INSTITUTIONAL CHANGE, DIVERSITY, AND COMPETITION:
FOREIGN BANKS IN SHANGHAI, 1847-2004

JEROEN KUILMAN
Erasmus University Rotterdam
Department of Organization and Personnel Management
Room T8-17, Burg. Oudlaan 50
P.O. Box 1738
3000 DR Rotterdam, The Netherlands
Phone: +31 10 408 1962
Fax: +31 10 408 9015
E-mail: jkuilman@rsm.nl

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**INTRODUCTION**

In the last twenty-five years, Shanghai has experienced a rapid increase in the number of foreign banks. While only four 'quasi-foreign' banks were present in Shanghai in the early 1980s (the Hong Kong and Shanghai Banking Corporation (HSBC), most notably), this number grew to over one hundred foreign banks after 1997. To many casual observers, this may not seem surprising given the fact that this city receives the lion's share of foreign direct investment (FDI) in China and accounts for a large proportion of foreign trade, both of which increased substantially after China embarked on its open door policy in the early 1980s. In 2004 for instance, Shanghai, with a population of only 1.3 percent of China's total and a land area of only 0.1 percent, accounted for more than ten percent of the total level of FDI in China and a similar share of China's total foreign trade, more than any other city. Foreign enterprises have also come to play an important role in Shanghai's local economy: foreign invested enterprises accounted for more than 60 percent of Shanghai's gross industrial output in 2004.

However, many are surprised to learn that foreign direct investment and the inflow of foreign banks into Shanghai are not new phenomena. The history of foreign banking in Shanghai dates back to 1847, when the first international bank established itself in this city. Much later, in the 1920s and early 1930s (before China slipped into a phase of economic isolationism), Shanghai functioned as one of Asia's main financial centres; outcompeting other financial centres such as Hong Kong, Singapore, and Yokohama. Shanghai's development as a financial centre was stimulated by the founding of many modern local banks, along with industry associations and a stock exchange. At the time, Shanghai's riverfront boulevard, 'The Bund', housed a relatively large number of foreign financial institutions and was widely referred to as the 'Wall Street of the Orient'.

The protracted and volatile history of foreign banks in Shanghai provides a useful window on long-term industry evolution. We are centrally interested in observing how organizational *diversity* evolves over time, along with more intensively studied aspects such as *density* (defined as the number of organizations) and the role of *institutional change*. Diversity in corporate demography has not been adequately
addressed by models of density-dependent market entry and exit (Hannan and Carroll 1992). For the purpose of this discussion, diversity can be quantified in terms of the variety of foreign banks in Shanghai. This is in line with the approach used by Xu (2006) who studied diversity among newspapers in terms of their ethnicity. In the case of Shanghai banking, diversity here may be expected to reflect diversity as well in governance structures, corporate culture, size, and strategies.

The main objective of this chapter is to illustrate how diversity in Shanghai banking evolved over time, to correlate this with density and institutional change, and in this way to counterbalance the thrust of many other conceptual studies in organization theory and strategic management (e.g. Carroll and Hannan 2000, pp. 439-451). This review should thus be seen as a companion text to the theoretical work in this area. A focus on abstract concepts such as diversity and density will facilitate comparative analysis, and this may generate insights that go beyond the single-industry focus. Second, it provides institutional and historical knowledge about an important element of China’s financial sector. This sector deserves attention because it plays a pivotal role in China’s ongoing reform efforts today (Keister 2002). Although the industry has changed markedly over the past 150 years, there are also some parallels between historical developments and today’s situation which may shed some light on current and future developments. These continuities include for instance the competitive interactions between foreign and domestic banks, as well as the location choices of foreign banks in China.

The following historical account distinguishes four distinct phases of foreign banking in Shanghai: (1) the British hegemony in financing foreign trade with China, 1847-1889; (2) the rise of international banking, 1890-1933; (3) decline and virtual disappearance of foreign banks from the Shanghai scene, 1934-1981; and (4) the re-emergence of foreign banks in Shanghai, 1982-2004. Although the boundaries between these time periods are often not sharp and alternative ways of identifying the industry’s phases are possible, these time periods do reflect substantial differences in the industry’s competitive and institutional structure.

