CIGI PAPERS

NO. 59 — FEBRUARY 2015

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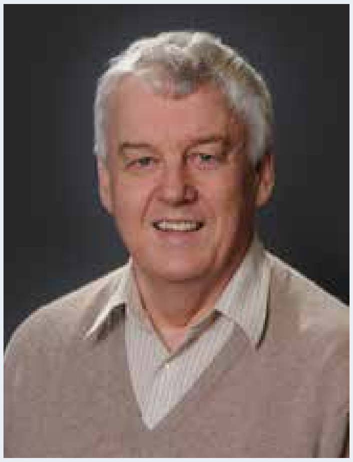

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ACRONYMS

BRIC	Brazil, Russia, India and China
CNH	offshore RMB
CNY	onshore RMB
EIA	economic integration agreement
FDI	foreign direct investment
FRED	Federal Reserve Economic Data
FTA	free trade agreement
FTU	free trade accounting unit
FTZ	free trade zone
PBoC	People's Bank of China
PM10	particle pollution
RMB	renminbi
RTA	regional trade agreement
SPFTZ	The China (Shanghai) Pilot Free Trade Zone
SZIP	Suzhou Industrial Park
WDI	world development indicators
WTO	World Trade Organization

EXECUTIVE SUMMARY

The China (Shanghai) Pilot Free Trade Zone (SPFTZ) founded in September 2013, is a trial for China's new round of "reform and opening up" (China.org.cn 2008). The SPFTZ has promised liberalization on capital account and trade facilitation as its main objectives. This paper discusses reasons why China needs such a pilot zone after three decades of economic development, examines the differences between the SPFTZ and other free trade zones (FTZs) and highlights the developments of the SPFTZ since its inception. The SPFTZ's initial impressions are assessed, especially its impact on the opening of China's capital account and financial liberalization. The hope is that the success of the SPFTZ, and more pilot policies replicated in China, will give rise to a more balanced Chinese economy in the following decade.

INTRODUCTION

This paper discusses the SPFTZ over a year after its introduction. Launched on September 29, 2013, the SPFTZ is more than a traditional FTZ and more of a trial zone for China's new opening up and reform strategy. It is a unilateral set of measures and procedures relating to a small area in Shanghai, which has promised liberalization on China's capital account and trade facilitation as its main objectives. Relatively little has been written in English about the SPFTZ, and so, in part, this paper will describe and document this unique initiative. Importantly, the SPFTZ is not an FTZ based on bilateral or plurilateral tariff liberalization.

The SPFTZ is a pilot zone for China's new round of reforms and opening up. The paper discusses why China needs such an FTZ and what its objectives are. Over the last 20 years, China's considerable economic development has been export and investment dependent, but the country cannot continue developing in this way much longer. There is no more room globally for the second-largest economy in the world to develop like a small export-oriented developing country. The precedents of Korea or other East Asian Tigers cannot be replicated much further by China.

This paper reviews the development of the SPFTZ over the past year. As a pilot zone for exploring policy, the main impacts of the SPFTZ are not the amount of its trade volume or foreign investment, but the institutional innovation it generates. The most significant new institutions lie in four areas: the implementation of a "negative list" model for foreign investment management; the more efficient operation of new trade supervisory institutions for trade execution; the beginning of financial reform experiments on capital account convertibility and financial services; and the reduction of bureaucracy within administration. These are analyzed later in more detail.

After one year's operation, the impact of the SPFTZ on economic performance, especially in regard to financial liberalization, needs to be examined. Using onshore and offshore renminbi (RMB) exchange rates is one way to assess the SPFTZ's financial liberalization effect. This data suggests that capital restrictions are loosening with the founding of the SPFTZ. With more reform policies in the SPFTZ, and if replicated in other areas in China, the hope is that economic performance will be further improved in such areas as interest and exchange rate liberalization, capital account opening and RMB internationalization.

SPFTZ: THE BACKGROUND

The SPFTZ can be compared with the Shenzhen Special Economic Zone near Hong Kong, which ushered in reforms and spectacular growth 35 years ago.

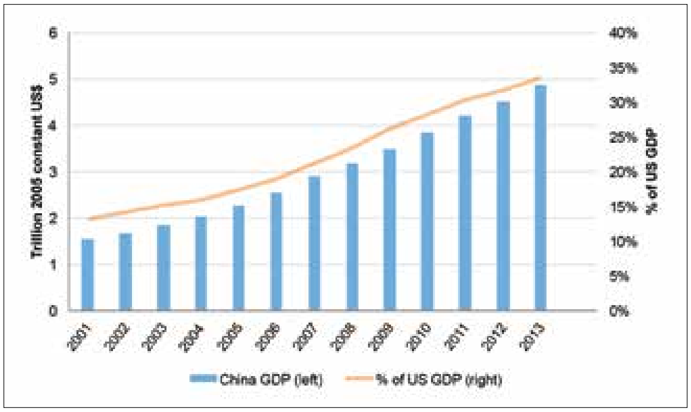
Why a Pilot FTZ? A New Stage for China's Economy and Structural Unbalance

