China: highlights of the Shanghai Free Trade Zone

China (Shanghai) Pilot Free Trade Zone will be officially opened at the end of this month. Although details have not been announced, it has been considered as an important step for China to further open its market and a weather vane of the next phase of reforms initiated by the new government since the very day it obtained approval.

It is interesting that market focus has been largely on the financial reform within the Free Trade Zone, e.g. interest rate liberalization. Market watchers are particularly excited about the convertibility of renminbi on the capital account on a first-to-do and first-to-try basis within the zone. Ongoing discussions over the Free Trade Zone tend to generate a wrong impression that the Free Trade Zone is merely a testing ground for financial reform.

Is that true? We believe this understanding is too narrow which has overlooked the key importance behind supportive reforms of various areas within the zone. Excessive emphasis on the financial reform and impractical expectations on the progress of it are more like a market hype of castles in the air, which is likely to result in confusion and disappointment to the market after a short period of excitement (just as the financial reform in Wenzhou)

What are included in Shanghai Free Trade Zone?

The Shanghai Free Trade Zone, personally endorsed by Premier Li Keqiang, is by no means not only a testing ground for financial reform that takes on a new look. Overall, **the pilot reforms within the zone comprise four areas, including trade, investment, finance and administrative government**.

First, trade liberalization. Trade upgrading is an essential part of a Free Trade Zone, which includes two aspects: (1) Further liberalization of traditional trade businesses to achieve free imports, storage, re-exports, processing and manufacturing of goods within the zone. This has no essential differences with preferential measures provided by existing bonded zones, but further initiatives may be undertaken to relax customs and tariff regulations. (2) Expansion and development of Shanghai's position in relevant sectors with the development of the trade sector. For instance, the Free Trade Zone has proposed to bring into full play the linkage of Waigaoqiao Port, the Yangshan Deep Water Port, and the Pudong International Airport and develop shipping finance, international shipping, ship management, etc. to turn Shanghai into an international shipping center. Moreover, an international commodity trading platform and warehouses for the delivery of commodity futures are expected to be built and international trade covering energy products, industrial raw materials and agricultural products to be conducted within the zone. If these goals will be achieved, it will give a boost to Shanghai's prosperity as a free trade port.

Second, investment liberalization. The negative-list approach and pre-establishment national treatment will be adopted across the board within the zone, which are of significant importance. The negative list approach means that all sectors will be opened up, except those specifically excluded by law. Although there is only a single-word difference with the positive list approach (means only those specifically included by law will be opened up), the two approaches are totally different. in their concepts and the negative list approach is a demonstration of decentralization of power by the government. Moreover, the pre-establishment national treatment will be offered to foreign firms, which means the majority of the investment within the zone (including inbound investment and outbound investment) will be subject to a filing system. Foreign investments within the zone will not be under administrative control under the prevailing Catalogue for Guiding Foreign Investment and restrictions on foreign ownership and scope of business (corresponding revisions to applicable laws have been approved by the State Council and will be effective since October 1). The current approval system involving relevant government ministries (e.g. the NDRC, MOC) for foreign investments made by Chinese companies may be removed within the zone, and foreign investment funds are encouraged to be established to further facilitate overseas investment.

Third, as the biggest highlight of the reforms at the Shanghai Free Trade Zone, the financial reform, has caught great attention from the market. As compared to other free trade zones currently under construction outside China (e.g. HK), China may have the biggest gap in the financial sector and the lagging development of the financial sector could drag on the development of the free trade zone. Financial reform measures within the zone that are circulating in the market include 9 aspects: (1) interest rate liberalization, market-oriented pricing for assets of financial institutions; (2) the convertibility of renminbi on the capital account on a first-to-do and first-to-try basis; (3) foreign banks and joint venture banks between domestic private capital and foreign capital are allowed to be established; (4) restricted license banks are allowed to be established; (5) foreign-invested credit rating companies are allowed to be established; (6) some Chinese banks are allowed to engage in offshore business; (7) financial lease businesses are encouraged and tax incentives are given; (8) overseas companies will be gradually allowed to participate in commodity futures trading, financial lease companies are allowed to engage in the commercial factoring business related to their primary business, overseas futures exchanges are allowed to designate or set up warehouses for the delivery of commodities futures; (9) project companies engaged in overseas equity investment could be subject to a 15% corporate tax in line with the high-tech service sector. Overall, the financial reform within the zone is beneficial to overcome the obstacles in the financial sector in the construction of the free trade zone and is also beneficial to accumulate experience for the nationwide financial reform and RMB internationalization. In the long-term, the free trade zone may be developed into an offshore financial sector onshore.

