

# Shanghai SUPER SIZED

**With a 13.6 percent surge in its economy last year and a 19 percent gain in first-quarter real estate prices, China's fastest-growing city shows the promises—and pitfalls—of the national rush for financial superpowerdom.**

◆ On an overcast Sunday in April, British banker Ray Li climbed into a white Porsche 911 and sped off in pursuit of a trophy on the world's newest and most expensive Formula One raceway: the Shanghai International Circuit. "If I could drive around this track as fast as Shanghai is growing, I'd be crowned champion this year for sure," says Li, 35, who heads an Asian consumer banking unit at Barclays Plc, the U.K.'s No. 3 bank. Li, who's based in Hong Kong, finished sixth that day in a field of 23 in the 2005 Asia GT Challenge event.

From the \$417 million racetrack to the monorail that whisks visitors at 431 kilometers (268 miles) per hour from the \$3.6 billion Pudong Airport into the country's fastest-growing city, Shanghai is China on steroids. One side effect: In the first quarter alone, real estate prices rocketed 19 percent, and any collapse might ripple through the nation's banking system, with its \$188 billion of bad loans. Another concern: the Shanghai Stock Exchange Composite Index's 50 percent plunge during the past four years, which has left many once-hopeful Chinese investors impoverished, disillusioned and restless.

Shanghai's economy accelerated at 13.6 percent last year, says Vice Mayor Zhou Yupeng, 57, sipping tea in the government headquarters that dominates Renmin (People's) Square. The increase outpaces the 9.5 percent rise in gross domestic product for China as a whole. Shanghai's official population of 13.5 million has swelled by almost one-third to 17.4 million as the city's boom has lured 3.9 million migrants, mostly from rural areas, according to government statistics. "China is going to be the biggest urbanization story anyone has seen in a long time," says Shu Yin Lee, 38, who helps manage \$1 billion in Shanghai for Los Angeles-based Dalton Investments LLC and who invests in Shanghai real estate through his own company, Grand River Investments Ltd., which he co-founded in 2003. "Shanghai will feel the biggest effect of that drift."

This year, Zhou says, Shanghai's per-capita GDP will top \$6,000, which would be six times the rate for the rest of China, according to data compiled by Bloomberg. The figure will rise to \$10,000 within five years, predicts Huang Yaocheng, deputy director general of the Shanghai World Expo Coordination Bureau, which is planning a six-month-long trade show for 2010 that he says will draw 200 nations and as many as 170 million visitors.

Many Shanghaiese already surpass Huang's wealth projection. Handel Lee, who spent \$80 million transforming a 90-year-old office building into Three on the Bund,

a luxury retail complex that features an Armani store and an Evian spa, says his research shows that 800,000 residents—5 percent of Shanghai's registered population—have either a net worth of \$100,000 excluding their homes or an annual income of \$75,000.

"And they're spending that wealth," says Lee, 43, a Washington-born lawyer whose tenants include Jean Georges, a

century Shanghai neighborhood into the Xintiandi entertainment, restaurant and retail district. "I firmly believe it will once again become one of the major international and economic centers."

China must break down a series of self-imposed obstacles for Shanghai to become a financial superstar, says Frank Gong, 41, Hong Kong-based chief economist for China at JPMorgan

## 'Shanghai was once one of the five major financial hubs,' Hong Kong billionaire Vincent Lo says.

haute-cuisine French restaurant run by New York-based restaurateur Jean-Georges Vongerichten. "In China, with its history of war and revolution, you were considered decadent or foolish to spend your savings. Attitudes have changed deeply. People here have lost their guilt and fear." At Jean Georges, dinner for two can easily cost \$190—equivalent to the average monthly wage.

By 2020, the government wants Shanghai to reprise the role it held before China's communist revolution in 1949, Zhou says. The city had been one of the world's financial and commercial centers. In 1865, it gave its name to Hongkong & Shanghai Banking Corp., which, now known as HSBC Holdings Plc and based in London, is the world's second-largest lender, after New York-based Citigroup Inc. American International Group Inc., the world's biggest insurer, got its start in Shanghai in 1919.