China has accomplished major economic development in this new millennium. According to the World Bank's World Development Indicators (WDI), when China joined the World Trade Organization (WTO) in 2001, the country's GDP was US$1.535 trillion (constant 2005 US$).[1] By 2013, China's GDP was US$4.864 trillion, with an average annual rate of increase of 10.09 percent. By comparison, the world total economy in the same period increased from US$41.02 trillion to US$55.94 trillion, with an annual rate of increase of only 2.62 percent. In these 12 years, China's share in the world economy more than doubled, from 3.74 percent in 2001 to 8.69 percent in 2013. In 2013, and within the BRIC (Brazil, Russia, India and China) countries, China loomed large over the others with a GDP about 57.3 percent of the BRIC total. In comparison with the United States, as demonstrated in Figure 1, China's GDP has increased from about one-eighth (13 percent) of the United States' GDP in 2001 to more than one-third (33.5 percent) in 2013.[2]

1 All the data in this paper are obtained from the WDI (2014) database unless otherwise indicated.

2 If evaluated by exchange rate in constant 2005 US$, China's GDP in 2013 was 4.86×10^{12} while the US's GDP was 1.45×10^{13}. In 2001, China's GDP was 1.53×10^{12} while the US's GDP was 1.17×10^{13}.

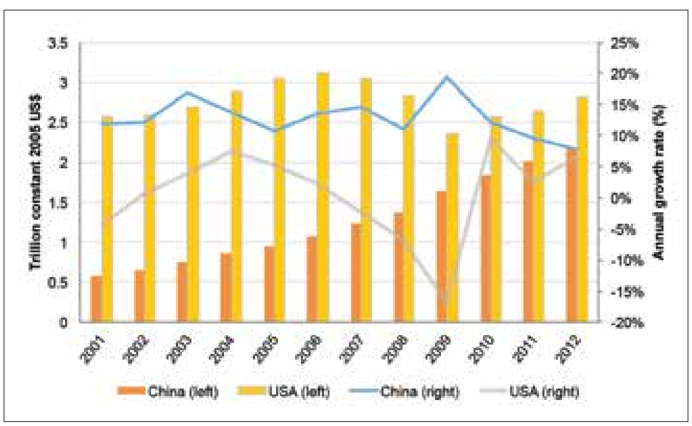
Figure 1: The Economic Development of China



Source: WDI database.

China's macroeconomic performance in the past decade reflects high domestic investment, high dependence on the foreign market and a low consumption ratio. The proportion of China's gross capital formation in the world tripled from 6.3 percent in 2001 to 16.9 percent in 2012, increasing from US$575 billion to US$2.17 trillion, not much less than the United States' $2.81 trillion. The annual growth rate of China's gross capital formation has been in double digits since 2001, peaking in 2009 at 19.3 percent, while all other main economies struggled in the aftermath of the 2008 global financial crisis wherein gross capital formation decreased by more than 10 percent in 2009.

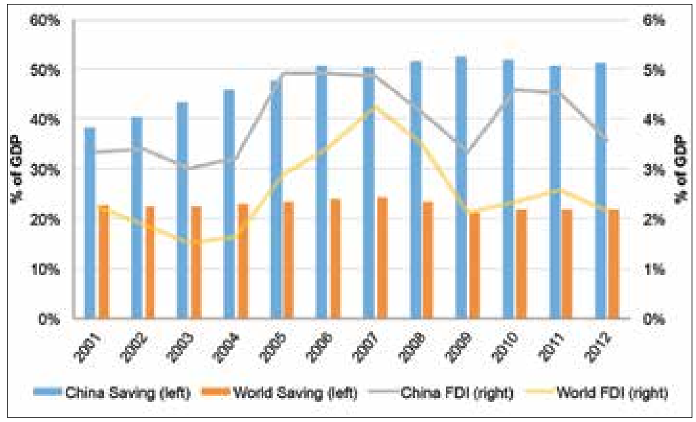
Figure 2: Gross Capital Formation of China and the US



Source: WDI database.

To increase investment, China relies not only on domestic saving, but also on foreign capital inflows. In 2001, the ratio of gross domestic saving to GDP in China was 38.4 percent, approximately two-thirds higher than the world average ratio of 22.8 percent. In 2006, that same ratio in China increased to 50.7 percent, and has since remained at more than 50 percent. China is also a major destination for global foreign direct investment (FDI). In 2001, the net inflow of FDI into China was US$44.2 billion,

Figure 3: Gross Saving and FDI Net Inflow, China and the World



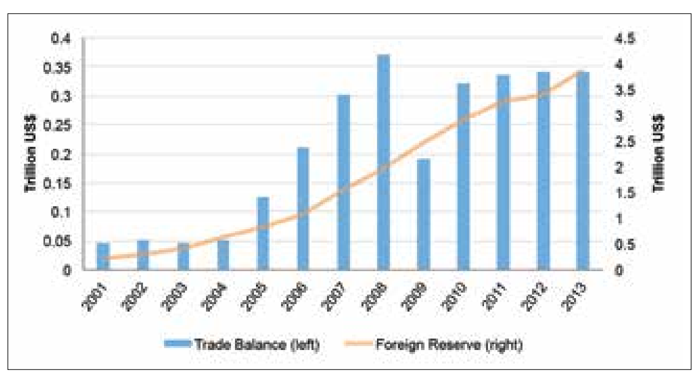
Source: WDI database.

about 6.1 percent of the world total, and this increased to US$348 billion in 2013, nearly a quarter (24.2 percent) of the world total (Figure 3).

