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Structural Economic Reform in China: The Role of the Shanghai Free Trade Zone

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Highlights

This note reviews the emerging imbalances in the Chinese economy and the attendant need for structural reforms, including financial sector and services liberalization. The role that the recently launched Shanghai Free Trade Zone could play in accelerating these reforms is then considered, alongside an assessment of progress to date. Key findings:

- China's dramatic economic growth has delivered impressive welfare gains. But the current growth model is now producing severe structural imbalances in the economy putting future prospects at risk.
- The Shanghai Free Trade Zone (SFTZ) was launched in September 2013 to provide a testing ground in which China's policymakers can experiment with economic reforms to be rolled out nationwide, paving the way for China's transition to a more efficient service- and consumption-driven economy.
- The SFTZ will open up many services sectors, including finance, to increased foreign investment. For the first time in China, a 'negative list' approach is being used: this specifies sectors in which foreign investment is prohibited or restricted—the default position being that it is otherwise allowed.
- The SFTZ has also been seen as an important stepping stone towards the internationalization of the Renminbi (RMB).
- The launch of the SFTZ generated considerable initial excitement among investors. However, despite the high level of attention given to the zone, so far commentators have been broadly disappointed and businesses report little change from the status quo.
- The recent change of leadership in the SFTZ, as well as renewed commitments to reform from top leadership, indicate that new impetus may be attached to reforms. Without bolder moves in this direction, the opportunity to pursue crucial economic adjustments via a timely managed process may be missed.

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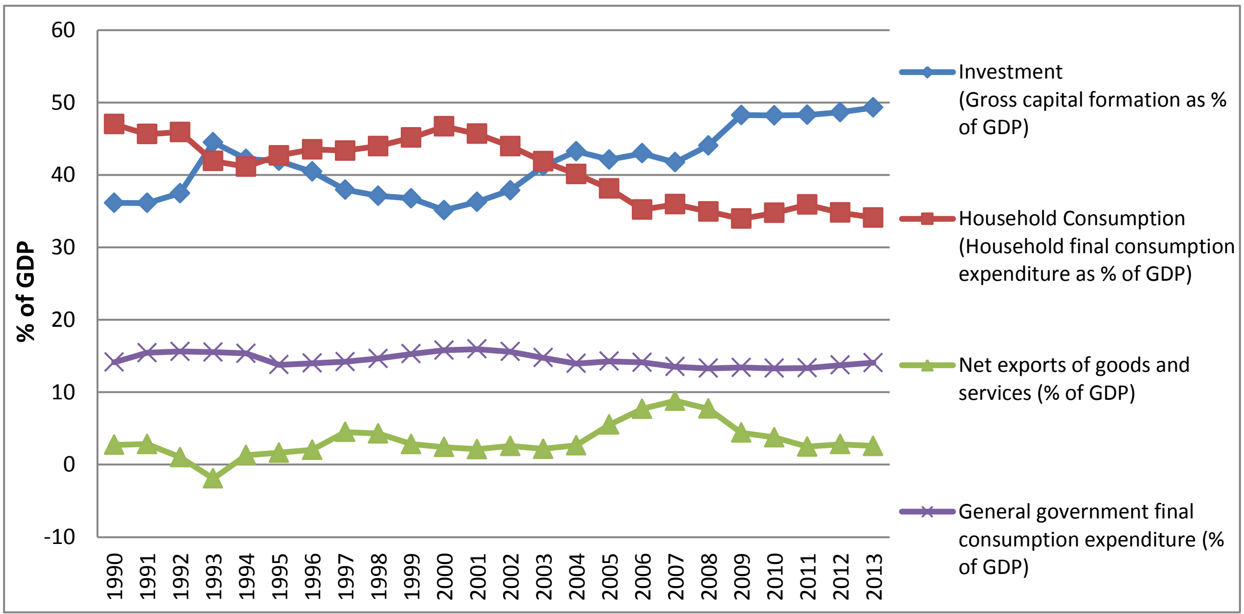
Introduction: the case for structural economic reform in China