**BRITISH MONOPOLY: 1847-1889**

The first emergence of foreign banks in Shanghai is generally seen to be a direct consequence of the Opium War (1839-1842) between China and Great Britain.
This war started when China demanded an end to British imports of opium, which were having devastating effects on the Chinese population. Growing addiction, smuggling and official corruption led the Chinese to take active steps to cut off the opium trade in June 1839. The British, who imported the goods mostly from their territories in India, retaliated against these attempts. British imperial forces started a series of attacks on the Chinese mainland, and finally defeated China. The war officially ended with the Treaty of Nanking signed on 29 August 1842, which required the Chinese government to pay war indemnities and exempted Westerners in China from the operation of Chinese law. It also opened five coastal cities to foreign residence and trade. These 'treaty ports' were Canton (Guangzhou), Amoy (Xiamen), Fuzhou, Ningbo, and Shanghai. In addition, Hong Kong was ceded to Britain.

Shanghai opened for foreign trade in November 1843, and, like the other treaty ports, it experienced rapid economic growth. Shanghai was particularly successful since it had a favorable geographic position: it offered easy access to large silk producing areas, and major tea plantations close to the city (McElderry 1976). In addition, Shanghai is situated at the mouth of the Yangtze River, so it was positioned to benefit from the ensuing increase in shipping between the upstream provinces and the delta region (Bergère 1996). Later, the city’s position as a trading hub was further enhanced due to the internal disruptions that China experienced between 1850 and 1865, most notably the Taiping Rebellion. These disruptions closed off many of the other treaty ports from the resources in their hinterland, but the hostilities did not spread to the city of Shanghai. As a result, treaty ports such as Canton saw their trade in silk and tea largely diverted to Shanghai, leading to substantial growth in the exports of these commodities through Shanghai’s port (McElderry 1976).

In the midst of this increase in trade, foreign banks were needed to mediate between Chinese and foreign merchants, to finance the imports and exports of foreign firms, and to provide foreign currency exchange (Tamagna 1942). The first foreign bank to set up in Shanghai was the Oriental Bank Corporation in early 1847, a British bank which established itself on The Bund. This boulevard, part of the so-called 'International Settlement' in which foreign firms enjoyed extraterritorial rights, later housed many other local and foreign banks financial institutions. Then, in 1854, the Chartered Mercantile Bank of India, London, and China established its own branch
office in Shanghai. Later, on April 3, 1865, what would become one of the most important foreign bank in Shanghai's financial history, the Hong Kong and Shanghai Banking Corporation (HSBC), started operations after opening for business in Hong Kong a month earlier. By the end of 1865, the number of foreign banks in Shanghai totalled eleven (see Figure 1), of which ten had British origins.

In 1866, these banks were hit hard by an international financial crisis caused by excessive speculation in shares of limited liability companies. The so-called 'Overend-Gurney Crisis' (named after the company that took a leading role in this speculation boom) led to widespread failure within world banking circles, and beyond. Compared to their domestic banks, British banks with offices overseas were particularly vulnerable, since the panics caused by the Overend-Gurney Crisis led to runs on the branches of these banks worldwide (Baster 1929). In Shanghai, the offices of such banks as Agra and Masterman's Bank, the Bank of India, and the Commercial Bank of India were closed down as a result of heavy losses. Of these banks, only Agra and Masterman's Bank was able to re-establish itself after the crisis. In May 1870, it reopened in Shanghai under the name Agra Bank.

During the following years, British banks nevertheless maintained their dominant position. With London being the centre of the world’s silver market and of international finance, British banks controlled the foreign exchange business in China. Firms and governments from other nations wishing to engage in trade with China had to do so through these British banks. British banks also de facto created their own institutional environment in Shanghai following the Treaty of Nanking. Not only did they enjoy the benefits of extraterritoriality throughout China, but Shanghai’s International Settlement had its own police force, a Municipal Council, and a (liberal) legal system. The local banking system then was dominated by a relatively small and homogeneous set of British banks that faced little competition from other foreign banks, and as a consequence mainly competed with each other. This lack of diversity apparently did not induce non-British banks to establish a presence in Shanghai and the situation persisted for much of the nineteenth century. As Hannan and Freeman (1989, p. 142) have noted, ‘When diversity is low, a few organizations or a few organizational forms can more easily dominate a sphere of activity. If these few
organizations have high market power, they may be able to prevent other organizations from getting started.’ There is some evidence that this might have happened in Shanghai in this period. Foreign banks from rival nations never fared well there. Deutsche Bank opened its first office in Shanghai in 1872, however this venture does not appear to have been very successful. Silver prices declined sharply in the mid 1870s, and its Shanghai office was closed down in 1875 as a result. Furthermore, from 1875 to 1884, not a single new branch of a foreign bank was opened. In this period, incumbent British banks consolidated their positions by seeking further expansion throughout China³ (Tamagna 1942).