"Shanghai was corrupt but glamorous, barbaric but sophisticated, repugnant but remunerative," U.S. author Ted Fishman, 46, says. Fishman, a former commodities trader on the Chicago Mercantile Exchange, spent 18 months researching his book *China, Inc.: How the Rise of the Next Superpower Challenges America and the World* (Scribner, 2005). In April, he testified before the U.S.-China Economic Security and Review Commission, which is studying U.S. relations with China.

After the revolution, Mao Zedong's communists ordered most foreign banks and businesses out. "International capitalism was not given any chance to stay," says Willem van Kemenade, 62, a consultant to the Brussels-based European Institute for Asian Studies, a European Union research and policy group, and author of *China, Hong Kong, Taiwan, Inc.: The Dynamics of a New Empire* (Alfred A. Knopf, 1997).

In 1978, Deng Xiaoping, China's paramount leader, began turning away from doctrinaire communism. He created special economic zones in smaller cities. In 1990, he gave the go-ahead for the full-scale development of Shanghai, including the re-opening of a stock market that Mao had closed 41 years earlier.

"Shanghai was once one of the five major financial hubs in the world, along with New York, London, Paris and Tokyo," says Hong Kong-based billionaire Vincent Lo, 56, chairman of Shui On Construction and Materials Ltd., who has raised \$8 billion for mainland projects including converting a 19th-

Chase & Co., the third-biggest U.S. bank. It can't compete with even its regional rival, the former British colony of Hong Kong, as long as rulers in Beijing refuse to make the currency fully convertible and restrict foreign investment in China's \$400 billion domestic stock market, Gong says.

China has pegged its yuan at about 8.3 to the U.S. dollar since 1995. Hong Kong, which became a special administrative region of China in 1997, retains its own currency, the Hong Kong dollar, which is also pegged to the U.S. currency. Unlike Hong Kong, China restricts movement of funds out of the country to about 20,000 yuan (\$2,416) per customer each day. People can bring in about 50,000 yuan a day.

Shanghai would benefit should China loosen its fixed exchange rate, Gong says. "It will slow down hot areas of the economy," Gong says. "There will be a healthy correction in real estate prices."

China allows only 27 foreign banks and brokerages to invest in yuan-denominated securities traded on the two mainland stock exchanges, in Shanghai and in the southern city of Shenzhen. These so-called qualified foreign institutional investors, which include Credit Suisse Group, Merrill Lynch & Co., UBS AG and Citigroup, have been limited to a total of \$4 billion of investments as of April 22 by the State Council, China's cabinet. They can't take the funds they've invested or any profit they make out of the country for a year. "For Shanghai to be a viable financial center, you have to allow capital in and out freely," Gong says. "China won't allow that for the foreseeable future."

Shanghai also suffers because the government can retain as much as three-quarters of the stock of any company on the 15-year-old exchange, says Stephen Green, 33, Shanghai-based senior economist at Standard Chartered Plc, a London-based bank that makes two-thirds of its profits in Asia. "Neither public officials nor private shareholders enjoy effective control over most listed firms, and few in management have incentives to help their firms create value," says Green, whose book, *China's Stockmarket: A Guide to Its Progress, Players and Prospects* (Profile Books, 2003), contains examples of corruption.

In one case in 2002, Jinan Qingqi Motorcycle Co. reported a \$410 million loss—the biggest ever by a Chinese-listed company—because of a hidden loan it had made to its state-owned parent. China's biggest motorcycle maker was sus-

pendent from trading for 15 months. "Of 1,450 listed companies, maybe up to 50 are worthy of long-term investment," Green says.

Investors worry that any mass sell-off of state-owned, so-called nontradable shares would reduce the value of privately held stock, Green says, adding that a sell-off can be avoided if China moves carefully. On May 9, China picked four companies for a trial sale of nontradable shares, the first stage in a plan to dispose of as much as \$264 billion of government holdings.