China's remarkable economic performance over the last three decades has delivered impressive growth rates and lifted some 500 million citizens out of poverty over the past three decades (World Bank, 2013). Despite the obvious successes of China's growth model, the Chinese government and outside observers share rising concerns that the economy is suffering from severe structural imbalances or vulnerabilities (IMF, 2014). There is a risk that these problems, if not addressed, could reduce future growth prospects or even lead to an abrupt financial crisis. Today, although total annual GDP growth remains a healthy 7%, the Chinese economy has a number of worrying features, many of which are interconnected:

Excessive investment: The share of investment in GDP rose from around 35% in 2000 to reach around 50% in 2013 (figure 1). This rate is notably higher than shares seen in other Asian economies, such as Japan and the Republic of Korea, at similar stages of industrialization. Investment has been concentrated in infrastructure, real estate, and export-oriented production capacity such as machinery and plants (The Economist, 2012). With rising total investment, rates of return have fallen and the risks of default on non-performing loans have risen – increasing the fragility of the banking system. Much recent investment has been funded by debt: total outstanding debt (including government, corporate, and household debt) is estimated at 250% of GDP, up from 150% six years ago (The Economist, 2014a).

High levels of saving and low consumption rates: According to IMF data, urban household saving rates have risen from less than 20% in the mid-1990s to over 30% in 2011 (IMF, 2012). The rural household saving rate has risen over this period as well, but to a lesser extent. These high savings rates are often attributed to the absence of a well-developed social safety net under which households are incentivized to undertake precautionary saving. The flipside of high-savings and investment rates is low household consumption rates: at around 35% of GDP, consumption (figure 1) is considerably lower than in other economies (i.e. Japan and Republic of Korea) at a similar stage of development, (The Economist, 2012). Low domestic consumption rates increase the economy's reliance on exports and investment.

Figure 1. Composition of Chinese GDP (Expenditure Approach)



Source: CEIC Data

Financial sector inefficiencies: A critical feature of the financial system has been the transfer of funds from savers to producers, namely large SOEs. This has been achieved through interest rate controls, state-controlled credit allocation, entry barriers and state ownership in the banking sector. China's financial sector is still overwhelmingly dominated by state-owned banks, five of which accounted for 44% of the banking industry in terms of total assets in 2012. These banks have guaranteed state-owned enterprises (SOEs) access to capital at very cheap lending rates, below market clearing levels, but private enterprises have remained credit-constrained (World Bank, 2013). This structure distorts the allocation of capital and prevents investment being channeled to where it can be used most efficiently, with detrimental consequences for competition and long-run innovation.

Export-dependence and currency undervaluation: China is the world's biggest trader and an integral part of global supply chains. The export sector is critical for employment and has been a major destination for investment, both foreign and domestic. However, export-dependence also makes China more vulnerable to external shocks. Export competitiveness has also been supported by low real wages and managing the value of the currency; while the RMB has been allowed to gradually appreciate over time (33% against the US dollar since 2005) some suggest that it is still undervalued. According to an IMF assessment in July 2013, the RMB is currently moderately undervalued, by between 5 to 10% (IMF, 2013). Nevertheless, currency undervaluation also has detrimental consequences for China including (i) encouraging a diversion of resources towards the export sector from other areas, such as services; and (ii) eroding the purchasing power of Chinese incomes and thus the living standards of China's consumers.

Low productivity and value-added in services: While China is dubbed the 'workshop of the world' because of its manufacturing prowess, the services sector is less developed. No doubt, China's services sector has been growing: in 1978 services accounted for about 23% of China's GDP and 12% of China's labor force (ADB, 2011). By 2012 the former figure rose to 46% while the latter increased to around 37% (IMF, 2013). However, the sector's contribution to the domestic economy is lower than that of other large emerging economies. For instance, the service sector accounted for 69% of GDP in Brazil in 2013, 59% in India, 59% in the Russian Federation, and 70% in South Africa (World Bank data). Long-run innovation and competitiveness, required to drive the shift to greater productivity and higher-value added activities, will require a modernized services sector.

