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THE CHINA (SHANGHAI) PILOT FREE TRADE ZONE:
BACKGROUND, DEVELOPMENTS AND PRELIMINARY ASSESSMENT OF INITIAL IMPACTS

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ABSTRACT

The China (Shanghai) Pilot Free Trade Zone (SPFTZ) founded one year ago is a trial for China's new round of reform and opening out, which has promised liberalization on capital account and trade facilitation as its main objectives. Here we discuss the differences between the SPFTZ and other free trade areas, and the developments of the SPFTZ in the past year. We also make a preliminary assessment of the SPFTZ's initial impacts, especially of its impact on China's capital account opening and financial liberalization. It is possible that the successful practice of the SPFTZ and more pilot policies replicated in China will give rise to a more balanced Chinese economy in the following decade.

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1. Introduction

This paper discusses the Shanghai Free Trade zone (more accurately the China (Shanghai) Pilot Free Trade Zone (SPFTZ)) one year after its introduction. Launched on Sep.29, 2013, the SPFTZ is more than a traditional "free trade area", and more a trial zone for China's new opening and reform strategy. It is a unilateral set of measures and procedures relating to a small area in Shanghai, which has promised liberalization on capital account and trade facilitation as its main objectives. Relatively little has been written in English about the SPFTZ, and so in part we describe and document. Importantly, the SPFTZ is not a Free Trade Area based on bilateral or plurilateral tariff liberalization.

The SPFTZ is a pilot zone for China's new round of reform and opening out. The paper discusses why China adopted such a FTZ, and what its objectives are. China has achieved considerable economic development that was export and investment dependent, but she 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.

We review the development of the SPFTZ over the past one year. As a pilot zone for exploring policy, the main impacts of the SPFTZ are not on the amount of its trade volume or foreign investment, but on 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 in financial services; and the cutting of red tape in administration. These are analyzed later in more detail.

After one year’s operation, the impacts of the SPFTZ on economic performance need assessment, especially on financial liberalization. One element is using data of on shore and off shore RMB exchange rates to assess 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, it is possible that economic performance will be further improved in such areas as interest and exchange rate liberalization, capital account opening, and RMB internationalization.

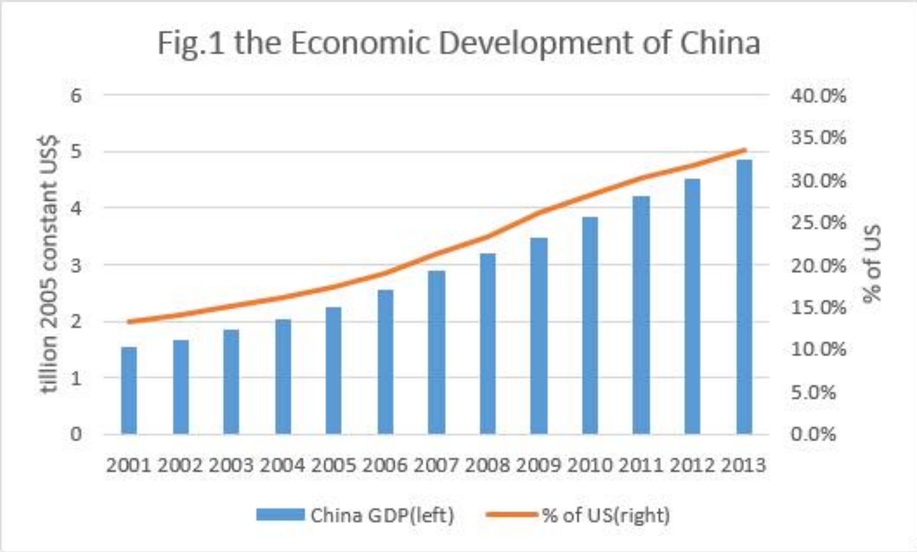
2. Shanghai Pilot FTZ, the background

The SPFTZ can be compared with the Sheng Zheng special economic zone near Hong Kong 35 years ago, which ushered in reforms and spectacular growth.