EXPANSION OF INTERNATIONAL BANKING: 1890-1933

In the last decade of the nineteenth century, the hegemony of British foreign banks slowly started to erode for two major reasons: first, China's trade with other nations had increased substantially (Table 1); and second, foreign banks had also increasingly moved into financing government projects, the number of which had increased substantially by the end of the nineteenth century. Such projects included investment in railway and telecommunications infrastructure, and were part of an effort by the Chinese government to modernize and strengthen the national economy. Since China at the time lacked a well developed internal capital market, foreign banks were well positioned to play a pivotal role in lending to the Chinese government⁴. A particular expansion in the number of loans to the Chinese government by the foreign banks came after the Sino-Japanese War. Following her defeat in 1894, China was obliged to pay heavy war indemnities, and to finance this they turned to foreign banks (Cheng 2003).

As a consequence of these factors, financiers in countries other than Britain increasingly recognized the disadvantages of not having a direct presence in Shanghai, such as a lack of local information (Jones 1993). Countries that traded with China had been doing so through British merchant banks, but there was an increasing desire to reduce the transaction costs here. This pushed banks from other nations towards setting up their own branch offices in China and building up direct ties. On January 2, 1890, a consortium bank opened an office in Shanghai representing German interests. (Among the stakeholders was the earlier mentioned Deutsche Bank.) Later, in 1893, the first Japanese bank (the Yokohama Specie Bank) established a branch office in Shanghai⁵,
and with the creation of the Russo-Chinese Bank in 1896, the first foreign-Chinese jointly owned bank was founded. The International Banking Corporation (a predecessor of Citibank) opened an office in Shanghai on 15 May 1902. A Dutch bank, the Nederlandsche Handel-Maatschappij, opened its Shanghai office on 11 February 1903\(^6\). In short, from only five foreign banks in 1889, the number grew to thirteen by 1903.

--- Insert Figure 2 here ---

Figure 2 shows the historical trajectory of the diversity of foreign banks in terms of their nationality. Diversity is quantified as one minus the Herfindahl index\(^7\), which can be interpreted as a measure of the likelihood that two random foreign banks in Shanghai have different countries-of-origin. This diversity of foreign banks in Shanghai in terms of their nationality reflected the diversity in trade and financing relations that China maintained with various countries. Institutional theory predicts that dependence on one single source of support for vital resources will give rise to homogeneity (DiMaggio and Powell 1983), however if multiple sources for resources become available, then the diversity among organizations is likely to increase as well. Similarly, organizational ecology predicts that as the number of dimensions that characterize a resource environment increases, the opportunities for new types of organizations will increase as well (Péli and Nooteboom 1999). Diversity in the resource environment provides a possibility for new entrants to position their organizations further away from incumbents in the competitive space, reducing the negative effects associated with a proximate positioning (e.g. Baum and Mezias 1992). Here, the increase in diversity in China’s trade and financing relations (the relevant resource environment for foreign banks) provided an opportunity for banks with other nationalities to operate under reduced competitive pressure.

Although the rise in organizational diversity in the early twentieth century was exceptional, Figure 2 also reveals a more general pattern in which diversity had an overall tendency to increase as the industry aged in Shanghai, a tendency that can also be observed in earlier work studying diversity in other contexts (Boone et al. 2005; Solari and Rossi 2000). Obviously, these empirical patterns are in sharp contrast to the predictions of institutional theory (Dacin 1997; DiMaggio and Powell 1983; Kraatz and Zajac 1996), but they are in line with the recent observations of Hambrick et al. (2005).
While the competitive boundaries of the industry changed dramatically in the early twentieth century, the business of foreign banks appeared to be immune to some of the institutional changes that took place at that time. For instance, foreign bank failures did not increase substantially as a result of the revolution of 1911 and the subsequent change of regime, i.e. the founding of the Republic of China. Also, during the First World War the number of foreign banks in Shanghai remained relatively stable (although the assets of the Deutsch-Asiatische Bank were frozen in 1917 when China joined the war). After the First World War, however, some European banks had to take a step back. Preoccupied with post-war reconstruction, these banks retrenched or reduced their financial interests in China by channelling funds to their home country. Nevertheless, the total number of foreign banks increased steadily in the post-war period. This growth was largely due to the arrival of banks representing new foreign financial powers, most notably new American and Japanese banks. These banks basically moved into the void left by the European banks. In 1918 alone, seven banks established a presence in Shanghai, two of which were from the United States (the American Express Company and the American Oriental Banking Corporation) and three from Japan (the Bank of Chosen, the Exchange Bank of China and the Shanghai Bank).