Towards a new growth model: The role of the Shanghai Free Trade Zone

A strong consensus has emerged among Chinese policymakers that China's economic growth model is no longer sustainable and requires a structural transformation towards a service-oriented and consumption-driven economy (World Bank, 2013). Chinese policymakers are actively emphasizing the *quality* of economic growth not just the *quantity*, and China's new President Xi Jinping has made the overhaul of the economy a top priority. During the Third Plenum in November 2013, the leaders of the Communist Party of China (CPC) stated that one of the critical points of the government agenda is "to deepen economic reforms by allowing the market to play a more decisive role in resource allocation." The Shanghai Free Trade Zone is expected to play an important catalytic role in this transformation, especially in the areas of financial sector reform and RMB internationalization.

Overview of the SFTZ

On 29 September 2013 the Chinese government officially launched the *China Shanghai Pilot Free Trade Zone* (SFTZ). This was hailed as a significant step forward in China's process of economic liberalization, especially for financial services. The SFTZ is intended to follow earlier Free Trade Zones ('Special Economic Zones', henceforth "FTZs") in China as a 'policy laboratory' in which experimentation with reforms can occur on a small scale before being rolled out to the wider economy.

Indeed, FTZs played a notable role at the vanguard of earlier rounds of economic reform and opening in China. Four Free Trade Zones – three in Guangdong and one in Fujian province – were established during the first phase of the reform area, in 1980, in proximity to two strategic and dynamic export-oriented economies, namely Hong Kong, China and Taiwan Province of China. These zones played a crucial role in China's economic opening to the rest of the world, especially in attracting foreign investment and technology. In terms of incentives, the four zones offered lower corporate tax rates or even tax exemptions, , and removal of custom duties on imported goods as long as such goods were used for re-exports. In addition to their role in attracting foreign capital, generating employment and encouraging technology transfer, FTZs have a symbolic status as emblems of the economic reform agenda.

In comparison with other earlier FTZs, the Shanghai FTZ is not intended to target export-oriented manufacturers but rather foreign investors in critical services industries. The financial measures introduced within the zone may have important implications for China's integration in international financial markets, especially the internationalization of the RMB. It is hoped to also transform government functions and bring trade and investment administration systems up to international standards. Shanghai as China's de-facto financial capital was the natural location for the SFTZ (figure 2). The area of the SFTZ incorporates four existing special customs zones including: a bounded zone (the Waigaoquiao Free Trade Zone), a bounded logistics parks (the Waigaoquiao Bonded Logistics Park), a bounded port (the Yangshan Free Trade Port Area), and an export processing zone (the Pudong Airport Free Trade Zone).

