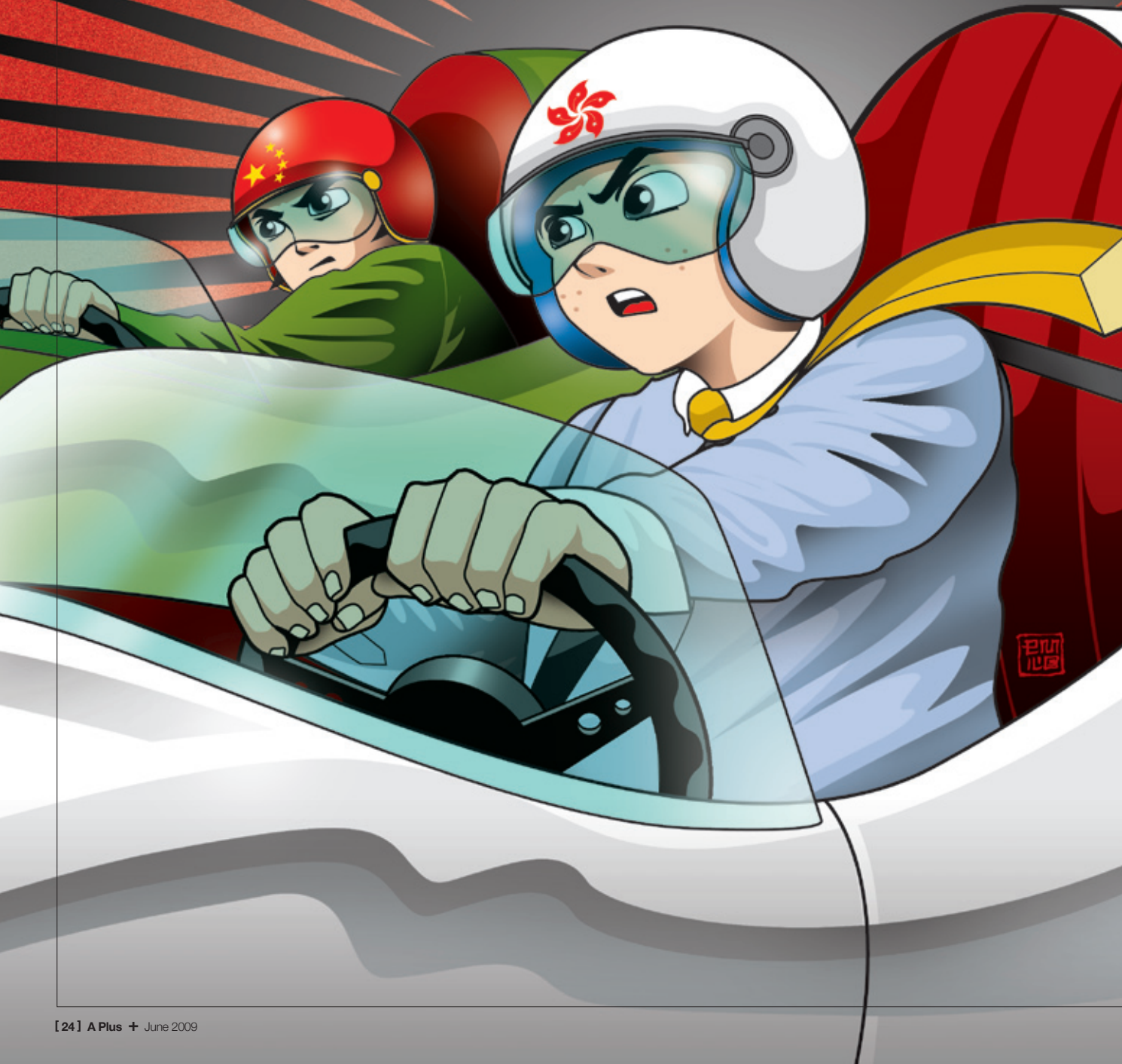


Hong Kong vs. Shanghai

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BOOM

THE RACE HAS JUST BEGUN...

Will Shanghai overtake Hong Kong as an international financial centre?

By Naomi Martig Illustrations by Emilio Rivera III and HHW

After years of pushing from mainland officials, the Chinese government announced in March plans to turn Shanghai into an international financial centre and a global shipping hub by 2020, and to gradually make the yuan fully convertible.