2a) Why a Pilot FTZ? A new stage for China’s economy, and structural unbalance

China has accomplished major economic development in the new millennium. According to the World Bank's World Development Indicators[1], China's GDP in the year 2001 when she joined the WTO was 1.535 trillion (constant 2005 US$). By 2013, China's GDP was 4.864 trillion, reflecting an annual rate of increase of 10.09%. By comparison, the world total economy in the same period increased from 41.02 trillion to 55.94 trillion, with an annual rate of increase of only 2.62%. In these twelve years, China's share in the world economy more than doubled, from 3.74% in 2001 to 8.69% in 2013. China dwarfs Brazil, India and Russia with her 2013 GDP about 57.3% of the four BRIC countries as a whole. In comparison with the United States, as in Fig.1, China's GDP has increased from about one-eighth (13%) of that of US in 2001 to more than one-third (33.5%) in 2013[2].

[1] All the data in this paper are obtained from the WDI database unless otherwise expressed.
[2] If evaluated by exchange rate in constant 2005 US$, China's GDP in 2013 is 4.86×10^{12}, while US's GDP is 1.45×10^{13}. China's GDP in 2001 is 1.53×10^{12}, while US's GDP is 1.17×10^{13}.

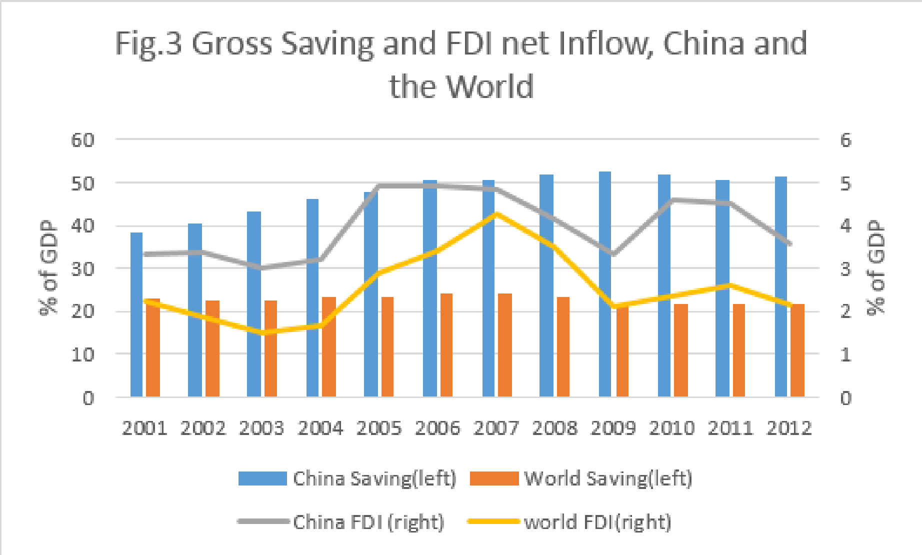


Source: WDI database

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% in 2001 to 16.9% in 2012, increasing from US$575 billion to US$2.17 trillion, not much less than United States' 2.81 trillion. The annual growth rate of China's gross capital formation has been in two digits, since 2001, peaking in 2009 at 19.3%, while all other main economies struggled in the aftermath of 2008 global financial crisis with their gross capital formation decreased by more than 10% in 2009.

