The Shanghai Free Trade Zone – a Strategic Decision by China

Author Yizhi Wang

By Yizhi Wang

The Shanghai Free Trade Zone (SFTZ) has been in the spotlight both at home and abroad since its establishment in August 2013 upon approval by the State Council of China. There are already many bonded zones in China, such as the Shanghai Waigaoqiao Free Trade Zone and the Shenzhen Qianhai Bonded Zone. What's the difference between the SFTZ and all these existing bonded zones across the costal areas of China? This article will elaborate on the reasons for setting up a pilot free trade zone in Shanghai, explain the publicized "Framework Plan for the China (Shanghai) Pilot Free Trade Zone", and show the actual progress already made.

Domestic Background to the Establishment of the SFTZ

Pushed forward by the reform and opening-up policy, the Chinese economy has enjoyed continuous growth at high speed. Looking back at developments over the past 30 years, there are two events which have been milestones in China's economic achievements: one is Deng Xiaoping's South China tour speech in 1992, in which he announced the national policy of reforming the economic system and opening up the market to the rest of world for the first time, which became the framework for the socialistic market economy that was fully rolled out in 1994; and the other is China's decision to join the WTO in 2000, promoting the integration of China's economy and the world economy.

Problems, however, gradually loomed as this high-speed growth continued. For instance, with labor costs growing, the profits of low added-value and labor intensive industries were lessened. Generally, the technical component of the Chinese economy was proportionally low. The continuous high-speed economic growth caused over-consumption of environmental and natural resources, which began to put sustainable development out of reach. The global economy hasn't yet recovered from the downturn caused by the international financial crisis of 2008, making the problems even worse. Furthermore, because of the increase in manufacturing costs and the appreciation of the renminbi (RMB), Chinese exports have largely declined in recent years, especially for those at the low end of the industry chain. It means to some extent that China has to seek new development options. The mainstream view in China now is that economic growth should increase its reliance on domestic-demand growth (including both investment demand and consumption demand), speed up industrial restructuring, and raise the proportion of the economy's technical component.

From the perspective of the structure of consumption and accumulation, the propensity to save in China is rather high all the time. However, the problem is that the efficiency of converting savings to investment by the financial sector is relatively low, despite the fact that the amount of savings by individuals is maintained at a high level. Financial reform must be pushed further to increase efficiency in the financial sector, in order to promote domestic investment demand and improve the efficiency of resource allocation. Some financial reforms have been taken in China, such as shareholding reconstruction of state-owned commercial banks and lowering the thresholds for foreign and private capital to enter the financial industry, which aim at increasing competition in the financial market to some extent. Nevertheless, interest rates on savings are not fully liberalized, and there has been too much administrative intervention from the government in financial management, which will hamper the regulatory effect of financial instruments on the market and lower the efficiency of resource allocation. With the deepening integration of China's economy with the global economy, and the speeding up of the full convertibility of the RMB, it is inevitable that China will promote further financial reform as never before. In the environment of an opening economy, the risk management of financial reform is complicated. It is crucial to manage and control the financial risks in the course of reform. The most urgent issue for China in promoting further reform is to explore the proper measures and accumulate management experience.

With the rapid development of network technology, the Internet has penetrated into almost all fields of society — politics, the economy, etc. — with a pace, scope and depth beyond our expectations. Network technology has applications for business, international trade, industrial manufacturing, entertainment, and social communications, which indicates that on the one hand information services themselves will become an extensive sector of the service industry, and on the other hand such technology will continue to provide new opportunities for international trade and services trade. All these will pose challenges for traditional management models in international trade — sub-accounting of cross-border online shopping (including games), for example, is weakening the role of traditional customs management — so it is inevitable that a new order of international trade and national management systems for it will be built. Information services will grow into a huge service industry sector with rapid development and enormous output value, and will become an increasingly important sector in international trade. Undoubtedly China will face pressure to open this sector. In the light of the management of cyber-security related to the opening of the information service sector, China will greatly need to accumulate experience of managing this sector under open market conditions.

International Background to the Establishment of the SFTZ

The Smiling Curve theory explains how developed countries transfer the processing and manufacturing sectors to developing countries. The fast-changing development of new Internet technologies brought forth new industries and new business models. Multinational corporations, which have great influence on the global economy, are integrating their resources not only in manufacturing and sales, but also in global R&D. This trend makes services trading a new focus in international bilateral and multilateral trade negotiations, especially since the financial crisis of 2008. The global trade order is changing, together with changes in the world economic situation. The global multilateral trade system of the WTO is being challenged by regional multilateral trade systems. For instance, the Trans-Pacific Partnership (TPP) agreement led by the United States with the aim of propelling free trade in the Asia-Pacific area is now in the spotlight, while the WTO's Doha trade talks are suffering from setbacks. After 16 rounds of negotiations, even if there are disagreements on the protection of intellectual property, environmental standards, labor standards, and rules of origin, great progress has been made in the field of cutting tariffs and liberalizing services trade between the members of the TPP.