In the following years, Shanghai experienced a period that is sometimes referred to as its 'golden age' (Ji 2003). In this period, Shanghai gained a reputation as a centre of international finance, not only through the prosperity of the foreign banks present in the city, but also through the rapid development of modern local banks and other financial institutions, such as the stock exchange. It was in this period that Shanghai's Bund, which housed many of the foreign banks, became known as the 'Wall Street of the Orient'. At the end of 1934, the number of foreign banks peaked at 33. For comparison, alternative financial centres such as Singapore (21 'full-license' banks in 1934, many of which were foreign banks, see Carroll and Hannan (2000, p. 23)) and Hong Kong (17 foreign banks, excluding banks from mainland China) hosted a much lower number of foreign banks. Jones (1992, p. 407) states that Hong Kong 'was essentially a smaller version of Shanghai throughout the interwar years'.

Such a rise in the density of organizations is typically associated with a growth in their perceived legitimacy. Growth in numbers gives force to claims of institutional
standing and facilitates the social recognition of an organizational population. Tests of a theory of density dependent industry evolution proposed by Hannan and Carroll (1992) suggest that, especially in the period following World War I, Shanghai gained widespread legitimacy as a centre for international finance (Kuilman 2005). However, despite this legitimation, in the mid-1930s Shanghai’s position as a major finance and trading hub quickly started to crumble.

**DEMISE OF FOREIGN BANKS: 1934-1981**

Numerous factors contributed to the decline of Shanghai's role in international finance. Starting in 1934, there was a currency crisis that resulted from the adoption of the Silver Purchase Act by the United States. This change in U.S. monetary policy caused silver to flow out of China and world silver prices to climb sharply. Responding to this crisis, the silver standard was abandoned and issuing bank notes became the sole right of three government banks (the Central Bank of China, the Bank of China, and the Bank of Communications). This was a shift in financial authority from the foreign banks, many of which had previously issued their own notes, to the Chinese government. In addition, in connection with abandoning the silver standard, banks had to hand over their silver supplies to the government. Foreign banks which previously had operated almost autonomously in the Chinese financial market, now found themselves in a position of 'subordinate dependence' (Tamagna 1942, p. 119). The role of foreign banks then diminished further as they increasingly faced competition from the growing number of local banks. Cheng (2003) notes that domestic banks, which had matured substantially in the 1920s and 1930s, made successful efforts to attract depositors away from foreign banks. In addition, many of the more modern domestic banks were able to break into the financing of government debts, an area which the foreign banks had previously controlled. The balance of power in the financial market thus shifted from foreign to domestic banks.

The onset of another Sino-Japanese War in 1937 (and the subsequent occupation of substantial parts of China by the Japanese), did not have immediate consequences for the presence of foreign banks in Shanghai, although their financing activities were hampered by a decrease in trade flows. Protected by the extraterritorial rights of the International Settlement, they continued their banking activities in, for example, currency exchange. The Japanese, however, attempting to gain more control over China's financial system, expanded their financial interests in the occupied
In May 1939, the Japanese-supported Hua Hsing Bank was established. Later, in January 1941, the Central Reserve Bank of China was founded. Both the Hua Hsing Bank and the Central Reserve Bank of China issued their own banknotes and were instrumental in financing the expenditures in China of Japan’s armed forces.

The immunity of foreign banks in the International Settlement lasted until December 1941 when, immediately after the Japanese attack on Pearl Harbor, Japanese military forces entered the settlement. The Japanese took control of the American, Belgian, British, and Dutch banks in Shanghai and turned them over to Japanese banks, such as the Yokohama Specie Bank, for liquidation. Banks of friendly or neutral nationalities (French, German and Italian banks) continued to operate, together with the Japanese banks, albeit on a more limited scale (Tamagna 1942).

The end of the Second World War led to the closing down of all Japanese and Japanese-supported banks and the confiscation of their assets (Ji 2003). In total, ten foreign banks had to close their banking facilities in Shanghai in 1945. On the other hand, banks from other countries whose branches had been liquidated at the end of 1941 started to re-establish themselves in Shanghai and their total number remained fairly stable for several years (see Figure 1). Initially, these returning foreign banks hoped they could rapidly restore their banking business, including the elaborate networks of branches they had previously maintained in various parts of China. However, civil war between communist and nationalist factions spread across the country, and when the communists prevailed, these hopes were soon disappointed. The civil war was accompanied by economic and financial chaos: heavy inflationary pressures troubled the banking business in particular. For instance, the wholesale price index for Shanghai in September 1947 was 4,635,700, based on an index of 100 for the first half of 1937. As a result, the foreign banks were never able to fully recover from the turbulence generated by the Second World War even though they were able to restore their presence.

