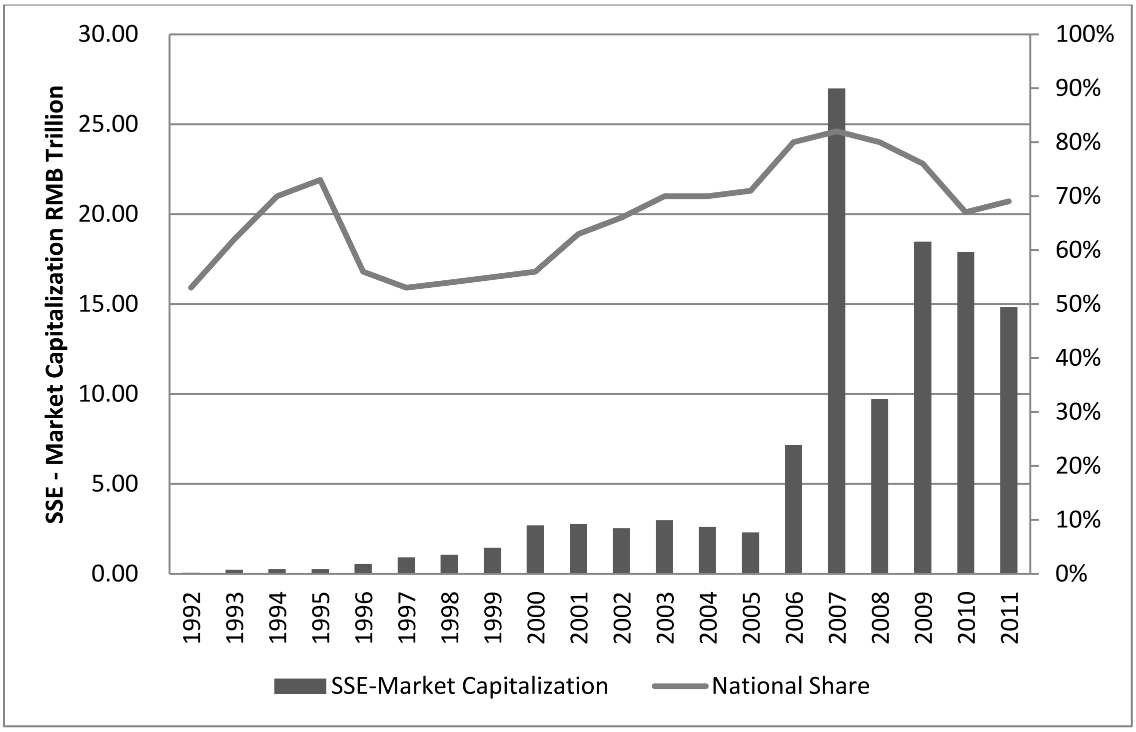
Table 7.2: A comparison of the largest stock exchanges in the world (2011)

	Exchanges	**Market Cap USD billion**		**Exchanges**	**Value of Share Trading USD billion**
1	NYSE Euronext (US)	11,796	1	NYSE Euronext (US)	18,027
2	NASDAQ OMX (US)	3,845	2	NASDAQ OMX (US)	12,724
3	Tokyo Stock Exchange	3,325	3	Tokyo Stock Exchange	3,972
4	London Stock Exchange	3,266	4	Shanghai Stock Exchange	3,658
5	NYSE Euronext (Europe)	2,447	5	Shenzhen Stock Exchange	2,838
6	Shanghai Stock Exchange	2,357	6	London Stock Exchange	2,837
7	Hong Kong Exchange	2,258	7	NYSE Euronext (Europe)	2,134
8	TMX Group	1,912	8	Korea Exchange	2,029
9	BM & FBOVESPA	1,229	9	Deutsche Borse	1,758
10	Australian SE	1,198	10	TMX Group	1,542

Source: WFE (2012)

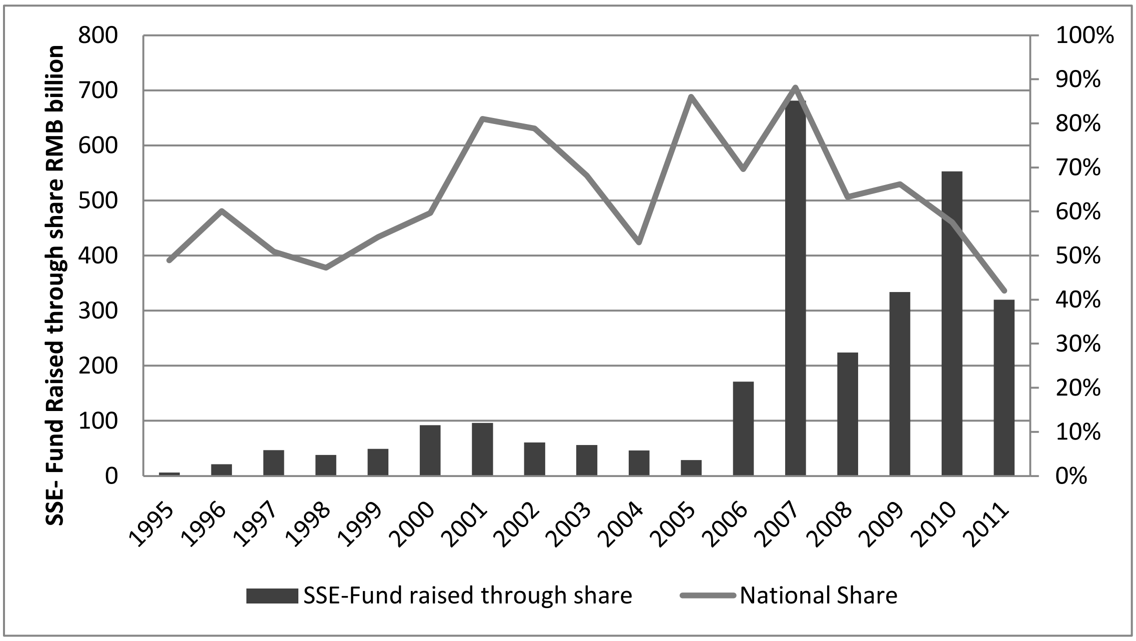
[56] The inter-bank market includes overnight lending (RMB 27.9 trillion), bonds' trading (RMB 64 trillion) and repos (RMB 87.6 trillion).

Figure 7.2: Market capitalisation of the SSE (1992-2011)



Source: Yearbook of Shanghai 1996-1997, Yearbook of China's Securities and Futures Market 2011, Year book of Shanghai Stock Exchange

Figure 7.3: Fund raised through shares in the SSE (1995-2011)



Source: Yearbook of Shanghai 1996-1997, Yearbook of China's Securities and Futures Market 2011, Year book of Shanghai Stock Exchange

According to the SSE Statistical Yearbook, at end-2011 Shanghai had nearly 1,700 listed securities (including shares, bonds, funds and warrants) and 931 listed companies, of which 39 were new listings. Listed stocks had a market capitalisation of RMB 14.8 trillion, representing 69 percent of national share. In terms of fundraising, the SSE generated RMB 320 billion through the issue of new stock offerings during 2011 (see Figure 7.3). By the end of 2011, the SSE had over 87 million investor accounts, with a total turnover of RMB 45.4 trillion, of which the value of stock trading totalled RMB 23.8 trillion. Within only two decades, the SSE has grown to be the sixth largest exchange in the world in terms of market capitalisation. The turnover of stock trading has surged to fourth in the world (Table 7.2). In addition, in 2011 Shanghai also became the sixth largest IPO market in the world.

How could this surge happen in such a short period? During the early stage, state intervention played a significant role in jump-starting the stock market development. From 1993 to 2000, stock issuance was managed by the central government through administrative measures based on a quota system. This created incentives for provincial government officials to screen companies at the IPO stage (Pistor and Xu 2005). This, in turn, encouraged local bureaucrats to pick better-performing SOEs in the region for public listing as they would then be rewarded with more stock issuance quotas from central government (Du and Xu 2006). In the meantime, priority was given to SOEs in accordance with the policy guidance adopted by the government agencies (see Section 6.2.1). As a result, the bulk of shares listed on the market were owned by the state, as most of the firms going public were former SOEs.

In the meantime, in order to fund the SOEs while maintaining state control, pre-existing shares prior to an IPO were designated non-tradable; only the new shares that issued during an IPO or a follow-on offering were tradable. In this way, the shares in listed companies were segmented. By 2005, 62 percent of the SOE shares were owned by the government and were legally non-tradable (Allen et al 2007). However, in practice, the coexistence of tradable share and non-tradable shares created some adverse effects. The most serious drawback was that the holders of tradable and non-tradable shares had divergent rights and interests. For example, the major shareholders with non-tradable shares tried to maximise the book value of their companies by issuing more non-tradable shares in order to exploit the liquidity premium[57] (Chan et al 2007). For another, non-tradable shareholders were unable to sell their shares when the stock price was going up. Some high-performing private enterprises thus sought to list on overseas exchanges, such as the NYSE, NASDAQ and HKSE (Fang 2013). In 2005, the authorities decided to carry out reforms to convert non-tradable shares into tradable ones and thereby make management more accountable to shareholders. These reforms were completed in 2007, leading to the surge of Shanghai Composite Index peaking at 6,124 on 16th October.

Despite rapid expansion, there are still a number of problems in Shanghai's stock market. First of all, it is overly volatile and entails an element of high risk. In 2007, the Shanghai Stock Composite Index jumped 96.7 percent and market capitalisation soared by 302.7 percent higher than the year before; yet from October 2007 to June 2008 the index dropped 55 percent - the market resembled a roller-coaster ride. Poor regulation and a lack of institutional investors (i.e. insurance companies, mutual funds, pension funds or hedge funds) increased the likelihood of speculation. The industrial structure of listed companies in China was another reason for the volatility. In the SSE, the top three listed industrial sectors are finance, real estate and energy, all of which are cyclical and sensitive to the money supply. This contrasts with the situation in the United States, where the top listed sectors are less cyclical, such as healthcare and information technology (Interview 9). Given that the industrial structure cannot change overnight, high volatility will likely remain a factor for some time to come.

Secondly, the equity market has yet to function effectively as a vehicle for capital relocation. The stock price can not reflect the performance of listed companies and macro-economic conditions, but is sensitive to policy change. Since the bulk of listed

[57] Liquidity premium refers to the price difference between the market value of the tradable shares and book value of non-tradable shares (Chan 2007). Although non-tradable shares could not be traded at the Stock Exchange directly, they could still transfer through agreement or auction.

companies were SOEs, the soaring stock market has often been attributed to “the low costs of direct financing, underdeveloped performance control on listed companies and the small burden of dividends” (Baek 2005, p. 490). Apart from that, the stock market remains restricted in available instruments, legal structures are still deficient and transparency is rather limited.

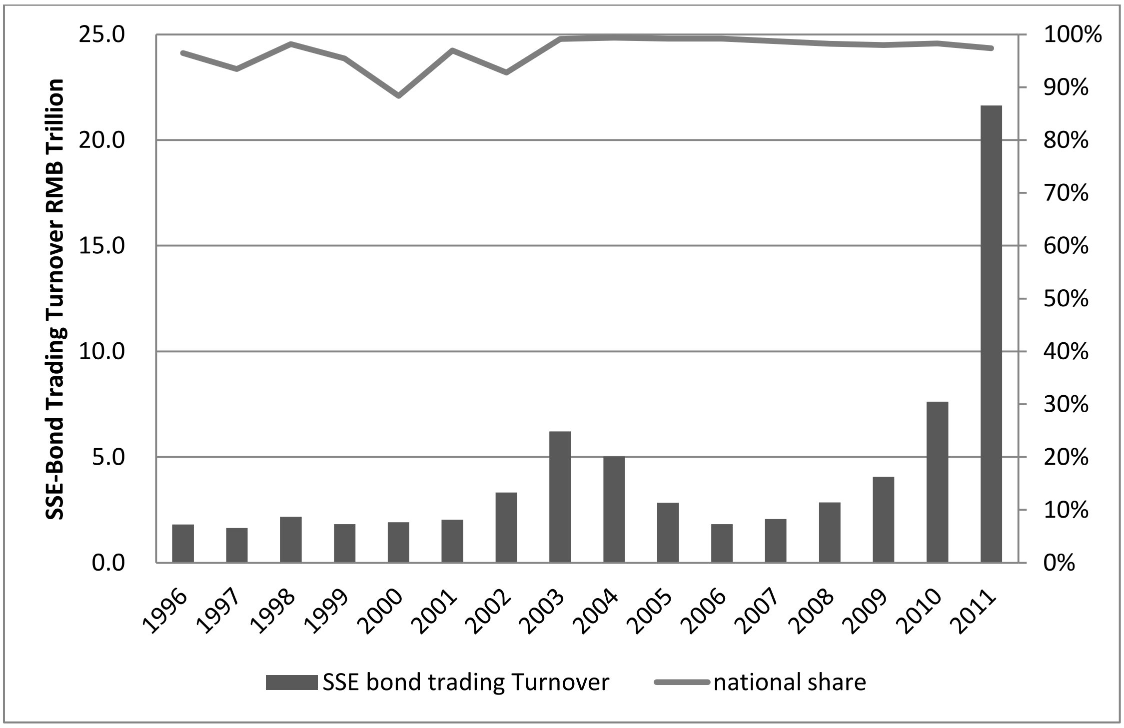
Thirdly, the equity markets remain largely closed to outside investors. Foreign investment in securities firms is even more restrictive than in the banking and insurance sectors. It has created an A-share and B-share market, with the former for domestic investors and the latter for foreign investors. This structure has been created to protect domestic firms from foreign control because the central government continues to restrict the free flow of capital in the capital account (Chan et al 2007). In effect, A-shares play the central role in the stock market development, overshadowing the much smaller foreign currency B-share market. Consequently, the liquidity of B share markets in China was very poor. Although in 2001 Chinese authorities changed the rules and allowed domestic investors to use foreign currency to invest in B shares, the market still seems unsustainable. In 2013, China International Marine Containers (CIMC) became the first company to convert its Shenzhen-based B shares into Hong Kong-listed H shares (Noble 2013).

For the reason of capital control policies, the development of Shanghai’s equity market has lagged behind other leading Stock Exchanges, such as New York and London. In 2010, there were 816 foreign companies listed in New York, making up 16 percent of total listed companies. The number of foreign companies listed in London was 604, accounting for around 20 percent of the total (SFPI 2011). However, foreign companies are still not allowed to be listed in mainland China’s stock exchange. The sheer scale of stock trading in Shanghai was mainly achieved domestically and the rate of foreign investors in Chinese capital market has been very low. Due to the low degree of internationalisation, Shanghai’s stock market has little influence in the Asia-Pacific region, let alone globally.

Fixed Income Market

In China, the bond markets consist of an inter-bank market (i.e. an OTC market) and an exchange market. China's inter-bank bond market was developed in 1997 when the central bank declared that commercial banks were prohibited from trading bonds in the exchanges. Alternatively, they were allowed to trade through the China Foreign Exchange Trading System (CFETS) in Shanghai. In 1999，other financial institutions such as securities firms and fund management companies were permitted to participate in the inter-bank bond market. The inter-bank bond market thus became a national bond trading market mainly for large institutional investors. In contrast, the exchange bond market was an order-driven market brokered by securities companies. The bonds listed in the exchange market include treasury-bonds, corporate bonds and repos. In contrast to the inter-bank market, the major players in the exchange market were primarily small investors and individuals. The SSE was the most important bond exchange market in the country, making up over 90 percent in terms of trading value (Figure 7.4).

Figure 7.4: The value of bond trading in Shanghai Stock Exchange (1996-2011)



Source： Yearbook of China's Securities and Futures Market 2011

It is noteworthy that the role of the bond markets in China - whether the inter-bank market or the exchange market - were rather limited before 2005. In 2004, bond trading turnover in the SSE stood at RMB 5 trillion, while that of interbank trading was valued at RMB 2.5 trillion. Firms preferred equity financing to bond issuance mainly because under financial statism the SOEs could attain funding from state banks at preferential interest rates. There were no incentives for them to raise funds through the bond markets (interview 9). Coincidentally, SOEs were not financially constrained before corporate reforms[58], which meant they would face few adverse consequences if they defaulted on their debts or filed for bankruptcy. As a matter of fact, in the early 1990s SOEs issued excessive bonds and most of them ended up in default (Huang and Zhu 2009). These defaults led to increases in non-performing assets on the balance sheets of state-owned banks, the major holders of such securities. The central government thus decided to tighten the regulations and close down the corporate bond market. Therefore, compared with government-issued bonds, the size of the corporate bond market was minuscule (Allen et al 2007). The low-volume of corporate bonds have constrained efficient pricing in the secondary market and hindered growth. Another reason for its beleaguered growth is institutional weakness and deficiencies relating to bond issuance, such as the absence of a credit rating system, a sound accounting system and information disclosure mechanisms (Zhou 2005). In a speech to China's bond market development summit, the governor of the PBoC, Zhou Xiaochuan contended:

> Compared with other financial instruments … China's corporate bond market has been developing very slowly and its role in economic growth has been rather limited. Such lack of development has also distorted the financing structure and produced considerable implicit risks, whose consequences may be grave for social and economic development. (quoted in Walter and Howie, 2010)

Surprisingly, China's bond markets have experienced rapid growth since 2005. In the interbank bond market, the turnover jumped dramatically from RMB 2.5 trillion in 2004 to the peak of RMB 64 trillion in 2010, representing a 25 times-plus increase in only six years (Figure 7.5). The trading value of the bond exchange market had totalled RMB

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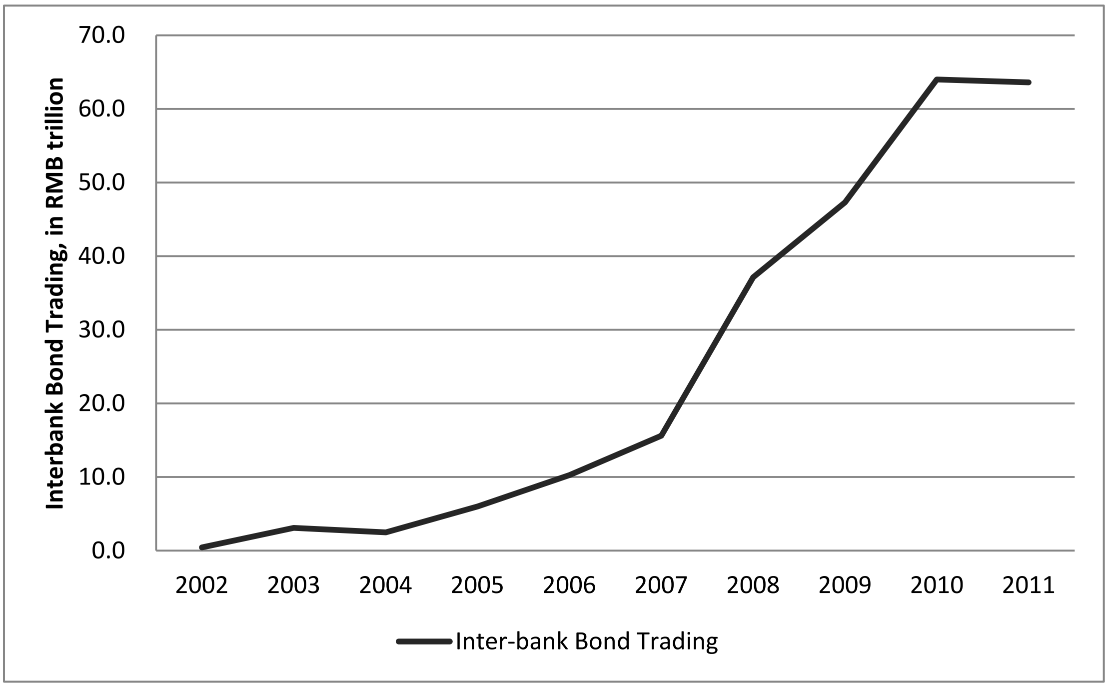
[58] The corporate reforms of SOEs refer to establish a "modern enterprises system" (MES), characterized by "clearly established property rights, well-defined powers and responsibilities, separation of the enterprise from the government and scientific management" (also see section 6.2.1).

21.6 trillion by the end of 2011 and the SSE accounted for 97 percent[59] of this figure. The listed number of bonds increased from 24 in 1996 to 680 in 2011. Trading value surged to RMB 21 trillion; almost three time that of 2010.

Figure 7.5: The turnover in Shanghai's inter-bank bond market (2002-2011)



Source: Yearbook of China's Securities and Futures Market 2011

There are a number of reasons for the rapid growth of the bonds markets since 2004. Firstly, corporate bonds are increasingly seen as an alternative source of capital that may transform China away from a bank-driven credit economy. For example, the State Development Bank has taken over part of the policy lending from the state banks and financed it through bond issues, which is viewed as "replacing non-interest bearing money with interest bearing debt" (Hofman 1998). Meanwhile, the number of investors in the bond markets soared after 2005. At the end of 2010, there were 10,235 participants in the inter-bank bond markets, an increase of 44.3 percent over 2007. Besides, the participants in the inter-bank bond markets were becoming more diverse; with new entrants including commercial banks, insurance companies, mutual funds,

[59]There are two bond exchange markets in China, the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

credit cooperatives, non-bank financial institutions and securities companies (KPMG 2011). A number of qualified international institutions are now also permitted to trade on the inter-bank bond markets.

Secondly, both the central government and the municipal government stimulated growth in the domestic bond markets by promoting new issues. The inter-bank bond market, for example, has gradually become the main platform for allocating capital and conveying monetary policies (KPMG 2011). Since 2000, the state has allowed the bigger SOEs to issue bonds and these can be invested by institutional investors (mainly large banks and other financial institutions) through the inter-bank market (interview 9). Companies have also become more sensitive to cost of capital and have been looking for alternative ways of financing themselves (Huang and Zhu 2009). With the expansion of markets in breadth and depth, a yield curve for the inter-bank bond market has been established and provides a basis for the pricing of financial products in China. Furthermore, the regulatory agency also took measures to facilitate bonds' application. In 2010, the CSRC shortened the application duration to 30 days for new bond issuance applicants providing they met certain criteria[60] (SFPI 2012).

The third point relates to the introduction of new fixed income products. Between 2005 and 2010, the central government launched short-term bonds, corporate bonds, medium-term notes and SMEs' collective notes (KPMG 2011). In addition, trading mechanisms have also diversified from spot transaction and collateralised repos to such as outright repo, bond forward transactions, interest rate swaps and forward rate agreements. In November 2011, the local government was also permitted to launch a pilot scheme to issue bonds on the inter-bank bond market.

The money market is another important component of the fixed income market, which provides a short-term (usually of less than one year) lending and savings option for commercial banks and other financial firms. This is in marked contrast to capital

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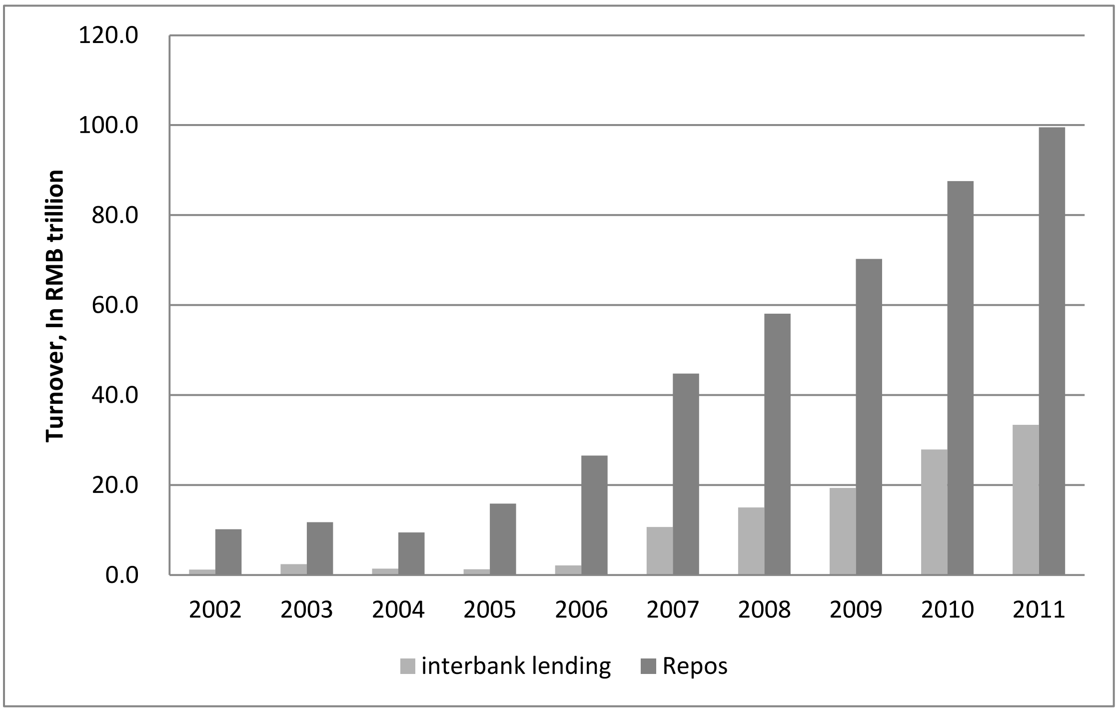
[60] The applicants can simplify the application process if they meet certain criteria. They must have: (1) over 10 billion in net assets; (2) a AAA credit rating; (3) be institutional investors; (4) invest bonds with a duration of one to three years.

markets, which provide long-term funding underpinned by stocks and bonds. The core business of the money market is inter-bank lending and bond repurchasing (i.e. repo). As shown in figure 7.6, the turnover in inter-bank lending market hovered at RMB 1.5 trillion between 2002 and 2006. Then it grew dramatically to RMB 10.7 trillion in 2007. In 2011, turnover reached RMB 33.4 trillion, nearly three times the 2007 figure. The turnover of bond repos has increased even more quickly than the inter-bank lending. In 2002, the turnover of repos stood at RMB 10.2 trillion – by the end of 2011, it had risen sharply to RMB 99.5 trillion(Figure 6.6).