Source: WDI database

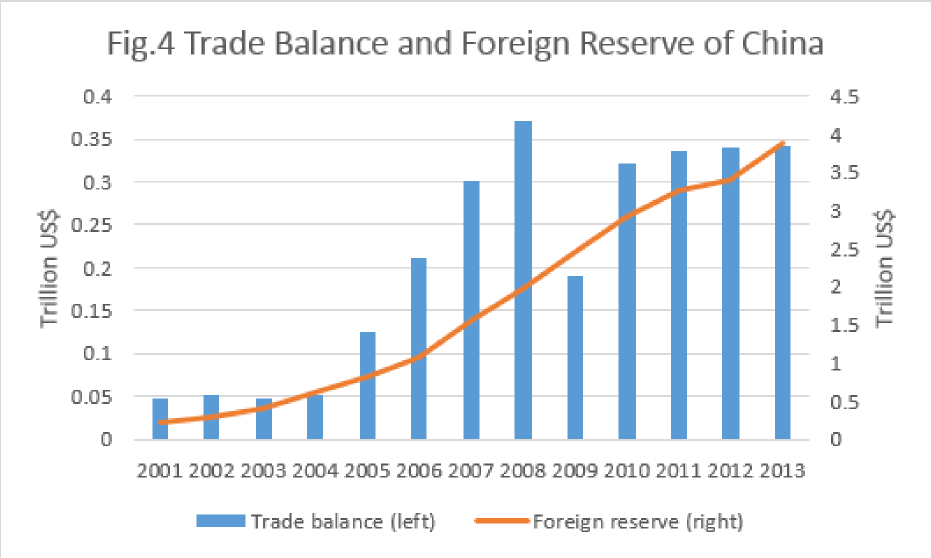
To increase investment, China relies not only on domestic saving, but also on foreign capital inflows. In 2001 the ratio of gross domestic saving to GDP in China was 38.4%, more than two-thirds higher than the world average ratio of 22.8%. In 2006, that ratio in China increased to 50.7%, and has remained at more than 50% since.. China is also a main destination for global foreign direct investment (FDI). In 2001 the net inflow of FDI into China was 44.2 billion US$, about 6.1% of the world, and this increased to 348 billion US$ in 2013, nearly a quarter (24.2%) of the world (Fig.3).



Source: WDI database

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 400 billion in 2005 constant US$, about 4% of the world. In 2013 China's exports reached 1.92 trillion, more than 10% of the world. Since China exported much more than she imported, the trade balance increased steadily, from 47.7 billion in 2001 to 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 220 billion current US$, and by the year of 2013 it had increased to 3.88 trillion, more than triple the second largest reserve holder Japan's 1.27 trillion (Fig.4).



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.

Firstly, the world has less ability to accommodate China's future development in the same way. China's GDP per capita in 2013 was 3583 in constant 2005 US$, about 45% of the world average 7852. If China and the world maintain a growth rate of GDP per capita in the past twelve years, of 9.5% and 1.4% respectively[1], China will reach the world average GDP per capita in a decade, by 2023. But this would mean that China's gross domestic savings accounts for 70% of her GDP, exports account for 25% of the world, and accommodate 59% of global FDI[2], which is unlikely to happen[3]. Since

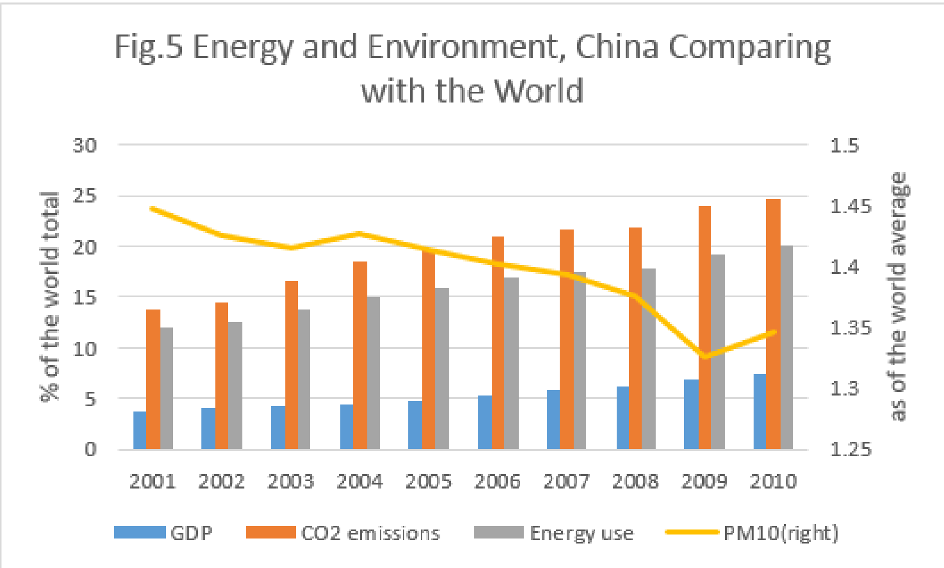
[1] If evaluated in constant 2005 US$, the GDP per capita of China in 2001 is 1206, in 2013 is 3583, and the GDP per capita of the World in 2001 is 6636, in 2013 is 7852. From these we can easily compute the growth rate is 9.5% and 1.4% respectively. Based on these growth rate, China's GDP per capita will be equal to the World's in 10.2 years.

