

Yangtze experiment: the Shanghai Free Trade Zone

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Summary

The plans for the new Shanghai Free Trade Zone have been closely read since they were published by the Chinese authorities at the end of last week. Details about the Zone's operation remain unclear in many respects, although it will potentially create an enclave on Chinese soil where the rules for foreign businesses will look dramatically different. The Zone will genuinely roadtest new modes of liberalisation and regulation in the services sector in particular and with respect to foreign participation in the financial sector, although scaling these things up to a national level would be complex and sensitive and should not be assumed. But is it also a political strategy for a new leadership consolidating its power and choosing its battles?

On 27th September, the China State Council released the Overall Plan for China (Shanghai) Pilot Free Trade Zone (SFTZ). The plans for the Free Trade Zone have been widely studied and commented on - as has the question of whether they provide a guide for wider policy reform in China. As with all Chinese economic reform, the SFTZ has to be understood as part of a political process. It comes with a clear top-down blessing - Premier Li Keqiang is personally championing the SFTZ and clearly taking a close interest in even small details of implementation. He has guided the Shanghai initiative through the Politburo and State Council.

This implies a serious investment of political capital, both from Li and other key patrons such as Vice-Premier Wang Yang (formerly Party Secretary of Guangdong, with a record of economic reform) and Wang Qishan. Wang is now the CCP's chief disciplinarian, but in earlier roles was that main Chinese protagonist in the US-China Strategic Economic Dialogue which has good claim on being the forum that most clearly articulated the list of issues and sectors the SFTZ focuses on. So there is serious political investment here and a genuine signal of intent. But intent to do what and why?

Some elements of the SFTZ involve simple but potentially far-reaching change. Unlike the rest of China, the SFTZ will use a 'negative list' for inward

investment - meaning any sector that is not explicitly excluded is open in principle to foreign engagement. This reverses the current practice of the Chinese Foreign Investment Catalogue which sets out the current areas open to foreign investment and on what terms. There is also a strong element of deregulation and strengthening the commercial legal environment: some of the restrictive rules blocking foreign control of Chinese-based companies have been relaxed, along with thousands of other small regulations.

The zone also relaxes foreign-exchange controls, which inevitably captures the attention of foreign observers. The pilot proposes allowing greater freedom in the convertibility of RMB to settle trades. But it is as yet unclear how this will be applied to those who establish in the zone and then seek to deploy capital outside the zone in mainland China. It comes off the back of measures since April including national monetary policies, such as the removal of the loan rate floor in July, and regional measures, such as raising quotas for qualified foreign institutional investors in Shanghai that allows approved fund managers to raise local funds and deploy them outside of China.

Feeling the stones

At one level, the Zone is simply an extension of the Deng Xiaoping maxim of crossing the river by feeling

the stones. The Zone is a pilot and a petri-dish as much as a change of policy. The focus of the Zone is strongly on the services sector whose ‘facilitative’ role in a modernising Chinese economy is a core strategic policy focus of the Chinese government. It is also an area where the Chinese authorities will be interested to assess the impact of widening access for foreign companies on the strength of local players and the overall dynamism of the sector.

Reading the Shanghai blueprint closely flags some long-standing preoccupations of Chinese policymakers in this area; some large, some small. The widening of establishment rights for foreign healthcare and health insurance providers reflects a general concern over the provision of affordable healthcare in China and its impact on precautionary savings rates. New rights for foreign performance management agencies reflects a concern that China is struggling to find the cultural content to fill a glut of performance venues. Wider access for vocational education services reflects an anxiety about the Chinese skills base in an era when China relies less and less on low-skilled manufacturing.

At a more technical level, China also knows it lacks the depth of regulatory experience to manage an open capital account and large scale capital account transactions, especially involving non-Chinese financial institutions. The Zone provides a three-year training programme for Chinese regulators to observe, experiment and learn. Perhaps ironically, it is an implicit reminder from the Chinese authorities that they will not be rushed into capital account liberalisation, especially with a creaking banking system and the prospect of both large inflows and - always unspoken - the fear of large scale capital flight if local money could leave China more easily.