The productive capacities induced by high investment and low domestic consumption found an outlet in an export-oriented trade policy with a fixed-exchange rate currency policy. In 2001, exports of goods and services by China were US$400 billion in 2005 constant US$, about four percent of the world total. In 2013, China's exports reached US$1.92 trillion, more than 10 percent of the world total. Since China exported much more than the country imported, the trade balance increased steadily, from US$47.7 billion in 2001 to US$342 billion in 2013.

With both increasing foreign capital inflows and a trade imbalance induced by a fixed exchange rate, as well as hot money for speculative RMB appreciation, China's foreign reserves increased rapidly. The value of China's total reserves in 2001 were US$220 billion, and by 2013 had increased to US$3.88 trillion, more than triple Japan's US$1.27 trillion, the second largest reserve holder (Figure 4).

Figure 4: Trade Balance and Foreign Reserve of China



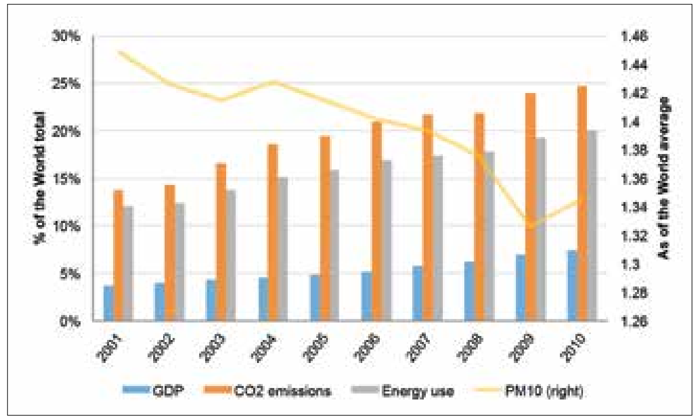
Source: WDI database.

While the economic accomplishments noted above are universally recognized, the current development model of China has drawbacks and cannot sustain itself for another one or two decades for at least three reasons.

First, the world has less ability than previously to accommodate China's future development in the same way. China's GDP per capita in 2013 was US$3,583 in constant 2005 US$, about 45 percent of the world average US$7,852. If China and the world maintain the same growth rate of GDP per capita as in the past 12 years, 9.5 percent and 1.4 percent respectively,[3] China will reach the world average GDP per capita by 2023. But this would mean that China's gross domestic savings would account for 70 percent of GDP. In addition, this would mean exports would account for 25 percent of the world and accommodate 59 percent of global FDI,[4] which is unlikely to occur.[5] Since China has become the second largest economy in the world, it cannot simply replicate the past development path from when it was relatively small.

The second reason why Chinese growth cannot continue as in the early years of the twenty-first millennium is that China cannot afford the environmental costs accompanying the current development pattern for another decade. China accounts for 20 percent of the world's energy consumption and 25 percent of carbon dioxide emissions. Particle pollution (PM10) levels are 35 percent higher than the world average.

Figure 5: Energy and Environment, China Compared with the World



Source: WDI database.

Third, the national income of China may not be as large as the GDP appears. Lacking technology and patents, Chinese firms earn a small share of profit, as they are usually at the bottom of the product value curve using unskilled labour for low-technology production such as assembling. An example of this is provided in research by Yuqing Xing and Neal Detert (2010), which shows Chinese firms receive a US$6.50 manufacturing fee for each individual Apple iPhone, for which the total cost is US$178.96.

If the Shenzhen Special Economic Zone has been a symbol of the traditional Chinese development model in the past three decades, then the SPFTZ aims to be the symbol for the new development model in the following decades.

A Pilot Zone for Reform, Not Just for Trade

It is not accidental for such a pilot FTZ to be located in Shanghai. Shanghai is the largest city in China and also the financial and economic centre. Consisting of only 0.06 percent of China's total area, the GDP of Shanghai accounted for 3.8 percent of China's total in 2013. Shanghai leads China in the international economic and trade sector, with a container handling amount accounting for 17.8 percent of China's total, a goods import and export amount accounting for 19.5 percent and an FDI amount accounting for 14.3 percent. If the policy trials succeed in Shanghai, they may be replicated in other parts of China.

Located in the outskirts of Shanghai, the SPFTZ consists of four existing "bonded zones," shown in Table 1.

Although named as an FTZ, the SPFTZ has been, since its inception, a pilot zone for reform, not just for trade. The differences between the SPFTZ and other FTZs lie mainly in the following two elements.