Figure 7.6: The turnover of interbank lending and repos in Shanghai's money market (2002-2011)



Source: PBoC, The Report on China's Monetary Policies, 2002-2011

It is noteworthy that while China's bond market has become more open and market-oriented, it lags behind other developed markets by a significant margin. In particular, the corporate bond market is dominated by a small number of issuers, mostly state-owned entities, while the vast majority of private companies and SMEs have yet to fully participate in it.

Futures Market

Between 1992 and 1993, Shanghai established six commodity exchanges in metals, foodstuffs, petroleum, cereals & oil, chemical materials and building materials. In 1999, these exchanges were merged into the Shanghai Futures Exchange (SFE). In 2008, Shanghai ranked first in the world in the futures trading of rubber and second in copper, aluminium and zinc behind the London Metal Exchange (LME). According to the Futures Industry Association (FIA), the trading value of China’s commodity futures markets (including Shanghai, Dalian and Zhengzhou) in 2010 was RMB 226.99 trillion. Shanghai’s commodity futures market totalled RMB 123.4 trillion, accounting for 54.4 percent of the total value in the country (see table A10 in Appendix 2). In terms of volume of commodity futures traded in 2010, Shanghai ranked 11th among all futures exchanges in the world. Meanwhile, the scope of commodities traded on the SFE also increased rapidly. As can be seen from Table 7.3, there were only three items traded on the exchange in 2003 - aluminium, copper and natural rubber. Since 2004, the SFE has introduced fuel oil, gold, zinc, steel rebar, steel wire rod, plumbum and silver. As of 2012, there were ten commodities traded on the SFE.

On 8th September 2006, the government launched the Shanghai Financial Futures Exchange. Investors were granted access to stock index futures in April 2010. Shanghai became the first centre in the country to launch a stock index futures exchange, which not only helped to curtail stock exchange risks, but also provided the necessary pricing function. From the outset, the government imposed a relatively stringent set of rules including a threshold of RMB 500, 000 as the minimum deposit for a single trading account. By the end of 2011, 50.4 million contracts had been traded. The total value of trades in stock index futures in 2011 reached RMB 87.5 trillion. The introduction of stock index futures is another sign of the maturity of capital markets in China, which means investors are able to profit from both the rises and falls in the market through more sophisticated investment instruments.

Table 7.3: The commodities traded on the Shanghai Futures Exchange (2000-2012)

Year	AL	CU	RU	FU	AU	ZN	RB	WR	PB	AG
2000	√	√	√							
2001	√	√	√							
2002	√	√	√							
2003	√	√	√							
2004	√	√	√	√						
2005	√	√	√	√						
2006	√	√	√	√						
2007	√	√	√	√	√	√				
2008	√	√	√	√	√	√				
2009	√	√	√	√	√	√	√	√		
2010	√	√	√	√	√	√	√	√		
2011	√	√	√	√	√	√	√	√	√	
2012	√	√	√	√	√	√	√	√	√	√

Note:
AL: Aluminium; CU: Copper; RU: Natural Rubber; FU: Fuel Oil
AU: Gold; ZN: Zinc; RB: Steel Rebar; WR: Steel Wire Rod
PB: Plumbum AG: Silver
"√" indicates commodity being traded in the exchange
Source: Shanghai Futures Exchange website

Nevertheless, Shanghai's futures market is still in its infancy. The market price of commodities can only reflect supply and demand in the domestic market, which remains largely segregated from the outside world (interview 9), as it is not yet open to foreign investors. Furthermore, the commodities traded in the futures exchange are relatively limited compared with other futures exchange in developed countries. As seen from Table 7.3, there were only 10 items traded on the SFE in 2012, while there were 815 items traded on the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT) (SFPI 2011). The limited variety of products traded in the futures market is also connected to tight approval procedures by regulatory bodies. As an interviewee commented:

> The government was overly concerned about the risks of trading derivative products in the futures market. Actually, there were misunderstandings about futures trading among government officials. Shanghai, as an international financial centre, should take the lead to dispel undue misgivings surrounding derivatives. This would, to a large extent, contribute to the prosperity of China's futures market (interview 8).

Foreign Exchange Market, Derivatives Market and Others

The foreign exchange market is a leading and broad indicator of the status of an IFC. Its volume of business generally rests on the presence of a sufficient number of banks, openness to foreign trade and a large international business base (Young et al., 2009 p. 82). The development of Shanghai's foreign exchange market was closely associated with China's capital control regime and foreign exchange policies. In 1988, Shanghai was the first city in the country to set up a foreign exchange swap market, which can be regarded as an embryonic form of foreign exchange market. However, it had several deficiencies. Firstly, the foreign exchange rate under the swap market regime was two-tiered; there was an official rate and a swap market rate. Secondly, the swap market was not unified throughout the country - other cities such as Fuzhou, Shenzhen, Xiamen and Beijing established their own swap markets. (Lou and Gao 2008)

In April 1994, following exchange rate reform, the China Foreign Exchange Trading System (CFETS) was created in Shanghai and it operated on a membership basis (Neftci et al. 2007, pp.120-1) This changed the then two-tiered exchange-rate system, which was integrated into one official rate (USD 1.00 = RMB 8.70). Moreover, a unified foreign exchange market was established in Shanghai. Regulations concerning foreign exchange were also relaxed in 1995 when the Chinese government moved from an "earn to use" to a "buy to use" foreign exchange policy (Buckley et al. 2007; Luo et al. 2010, p.75). Between 1995 and 2005, China adopted a single, US dollar-pegged, managed floating exchange regime. The exchange rate was relatively stable, appreciating only five percent cumulatively from 8.70 to 8.27 during that period. This exchange regime played an important role in boosting China's foreign trade during the Asian financial crisis and thereafter its accession into the WTO. In 2005, the central government further allowed the Renminbi to appreciate by 2.1 percent against the US dollar, with the PBoC announcing that the Renminbi would be decoupled from the US dollar and switched to a new exchange rate regime with reference to a basket of other currencies (Luo 2012, p.28).

With the establishment of the CFETS in Shanghai, the turnover of foreign exchange transactions developed rapidly. As can be seen from Table 7.4, the turnover of spot transactions increased from USD 32 billion in 1999 to USD 3,554 billion in 2011. After

August 2005, the CFETS also started to trade outright forwards. The trading value of outright forwards amounted to USD 214.6 billion in 2011, growing from USD 14 billion in 2006. After that, the CFETS also introduced foreign exchange swaps and options in 2006 and 2011 respectively. Meanwhile, CFETS membership was also growing. In 2011, the total number of members was 318; comprising 73 forward trading members; 71 swaps traders, 27 options traders, 26 spot transaction dealers and 20 forward market dealers (SFPI 2012).

Table 7.4: The growth of trading values and products in the foreign exchange market (1999-2011)

	Spot Transactions USD billion	**Outright Forwards USD billion**	**Foreign Exchange Swaps USD billion**	**Options USD billion**
1999	32	--	--	--
2000	42	--	--	--
2001	75	--	--	--
2002	97	--	--	--
2003	151	--	--	--
2004	209	--	--	--
2005	581	--	--	--
2006	1,162	14.1	50.9	--
2007	2,290	22.4	314.6	--
2008	2,470	17.4	440.3	--
2009	2,940	9.8	801.8	--
2010	3,050	32.7	1,283.8	--
2011	3,554	214.6	1,771.0	1.01

Source: China's Yearbook of Banking and Finance 2007; PBoC, The Report on China's Monetary Policies, 2002-2011, Shanghai Financial Association.

In recent years, the CFETS has also introduced more derivatives. Since 2006, interest rate swaps and bond forwards have been introduced and traded through the exchange. The transactions in derivatives markets in Shanghai surged in 2010 and 2011. The trading value of interest rate swaps roared from RMB 461.64 billion in 2009 to RMB 1500.34 billion in 2010 and further to RMB 2675.96 billion in 2011. Other derivatives such as bond forward and forward rate agreement instruments also traded in a stable fashion (Table 7.5). These derivatives provide diversified options for commercial banks and financial firms for short-term financing.

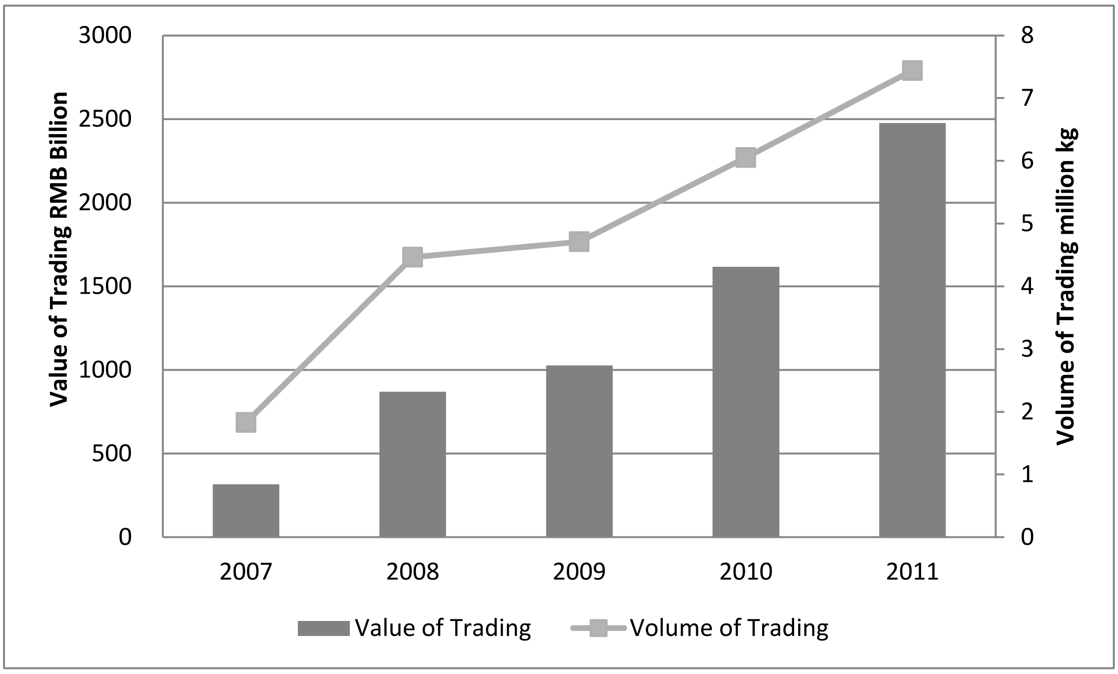
Table 7.5: The development of interest rate derivatives (2006-2011)

Year	Interest Rate Swaps RMB billion	Bond Forward RMB billion	Forward Rate Agreement RMB billion
2006	35.57	66.45	--
2007	218.69	251.81	1.1
2008	412.15	500.55	11.4
2009	461.64	655.64	6.0
2010	1500.34	318.34	3.4
2011	2675.96	103.01	0.3

Source: PBOC, The Report on China's Monetary Policies 2011

It is also important to note that Shanghai's gold spot market has become the largest of its kind in the world, despite only launching as late as 2002. From 2007 to 2011, the total trading value of gold increased from RMB 316 billion to RMB 2,477 billion (see Figure 7.7). In 2010, the total trading volume of gold reached 6,051.5 tonnes, silver 73,614.96 tonnes and platinum 54.69 tonnes (SGE 2010). Meanwhile, gold leases, mortgage business and gold trading in bulk also developed rapidly. In 2010, the Shanghai Gold Exchange had 163 members, including large state owned banks, foreign financial institutions and other related firms.

Figure 7.7: Turnover of gold trading in Shanghai Gold Exchange (2007-2011)



Source: Shanghai Gold Exchange, Annual Report 2007-2011

Table 7.6 Selected targets and actual development in the 11th Five Year Plan (2006-2010)

Indicators	Target (2010)	Actual (2010)
The national share of direct fundraising from Shanghai financial markets [a]	25%	21.7%
Total financial market trading turnover (RMB)	80 trillion	386.2trillion
The national share of financial assets located in Shanghai	10%	7.4% [b]
Trading turnover in money market (RMB)	40 trillion	115.5 trillion
Capital marketisation in securities market (RMB)	7 trillion	17.9 trillion [c]
Total deposits outstanding (RMB)	4.5 trillion	5.2 trillion
Total lending outstanding (RMB)	3.2 trillion	3.4 trillion
Insurance penetration rate[61]	5%	5.2%
Insurance density[62] (RMB per capita)	4,000	3,840

Note:
a. Direct fundraising includes IPO, treasury bills, corporate bonds and short-term financial bills etc
b. The actual data refers to banking assets only
c. The actual data refers solely to the stock market
Source: PBoC (2011), SFPI (2012), SMG (2006)

The central government's 11th Five Year Plan (2006-2010) detailed a three-phase development strategy to grow Shanghai into an international financial centre[63]. It is interesting to note that the selective quantitative objectives set by the Shanghai Municipal Government were primarily related to financial markets' development (Table 7.6). By 2010, Shanghai had nearly met the main targets set out in the plan. Furthermore, actual turnover has substantially exceeded the forecast targets for the size of the financial market. Shanghai has made remarkable progress and become the

[61] The insurance penetration rate is measured as the ratio of premiums underwritten in a particular year to the GDP.

[62] Insurance density is calculated as the ratio of total insurance premiums to the total population.

[63] The first phase of the three-phase development strategy was successfully completed by 2005. Its goal was to set up the foundations for a financial industry and consolidate Shanghai as a domestic financial centre. The second phase, 2006-2010, sought the establishment of a fundamental framework of an IFC, focusing on financial services, instruments and products denominated in Renminbi. The third phase was to develop Shanghai into one of the major IFCs in the Asia-Pacific Region by 2020.

best-developed city in terms of financial markets and infrastructure in mainland China.

7.2 Financial Institutions, Human Capital and Services Innovation

Financial Institutions

Along with the stunning growth of financial markets, Shanghai has become the hub for domestic and foreign financial institutions. As mentioned previously, the city hosts China's leading stock exchange, a unique inter-banking market, the headquarters of the country's foreign exchange trading system (CFETS) and a major commodity and financial futures exchange. Viewing the SIFC development as a golden opportunity, one after another the leading banks and other financial institutions have established their branches or regional headquarters in Shanghai. In particular, it has also become the country's asset and wealth management centre as a growing number of Non-bank Financial Institutions (NBFI) have set up offices there, including fund management companies, insurance asset management companies, investment banks, trust companies and private equity firms etc（Fang 2013, p.185）. Within the past two decades, the numbers of financial firms and institutions in Shanghai have grown remarkably. By the end of 2010, there were 1,049 financial institutions in the city; including 140 banking institutions, 138 securities firms and 320 insurance companies.

The strong presence of foreign financial institutions is essential for the re-emergence of Shanghai as an international financial centre. The city now hosts the largest number of foreign investment banks and financial firms in mainland China, surpassing Beijing (see Section 7.3.2). By the end of 2010, Shanghai housed 173 foreign financial firms, more than double the 71 located there in 2000. There were 21 domestically incorporated foreign banks[64] headquartered in Shanghai. These accounted for 68 percent of the total number of such institutions in China and 85 percent of the assets (Table 7.7). In spite of this, the city is nowhere near saturation point when it comes to foreign presence.

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[64] Domestically incorporated foreign banks were independent legal entities, and were subject to same regulations as domestic banks in China. Their equity capitals were warranted by the law and cannot be transferred to overseas, even if their parent banks were affected by the crisis.

Although the number of foreign banks has continued to expand quite rapidly in recent years, the total market share remains relatively inconsequential. In 2008, the balance of foreign bank assets only accounted for 17% of Shanghai's total bank assets (Zhao 2009, p.286). This was partly due to capital control policies, which restricted the financial services that foreign banks were able to provide. Consequently, the foreign banks primarily provided corporate services to foreign-invested companies and private banking to wealthy individuals in Shanghai.

Table 7.7: The growth of foreign financial institutions in Shanghai (2006-2010)

	2006	**2010**	**2006-2010 Change**	**2006-2010 Rate of Change**	**2010 National Share**
Total Financial institutions	706	1,049	343	48.5%	N.A.
#Foreign financial institutions (including representative offices)	357	394[a]	37[a]	10.4%[a]	N.A.
# Foreign financial firms operating in Shanghai	110	173	63	57.2%	N.A.
# Foreign incorporated banks	0	21	21	-	68%
# Joint venture Securities Firms	4	5	1	25%	45%
# Foreign insurance Co	14	19	5	35.7%	36%
# Joint venture fund management Co	16	22	6	37.5%	63%

Note:
a. The data refers to 2011
Source: SFPI (2011), Shanghai Statistics Yearbook (2007-2011)

In order to bolster the city's international recognition and enhance its status as an IFC, the central bank (i.e. PBoC) set up its second headquarters in Shanghai on 10th August 2005. Under this dual-headquarters' structure, its Shanghai base focuses mainly on activities such as promoting financial innovation and market development, conducting market information analysis and coordinating regional financial development (Xinhua 2005). The launch of the second headquarters was regarded as a signal from the central government to promote SIFC development. Nevertheless, it is arguable its significance is overrated. As an interviewee from the Shanghai Academy of Social Sciences commented:

> The role that the Shanghai headquarters played is far away from that of New York Federal Reserve. In general, everyone would assume that the second headquarters of the central

> bank would be responsible for market regulation. However, the CSRC, CBRC and CIRC in Beijing actually take those functions, which leave the Shanghai headquarters in an awkward position (Interview 3).

China’s “Big Four” state banks have decided to relocate their Renminbi business headquarters to Shanghai in recent years. In March 2012, one of the “Big Four” – the Bank of China – has taken the lead by establishing its Renminbi business headquarters in Lujiazui, Shanghai. The other three state banks - ICBC, ABC and CCB - also said they would follow suit. The reasons were basically twofold: firstly, it was a concrete measure to bolster Shanghai’s status as an IFC, which is also one of their political tasks; Secondly, the relocation could also benefit them as it allows them to stay close to market information because Shanghai has become the hub for various financial markets.

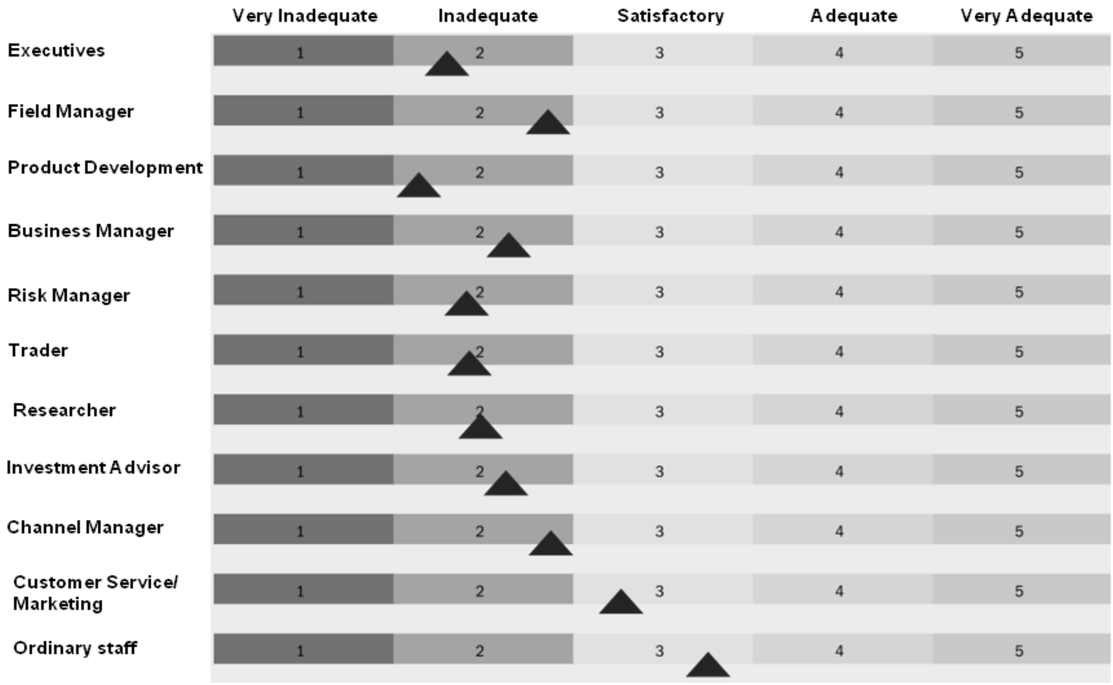
Human Capital

Human capital was often considered as the most significant aspect for IFCs competitiveness (e.g. City of London 2003). In terms of total numbers of employees in the financial sector, Shanghai has become closer to other major IFCs. The number of financial employees in Shanghai increased to 278,000 in 2011, from roughly 95,000 in 1999. In 2010, New York had 436,000 financial employees, London 315,000 and Tokyo 328,000 (SFPI 2011). As for the ratio of financial staff to total employees, Shanghai had 3.3 percent - much lower than other leading IFCs. New York comprised 8.5 percent; Tokyo 7.4 percent; London 6.5 percent; and Hong Kong 5.5 percent (Eoyang et al. 2010, p.42).

One of the biggest challenges facing the development of the SIFC lies in its ability, or otherwise, to attract human resources. According to a survey conducted by the SFSO in 2006, the managements in foreign banks were quite satisfied with entry-level recruits from universities but found it difficult to recruit experienced candidates for management positions (Fang 2013, p.147). Therefore, they had to hire university graduates and provide training by themselves, which incurred significant costs. To make matters worse, these trainees tended to be headhunted by other banks or firms after a couple of years. The finding of the survey suggested the talent pool in the financial sector in Shanghai was not broad enough.

Another survey undertaken by the Shanghai Financial Industry Association in 2010 drew a similar conclusion: a large number of financial employees were at the operational level (e.g. customer service/market and entry-level staff) but the city was short of high-skilled financial professionals, such as management executives, product development managers, researchers, investment advisers, risk managers and traders.

Figure 7.8: The supply of financial professionals by position in Shanghai (2010)



Source: SFPI (2011)

In view of this, central and local government have spared no effort in recent years to enhance the training of local financial talent. The Shanghai Municipal Government has invested in a number of educational projects. For example, in 2009, RMB 320 million was allocated to build the Advanced Institute of Finance in Shanghai Jiaotong University, with the aim of encouraging students to choose careers in finance. The government has also encouraged cooperation with top universities across the world to provide professional training for young talent in Shanghai. In 2010, Harvard University in the United States set up a research and teaching centre in Lujiazui. In 2011, the Shanghai Fengxian district government signed a memorandum with the University of Nottingham in England to build up a new campus there. In the same year, the East China Normal University and the University of New York also agreed to launch a joint university in Shanghai.

Furthermore, the city government has also managed to attract financial expatriates to work in the SIFC. Following the global financial crisis of 2008, the Shanghai Municipal Government dispatched expert groups to several leading financial centres, such as New York, Hong Kong and Singapore to recruit skilled professionals in an attempt to attract casualties of the crisis to Shanghai. The municipal government also pledged to provide a friendlier, cleaner and more amenable environment for expatriates living in Shanghai. In particular, it built more international schools and English-speaking clinics for expatriates and their families to allow them easier access to high-quality education and healthcare services.

Another obstacle to attracting financial talent was Shanghai's unfavourable tax regime compared with those operating in Hong Kong and Singapore. Hong Kong's 'One country, two systems' income tax rate is relatively low. The highest tier of individual income tax is 17 percent; the standard rate is 15 percent. In Shanghai, the highest tier of individual income tax could have been as high as 45 percent. To provide a more favourable tax environment, Shanghai's government decided to provide subsidies to financial employees who had worked at the regional headquarters of banks and other financial firms. This new tax regime went into effect from 1st January, 2010. According to SFSO, the government would refund tax levied over the rate of 25 percent to financial professionals in the name of "Financial Talents Award"(Fang 2013). In effect, the government subsidies have lowered the individual income tax rate from 45 percent to 25 percent.

Services Innovation

During the process of the SIFC's development, Shanghai had acted as a 'guinea pig' for China's financial reform. A number of pilot projects were sanctioned by the relevant central government supervisory authorities that allowed them to operate or transact in Shanghai for a certain period before they were formally approved. During this time the supervisory authorities could terminate these projects at any time if they exposed the system to unconscionable risks or they could promote them if they went well. Meanwhile, under financial statism, the relevant government bodies (e.g. the SFSO) would provide a range of guidelines as well as policy measures and SFIs often served as 'places of learning' or 'testing grounds', not only for technical skills, but also for managerial capabilities.

Here I intend to highlight several selected financial schemes or products in China. They were characterised by the ways in which market participants overcame deterrents to financial markets through new innovations and instruments. From these examples, a managed opening can be deduced involving the selective targeting of particular transactions, countries and firms rather than wholesale cross-border liberalisation of the kind endorsed by some European countries in the 1960s. These schemes included QFII, QDII, QFLP and RQFII etc.

The Qualified Foreign Institutional Investor (QFII) program was a transitional measure to partially open up the domestic capital market to foreign investors. The Chinese government started to introduce the QFII scheme in 2002 to permit qualified foreign institutional investors to buy and sell domestic-listed stocks (A-shares) on China's stock market. The scheme currently licenses over 100 foreign institutions including commercial banks, trust companies, insurers, asset managers, securities firms, sovereign wealth funds, pension funds and endowment funds. At the end of February 2012, the total investment quota approved by the State Administration of Foreign Exchange (SAFE) reached USD 22.4 billion[65].

In 2006, the introduction of the Qualified Domestic Institutional Investor (QDII) scheme allowed certain domestic financial institutions approved by the CSRC to invest in offshore markets such as securities and bonds. The QDII scheme approved by the Chinese authorities allows qualifying domestic institutional investors to invest in overseas financial products. Prior to this, Chinese residents were not allowed to invest in foreign equities. In the beginning, QDII funds were largely confined to investments in overseas fixed-income products. Given the combination of low returns from fixed-income investments and an appreciating Chinese currency (Fang 2013, p.100), the growth of QDII funds was relatively modest but they did provide an alternative way for Chinese residents to invest overseas under financial statism.

