The SPFTZ, a concrete first step towards China's new development model?

John Whalley, Daqing Yao 23 February 2015

Since September 2013 China has been operating a new form of free trade zone based in a small area of Shanghai. This column describes the implied new trade and investment policies in detail and concludes that the new special zone is likely to be a first step towards a floating exchange rate, free capital account and independent monetary policy.

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Since September 2013 China has been operating a new form of free trade zone based in a small area of Shanghai, called the China (Shanghai) Pilot Free Trade Zone (SPFTZ). It reflects new thinking in China as to how to move forward to a new policy regime to maintain or even accelerate growth through liberalised capital account transactions and speeded trade clearance at one and the same time. It has been compared in significance to Deng Xiaoping's 1992 southern tour which launched zone based foreign investment and trade policies which were the basis for China's industrial growth and integration into the world economy. Several other areas (in Tianjin, Fujian and Guangdong) in China are now moving in the same direction and expectations of impact are high. While data is somewhat limited as the changes are recent, here we discuss the financial liberalisation impact of the SPFTZ thus far which seem to be positive.

What is the SPFTZ?

The SPFTZ is located in the outskirts of Shanghai and covers four existing "bonded zones" (EY 2014). It has since been expanded in December, 2014, and its total area is now 120.7 square kilometres.

Although named as a "Free Trade Zone", the SPFTZ has been seen from the beginning as a pilot zone for reform, not just for trade. The difference between the SPFTZ and conventional free trade agreements thus lies in two directions. Firstly, the SPFTZ is not an area established by bilateral or multilateral negotiation, but a unilateral policy trial area of the Chinese government. Secondly, the SPFTZ is not aimed at free trade with other countries through mutual agreement to lower trade barriers, but rather emphasises new reform directions inside China. Importantly it incorporates what are de facto new forms of capital account liberalisation. After one year's operation, the SPFTZ has already seen several changes on existing arrangements.

a. Financial innovation

The People's Bank of China, and three regulatory commissions on banking, securities, and insurance, have adopted 51 new regulatory methods to build a new financial architecture in the SPFTZ. These methods are mainly in four areas.

1) Free Trade Accounts, in which both domestic currency and foreign currencies are regulated by the same rules.

2) Currency exchange and remittance for investment and financing. In 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 zone can make various kinds of overseas investment, including securities investment.

3) Interest rate marketisation. Financial institutions in Shanghai can independently price the foreign currency deposits of enterprise clients. The interest cap for foreign currency deposits of individual clients will be removed later.

4) Renminbi cross-border use. Banks in Shanghai (both inside and outside the SPFTZ) can provide

cross-border Renminbi settlement services directly in current accounts and direct investment accounts to their SPFTZ clients (organisations or individuals meeting SPFTZ requirements). These changes represent the important financial liberalisation on capital account mentioned above and discussed below.

b. 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 free trade zone". The so-called "first-line" refers to the border, and "second-line" refers to the domestic market boundary.

c. Legal and regulatory system

The 12th National Congress Standing Committee has authorised the State Council to temporarily adjust certain administrative examination and approval requirements under three laws on SPFTZ enterprises which are wholly foreign owned, Sino-foreign equity joint venture, or Sino-foreign cooperative joint venture. The administrative methods are updated according to international norms.

d. Negative list for foreign investment

In the SPFTZ, a foreign investment project no longer need apply for the confirmation from Chinese government, unless it is included in a negative list. The current (2014) version of negative list was declared by the Shanghai municipal authorities on 1 July 2014, which decreased the 190 regulations in 2013 version to 139. The list is to further decrease in 2015.

Why is the SPFTZ important?

The SPFTZ's meaning to China can only be seen clearly by analysing China's development path thus far and its future in the world economy. The importance of the SPFTZ cannot be evaluated on its own. No matter how highly developed, the GDP of SPFTZ will be negligible relative to the second largest economy of the world as a whole.

Ever since the Reform and Opening policy in 1978, China has maintained an evolutionary policy stance. In the past, China chose a pegged (and often under-valued) currency with rigorous capital controls, which induced export orientation and foreign capital competition, and fitted well with a "catching up strategy" for China. China's GDP more than tripled in merely twelve years after she joined the WTO in 2001, reflecting an annual rate of growth of 10.09%. China's macroeconomic performance in the past decade has been characterized by high domestic investment, high dependence on the foreign market and a low consumption ratio. As a result, China's foreign reserves have increased sharply.

While the accomplishments noted above are universally recognised, the current development model of China 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. Since 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.

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 labour to produce low technology production such as assembling, and earn a small share of the profit.

If the Shen Zhen special economic zone from the 1990s are the symbol of the traditional development model in past three decades, it is the SPFTZ that is aimed to be another symbol for the new model in the following decades. This is a more structurally balanced, domestic demand pulled, environmental friendly, and people shared economic development.

An evaluation of the impact of the SPFTZ

In a recent paper (Yao and Whalley 2015), we have employed three different approaches to evaluate the financial innovation part of the SPFTZ by focusing on China's capital control. Firstly, we compute China's capital flows in more recent periods after the SPFTZ following Ma (2008). Since the start of the SPFTZ on 30 September 2013, capital flows of China have increased. Before the start of the SPFTZ, the inflow and outflow volumes were about \$300-400 billion per quarter. From the fourth quarter of

2013, overall capital outflows increased gradually to $620 billion. Capital inflows show a more rapid increase, from $402 billion to $636 billion, more than a 50% increase in three quarters.

Secondly, we conduct price tests for the impact of China's capital controls after the SPFTZ. Assessment of the SPFTZ's impact on capital controls can be achieved by studying the price spread between CNY and CNH. The CNY is the onshore exchange rate of the Renminbi, while the CNH is the offshore exchange rate of the Renminbi, in Hong Kong, China. If capital controls have been loosened, this price spread should show a tendency to diminish after the founding of SPFTZ.

Generally speaking the start of the SPFTZ has brought the price spread of CNY and CNH closer. In the year before the SPFTZ, the price spread reached 300 basis points (1 basis point equals 0.0001). But since the SPFTZ, especially since late March, 2014, the price spread seldom reached 100 basis points. Considering that the policy of supporting Renminbi cross-border use in the SPFTZ was declared on 21 February 2014, the price spread data fits this policy experience quite well.

A formal price test can be conducted by analysing the combination of onshore Renminbi interest rates, offshore dollar interest rates and non-deliverable forward exchange rates. If we do a formal test on the yield gap between onshore and offshore Renminbi, we can reject the null hypothesis that there is no structural change before and after the end of September 2013. There is a regime break in China's capital control when the SPFTZ started.

All these tests give consistent results that the impact of capital controls in China is less since the SPFTZ. With the further successful practice of the SPFTZ and more pilot policies replicated in China as a whole, the impacts of China's capital controls will diminish further. It is likely that China will choose a floating exchange rate, free capital account and independent monetary policy, just as other developed economies do, including the US, the EU and Japan, and the policy changes stemming from the SPFTZ will have played a key role.

Acknowledgement: We are grateful to the ORF (Ontario Research Fund) and CIGI (Centre for International Governance Innovation) for financial support.

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