3 In constant 2005 US$, the GDP per capita of China in 2001 was 1,206, in 2013 this figure was 3,583. The GDP per capita of the world in 2001 was 6,636, and in 2013 it was 7,852. From these, we can easily compute a growth rate of 9.5 percent and 1.4 percent respectively. Based on these growth rates, China's GDP per capita will be equal to the world's in 10.2 years.

4 All these projections assume the same increase rate of 2001 to 2012 for the years 2013 to 2023. For example, China's saving ratio of GDP in 2001 was 0.383, in 2012 was 0.515; if the rate continues to increase, in 2023 this ratio will increase to 0.692, about 70 percent. The export and FDI in 2023 are projected in the same way.

5 According to macroeconomic theory, $S=I+CA$, where S is national saving, I is investment and CA is current account surplus. As a big country in the world, a current account surplus of 5 percent of GDP is rare, therefore if China's national saving equals 70 percent of GDP, its investment would be equal to 65 percent of GDP.

Table 1: Transformation of Existing Bonded Zones into the SPFTZ

Existing Bonded Zones	Description	Area (km2)
Existing Bonded Zones	Officially launched in September 1990. This is the first bonded zone in China and currently has the largest total economic output among all bonded zones in China	10
Shanghai Waigaoqiao FTZ	China's first "bonded logistics park" to obtain the special approval of the State Council. It is also connected to the Waigaoqiao port and is 3 km from the Waigaoqiao FTZ.	1.03
Waigaoqiao Bonded Logistics Park	Officially approved by the State Council in July 2009. The Shanghai international shipping centre includes not only water shipping but also air transport. Air cargo, which involves high-value goods and high transportation speed, is complementary to water transportation.	3.59
Yangshan Free Trade Port Area	Launched when the Yangshan Deep-water Port was officially opened on December 10, 2005. It is also China's first bonded port.	14.16
Total		28.78

Source: Wan (2014)

The SPFTZ is Not an Area Established by Bilateral or Multilateral Negotiations, but a Unilateral Policy Trial Area of the Chinese Government

An FTZ can be used in two different ways. The first is a type of trade bloc, a designated group of countries that have agreed to eliminate tariffs, quotas and preferences on most (if not all) goods and services traded among them. Within the WTO, free trade agreements (FTAs) are regional trade agreements (RTAs), which are reciprocal trade agreements between two or more partners.

According to the WTO's RTA database (2015), there are currently 109 FTAs in the world and all of them cover goods. Among them, about half (54) of the FTAs are between two countries and the other 55 are among three or more countries. There are also 115 FTA and economic integration agreements (EIAs) that cover both goods and services. Among them, 71 are between two countries and the other 44 are among three or more countries. According to the WTO's RTA database, China has signed 11 FTAs and EIAs with other countries and areas. Each counterpart and year of entry into force are: The Association of Southeast Asian Nations (2005), Chile (2006), Costa Rica (2011), Hong Kong (2003), Macao (2003), New Zealand (2008), Singapore (2009), Iceland (2014), Pakistan (2007), Peru (2010) and Switzerland (2014). Four other FTAs have been signed with early announcements to the WTO: the Cross-Straits Economic Cooperation Framework Agreement, China-Australia, China-Korea and China-Norway.

The SPFTZ is more similar to the second way in which an FTZ can be utilized. In this manner, an FTZ refers to a geographic area where goods may be landed, handled, manufactured or reconfigured and re-exported without the intervention of customs authorities. Only when goods are moved to consumers within the country subject to the FTA, are the prevailing customs duties applied. Such kinds of FTZs are organized around major seaports, international airports and national frontiers — areas with many geographic advantages for trade. The SPFTZ is one of these special economic zones in China.

The SPFTZ is Not Aimed at Free Trade with Other Countries, but Rather Emphasizes New Reform Methods

The traditional development model of China has three economic pillars: an investment policy promoting FDI in the assembling industry to absorb labour surpluses, a trade policy encouraging exports to sell excess products and a financial policy aimed at stabilizing an undervalued RMB exchange rate. The SPFTZ is designed to accommodate these policy directions.

According to the overall plan for the SPFTZ designed by the State Council, the central government of China, there are two major tasks of the SPFTZ. First, the opening up of new investment sectors. In the past, China has welcomed FDI while maintaining strict controls on other capital inflows. In the SPFTZ, a range of services including the financial, transportation, commerce and trade, professional, cultural and public services sectors are to be enlarged and opened. In most sectors, market access restrictions will be suspended or cancelled regarding requirements concerning the qualification of investors, limitations on foreign participation and restrictions concerning business scope, among others. A "negative list" mechanism will be implemented within the zone. For the projects that are not stated in the negative list, foreign investors and domestic investors will receive the same treatment.