[2] All these projections are assuming the same increase rate of 2001 to 2012 in the following years of 2013 to 2023. For example, China's saving ratio of GDP in 2001 is 0.383, in 2012 is 0.515, if keep the same increase rate, in 2023 this ratio will increase to 0.692, about 70%. The export and FDI in 2023 are projected in the same way.

[3] According the macroeconomic theory, S=I+CA, where S is national saving, I is investment and CA is current

China has become the second largest economy in the world, it cannot simply replicate the past development path from when she was relatively small.

Secondly, China cannot afford the environmental costs accompanying her current development pattern for another decade. China accounts for 20% of the world's energy consumption, 25% of CO2 emissions and the PM10 level is 35% higher than the world average. According to a report of WHO, there are 16 Chinese cities in the top 20 most heavily air polluted cities of the world, including Tianjin, Chongqing, Shenyang, and Beijing (Fig.5).



Source: WDI database

Thirdly, the national income of China may not be as large as her GDP appears. Lacking technology and patents, Chinese firms are usually at the bottom of the product value curve, using unskilled labor to produce low technology production such as assembling, and earn a small share of the profit. According a latest research by two Asian

account surplus. As a big country in the world, a current account surplus of 5% of GDP is rare, therefore if China's national saving equals 70% of her GDP, its investment would be equal 65% of GDP, which is unbelievably high.

Development Bank economists[1], when China exports an Apple iPhone, she only receives US$6.5 as the manufacturing fee in the total cost of $178.96.

If the Sheng Zhen special economic zone can be seen as a symbol of the traditional development model in past three decades, it is the SPFTZ that is aimed to be another symbol for the new development model in the following decades.

2b) A pilot zone for reform, not just for trade

It is not accidental for such a pilot free trade zone to be located in Shanghai. Shanghai is the largest city in China and also the financial and economic center. Consisting of only 0.06% of China's total area, the GDP of Shanghai however accounts for 3.8% of China's total in 2013. Shanghai is leading China in the international economic and trade sector, with container handling amount accounting for 17.8% of China's total, goods import and export amount accounting for 19.5%, and FDI amount accounting for 14.3%. Just as the reform and opening of the Pudong New Area of Shanghai in 1991, if the policy trials succeed in Shanghai, they may be replicated more easily in other parts of China.

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

[1] Yuqing Xing and Neal Detert, How the iPhone Widens the United States Trade Deficit with the People's Republic of China, ADBI Working Paper Series, No. 257, December 2010

Table 1: Transformation of existing bonded zones into the Shanghai FTZ

Existing bonded zones	Description	Area (km2)
Shanghai Waigaoqiao FTZ	Officially launched in September 1990. It is the first bonded zone in China and currently has the largest total economic output among all bonded zones in China	10
Waigaoqiao Bonded Logistics Park	It is China's first "bonded logistics park[1]" that obtained 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
Pudong Airport FTZ	Officially approved by the State Council in July, 2009. The Shanghai international shipping center includes not only water shipping but also air transport. Air cargo, which involves high-value goods and high transportation speed, is complimentary 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: reproduced from Wan (2014)

[1] In China, a bonded logistics park is a special customs zone in a bonded area with the aim to develop modern international logistics under the permission of the State Council.

Although named as a "Free Trade Zone", the SPFTZ is from the beginning actually a pilot zone for reform, not just for trade. The difference between the SPFTZ and other FTAs lies mainly in the following.