After peaking at 2242 on June 13, 2001, Shanghai's benchmark stock index had lost half of its value as of May 10, when it hit a six-year low of 1108. By comparison, state-owned Chinese companies listed on the Hong Kong Stock Exchange doubled in value during the same period. The Hang Seng China Enterprises Index rose 104 percent to 4759 on May 10. Shanghai Stock Exchange officials declined to be interviewed for this story.

"Allow us some time; we are still learning," says Ma Xuejie, 45, a vice director of the People's Government of Pudong, Shanghai's financial district. "The stock exchange of London has been going for how many years? This is a very tricky sector. There are a lot of obstacles to overcome."

The U.K. bourse traces its history back 307 years to London coffeehouses where patrons exchanged marketable securities. Today, the London Stock Exchange, with a market value of \$27 trillion, is the world's third largest, after New York and Tokyo.

While China's stock market languishes, Shanghai property prices have surged as local investors join foreigners in putting their money into bricks and mortar. "The millionaires aren't trading now: They've been investing in Shanghai real estate in the past few years," Green says. The city's home values have doubled in three years, says Alan Zhang, 39, chief executive officer of Anjia Group, Shanghai's largest mortgage brokerage. Last year, Anjia handled \$600 million of mortgages.

Real estate in Shanghai is almost as expensive as it is in the wealthier cities of Hong Kong and Singapore when per-capita GDP is factored in, Gong says. "It does feel like a bubble, especially at the high end," he says. "People are trading flats like they trade shares."

In January and February alone, some inner-city Shanghai luxury apartments soared in value by 40 percent as foreign speculators snapped up property, Zhou says. The

**Second best** Shanghai's index has underperformed as the city tries to become a major financial center.



Index: Dec. 31, 2001 = 100. Source: Bloomberg

government imposed a 5.6 percent capital gains tax and higher minimum mortgage payments. It also insisted that homeowners pay off their mortgages before selling their properties. Those restrictions followed China's decision in October 2004 to lift the benchmark one-year lending rate by 0.27 percentage point to 5.58 percent, the first increase in nine years. "If we had not taken measures to curb speculation, it could have caused social instability," Zhou says.

HSBC is betting \$4.1 billion that China's leaders will release their grip on

banking services and capital markets. When China joined the World Trade Organization in 2001, it agreed to let foreign banks conduct local-currency business with Chinese citizens by the end of 2006. Such a move would enable the London-based bank to tap the \$1.56 trillion in savings that China's 1.3 billion people have squirreled away.

In 2000, HSBC moved its Chinese headquarters from Hong Kong to the 44-story HSBC Tower in Shanghai. In 2001, HSBC paid \$62.6 million for an 8 percent stake in Bank of Shanghai, an unlisted city lender. Ten months later, it bought a 10 percent stake in Ping An Insurance (Group) Co., China's second-biggest life insurer, for \$600 million. On May 9, it agreed to pay another \$1.1 billion to double its stake to 19.9 percent, the maximum allowed under Chinese law. In 2003, it spent \$20 million for 27 percent of Ping An Bank, which was founded as Fujian Asia Bank and classified as a Sino-foreign joint venture, allowing HSBC to exceed the 19.9 percent limitation. This past August, HSBC made the biggest single investment yet by a foreign bank in China. It paid \$1.75 billion for a 19.9 percent stake in China's fifth-biggest lender, Shanghai-based Bank of Communications. "As mainland China's financial center, Shanghai offers great potential," says former Hongkong and Shanghai Banking Corp. Chairman David Eldon, 60, who retired on May 24.

Citigroup, whose history in China dates to 1902, moved its Chinese headquarters to Shanghai from Hong Kong in 1993. This year, it will occupy the new, 40-story Citigroup Tower. "Shanghai has done much to become a global financial center," Richard Stanley, CEO of Citigroup China, says without elaborating. In 2003, Citigroup paid \$72.6 million to acquire 4.62 percent of Shanghai Pudong Development Bank Co., the country's second-biggest publicly traded lender.