Table 2: Comparison of SPFTZ, Qianhai and Suzhou in Financial Policies

	Shanghai Pilot Free Trade Zone	Qianhai	SZIP
Background	Trial for financial reform and opening up	Cooperation between Shenzhen and HK	Cooperation between China and Singapore
Location	Pudong (Shanghai)	Shenzhen	Suzhou
Starting date	September 2013	December 2012	June 2014
Finance source	No limit	Banks in HK	Banks in Singapore
Finance quota	Related to the paid-in capital and macroprudential supervision	Balance management	Balance management
Use of finance	In the SPFTZ or foreign	In the Qianhai area	In the SZIP
Replicable or not	Will replicate to other areas in China	Not	Not

Source: Shen (2014).

The second major task of the SPFTZ is to promote the transformation of China's trade development approach. In order to change from a low-value-added trade pattern, the SPFTZ is cultivating new trading types and functions. The aim is to increase China's competitive advantage and enhance its position in the global trade value chain by focusing on the development of technology, brands, quality and service. Multinational companies are encouraged to set up Asia-Pacific regional headquarters with comprehensive functions including trading, logistics and settlement. More efforts will be made to promote Shanghai as an international trade settlement centre, and to expand the function of the special account regarding cross-border receipt or the payment and financing of trade in services. In addition, enterprises in the SPFTZ will be supported to develop offshore business.

The third major task of the SPFTZ is the deepening of innovation and opening up of financial services. Under proper risk control, the SPFTZ will pilot RMB capital account convertibility, interest rate liberalization and the cross-border use of the RMB. In the SPFTZ, the assets of financial institutions will be recorded at market rates. The SPFTZ will explore a trial foreign exchange administrative system that is in line with international practices to better facilitate trade and investment. Enterprises are encouraged to leverage both domestic and international market resources to liberalize cross-border financing. Administration on foreign debt will be further reformed to simplify cross-border financing.

Comparison of SPFTZ and Other Special Economic Areas

There are several other special economic areas in China and some of them have a degree of comparability with the SPFTZ. One is in Qianhai, the modern service industry cooperation zone of Shenzhen and Hong Kong. Another is the financial cooperation between China and Singapore in the Suzhou Industrial Park (SZIP). Table 2 lists a comparison of these areas and their financial policies.

DEVELOPMENTS IN THE PAST YEAR

After one year's operation, the SPFTZ has already met several important policy objectives.

Legal and Regulatory System

The Twelfth National Congress Standing Committee authorized the Chinese State Council to temporarily adjust certain administrative examination and approval requirements under the "Law of the People's Republic of China on Wholly Foreign Owned Enterprises," the "Law of the People's Republic of China on Sino-Foreign Equity Joint Venture Companies" and the "Law of the People's Republic of China on Sino-Foreign Cooperative Joint Venture Companies." Such adjustments will be implemented over three years commencing October 1, 2013.

The regulatory environment for supervision and tax has also been improved. In the SPFTZ, a foreign investment project no longer need apply for confirmation from the

Chinese government unless it involves the negative list. As for business registration, the Administration for Industry and Commerce has adopted a registered capital contributions system, which is a reform to the former "registered capital paid up" system.[6] The Administration of Quality Supervision, Inspection and Quarantine allocates a specific organizational code to foreign investment enterprises in real time. The Administration for Taxation has adopted a one-net express system in the SPFTZ. Firms applying for taxation registration need not be examined. The e-invoice issued by e-commerce firms has been extended from individual consumers to enterprises. Several taxation procedures can now be accomplished on the Internet rather than physically going to the taxation office.

Negative List for Foreign Investment

On September 30, 2013, the Shanghai municipal government published special management recommendations for foreign investment in the SPFTZ (2013 version), usually called the negative list, which covers 1,069 businesses in 89 divisions within 18 main categories. There are also 190 regulations on the conduct of business in the SPFTZ. Any sectors not on the list are open to foreign investors. The 2013 version of the list was quite similar to the existing Foreign Investment Industrial Guidance Catalogue. The Shanghai municipal authorities announced the 2014 version of the negative list on July 1, 2014, decreasing the 190 regulations to 139, among which 110 regulations are restrictive and the other 29 are prohibitive.

Trade Facilitation

In the past year, Shanghai Customs, the Inspection and Quarantine Bureau and the Maritime Affairs Administration of the SPFTZ have provided more than 60 new policies on trade facilitation. The basic policy is "first-line decontrolled; second-line controlled safely and efficiently and free movement within the FTZ" (*Xinhua* 2013). The so-called first-line refers to the border and "second-line" refers to the domestic market boundary (Guan 2014). Shanghai Customs has provided 23 regulations in the SPFTZ, including entering the FTZ, applying for customs declaration, self-transportation within the FTZ and simplifying the documents in customs declaration. The Inspection and Quarantine Bureau has adopted a paperless customs clearance operation and the admission of a third party's inspection and quarantine results. The Maritime Affairs Administration has adopted supervision of ship safety operations and a high efficiency ship registration, among other things. Customs and the Inspection and Quarantine Bureau also jointly conduct the "one application, one inspection, and one pass" system, in addition to paperless customs access when crossing the international border through the frontline or when entering the FTZ through the second line from another area of China.