(i) Firstly, the SPFTZ is not an area established by bilateral or multilateral negotiations, but a unilateral policy trial area of the Chinese government. A Free Trade Area (FTA), or equally a Free Trade Zone, can be used in two different ways. The first meaning of a free trade area 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 between them. In the WTO, free trade agreements are regional trade agreements (RTAs), which are reciprocal trade agreements between two or more partners.

According to the RTA database of WTO[1], there are currently 109 FTAs in the world, all of them cover goods. Among them about half (54) FTAs are between two countries, and other 55 are among three or more countries. There are also 115 FTA & EIA[2] with coverage on both goods and services, among them 71 are between two countries, and other 44 are among three or more countries. According this database, China has signed 11 FTA & EIA with other countries and areas, the counterpart and the year of entry into force are: ASEAN(2005), Chile(2006), Costa Rica(2011), Hong Kong, China(2003), Macao, China(2003), New Zealand(2008),

[1] http://www.wto.org/english/tratop_e/region_e/rta_pta_e.htm
[2] EIA means Economic Integration Agreement.

Singapore(2009), Iceland(2014), Pakistan(2007), Peru(2010), Switzerland(2014). Four other FTAs have been signed with early announcements to the WTO: ECFA (the Cross-Straits Economic Cooperation Framework Agreement), China-Australia, China-Korea and China-Norway.

The SPFTZ is more like the second meaning of Free Trade Zone, which refers to a geographic area where goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities. Only when goods are moved to consumers within the country in which the zone is located do they become subject to prevailing customs duties. Such kind of Free Trade Zones 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.

(ii) Secondly, 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 encouraging foreign direct investment in assembling industry to absorb excess labor, a trade policy encouraging exports to sell the excess products thus produced, and a financial policy aimed at stabilizing an undervalued RMB exchange rate. The SPFTZ is designed to accommodate these directions of policy.

According to the Overall Plan for the SPFTZ designed by the State Council, the central government of China, the major tasks of the SPFTZ include the following.

Firstly, the opening up of new investment sectors. In the past China has welcomed foreign direct investments, while maintaining strict controls on other capital inflows.. In the SPFTZ, the financial services, transportation services, commerce and trade services, professional services, cultural services, and public services sectors are to be enlarged and opened, and in most sectors market access restrictions such as requirements concerning the qualification of investors, limitations on foreign participation, restrictions concerning business scope, etc., will be suspended or cancelled. 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.

Secondly comes the promotion of a 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, aiming to increase China's competitive advantage and enhance their 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 and/or operation centers with comprehensive functions of trading, logistics, settlement, etc. More efforts will be made to promote Shanghai as an international trade settlement center, and to expand the function of the special account on cross-border receipt or payment and financing of trade in services. Enterprises in the SPFTZ will be supported to develop offshore business.

Thirdly, 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 on both domestic and international market resources to liberalize cross-border financing. Administration on foreign debt will be further reformed to facilitate cross-border financing. Foreign exchange operations by multinational companies will be enhanced to encourage the setup of regional or global treasury centers in Shanghai.

3c) Comparison of SPFTZ and other special economic areas

There are several other special economic areas in China, some of them have a degree of comparability with the SPFTZ. One is 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 among these areas in their financial policies.

Table 2: Comparison of SPFTZ, Qianhai, and Suzhou in financial policies

	SPFTZ	Qianhai	SZIP
Background	Trial for financial reform and opening out	Cooperation between Shengzhen and HK	Cooperation between China and Singapore
Location	Pudong (Shanghai)	Shengzhen	Suzhou
Starting Time	Sep. 2013	Dec. 2012	Jun. 2014*
Finance source	No limit	Banks in HK	Banks in Singapore
Finance Quota	Related to the paid-in capital and macro prudential 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: reproduced from Shen (2014)

* The SZIP launched in 1994, but the trial financial policies began in Jun. 2014.