Negotiations on a Trans-Atlantic Trade & Investment Partnership (TTIP) agreement officially kicked off at the G8 Summit in the United Kingdom in June 2013. Europe and the US share a similar economic development and social institutions, and also a close average tariff. Except for agricultural products, tariff concessions can be made with little difficulty. Possible controversy may come in the non-tariff field. The popular point of view is that if a member nation is willing to compromise on agricultural products and non-tariff fields, it will not be very hard to promote the TTIP. Therefore, even though the Doha talks have broken their deadlock, will the WTO, a global multilateral trade institution, be replaced by a regional multilateral trade institution to a certain extent? This is attracting extensive attention.

Based on the above, we can foresee that China, which needs to further open up its market and be part of the global economy, will encounter a series of regional multilateral free-trade deals in the near future even though it has already become a member of the WTO. According to international practices, for example negative list management, the liberalization of trade in services will become a main concern in coming multilateral trade negotiations. To further open up the finance and telecom sectors, China's government needs to quickly accumulate relevant management experience through pilot projects.

We can conclude that setting up the STFZ is aimed at deepening reforms by opening the market further, and therefore pushing domestic economic transition. A more open market would lead China to a better place on the world stage to fit in with the new global economy order. Although the construction of the SFTZ will benefit Shanghai in promoting itself as an international financial center and shipping center, it is more significant for the further reform of China and the opening up of its economy.

Framework of Expanded Reform & Opening Up of the SFTZ

Free trade zones can be divided into two types. One, in a more general sense, indicates a zone granted most-favored nation treatment by the WTO, in which two or more countries or regions take such measures as opening their markets to each other, canceling tariff and non-tariff barriers on most goods in various phases, improving access to the service industry, and liberalizing trade and investment, in order to facilitate the free flow of commodities, services, capital, technology and human resources. The promotion of a free trade zone between China, Japan and South Korea would fall into this category.

The other type, in a narrower sense, is that defined by the International Customs Council in 1973, in which the tariffs and other taxes on any goods imported to a specific part of the territory of one country can be considered as abroad, which means they are free from the regular supervision by customs. The SFTZ is a free trade zone in this narrower sense, as it is located geographically within the territory of China but is free from the usual customs clearance procedures. It is composed of four specially supervised sub-zones, namely the Waigaoqiao Free Trade Zone, Waigaoqiao Bonded Logistics Park, Yangshan Free Trade Port Area and Pudong Airport Free Trade Zone, covering a planned area of 28.78 square kilometers (see *Map*).

In September 2013, China's State Council approved the overall plan of the SFTZ with a focus on five aspects: transforming government functions, opening up the investment sectors, TABLE

18 service sectors of trade opened up in the SFTZ

Financial services	Banking services
	Professional medical insurance
	Financial leases
Shipping services	Ocean cargo shipping
	International ship management
Trading services	Value-added telecommunication
	Video games, amusement machine sales & services
Professional Service	Legal services
	Credit investigation
	Travel agencies
	HR consulting services
	Investment management
	Engineering design
	Construction services
Cultural services	Artistic performance brokerage
	Entertainment facilities
Social services	Educational & occupational training
	Medical services

Source: China (Shanghai) Pilot Free Trade Zone

innovating and opening up the financial industry, transforming trading methods, and improving the legal system. Eighteen industries from six major service categories were chosen to be made more accessible to the rest of the world (see *Table*). According to the overall plan, the STFZ will pilot RMB convertibility in capital accounts, interest rate liberalization, and liberalization of exchange rates and cross-border RMB circulation. National treatment management and "negative list management" at all stages of access to foreign investment according to international practice will be implemented within the zone, and the STFZ will reform the investment management regime by gradually shifting the focus from examination and approval in advance to monitoring and supervision during the operation or afterward. I think that the overall plan with these measures is more far-reaching and significant for deepening economic reform, transforming government functions and broadening the opening up of China.