The Communist Party formally seized power on October 1, 1949, and this event presaged the end of the foreign banks’ China operations. An adverse economic environment combined with a socio-political environment in which foreign banks were seen as agents of Western imperialism created resource scarcity and led to the temporary demise of international banking activities in the city. In the years that
followed 1949, foreign banks disbanded their China operations one by one. American banks, such as Chase Bank and the National City Bank of New York, were among the first to shut down their operations at the end of 1950 because of the tensions generated by the Korean War. A United Nations trade embargo imposed on China in May 1951 worsened the economic climate for the remaining foreign banks in Shanghai. Banks such as the Nederlandsche Handel-Maatschappij, the Banque Belge pour l'Etranger, and the Banque de l'Indo-Chine all closed their branches.

By the late-1950s, only four 'quasi-foreign' banks were left in Shanghai: HSBC; the Bank of East Asia; the Chartered Bank of India, Australia, and China (later to become the Standard Chartered Bank); and the Overseas Chinese Banking Corporation (incorporated in Singapore). These four banks were granted a special legal status and were only permitted to provide such financial services as the government deemed necessary for China's national economic development (MacCormac 1993). In practice this resulted in a small, continuing business in inward remittances and export bills, while China moved into a period of economic isolation.

Ruef's (2004) generic model of the demise of organizational forms fits well with this stage of the historical development of the Shanghai banking industry. Ruef (2004) points out that exogenous factors such as regulatory actions and material resource conditions can lead to the disappearance of organizational forms. In the context of Shanghai banking, regulatory actions such as the abandonment of the silver standard and the requirement that foreign banks hand over their silver reserves, both serve as a partial explanation for the decline of foreign banking in Shanghai. In addition, wars disrupted the industry and led to resource scarcity and inflation. Competition from related, alternative populations is another possible explanation offered by Ruef (2004). In the 1950s, Shanghai became an industrial city under heavy state control and Hong Kong was able to position itself as one of the main international trade and financial centre in the Far East at this time (Tian 1996; Schenk 2001). Kuilman (2005) discusses how the more favourable institutional environment of Hong Kong provided an alternative for the foreign banks in Shanghai. As a consequence of the adverse conditions in mainland China, the foreign banking population in Hong Kong started to grow rapidly in the 1960s and 70s.
RE-EMERGENCE OF FOREIGN BANKS: 1980-2004

Starting in 1978, a series of steps were introduced in the form of a new reform program which ended China's economic isolation. The reforms aimed to stimulate economic growth and to improve living standards, and included the opening of the national economy to foreign trade and investment. The part of the reform program regarding foreign trade and investment became known as China’s Open Door policy. Within this policy, foreign financial institutions were not only encouraged to invest in the country, but also to promote reform of the financial system and to foster China's economic and financial relationships with other countries (Lees and Liaw 1996).

In 1980, the first foreign banks started to open representative offices in Beijing, since the relevant ministries, and headquarters (notably that of the Bank of China) were based there. Establishing a representative office in Beijing facilitated liaison activities, which were, in effect, the only activities that were permitted for these early representative offices. However, the most important locations for foreign banks later proved to be the four Special Economic Zones (SEZs) in Southern China: three in Guangdong Province and one in Fujian. These SEZs were granted a degree of autonomy, greater infrastructural investment, and tax incentives. Foreign investment projects in these areas proliferated rapidly.

With the SEZs designated by the central government as the main recipients of foreign investment in the 1980s, Shanghai was put at a relative disadvantage. Tian (1996) suggests that one of main reasons for not including Shanghai in the initial implementation of the open-door policy was a fear of political instability: in the 1950s and 60s Shanghai had become a heavy contributor to the central government's tax revenues (85 percent of its local revenue was remitted to the central government in the period 1958-82), so a failure of the reform policy in Shanghai would have greatly upset the national budget.

Nevertheless, Shanghai did see some considerable growth in the 1980s, most notably in the development of its financial functions. Shanghai experienced the entry of new foreign banks for the first time since 1949. In December 1982, the Industrial Bank of Japan and the Bank of Tokyo established representative offices in the city. In April 1984, Shanghai and 14 other coastal cities were 'opened' for foreign investment,
and this led to additional bank entries. Shanghai also started to strengthen its financial system in other areas. In 1986, an interbank lending market was established, and in 1988 a forex swap market was introduced. By 1989, the number of foreign banks in Shanghai had reached 34, exceeding the highest number of foreign banks before 1949. This reflects at least a partial revitalization of Shanghai’s identity as a financial centre, and a continuation of its historical role (Lees and Liaw 1996).