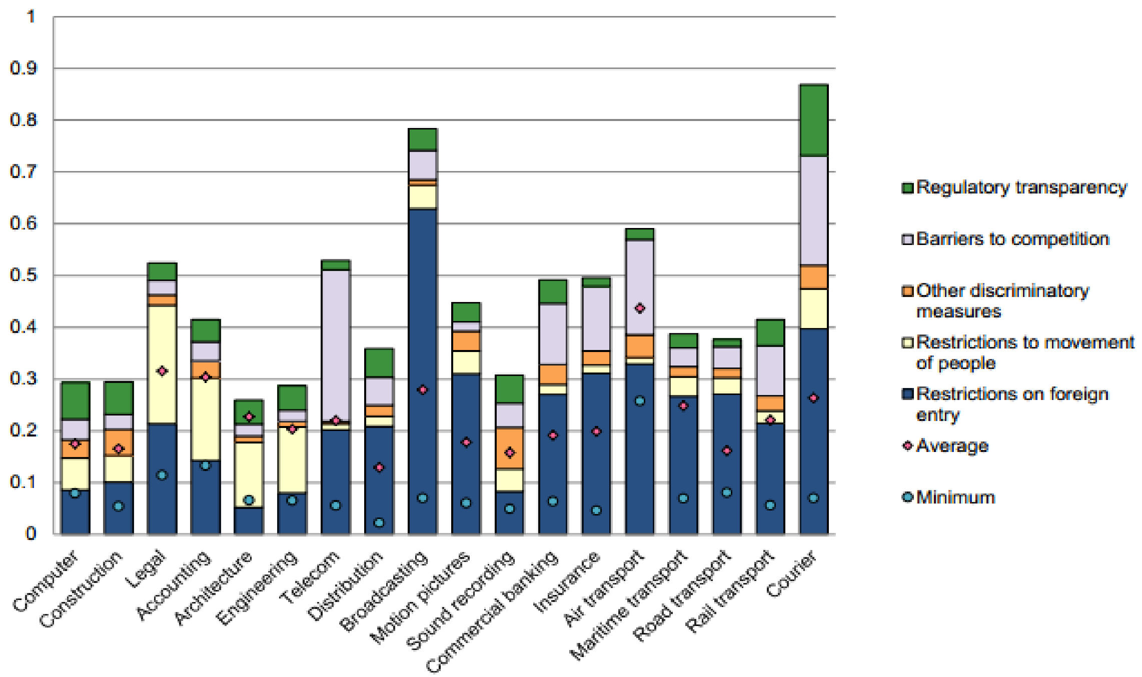
Figure 2. Location of the Shanghai Free Trade Zone

Opening to Services

China will not be able to transition to a more durable growth model without a strong, competitive services sector, including a well-functioning and developed financial sector. Not only are services an important driver of innovation and higher-value added activities, but the availability of services (for instance logistics, marketing, design and communications) are essential inputs into higher-value added manufacturing.

Foreign investment in services can bring much needed expertise and enhance competition and innovation. At present though, China's services sectors are largely closed. For instance, the OECD Services Trade Restrictiveness Index which measures openness across sectors, shows China is considerably more closed than the average of the 40 countries surveyed (34 OECD countries plus Brazil, China, Russia, Indonesia, India, and South Africa). Restrictions on foreign entry account for the bulk of the restrictiveness in many sectors (figure 3). In general, the most restrictive sectors are the ones dominated by SOEs, especially broadcasting, commercial banking, insurance, telecom, air transport, and courier services. As many incumbents could lose out to foreign competition there is likely to be resistance to further opening (Koch-Weser, 2014). In October 2013 China formally requested to join the Trade and Services Agreement (TISA) negotiations which entered their 6th round in February 2014. This is a plurilateral negotiation under the WTO to modernize and liberalize rules of services trade. However, China's commitment to this process is unclear.

Figure 3. Services Trade Restrictiveness Index by sector and policy areas



Source: OECD (2014)

A major focus of the SFTZ is further opening up of the services sector, especially in the following areas: financial services, shipping services, commercial services, professional services, cultural services, and social services (table 1).

One major innovation in the SFTZ is the adoption of a "negative list" for liberalization (officially the "Special Administrative Measures on the Entry of Foreign Investment into China (Shanghai) Free Trade Zone"). The list specifies in which sectors foreign investment is restricted and provides administrative guidelines and financial requirements (e.g. equity ratio, capital, business scope) by investment sector. For sectors included in the list, foreign investment will be subject to restrictions or prohibited. Any sector outside the list is now, in theory, fully open; foreign companies are now granted pre-establishment and are only required to go through an online record-filing procedure with the Shanghai PFTZ (Pilot Free Trade Zone) Administrative Commission in order to obtain a business license. The license can now be obtained within only four days within the zone, significantly less than an average of 29 days in other parts of China. This mechanism replaces the older one whereby foreign companies were required to apply for pre-approval and had to go through tedious and time-consuming administrative procedures. With the new system, all application materials will be submitted and handled by the Authority for Industry and Commerce (AIC). The approval and filing procedures are conducted through an inter-departmental circulation and all the various licenses and certificates (business license, enterprise code certificate, and tax registration certificate) will be issued altogether by AIC (China Briefing, March 2014).