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[65] See SAFE website, http://www.safe.gov.cn/model_safe/tjsj/pic/20120229172752544.pdf, accessed 4 March, 2012.

Table 7.8 Pilot schemes for capital markets' opening in Shanghai

Pilot Schemes	QFII (Qualified Foreign Institutional Investors)	QDII (Qualified Domestic Institutional Investors)	QFLP (Qualified Foreign Limited Partners)	RQFII (Renminbi Qualified Foreign Institutional Investors)
Launch Year	2002	2006	2010	2011
Qualifying Candidates	Foreign securities firms, foreign fund managers, Foreign banks, Foreign Insurers, others, e.g. pension funds, Sovereign Wealth Funds etc	Domestic banks and financial companies, e.g. trust companies, fund management companies etc	Foreign Private Equity (PE) Funds registered in large cities e.g. Shanghai and Beijing	HK subsidiaries of Chinese securities firms and fund management companies
Currency	Foreign currency converted into RMB via Chinese custodian banks	Onshore RMB converted into foreign currencies	Foreign currency converted into RMB	Offshore RMB from Hong Kong only
Quota Approved	USD 36.04 billion approved as of November 2012 (total quota USD 80 billion)	USD 86.65 billion approved as of November 2012	Shanghai: USD 3 billion Beijing: USD 3 billion	RMB 63 billion approved as of November 2012 (total quota RMB 270 billion)
Investment scope	Listed stocks (A share), listed bonds, ETFs, Warrants in mainland China	Overseas listed stocks, ETFs, investment funds etc.	Private equity and venture capital companies in mainland China	Listed stocks, bonds, ETFs in mainland China

Source: KPMG (2011), compiled by Author

The Renminbi Qualified Financial Investors scheme (RQFII) was a variation of the original QFII scheme that allowed qualifying offshore financial institutions to invest their offshore Renminbi deposits in the mainland's onshore interbank bond market and equity markets. Shanghai hosts the largest stock and bond market in mainland China, while Hong Kong has a base for overseas investors. The launching of the RQFII provided an attractive instrument to connect Hong Kong's international client network with Shanghai's investment opportunities.

In 2010, Shanghai was granted approval to launch the Qualified Foreign Limited Partners (QFLP) scheme to allow a certain number of foreign private equity funds to convert their foreign currency capital into Renminbi and make equity investments in China. Unlike QFII, which only permitted foreign investment in listed stocks and bonds in the securities market, the QFLP scheme allowed foreign investment in private equity and virtual capital companies in mainland China. As such, foreign private equity firms were permitted to convert foreign currencies into Renminbi within an approved quota and to invest in private equity fund companies. This had two implications: firstly, the QFLP brought Renminbi convertibility a step closer, although the total quota remained under the control of regulatory agencies (e.g. SAFE). Secondly, the QFLP could enjoy national treatment on a par with local PE funds and could invest in certain sectors previously off-limits to foreign investors, including the media, internet business, investment banking etc.

However, Shanghai continues to lag behind other leading financial centres, particularly in the capacity and capability of financial innovation. Most financial markets and services recently introduced in Shanghai have been operating in Western advanced economies for many years, including financial futures, options, ETFs, etc. Financial innovation originating in Shanghai is relatively rare. In this respect, Shanghai has yet to become a pre-eminent international financial centre. Some might argue that the scarcity of innovation is the consequence of financial statism – that state control over the financial sector has restrained creativity. While I partially agree with this view it should also be acknowledged that China is still at the early stages of financial development despite strong economic growth in recent years and the primary function of the SIFC in its current incarnation is learning and catching-up by imitation.

7.3 General Competitiveness of the SIFC: Strengths and Weaknesses

7.3.1 Benchmarking the SIFC on the World Stage

To evaluate the general performance of IFCs is a time-consuming and complicated task. It is also beyond the scope of this thesis to carry out a first-hand study. Fortunately, there is a large body of academic and financial information available to enable some informed assessment. In this section, two sets of data sources are quoted in evaluating the competitiveness of the SIFC, namely the Global Financial Centre Index (GFCI) [66]and the International Financial Centre Development Index (IFCD)[67].

The GFCI uses two different inputs: an online assessment questionnaire and an indicator system comprising many instrumental factors. Instrumental factors are viewed as objective evidence of competitiveness derived from a wide range of comparable sources (see appendix 4 for details). Table 7.9 presents the rankings of IFCs between 2007 and 2014. It posits that during that period, London, New York, Hong Kong and Singapore retained the top four spots in the world rankings. Shanghai's ranking moved upwards significantly from 24th in 2006 to 5th in 2011 at its peak before dropping down to 20th in 2014. Despite this, we can see from the table that the ranking of Shanghai is significantly higher than other cities from BRICs countries in 2014, such as Mumbai

[66] The Global Financial Centre Index (GFCI)[66] was commissioned by the City of London. The GFCI has been published twice a year since 2007. The instrumental factors used in the GFCI 15 model are grouped into five key areas of competitiveness, i.e. human capital, business environment, financial sector development, infrastructure and reputational and general factors. A total of 103 external indicators were used in the GFCI 15.

[67] China's Xinhua News Agency, a top state-run media group, linked up with the Chicago Mercantile Exchange (CME) Group to launch the International Financial Centre Development Index (IFCD). The IFCD Index is published once a year and aims to reflect the developmental capacity of 45 international financial centres around the world. Its indictor system values international financial centres on five grounds: financial market, growth and development, supporting industries, service levels and the general environment.

(76th), Moscow (73rd), San Paulo (38th) and Johannesburg (50th).

Table 7.9: GFCI rankings of major developed and emerging economies (2007-2014)

GFCI#	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
MM/YY	03/14	09/13	03/13	09/12	03/12	09/11	03/11	09/10	03/10	09/09	03/09	09/08	03/08	09/07	03/07
New York	1	2	2	2	2	2	2	2	2	2	2	2	2	2	2
London	2	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Hong Kong	3	3	3	3	3	3	3	3	3	3	4	4	3	3	3
Singapore	4	4	4	4	4	4	4	4	4	4	3	3	4	4	4
Shenzhen	18	27	38	32	32	25	15	14	9	5	-	-	-	-	-
Shanghai	20	16	24	19	8	5	5	6	11	10	35	34	31	30	24
San Paulo	38	38	44	48	50	49	44	44	40	42	54	52	53	49	-.
Beijing	49	59	58	43	26	19	17	16	15	22	51	47	46	39	36
Johannesburg	50	61	62	54	55	52	54	54	54	50	48	44	41	43	-
Moscow	73	69	65	64	65	61	68	68	68	67	60	57	56	-	-
Mumbai	76	72	66	63	64	64	58	57	58	53	49	49	48	41	39

Source: GFCI (2007-2014)

In the GFCI，each financial centre is measured in two dimensions: by its level of connectivity and its level of financial breadth and depth. Connectivity is defined as “the centre’s level of interaction with other financial centres” and provides the criterion for its classification as a global, transnational or local financial centre. The level of financial breadth and depth is also classified into four sub-groups: broad and deep, relatively broad, relatively deep and emerging. As shown in Table 7.10, financial centres from mature economies, such as London, New York and Hong Kong are global leaders, being located in top left corner. This means they not only have a global reputation in the financial network but also can provide broad and special financial services and products. Financial centres from emerging economies are called “evolving centres”, primarily located in lower right corner. According to the GFCI (2014), Shanghai is classified as a “transnational diversified centre”, which suggests it shares comparable levels of market breadth to those of global leaders and its influence has already gone beyond country borders. The financial centres in other BRICS countries, such as Sao Paulo, Johannesburg and Mumbai were labelled “local”, showing that their influence in finance was rather limited compared to others.

Table 7.10: International financial centres by level of connectivity, breadth and depth

	Broad and Deep	Relatively Broad	Relatively Deep	Emerging
Global	New York (1) London(2) Hong Kong (3) Frankfurt (11) Toronto (14) Paris (36)			Beijing (49) Moscow (65)
Transnational	Tokyo (6) Sydney(23)	Shanghai (20)		
Local		Sao Paulo(38) Johannesburg(50)	Taipei(55)	Shenzhen(18) Mumbai(76)

Note:
(1) This only lists major financial centres in G7 and BRICS countries.
(2) The numbers in brackets indicate the ranking of IFCs in GFCI 15
Source: GFCI (2014)

Although the GFCI rankings are quoted by numerous researchers to show the competitiveness of various international financial centres (e.g. Subacchi and Huang, 2012; Cheung 2010; Lai 2011; Young et al. 2009), some commentators have questioned its objectivity in evaluating the growth of IFCs in emerging economies (e.g. Chu et al. 2010, p.369). For example, in the GFCI 6 report published in 2009, five cities in Greater China were among the top 25 in ranking terms, notably Hong Kong 3rd, Shenzhen 5th, Shanghai 10th, Beijing 22nd and Taipei 24th. It seems strange that Shenzhen had not even been included among the top 62 in the GFCI 5 report. Moreover, in 2009, the ranking of Shanghai had jumped from 35th to 10th within six months (from March to September, see Table 7.9). Presumably the global financial crisis in 2008-2009 had some impact on the status of IFCs across the world but it is still unconvincing that Shanghai had emerged as a competitive IFC within six months. It is also odd that the ranking of Shanghai suddenly fell from 8th to 24th in 2012-13. One possible explanation is that the authors of the GFCI adjust their scope and methodology from time to time. Nevertheless, the apparent anomalies do cast some doubt on the acceptance and interpretation of the results (Young et al. 2009, p.35).

To address this concern, another indicator – the International Financial Centre Development Index (IFCD) - was launched in 2010. It was developed by China's

Xinhua News Agency, a top state-run media group, in conjunction with the Chicago Mercantile Exchange (CME) Group. The IFCD includes 17 level-2 indicators and 66 level-3 indicators (see Appendix 5 for details). Table 7.11 presents the rankings of the IFCD index from 2010 to 2012. It shows that Shanghai was 8th in 2010, going up to 6th in 2011 and levelling out at 6th in 2012, behind New York, London, Tokyo, Hong Kong and Singapore.

Table 7.11: The IFCD ranking of key IFCs in developed and emerging countries (2010 -2012)

City	**Ranking (2012)**	**Rating (2012)**	**Ranking (2011)**	**Rating (2011)**	**Ranking (2010)**	**Rating (2010)**
New York	1	87.27	1	87.69	1	88.43
London	2	85.62	2	85.96	2	87.66
Tokyo	3	72.93	3	85.81	3	85.55
Hong Kong	4	72.18	4	82.18	4	81.01
Singapore	5	64.11	5	74.53	6	70.06
Shanghai	6	63.80	6	71.42	8	63.75
Mumbai	30	34.64	34	35.68	40	31.5
Moscow	31	34.58	35	35.40	35	34.2
San Paulo	43	25.92	41	29.71	39	32.2
Johannesburg	45	22.36	45	24.35	45	22.5

Source: IFCD (2010-2012)

Let us look at the similarities and differences between the GFCI and IFCD. Both are built upon a comprehensive evaluative system, covering numerous relevant factors. However, closer scrutiny (Appendix 4 and 5) shows that the GFCI emphasises a “soft environment”, such as the availability of human capital, access to the international market, corporate and individual tax regimes, the regulatory environment etc. In contrast, the IFCD gives more credit to the “hard environment”, such as economic power, growth rate of GDP, quality of infrastructure etc. These inherent differences in emphasis can explain why the IFCD ranking for New York surpassed London on the top list while Tokyo’s ranking was higher in the GFCI.

Another distinct characteristic of the IFCD is its emphasis on the IFCs from emerging economies. This is partially due to the fact that large, fast-growing developing countries like BRICS have paid more attention to IFCs’ development in their countries. Therefore, each year IFCD conducts a special survey of five major cities from BRICS countries, i.e.

Shanghai, San Paulo, Johannesburg, Moscow and Mumbai, to ascertain their developmental potential. In 2012, the indicators in this survey were expanded from three to nine in the questionnaire (Table 7.12).

Table 7.12: Rating of financial centres from BRICS countries in 2012

	Confidence Index (Ranking)	**Capital Attraction Index (Ranking)**	**Talent Attraction capacity (Ranking)**
Shanghai	3.76 (1)	3.45 (1)	3.48 (1)
San Paulo	3.25 (2)	3.07 (4)	3.10 (2)
Johannesburg	3.14 (4)	3.08 (3)	3.08 (3)
Moscow	3.20 (3)	3.15 (2)	3.07(4)
Mumbai	3.09 (5)	3.01 (5)	3.00 (5)
	Level of Internationalisation (Ranking)	**Degree of Financial Innovation (Ranking)**	**Level of Facilities (Ranking)**
Shanghai	3.34 (1)	3.35 (1)	3.29 (1)
San Paulo	3.09 (2)	3.07 (2)	3.07 (3)
Johannesburg	3.09 (2)	3.06 (3)	3.09 (2)
Moscow	3.05(4)	3.02 (4)	3.04 (4)
Mumbai	3.00 (5)	2.99 (5)	3.00 (5)
	Level of Intermediary Service (Ranking)	**Financial Legal Environment (Ranking)**	**International recognition of Currencies (Ranking)**
Shanghai	3.34 (1)	3.24(1)	3.17 (1)
San Paulo	3.08 (3)	3.00(3)	2.92 (3)
Johannesburg	3.09 (2)	3.04(2)	2.71 (5)
Moscow	3.05 (4)	2/95(4)	2.95 (2)
Mumbai	2.95 (5)	2.90(5)	2.84 (4)

Source: IFCD (2012)

Table 7.12 shows the following features of financial centre among BRICS countries. Firstly, Shanghai stands out among BRICS countries, ranking top in all nine indicators. San Paulo comes second in four indicators: confidence, talent attraction, level of internationalisation and degree of financial innovation. Johannesburg also ranks second in four indicators: level of internationalisation (tied with San Paulo), facilities, intermediary services and financial environment. Moscow scores second in capital attraction and international recognition of currency. Mumbai is at the bottom in eight indicators out of nine.

Secondly, the confidence in Shanghai as an IFC is significantly stronger than the other four cities. As far as the report is concerned, the rating of confidence index for Shanghai is as high as 3.76, which is 0.51 points higher than second-placed San Paulo. Yet the rating differences are negligible among other four cities. Among the nine indicators, Shanghai scores relatively low in two: financial legal environment (3.24) and international recognition of currencies (3.17). This indicates Shanghai still lacks a solid regulatory environment while the inconvertibility of Renminbi is also an obstacle to further integration to the world market.

Thirdly, Shanghai's ratings in terms of internationalisation and international recognition of currencies are higher than four other countries. On the face of it, this appears strange given that the SIFC developed under a stringent capital control regime. This might be explained by two factors. China has gradually opened its capital markets through QDII, QFII and the internationalisation of the Renminbi in recent years (see section 8.1.3). The rating is also based on interviewees' responses in emerging countries and they indicate China is far from alone in having plenty of constraints in capital markets and currencies.

Overall, both indices suggest some commonalities in the SIFC development. Firstly, Shanghai's competitiveness as a financial centre has been greatly enhanced in recent years, but its ranking on the world stage is still unstable. Secondly, Shanghai has greater potential to be an IFC, compared with other cities in emerging economies. Nevertheless, these findings still need to be viewed with scepticism. Although both indices provide a useful and systematic framework, some methodological limitations still exist. Firstly, the ranking and rating of IFCs can be quite arbitrary: it all depends on how any single 'quality' is measured and how components are then combined. Secondly, the final listing tends to combine different factors into a mono-dimensional summary, which tends to downplay niche financial centres whose performance may not be strong in general terms but very significant in their particular areas of strength (Young et al. 2009, p.35) .

7.3.2 Positioning SIFC among Domestic Players

The re-emergence of Shanghai as an IFC does not mean lack of competition in China itself. Since 2005, a number of Chinese cities have launched plans to build financial centres, including Beijing, Shenzhen, Guangzhou, Dalian and Tianjin. Among them, Beijing and Hong Kong are considered to be the most competitive rivals to Shanghai (Lai 2011; Jarvis 2011).

In 2008, Beijing's municipal government formally announced it would build an IFC for the first time (BMG 2008). As it is China's political capital, Beijing holds incomparable political and administrative resources. Apart from hosting the country's financial regulatory bodies - "One Bank, Three Commissions" [68] - Beijing is also headquarters to the four largest state banks ("Big Four") and the largest insurance company in the country. Consequently, the banking assets managed by Beijing totalled RMB 72 trillion in 2011(Table 7.13), which is significantly higher than those of Shanghai (RMB 9.3 trillion). In terms of insurance assets, Beijing is also far ahead. In this sense, it is already China's financial decision-making and management centre.

Zhao et al. (2004, 2005) investigated the site selection of multinational companies (MNCs) headquarters in seven major Chinese cities. They argue that Beijing is closer to the centre of political power and is more convenient to access relevant information, which are the key reasons for MNCs to prefer it over Shanghai as their regional headquarters. They maintained that after China's entry to the WTO, Beijing would replace Shanghai as the most important financial centre in China. Furthermore, Shanghai's ability to raise capital and funds is also relatively weak because more large financial institutions are headquartered in Beijing.

[68] "One bank, Three commissions" refers to China's current financial regulatory model, with the People's Bank of China (central bank) playing the central role and CBRC (China Banking Regulatory Commission), CSRC (China Securities Regulatory Commission) and CIRC (China Insurance Regulatory Commission) in charge of banking, securities and the insurance sector respectively.

Table 7.13: Financial institutions: Shanghai versus Beijing in 2011

Indicators	Shanghai	Beijing
Assets of local banks (RMB, trillion)	9.3	72.1
Assets of local insurance firms (RMB, trillion)	0.82	3.3
Assets of local securities firms (RMB, trillion)	0.33	0.23
Assets of local fund management companies (RMB, trillion)	1.43	0.64
Number of foreign bank branches	71	44
Number of foreign securities firms representative offices	73	61
Number of foreign insurance company branches	15	11

Source: CDI (2013)

I partially agree with Zhao et al. (2004)'s argument that information is a critical factor in the location of financial institutions. This can explain why the "Big Four" and the largest insurance company did not relocate their headquarters to Shanghai in the 1990s[69]. However, I question their conclusion that Beijing will eventually replace Shanghai as the most important IFC in China. There are several considerations here.

Firstly, Shanghai is the only city in mainland China that has the endorsement of central government to be an IFC. In China, political support, in particular from central government cannot be understated even if inter-city competition has invariably caused fragmentation in the regime. The announcement in the resolution of the 14th CCP Party Congress[70] and the recent "Double-Centre Plan"(see Section 6.2.2) suggest that the SIFC's development remains a serious political commitment from the central state.

Secondly, Shanghai has already become the hub of domestic financial markets. For modern IFCs, financial markets (capital markets in particular) are a central plank of

[69] In fact, the Bank of China transferred Renminbi business headquarters to Shanghai in 2012 as mentioned in Section 6.2.

[70] In 1992, the 14th National Congress of the Communist Party passed a resolution to build Shanghai as "the dragon head and one of the international economic, financial and trading centres to drive the growth of the Yangtze River Delta and in turn the take-off of the whole economic region" (quoted in Wu 2003, p.1684).

being considered a global financial centre. An official from the SFSO recently commented:

> Beijing has always been a hub of financial institutions; in effect, Beijing has made considerable progress in attracting financial headquarters. Yet Beijing has been excluded as a candidate for global financial centre status due to the deficiency of financial markets (interview 10）.

Information is critical to the formation of an IFC but this is not exclusively political. Under financial statism, Beijing has key strengths in policy making and strategic planning. Yet with the further enhancement of the market system, market information will become more significant than political and the advantages of Beijing will therefore diminish.

Finally, Zhao et al. (2004) did not discriminate financial MNCs from others (e.g. manufacturing) in their analysis and the former are more closely correlated to the formation of IFCs. In fact, Shanghai outpaces Beijing in terms of numbers of foreign-invested banks, securities firms and insurance companies (Table 7.13).

Another contested issue is Shanghai's relationship with Hong Kong. Why did the central government choose Shanghai rather than Hong Kong as China's international financial centre? Hong Kong was returned to China in 1997 and was already been an established international financial centre. Yet the central government's preference for Shanghai is attributable to the broad interests of the country. Fang (2013, p.160) gives five reasons: (i) *Geographic location*: the Yangtze River Delta where Shanghai is located is the most powerful economic engine for China; Shanghai as an IFC is beneficial for the country's economic growth as a whole. (ii) *Financial security:* as a free trade area, Hong Kong's market features foreign speculative capital and hot money, which increase the risks of economic instability and financial disturbance. (iii) *Political consideration*. Hong Kong is a special administration region (SAR) under "one country, two systems". The political relationship between the central government and SAR remains unsettled. (iv) *Currency issues*: Hong Kong has its own currency and independent financial regulatory system. Choosing Hong Kong would not be conducive to the Renminbi's aspiration to become a world currency on par with the US dollar and Euro. Further, it makes no sense that China's financial centre is not denominated in

Renminbi. (v) *Monetary policies*: it is easier for the central government to supervise and monitor monetary policies if Shanghai is an IFC. In order to maintain the effectiveness of monetary policy and financial security, the Renminbi onshore centre could only be positioned in Shanghai, rather than Hong Kong.

Yet this does not mean Hong Kong's current status as an IFC is fading. Other than the tax regime mentioned above, Hong Kong has many strengths; *inter alia*, a sound legal system, a comprehensive regulatory framework, well-established infrastructure and a broad talent pool of financial professionals. Hong Kong nowadays is a regional headquarters for many global financial institutions, including investment banks (Young et al. 2009). Whereas Hong Kong has been well connected to the international financial markets, Shanghai would still only have limited openness to foreign investment.

Some commentators also argue that Shanghai, Hong Kong and Beijing should be more complementary, rather than just vying to become 'the' global financial centre. For instance, Lai (2011,p.1) argues that Shanghai, Hong Kong and Beijing operate within a network of IFCs, in which "Shanghai acts as a commercial centre, Beijing as a political centre and Hong Kong as an offshore financial centre, with all three financial centres performing distinctive and complementary roles within the regional banking strategies of foreign banks".

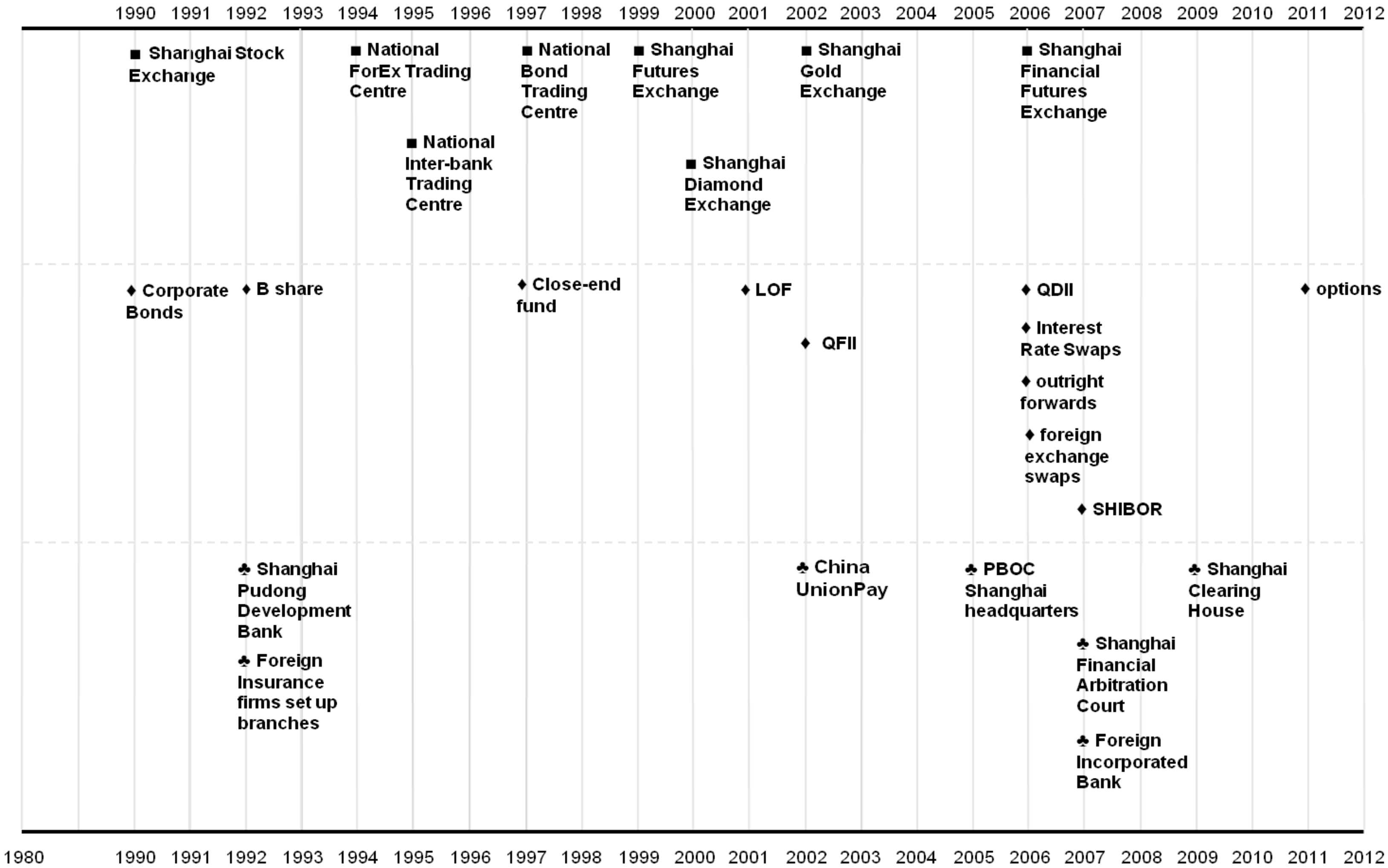
7.4 Summary

This chapter provides a detailed evaluation of Shanghai's financial sector development in the past 20 years. Indeed, Shanghai's financial development has been "a process of institutional, regulatory and market design from the ground up" (Jarvis 2011), starting from the early 1990s. The study demonstrates that Shanghai has experienced remarkable growth in terms of agglomeration of financial markets, institutions and services (see Figure 7.9). In just two decades, Shanghai's financial markets have made such significant progress in depth and breadth that they parallel those of peer cities from the more advanced economies. To some extent, Shanghai has become the country's domestic financial centre; it has outpaced Beijing and other peer cities in mainland China in terms of the density and diversity of financial markets.