The overall plan provides only a framework and principles, and more detailed rules for implementation are under consideration. The Chinese central government is actively promoting and supporting the Shanghai municipal government in creating implementation rules that will gradually be released. So the experiments in the SFTZ will certainly be an evolving process. Chairman Xi Jinping pointed out at the second session of the 12th National People's Congress on March 5 that setting up a free trade zone is a significant measure for promoting reform and market opening. China has to actively explore a framework and supervision model according to international investment and trade standards, and come up with a new system replicable in the rest of China in a dare-to-try and self-adjusting manner. I think Xi's speech made clear the position and attitude of the Chinese government in creating the SFTZ.

Progress in Construction of the STFZ

The STFZ was established over six months ago, and during this trial period headway has been made and several characteristics have been exhibited.

a) Emphasis on financial industry

Although 18 industries are preparing to open up, the financial industry is the most important with its "spillover effect", reflected in its influence on the national economy, its role in negotiations on new services trade and the complexities for management in opening this industry. Since the People's Bank of China issued its "Suggestions on the Trial Establishment of the Shanghai Free Trade Zone of China" (known as the 30 suggestions of the central bank) in early December 2013, the central bank, the Banking Regulatory Commission, the Securities Regulatory Commission, and the Insurance Regulatory Commission (known as "one bank, three commissions") have successively issued a total of 51 detailed rules for financial trial reform. It is reported that rules on the free trade account system and financing and investment for facilitation will be published in the near future. Compared with other trial industries, detailed rules for the financial industry are being issued in a prompt and intensive way, showing the particular attention that the STFZ is paying to the financial industry.

b) Facilitating investment and trade

The present trade management system (including the investment management system) in China is mainly based on the requirements of goods trade and industrial investment. Adopting the present system of trade and investment management in the management of services trade will cause a problem of applicability. One of the main reasons is that services trade involves more small and medium-sized enterprises which are more sensitive to cost and convenience than large transnational enterprises in cross-border investment and cross-border operations. Therefore to improve facilitation of investment and trade is a key objective in the development of the SFTZ. For example, the published rules and measures for the financial industry include cross-border RMB payments, raising the upper limits on interest rates for deposits of small amounts of foreign currency, and initiating offshore business.

c) Duplicability and controllability of risk management

The ultimate aim of the Chinese government in establishing the SFTZ is to build a trial zone for further opening up and reform instead of to set up a single special financial zone in a prescribed area. The government needs to understand what kind of risks may emerge during the opening process, and to explore effective management to control these risks that will not only comply with standard international practices but also suit the Chinese context. Only with such knowledge and experience will the government be able to duplicate the administrative regulations and policies of the SFTZ in the rest of China in order to push forward the overall market economy reform and further opening up of the country.

MAP

Location of the STFZ

Source: China Briefing

The progress the SFTZ has made in the half-year since its establishment has attracted domestic and foreign attention, especially in the financial industry. An innovative framework for the financial sector has been built. Reform and innovation are expected in the main areas of market-oriented interest rates, currency convertibility, and liberalization of exchange rates, and reform of the administrative examination and approval system will be deepened. The basic framework for an international financial market platform is also being prepared, for example, the Shanghai Stock Exchange will establish an international financial asset exchange platform in the free trade zone, the Shanghai Futures Exchange has already built an international energy exchange center in the zone, and the China Financial Futures Exchange, Shanghai Clearing House and Shanghai Equity Exchange are currently considering setting up international financial service platforms in the zone.

The reform and opening initiatives mentioned above have generated very positive market feedback. According to the *Shanghai Business Daily* of March 26, 2014, by the end of February 2014 the number of financial institutions in the SFTZ totaled 1,383, among which are 43 licensed financial institutions, 102 equity investment enterprises or finance lease companies, 147 financial information service organizations, and more than 1,000 investment and asset management companies. In addition, reforms in such fields as payments and settlements, and approval procedures for investment, have been well received by the market. According to feedback from some of the enterprises in the SFTZ, they have already felt a greater convenience in their payment and settlement business than previously, and the efficiency of using cross-border capital has improved substantially, helping the management of cross-border capital for those enterprises that have overseas businesses. The Shanghai Pilot Free Trade Zone is exploring the trial of a foreign exchange administrative system that is in line with international practices to better facilitate trade and investment. Enterprises in the SFTZ are encouraged to leverage in both domestic and international market resources to liberalize cross-border financing.

Of course, building up the SFTZ has a long way to go, but I believe it will play a significant part in the history of China's reform and opening up. JS

Yizhi Wang is a professor at the Graduate School of the Shanghai Academy of Social Sciences, and vice president of the Shanghai Quantitative Economics Society. He has previously been a visiting scholar at Columbia University in the US and a visiting professor at City University in Hong Kong.