3. Developments in the past year

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

3a) Legal and regulatory system

The 12th National Congress Standing Committee authorized the State Council to temporarily adjust certain administrative examination and approval requirements under "Law of the People's Republic of China on Wholly Foreign Owned Enterprises", "Law of the People's Republic of China on Sino-Foreign Equity Joint Venture Companies", "Law of the People's Republic of China on Sino-Foreign Cooperative Joint Venture Companies" and such adjustments will be implemented in the next three years started from 1 October 2013.

The regulatory environment for supervision and tax has also been improved. In the SPFTZ, a foreign investment project no longer need apply for the confirmation from Chinese government, unless it involves the negative list. As for the business registration, the administration for industry and commerce has adopted a registered capital contributions system, which is a reform to the former used registered capital paid up system[1]. The administration of quality supervision, inspection and quarantine allocates a specific organizational code to foreign investment enterprises in real time. The

[1] According to the older 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 called as registered capital paid up system. After the trial in the SPFTZ, the new version of that law has changed the article as "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", which is called as registered capital contribution system.

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 go to the taxation office.

3b) Negative list for foreign investment

On September 30th, 2013, the Shanghai municipal government published special management recommendations for foreign investment in SPFTZ (2013 version), usually called “Negative list”, which covers 1069 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. Since the 2013 version of the list was quite similar to the existing Foreign Investment Industrial Guidance Catalogue, the Shanghai municipal authorities declared a 2014 version negative list on the July 1st, 2014, decreased the 190 regulations to 139, among which 110 regulations are restrictive, and the other 29 are prohibitive.

3c) Trade Facilitation

In the past year, the Customs, Inspection and Quarantine Bureau, and Maritime Affairs Administration of 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". The so-called "first-line" refers to the border, and "second-line" refers to the domestic market boundary (Guan, 2014). The Shanghai Customs have provided 23 regulations in the SPFTZ, including entering FTZ first and then applying for customs declaration, self-transportation within FTZ, simplifying the documents in customs declaration, etc. The Inspection and Quarantine Bureau have adopted paperless customs clearance operation, the admission of third-part's inspection and quarantine results. The maritime administration have adopted supervision of ship safety operations, high efficiency ship registration, among other things. The Customs and Inspection and Quarantine Bureau also jointly conduct "one application, one inspection, and one pass", and paperless customs access when going out of the border through the frontline or entering the FTZ through the second line from other area of China.

3d) 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 new regulating methods to build a new financial architecture in the SPFTZ.

i. Free Trade Accounts. The People's Bank of China issued Implementing Rules on accounts differentiating in the SPFTZ on May 22th, 2014, which set out the regulation of free trade accounts.

According to the rules, the financial institutions in Shanghai can build a FTU (Free Trade Accounting Unit), which is separated from the institution's other accounting system. The accounts opened in such 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 qualified to open these free trade accounts. Cross border capital transactions under current account and direct investment can be settled in the free trade accounts.

ii. Currency exchange and remittance for investment and financing. According to the Opinions of the People's Bank of China on Financial Measures to Support the SPFTZ, cross-border payment, receipt, and exchange involved in direct investment by enterprises can be processed directly by banks. Eligible individuals who are employed in the FTZ can make various kinds of overseas investment, including securities investment. 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.

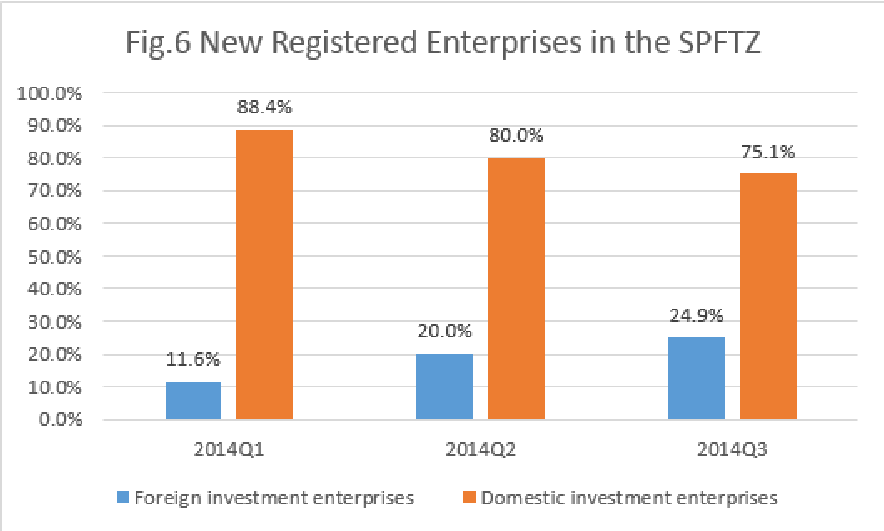
iii. Interest rate marketization. The People's Bank of China, Shanghai Head Office removed the interest cap on retail foreign currency deposited in Shanghai from June 27th, 2014. Financial institutions in Shanghai can price independently the foreign currency deposits of enterprise clients. The interest cap for foreign currency deposits of individual clients will be removed later.