Nevertheless, the SIFC development still faces a number of problems and it should be recognised that a domestic financial centre and an international financial centre are very different. Due to capital controls and Renminbi inconvertibility, Shanghai's financial market is still semi-closed. There are still no overseas firms listed on the Shanghai Stock Exchange. The number of foreign financial institution operating in Shanghai is still not comparable with other leading global financial centres such as London, New York and Hong Kong. As for human capital, financial talent is inadequate and this too has weakened the aspiration of Shanghai to be an IFC. Therefore, it is far too early to conclude that Shanghai has become a genuine international financial centre.

The case study discovered an interesting paradox. China's financial statism has successfully channelled the funds into the real economy and supported the macro-economic growth critical to maintaining a stable environment for the SIFC's development. However, financial statism conflicts with the liberalisation of interest rates and the full convertibility of the Renminbi, which are regarded as the *sine qua non* for a functional international financial centre. By this logic, financial statism is conducive for the development of a domestic financial centre, rather than an international one. Accompanying the rapid advancement of Shanghai's financial marketplace, Chinese authorities remain cautious in their attitudes to free capital flows and the full convertibility of the Renminbi. This shows the central government has its own agenda to promote the SIFC's development: the priority is economic growth and social stability at macro-level, rather than global connectivity, efficiency and innovation at micro and meta-levels. Therefore, despite certain disadvantages and deficiencies, financial statism and the SIFC's development share a common motivation: to achieve the strongest economic growth and prevent social and political instability.

Figure7.9: The development of financial markets, services and institutions in Shanghai (1990-2012)



Note: ■ financial markets ♦ financial services ♣ financial institutions

Source: Author

8. Shanghai from Domestic to International: Dismantling Financial Statism?

Although China's financial statism is pinpointed as a defining feature of the SIFC's development, it would be reckless to assume it remained unchanged over the past 20 years. In the first decade of 21st century, China triggered a new round of financial reforms. In this chapter, three key aspects of these reforms are presented: the commercialisation of its state banks through joint-stock reforms; the gradual loosening of administrative controls over interest rates; and the promotion of the internationalisation of the Renminbi after the global financial crisis in 2008. These reforms all suggest China is poised to withdraw financial statism because of changing contexts internally and externally. These will be discussed in Section 8.2. The penultimate section discusses the consideration of China's central government regarding its financial statism regime. The final section summarises the above.

8.1Recent Withdrawal of Financial Statism in China

8.1.1 Diversification of Ownership

At the turn of 21st century, the central government embarked on a wide range of measures that aimed to commercialise state banks and improve their balance sheets. These reforms included recapitalising state banks, strengthening corporate governance and introducing new strategic partners from overseas. In 1998, RMB 270 billion of special treasury bonds were issued to recapitalise the state banks. One year later, four asset management companies (AMCs) [71] were established by the Ministry of Finance to transfer the toxic assets in the state banks. That is to say, the mission of these four AMCs was to maximise the value of toxic assets in the "Big Four". To achieve this goal, these asset management companies were authorised to use a variety of measures, including foreclosure, restructurings, debt-equity swaps, and outright sales through auctions and other means (Herd 2010). From 1999 to 2005, the four asset management companies transferred at least RMB 2.18 trillion in non-performing loans from the balance sheets of the large state banks. Meanwhile, the state policy banks had increasingly built up their capacities to take over policy-lending functions from the "Big Four" in late 1990s[72].

The establishment of the Central Huijin Investment Corporation (Huijin) is another concrete measure that enhanced state bank reform. At the end of 2003, the central government injected USD 45 billion of foreign reserves into the BOC and CCB through Huijin. The ICBC also took in USD 15 billion during the first half of 2005. Since then, Huijin, being a state-owned investment company, became the central shareholder of state banks on behalf of the central government[73]. In this way, the governance structure of state banks conformed more to international practice.

In addition, to increase the accountability of state banks through foreign entry, the Chinese authorities adopted a minority stake approach through joint-stock reform, which was at odds with privatisation strategy and control participation of foreign banks pursued in Latin America and Eastern Europe throughout the 1990s. As early as 1996, several pilot reforms were carried out by small banks including the Bank of Shanghai,

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[71] The four asset management companies are Cinda Asset Management Company, Orient Asset Management Company, Huarong Asset Management Company and Great Wall Asset Management Company.

[72] In 1994, the central government established three policy banks: Agricultural Development Bank of China, China Development Bank, and Import and Export Bank of China.

[73] Nowadays Huijin holds stakes in various state-owned financial institutions, including commercial banks, securities house, financial conglomerates, re-insurance companies etc.

which sold seven percent of its share to the International Financial Corporation. The Chinese authorities applied the same approach to reform the “Big Four” at the turn of 21st century. For example, Bank of America invested USD 2.5 billion in the China Construction Bank (CCB) in 2005, representing 9.1 percent of its total ownership. Temasek Holdings, a Singapore state-owned investment company, also held 5.1 percent of ownership through the investment of USD 1.47 billion (Table 7.1). By the end of 2012, there are over 35 banks in mainland China with stakes from foreign strategic investors (KPMG 2012).

Table 8.1: Foreign investment in major mainland Chinese banks (1996-2008)

Chinese Banks	Year	Foreign Investors	Price USD million	Stake Size
Bank of Shanghai	1996	International Finance Corporation	55.1	7%
	2001	HSBC	63	8%
	2001	Shanghai Commercial Bank	23.6	3%
China Everbright Bank	1996	Asian Development Bank	20	3.0%
	2005	International Financial Corporation	19	4.9%
Shanghai Pudong Development Bank	2002	Citibank	67	4.62%
Fujian Industrial Bank Co. Ltd	2003	Hang Seng Bank	208	16%
Jinan City Commercial Bank	2004	Commonwealth Bank of Australia	17	11%
Bank of Communication	2004	HSBC	1747	19.9%
Shenzhen Development Bank	2004	New Bridge Capital LLC	150	18%
	2005	GE Consumer Finance	100	7%
Ping An Bank	2004	HSBC	N.A.	10.8%
	2005	HSBC	N.A.	9.1%
Bank of Beijing	2005	ING	215	19.9%
	2005	International Finance Corporation	54	5.0%
China Construction Bank	2005	Bank of America	2,500	9.00%
	2005	Temasek Holdings	1,466	5.10%
Bank of China	2005	Royal Bank of Scotland	3,048	8.47%
	2005	UBS	492	1.37%
	2005	ADB	74	0.21%
	2006	Temasek holdings	1,524	4.77%
Industrial and Commercial Bank of	2005	Goldman Sachet,	2,582	5.75%
	2005	Allianz Group	825	2.25%

China	2005	American Express	200	0.45%
Huaxia Bank	2005	Deutsche Bank	233	9.9%
	2005	Sal Oppenheim	96	4.1%
Nanjing Commercial Bank	2005	BNP Paribas	87	19.2%
GuangDong Development Bank	2005	Citigroup	N.A.	19.9%
	2005	IBM	165	4.7%
Xi'an Commercial Bank	2005	Bank of Nova Scotia	20	12.5%
Hangzhou City Commercial Bank	2005	Commonwealth Bank of Australia	77	29.9%
Bohai Bank	2005	Standard Chartered	123	19.9%
Ningbo Commercial Bank	2006	OCBC	70	12.2%
Tianjin City Commercial Bank	2006	Australia and New Zealand Banking Group	112	19.9%
Shanghai Rural Commercial Bank	2006	Australia and New Zealand Banking Group	252	19.9%
CITIC Bank	2006	BBVA	648	5.0%
	2008	BBVA	N.A.	5.1%
Chongqing Commercial Bank	2007	Dah Sing Bank	89	17%
Qindao City Commercial Bank	2007	Intesa Sanpaolo	135	19.9%
	2007	Rothschild	33	5%

Source: Wang (2008, p.50), Adapted from Garcia-Horrero and Stantabarbara (2008)

What are the impacts of these reforms? Firstly, introducing foreign strategic player helps to bring forward a more effective corporate governance mechanism. Berger et al. (2010) found that China's state banks with minority foreign ownership were associated with better performance in terms of ROA as foreign ownership played an important mitigating role: they tend to have lowered costs/assets when they diversify in their loans, deposits, assets, or geographic portfolios. As foreign investors took seats on corporate boards and became actively involved with bank management, a new monitoring discipline emerged (Berger et al. 2009). The reforms have to some extent lessened degree to which loans are given to different levels of government because non-state stakeholders might object. Garcia-Herrero and Santabarbara (2008) also argue that Chinese banks appear to be more profitable and increasingly efficient when foreign banks act as strategic investors.

The second point to consider is that introducing foreign strategic players also helps to build up confidence for investors in later IPOs. In February 2002, at the conference of the National Financial Work Committee, the Chinese government decided to take the joint-stock reforms of state banks and to list them on the stock market. As pre-eminent global banks were shareholders, their stocks were more appealing to investors. Three years later, the “Big Four” launched on the Hong Kong Stock Exchange and Shanghai Stock Exchange (Table 8.2). By 2010, they had completed their public listings, thereby completing their transformation from state-owned to publicly-listed banks with a more diversified shareholding structure. Furthermore, they now follow international reporting standards and have large institutional investors monitoring their activities. In this way, these four largest state banks were converted into “freestanding business corporations, accountable to their shareholders and listed on the international stock exchanges” (Pistor 2009). As of 2013, the total number of listed banks in mainland China increased to 16.

Table 8.2: The public listings of the “Big Four” in SSE and HKSE

Bank	**IPO Date**	**Type**	**Offer Price**	**Share issued (million shares)**	**Funds Raised**
CCB	27/10/2005	H share	HK$2.35	30,459	HK$59.94Bn
	25/09/2007	A Share	RMB6.45	9,000	RMB58.05Bn
BOC	01/06/2006	H share	HK$2.95	29,404	HK$82.86bn
	05/07/ 2006	A Share	RMB3.08	6,494	RMB20.00bn
ICBC	27 /10/2006	H share	HK$3.07	40,699	HK$124.95bn
	27/10/2006	A Share	RMB3.12	14,950	RMB46.64bn
ABC	16/07/2010	H share	HK$3.20	29,220	HK$93.5bn
	15/07/ 2010	A share	RMB2.68	22,235	RMB68.5bn

Source: Author, available public information

Thirdly, introducing foreign strategic partners promotes inter-organisational learning (Pistor 2009) .Garcia-Herrero and Stantabarbara (2008) conducted an empirical analysis and showed that foreign investors could benefit Chinese state banks in terms of transfer of technology, skills etc and corporate governance improvements. Pistor (2009) suggests that institutional learning took place through the creation of equity ties between large state banks and two or more foreign strategic investors, which enabled cooperation and inter-organisational learning. She argues this approach reshaped institutional reform in the financial sector, increased payoffs and to some extent, provided an alternative model that was superior to privatisation strategies. Those Chinese banks that partnered with more than one foreign investor benefited from the inputs from different players in the global financial marketplace and from the range of technical and governance expertise offered.

Through wide-ranging reforms, China successfully coped with extensive non-performing loans in the state banks. Between 2001 and 2006, the rate of non-performing loans in the "Big Four" decreased dramatically. The share of non-performing loans as a proportion of total loans in state banks declined from 16.9 percent in 2003 to 2.8 percent in 2008. As of 2011, the rate of non-performing loans across China's banking sector fell further to one percent. With the drop in non-performing loans, the capital adequacy ratio went up. At the end of 2003, the overall weighted average capital adequacy ratio of China's commercial banks was negative (-2.98 percent). The ratio turned positive in 2004, rose to 4.91 percent in 2005, and further jumped to 12.2 percent at the end of 2010 (CBRC 2010, p. 29). In 2003, there were only eight commercial banks whose capital adequacy ratio exceeded eight percent; in 2010 that number surged to 281[74]. The weighted average capital adequacy ratio has already met the upper end set out in the Basel Accord. This suggests the assets' quality of Chinese banking sector was significantly ahead of the rest of the global banking industry at the end of 2010. Anderson (2007) acknowledged the "bad old days" of massive resource misallocation in the China's banking sector were truly over.

Through joint stock reform, China has established a more responsible banking sector, combining state-ownership with market mechanisms. The market plays a major role in resources' allocation and the government is not allowed to interfere with the daily operations of the state banks. This means the most common agency problems associated with state ownership (e.g. lack of commercial orientation, the absence of high-powered incentives and the influence of politics in the management of corporations) have been tamed. Soft budget control has been partially addressed by improving corporate

[74] The information derives from China Banking Regulatory Commission (CBRC) website.

governance structures. The state still retains ownership in commercial banks and other financial firms but the daily management of these banks has largely been delegated to professionals.Through minority ownership states keep cash-flow rights in key industries without necessarily having to worry about running companies themselves (The Economist 2012).

More importantly, following public listings state-owned shares became tradable on the stock exchange. The state could then buy or sell shares, which gave them indirect influence on these entities. Interview with some government officials and senior managers in the state-owned banks also showed that joint stock reform had made the state banks more independent, market-based players and put them in a better position to pursue the commercial goal of profit maximisation. One interviewee from the SDRC commented:

> After reform, state banks have more incentives to make lending decisions based upon purely commercial goals. Actually, state banks have competed well with one other in the market and their performance is contingent more on their own branding and reputation (interview 6).

After the joint-stock reforms of state banks, we observed the rapid growth of profits for these banks. Bank performance has improved significantly. In 2008-2009, China's state banks became the most profitable in the world. The "Big Four" were among the top ten most profitable banks in the world at the end of 2010, measured by pre-tax profits (see Table8.3). Financial statism also produced champions on a par with global players in terms of size and profitability. In 2011, China's "Big Four" were positioned 1st, 2nd, 4th and 6th respectively among global banks in terms of capitalisation.

Table 8.3: Global top 10 banks by pre-tax profits, 2007-2010

2007	Bank	Country	USD million	2008	Bank	Country	USD Million
1	Bank of America	USA	31,973	1	ICBC	China	21,260
2	Citigroup	USA	29,638	2	CCB	China	17,520
3	HSBC	UK	22,086	3	Banco Santander	Spain	15,825
4	JP Morgan Chase	USA	19,886	4	BOC	China	12,620
5	RBS	UK	18,033	5	BBVA	Spain	9,640
6	Credit Agricole	France	14,060	6	HSBC	UK	9,307
7	Barclays	UK	14,009	7	Barclays	UK	8,859
8	BNP Paribas	France	13,921	8	ABC	China	7,659
9	Mitsubishi UFJ	Japan	12,824	9	UniCredit	Italy	6,952
10	Wells Fargo	USA	12,745	10	Royal Bank of Canada	Canada	6,077

2009	Bank	Country	USD million	2010	Bank	Country	USD Million
1	ICBC	China	24,494	1	ICBC	China	32,528
2	CCB	China	20,316	2	CCB	China	26,448
3	Goldman Sachs	USA	19,826	3	JP Morgan Chase	USA	24,859
4	Barclays	UK	18,869	4	BOC	China	21,463
5	Wells Fargo	USA	17,606	5	HSBC	UK	19,037
6	Banco Santander	Spain	16,951	6	Wells Fargo	USA	18,700
7	BOC	China	16,319	7	ABC	China	18,230
8	JP Morgan Chase	USA	16,143	8	BNP Paribas	France	17,406
9	BNP Paribas	France	12,222	9	Banco Santander	Spain	16,079
10	Itau Unibanco	Brazil	11,521	10	Goldman Sachs	USA	12,892

Source: The Bankers, 2011; Subacchi and Huang 2012, p.32

8.1.2 Liberalisation of Interest Rates

The Chinese state has been relaxing controls over interest rates gradually in recent years. Interest rates fall into three categories: (i) Liberalised, e.g. the inter-bank lending rate, the refinancing rate (discount rate) and the yield rate of treasury notes and repos (ii) Being liberalised, e.g. retail rates, the rate on the issuance of corporate bonds (iii) Not liberalised - set by the central bank - such as the deposit reserve rate, which is generally reckoned as an important monetary instrument to manage the money supply at the macro-level.

The earliest market-based interest rate was witnessed in the wholesale money market. In 1996, along with the creation of the inter-banking lending market, the inter-bank lending rate and issuance yield of Treasury bonds were liberalised. In 1998, foreign banks were permitted to participate in the inter-bank lending market (PBoC 2008). The central bank's refinancing rate was also liberalised in September 1998, as the central bank often provided short-term financing to commercial banks through open market operations (PBoC 2008). In January 2007, SHIBOR (the Shanghai Interbank Offered Rate) was launched, using pricing mechanisms that reflected international practice. The SHIBOR group consists of 16 commercial banks, which are the premium dealers of open market operations or market makers in the money market. The launching of SHIBOR marked the formation of the Renminbi benchmark rate in money market, although it will still take some time to become the worldwide accepted benchmark rate, e.g. LIBOR in London, EURIBOR in Frankfurt, HIBOR in Hong Kong, SIBOR in Singapore, and TIBOR in Tokyo.

The liberalisation of retail rates is progressing much slowly as the central bank is more cautious about their possible adverse impact. The central bank's strategy has been to liberalise foreign currency interest rates prior to following suit for the Renminbi. In 2000, the PBoC started to liberalise the foreign currency lending rate. Commercial banks were thus allowed to decide their lending rates in accordance with international markets. Meanwhile, the rate on deposits over USD 3 million could be determined through negotiations between banks and clients and deposit rate for small denominations of foreign currency were no longer monitored by the PBoC. In 2003, the PBoC further lifted restrictions of deposit rates on British Pounds, Swiss Francs and Canadian Dollars. In the same year, the central bank removed its lower limit for other small-amount foreign currency deposit, such as the US dollar, the Euro and Japanese Yen. In 2004, the PBoC eased restrictions on the deposit rate for small-amount foreign currencies with maturities over one year (Guo 2013).

In terms of Renminbi deposits and lending rates, modest progress has been made in recent years. In November 2004, restrictions on the upper limit of lending rate and lower limit of deposit rate for the Renminbi were lifted. The commercial banks were allowed to decide their own rates within a band, i.e. the rate of deposit benchmark as the upper limit and 90 percent of the rate of the lending benchmark as the lower limit. In 2012, the PBoC further widened the floating range of deposit and lending rates. The commercial banks were allowed to lend using 70 percent of the rate of lending benchmark as the lower limit and 110 percent of the rate of deposit benchmark as the upper limit. So, compared with the deposit and lending rates in the early 1990s, they were much more variable and market-based.

The central bank's cautious moves towards full liberalisation of retail rates are threefold. Firstly, the PBoC was concerned that commercial banks would be tempted to raise their deposit rates to attract more business while they were simultaneously trying to hold down lending rates to expand their loans business. These banks would then run the risk of lapsing into a vicious circle with a consequent deterioration in their balance sheets. This would also give rise to the possibility of a widespread banking crisis, particularly as the deposit insurance system had yet to be established. Further, retail depositors would be confronted with the massive risk of losing their entire savings if these banks went bankrupt (Xie 2001).

Secondly, a specified interest margin created rents to state banks, which enabled them to continuously support the real economy with low-cost loans while securing their profits (Song 2005). As stated in section 6.2.1, the state banks were the source of massive infrastructure project investments in China when private banks were reluctant to fund them because of their huge costs and delayed returns on investment.

Thirdly, although interest rate controls have led to lack of efficiency in resource allocation, the regime is consistent with its objective of maximising the societal welfare. It is noteworthy that economic efficiency is not the sole criterion for evaluating financial statism in IFC development. For an economy under transition, China's experience shows that maintaining macroeconomic and social stability is perhaps more important than improving economic efficiency.

Table 8.4 The interest rate liberalisation process

1. Liberalisation of inter-bank lending rate	
1990	Pilot liberalisation of inter-bank lending market and rates
1996	Creation of unified inter-bank market
1996	Abolish the upper limit of inter-bank lending rate
2. Liberalisation of bond market interest rate	
1996	Market-based issuance of government bonds on pilot markets (stock markets)
1997	Utilisation of the inter-bank market to deal in inter-bank bond repo transaction
1997	Liberalisation of the bond repo interest rate
1998	Market-based issuance of financial bonds by policy banks
1999	Market-based issuance of government bonds
3. Market-based reform of lending and deposit rates	
3.1 Foreign currency	
3.1.1 Loans	
1996	Introduction of foreign currency business in the commercial banks
2000	Liberalisation of lending rates
3.1.2 Deposits	
2000	Liberalisation of over USD 3 million deposit rates
2002	Liberalisation of small deposit rates of residents in foreign financial institutions
2003	Liberalisation of deposit rate in British pounds, Swiss Franc and Canadian dollar
2003	Lower limit of deposit rates removed
2004	Liberalisation of small deposit rates with maturity above one year
3.2 Renminbi	
3.2.1 Loans	
1987	Surcharge until 20% on reference rates on loans (working capital)
1996	The band changes to ±10% around reference rates
1998	Increase of upper limit to 20% (RCCs 50%)
1999	Increase of upper limit to 30% (RCCs and large enterprises 10%)
2003	Increase of upper limit to pilot RCCs to 100%
2004	Increase of upper limit to 70% and RCCs to 100%. Lower limit remain at 90%
2004 2011	Liberalisation of upper limit of RMB lending rate (excluding UCCs and RCCs, that increase until 130% above reference rate) Decrease of lower limit to 70%
3.2.2Deposits	

1999	Negotiation on rates on over RMB 30 million deposit with maturity above 5 years for insurance companies
2002	Same scheme for Social Security Fund
2003	Same scheme for China Postal Saving and Remittance Bureau
2004	All kinds of deposit rates can adjust downward
2011	Increase of upper limit to 110%

Source: PBoC (2005), Garcia-Herrero et al 2006, Guo (2013)

In sum, a full liberalisation of interest rates is contingent on a robust and deep financial market. The joint-stock reform of China's state banks has to a larger extent cleared the way for this to happen. The liberalisation of interest rate would encourage the banking sector to increase its focus on the innovation of products and services, rather than creating policy-led interest margins.

8.1.3 The internationalisation of the Renminbi

Although the Renminbi is still inconvertible in the capital account, the Chinese government has initiated a series of policies to encourage the internationalisation of the Renminbi in the wake of the global financial crisis of 2008. Although China's massive foreign reserves are beneficial for macro-economic stability, they create high-risk exposure at the meta-level. The United States' quantitative easing policy (QE) has led to the depreciation of its currency. As a result, the PBoC is buying depreciating US dollars with appreciating Renminbis. Furthermore, the PBoC has been forced to raise interest rates in the face of mounting inflation. This suggests China is engulfed in a vicious circle. To make matters worse, China's tremendous foreign reserves are heavily exposed. The depreciated US dollar has caused a massive value loss for China's reserves, which Krugman (2009) terms the "dollar trap". Moreover, following the global financial crisis in 2008, there is a potential loss of confidence in the US Dollar as a reserve currency.

> Continuing large payment deficits, the lack of a credible fiscal plan and the recent downgrade of the US credit outlook by S&P have damped investors' confidence in the US Dollar (The Times, 2011).

Given that the current international monetary system is still dominated by the US dollar, it is very difficult for China to reform the international financial infrastructure by itself. Against this background, China has sought to turn the Renminbi into an international currency on a step-by-step basis through a series of pilot schemes.

Table 8.5：Bilateral currency swap agreements with the PBoC

Counterparty	Date of Agreement	Size of Swap RMB billion
Bank of Korea	12 December, 2008	180
Hong Kong Monetary Authority	20 January, 2009	200
Bank Negara Malaysia	8 February, 2009	80
National Bank of the Republic of Belarus	11 March, 2009	20
Bank Indonesia	23 March, 2009	100
Central bank of Argentina	2 April, 2009	70
The Central Bank of Iceland	9 June, 2010	3.5
Monetary Authority of Singapore	23 July, 2010	150
Reserve Bank of New Zealand	18 April, 2011	25
Central Bank of the Republic of Uzbekistan	19 April, 2011	0.7
Central Bank of Mongolia	6 May, 2011	5
National Bank of the Republic of Kazakhstan	13 June, 2011	7
Bank of Korea	26 October, 2011	360 *
Hong Kong Monetary Authority	22 November, 2011	400*
Bank of Thailand	22 December, 2011	70
National Bank of Pakistan	23 December, 2011	10

Note: all agreements have a maturity of three years and are renewable.
* The agreement was renewed after maturity and the size of swap doubled
Source: PBoC website, www.pbc.gov.cn;

Since December 2008，the PBoC has embarked on a series of swap currency agreements with its trading partners and has been experimenting with the idea of conducting trade and investment activities using the Renminbi and the respective partners’ currencies. As of the end of 2011, China had conducted 14 bilateral currency swaps (Table 8.5) with countries including South Korea, Malaysia, Singapore, Indonesia, Thailand, Brazil and Argentina, totalling more than RMB 1,300 billion (USD 190 billion). These currency swaps allow China to receive Renminbi instead of US dollars for its exports to those countries. It is noteworthy that the Renminbi’s cross-border settlement is irrelevant to sensitive issues such as capital account convertibility (He and McCauley 2010). The currency swap agreement only allows foreign importers to obtain Renminbi from their own commercial banks. In the meantime, Chinese exporters are entitled to use Renminbi as their settlement currency, instead of US Dollars, Euros or other currencies. Denominating transactions in Renminbi significantly reduces the exchange risks faced by Chinese exporters and importers. Bilateral currency swap agreements are an important step in increasing the Renminbi's share of international trade.