Liu Tienan, director-general of China's National Development and Reform Commission, held a rare news conference in Shanghai, saying the city's emergence would reflect "China's economic strength and the status of its currency."

The Shanghai Stock Exchange is wasting no time. Last month, China pledged to open the door for U.K. companies wishing to list in Shanghai, according to the *Financial Times*, without giving an exact timetable.

Regulations banning Chinese companies from listing in the U.K. are expected to be lifted within months, allowing more mainland enterprises to join 70 counterparts already listed in London before the ban was imposed.

The Chinese government has indicated that it will allow qualified foreign companies to issue A shares "at an appropriate time." Large corporations including Hang Seng Bank, The Bank of East Asia and HSBC Holdings PLC have

already expressed interest in eventually listing there.

During last month's Lujiuzui Forum in Shanghai, Tu Guangshao, the city's vice mayor, said Shanghai is also stepping up efforts to lure more talent, beef up its legal system by improving the arbitrary hearing and verdict processes of financial cases, and make Pudong a pioneer for financial reforms, the official *Shanghai Daily* reported. Xu Lin, party secretary of the Pudong New Area, told the forum that the district is preparing to establish an over-the-counter equity exchange for technology start-ups. He also said Shanghai will put trial programmes in place to settle cross-border trade using the yuan.

The multitude of announcements have stirred a raging debate in Hong Kong over whether China can successfully house two international financial centres and more importantly – whether Hong Kong can weather the increased competition.

Fortress China

Behind the walls of a closed capital account, China is withstanding the battering of the financial crisis better than most developed nations. With a slowing but expected positive GDP growth of around 7 percent this year and

its position as the export hub of Asia, many say now is prime time for China to advance its financial system, particularly as other international finance centres have taken heavy beatings.

Paul Tang, chief economist for The Bank of East Asia in Hong Kong, says a perfect example is China's push for regional neighbours to deal in yuan while the U.S. dollar declined in volatile trade. "Because the yuan exchange rate has remained stable throughout the current economic crisis, companies in the region are increasingly willing to settle in yuan," he says.

According to "Challenges Facing Hong Kong Financial Industry," a report released by the bank last month, the mainland has signed 650 billion yuan in currency swap arrangements with Hong Kong, South Korea, Malaysia, Indonesia, Argentina and Belarus since December. The agreements extend the range of options for managing each economy's reserves and open a door for settling future bilateral trade in yuan – essential as China makes its currency fully convertible.

The Chinese government will, over the next few years, internationalize the yuan and carefully set its exchange rate, says Andrew Lam, assurance partner at Grant Thornton's Hong Kong office.



“The Chinese economy still needs [to fine-tune] government policy – and being able to influence the exchange rate, the interest rate, the money supply, those are all aspects of it. The Chinese government does not have the experience to handle opening this system right away. I think it will happen in the next decade or so,” says Lam.

Shanghai’s stock market has already grown leaps and bounds. Its daily average trading volume has soared “from 20 billion yuan in 2005 to 200 billion yuan in 2009,” says Li Dapeng, chief information officer of the Shanghai Stock Exchange.

In 2007, before global markets tumbled, Shanghai’s bourse reached a total turnover of 12.8 billion yuan, an impressive year-on-year spike of 117 percent, according to the website of the state-run *People’s Daily*.

By the end of June 2008, a total of 375 foreign-capital financial institutions and Chinese-foreign joint equity financial institutions had set up headquarters or branch offices in Shanghai, accounting for nearly half (44.1 percent) of the city’s financial institutions, the paper said. Among them are 17 foreign banks and five foreign insurance companies.

Lam says Shanghai has accumulated nearly all of the ingredients needed to turn itself into an international finance centre. “They have a big hinterland, a lot of small to medium sized companies growing at a rapid pace, excellent initial public offering candidates and a swelling middle class that is likely to be future shareholders,” he says.

There are many Chinese state-owned and private enterprises ready to go to the public capital markets in the next few years, Lam says. And with a stock market that now includes bonds, currency, foreign exchanges, commodity futures, over-the-counter derivatives, gold and property, Shanghai is positioning itself to give Hong Kong a run for its money over the next decade.

One country, two systems?