There is a good chance that if the Chinese system perceives things to have worked in the Zone that they will be scaled up to China more widely. Liberalisation of any kind is typically harder to reverse than to initiate and the champions of the SFTZ know this. But it cannot be assumed that this will be the case, and the development of policy may not be linear when the experiment is concluded.

This is particularly true for capital account liberalisation, where transitioning policy from a small essentially offshore financial enclave to the entire Chinese economy is not just a question of ‘scaling up’. Three years gives the Chinese authorities a window of time for addressing some of the underlying weaknesses of the banking system, which may help. The zone itself will in theory offer the prospect of using foreign banks to pick up the pieces from failing local ones - qualified foreign finance institutions will be permitted to set up foreign-invested banks and Sino-foreign joint venture banks with foreign finance institutions will also be permitted. Citigroup is reported to be considering launching operations in the zone.

But the bigger error is probably the assumption that full capital account liberalisation on the western model is in fact the Chinese goal - rather than targeted, incremental steps to achieve what the Chinese system itself sees as the aim. This list would include allowing the yuan to respond more to market signals, improving resource allocation in the Chinese banking system, cleaning up the shadow banking sector and widening the scope for foreign capital to enter Chinese equity markets, all of which the Chinese authorities are actually doing to a greater or lesser degree. The SFTZ can be seen a small further step in this direction, rather than the precursor to a big leap.

Opening up to close down the argument

The SFTZ provides an insight into the way this new Chinese leadership is handling the thorny issue of reform in the wider Chinese political economy. Xi and Li are probably calculating that that conducted cautiously, with a defined time period, the SFTZ will enable them to compartmentalise the debate in China over economic reform for the next three years. Advocates of reform now have their beachhead and the expectation that there is momentum behind it. Critics have a controlled experiment whose ‘results’ will help settle questions of future policy change. This zone is what you make of it, and one of the challenges for Western business operating in China and in the SFTZ will be reading the way the weather is shifting on the interpretation of the experiment.

The compartmentalisation could give Xi and Li space to focus on what they see as even more pressing concerns. At the top of this list would be reform of state-owned enterprises (SOEs), which requires a huge amount of political capital and the tackling of major vested interests. This was recently demonstrated by the forced departure of China's most senior SOE regulator (SASAC) from his post, under a cloud of corruption. There are several motivations for this: to increase efficiency, to reduce their capacity to crowd-out the private sector, and to begin the process of reducing subsidies. But such steps are not without costs and it is easy to underestimate from outside how convulsed the CCP is by the process of trying to purge weak SOE management, change SOE practices and bring the barons of the SOE sector to heel.

To this end the Third Party Plenary in November will be interesting but, a little like the SFTZ itself, expectations of dramatic changes of policy are almost certainly going to be disappointed. Xi and Li are establishing their leadership credentials and although they are doing it in a way that is less consensual than that of Hu and Wen there are still limits on their autonomy. Xi's first six months give the very real impression of a leader consolidating power, often with high-risk, aggressive moves against those who might otherwise stand in his way. But this confidence is precarious - it depends on economic stability at home and his own political strength. Seen from this perspective, the SFTZ is as much about shutting down a flank of internal debate for a period as driving policy in a new and controversial direction. In this respect, it is not unlike Deng Xiaoping's tactics with the Shenzhen Special Economic Zone in the 1980s.

Deng won the argument for orienting Chinese manufacturing towards export production and tapping into the demand of western markets. The debate Xi and Li are navigating is even more complex and sensitive. It goes to the heart of foreign participation in the Chinese economy and the integration of the Chinese financial system into global financial markets. It would be excessively hopeful to assume that three years in Shanghai can resolve these questions, although they will reframe them. The answer, as usual, and however much it might

frustrate foreign observers, is to watch and wait and see.

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