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Flash Notes

China: Shanghai FTZ To Broaden And Deepen Market Reforms

- The establishment of the Shanghai FTZ pilot program – already dubbed by some as "Shenzhen 2.0" - is a significant step forward and shows the government's commitments to market reforms and to support the other pillar of China's next phase of development

- Of more significance is the deepening for financial sector reforms within the FTZ, which include RMB convertibility, market determined interest rates, and capital account opening. These initiatives could take up to 3 years before conclusions and lessons can be drawn.

- Meanwhile, we see limited near-term impact on the broader fundamentals due to the experimental nature of the program. We continue to see the RMB continue on its current moderate appreciation path at least over the next 6-12 months.

Background

China's State Council announced last Friday (27 Sep 2013) the establishment of the experimental Shanghai free trade zone (FTZ), with the release of further details of the idea that was first publicly disclosed by Premier Li Keqiang earlier in March[1]. The FTZ is formally in service starting from 29 Sep 2013. Relevant regulations will be progressively introduced over a 3-year period, according to the press release.

The zone is officially called 中国（上海）自由贸易试验区 (China (Shanghai) Pilot Free Trade Zone), and covers 28.78 sq km of existing customs specially supervised areas (CSSAs or 海关特殊监管区域) in Shanghai. These include: Shanghai Waigaoqiao bonded zone (上海市外高桥保税区), Waigaoqiao bonded logistics park (外高桥保税物流园区), Shanghai Yangshan bonded port (洋山保税港区), and Shanghai Pudong Airport comprehensive bonded zone (上海浦东机场综合保税区).

Source: http://www.taimaclub.com/data/attachment/forum/201309/10/092721giybzg1qyviuuzx1.png

1 Full text of the State Council's official announcement: "国务院关于印发中国（上海）自由贸易试验区总体方案的通知 (国发〔2013〕38号)", dated 27 Sep 2013: http://www.gov.cn/zwgk/2013-09/27/content_2496147.htm

The key aim of the Shanghai FTZ is look for new ways of deepening reforms in managing investment flows, opening up and upgrading the services sector, deepening the financial sector, as well as the relevant regulatory and monitoring requirements, while at the same time fulfilling the needs to connect with the rest of the world and global practices.

This would mean 'internationalizing" practices in the FTZ, including financial, accounting, legal, intellectual property, human resources, medical, taxation systems, etc. According to the State Council's notice, about 18 sectors will be opened up in the FTZ which include financial, legal, shipping, trade, arts, among others.

One key focus is the initiatives on financial sector, with the experiment on the convertibility of the RMB (for companies, not personal for now), liberalization of interest rates, and opening up of the capital account and cross border financing, financial innovations such as RMB reinsurance business, comprehensive financial services platform, participation by foreign companies in commodities futures trading, among others, with the aim of having essentially free market within the FTZ.

According to media reports, the relevant rules and regulations within the Shanghai FTZ will be completed over the next 3 years and that a first batch of 25 domestic and foreign companies have already been granted licenses in the Shanghai FTZ.

Implications

The establishment of the Shanghai Pilot FTZ is a significant forward and shows the commitment of the new government led by Xi Jinping-Li Keqiang towards broadening and deepening market reforms as well as elevating the value added and efficiency of the services sector, with an eye of spreading these practices to other parts of China. The fact that the FTZ is called "China (Shanghai)", rather than just "Shanghai", suggests that this is a central government's initiative, with the aim of introducing similar projects and practices to other parts of China in the years to come.

At the same time, the scale is necessarily small at the beginning to ensure the experiment is conducted in a controlled environment and the risks manageable. This is reflected in the diminutive size of the area involved, at only 28.78 sq km, or just 1/266 size of Shanghai City's area.

The effort is indeed a natural progression and next step up for China to move from the current model of free trade of goods – within bonded zones – towards free trade in services and investments. This is essential for China if it wants to further integrate itself to the global trade system which covers both goods and services, e.g. the ongoing Trans-Pacific Partnership (TPP) negotiations.

It will be interesting to note whether this project, dubbed by some as "Shenzhen 2.0", would have the similar breakthrough effect of Deng Xiaoping's initiative in south China back in 1979 which heralded a period of reforms. Nevertheless, more than two decades after the granting of its first free trade areas in the 1990s, it is time step up the game to liberalizing services sectors as another pillar to support the broader economy. This will be a more complicated, as unlike tangible goods, intangible services will be the main focus, and the leaders have vowed to take the initial steps forward and try it out within a set boundaries ("先行先试、风险可控、分步推进、逐步完善").

As for the broader economy, near term impact on topline growth is likely to be relatively minor beyond the initial investments into physical structures and systems as companies rush in to make their presence felt. This is because of the experimental nature of this new program as well as initial kinks to be ironed out.

Even with the removal of restrictions on interest rates and capital account, as well as RMB convertibility and cross border flows within the FTZ, we do not see any substantial impact at this beginning stage. We still look for the RMB to continue to move at a 1-3% annual appreciation pace in the 1-2 years. One reason is that the pressures that keep the currency supported such as underlying fundamentals will remain. We continue to look for the RMB to rise to 6.10/USD by end-2013 and to 5.95/USD by end-2014.