However, new limitations on entry to China’s financial markets were introduced after the Tian’anmen Incident in June 1989 (MacCormac 1993). Foreign banks adopted a cautious wait-and-see attitude towards the Chinese market. The earlier boom in the entry of new foreign banks (in the form of new representative offices) came to a halt. Moreover, the austerity program(1989-1991) put in place after Tian’anmen led to loan defaults, and foreign banks which had already opened branches elsewhere in China found that collecting debts or enforcing guarantees was difficult (MacCormac 1993).

In the aftermath of Tian’anmen, the central government wanted to show the outside world that China was still open for investment and was continuing its reforms (Gold 1991). This could be seen, for example, in the acceleration of the development of a previously planned zone for trade and finance in Pudong, formerly a rural hinterland east of Shanghai. This new financial zone was announced in 1990 and foreign banks were encouraged to open branch offices there. In addition to this initiative, other ways to further Shanghai’s economic development were explored. Investments were made in physical infrastructure, such as a ring road bypassing the city centre, public transportation, and gas and water works. In December 1990, the Shanghai Stock Exchange re-opened for business, stimulating the growth of China's financial market. The events of 1990 heralded a period of rapid economic growth.

Since 1991, Shanghai's annual growth in gross domestic product has generally exceeded the national average: reaching 14-15 percent between the years 1992 and 1995. Foreign direct investment figures have also improved substantially. In 1995, Shanghai attracted China’s second largest amount of FDI (after the province of Guangdong) (Tian 1996). This improved economic climate, together with a thriving real estate market and a more attractive capital market, led to a further increase in the number of foreign banks in the 1990s. From the 34 foreign banks present in Shanghai
in 1990, this number increased to a total of 108 foreign banks by the end of 1999\textsuperscript{12}. Despite the increase in the number of foreign banks, their share of the Chinese financial market remained small; and in fact decreased in the late 1990s, from 2.5 percent in 1996 to 2 percent in 2000 and 1.2 percent by the end of 2002\textsuperscript{13}. To a large extent, this is a result of the restrictions that foreign banks have faced in the Chinese market. Foreign banks have throughout China's reform era mainly been permitted to provide foreign currency services to non-Chinese individuals and enterprises, i.e. foreign corporations and joint-ventures in China. Despite the fact that this potential customer base has been growing rapidly, this has not resulted in a larger market share for the foreign banks. Foreign banks have thus appeared to be merely peripheral players in a market dominated by large, state-owned domestic banks.

However, further deregulation of the banking system (see Table 2) agreed upon as a condition of China's accession to the World Trade Organization (WTO) in December 2001 is generally expected to enlarge the market for foreign banks. Among others stipulations, China was to allow foreign banks to provide local currency services to all types of local enterprises by the end of 2003, and to Chinese citizens by the end of 2006 (i.e. five years after WTO accession).

During the second half of the 1990s, it became evident that deregulation had generated what Barnett and Carroll term ‘competitive release’ (Barnett and Carroll, 1993, p.116). This has manifested itself in several ways, most notably in the fact that competition between domestic and foreign banks has been intensifying. In this connection, Kuilman (2005) has shown that a gradual increase in the number of domestic banks has slowed down the time-to-profitability for foreign banks with branch offices. Another manifestation of the increased competition is the increasing number of equity stakes in domestic banks purchased by foreign financial institutions (see Table 3).

These phenomena suggest that the boundaries between the two organizational populations are slowly blurring. The growing competitive overlap between domestic and foreign banks also signals a resurrection of the competitive relationship between foreign and domestic banks that existed in the 1920s and 1930s. Although the market
has so far remained fragmented due to the legacy of socialist attitudes, recent years have seen renewed direct competition between the two organizational populations.

**CONCLUSION**

Institutional change can have dramatic effects on the number and diversity of organizations in an industry, and those effects are best seen across a long historical time frame. The history of foreign banking in Shanghai shows that the role of the state has been crucial in determining the level of diversity. At the end of the nineteenth century, for example, the Chinese government increasingly sought loans in the international capital markets, and an increased number of nations became involved in financing government projects. Banks from these nations increasingly felt the need to establish a direct presence in China rather than depending on the then-dominant British banks. American, Dutch, French, German, and Japanese banks all established a presence in Shanghai. These changes fundamentally altered the industry’s competitive structure. The increase in organizational diversity thus appears to have been a direct effect of institutional change.