Oswald Grübel, 61, CEO of Zurich-based Credit Suisse Group, wanted to make sure his management team at

**'The millionaires aren't trading now: They've been investing in Shanghai real estate,' an economist says.**

Switzerland's second-biggest bank knew what was going on in Shanghai. In September, he flew all 13 members to Shanghai for the executive board's first ever meeting in China. "Members could see China's amazing growth story firsthand," Grübel said in a statement e-mailed to Bloomberg News.

Shanghai's Pudong district is the visible symbol of China's aspirations. Until 1990, Pudong was a 580-square-kilometer (224-square-mile) expanse of rice fields, marshes and warehouses. Today, it's a sea of Manhattan-size high-rises. By day, Western-educated Chinese executives, BlackBerryes welded to their palms, scurry between banks, hotels and restaurants. They dodge the Chinese tourists taking photographs against a skyline that resembles a *Star Wars* set erected between conventional glass and concrete offices. By night, laser beams from Pudong's skyscrapers stab the sky above the Huangpu River to illuminate the Bund, the center of Old Shanghai, with buildings resembling those of 19th-century London, Paris and Berlin.

Towering above Pudong's skyscrapers are two landmarks: the 468-meter (1,535-foot), bauble-adorned Oriental Pearl telecommunications tower and, nearby, Chicago-based Hyatt Corp.'s Grand Hyatt Shanghai hotel. The hotel, topped by its Cloud 9 bar, occupies the top 34 floors of the 420-meter Jin Mao Tower, which was designed with pagoda-style flourishes by Chicago architectural firm Skidmore, Owings & Merrill LLP.

Mori Building Co., Japan's largest private construction company, is hoping to outdo the Jin Mao Tower. It's building the Shanghai World Financial Center, which, when completed at the end of 2007, will be 492 meters and 101 stories, a spokesman says.

Mori declined to comment on any impact from anti-Japanese protests that broke out across China in April. A rift over oil drilling and Japanese textbooks that China says gloss over World War II atrocities sparked demonstrators in Shanghai to hurl stones and paint bombs at the Japanese consulate and to vandalize some Japanese restaurants.

Beyond Pudong's high-rises, Century Boulevard and a stream of multilane highways fan out to low-slung industrial parks. Here, foreign companies make products ranging from General Motors Corp. Buick sedans to Alcatel SA phones. China is the world's largest market for mobile phones and

the Yangshan Islands, is linked to the mainland by a 32-kilometer bridge. A quarter of China's \$1 trillion of imports and exports pass through the port at the mouth of the Yangtze River.

"When I was a kid, I used to take the ferry to Pudong to catch crickets," says Anjia Group's Zhang, who worked in the U.S. from 1989 to '97, his last job as a vice president at First National Bank of Boston, now part of FleetBoston Financial Corp. "Now when I look out my office window to where those fields used to be, I doubt what I see can be true," Zhang says. "It looks like Hong Kong."

Soon Shanghai will look even more like Britain's former colony. The city is spending \$4 billion to demolish 272 factories and relocate 17,600 families to clear a 5.28-square-kilometer swath for the 2010 World Exposition. The city and private investors plan to spend billions of dollars more to almost triple capacity on the suburban rail system. They'll increase the number of subway and above-ground lines to 12 from five, build more runways at the Pudong and older, Hongqiao airports and more than quadruple hotel rooms to 400,000 from 90,000, Huang says. Shanghai government officials say there's no rivalry with China's two other seats of political and financial power, Beijing and Hong Kong. Still, Shanghai will spend more on the expo than Beijing will on the 2008 Summer Olympics. "Both events are very complex, but expo is more complex and needs more investment," Huang says. Adds Vice Mayor Zhou, "It will be our calling card to the world."