Table 1: Summary of major reforms in selected service sectors

Financial Services	*Banking services*	► Allow qualified foreign financial institutions to set up foreign banks ► Allow qualified private capital and foreign financial institutions to establish joint venture banks ► Allow qualified domestic banks to engage in offshore business
	Health and medical insurance	► Allow foreign investment of health and medical insurance institutions on a pilot basis
	Finance leasing	► Remove the minimum threshold requirement of registration capital and expanding business scope
Shipping Services	*Ocean shipping*	► Relax the restriction of the equity ratio between foreign funds and domestic funds for joint venture international marine business ► Expand business scope
	International ship management	► Allow for wholly foreign-owned enterprises (henceforth WFOE)
Commercial Services	*Value-added telecommunications*	► Allow foreign investment enterprises to engage in certain value-added telecommunication services
Professional Services	*Law firms*	► Innovate cooperation methods between foreign and domestic law firms
	Credit investigation	► Allow foreign investment
	Travel agency	► Expand the business scope of the Sino-foreign Equity Joint Venture travel agencies
	Headhunting service	► Increase the limitation of equity ratio of foreign investors to 70% ► Allow it to be wholly owned by Hong Kong or Macau investors ► Reduce the minimum threshold requirement of registered capital

	Investment management	► Allow the establishment of joint-stock foreign investment companies
	Engineering design	► Relax application criteria
Cultural Services	*Artists agency*	► Remove restrictions of the equity ratio between foreign funds and domestic funds; allow WFOE to engage
	Entertainment	► Allow WFOE to engage
Social Services	*Education and training employment skills training*	► Allow Sino-foreign cooperative joint ventures to engage
	Medical services	► Allow for establishing WFOE medical institutions

Source: Ernst & Young (2013)

Companies outside the sectors on the list enjoy so-called Pre-Establishment National Treatment (PENT). This principle ensures that foreign companies receive the same treatment as their domestic counterparts do throughout the pre-establishment period of the business.

Further, in order to facilitate the administration of trade and investment, a simplified reporting procedure was introduced as of March 2014 whereby the companies in the zone need to issue an annual report as a public announcement instead of going through an annual inspection, which was previously the case. Companies are therefore required to provide certain information to an AIC online platform which will in turn make the information available to the public.

The previous "Pre-Approval" requirement has therefore been leveled down to an "Online Filing" and "After-Supervision" requirement. These measures were introduced to respond to the criticism that Beijing received for being excessively involved in the operations of private businesses, and to avoid time-consuming procedures that typically occurred under the previous Pre-Approval mechanism.

Financial Sector Reform and RMB Internationalization

To tackle fragilities in the financial system stemming from over-investment and related non-performing loans, as well as to promote more efficient use of capital, several reforms have been undertaken in recent years. These cover key areas such as interest rate liberalization, governance of state-owned banks, entry restrictions and controls for foreign investors. Despite this progress, the "Chinese financial system remains repressed, unbalanced, costly to maintain, and potentially unstable" (World Bank, 2013).

Similarly, with regards to internationalization, there have been some moves towards gradual capital account liberalization. Although most restrictions on FDI have been removed, portfolio investments have been relaxed only partially since 1994 and cross-border money transactions as well as financial derivatives are still under strict controls (Gallagher et al., 2014). While ultimately capital account liberalization could improve the efficiency of the economy, it needs to be implemented in an appropriately sequenced and integrated fashion. Three prior adjustments are often considered necessary to avoid instabilities arising from full capital account opening: (i) banking sector development including an effective regulatory system; (ii) interest rate liberalization; and (iii) exchange rate flexibility.