Financial Innovation

The four financial supervisors, namely the People's Bank of China (PBoC) and three regulatory commissions on banking, securities and insurance, have adopted 51 regulating methods to build a new financial architecture in the SPFTZ. In regard to the opening up of the financial sector, there are now four main policies:

- **Free Trade Accounts.** The PBoC issued implementing rules on accounts differentiating in the SPFTZ on May 22, 2014, which set out the regulation of free trade accounts. According to the rules, the financial institutions in Shanghai can build an FTU (Free Trade Accounting Unit), which is separate from the institution's other accounting system. The accounts opened in the FTU are called free trade accounts, in which both domestic currency (RMB) and foreign currencies are regulated by the same rules. Both organizations and individuals in the SPFTZ are authorized to open these free trade accounts. Cross-border capital transactions under current account and direct investment can be settled in these free trade accounts.

- **Currency exchange and remittance for investment and financing.** Financial measures to support the SPFTZ, cross-border payment, receipt and exchange involved in direct investment by enterprises can be processed directly by banks, according to the PBoC. Eligible individuals who are employed in the FTZ can make various kinds of overseas investments, including securities investments. The capital market is thus opened up steadily by these developments. Financial institutions and enterprises in the FTZ can make investments and trade in the securities and futures markets in Shanghai in accordance with relevant regulations.

- **Interest rate marketization.** The PBoC removed the interest cap on retail foreign currency deposited in Shanghai from June 27, 2014. Financial institutions in Shanghai can price the foreign currency deposits of enterprise clients independently. The interest cap for

6 According to the 2005 version of "Company Law of the People's Republic of China," the registered capital of a limited liability company shall be the amount of the paid-up capital contributions of all its shareholders as registered with the company registration authority, which is referred to as registered capital paid up system (China.org.cn 2011, Article 26). After the SPFTZ trial, the new version of that law has changed the Article to "The registered capital of a limited liability company shall be the total amount of capital contributions subscribed to by all the shareholders registered in the company registration authority"(Cai and Huang 2014). This is referred to as the registered capital contributions system.

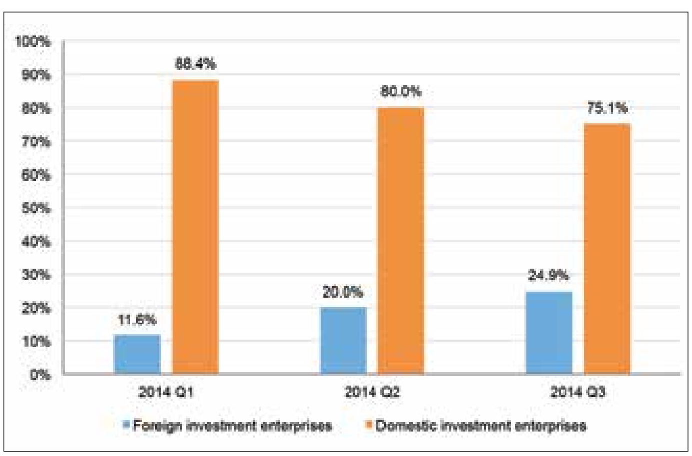
foreign currency deposits of individual clients will be removed later.

- **RMB cross-border use.** On February 21, 2014, the PBoC issued detailed rules supporting RMB cross-border use in the SPFTZ. According to these rules, banks in Shanghai can provide cross-border RMB settlement services directly in current accounts and direct investment accounts to their clients. Individuals employed in the SPFTZ can open bank settlement accounts for cross-border RMB transactions under current accounts. The non-bank financial institutions and enterprises in the SPFTZ can borrow RMB funds from overseas, up to a limit. Enterprises in the SPFTZ can build RMB fund pools to facilitate the double-direction flow within the enterprise's group. Banks in Shanghai can provide RMB settlement services to the cross-border e-commerce organizations in the SPFTZ. The China Foreign Exchange Trade Center and the Shanghai Gold Exchange can also provide cross-border RMB transactions in the SPFTZ.

ASSESSING THE EFFECT OF SPFTZ

Since the inception of the SPFTZ in 2013, it has made concrete progress in the following two areas. First, new registered enterprises have increased quickly. By September 26, 2014, there were 12,547 new registered enterprises in the SPFTZ. The number of domestic investment enterprises is 10,788 and the number of foreign investment enterprises is 1,759. When examined by the first three quarters of 2014, as in Figure 6, we can see the proportion of foreign investment enterprises is steadily increasing, from 11.6 percent to 24.9 percent. Of the 1,759 foreign investment enterprises, 1,581 enterprises prefer the new SPFTZ registration method (Shen 2014).

Figure 6: New Registered Enterprises in the SPFTZ



Source: Shen (2014).