iv. RMB cross-border use. The People's Bank of China, Shanghai Head Office issued detailed rules supporting RMB cross-border use in the SPFTZ on the February 21th, 2014. 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, with a limit on the amount. 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 organization in the SPFTZ. The China Foreign Exchange Trade Center and the Shanghai Gold Exchange can also provide cross-border RMB transactions in the SPFTZ.

3e) Assessing the effect of SPFTZ

Since the inception of the SPFTZ in 2013, it has made concrete progress in the following areas[1].

Firstly, new registered enterprises have increased quickly. By September 26, 2014, there were 12547 new registered enterprises in the SPFTZ, in which the number of domestic investment enterprises is 10788, and the number of foreign investment enterprises is 1759. If separated by quarter as in Fig.6, we can see the proportion of foreign investment enterprises is steadily increasing, from 11.6% to 24.9%. In the 1759 foreign investment enterprises, there are 1581 enterprises that prefer the new registration method in SPFTZ.



Source: reproduced from Shen (2014)

Secondly, financial innovation in SPFTZ has made progress. There are now 484 free trade accounts opened by enterprises, and the RMB balance of these accounts is about 90 million. Many financial institutions have business in the SPFTZ, including 14 Chinese banks, 23 foreign banks, 11 insurance companies, and three security companies. There are 28 enterprises who have built so called "RMB

[1] Some data are cited from Shen(2014)

money ponds”[1] in the SPFTZ, with a balance of 16.9 billion. The RMB cross-border settlement in the SPFTZ is 111.5 billion. There are 71 enterprises who are involved with RMB finance from abroad, with a balance of 16.06 billion.

What is the economic impact of the SPFTZ? To optimists the SPFTZ is seen as China’s most significant effort at economic reform since the reform and opening out in 1978, and it has gained support from top Chinese leaders including President Xi Jinping and Premier Li Keqiang. But to pessimists, the impact of the SPFTZ over the past year has been below expectation. The SPFTZ has not accomplished the economic liberation that many hoped it would provide. Progress in many areas, including the relaxation of capital restrictions and the liberalization of interest rates, have been lackluster. The 2013 version of negative list was seen as no more than a replication of the Foreign Investment Industrial Guidance Catalogue. The 2014 version list reduces restrictive regulations from 190 to 139, which is seen as a big step forward, but the actual effect may need more consideration. For example, the 2014 version list reduces restrictions on investment in catalogues such as cotton processing, non-ferrous metals smelting, but it seems no foreign enterprise will make such investment in the 29 square kilometer SPFTZ. Some restrictions are reduced because any investment is forbidden, no matter domestic or foreign capital, for example investment in the gaming industry.