Overall, the SIFC's development and the internationalisation of the Renminbi have a symbiotic relationship. It is evident that the SIFC's development is set to drive the international use of Renminbi (also see Subacchi and Huang 2012b). In April 2009, Shanghai and four other Chinese cities in Guangdong Province were initially selected for a pilot city project to conduct Renminbi cross-border settlements. The scheme was then extended to the entire country in October 2010. In 2011, China's Renminbi-denominated trade settlement comprises 9 percent (RMB 2.08 trillion) of the total value of commodity import and exports (USD 3.6 trillion).

Conversely, the Chinese government's efforts to use Renminbi as a settlement currency across borders will be a strong incentive to promote Shanghai into an international financial centre. For a start, Renminbi cross-border settlement facilitates companies trading abroad as it helps to prevent foreign exchange risks. As the Renminbi becomes accepted by more countries around the world, traders will want to use it to settle their transactions and investors will be willing to hold more of the currency as a store of value. An increase in Renminbi settlements means offshore Renminbi would require conduits for investment. This will force the government to further open up the financial system. In effect, the global currency status of the US dollar, UK Sterling and Japanese Yen are highly dependent on established financial markets in New York, London and Tokyo. Therefore, a deep, liquid and well-established onshore market is crucial for the internationalisation of the Renminbi. Shanghai thus needs to speed up infrastructure construction to build a cross-border clearing house for the Renminbi geared toward global demand (Xinhua 2012). Fang Xinghai, then Director General of the Shanghai Financial Services Office (SFSO), stated:

> The currency will go global and foreigners will hold Renminbi assets. But where will these assets be created? They will be created in this onshore financial centre. So, first of all,

> Shanghai has to be open to let the assets go out and outside investment to come in. For that to happen, the capability of creating these assets has to be greatly expanded. [75]

Although the move to Renminbi internationalisation is a gradual process, it may proceed more quickly than expected. China's central bank has scheduled a move in the direction of a more flexible exchange rate regime and a fully convertible currency. In a recent report, PBoC (2012) laid out a roadmap to ease capital account restrictions with a ten-year timeframe. The first phase occurs from 2013-2015 to encourage China's outward direct investment. The second phase, in between three and five years, would accelerate greater cross-border commercial lending, including loans in Renminbi. In the longer term over five to ten years, foreigners would be allowed to invest more freely in Chinese stocks, bonds and property. Full convertibility of the Renminbi would be the "last step" and would be taken at an unspecified time. It would also be combined with restrictions on "speculative" capital flows and short-term foreign borrowing. The PBoC also states that it would take other steps to further liberalise the financial industry. This will entail further attempts to strengthen the competitiveness of China's financial markets and to raise their attractiveness so that they can fulfil their role in meeting the demands of domestic and foreign users. This report suggests that with the internationalisation of the Renminbi, China's financial sector will be more "opening-up and going-global". Subramanian (2012) describes this aspect of currency internationalisation as an interventionist opening.

In parallel with China's WTO accession, which helped the country integrate into the global trading system, the further internationalisation of the Renminbi would help it integrate into the global financial markets. With the increase of its economic weight, China badly needs an international financial centre as a platform to allocate resources across borders to increase capital efficiency and reduce transaction costs (also see section 8.2). By having greater recognition of the Renminbi globally, it would also enhance the competitiveness of China's financial institutions (Eoyang et al., 2010, p.27).

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[75] See *Turning Shanghai into a Global Financial Hub: So Much to Do, So Little Time*, available at: http://www.knowledgeatwharton.com.cn/index.cfm?fa=viewfeature&languageid=1&articleid=2257, accessed on 10 December 2013.

Zhou Xiaochuan, the Governor of PBoC, contended at the Lujiazui Forum in 2008:

> Albeit China is a large economic entity, it is imperative for China to integrate into the international community rather than to be a standalone player. Only by going global, can the international financial centre gain competitiveness and be successful. Only in the course of integration can Chinese banks and financial firms learn from their counterparts and sharpen up their positions (original version in Chinese, translated by author).

In summary, the internationalisation of the Renminbi is a golden opportunity for Shanghai to build a real IFC. In a sense, it is only when Shanghai eventually builds up its global position in the Renminbi business that the city will become a genuine IFC on a par with New York and London.

8.2 Catalysts for the Withdrawal of Financial Statism

First of all, China is transforming its developmental model from an investment-incentive to a domestic-demand oriented one. The past 20 years have seen China gain comparative advantage, mainly in labour-intensive commodities. It is becoming clear that industrial policies that relied on directed credit, subsidies, trade barriers and government purchases of products to induce the development of targeted industries, are increasing costly and inefficient. Moreover, many of the instruments used in support of such policies are banned by the WTO (Yusuf and Nabeshima, quoted in Logan 2008 p.41). To sustain its growth, the Chinese central government has decided to shift its comparative advantage towards knowledge-intensive sectors, i.e. to spur growth through innovation, rather than high-pollution-led, low-value-added commodities[76]. Policy-makers realise the structural transformation of the economy – to rein in investment and expand domestic consumption in particular - will require a termination of the cheap credit policy.

Indeed, one of the sources of cheap credit is the specified interest margin for

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[76] Please see the the communique of the 18th CCP Congress for details. Available at: http://news.xinhuanet.com/18cpcnc/2012-11/17/c_113711665.htm

commercial banks. This has created new soft-budget restraints for state banks after joint-stock reforms. To counter the impact of the 2008 global financial crisis the Chinese authorities splurged a RMB 4 trillion stimulus package implemented through bank credit expansion (IMF 2011a, p. 19). The bulk of investment was largely derived from state commercial banks loans. It is notable that during that period, the state banks had already completed joint-stock reforms and had become more commercialised. Why then did they follow the scheme of stimulus package initiated by the government? One answer is that the specified interest margin set by the state would bring them large amount of profits if they expanded their credit loans, which rendered them ignorant of the potential high risks. In 2011, the IMF's report on China's Financial System Stability Assessment pointed out that "China confronts a steady building up of financial sector vulnerabilities" (IMF 2011, p.7). In 2012, a report published by the World Bank also wrote:

> The conflicting roles of government in ownership and regulatory functions have made it impossible for regulation and supervision to be truly effective; continued patronage of financial institutions, including through appointment of senior executives has prolonged the bureaucratic culture among banks; and the perception of implicit guarantor of failed financial institutions has exacerbated moral hazard (World Bank 2012, p.132).

The Chinese leaders were thus alerted to the high risks accumulated in the state-owned financial sector under financial statism.

Table 8.6: The share of industrial output by ownership (1978-2010)

Year	**SOEs (%)**	**Collectives (%)**	**Foreign, private, others (%)**
1978	77.6	22.4	0.0
1980	76.0	23.5	0.5
1985	64.9	32.1	3.0
1990	54.6	35.6	9.8
1995	32.6	35.5	46.2
2000	23.5	13.9	62.6
2005	10.6	4.4	85.0
2010	8.2	1.5	90.4

Source：China Statistical Yearbook, various years, Wu (2008, p.18)

The second point to consider is that market reform has significantly reduced the share of state-owned sector in manufacturing industry. China's economy has hitherto been dominated by non-state enterprises in many categories, such as private, foreign-invested enterprises, township and village enterprises, stockholding enterprises etc. In the mid-1990s, the Chinese government undertook the historically unprecedented task of downsizing state-owned enterprises by closing down, suspending operations, merging and shifting (in Chinese "*Guan Ting Bing Zhuan*"). The number of industrial SOEs has significantly decreased, particularly in the second half of the 1990s. As seen in Table 8.6, the share of SOEs has declined from 77.6 percent in 1978 to 8.2 percent in 2010 in respect to industrial output. In contrast to SOEs, the non-state sector is least dependent on financial support and state control. Furthermore, social welfare reforms have also made progress[77]. When the share of state sector in the industrial sector fell to a certain level, state banks should have been able to come more commercially oriented and their reform should have shown more progress.

For another, fiscal reform has made the revenue of central government increased sharply. In 2010, the budget revenue of government reached RMB 8,310 billion - more than 12 times above its 1995 total (see Table A1 in Appendix 2). Between 1995 and 2010, the ratio of budgeted revenue to GDP also grew from 10 percent to 21 percent. With the inclusion of additional budgeted revenue, the ratio stood at 22.2 percent in 2010. The increase in fiscal revenue strengthened the capacity of the state in promoting market reform of the banking sector.

The third point is that the recent withdrawal of financial statism is also influenced by exogenous forces, particularly after China's accession to the WTO. In 2001, China eventually became a member of the WTO after 15 years of negotiations, during which it faced enormous pressures from advanced economies such as the United States and European Union to open up its markets (Long 2007). To acquire the right to WTO membership, China committed to open up its service markets and in particular to afford market openness in banking, insurance, securities business etc. Table 8.7 depicts the

[77] In the 1990s, a payroll-tax-based and contributory social insurance system was established, which included community-based pension system, health insurance, public housing fund and unemployment insurance.

specific commitments made by the Chinese government on financial services after WTO. Foreign banks were permitted to provide Renminbi and foreign currency services without geographic and client limitation by the end of 2006.

Table 8.7: Schedule of specific commitments on financial services after WTO accession

Financial Sector	Description of Commitment	Time Frame
Banking Services	• Foreign providers of foreign currency services permitted without geographic and client limitation	Upon accession
	• Foreign providers of Renminbi services permitted without geographic and client limitations	Within 5 years of accession
	• Foreign providers of banking services subject to licensing and qualification requirements	Upon accession
Securities	• Foreign providers may establish fund management joint ventures with no more than 49 percent equity	Within 3 years of accession
Life Insurance services	• Foreign life insurers permitted to establish joint ventures with 50 percent equity, with no geographic limitations; subject to licensing requirements	Within 3 years of accession
Nonlife insurance services	• Foreign nonlife insurers permitted to establish wholly owned subsidiaries, with no geographic limitations; subject to licensing requirements	Within 3 years of accession

Source: MOFTEC (2001)

These audacious commitments imposed enormous challenges on China's state banks, although Long Yongtu, the Chief negotiator of China's WTO accession, contends that more openness might have been arranged if it hadn't been for the Asian financial crisis (Long 2007). Given that foreign banks held greater competitiveness in management, innovation and financial services, the only way domestic banks could survive was to accelerate reform. Otherwise, these crippled entities would surely have been taken over by foreign counterparts. The pressures from opening the door wider to foreign investors encouraged China's banks to operate as genuine commercial banks and become fully accountable for the profits they generated - and the losses they incurred. Had state banks treated themselves as "resource allocators rather than financial intermediaries" (Pistor

2009) and considered their daily operations to be based on maximising societal welfare rather than profits, they would lose their competitiveness to their foreign counterparts from the onset. Jao (2003, p.41) cautioned that the Chinese government should tackle non-performing loans as a priority before fulfilling other essential conditions of developing an IFC in Shanghai.

China's WTO commitment has also had direct repercussions on the selective intervention policies in Shanghai. As stated in the Chapter 6, financial statism functioned well in terms of creating financial markets and promoting infrastructure investment in Shanghai. Shanghai possessed various favourable policies (particularly in the Pudong New Area) which were not extended to other cities in the 1990s. However, most of these policies expired in 2002, particularly after China's entry into the WTO, after which the Chinese government committed to opening up financial services to foreign providers without geographic and client limitation. This has caused two outcomes: firstly, the rents generated from restricting competition policies have been reduced to normal levels because market opening without geographic limitations implies that no extra rents are obtainable if organisations choose Shanghai as their regional headquarters. Secondly, this has also led to a new phenomenon whereby nearly 30 cities in China have planned the creation of a financial centre among their future development goals (CDI 2013). Although only five of these cities have claimed to have built an international financial centre (i.e. Shanghai, Beijing, Shenzhen, Guangzhou and Dalian), the inter-city competition has, to certain extent, undermined the effectiveness of financial statism in the SIFC development.

In the new context, Shanghai's municipal government realised that to compete with peer cities within the country, Shanghai's strengths lie in its increasingly established financial markets rather than previous interventionist policies. Tu Guangshao, Deputy Mayor of Shanghai, expressed his preference for a more market-oriented approach for the SIFC development, when he made a speech at Caixin Annual Conference in 2010:

> Firstly, we should endorse the rule of law rather than preferential policies in SIFC development. The latter is temporary while the former is more enduring and effective. Secondly, we should pay more attention to human resources rather than physical facilities. Human capital is utterly more important in future SIFC development. Thirdly, the role of

> government should be changed and should give way to a more open and market-oriented system (Tu 2010, translated by Author).

Yu Zhengsheng, the then Party Secretary of Shanghai, was more straightforward when he responded in an interview in March 2012 that "without the full convertibility of the Renminbi, it is impossible to develop Shanghai into a successful international financial centre"[78]. His words imply that transforming Shanghai from a domestic financial centre to an international financial centre is largely dependent on the central government lifting capital controls in the medium term.

Last but not least, after 30 years of rapid development, China's macro-economic environment has significantly improved. China is currently "the workshop of the world" and the world's second-largest economy. The export-push strategy has led China to be the largest trading nation in the world[79]. Meanwhile, external debt is moderate and the exceptionally large foreign exchange reserves provide a considerable cushion against even large sudden capital outflows (Herd 2010, p.35).

At meta-level, the most direct result of capital controls has been the segregation of domestic and international markets. The PBoC announced that at the end of March 2011, it held USD 3.04 trillion in foreign currency reserves. However, China's massive foreign reserves have been invested in low-return US Treasury bonds. This phenomenon, often labelled as "capital doubtful recycling" (Pan 2009, p.54), has had a negative impact on the sustainability of China's economic growth. While China has been adopting various favourable policies to attract foreign capital and investment from developed countries at high rates, it has been unable to use this surplus capital to effectively support its own real economy, instead preferring to invest it in the form of treasury bills and other low-rate-of-return instruments (Stiglitz 1998).

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[78] See http://nf.nfdaily.cn/nfdsb/content/2012-03/11/content_40152960.htm, Accessed on 12 March, 2012.

[79] In 2013, China's total volumes of imports and exports reached USD 4.16 trillion (surpassing United States with USD 3.91 trillion), becoming the largest trading country in the world.

Why did China have to rely on foreign direct investment while maintaining such a high volume of foreign reserves? This is, to a large extent, due to the under-development of financial markets and stringent capital controls. In a liberal financial market, countries are not only able to absorb foreign investment from around the world, they can also invest surplus capital globally to reduce risks and increase returns. The Chinese financial system and market development is lagging behind its economic development. China confronts huge risks when it comes to foreign currency exchange but its capital controls mean it cannot take full advantage of its domestic capital and so is forced to borrow abroad to fund high-return industries. China's strong economic growth has also allowed overseas investors to reap huge profits.

Furthermore, enforcement of capital controls is likely to become progressively more difficult after China's financial system becomes more sophisticated and the involvement of Chinese businesses in international markets increases. The most important constraints on the pace of China's capital account liberalisation are the incentive and capabilities of domestic financial institutions and non-financial businesses to prudently manage the risks of cross-border transactions and the ability of supervisory authorities to monitor external exposures sufficiently to contain systemic risk (Herd 2010, p.35).

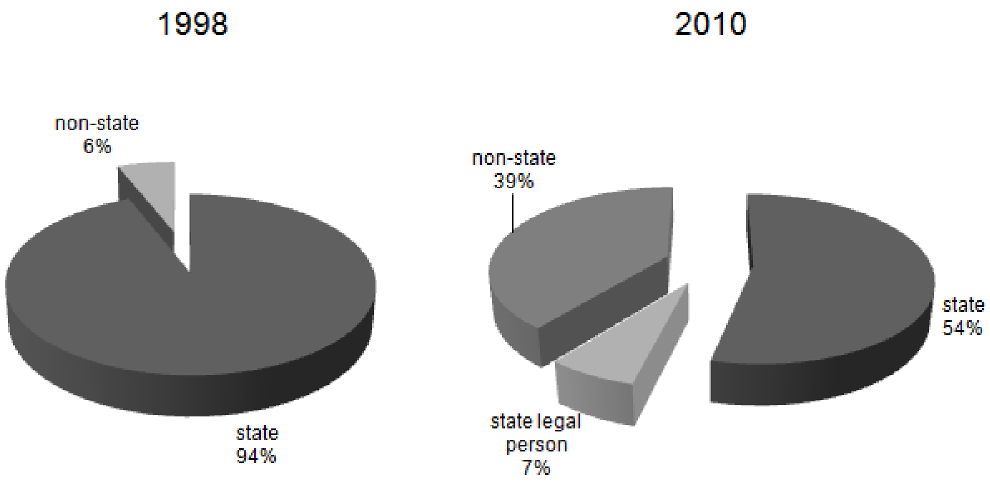
To summarise, the changing contexts have weakened the foundation of financial statism, which explains its recent withdrawal by the central government. It also demonstrates that financial statism is a development strategy that the state devised to maximise rents at macro, meso and meta levels, which have had a profound impact on the SIFC development.

8.3 Withdrawal without Dismantling

Although the central government has gradually relaxed its controls over the financial sector in some respects, it might be too early to conclude that financial statism has been fully dismantled in China.

First of all, although the ownership structure of large state banks has diversified through joint-stock reform, the Chinese state still maintains strong control over the large banks through share ownership and they remain the mainstay of the banking system after joint-stock reform. In 1990, large state banks comprised 96 percent of total assets in the banking sector (see Table A6 in Appendix 2). Between 2002 and 2011, the share of large state banks assets was on a downward trajectory, falling from 73.6 percent in 2002 to 48.5 percent in 2011. Yet the total assets of large state banks have increased from RMB 13.55 trillion to RMB 53.64 trillion. Moreover, the ownership structure of state banks has become more diversified after joint-stock reform. In 1998, the total capital of commercial banks amounted to RMB 515 billion, of which the state's share stood at RMB 484 billion, representing 94 percent of the total capital (Huang 2012). By the end of 2010, the state's capital share still accounted for 60.7 percent (including state legal person share[80]), although the joint-stock reforms have introduced a large number of non-state shareholders (Figure8.1).

Figure 8.1: Capital share of state and non-state for China's commercial banks (1998 vs. 2010)



Source: Huang (2012)

With respect to foreign investment in the banking sector, several features of the deals should be noted. First of all, foreign investors were offered minority stakes, which means the banking system would still controlled by the state. Under Chinese legislation,

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[80] The state-owned legal person shares (*Guo you Fa Ren Gu*) refer to shares of a joint stock company/bank owned by another State-owned company or institution with a legal person status.

a single foreign investor’s stake is limited to 20 percent of a Chinese domestic bank; all foreign investors have a combined maximum limit of 25 percent (Nie 2007, p.4; Herd et al. 2010). Secondly, foreign investors are required to lock in their investments for a set period, typically three years. Thirdly, foreign banks can only increase their stake to a maximum of 19.9 percent after this lock-in period has expired. Finally, investors holding shares above what is considered a critical threshold (i.e. 2.5 percent) can nominate directors to the board of the bank in which they have invested (Pistor 2009). Anderson (2007) holds that the introduction of foreign banks as strategic partners is somewhat of a ”red herring”, since China is one of the most overbanked economies in the world[81].

Table 8.8: A comparison of China’s capital controls with other countries in 2012

	China	**Russia**	**Brazil**	**India**	**USA**	**UK**	**Germany**	**Japan**
Controls on:								
Capital market securities	*	*	*	*	*		*	*
Money market instruments	*	*	*	*	*		*	*
Collective investment securities	*	*	*	*	*		*	*
Derivative and other instruments	*		*	*	*		*	*
Commercial credits	*			*				
Financial credits	*		*	*			*	*
Guarantees, securities, and financial backup facilities	*			*	*			
Direct investment	*	*	*	*	*	*	*	*
Liquidation of direct investment	*			*				
Real estate transactions	*		*	*	*		*	*
Personal capital transactions	*			*				
Provisions specific to:								
Commercial banks and other credit institutions	*	*	*	*		*		
Institutional investors	*	N.A.	*	*	*	*	*	*

Note: “*” indicates that there exists specific restriction
Source: IMF (2012),

[81] As of January 2012, China’s banking sector assets amounted to RMB 111.62 trillion, representing 93.6 percent of the total financial assets in the country. In comparison, the assets of securities firms totaled RMB 1.57 trillion, making up only 1.3 percent (CF40 2012).

In the financial markets, despite continuing government efforts to liberalise interest and exchange rates, controls on deposit rates remain in place and the floating of exchange rate is rather limited. Similarly, China's capital account still operated under strict controls compared with other countries in 2012. According to the IMF's 2012 Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), China had the strictest capital control regime (similar to India's) when compared with other developed and developing countries (Table 8.8). It is also worth noting that Renminbi internationalisation is not equivalent to full Renminbi convertibility and the free-flow of the Renminbi across borders.

The state might yet be reluctant to dismantle financial statism even after market mechanisms have been put in place. There are a number of reasons for this. Firstly, entrenched interests groups are unwilling to change the status quo, which is to the impediment of financial development. The management of state banks and the beneficiaries of cheap credit (e.g. other state-owned enterprises) will resist any attempt in liberalise interest rates. Furthermore, the state is not willing to lift the control on interest rates as this would increase the cost of loans for state-owned enterprises, which would have a negative impact on their finances. If interest rates were liberalised too rapidly, a number of SOEs and even local governments would go bankrupt (see Song 2005). Secondly, there is a symbiotic relationship between the interests of bureaucrats and the SFIs. To a large degree, state ownership of the financial sector is related to state capacity and its effectiveness in socio-economic intervention, which is critical to employment, investment and fiscal revenues. The third reason is due to ideological considerations. Some socialists argue the state sector is one of the defining features of socialism. State-ownership is considered the cornerstone of China's socialist market economy. According to Li Rongrong, the Chairman (2003-2010) of China's State-owned Assets Supervision and Administration Commission (SASAC):

> State ownership is the foundation of the socialist economic system. The state-owned sector, which takes a dominant place in the country's economic lifeline and key areas, is one of the key features that distinguish a socialist market economy from a capitalist market economy (Li 2004).

I would argue that Chinese leaders still remain cautious when it comes to dismantling financial statism. They are well aware China is still a developing country. Although the financial markets developed rapidly, they are still imperfect. As we discussed in chapter 7, the financial system is still fragile; the financial markets are not functional; the skilled human resources are insufficient; and the regulatory environment is relatively weak. China has yet to establish a deposit insurance system to protect savers from a meltdown of the banking system. Hence, dismantling China's financial statism will certainly be an incremental process and the development of the SIFC will also take some time to accomplish. Nevertheless, in the long run, a modern financial infrastructure and a more market-based financial system will help China to integrate into the global financial system and eventually transform Shanghai into a pre-eminent global financial centre[82].

8.4 Summary

China's financial statism has been rolled back in recent years, particularly after the global financial crisis in 2008. Policy measures such as ownership diversification within the banking sector, the gradual liberalisation of interest rates and the internationalisation of the Renminbi suggest the Chinese financial sector is leaning towards a greater emphasis on market mechanisms and away from administrative rule. This movement has been created by demands that the domestic financial sector be more competitive in the globalised marketplace and better skilled at handling the complexities of the international monetary system. From a system characterised by dominant state-ownership, financial restraint and stringent capital controls, a new one has been emerging in which the state still plays a major part in policy guidance and direction but emphasis is placed on its ability to enforce and steer. In a nutshell, financial statism might act as an alternative development strategy for developing countries where market mechanisms are weak and under-developed.

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[82] In November 2013, the resolution of the 3rd Plenary of 18th CCP Congress pledged a range of measures to deepen financial reform, including accelerating liberalisation of interest rates, giving permission for qualified private investors to set up small and medium-sized banks, and speeding up full convertibility of the Renminbi in the capital account. This resolution appears to show a willingness on the part of the Chinese leadership to further weaken the regime of financial statism.

9. Restating Financial Statism Approach: A Scaffolding Metaphor

The role of the state in IFCs development appears to be a contentious topic in the academic and practical arena. In this chapter, we bring forward a scaffolding metaphor for understanding the changing role of the Chinese state at the different stages of SIFC development. The chapter is organized as follows. Section 9.1 describes what the “scaffolding” metaphor is. Then we analyze the implication of the scaffolding metaphor. The final section addresses several possible misconceptions regarding financial statism approach for the IFCs development.

9.1 Financial Statism as Invisible Scaffolding

Interestingly, the World Bank (2012) reveals there are two conflicting views with respect to the role of the state in finance.

> First, there are sound economic reasons for the state to play an active role in financial systems. Second, there are practical reasons to be wary of the state playing too active a role in financial systems (p.1).

The conflicting views on the role of the state in finance are consistent with the dual nature of the state discussed preciously in section 4.1. In this thesis, I use the metaphor of scaffolding to describe the changing role of the state in the SIFC’s development. Just as scaffolding is necessary to provide temporary assistance when erecting a building, financial statism is also a supportive aid in the shaping of international financial centres, particularly in a transitional country. Using the scaffolding metaphor, the role of the state in IFCs’ development can be viewed as a function of financial development. Table 9.1 lists the transformation of financial statism at different levels of IFCs’ development. Generally speaking, emerging economies need a higher degree of development intervention than advanced economies. The poorer and weaker the situation and the financial market is, the deeper intervention in its economy will be required to create an internal environment adequate to the IFCs' development.

Table 9.1: The transformation of financial statism at different levels of IFCs' development

Levels	Description	Initial Stage	Matured Stage
Micro Level	The agglomeration of financial institutions, markets, services and professionals	Control over interest rate; entry barrier	Interest rate liberalisation, opening to private capital
Meso Level	The endowed factors, such as tax regimes, financial regulations, urban infrastructures and amenities etc. that the host city could offer	Tax breaks, market creation, institutional building	Direct administrative intervention reduced
Macro Level	The political, economic and societal environment of the country where the IFC is situated	State ownership over financial sector	Diversification of ownership, a growing private sector
Meta Level	Connection of the financial centre to the outside world, such as access to the international markets, mobility of capital flows and convertibility of the currency	Capital control, limited convertibility of currency	Capital account liberalisation, full convertibility of currency

Source: Author

The next important question is whether financial statism needs to be withdrawn or dismantled after late-developing countries have established well-functioning, competitive market institutions. Financial statism is a composite of state-owned financial institutions, financial restraint policies and capital controls; therefore we should discuss these components separately.