Second, financial innovation in the SPFTZ has made progress. There are now 484 free trade accounts opened by enterprises, and the balance of these accounts is about RMB90 million. Many financial institutions have businesses in the SPFTZ, including 14 Chinese banks, 23 foreign banks, 11 insurance companies and three security companies. There are 28 enterprises that have built so-called "RMB money ponds" in the SPFTZ, with a balance of RMB16.9 billion.[7] The cross-border settlement in the SPFTZ is RMB111.5 billion. There are 71 enterprises that are involved with RMB finance from abroad, with a balance of RMB16.06 billion (Shen 2014).

To optimists, the SPFTZ is seen as China's most significant effort at economic reform since the reform and opening up in 1978, and it has gained support from top Chinese leaders including President Xi Jinping and Premier Li Keqiang. But to pessimists, the performance of the SPFTZ over the past year has been below expectation. The SPFTZ has not acheived the economic liberation many hoped it would provide. Progress in many areas, including the relaxation of capital restrictions and the liberalization of interest rates, has been lacklustre. The 2013 version of the negative list was seen as no more than a replication of the Foreign Investment Industrial Guidance Catalogue. The 2014 list reduces restrictive regulations from 190 to 139, which is seen as a step forward, but the actual effect may need more consideration. For example, the 2014 list reduces restrictions on investment in catalogues such as cotton processing and non-ferrous metals smelting, but it seems no foreign enterprise will make such an investment in the 29 km^2 SPFTZ. Some restrictions are reduced because any investment is forbidden, whether domestic or foreign capital, for example investment in the gaming industry. Although far from satisfactory, financial regulation in the SPFTZ has been relaxed by the negative list and financial innovation strategies. The capital control in China is loosened with the founding of the SPFTZ.

The effect of SPFTZ on financial liberalization can be analyzed through the study of interest differentiation between onshore and offshore RMB exchange rates. There is currently a dual system of RMB markets (Chen and Whalley 2013). One is the onshore market with an official spot exchange rate set by the PBoC according to a basket of currencies. All current account transactions can take place in this onshore market freely, as a commitment to current account convertibility, but capital account transactions are under regulation of the State Administration of Foreign Exchange. The other RMB market is offshore, which means it remains outside the regulation of Chinese authorities.

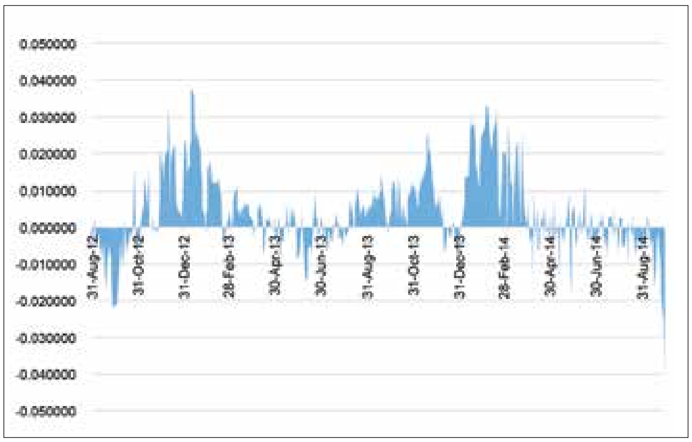
The offshore RMB market began in 2004, when personal RMB deposits were permitted in Hong Kong. From this point, the

7 According to the rules of the PBoC (2013), an RMB money pond is the finance of cross-border RMB money among the non-financial companies of a multinational company group.

RMB deposit balance in Hong Kong has increased steadily. Before 2009, the RMB in Hong Kong was brought in mainly by onshore tourists and Hong Kong residents. Since July 2009 when the PBoC announced the use of RMB in cross-border trade settlement, RMB deposits in Hong Kong increased sharply. From 2011 onwards, the RMB could also be used in overseas direct investment, and this drove more RMB into the offshore market. RMB deposits, loans and bonds are traded in the offshore market in Hong Kong, which is largely free of regulation from the monetary authority of Hong Kong.

The crucial point in understanding the offshore market is that, unlike the onshore market, which is tightly controlled by the Chinese authorities, the RMB in the offshore market can float freely. Therefore, the capital control in mainland China and capital free in Hong Kong bring two different prices for a single currency. It is a reasonable inference that the spread between onshore RMB (CNY) and offshore RMB (CNH) exchange rates would tend to diminish if the capital control in China were abolished, as we can see from Figure 7.

Figure 7: Price Spread of CNY and CNH



Source: The authors' computation based on the Wind (2014), Federal Reserve Economic Data (FRED) (2014) and Bloomberg (2014) databases.

We already know that the founding of the SPFTZ has loosened capital controls in China. Therefore, the assessment of its impact on financial liberalization can be based on the price spread between CNY and CNH, which has shown a slight tendency to diminish since the founding of the SPFTZ. This is discussed more fully in a separate paper (Yao and Whalley 2014).

CONCLUSION

This paper discusses the economic background to China's launch of the SPFTZ in the autumn of 2013. It also provides an overview of the main developments in the past year and assesses the effect of the SPFTZ on China's financial liberalization. The new generation of Chinese leaders, whose policy targets sustainable development of the economy and its social and natural environments, intend for the SPFTZ to herald a new round of economic reform.