Box 1: Progress towards Renminbi Internationalization

Internationalizing a currency generally means the encouragement of its use beyond the borders of the issuing country, not necessarily for transactions with the issuing country's residents, but more importantly for transactions between non-residents outside the issuing country. In this regard the currency can be used as: (i) a store of value; (ii) a medium of exchange; and (iii) a unit of account (Kenen, 2009). At present the RMB is not fully internationalized and strict restrictions remain on both the use of the RMB for transactions between non-residents and Chinese residents and on the use of RMB by Chinese residents abroad (CIFR, 2014). However, greater internationalization is seen as a crucial step in China's further financial development.

China could reap important benefits from the internationalization of the RMB. According to Deutsche Bank (2014), some of these would include:

- lower financing and transaction costs for foreign companies operating in or buying from China thereby making it a more attractive business environment;
- lower foreign exchange hedging costs for inward and outward investment;
- greater ability for firms to hedge RMB exposure as the currency becomes more used in international trade; and
- wider and deeper use of the RMB facilitating capital account liberalization and promoting integration in international financial markets.

RMB internationalization alongside capital account opening also involves some costs and risks for financial stability to which policymakers are very sensitive. The ability of the central bank to influence domestic interest rates and money supply by open market operations would be more limited (CIFR, 2014). Further, greater international capital inflows or outflows could lead to greater volatility in the exchange rate with attendant consequences for asset prices and inflation (ADB, 2014).

To date, a number of important measures towards RMB gradual internationalization have been taken, with the launch of the SFTZ being another important milestone. Some of such measures include:

August 2009	Launch of a pilot scheme of RMB cross-border trade settlement in 5 cities - Shanghai, Guangzhou, Shenzhen, Dongguan, Zhuhai - with HK, Macau and ASEAN
June 2010	Pilot scheme extended to 20 provinces and to trading partners worldwide
January 2011	People's Bank of China announces a pilot scheme for Outward-bound Direct Investment (ODI) in RMB
August 2011	RMB cross-border trade settlement scheme extended nationwide RMB20bn Qualified Foreign Institutional Investor (QFII) scheme launched
December 2011	Launch of RMB20bn RMB Qualified Foreign Institutional Investor (RQFII) scheme
April 2012	Expansion of QFII scheme (quota raised to USD80bn) and RQFII scheme quota raised to RMB70bn
February 2013	RMB business launched in Taiwan: Taiwanese banks start offering RMB services. First "Formosa bond" issued in Taiwan
September 2013	Shanghai Free Trade Zone is launched as an offshore RMB market
October 2013	RQFII scheme launched in Singapore (RMB50bn quota) and London (RMB80bn quota)
March 2014	RQFII quota granted to Paris (RMB80bn quota)

Source: Deutsche Bank (2014) and ASIFMA (2014)

The most transformative impacts of the SFTZ are expected to be felt in the area of financial services reform. A number of major features of the zone include:

- **New trade accounts:** Foreign companies and individuals working in the SFTZ are allowed to establish "free trade accounts" in the SFTZ. The accounts may be in RMB or foreign currencies and will be treated similarly to bank accounts outside China. The movement of funds between individual free trade accounts, and between these accounts, offshore accounts and non-resident bank accounts in China (but outside the FTZ), will not be subject to the existing restrictions on the movement of funds between China and overseas accounts.
- **Currency exchange for investment and financing.** Foreign investment projects will face simpler financial and foreign exchange regulations. The requirement for State Administration of Foreign Exchange registration for foreign exchange for FDI will be removed. Additionally, opportunities for Chinese individuals to buy foreign securities will be expanded and foreign individuals will have access to Chinese securities.
- **Cross border use of the RMB:** Cross-border RMB settlement for current account items and direct investment will be expanded. Both domestic- and foreign-invested enterprises registered in the FTZ will be able to obtain RMB loans from overseas and to provide security and loans to overseas parties.
- **Cross-border direct investment transactions:** Companies established in the FTZ can borrow offshore RMB of an amount equal to their paid-in registered capital multiplied by a “policy index” published by the Peoples Bank of China (Hogan Lovells, 2014).
- **Interest rate liberalization:** Measures moving towards market-based interest rates will be introduced gradually. As a major step towards market-driven interest rates, the People’s Bank of China announced to remove from June 27 the interest rate ceilings on foreign-currency deposits of less than US$ 3 million offered by banks across the whole city of Shanghai, an extension of a pilot scheme launched in March and confined to the SFTZ (Bloomberg, 2014).