A CPA and a director of three Hong Kong-listed mainland companies, who asks not to be identified, is worried that Shanghai’s rise will deal “a devastating blow” to Hong Kong and its accounting profession.

“If the government further eases restrictions for foreign investors, allowing them to buy stocks in Shanghai, and foreign enterprises can raise funds in the mainland, there is

no incentive for mainland Chinese enterprises or even foreign companies to come and list in Hong Kong in the long run.

“Companies listed in the Shanghai stock market now have a much higher valuation and price-earning ratio than those listed in Hong Kong. There is a large gap in market capitalization between the A shares and H shares of the same company,” making Hong Kong less attractive than the mainland as a fund-raising destination, the director says.

At the end of April, the average price-to-earnings ratio of all shares traded on the Hong Kong stock exchange was 11.0, as opposed to 20.2 in Shanghai and 29.7 in Shenzhen, without adjusting the currency factor.

Laurent Leung, director and head of investment banking of corporate finance firm KGI Capital Asia, says Hong Kong’s stock market has been heavily dependent on listings from mainland enterprises since 2003. “The number of H share listings had been on the rise in recent years and peaked in 2006, where 86 percent of total IPO funds raised in Hong Kong were by mainland enterprises,” he says. “Over the past two years, however, the number of mainland IPOs has been diminishing and so far this year, there has been no H share listing here.”

Leung says the central government’s policies have propped up the Hong Kong market over the past decade, but that is already changing, with Beijing wanting to see mainland enterprises raise funds in the domestic market before coming to Hong Kong.

Grant Thornton’s Lam acknowledges that Hong Kong is clearly being squeezed. “Obviously, if another big IPO comes up, [companies] now have another choice for listing and if they need to raise funds in yuan to support

their growth in China, there is a real commercial reason why they would favour a mainland listing over a Hong Kong listing.”

Not all hopes are lost, however. Alan Wong, chairman of the China Committee of the Hong Kong General Chamber of Commerce and a CPA, says facing increased competition in terms of IPOs and other financial services may not necessarily be bad for Hong Kong.

“I believe we’re looking at a cake that is going to become much bigger in terms of the development of the Chinese economy,” he says. “It’s just a different share of a bigger cake.” While Shanghai is likely to woo mainland manufacturing and port companies for listing on its exchange, experts predict that Hong Kong will get the wealth management business and multinational firms wanting to tap into the strength of the Pearl River Delta region.

Hong Kong Exchanges & Clearing Ltd. Chairman Ronald Arculli agrees. Speaking at a business forum last month, he said he believes the development of Shanghai as an international finance centre doesn’t have to be a “zero-sum game” for Hong Kong, the *Hong Kong Economic Journal* reported. China is big enough to house two international financial centres – one serving the Pearl River Delta and the other serving the Yangtze River Delta, he said.

Keith Pogson, managing partner for Ernst & Young’s Far East financial services and a council member of the Institute, says Hong Kong’s sophisticated wealth management industry will boom in the coming decade, as a growing number of wealthy mainlanders look for reliable private banking services. “Just as people elsewhere have a Swiss bank account, people in China will have a Hong Kong account,” he says.

“When you go to most economies and talk about financial services, you are talking about ATMs, credit cards,

insurance policies, fund management units and so on. That sort of wealth accumulation, combined with its technology and legal framework, has got to be a great pairing for Hong Kong,” he says.

Tang of The Bank of East Asia says it is wrong to assume Hong Kong will remain static during the next decade: “Take trading activities as an example. Sure, a lot of our seaborne trade may migrate to the mainland. But at the same time, our air cargo business may grow as the mainland is likely to still rely on our efficient airborne services.”

Still, HKEEx’s Arculli says Hong Kong needs to do an even better job at financial innovation to avoid ending up as a loser in the race.

The city is already working on that, according to Robert Partridge, managing partner for transaction advisory services

for Ernst & Young’s Far East Area.

“There is a whole community in Hong Kong that is always thinking: ‘How do we get better at this today from where we were at yesterday?’ And that alone will make it difficult for Shanghai to catch up,” he says.

China also faces the lack of a sound legal system, a competitive tax rate and a flexible currency, and until that happens, Partridge believes the mainland won’t be able to compete in financial markets on the same level.