The aim of the SPFTZ is to explore new systems, not preferential policies, and is a nursery of new measures transplantable to other parts of the country.

Analyzing the impact of the SPFTZ is difficult as it is still early, however if we examine the price spread between CNH and CNY exchange rates, we find the SPFTZ has a tendency to diminish the gap between the rates. In a companion paper (Yao and Whalley 2014), the analysis of the yield gap between onshore and offshore RMB of three-month maturity is reported and this gap was found to have decreased since the founding of the SPFTZ. These results suggest that China's capital control is also loosening since the SPFTZ was introduced.

The practice in the SPFTZ is still developing. However, on December 28, 2014, China announced the expansion of the SPFTZ, alongside the establishment of three new FTZs in Guangdong, Tianjin and Fujian, as well as the simplification of a number of investment procedures in these zones. The SPFTZ will be expanded to include the Lujiazui financial district, the Jinqiao development zone and the Zhangjiang hi-tech park. With the further successful practice of the SPFTZ and more pilot policies replicated in China as a whole, we can anticipate a more balanced Chinese economy in the following decade.

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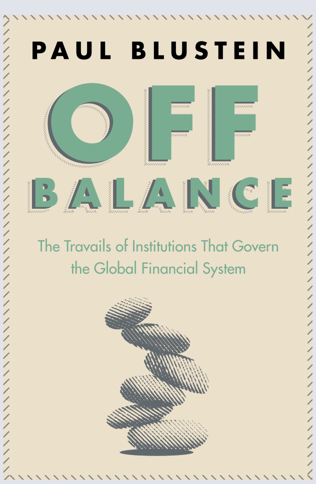

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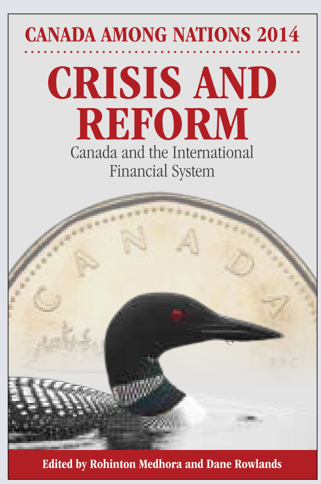

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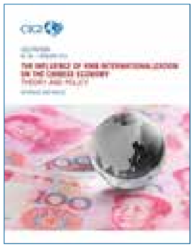

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To Come from Nicole.

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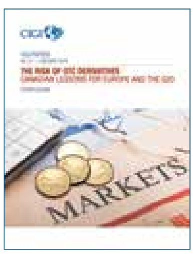
The measures regulators have largely agreed on for a strengthened and internationally harmonized financial regulatory regime, which were endorsed at the 2014 G20 leaders summit in Brisbane, are a major step toward achieving a robust and less crisis-prone global financial system. There are, however, a number of specific measures that need to receive closer attention in order for the G20 leaders to declare their reform program a success. This paper discusses what policy makers and regulators should focus on in 2015 and why closer international cooperation in implementing regulatory reforms will be essential for success.



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Over-the-counter (OTC) derivatives played an important role in the buildup of systemic risk in financial markets before 2007 and in spreading volatility throughout global financial markets during the crisis. In recognition of the financial and economic benefits of derivatives products, the Group of Twenty (G20) moved to regulate the use of OTC derivatives. Attention has been drawn to the detrimental effects of the United States and the European Union to coordinate OTC reform, but this overlooks an important aspect of the post-crisis process: the exemption of non-financial operators from OTC derivative regulatory requirements.

The Trade in Services Agreement: Plurilateral Progress or Game-Changing Gamble?

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Patricia M. Goff

Trade analysis in the current moment is understandably focused on mega-regional negotiations, but plurilateral talks also deserve our attention. Plurilateral negotiations leading to a Trade in Services Agreement (TiSA) is the focus of this paper. Barriers to trade in services are distinct and their removal consequential; thus inviting careful consideration and, ideally, public debate. This paper seeks to illuminate developments in negotiations toward the plurilateral TiSA. Just as it has become commonplace to ask whether regional agreements advance economic and political agendas, so is it useful to explore the promise and peril of plurilateral agreements such as TiSA.

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Gregory Makoff and Robert Kahn

The International Capital Market Association (ICMA) has recently published proposed standard terms for new, aggregated collective action clauses. Concurrently, the ICMA released new model wording for the *pari passu* clause typically included in international sovereign bond contracts. These announcements and the commencement of issuance of bonds with these clauses are an important turning point in the evolution of sovereign bond markets.

From "Taoguang Tanghui" to "Yousuo Zuowei": China's Engagement in Financial Minilateralism

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Hongying Wang

Through minilateral efforts, the Chinese government seeks to use financial minilateralism to stimulate reform of global financial institutions, provide financial public goods for its regional neighbours and fellow developing countries, as well as directly promote China's economic and political interests. This paper examines China's minilateral diplomacy in the financial area and explores possible international reaction to China's new activism and the domestic political dynamics in China.

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