Assessing the operation of the SFTZ: Progress to Date

The SFTZ generated considerable excitement in the business community upon its launch. Investors and experts have long awaited aggressive market-oriented measures by the Chinese government to restructure the economy and open up the financial sector to foreign investors. Initial figures confirmed the level of interest. By mid-February 2014, the zone attracted 434 foreign-invested enterprises from 40 countries and its trade volume (imports and exports) accounted for 27% of Shanghai’s total trade (WTO, 2014). By the end of June 2014, 39 banks had opened 42 business points in the SFTZ, including 14 branches and 4 sub-branches of Chinese banks, 23 sub-branches of foreign banks, and 1 financial lease sub-company (UKTI, 2014). According to official figures released upon the zone’s one-year anniversary, the zone had attracted some 12,000 firms after the first year, although only 1677 are foreign-funded companies (Xinhua, 2014). But excluding Taiwan Province of China and Hong Kong, China, the number of foreign companies accounts for only 5-6% of the total (643 organizations), far less than expected (Reuters, 2014a).

Table 2: The status of reforms in the SFTZ

Implemented	Not implemented yet
• Simplifying customs procedures • Speeding up company registration • Allowing Chinese companies offshore RMB borrowing • Liberalizing rules on company fund transfers • Facilitating RMB-denominated gold trading	• Exchange rate loosening • Liberalizing RMB interest rates • Permitting foreign banks entry into capital markets • RMB-denominated bond issuance • Derivatives trading

Source: Wall Street Journal (2014)

Despite the early rush of interest, there has been growing disillusionment with the SFTZ amongst the business community (Financial Times, 2014a). For instance, interest rate liberalization and capital account opening have not yet been delivered (Financial Times, 2014b). Businesses operating in the zone have not reported substantial changes in operations, and despite the shift to the 'negative list' 139 sectors are still affected by restrictions. A lack of clarity on policy incentives (Reuters, 2014b) and what is allowed in the zone (AMCHAM, 2014), is prompting a wait and see approach among investors.

The Chinese leadership has also expressed frustration about the slow rate of progress and the de-facto head of the zone has been replaced (The Economist, 2014b). Responding to criticisms about the pace of change, some further steps have been taken to deepen the reform in the SFTZ. For instance:

- In June 2014, the negative list was revised, reducing the number of restrictive measures to 139 from 190. The majority of the removals and changes were in manufacturing, transportation, warehousing, and postal services, and to a lesser extent wholesale and retail. The new negative list, operating from July 1st 2014, includes 110 restrictive clauses and 29 prohibitive ones.
- According to a circular released by China's State Council upon the zone's one year anniversary, more than 20 service sectors are expected to be opened to foreign investment in the near future. For example, further liberalization is expected in the shipping sector. According to the circular, for the first time foreign investors will be allowed to hold a 51% stake in joint-venture shipping agencies (South China Morning Post, 2014a).
- Despite the cautious approach taken so far, the SFTZ model is likely to be extended to additional zones in different localities. In January 2014, Beijing gave preliminary approval for 12 new free trade zones. Zones are expected in Guangdong and Tianjin with the other locations still being determined (South China Morning Post, 2014b). It may take at least a year for any of these additional zones to be fully established.

Despite the lack of progress to-date, it is too early to dismiss the SFTZ. Indications are that there is political commitment to deepening and extending the reforms. The risk for policymakers is that unless the pace of reforms is quickened, the risks within the broader Chinese economy from over-investment and debt will continue to rise making a managed and gradual transition to a more sustainable economic model more difficult.

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