When it comes to capital controls, Kose et al. (2009) identify five threshold conditions for financial liberalisation: financial market development; institutional quality; governance; macro-economic policies; and trade integration. They argue that if an economy is above a certain threshold regarding these, financial liberalisation will benefit total factor productivity and GDP while the risk of crises will diminish. If a country fails to meet these thresholds, financial integration will increase the risk of crises. Furthermore, connectivity to the global network is crucial for an IFC. Without free flow of capital, the efficiency and competitiveness of an IFC will be seriously undermined. More importantly, all states are being affected by globalisation; no single state can truly be isolated from the global process. Therefore, this thesis maintains that a capital control regime needs to be dismantled after emerging economies catch up with existing industrial powers.

Secondly, financial restraint policies in certain conditions can promote financial deepening through producing contingent rents. Yet, the optimal level of financial restraints falls as the economy increases its level of financial depth (Hellmann et al. 1998). As we have seen in the case of China, the specified margin of interest rate distorts the credit market, creating many redundant projects that are not sustainable. If financial markets are already functioning well, the state no longer needs to intervene through administrative tools. Financial restraint thus appears to be more effective during the early stages of modernisation than in later stages when the economy demands creativity rather than sheer scale. Therefore, it is desirable that financial restraint be phased out as the economy acquires financial depth.

Finally, it is still an open question as to whether the state should withdraw its significant ownership in the financial system, even after a functional market has been established. As discussed throughout this study, state-owned financial institutions can help to create an enabling environment that allows market institutions to grow. In this context, once a functional and effective market has been attained, the role of SFIs can be diminished. However, it is not clear if there is still a need for dominant state-ownership in a financial system once an international financial centre has been built up. In the academic arena, there are a number of scholars who endorse state-owned financial institutions, without connecting their existence with the maturity of a market system. Butzbach and von Mettenheim (2014), for instance, argue that public banks have competitive advantages over private banks with lower overall agency costs, greater stability and better societal welfare. From a Marxist perspective, finance is not neutral or classless. Within capitalist society, financial capital has taken on an increasingly hegemonic position, often to the detriment of labour (Marois 2012). State banks are a viable option for financing public services not only for developing countries, but also for advanced economies (Marois 2013).

However, one could question to what extent state-owned banks in developing countries are eventually able to cope with the problems they face, such as soft-budget constraints, conflicts of interest and so on. Meanwhile, with the enhancing of institutional strength and a market system, microeconomic information becomes increasingly complex: market opportunities become more uncertain and complex after the financial sector develops to a more advanced stage. A bigger concern is whether state-owned financial institutions are able to outstrip privately-owned ones in terms of competitiveness, innovation and efficiency in a globalised world. Further research is needed to clarify this issue.

Moreover, it is worth mentioning that withdrawal of state-ownership in the financial sector does not equate to full privatisation in the whole industry. For example, in China, the recent reform of state-owned commercial banks is introducing various investors to transform them into joint-stock banks consisting of mixed ownership; including state-owned, collectively-owned, individual, private and foreign ownership. In effect, there are certain types of state-owned banks, e.g. development banks or policy banks, which have been an important instrument used by governments to promote economic development in practically all countries around the world, regardless of their stage of development(Luna-Martinez and Vicente 2012) .

In a nutshell, financial statism is a developmental strategy deliberately designed by the state to catch up with developed countries during the process of IFCs' development. To some extent, financial statism creates the seeds of its own destruction. The set-up of scaffolding occurs at a time of IFCs' development when late-developing countries may not be able to deal with problems such as institutional failure, market dysfunction and unequal foreign competition. These supports are gradually removed after developing countries have established the necessary institutions, created markets and enhanced competitiveness in the global market. The scaffolding metaphor illuminates the changing role of the state in IFCs' development.

9.2 Implications of the Scaffolding Metaphor

My study advocates that large emerging economies might use financial statism as *invisible scaffolding* to catch-up to developed countries in the development of IFCs. A scaffold is a temporary framework for construction in progress. It is put up for support and taken away as needed when the structure is strong enough to stand on its own. Financial statism is thus an expedient measure designated to facilitate IFCs' development and as a long-term strategy to boost their competitive advantages in the global IFCs' network. Several significant implications of the scaffolding metaphor are highlighted as follows.

Firstly, the scaffolding metaphor sheds some light on the relationship between the state and the markets in the development of international financial centres. The development of the SIFC is a crossover development project affecting both the market and the state. Both parties are complementary. At different stages of development, the state and the market can play different roles, which can be viewed as a dialectical relationship. In the financial sector, the state can also provide essential regulations without which markets cannot function. Underpinning all of this, state managers have a special responsibility to create the institutional infrastructure that markets require. In the scaffolding metaphor, we view the state as part of the market system, rather than as an exogenous player. This concurs with the market-enhancing view (Aoki et al. 1998). In other words, if the government is not an endogenous player, the market is not complete. In the case of Shanghai, financial statism is necessary and advantageous due to the fact that its market system is imperfect and dysfunctional.

As it is part of the market system, the state is thus able to play an independent role as an owner, and therefore establishing a mutual relationship with private investors in this public-private joint venture. Financial statism was helpful in stabilising macro-economic conditions and promoting investment-incentive economy. At the initial stages of development, moderate government intervention was helpful in cultivating the market, as in the case of Shanghai. Without effective guidance, weak financial institutions and a rudimentary financial system would only evolve as the result of a long-term, gradual process. As Evans (1995, p.29) put it, an effective state was not simply an adjunct to the market; it was an essential prerequisite to the formation of market relations.

Development intervention, in one sense, is made up of targeted efforts to improve certain conditions (Lund 2010). Wang (2000, p.15) argues that a country's comparative advantages are not always naturally endowed. Instead, they are created through the adoption of deliberate state policies to enhance their competitiveness. Wang’s argument is appropriate for LDCs in the shaping of international financial centres. Considering the strategic significance and the large gaps behind advanced economies, the financial sectors in developing countries should be given privileged access to public resources in order to gain comparative advantage. Wang (2000) also maintains that only a strong state that is relatively autonomous from the influences of domestic and foreign special interests can undertake such a task. Where public resources are limited - as is the norm in LDCs - it is crucial that the state can use these limited resources wisely.

Here the transformative capability of the state is particularly important. Transformative capability refers to the governing capacity that the state can reconfigure or rescale its power or resources to and/or from other economic and social actors in accordance with its strategic objectives. In the course of IFC development, the transformative capability refers to the skilfulness of the state to rein in or unleash financial statism; including state ownership, control over financial instruments and the market, convertibility of currency etc, in accordance with the different stages of financial development and conditions in the external environment. The state should constantly re-examine the rationale for the regulations it has imposed. This means states need to be “adaptive” and “reflexive”, allowing them to respond creatively to evolving their roles in the new context. This capability is, in part, based on continuous learning in the form of interaction, coordination and dialogue among different domestic and international players.

Secondly, financial statism can be costly. The erection of scaffolding is also costly in terms of material and labour but it is necessary for the building process. Similarly, financial statism constitutes neither a free lunch, nor a one-size-fits-all approach. It can be expensive because it could cause inefficiencies, lack of competition and even some moral hazard issues (e.g. corruption, embezzlement). Nevertheless, in the face of institutional failure and infrastructure weakness, financial statism, if well designed, can be a temporary interventionist approach in the building of international financial centres in late-developing countries.

Thirdly, we maintain that financial statism is only an expedient measure and it is likely to be tempered or even dismantled when the market system becomes matured and functional. Scaffolding is a temporary framework that supports construction: when the task is completed it is disassembled because otherwise it would obstruct the function of the building. In the same vein, financial statism should become redundant when the market becomes mature. In practice, the vested interest groups who benefit from financial statism will likely be unwilling to remove the scaffolding even if it has already become the hindrance to the system as a whole. Certainly, the withdrawal of financial statism will be an incremental process, which is largely contingent on the maturity of the market system and the contextual environment, both domestically and internationally. In China, the withdrawal of financial statism is often pushed hard by top political leaders. For instance, at a press conference held in March 2013, Li, Keqiang, the Premier, compared reducing direct government intervention to “cutting one’s own wrist” to demonstrate his resolve to transform Chinese government into de facto limited government.

The case study also shows that in the recent years, China’s financial statism has been watered down somewhat for a number of internal and external reasons. It first occurred with China’s entry to the WTO in 2001. Chinese political leaders believed the original development model could not sustain optimal growth for China and the market economy had already been preliminary established. The conventional model of financial statism has become less significant, as economic policies and legislation have become more transparent and effective. This in turn has largely released the underhand-operation concerns of foreign investors when engaging in business in China. With the development of the market, the Chinese state has gradually changed its supervisory principles and adopted more market-oriented methods (Chen 2009, p.577). In the meantime, the Chinese state has shifted from its previous role as full-time manager to that of a more market-oriented regulator.

Finally, we argue that the sequencing, tempo and pacing of scaffolding remain central to the successful shaping of an IFC in developing countries. It is interesting to note that the Chinese state responded differently to the Asian Financial Crisis of 1997-8 and Global Financial Crisis of 2008. After the Asian financial crisis, the Chinese state became more cautious and slowed down market liberalisation. The central government strengthened financial statism, particularly in the control of capital flows across borders. In 2008, China had also become more proactive in building the SIFC. The state has expedited its developmental progress in this regard, including encouraging the internationalisation of Renminbi. In the previous section, we discussed the underlying reasons for such a response but now we must highlight the importance of proper timing in establishing or removing the scaffolding in the development process. Two key propositions of the scaffolding metaphor are highlighted here.

For one, the pace of financial liberalisation should neither hasty nor delayed. Excessive liberalisation can cause capital flight or an influx of huge speculative funds, which would adversely affect a country's monetary independence and financial stability. This would also pose threats to a country's creditworthiness, drag down its sovereignty rating and eventually jeopardise the entire financial system. In this regard, China is correct to retain controls on its capital account until a robust, healthy and resilient *domestic* financial system is established. Nevertheless, it is also crucial to avoid the other extreme of the spectrum. Japan experienced remarkable economic development between the 1960s and 1980s. Nevertheless, its government was reluctant to open the country's financial markets, believing protectionism was beneficial to the national interest. As a result, the Japanese government's tight controls over its financial sector and its regime of high taxation have undermined Tokyo's ascendancy as a global financial centre on a par with London and New York (Shirai 2007). Therefore, the tempo of financial liberalisation should be appropriate to the peculiar circumstances faced by a state.

For another, the sequencing of liberalisation is important: a deep and liquid domestic market is vital for liberalisation. The Asian financial crisis stemmed primarily from the internal deficiencies of its economic and financial system (Young et al. 2009). If financial investment is largely contingent on administrative command rather than market signals, it will invariably lead to lower competitiveness. Herein I concur with McKinnon (1993) that there should be an orderly sequence of fiscal, monetary and foreign exchange policies in the course of capital liberalisation. McKinnon listed an optimal order of economic liberalisation for the transition from a planned to a market economy. Currency convertibility in the capital account is the last stage of economic liberalisation.

McKinnon（1993）states that transition to a market economy requires the following steps:

- Before opening the international sector, the domestic capital market should be gradually liberalised and interest rates should be gradually shifted to a market-based rate
- Liberalisation of the foreign exchange sector and the adoption of single exchange rate can be undertaken after the liberalisation of domestic finance and trade market
- Stabilisation of domestic prices is necessary before allowing free international capital mobility
- Free foreign exchange convertibility on the capital account is usually the last stage in the optimal order of economic liberalisation (p.10).

Therefore, the degree of financial openness should reflect the maturity of the financial markets. There are a range of criteria for a matured financial market including sound macro-economic conditions with low inflation and a manageable government deficit, an efficient, market-based financial market, a large number of highly competitive and well-performing listed companies etc. Most importantly, interest rates should be fully liberalised - otherwise investments and financial allocations will be distorted.

Therefore, in the development of SIFC, the state is responsible for the order, pace and tempo of the development. This is critical as IFCs' development is a dynamic process that involves various factors. What the state did is weigh the importance of different factors relevant to the multi-faceted model of IFCs' development and identify their key strategic objectives. Generally, this will involve the maximisation of national interests and societal welfare (i.e. maximise the rents, in the words of the neo-institutionalists), although the details can be different contingent on the state structure and social setting of a country. The state needs to strike a balance and arrive at a trade-off in determining the sequence and pace of transformation. This is because some policies might promote the IFCs' development in one respect, but could hinder it in another. If it does not occur in the right sequence and at the right pace, it would have disastrous consequences. For example, Atkins (2006) states that if financial sectors in developing countries are privatised and opened for foreign investors all at once, their domestic financial sectors would be controlled by foreigners overnight. Although this might be beneficial to IFCs' development at a micro-level, i.e. the agglomeration of foreign financial firms, this will have greatly undermined national territorial sovereignty at a macro-level.

In sum, financial reforms and liberalisation are two sides of the same coin for IFCs' development. IFCs' development should be synchronised in line with substantial and well-designed financial sector reform. Sound financial reform is an important component of an IFC's development and its design is crucial: just as well-designed financial reforms can promote IFCs' development, poorly designed financial reforms can jeopardise their success.

9.3 Misconceptions of Financial Statism

In this section, I intend to clarify three possible misconceptions with regard to financial statism in China. First of all, it is noteworthy that financial statism is not equivalent to state capitalism. State capitalism has various meanings. In the early 20th Century, Bukharin (1915, p.157) identified state capitalism as a new stage in the development of capitalism, in which all sectors of national production and all important social institutions had been centralised by the state. Rothbard (1973) attaches state capitalism to Nazi economic management in Germany. In his book *The End of the Free Market* Bremmer (2010) labelled a broad set of countries as state capitalism countries, including Venezuela, Saudi Arabia, United Arab Emirates, Egypt, Algeria, Ukraine, Russia, India, Mexico, Brazil, China, and many countries in Africa and South East Asia. According to him, these countries have one thing in common: authoritarian governments use various kinds of SOEs to manage the exploitation of resources. As Bremmer (2010) states:

> The ultimate motive is not economic (maximising growth) but political (maximising the state's power and the leadership's chance of survival). This is a form of capitalism but one in which the state acts as the dominant economic player and uses markets primarily for political gain.

For Bremmer, there are two distinguishing features between state and free-market capitalism.

> First, policy-makers don't embrace state capitalism as a temporary series of steps meant to rebuild a shattered economy or to jump-start an economy out of recession… Second, state capitalism sees markets primarily as a tool that serves national interests, or at least those of ruling elites, rather than as an engine of opportunities for the individual.

I disagree with his categorisation of China. First of all, the Chinese government maintains that China is still a socialist state but a market economy is not the preserve of capitalist countries. Secondly, China is still governed by the Chinese Communist Party. In other words, the CCP is the only ruling party in China. I cannot imagine a capitalist country being ruled by a Communist Party as the ideologies and beliefs are diametrically opposed. However, I do not intend to delve into this subject more deeply as this is beyond the scope of the thesis.

Moreover, it is arguable there are two fundamental differences between financial statism and state capitalism as defined by Bremmer. Firstly, financial statism refers to state control over the financial sector; such as ownership, interest rates, capital flows etc. which is much narrower than the scope defined under state capitalism. In other words, for other sectors, such as manufacturing industries, the state is much less likely to intervene and these are primarily contingent on the market system. Secondly, in this thesis, financial statism is considered as a set of development policies used by developing countries to maximise social welfare and to modernise the financial sector. Specifically, financial statism is utilized by late-developing countries to mend institutional loophole, preclude financial shock and maintain macroeconomic stability. Financial statism would never pose a threat to democracy in developing countries as Bremmer postulates it would for state capitalism. On the contrary, financial statism is an alternative interventionist approach that allows developing countries to modernise their financial sectors and even to shape an international financial centre.

The second biased view is that financial statism inevitably leads to prevalent corruption and rent-seeking behaviour. In this case, the inability of political systems could reduce social welfare rather than address problems arising from information and transaction costs (see Barth et al 2008). In a broad sense, this issue might be pertinent to philosophical beliefs about human nature: is bureaucracy composed of "economic humans" or "reciprocal humans"? The former believes humans are narrowly self-interested, whereas the latter maintains that human beings are co-operative and motivated to improve their environment and that of their fellow human beings. To the best of my knowledge, it is still an open question. Evans (1995)'s discourse on "embedded autonomy" counters public choice theory (Buchanan et al. 1980; Self 1993). In a narrow sense, it is generally more concerned with good governance structures. Here we need to separate the legitimate role of the state from white-collar criminality in particular, such as embezzlement and corruption. Whether in laissez-faire or dirigisme states, there will always be corruption. To minimise corruption and rent-seeking behaviour, the most important measures are enhancements to the rule of law and enforcement. Singapore is a typical example of a country with a high proportion of public sector employment yet it is considered among the least-corrupt societies in the world.

When talking about the relationship between the state and the market in economic development, some commentators often impugn government bureaucracy as an untrustworthy interest group that seeks for self-interests. However, it is not always the case that the private sector is more productive than the state sector. In the real world, public policies are often manipulated by private sector interests who lobby governments to make policies that benefit them. The sub-prime fiasco taking place in the United States suggests it is not always the case that nobody is able to foresee a crisis but in this instance the commercial interests of Wall Street financiers deterred the Federal government from taking effective measures to prevent it (Fang 2013).

In addition, a wide range of market failures exist in the financial sector, including improper payments and bonuses for bankers. Table 9.2 presents a comparison of executive pay in the top banks in China and the United Kingdom. In the United Kingdom, although the banks have encountered huge losses and received billions in taxpayer bailout funds, their top executive still received millions of pounds in salary and bonus payments. The Royal Bank of Scotland, for example, received up to GBP 20 billion in a government bailout in 2008, while its chief executives received GBP 4.2 million in total. In contrast, the Industrial and Commercial Bank of China, the largest bank in China, earned GBP 27 billion (profit before tax) in 2011. Yet its Chairman and Chief Executive only received RMB 1.64 million (GBP 164,000) and RMB 1.44 million (GBP 144,000) respectively. These results might be an extreme example but they imply that when it comes to the financial industry even developed countries still cannot cope with the issue of “too big to fail”. This also shows the ownership of the banking sector has no direct bearing on its performance and that state banks are not always less profitable than private ones. Even developed countries still require more regulation when it comes to such matters as executive pay and bonuses.

Table 9.2: Executive pay of major banks: China versus United Kingdom

China		**United Kingdom**	
Banks/ Profitability 2011 GBP, billion	**Executive Pay 2011 GBP**	**Banks/ Profitability 2008 GBP, billion**	**Executive Pay 2008 GBP**
ICBC Profit before tax: 27.2	Chairman: 164,000 Chief Executive: 144,000	**RBS** Taxpayer funds received: 20	Chief Executive: 4,190,000
CCB Profit before tax: 21.9	Chief Executive: 186,000	**HBOS** Taxpayer funds received: 17	Chief Executive: 1,269,000
BOC Profit before tax: 16.9	Chairman: 187,000 Chief Executive: 169,000	**Lloyds** Taxpayer funds received: 5.5	Chief Executive: 2,884,000
ABC Profit before tax 15.8	Chief Executive: 174,000	**Northern Rock** Nationalised via Taxpayer funds: 55	Chief Executive: 785,000
BOCOM Profit before tax 6.5	Chairman: 182,000 Chief Executive: 165,000	**Bradford and Bingley** Nationalised via taxpayer funds: 150	Chief Executive: 1,113,000

Note: The data for Chinese banks has been transferred to British pounds with the exchange rate GBP 1.00 = RMB 10.00

Source: KPMG (2012), Hannam (2009), 2011 annual report of all listed banks, compiled by author

The third misconception is that financial statism is synonymous with financial repression, which is incompatible with IFCs’ development. In effect, as we mentioned earlier, financial statism embodies financial restraint policies, the preconditions for which are positive real interest rates and low inflation rates (Hellmann et al. 1998). The controlled interest rate might be lower than the Walrasian interest rate (i.e. the market equilibrium rate) but financial repression refers to a set of government policies that create low or negative real interest return on deposits (Lardy 2008). Under financial repression, the real interest rate is often negative. As seen from the earlier case study on China, although interest rates have been controlled by the state, real interest rates have been positive most of the time. On the contrary, the Federal Reserve, European Central Bank, Bank of Japan, and Bank of England all set their short-term policy rates to near zero after the global financial crisis in 2008. In addition, quantitative easing has been adopted by developed countries to counter the overhang of government debts. As a matter of fact, we have witnessed prevailing financial repression in developed markets where interest rates were liberalised (Shepherd 2013).

Financial statism is more applicable to developing and transitional economies, in that they are often associated with market incompleteness and institutional deficiencies. Financial restraint policies are effective in creating "contingent rents" for both the state and non-state financial sectors to develop strong financial institutions and markets. We have witnessed abundant evidence of this in the case of Shanghai's development of an international financial centre. Under financial statism, China experienced financial deepening rather than financial repression. If we look at the M2/GDP, the rate has grown radically from 32 percent in 1978 to 181 percent in 2010 (see Table A7 in Appendix 2). In terms of financial markets' development, we can see that under financial statism, the state has played a major part in fostering the market in Shanghai.

Therefore, financial statism cannot be summarily dismissed as a hindrance for the development of IFCs, although it is in conflict with some key building blocks of international financial centres, such as the open market, free capital flows etc (see chapter 3). The case study demonstrates that IFCs' development should be aligned with the different stages of a country's development. Moreover, for late-developing-countries, IFC development should be viewed a means to attaining social and economic development, rather than an ultimate end in itself. Under certain conditions, developing a competitive international financial centre, as opposed to an effective domestic financial centre, may conflict with other social and economic objectives of a given country (see Arner 2009). For instance, in the case of Shanghai, the central government restricted free capital liberalisation requisite for a successful international financial centre for the benefits of entire nation. As Wu Xiaoling, the then deputy governor of the PBoC, stated in a high-level Symposium in Shanghai in 2002:

> The SIFC should aim to service the real economy [of the country], rather than money brokers and capitalists; Shanghai should not become an enclave of the Chinese economy but a hub of global and domestic financial resources. [83]

In view of this, financial statism is better regarded as a strategic policy set by the government to support domestic economic development. With the establishment of effective market institutions, financial statism is gradually withdrawn, paving the way for a more liberal and open economic system. Chinese authorities have already announced the introduction of more diversity in financial services, derivative products and futures transaction for Shanghai in the years ahead. International development organisations have been encouraged to issue more Renminbi-denominated bonds. Over time, other foreign companies will be permitted to do the same and they will also be allowed to list shares on the Shanghai Stock Exchange. It is intended that Shanghai will develop a reinsurance market by encouraging international reinsurance companies to open business in the city, and setting up domestic and joint venture reinsurance companies. One more recent effort from central government to promote the SIFC development was its launch of the Shanghai Free Trade Zone (FTZ) in 2013. The idea is to allow onshore financial institutions to directly offer international financial services to domestic and international counterparts with fewer restrictions than those imposed on their onshore business. With the expansion of investment channels for offshore Renminbi, Shanghai is moving towards a hub of international Renminbi settlement.

[83] Key points of promoting Shanghai into an international financial centre, February, 2010, Shanghai city development, Chinese version

10. Concluding Remarks

Only the one wearing the shoes knows how they fit.

--*Xi Jinping*
Chinese President

In the contemporary world, international financial centres have gone beyond a geographic concept and become unique economic complexes with peculiar functions, including fund raising, settlement clearance, price discovery, risk diversification etc. Given the rapid pace of economic globalisation and the enormous advances in information technology, the development of IFCs is one of the defining agendas for all economies – both developed and fast-growing emerging ones. This chapter provides concluding remarks on the research findings, the limitation of the study and future research areas.

10.1 Research Findings

During this doctoral study, I have focused attention on the relationship between state intervention and a broad set of contributory factors on IFCs' development. The research findings shed some light on how large, fast-growing developing countries may, or may not, promote IFCs' development through deliberate institutional design and policy transformation.

The Multi-scalar Dimension of IFCs Development and the Role of the State

IFCs' development is multi-faceted and is associated with a wide range of contributory factors. The neo-classical economists attribute the formation of IFCs to the comparative advantages, economies of scale and agglomeration of economies (Kindleberger 1974; Davis 1990). This helps to explain why financial markets and institutions tend to concentrate on a particular place and to shape a financial centre. The socio-geographers highlight the interaction of information, globalisation and IFCs' development. The information hinterland theory explains why financial activities tend to concentrate on one particular location rather than another. They argue that financial centres usually locate in places with the best access to valuable information flows (Porteous 1995; Zhao et al. 2004, 2005).The world city thesis posits that each city, regardless of whether it is in a developed or developing country, has become a node in a hierarchical "world city network". The cities that contain advanced producer services are positioned in the higher tier of the network and play a role as "command and control centres" (Sassen 1991, 2001; Friedmann 1986; Taylor 2005). The theorists on the nexus of financial and growth focus on the significance and implication of IFCs' development for developing countries and two main contradictory discourses have been presented. One believes the IFCs' development in developing countries is an important development strategy for economic growth and a way of shaping a new international monetary infrastructure (Goldsmith 1969; Obstfeld 2007; Castells 2000a). The other argues that IFCs' development in developing countries is a new instrument of imperialist control imposed by Western developed countries (e.g. Gorostiaga, 1984). In this view, the worldwide financial network has been used to feed capitalism in developed countries, thereby redistributing wealth upwards and risks downwards, with the poorer countries suffering most (Shaxon 2011).