The Li family represents the human cost of Shanghai's resurgence. Margaret Zhu, 50; her husband, Lincoln Li, 59; and their daughter, Emmy, 20, occupy an 18-square-meter, one-room apartment in a 90-year-old *shikumen*, or traditional, stone-linteled Shanghai house. Although they share the home with 15 other families, Zhu says they like being just two blocks from Nanjing Road, Shanghai's shopping street, where Lincoln works as an electrician installing neon lights. Now their neighborhood will be demolished to make room for more high-rises.

"I won't miss this old building, and the government has said it will rehouse us," says Zhu, who declines to say how much money the family earns. "But it will be somewhere very far away." Today, the family pays \$2.17 a month for their state-owned housing.

## 'I have totally no confidence in the stock market,' says a Shanghai resident.

third largest for cars. The American Chamber of Commerce in Shanghai, the second largest in Asia, after Tokyo, has signed up 70 members a month for the past three years, Chairman Jeffrey Bernstein says.

Beyond the city limits, Shanghai is building the world's biggest deep-water port, a 52-berth container terminal that will lift the region's capacity to 22 million tons from 14 million. The port, on

Because of the property boom, Zhu says, she has no hope of buying a home, especially in the inner city. Part of the problem is the meager return from investing in the stock market, where she has 25 percent of her savings. "I have totally no confidence in the stock market," she says.

Zhu has done better than some. Her \$24,000 of stocks has kept its value through the four-year bear market. Her neighbor,

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retired factory worker Su Zheng, 67, has lost \$12,000—almost all of her savings.

The poor performance of Shanghai's stock market hasn't deterred Chris Ruffle, 46, who helps manage \$15.9 billion for Edinburgh-based Martin Currie Investment Management Ltd. Unlike most Chinese-fund managers, who are located in Hong Kong, Ruffle moved permanently to Shanghai three years ago. "The closest parallel would be the U.S. frontier in the late 19th century," says Ruffle, a Chinese speaker who manages \$1.2 billion of greater Chinese stocks listed in Hong Kong, Shanghai, Shenzhen and Taiwan. "There are plenty of snake oil salesmen, but there are also some very interesting companies listed here."


Being in Shanghai gives Ruffle an edge, he says. "There are lots of white guys running money in Hong Kong," he says. "Here we have this massive city, booming economy, and I, for the moment, am it."

Ruffle's \$100 million Martin Currie China A Share Fund Ltd., which invests in Shanghai- and Shenzhen-listed stocks, has gained 18 percent from the time it began trading in September 2003 to the end of April. That compares with a 20 percent drop in the Shanghai composite

index. His \$262 million New York Stock Exchange-listed China Fund Inc., which invests mostly in Chinese stocks listed in Hong Kong and Taiwan, was up 110 percent since Ruffle took it over on June 30, 2001, compared with a 33 percent rise in the benchmark MSCI Golden Dragon Index.

Ruffle's Shanghai-listed stocks range from Shanghai Airlines Co. and Yanzhou Coal Mining Co. to Henan Rebecca Hair Products Co., which makes hairpieces for African-Americans. "Whenever I watch performers on MTV, I think, 'I know where your hair extension comes from, and you don't,'" says Ruffle, who has visited the factory in Xuchang in Henan province.

After Henan Rebecca's initial public offering on July 9, 2003, the shares gained 43 percent to 13.58 yuan on May 10 compared with a 30 percent decline in the Shanghai index. "There's a profound ignorance of this domestic market by foreign investors," Ruffle says.

Investors interested in China will have to figure out quickly whether Shanghai, for all of its superlatives, is the harbinger of China's emergence as a global financial capital or the precursor of a colossal bubble waiting to burst. 

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WILLIAM MELLOR is a senior writer at Bloomberg News in Hong Kong. With additional reporting by JANET ONG and SAMUEL SHEN in Shanghai. [wmellor@bloomberg.net](mailto:wmellor@bloomberg.net)

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