However, some important institutional changes in mainland China, such as the revolution of 1911, affected neither the diversity nor the density of foreign banks in Shanghai. There are two reasons why this might have been the case. First, foreign banks may have been protected from failure by their parent banks and by home-country authorities. As affiliates of larger organizations, they may have had easy access to funds in times of adversity. In addition, these banks often also represented the financial interests of their home-country government. As such these banks were political agents as they facilitated inter-governmental finance. Second, prior to the Second World War, foreign banks in Shanghai had operated in their own institutional environment in the form of the International Settlement. This prevented some of the hostilities elsewhere in China spilling over to Shanghai.

Currently, however, given the volatile progress of contemporary reforms in China, institutionally i.e. state generated change is likely to continue to dominate the dynamics of foreign banking in Shanghai. The de-regulation process that started in the 1980s will continue to unfold. So far it seems to have generated a ‘competitive release’ (Barnett and Carroll 1993) with an increase in density surpassing any level that the local industry has ever seen, and a restoration of nationality diversity to pre-1949 levels. Expectations are that, at least in the short-term, the trends towards higher
density and diversity will continue and that Shanghai will increasingly compete with alternative financial centres such as Hong Kong and Singapore. Diversity will increase not only in terms of nationalities, but also in terms of the financial services being offered. As deregulation continues and the scope of operations for foreign banks expands, they will increasingly compete with domestic banks, which in the long term could cause downward pressure on the density and diversity of foreign banks.
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### TABLE 1
**Trade of Various Countries with China, 1880-1910**

<table>
<thead>
<tr>
<th>Year</th>
<th>United States</th>
<th>Japan</th>
<th>Great Britain</th>
<th>Germany</th>
<th>France</th>
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<tr>
<td>1880</td>
<td>71,000</td>
<td>103,000</td>
<td>1,539,000</td>
<td>88,000</td>
<td>69,000</td>
</tr>
<tr>
<td>1885</td>
<td>80,000</td>
<td>144,000</td>
<td>1,640,000</td>
<td>226,000</td>
<td>39,000</td>
</tr>
<tr>
<td>1890</td>
<td>22,000</td>
<td>267,000</td>
<td>2,032,000</td>
<td>262,000</td>
<td>114,000</td>
</tr>
<tr>
<td>1895</td>
<td>36,000</td>
<td>49,000</td>
<td>3,052,000</td>
<td>478,000</td>
<td>170,000</td>
</tr>
<tr>
<td>1900</td>
<td>131,000</td>
<td>751,000</td>
<td>3,240,000</td>
<td>638,000</td>
<td>281,000</td>
</tr>
<tr>
<td>1905</td>
<td>587,000</td>
<td>308,000</td>
<td>4,812,000</td>
<td>1,322,000</td>
<td>662,000</td>
</tr>
<tr>
<td>1910</td>
<td>289,000</td>
<td>2,655,000</td>
<td>4,943,000</td>
<td>1,326,000</td>
<td>553,000</td>
</tr>
</tbody>
</table>

*a* Measured in tonnage of vessels.


### TABLE 2
**Deregulation of Shanghai’s Foreign Banks, 1980-2006**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Business Scope Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 Oct. 1980</td>
<td>Representative offices permitted</td>
<td>Foreign banks are allowed to:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- liaise with the Bank of China</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- give advice to foreign firms in China</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- develop business with Chinese commercial and trade organizations</td>
</tr>
<tr>
<td>Dec. 1990</td>
<td>Upgrading to branch possible*</td>
<td>Foreign banks are allowed to engage in profit-making operations but prohibited from accepting deposits from or making loans to private domestic enterprises and Chinese individuals. All restricted to foreign currency transactions.</td>
</tr>
<tr>
<td>31 Dec. 1996</td>
<td>Local currency licenses*</td>
<td>Foreign banks can obtain a local currency license provided that they have been profitable for two consecutive years.</td>
</tr>
<tr>
<td>17 Dec. 2001</td>
<td>China’s WTO entry</td>
<td>Selected foreign banks are allowed to expand their foreign currency business to all institutions and individuals in China.</td>
</tr>
<tr>
<td>17 Dec. 2003</td>
<td>Two years after WTO entry</td>
<td>Foreign banks with a local currency license will be allowed to lend to and accept deposits from private domestic enterprises.</td>
</tr>
<tr>
<td>17 Dec. 2006</td>
<td>Five years after WTO entry</td>
<td>Foreign banks with a local currency license are allowed to lend to and accept deposits from Chinese citizens. Private banking will also be permitted.</td>
</tr>
</tbody>
</table>

*a* Local regulations (only in Shanghai), other regulatory changes are on the national level.
### TABLE 3
Foreign Investments in Chinese banks, 1996-2004