The literature review of different perspectives of IFCs' development shows there are at least two major weaknesses in previous studies on IFCs' development: firstly, they were primarily segregated and isolated within particular subjects or disciplines; and secondly, the role of the state was understated. To fill these gaps, to some extent I have attempted to cross the boundaries of different disciplines in the investigation of this subject, i.e. I integrated various contributory factors into a multi-scalar approach in the exploration of the state in the development of IFCs. In this thesis I have categorised various contributory factors in an IFC's development into four levels: macro, meso, micro and meta. The macro-level is related to the macro-economic, political and legislative environment from the entire hinterland. The meso-level considers the urban and business environment in the host city. The meta-level is defined as connectivity to the global financial network and interaction with other IFCs. The micro-level refers to the agglomeration of financial markets, institutions and human capital, all of which have a direct bearing on the breadth, depth and competitiveness of a financial centre.

In chapter 4, we reviewed the role of the state in different strands of development theory, which are often considered incompatible or contradictory with each other but they give several insights to the IFCs' development for emerging economies. Firstly, from an historical perspective, every rising power has relied on the state to kick-start growth or to protect fledgling industries. Developed countries are now attempting to "kick away the ladder" (Chang 2002) after they have attained the position as leading players. In this respect, we need to re-erect the ladder to allow late-developing-countries seek to develop their IFCs. Secondly, the state plays a major role in determining ownership structures and thereby maximising the rents for ruling elites. According to NIE, the state has two paradoxical roles most of the time: it can be a "grabbing hand" as well as a "helping hand". In particular, a rational state tends to maximise its rents during the process of institutional change. In the process of IFCs' development, the state is likely to opt for an ownership structure that produces maximum rents even if this is inefficient. Thirdly, the role of the state in economic development is not rigid; it oscillates between laissez-faire policies at one end of the spectrum and intense state intervention at the other (Brett 2009; Aoki et al. 1998). The extent of state intervention varies from country to country and is contingent on institutional, structural and ideological conditions.

Financial Statism as Alternative Interventionist Approach

Neo-liberals claim IFCs' development is a time-consuming, spontaneous and self-sustaining process. Financial statism provides an alternative approach for IFCs development in LDCs. In the case of Shanghai, we have witnessed that as an endogenous actor the Chinese state played a pivotal role at different stages of the SIFC's development. The case study shows China's financial statism is not an obstacle, rather it serves as "invisible scaffolding" in its development. Just like scaffolding is necessary to provide crucial temporary assistance to construction workers when erecting a building, financial statism is also a supportive device that has helped shape a financial centre in Shanghai. Financial statism connotes a custom-made support for the SIFC's development, a support that can eventually be disassembled when it is no longer needed.

The case of Shanghai shows that financial statism has made China's economic transition a source of growth at macro-level. Financial statism has been extraordinary successful in mobilising deposits and channelling capital to strategic sectors during China's economic take-off in the 1990s when the state was confronted with massive fiscal deficits and institutional weaknesses. Financial statism has not only provided substantial investment in the process of industrialisation, but also shouldered much of the reform costs since the beginning of the reform era. It has served as an important stabilising force in safeguarding economic transition and it has successfully underpinned the SIFC's development at macro-level.

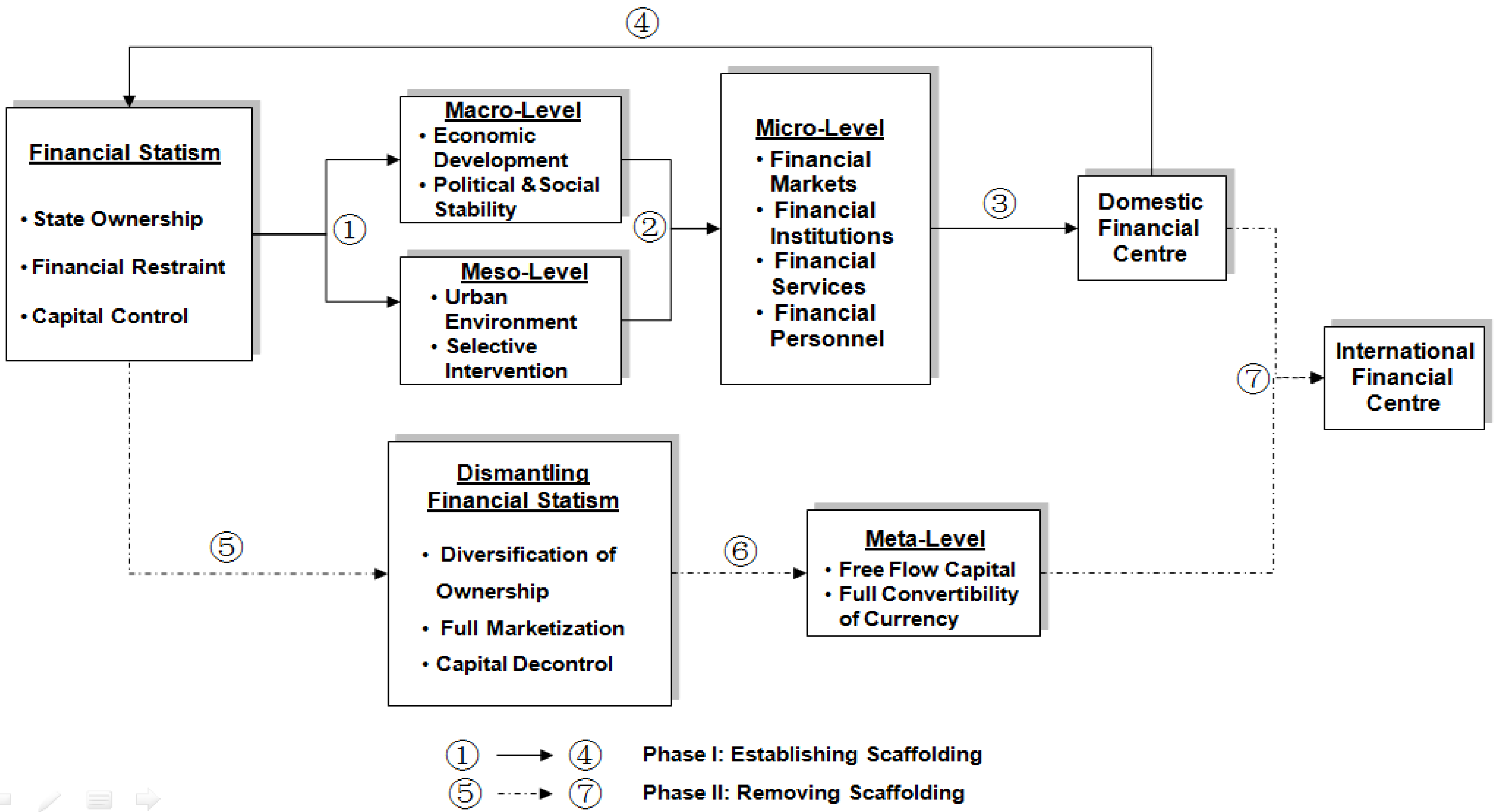
At meso-level, financial statism has also played an active role in infrastructural upgrades and institutional building over recent decades. Under financial statism, the Shanghai municipal government has developed a large number of infrastructure projects through lump-sum investments from state banks and capital markets, which has helped to overcome the threshold effect often confronted by developing countries. Market restriction policies also created rents to encourage international banks and financial institutions into the Lujiazui Financial City, the new CBD of Shanghai. Shanghai's financial markets have been thriving from the ground up in the past decades (see Chapter 7). The trajectory of SIFC development reveals that the booming financial markets and institutions in Shanghai did not evolve as a consequence of its historical and geographical legacy or the natural evolution of its market economy but occurred as a result of a powerful push by its government. It also showed that central government played a major part in formulating the developmental strategy and mediating the conflicts of these policies at different stages of development.

However, at meta-level, the case study reveals that financial statism has been a mixed blessing. On the one hand, it is widely recognised that stringent capital controls have prevented China from financial carnage amid two widespread economic crises: the Asia financial crisis of 1997-8 and the global financial crisis of 2008. On the other hand, the capital control regime under financial statism contradicts key elements of an IFC - most notably the free capital flows across borders and full currency convertibility. In China, the stringent control of capital and other red tape have segregated the city from the rest of the world and hampered its further connection to the globalised economy. In this sense, it has impeded Shanghai's transformation from a domestic financial centre to an international one.

The micro-level assessment of the SIFC's development is consistent with the meta-level analysis. The study demonstrates that Shanghai has experienced remarkable growth in terms of agglomeration of financial markets, institutions and human capital. However, the SIFC's development has also been confronted by challenges; such as the semi-closed financial markets, a shortfall of international players, incompetency of financial innovation etc. There is also compelling evidence that the progress of the SIFC's development at micro-level has been closely related to various conditions at macro, meso and meta levels, on which China's financial statism has a direct impact. The study thus posits that the mechanisms for shaping a domestic financial centre are different from those employed to develop an international one. The former favours more state intervention whilst the latter favours a more open and liberalised market system, particularly at the meta-level.

The case study of Shanghai also shows that China's financial statism was not constant throughout the SIFC's development. Chapter 8 explores the recent evolutions of financial statism after China's accession to the WTO in 2001. The study references the new round of financial reforms carried out by the state in the aftermath of WTO entry, including the diversification of ownership in state banks, the gradual liberalisation of interest rates and the internationalisation of the Renminbi. These reforms indicate that the Chinese state has taken steps to withdraw financial statism amid changes to the contextual setting in recent years (see Section 8.2). In this respect, the Chinese state is well underway towards transforming Shanghai into an international financial centre. Figure 10.1 depicts how financial statism serves as the scaffolding in transforming a domestic financial centre into an international financial centre in Shanghai.

Figure 10.1: Financial statism as the scaffolding for SIFC development in China



Source: Author

Overall, the case of Shanghai provides an example of how financial statism might be used as an alternative interventionist approach to IFCs' development. Over the past couple of decades, financial statism has successfully transformed Shanghai into a domestic financial centre during the nascent stages of China's financial development. The scaffolding metaphor shows what is implicit, but not explicitly articulated, in the SIFC's development.

The strengths and Limitations of the Scaffolding Metaphor

The scaffolding metaphor is useful for enriching our understanding of the appropriate role of the state in IFCs' development.

The first strength of the metaphor is that it is different from the gradualist approach favoured by a large number of scholars and commentators in development studies. The gradualist approach highlights the pace of the liberalisation while the scaffolding metaphor of financial statism emphasises the role of the state in development. In vying for IFC status, developing countries are not only confronted with internal problems such as institutional weaknesses, market deficiencies, governance failures and brain drain, they also face intense competition from foreign counterparts (see Chapter 4). These idiosyncrasies act as pre-existing, structural conditions for IFCs' development, which exert strong influences on the role of the state in the course of such development. The scaffolding metaphor suggests that when advanced market institutions are not in place and effective market mechanisms have yet to be established, the state must step in if it is in a position to do so. More importantly, the state acts deliberately to alter rather than simply react to pre-existing structural conditions.

The second point to consider is IFCs' development in developing countries should not be seen as an end in itself, but rather an instrument to enhance the entire economy. Ostensibly, such financial statist policies contradict the key ingredients of IFCs' development but there are plenty of reasons why developing countries should follow this path. In the case of Shanghai, the central government applied dominant state ownership and restricted market entry to the financial markets to channel financial resources to strategic sectors. At meso-level, the state played a key role in determining the timing, pace and sequencing of market reform and liberalisation in order to mediate the global-local nexus. At the meta-level, the state managed to impose control on capital flows and currency convertibility to reflect the chasm in institutional and market efficiencies between advanced economies and the developing world. All of these efforts were for the ultimate purpose of sustaining political stability and creating economic growth. As far as the Chinese state is concerned the SIFC's development must serve the needs of the real economy, i.e. industry and commerce. In this respect, China's bid for an IFC is part of its development strategy that plays an integral role for national interests and economic growth. In other words, financial statism has had very clear goals that make national economic growth and social stability a priority. This was essential to ensure that IFCs' development was a developmental strategy for developing countries, rather than an instrument of imperialist control by the developed world. During this process, the state acted as a strategic planner and policy coordinator, deciding the tempo and space of the development process based on domestic and international conditions. Only in this way, can IFCs' development be viewed as a means to attain financial and economic development for developing countries.

Thirdly, the scaffolding metaphor also suggests state intervention in IFCs' development is bi-directional rather than uni-directional. At the nascent stage, state intervention can be exerted via stringent controls on ownership, interest rates, capital mobility etc. When the external conditions have changed and market mechanism and institutions have been established, the state should be alert to deregulate and liberalise financial markets and the system under which they operate. If market mechanisms have been able to take hold, then the process of IFCs' development will be more self-reinforcing and self-sustaining. In other words, central government should be responsible for establishing and removing the scaffolding according to internal and external conditions. Certainly, progress is rarely linear or continuous. It is also worth noting that establishing scaffolding can be recursive, especially when the building becomes damaged and needs to be overhauled. That is to say, when a financial crisis occurs or the economy is paralysed, the state should step back in and reconfigure the financial system.

Finally, the scaffolding metaphor gives some hints for dealing with the dual nature of the state. The state often confronts a series of dilemmas. On the one hand, it requires centralised policy coordination to maintain social stability; on the other hand, it needs decentralised capacities for gathering information and fulfilling policy goals in various social settings. It requires financial ownership to enhance capital accumulation and foster national champions so as to strengthen state capacity but it also needs to promote the participation of the private sector and to boost economic efficiencies. It requires direct control measures to maintain economic sovereignty but it also needs to ensure capital mobility and liquidity to connect with the international community in the globalised world. The scaffolding metaphor provides a vivid description for the role of the state in IFCs' development, particularly for large, fast-growing economies.

The scaffolding metaphor also has its limitations. Firstly, it does not address the question of what kind of role the state should take to develop an IFC in developing countries. The role of the state can be as an active planner, implementer, as well as facilitator, regulator and coordinator; it all depends. We should adopt appropriate policies subject to the context of different countries and their developmental stages. States are not generic and state intervention can only be determined in the concrete historical, institutional and geographical context (Chang, 2003). The financial statism approach in this thesis might provide a recipe of interventionist policies that LDCs can pick up in accordance with their own needs.

The metaphor also emphasises the pace, tempo and sequencing of IFCs' development but it is incapable of setting a unified development agenda. Institutional change has to be implemented at a measured pace set by the state to ensure fiscal, financial and resource sustainability. Dai Xianglong, the ex-governor of PBoC, said in World Economic Forum in 2012:

> The timetable of financial reforms cannot be pre-determined like a train schedule since they would be frequently influenced by various economic and financial settings, both global and domestic.

Moreover, financial statism might be suitable for certain developing countries but it is far from a universal model suitable for all developing countries. In this thesis, financial statism as scaffolding is embedded in China's unique political, economic and historical contextual setting. To what extent financial statism approach can be replicated in other large emerging economies remains an unsettled question.

10.2 Policy Recommendations for Late-developing-countries

Given that the financial sector is a "lubricant for the main engine of growth" (Stiglitz et al. 1993), it is well-accepted that developing countries should strive to modernise their financial services and build their own international financial centres. Compared with developed countries, emerging economies are often confronted by undeveloped financial markets, poor regulation, insufficient financial professionals and immature financial instruments. These are obvious obstacles for them to build their own financial centres. However, sophisticated financial institutions and markets rarely spring up automatically. Moreover, given the nature of the evolutionary process, there is no guarantee that a laissez-faire approach will in fact yield the best possible institutions (Chang 2002, p.70) . Even though some of them might turn up spontaneously through institutional evolution, it is likely be too lengthy and costly for developing countries to obtain.

While China's unique contexts are not entirely duplicable, some aspects might be helpful to other emerging economies.

First of all, financial statism should be understood as state-led marketisation/modernisation process implemented by well-designed, restricted state intervention, which is totally at odds with the "command and control" planned economy. As seen in the case of Shanghai, financial statism was used to strengthen the competitiveness of the real economy in an increasingly globalised world. State banks provided policy loans to support SOEs in the course of economic transition. This helped China to carry forward further marketisation while maintaining relative social stability and economic growth. Besides, we need to cast aside the biased views that state ownership will always lead to low efficiency. Through establishing good corporate governance and introducing competition, state banks and other SFIs can be compatible with a market system.

Meanwhile, working out a systematic and practical strategy is crucial for late-developing-countries to catch up with developed countries in IFCs' development. Developing the international financial centre is a multi-scalar and comprehensive project. A sound strategy is beneficial for developing countries to gain the "advantages of backwardness" (Lin 2004). When drawing up a strategic plan, late-developing-countries are encouraged to learn from developed countries. However, special attention should be drawn to policies and practices these countries adopted when they were in the course of development. Late-developing-countries should be alert to the dual nature of IFCs' development, i.e. a developmental strategy for emerging economies as well as an instrument of imperialist control by developed countries. In this manner, developing countries are able to choose an appropriate approach to maximise the benefits to their national interests.

At macro-level, the IFCs' development should first serve the real economy and accommodate economic conditions at both home and abroad. During the IFCs' development, it is crucial to balance social stability and economic development. In developing countries, there often have various social problems, such as urban poverty, unemployment, deterioration in environmental conditions etc. Sometimes the maintenance of a stable macroeconomic and social environment is perhaps even more important than improving efficiencies in an individual industrial sector. Without political and social stability it is unlikely economic growth can be attained, let alone the building of a premier international financial centre. Therefore, developing countries should not only formulate economic and financial policies based on hitherto conventional theories and concepts. In certain circumstance, financial statism might be a viable option.

In addition, an enticing urban and business environment is vital for hosting an IFC. At the nascent stage of an IFC's development, state-led investment is beneficial to upgrade urban infrastructure and the business environment through large-scale investment. A developing country in transition, where market mechanisms are not yet in place, requires selective intervention by the state to speed up institutional and physical infrastructure. With the support of various interventionist policies, developing countries could improve their market infrastructure in a more efficient and effective way by, for example, market entry restrictions, control of interest rates and even direct government subsidies.

At the meta-level, capital controls are necessary at the initial stages of an IFC's development. For late-developing countries, IFCs' development is a process of modernising a financial sector and connecting to the global network. Yet financial deregulation and liberalisation can cause overwhelming risks, especially when necessary institutions are not prepared and prudent regulation and supervision are not properly developed (Demirgüç-Kunt and Detragiache 1999). For example, it is claimed South Korea suffered most in the Asian Crisis not because it deviated too much from the free market but because it had abandoned too much of its developmental capacity (Weiss 1999; Chang et al 1998).

It is also important to bear in mind that financial statism needs to be withdrawn with the advancement of the market system. It is particularly important for the state to transform its role from setting up a market system to regulating and supervising it. If it is not transformed in a timely manner, it risks undermining its competitiveness. Meanwhile, the state needs to be cautious about the sequence, tempo and pace of financial liberalisation. Usually, external liberalisation should follow internal marketisation; current account liberalisation should precede capital account liberalisation. Developing countries should first establish a solid and liquid market system in their domestic financial markets, e.g. the liberalisation of interest rates and allowing private capital to access the financial industry before opening it up further to foreign investors.

Can the state provide an adequate policy framework to fast-track an IFC development agenda? This is far from a simple yes or no answer. It is reckless to analyse the formation of IFCs without considering their special individual contextual settings. I would argue that for LDCs the approach to developing financial markets depends on a country's current capacity and institutional environments. In a country with well-established market institutions, it is viable to choose a market-oriented approach but in a country with high administrative capacity stock it may be more efficient to choose a state-led approach, especially at the early stages of development.

Finally, there is no one-size-fits-all model to prompt IFCs' development in every country at every time. States differ in political, historical and cultural legacies and these differences shape their ability to operate both at home and within the world system. The same government action may succeed in facilitating IFC development in certain conditions but may fail under others. Different ideological approaches and state-market relationships have resulted in dissimilar development outcomes among nation states because each one has its own national embeddedness (Evans 1995).The need to analyse states in relation to political and socio-economic contexts has been widely illustrated in the present research on the evolution of IFCs. Therefore, we must be cautious to adopt a single model of development drawing from the experience of a few industrial countries. In the words of Fang Xinghai:

> When we evaluate a developmental model, it is senseless to assert that one particular approach is perfect. Central to this subject is an assurance that the ruling party is able to let their people share the benefits of economic growth, while not merely empathising with the public（Fang 2013）.

10.3 Future Research Areas

There are still a number of issues I have not elaborated upon in this thesis due to the limited resources and time constraints.

One of the under-examined issues concerns the legal system and legislation, which are also essential to the IFCs' development (Arner 2009). In developing countries such as China, not only markets and institutions tend to be underdeveloped, but also laws and regulations (Allen et al 2005; Zhao 2013). They are often not transparent and apt for the market economy. Different laws and regulatory systems also have different impacts on the IFCs' development, which needs further investigation in future studies. Meanwhile, since the development of Shanghai as an international financial centre is still underway, the conclusions drawn from the case study are generally provisional. Further investigation and surveys are needed to give an overall picture of its development.

It would also be meaningful to conduct a comparative study among different emerging economies (e.g. BRICs) to explore the roles of the state in developing their international financial centres. It would be also interesting to explore whether other developing countries have also imposed similar controls over their financial sectors during the development process in a similar vein to financial statism in China.

Aside from IFCs' development, financial statism might also be applied as an alternative interventionist approach in dealing with other development issues. For example, in the recent debt crisis in the European Union, the Greek government was in heavy debt and confronted serious challenges in political and social stability as well as economic growth. Extrapolating from the Chinese experience, selective state intervention such as nationalising commercial banks, capital control regimes and financial restraint policies could have been considered as scaffolding to overhaul that country’s financial system and to help other, similarly highly-indebted countries to get through the crisis.

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Appendix 1 Chronology of SIFC Development (1990-2012)

Year	**Contents**
1990 (December)	Shanghai Stock Exchange incorporated
1992	The first B share – *ZhenKong Dianzi* – was listed on the Shanghai Stock Exchange
1992	Four foreign insurance companies including AIG, started to set up branches in Shanghai
1992 (October)	The 14^{th} CCP Party Congress announced "the building of Shanghai into an international economic, financial and trading centre".
1992 (October)	Shanghai Pudong Development Bank established
1992 (December)	T-bond futures transactions launched
1994 (April)	China Foreign Exchange Trading Centre Launched in Shanghai
1994	Unification of exchange rate
1996	Law of Negotiable Instruments Enacted
1996	Restriction of interbank lending rate relaxed
1996 (January)	National Interbank Market launched in Shanghai
1996 (December)	Qualified foreign institutions were allowed to conduct Renminbi business in Pudong
1997	National Interbank Bond Market established in Shanghai
1997	Renminbi exchange rate pegged to US dollar
1998 (December)	The Securities Law promulgated
1999 (December)	Shanghai Metal Exchange, Shanghai Commodity Exchange and Shanghai Cereal and Oil Exchange merged into Shanghai Futures Exchange
2000 (October)	Shanghai Diamond Exchange launched
2001 (February)	Domestic residents permitted to trade B shares
2001 (March)	China Security Registration and Clearing Company launched in Beijing, establishing two branches in Shanghai and Shenzhen
2001	China joins World Trade Organization
2002 (October)	Shanghai Gold Exchange launched
2002	Qualified Foreign Institutional Investor (QFII) scheme launched
2003	CBRC branches off from PBoC
2004 (June)	Law of Securities Investment Fund enacted
2005 (April)	CSRC initiated reform of non-tradable shares
2005 (July)	Renminbi abandoned the peg to US dollar and was transformed to a managed-floating regime based on a basket of currencies
2005 (August)	PBoC, Shanghai headquarters established
2006	Wholly foreign-owned insurance brokerage companies allowed
2006 (February)	Interest Swaps launched

2006 (June)	Qualified Domestic Institutional Investors (QDII) scheme launched
2006 (September)	China Financial Futures Exchange launched in Shanghai
2007 (January)	Shanghai Interbank Offered Rate (SHIBOR) established
2009 (April)	State Council released Double-Centre plan
2009 (July)	Pilot scheme for Renminbi cross-border settlement announced
2009 (September)	First Renminbi sovereign bond issued by Ministry of Finance (MOF)
2009 (November)	Shanghai Clearing House launched
2010 (April)	Stock Index Futures launched in CFFE
2010 (from May to October)	Shanghai hosts World Exposition
2010 (August)	Foreign financial institutions permitted to invest in Interbank Renminbi market
2010(September)	Offshore institutions permitted to open RMB settlement accounts
2010 (October)	Renminbi cross-border settlement scheme extended to the whole country
2011 (January)	Chinese firms allowed to conduct overseas direct investment (ODI) in Renminbi
2011 (December)	National Development and Reform Commission (NDRC) releases the 12th five-year (2011-2015) plan for Shanghai's IFC development
2012 (March)	Bank of China relocates its Renminbi business headquarters to Shanghai
2012 (April)	World Bank permitted to participate in China's inter-bank bond market

Source: complied by the author

Appendix 2 Tables and Figures

Table A1: China's fiscal revenue and household deposits (1978-2010)

Year	BR RMB billion	EBR RMB billion	BR/GDP %	(BR+EBR)/ GDP (%)	HD RMB billion	HD/GDP %
1978	113	35	31	40.6	21	6
1980	116	56	26	37.8	40	9
1985	200	153	22	39.2	162	18
1990	294	271	16	30.2	712	38
1991	315	324	14	29.3	924	42
1992	348	386	13	27.3	1,176	44
1993	435	143	12	16.4	1,520	43
1994	522	186	11	14.7	2,152	45
1995	624	241	10	14.2	2,966	50
1996	741	389	10	15.9	3,852	55
1997	865	283	11	14.5	4,628	59
1998	988	308	12	15.4	5,341	64
1999	1,144	339	13	16.5	5,962	67
2000	1,340	383	14	17.4	6,433	66
2001	1,639	430	15	18.9	7,376	68
2002	1,890	448	16	19.4	8,691	73
2003	2,172	457	16	19.3	10,362	77
2004	2,640	470	17	19.4	11,956	75
2005	3,165	554	17	20.1	14,105	77
2006	3,876	641	18	20.9	16,159	75
2007	5,132	682	19	21.9	17,253	65
2008	6,133	662	20	21.6	21,789	69
2009	6,852	641	20	22.0	26,077	76
2010	8,310	579	21	22.2	30,330	75