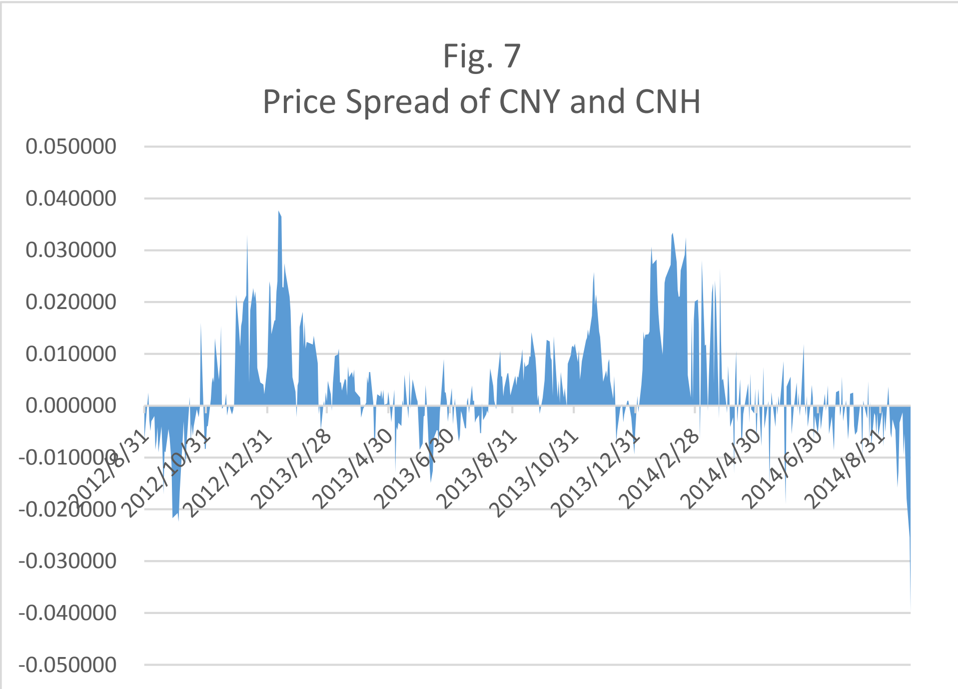
Although far from satisfactory, the financial regulation in the SPFTZ is relaxed by the

[1] According to the rules of the People’s Bank of China, a “RMB money pond” is the finance of cross-border RMB money among the non-financial companies of a multinational company group.

negative list and financial innovation. The capital control in China is loosened with the founding of the SPFTZ. We may analyze the effect of SPFTZ on financial liberalization through the study of interest differentiate between on shore and off shore 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 People's Bank of China 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 the transactions in capital account are under regulation of the State Administration of Foreign Exchange. The other RMB market is offshore, which means out of the regulation of Chinese authorities.

The offshore RMB market began in 2004, when personal RMB deposits were permitted in Hong Kong. From then on, the RMB deposit balance in Hong Kong have increased steadily. Before 2009, the RMB in Hong Kong was mainly brought in by onshore tourists and Hong Kong residents. Since July 2009 when the People's Bank of China announced the use of RMB in cross-border trade settlement, RMB deposits in Hong Kong increased sharply. From 2011 and onwards, the RMB could also be used in ODI (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 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 can be a reasonably 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 Fig.7.



Source: the authors' computation based on the Wind, Fred and Bloomberg Databases

We already know that the founding of SPFTZ has loosed 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 SPFTZ. This is discussed more fully in a separate paper by us (e.g. see Yao and Whalley, 2015).

4. Concluding Remarks

In this paper we discuss the economic background to China's launch of the SPFTZ last autumn, the main developments in the past year, and give an assessment on its effect on China's financial liberalization. The SPFTZ aims to herald a new round of economic reform by the new generation of Chinese leaders, whose policy is targeting sustainable development of the economy, and its social and natural environment. 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 off shore CNH and on shore CNY exchange rates, we find it has a tendency to diminish the gap. In a companion paper (Yao and Whalley (2015)) we report analysis of the yield gap between onshore and offshore RMB of 3-month maturity, and find this gap is decreasing since the founding of the SPFTZ. These results suggest that China's capital control is also loosening since the SPFTZ.

The practice in the SPFTZ is still developing. On December 28, 2014, China announced the expansion of the SPFTZ, the founding 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 is expanded to include the Lujiazui financial district, Jinqiao development zone and Zhangjiang hi-tech park. With the further successful practice of the SPFTZ and more pilot policies replicated in China as a whole, it is possible that a more balanced Chinese economy in the East Asia in the following decade.

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