Fourth, there should be supporting measures to be announced on addressing administration process and legal restraints. We believe, **the transition of administrative functions of government is the most essential part of the reform within the Free Trade Zone, redefining relationship between government and market**. For example, the above-mentioned negative-list approach on investment will help China to certify to the latest standards of international trade so as to enhance investors' confidence and get them motivated, and more importantly, it will represent a fundamental change on the existing concept of administrative process in China. It will result in market playing a more important role, and prevent rent-creating and seeking activities under the current regime, and crack down monopolization. In terms of legal restraint, the Shanghai Free Trade Zone has been allowed an ad hoc three-year suspension of implementation of "three foreign investment laws" ("Law on Wholly Foreign-owned Enterprise", "Law on Chinese-foreign Equity Joint Ventures", "Law on Chinese-foreign Contractual Joint Ventures") by the National People's Congress in late August.

What to expect in the near term?

The Free Trade Zone is built by following the guideline of "complete deregulation of first tier, safe and efficient full-control of second tier and free flow of goods within the Zone". "First tier" refers to the relationship between the Free Trade Zone and abroad, which goods can freely exit from and enter into China free of customs supervision; "Second tier" refers to the relationship between the Zone and the rest of mainland China, which movements of goods shall be subject to applicable taxes and regulation.

The above guidelines are fairly easily understood when applied in physical trade, however, they are confusing when applied in the financial industry. These guidelines seemingly borrowed directly from the experience of other international free trade zones, but Shanghai appears to be an exception where its financial reform has been much more laggard than other free trade zones. The definitions have also given rise to various speculations and uncertainties on the financial reform, such as, should one financial institution have to open a branch or subsidiary in the Free Trade Zone (with area of only 28.78km^2) to benefit from the financial reform? Does complete deregulation of first tier mean full liberalization of financial operations within the Free Trade Zone? How full-control of second tier concerning financial industry will be ensured once first tier is deregulated?

We believe the government is unlikely to make an aggressive move in reforming the financial market. Over the near term, financial reform in the free trade zone will focus on three aspects: first is to lower the threshold for the establishment of financial institutions (e.g. foreign banks, banking JVs, financial leasing companies) in the free trade zone; second is the potential removal of restrictions on certain offshore financial businesses, which may start from RMB settlement and treasury services for multi-national corporate, and then extend to RMB convertibility and cross-border investment etc. However, the possibility of a big-bang liberalization of offshore financial businesses is limited. The full liberalization of interest rates (including deposit rates) anticipated by the market is not likely in the short run. Thirdly, channels connecting the free trade zone and the rest of the mainland may be made available to enable capital flows to a certain extent (similar to the RQFII scheme in the offshore RMB center in Hong Kong). However, the scale will be highly restricted in the near term.

Generally speaking, the development of the free trade zone is likely to be a gradual process and it can not be built overnight. Details regarding the free trade zone are anticipated in the coming one or two weeks. That, however, is only the beginning rather than an end. More specific rules and improvements relating to different areas are expected to phase in over the next one or two years.

It should be reemphasized that the free trade zone is never simply a trial zone for financial liberalization. It covers aspects including trade, investment, finance and government administration, and at the heart of the reform is to redefine the relation between the government and the market. As summarized by Premier Li in the Summer Davos Meeting last week, "the Shanghai Free Trade Zone attempts to explore the negative list approach, and priority will be given to easier investment access and greater openness in the service sector."

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