Note: BR: Budgeted Revenue
EBR: Extra-budgetary Revenue
BR/GDP: Budgeted-Revenue-to-GDP Ratio
HD: Household Deposits
HD/GDP: Household Deposits to GDP Ratio
Source: China Financial Statistics Yearbook 2012, the Ministry of Finance website

Table A2: One-year deposit and lending rate set by the PBoC (1990-2010)

Year	One-year Lending Rate (%)	One-year Deposit rate (%)	Interest Margin (Percentage points)
1990	9.36	8.64	0.72
1991	8.64	7.56	1.08
1992	8.64	7.56	1.08
1993	10.98	10.98	0.00
1994	10.98	10.98	0.00
1995	10.98	10.98	0.00
1996	10.08	7.47	2.61
1997	8.64	5.67	2.97
1998	6.39	3.78	2.61
1999	5.85	2.25	3.60
2000	5.85	2.25	3.60
2001	5.85	2.25	3.60
2002	5.31	1.98	3.33
2003	5.31	1.98	3.33
2004	5.58	2.25	3.33
2005	5.58	2.25	3.33
2006	6.12	2.52	3.60
2007	7.47	4.14	3.33
2008	5.31	2.25	3.06
2009	5.31	2.25	3.06
2010	5.81	2.75	3.06

Source: China Statistical Yearbook 1996-2011

Table A3: Shanghai's GDP and financial services output 1990-2012

Year	Nominal GDP (RMB billion)	GDP Growth Rate %	Financial Services Industry RMB billion	Financial Output Share of GDP (%
1990	78.2	3.5	7.1	9.1
1991	89.4	7.1	8.3	9.3
1992	111.4	14.8	9.9	8.9
1993	151.9	15.1	14.1	9.2
1994	199.1	14.5	21.5	10.8
1995	249.9	14.3	24.5	9.8
1996	295.8	13.1	34.8	11.8
1997	343.9	12.8	46.0	13.4
1998	380.1	10.3	51.2	13.5
1999	418.9	10.4	57.8	13.8
2000	477.1	11.0	60.3	12.6
2001	521.0	10.5	62.0	11.9
2002	574.1	11.3	58.5	10.2
2003	669.4	12.3	62.5	9.3
2004	807.3	14.2	74.2	9.2
2005	924.8	11.4	67.5	7.3
2006	1057.2	12.7	82.5	7.8
2007	1249.4	15.2	120.9	9.7
2008	1407.0	9.7	141.4	10.1
2009	1504.6	8.2	180.4	12.0
2010	1716.6	9.9	195.1	11.4
2011	1919.6	8.2	227.7	11.9
2012	2018.2	7.5	245.0	12.1

Source: Shanghai Statistics Yearbook 2011

Table A4: China's position in merchandise import and export in 2010

	Merchandise export		Merchandise import		
	USD billion	Share, %		USD billion	Share, %
China	1578	10.4	USA	1969	12.8
USA	1278	8.4	China	1395	9.1
Germany	1269	8.3	Germany	1067	6.9
Japan	770	5.1	Japan	694	4.5
Netherlands	573	3.8	France	606	3.9
France	521	3.4	UK	560	3.6
Korea	466	3.1	Netherland	517	3.4
Italy	448	2.9	Italy	484	3.1
Belgium	412	2.7	Hong Kong	442	2.9
UK	406	2.7	Korea	425	2.8
World total	15,237	100	World total	15,402	100

Source: WTO (2011)

Table A5: Mainland China's position in FDI inflows and outflows in 2009

	FDI inflows USD billion	Share %		FDI outflows USD billion	Share %
USA	130	11.7	USA	248	22.5
China	95	8.5	France	147	13.4
France	60	5.4	Japan	75	6.8
Hong Kong	48	4.3	Germany	63	5.7
UK	46	4.1	Hong Kong	52	4.7
Russia	39	3.5	China	48	4.4
Germany	36	3.2	Russia	46	4.2
Saudi Arabia	36	3.2	Italy	44	4.0
India	35	3.1	Canada	39	3.5
Belgium	34	3.1	Norway	34	3.1
World total	1,114	100	World total	1,101	100

Source: UNCTAD (2010)

Table A6: Market share of state bank assets in total banking institutions (1983- 2011)

Year	Total Banking Assets RMB billion	Large State Banks (LSB) RMB billion	Share of LSB %
1983	396	396	100
1990	2,896	2,788	96.3
1995	6,422	4,436	69.1
1996	7,903	5,227	66.1
1997	9,501	5,890	62.0
1998	11,042	7,041	63.8
1999	12,323	7,926	64.3
2000	13,548	9,296	68.6
2001	15,487	10,104	65.2
2002	18,403	13,550	73.6
2003	27,658	16,051	58.0
2004	31,599	17,982	56.9
2005	37,470	21,005	56.1
2006	43,950	24,236	55.1
2007	52,598	28,007	53.2
2008	62,388	31,836	51.0
2009	78,769	40,089	50.9
2010	93,125	46,804	50.3
2011	110,680	53,634	48.5

Source: Wang (2008), CBRC Annual Report 2009-2011

Table A7: China's overall financial Development (1978-2010)

Year	GDP RMB trillion	M2 RMB trillion	M2/GDP %
1978	0.36	0.12	32
1980	0.45	0.18	41
1985	0.90	0.55	61
1986	1.03	0.71	69
1987	1.21	0.88	73
1988	1.50	1.08	71
1989	1.70	1.27	75
1990	1.87	1.53	82
1991	2.18	1.94	89
1992	2.69	2.54	94
1993	3.53	3.49	99
1994	4.82	4.69	97
1995	6.08	6.08	100
1996	7.12	7.61	107
1997	7.90	9.10	115
1998	8.44	10.45	124
1999	8.97	11.99	134
2000	9.92	13.46	136
2001	10.97	15.83	144
2002	12.03	18.50	154
2003	13.58	22.12	163
2004	15.99	25.41	159
2005	18.49	29.88	162
2006	21.63	34.56	160
2007	26.58	40.34	152
2008	31.40	47.52	151
2009	34.09	60.62	178
2010	40.12	72.58	181

Source: Chinese Statistic Yearbook 2011, Wang 2008

Table A8: The market capitalization and fund raising in SSE(1990-2011)

Year	SSE-Market Cap RMB billion	National Share* %	SSE-Fund raising through Share RMB billion	National Share* %
1990	1	N.A.	1	N.A.
1991	3	N.A.	0	N.A.
1992	56	53	5	54
1993	221	62	11	29
1994	260	70	17	51
1995	253	73	6	49
1996	548	56	21	60
1997	922	53	47	51
1998	1,063	54	38	47
1999	1,458	55	49	54
2000	2,693	56	92	60
2001	2,759	63	96	81
2002	2,536	66	61	79
2003	2,980	70	56	68
2004	2,601	70	46	53
2005	2,310	71	29	86
2006	7,161	80	171	70
2007	26,984	82	681	88
2008	9,725	80	224	63
2009	18,466	76	334	66
2010	17,901	67	553	58
2011	14,838	69	320	42

*Note: H share is not included in the calculation
Source: Yearbook of Shanghai 1996-1997, Yearbook of China's Securities and Futures Market 2011, Yearbook of Shanghai Stock Exchange

TableA9: Market share of bond market in SSE (1996-2011)

Year	SSE-Listed Numbers	National-Listed Numbers	National Share %	SSE-Trading Turnover RMB, billion	National-Trading Turnover RMB, billion	National Share %
1996	24	43	56	1740	1804	96
1997	22	42	52	1,540	1,648	93
1998	20	39	51	2,127	2,166	98
1999	23	43	53	1,745	1,828	95
2000	25	46	54	1,690	1,912	88
2001	31	54	57	1,979	2,042	97
2002	39	74	53	3,085	3,325	93
2003	65	115	57	6,160	6,214	99
2004	90	155	58	5,000	5,032	99
2005	165	245	67	2,814	2,837	99
2006	196	289	68	1,813	1,828	99
2007	198	299	66	2,040	2,067	99
2008	225	356	63	2,809	2,860	98
2009	411	648	63	3,981	4,064	98
2010	536	822	65	7,491	7,621	98
2011	680	1,014	67	21,072	21,635	97

Source： Yearbook of China’s Securities and Futures Market 2011

Table A10: The turnover of commodities in Shanghai Futures Exchange (2000-2010)

Year	Trading Turnover RMB, trillion	National Share (%)	Trading Volume, #Contracts, million	National Share (%)
1999	0.49	21.97	6.83	9.28
2000	0.67	41.43	8.25	15.11
2001	0.85	28.34	11.22	9.31
2002	1.64	41.53	24.35	17.46
2003	6.05	55.85	80.16	28.64
2004	8.43	57.39	81.15	26.55
2005	6.54	48.64	67.58	20.93
2006	12.61	60.03	116.21	25.85
2007	23.13	56.45	171.13	23.49
2008	28.87	40.15	280.53	20.57
2009	73.76	56.51	869.73	40.31
2010	123.48	54.40	1,243.80	40.89

Source: Yearbook of China's Securities and Futures Market 2011, Shanghai Futures Exchange website

Appendix 3 Implementation Guidelines for SIFC Development by 2020

Theme 1. strengthening financial markets	
Tasks	Key Points
1.1 Expand the breadth of financial markets	• Build Shanghai into a national clearance centre for bills exchange • Develop credit loan transfer market • Explore the establishment of other markets, including insurance policy and trust asset transfer
1.2 Expedite bond markets development	• Improve the market-maker system • Allow listed commercial banks to enter SSE bond market • Promote the connection and communication between bond exchange market and inter-bank market
1.3 Boost futures markets development	• Support new futures products such as crude oil, gasoline, diesel oil and asphalt etc • Promote new option products, such as copper and aluminium; • Introduce new futures products such as lead, silver as well as commodity index futures • Undertake delivery of futures products in the bonded area of customs • Introduce qualified institutional investors into futures market
1.4 Improve the multi-layered capital markets system	• Explore the transfer of listed companies among different boards at exchange markets • Increase industry coverage of listed companies on the main board of SSE • Establish an over-the-counter equity market for high-tech companies
1.5 Develop reinsurance markets	• Develop domestic invested and Sino-foreign joint venture reinsurance companies • Attract renowned reinsurance agencies at home and abroad • Foster reinsurance brokers • Develop offshore reinsurance business
Theme 2. Strengthening financial institutions	
Tasks	Key Points
2.1 Boost the development of various financial	• Strengthen policy supports for the development of banks, security firms, insurance companies and trust

institutions	companies • Promote development of investment banks, fund management companies, assets management companies, money brokerage companies, financial leasing companies and auto financing companies etc
2.2 Promote pilot programmes for integrated operations	• Attract financial holding groups to Shanghai • Establish financial supervisory and coordination mechanisms
2.3 Promote the reform and restructure of local financial SOEs	• Encourage reform and restructure of local state-owned financial firms • Foster and attract financial firms with national influence
2.4 Encourage the development of equity investment funds	• Encourage equity investment from overseas PEs; • Encourage the set-up of qualified foreign limited partnership schemes.

Theme 3. Accelerating financial innovations and business development

Tasks	Key Points
3.1 Boost the development of various debt instruments	• Expand the issuance of corporate bonds • Develop asset-backed securities • Carry out pilot scheme of revenue bonds • Carry forward foreign currency bonds and others bonds
3.2 Steadily develop various financial derivative products	• Roll out financial derivatives e.g. stock index futures, treasury bond futures, foreign exchange futures, stock index options, interest rate options and gold ETFs etc. • Improve SHIBOR as benchmark interest rate • Foster various derivatives using this pricing benchmark
3.3 Pioneer the pilot programmes for tax-deferred pension products	• Introduce pilot programmes for tax-deferred pension products • Formulate relevant rules and procedures for tax-deferred pension products
3.4 Support the M &A funding of commercial banks	• Encourage commercial banks to increase loan-lending for M&A activities • Encourage cooperation among commercial banks, securities firms and trust companies regarding M&A funding
3.5 Expand the types of financial services	• Promote business development such as private banking, broker direct investment, offshore financing, trust leasing, automobile financing etc • Introduce new mechanisms for hi-tech loans

	• Improve IPR pledge financing • Carry out insurance policy credit financing, SMEs network joint guarantee loans, and special asset management business etc.

Theme 4. Steadily opening up financial markets

Tasks	Key Points
4.1 Promote the further opening up of financial markets	• Expand overseas investment in Shanghai's financial markets • Encourage offshore Renminbi investment in domestic market • Expand QFII quota • Introduce QFII to Shanghai's futures markets • Expand issuance of Renminbi-denominated bonds by international development agencies, foreign incorporated banks and other qualified overseas institutions • Support the introduction of an international board on SSE
4.2 Support the business expansion of existing joint ventures in Shanghai	• Increase the number of joint-venture securities firms based in Shanghai • Encourage the establishment of subsidiaries for joint-venture fund management companies
4.3 Explore the cooperation between Shanghai and Hong Kong on securities products	• Strengthen cooperation with Hong Kong United Exchange; • Roll out Hang Seng Index ETF, SOEs ETF and red-chips index ETF in SSE

Theme 5. Improving the financial system

Tasks	Key Points
5.1 Improve modern financial support systems	• Form a unified backstage support system of registration, trust, clearance and settlement • Establish a cross-boarder payment and clearance system for Renminbi-denominated trading • Establish a national trust registration system • Prepare for the opening of the Shanghai Clearance Co. Ltd
5.2 Strengthen the planning and development of various financial zones	• Lujiazui Financial City • The Bund Financial Belt • Zhangjiang Industrial base of financial information services • YangShan bonded port area etc.

5.3 Accelerate the development of financial intermediaries	• Financial guarantee institutions • Financial advisory firms • Credit ratings' agencies • Appraisal, accounting and legal services
5.4 Facilitate the development of a financial information services platform	• Facilitate the development of a financial services platform • Support domestic financial information service providers
5.5 Optimise the growth environment for the financial industry	• Improve taxation for the financial industry and overall legal system • Optimise the legal environment • Strengthen the development of a social credit system • Improve the policies and mechanisms for financial innovations • Improve the regulatory framework • Maintain the stability and security of the financial system

Source: Adapted from Shanghai Municipal Government Website, www.shanghai.gov.cn

Appendix 4 The Indicator System for GFCI 15

Areas of Competitiveness	Instrumental factor	Source
1. Human Capital	Graduates in Social Science Business and Law	World Bank
	Gross Tertiary Education Ratio	World Bank
	Visa Restrictions Index	Henley & Partners
	Human Development Index	UNDP
	Citizens Purchasing Power	City Mayors
	Quality of Living Survey	Mercer HR
	Happy Planet Index	New Economics Foundations (NEF)
	Number of High Net Worth Individuals	City Bank & Knight Frank
	Personal Safety Index	Mercer HR
	Homicide Rates	UN Office of Drugs and Crime
	World's Top Tourism Destinations	Euromonitor Archive
	Average Days with Precipitation per Year	Sperling's Best Places
	Spatial Adjusted Livability Index	EIU
	Human Capital	EIU
	Global Talent Index	EIU
	Citywide CO2 Emissions	Carbon Disclosure Project
	Healthcare	EIU
	Global skill Index	Hays
2. Business Environment	Business Environment	EIU
	Ease of Doing Business Index	World Bank
	Operational Risk Rating	EIU
	Real Interest Rate	World Bank
	Projected City Economic Growth	PWC
	Global Services Location Index	AT Kearney
	Corruption Perceptions Index	Transparency International
	Wage Comparison Index	UBS

	Corporate Tax Rates	PWC
	Employee Effective Tax Rates	PWC
	Personal Tax Rates	OECD
	Total Tax Receipts (as % of GDP)	OECD
	Bilateral Tax Information Exchange Agreements	OECD
	Economic Freedom of the World	Fraser Institute
	Banking Industry Country Risk Assessments	Standard & Poors
	Government Debt as Percentage of GDP	CIA World Fact Book
	Political Risk Index	Exclusive Analysis Ltd
	Global Peace Index	The Institute of Economics and Peace
	Financial Secrecy Index	Tax Justice Network
	Institutional Effectiveness	EIU
	City GDP Figure	Brookings Institute
	Number of Greenfield Investments	KPMG
	Open Government	The World Justice Project
	Regulatory Enforcement	The World Justice Project
3. Financial Sector Development	Capital Access Index	Milken Institute
	Securitization	IFS London
	Capitalization of Stock Exchanges	WFE
	Value of Share Trading	WFE
	Volume of Share Trading	WFE
	Broad Stock Index	WFE
	Value of Bond Trading	WFE
	Volume of Stock Options	WFE
	Volume of Stock Futures Trading	WFE
	Domestic Credit Provided by Banks (% GDP)	World Bank
	Percentage of Firms Using Bank Credit to Finance Investment	World Bank
	Total Net Assets of Mutual Funds	Investment Company Institute
	Islamic Finance	International

		Financial Services London (IFSL)
	Net External Position of Banks	BIS
	External Position of Central Banks (as % GDP)	BIS
	Liner Shipping Connectivity	World Bank
	Commodity Options National Turnover	WFE
	Commodity Futures National Turnover	WFE
	Global Connectedness Index	DHL
	City GDP Composition	Brookings Institutions
4. Infrastructure	Office Occupancy Costs	CBRE
	Office Space Across the World	Cushman & Wakefield
	Global Property Index	Investment Property Databank
	Real Estate Transparency Index	Jones Lang Lasalle
	Digital Economy Ranking	EIU
	Telecommunication Infrastructure Index	United Nations
	City Infrastructure	Mercer HR
	Quality of Ground Transport Network	WEF
	Quality of Roads	WEF
	Roadways per Land Area	CIA World Fact Book
	Railways per Land Area	CIA World Fact Book
	Physical Capital	EIU
	Connectivity	EIU
	IT Industry Competitiveness	BSA/EIU
	Energy Sustainability Index	World Energy Council
	City Infrastructure	EIU
	Urban Sprawl	EIU
	Metro Network Length	Metro Bits
	Global Information Technology	WEF
	The Web Index	WWW foundation
5. Reputation and General Instrumental	World Competitiveness Scoreboard	IMD
	Global Competitiveness Index	WEF
	Global Business Confidence	Grant Thornton

Factors	Foreign Direct Investment Inflows	UNCTAD
	FDI Confidence	AT Kearney
	City to Country GDP Ratio	World Bank, PWC
	GDP per Person Employed	World Bank
	Global Innovation Index	INSEAD
	Global Intellectual Property Index	Taylor Wessing
	Retail Price Index	Economist
	Price Levels	UBS
	Global Power City Index	Institute for Urban Strategies & Mori Memorial Foundation
	Global Cities Index	AT Kearney
	Number of International Fairs & Exhibitions	WEF
	Innovation Cities Global Index	2thinknow Innovation Cities Project
	City Global Appeal	EIU
	Global City Competitiveness	EIU
	The Big Mac Index	The Economist
	City Global Image	KPMG
	City’s Weight in National Incoming Investments	KPMG
	Sustainable Economic Development	BCG
	Global Enabling Trade Report	WEF

Source：GFCI(2014)

Appendix 5 The Indicator System for Xinhua-Dow Jones IFCD Index

Level-1	Level-2	Level-3	Source
1.Financial Market	Capital Market	Total Value of Share Trading	WFE
		Total Value of Bond Trading	WFE
		Total Volume of Commodity futures Trading	WFE
		Total Volume of Stock Futures Trading	WFE
		Stock Market's Significance in the National Economy	WFE
		Internationalization of Securities Markets	WFE
	Foreign Exchange Market	Foreign Exchange Derivatives Turnover	WFE
		Foreign Exchange Reserves	Pinggu.org
		Exchange Rate Volatility	MasterCard
	Banking Market	Number of Major Bank	The Banker
		Major Bank Assets	The Banker
		Central Bank Assets To GDP	WFE
		Bank Assets To GDP	WFE
	Insurance Market	Insurance Premium	WFE
		Growth of Insurance Premium	WFE
		Insurance Services Level	Xinhua News Agency Global Survey Network
2.Growth and Development	Capital Market Growth	Growth Rate of New Bonds	WFE
		Growth Rate of Listed Companies	WFE
		Growth Rate of Share Trading	WFE
	Economic Growth	Five Year Average Growth Rate of GDP	Global Urban Competitiveness Project
		Three Year Average Growth Rate of Residential Income	UBS
		Three Year Average Growth Rate of General Price Index	UBS
		Growth Rate of Taxes and Social Security	UBS
	Innovation Outputs	Three Year average Growth Rate of Domestic Purchasing Power	UBS

		Added Value of High-tech Products to Added Value of Manufacturing	Centre for International Competitiveness
		Five Year Average Growth Rate of Government R&D Expenditures	Centre for International Competitiveness
		Five Year Average Growth Rate of Government R&D People	Centre for International Competitiveness
	Innovation Potential	Innovation Index	INSEAD
		Employment in High-Tech Services per 1,000 Inhabitants	Centre for International Competitiveness
		Per Capita Expenditure on R&D performed by Government	Centre for International Competitiveness
3.Industrial Support	Business Environment Support	Strength of Manufacturers	Global Urban Competitiveness Project
		Strength of Traders and Retailers	Global Urban Competitiveness Project
		Strength of IT Companies	Global Urban Competitiveness Project
		High-technology exports	World Bank
		Strength of Financial Services Providers	Global Urban Competitiveness Project
		Number of Multinational Headquarters	Global Urban Competitiveness Project
	Basic Urban Conditions	Geographical Location	Global Urban Competitiveness Project
		City Population Density	Wikipedia
		Cost of Renting Office	UBS
	Urban Infrastructure	Cargo Throughput	Global Urban Competitiveness Project
		Airline Carriers	Global Urban Competitiveness

			Project
		IT Infrastructure	World Economic Forum
4.Service Level	Government Service	Services Employment Proportion	Global Urban Competitiveness Project
		Regulatory Quality	World Bank
		Digital Governance	Global E-Government Development Report
	Intellectual Capital	Financial Services Employment Percentage	Global Urban Competitiveness Project
		Per Capita Public Expenditure on High Education	Centre for International Competitiveness
		Population Education Level	Global E-Government Development Report
		Number of Universities	Global Urban Competitiveness Project
	Urban Living Conditions	Per Capita GDP	World Economic Forum
		Cost of Living	Global Urban Competitiveness Project
		Quality of Living Index	Mercer HR
		Unemployment Rate Index	World Economic Forum
		Crime Statistics	Global Urban Competitiveness Project
5.General Environment	Economic Environment	Ease of Doing Business	World Bank
		Total Foreign Trade Volume	CIA-The World Facebook
		Consumer Price Index	IMF

		Economic Freedom Index	Fraser Institute
		Economic Extrovert Degree	World Economic Forum
	Political Environment	Happiness Planet Index	NEF
		Political Risk Index	Exclusive Analysis Ltd
		Corruption Index	Transparency International
	Openness	Social Globalization Index	KOF-Index of Globalization
		Networked Readiness Index	World Economic Forum
		Global Competitiveness Index	World Economic Forum
		Foreign Direct Investment	UNCTAD

Source: Xunhua-Dow Jones International Financial Centres Development Index 2012

Appendix 6 List of Interviewees

	Organization	Duration	Date
Interview 1	Development Research Centre, SMG	90 minutes	December 2009
Interview 2	Tongji University	60 minutes	December 2009
Interview 3	Shanghai Academy of Social Science	45 minutes	July 2010
Interview 4	Development Reform and Planning Commission, SMG	60 minutes	July 2010
Interview 5	Shanghai Jiaotong University	30 minutes	July 2010
Interview 6	Development Research Centre, SMG	60 minutes	July 2010
Interview 7	Agricultural Bank of China, Shanghai Branch	45 minutes	December 2011
Interview 8	PBoC, Shanghai headquarters	60 minutes	December 2011
Interview 9	Shanghai Stock Exchange	60 minutes	December 2012
Interview10	Shanghai Financial Services Office	60 minutes	December 2012
Interview 11	Shanghai Tongji University	60 minutes	September 2013
Interview 12	Shanghai University of Finance and Economics	60 minutes	September 2013
Interview 13	Shanghai Academy of Social Science	60 minutes	January 2014

Appendix 7 List of Semi-Structured Questionnaire

General Judgement

- What do you think of SIFC development in the past 20 years? Has it been successful or not?
- Do you think the SIFC's development in the past 20 years was state-led or market-driven? Why?

Financial Statism

- Do you think financial statism is a good description of China's financial sector during past two decades?
- Why did the central government remain stringent controls over the financial sector in the 1990s? Do you think it was a blessing or a curse?
- What was the impact of state-ownership in banking and other financial firms on SIFC development?
- What are the underlying reasons for interest rate control, particularly for deposits and lending?
- What were the roles of the state (central and local government respectively) in the SIFC development?
- Were there any disagreements or tensions between central and local government in terms of formulating financial policies to promote the SIFC? How did they deal with them?

Evaluation of the SIFC

- What do you think of the development of China's stock market in Shanghai? Why has it been so volatile in the past two decades?
- Why did China have a dual system of tradable and non-tradable shares at early stages of stock market development?
- What do you think of the recent boom in the bond market? What is the underlying reason for this?
- What are the key challenges for the SIFC in transforming into an international financial centre?

- Comment on Shanghai's "soft amenities" to attract financial talents.
- What are the key measures that the Shanghai Municipal Government has taken to attract financial expatriates?
- Will the re-emergence of Shanghai as an international financial centre undermine the current position of Hong Kong?

Recent Changes and Tendencies

- Have the growing numbers of foreign-invested financial firms threatened domestic ones following China's WTO entry in 2001? Why?
- What do you think of the recent joint-stock reforms of state banks? Does this favour the SIFC's development?
- Do you think it is the right time for China to further relax its capital account controls?
- What are the underlying reasons for the state's internationalisation of the Renminbi since 2009?
- What is the impact of the internationalisation of the Renminbi on the SIFC's development?
- Has the state (both central and local) transformed their roles in developing the SIFC from 1990 to 2010?
- What are the major problems or challenges for the SIFC's development in the next decades?