<table>
<thead>
<tr>
<th>Date</th>
<th>Chinese Bank</th>
<th>Foreign Investor</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>China Everbright Bank</td>
<td>Asian Development Bank</td>
<td>1.9</td>
</tr>
<tr>
<td>Sep. 1999-Mar. 2002</td>
<td>Bank of Shanghai</td>
<td>HSBC / International Finance Corporation / Shanghai Commercial Bank (HK)</td>
<td>8 / 7 / 3</td>
</tr>
<tr>
<td>Nov. 2001</td>
<td>Nanjing City Commercial Bank</td>
<td>International Finance Corporation</td>
<td>15</td>
</tr>
<tr>
<td>Dec. 2003</td>
<td>Fujian Industrial Bank</td>
<td>SHK Financial Group</td>
<td>10</td>
</tr>
<tr>
<td>Dec. 2003</td>
<td>Dalian City Commercial Bank</td>
<td>Newbridge Capital</td>
<td>17.89</td>
</tr>
<tr>
<td>Jun. 2004</td>
<td>Shenzhen Development Bank</td>
<td>Bank of Nova Scotia / International Finance Corporation</td>
<td>2.5 / 2.5</td>
</tr>
<tr>
<td>Sep. 2004</td>
<td>Xi’an City Commercial Bank</td>
<td>Commonwealth Bank of Australia</td>
<td>11</td>
</tr>
<tr>
<td>Sep. 2004</td>
<td>Jinan City Commercial Bank</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nov. 2004</td>
<td>Tianjin Bohai Bank</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### FIGURE 1
Number of Foreign Banks in Shanghai, 1847-2004
FIGURE 2
Diversity in Country-of-Origin among Shanghai Foreign Banks, 1847-2004

![Diversity Graph](image)

ENDNOTES

1 The Taiping Rebellion was one of the largest peasant upheavals in Chinese history, directed at the educated Confucian elite. Twenty million Chinese died as a result of this rebellion. See also Feuerwerker (1975), Kuhn (1978), and Nee and Peck (1975).

2 Among historians there seems to be little consensus regarding the founding year of this bank in Shanghai. Authors such as Cheng (2003), McElderry (1976), and Tamagna (1942) claim its branch office was opened in 1848. Others, such as Hong et al. (2003) and Ji (2003) point to 1847 as the starting year. I find Ji's (2003) source and argumentation the most convincing. Moreover, 1847 is mentioned by two museums in Shanghai (the Bank History Museum and the Bund History Museum) as the year of establishment.

3 For instance, the Hong Kong and Shanghai Banking Corporation also opened offices in Xiamen (1873), in Fuzhou (1877), and in Tianjin (1881).

4 This is in contrast to, for instance, the modernization of Japan, which was largely financed by a domestic government debt market, modeled after successful Western models (Han 1998).

5 Earlier however, on April 9, 1878, the First National Bank of Japan installed an agent at the Shanghai branch of Mitsui & Co. for the purpose of assisting in exchange transactions. This agent was recalled on February 4, 1881.

6 Earlier, from 1825 to 1827, the Nederlandsche Handel-Maatschappij (NHM) maintained a trading post in Shanghai, but the NHM at the time was not yet active in the banking business.

7 This measure has earlier been used by Carroll, Xu and Koçak (2005), Koçak and Carroll (2005), and Xu (2006) and can be formally represented as:

\[ \text{DIV} = 1 - \sum_{i=1}^{n} \left( \Pi_i \right)^2 \]

with \( \Pi \) the ‘market share’ of every country in the market (in a decimal figure), and \( n \) being the total number of countries.

8 But even if these quasi-foreign banks wanted to leave they ran into severe difficulties. This is shown most clearly by the experiences of the Hong Kong and Shanghai Banking Corporation. The bank tried to sell its local assets and withdraw its funds from the Chinese mainland, but was not allowed to do so. After years of negotiation, the Chinese authorities eventually confiscated HSBC’s prominent building on
the Bund, but insisted that the branch itself remained active in Shanghai. Its staff therefore moved into rented premises where it continued its (limited) business activities (Collis, 1965).

9 For a detailed account of various aspects of the reform program, see Qian (1999).

10 This austerity program was introduced to prevent the economy from overheating. In this period, the Chinese government also attempted to re-centralize investment and financial powers (Weingast, Qian, and Montinola 1995).

11 Branch offices, in contrast to representative offices, are allowed to engage in profit-making operations, such as the granting of loans. By allowing foreign banks to open branch offices in the city, the local government created a source of working capital and funds for the development of Pudong.

12 A wave of mergers and acquisitions in the global banking industry, most notable among Japanese financial institutions, was among the main factors that caused the number of foreign banks to decline after 1999.

13 PBOC Quarterly Statistical Bulletin.