“As long as there are organizations that want to be raising truly international capital, there is going to be a need for them to go through Hong Kong, London or New York,” adds Pogson. “And Hong Kong, I am fairly convinced, will remain the premier choice for capital raising for the Chinese community outside of China.”

Some of the largest exchanges by total value of share trading in 2007 and 2008 – in US\$ billions

Exchange	End-2008	End-2007	% Change
NASDAQ	36,446	28,116	29.6%
NYSE Group	33,639	29,210	15.2%
London Stock Exchange	6,474	10,324	-37.3%
Tokyo Stock Exchange Group	5,586	6,476	-13.7%
Euronext	4,454	5,648	-21.1%
Shanghai Stock Exchange	2,587	4,070	-36.4%
Hong Kong exchanges*	1,629	2,139	-23.8%

Some of the largest exchanges by investment flows in 2007 and 2008 – in US\$ billions

Exchange	End-2008	End-2007	% Change
Euronext **	156.7 **	NA	—
NYSE Group	151.2	137.0	10.4%
London Stock Exchange	124.6	82.8	50.5%
Hong Kong exchanges*	51.9	74.0	-29.8%
Shanghai Stock Exchange	27.6	87.2	-68.3%

* Hong Kong exchanges include the main board and the GEM board.
** For Euronext, 2008 figures are still being finalized.

Source: Statistics provided by World Federation of Exchanges



people will trust it, rely on it and be comfortable using it," he says. "If we position ourselves correctly, we should be able to benefit from what is going to happen in the next five to 10 years."

Partridge, however, cautions it may not be wise to underestimate the quality of China's accounting profession. "Take a look at the two exchanges, Shenzhen and Shanghai. Of the 1,500 companies listed on those two exchanges, less than 300 of them are audited by Big Four firms. So you have 80 percent of listed companies that are audited by local and regional firms.

"But as companies get more massive in scale and more international services are required, by simple demand you need to have more international accounting firms," says Partridge.

China's economic development is far outstripping its financial system and over the next few years, it is certain Hong Kong and Shanghai's financial professionals will be forced to deal with this. And while the sceptics are debating whether any country can successfully house two international financial centres, Tang stresses that China stopped following mainstream trends a long time ago.

"Four or five years ago, there was a conversation about how China was listing its state-owned banks. There was a gentleman who questioned: 'Quote me one example of a country that has successfully listed its state-owned banks.' Nobody even mentions that anymore.

"The point is, China has been doing so many first times and they've become an anomaly in terms of its path to progress. The dual financial system was definitely not proposed because it is looking down in history, but because it is looking forward," he says. **A+**

— Additional reporting by Helen Luk and Vincent Lam

During a visit to Hong Kong last month, Xu Lin, head of the Department of Fiscal and Financial Affairs at the National Development and Reform Commission, which sets policies for China's economic and social development, agreed the city doesn't have to worry about competition from Shanghai because the latter still lags far behind in terms of the number of financial institutions and financial talent, the *Hong Kong Economic Journal* reported.

Indeed, Shanghai still has some way to go. In terms of total capital raised from IPOs, the Hong Kong stock exchange raised US\$4.8 billion between January and November last year, while Shanghai only raised US\$9 million, according to Ernst & Young's 2008 global IPO update released in December.

Hong Kong also stands to benefit from the development of China's currency reform. The Chinese government recently announced mainland subsidiaries of Hong Kong banks will soon be able to issue yuan-dominated bonds and the territory

will become the first outside of the mainland to settle trade in yuan.

"Mainland exports to Hong Kong totalled US\$190.7 billion, or 13.4 percent of China's total in 2008. Even if only a fraction of this trade is settled in yuan in Hong Kong, it will significantly expand yuan-denominated financial activities in the city," according to The Bank of East Asia report. Leung of KGI Capital Asia, however, points out that as China further opens up and extends yuan trade settlement to other places, Hong Kong won't hold onto its niche in the long run.

Meanwhile, Hong Kong is still feeding China's voracious demand for both high-quality accounting and financial professionals. Grant Thornton's Lam says foreign investors still have a high degree of uncertainty and distrust in the mainland's legal and accounting profession.

"The pool of professionals on the mainland, be they financial or legal, is growing rapidly. But China still needs time to test its financial system so that