China’s Policy Think Piece Series (Issue No. 7)
Business Policy and City Clusters in China

China’s Free Trade Zones After 3 Years: A Review and Assessment
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(Part I) Basic facts and macro background
## FTZs in China: testing grounds for structural reforms and institutional innovations

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<th>Stages</th>
<th>Date of launch</th>
<th>FTZs</th>
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</thead>
</table>
| FTZ 1.0 | 29 Sep 2013 | 1. Shanghai FTZ (phase I) | • To provide a testing ground for *nationwide* deregulation and market-opening reforms  
• Reform measures in the zone should be *replicable* and *expandable* |
|        |                | 2. Shanghai FTZ (phase II) | |
| FTZ 2.0 | 21 April 2015 | Following the Shanghai FTZ model, but with “local characteristics” | 3. Guangdong FTZ  
• To deepen Hong Kong-Macau-Guangdong cooperation in modern services through further reform and liberalization  
• To attract investments in selected industries from Hong Kong and Macau and help upgrade Guangdong’s industrial structure |
|        |                | 4. Tianjin FTZ | • To promote the coordinated development of the Beijing-Tianjin-Hebei area through reform and liberalization |
|        |                | 5. Fujian FTZ | • To promote cross-strait cooperation through reform and liberalization and attract *Taiwan investments* in selected industries |
| FTZ 3.0? | Many provinces/cities are waiting for the central government approval to establish FTZs in their territories |
FTZs in China: location and positioning

**Tianjin FTZ**
- To promote the coordinated development of the Beijing-Tianjin-Hebei area through reform and liberalization
- An offshore financial center in Northern China
- A focus on financial leasing and cross-border financing
- To promote innovation in the shipping industry

**Shanghai FTZ**
- A testing ground for nationwide deregulation and market-opening reforms
- Plays a central role among all FTZs
- Reform measures in the zone should be replicable and expandable
- Includes China’s *de facto* financial center, Lujiazui

**Guangdong FTZ**
- Focused on deepening Hong Kong-Macau-Guangdong co-operation in modern services to help upgrade Guangdong’s industrial structure
- Reform and liberalization measures in financial, trade, logistics and technological services to attract investments from Hong Kong and elsewhere

**Fujian FTZ**
- Focused on promoting cross-strait cooperation in trade and investment
- A financial center serving cross-strait business
- Pilot policies to attract investments from Taiwan in advanced manufacturing, tourism, financial services
FTZ 1.0: The Shanghai FTZ (phase I)

- launched in **September, 2013**
- Spans 28.78 km² in Shanghai’s Pudong New Area, consisting of 4 existing **bonded zones**:
  1. Waigaoqiao Free Trade Zone (外高橋保稅區)
  2. Waigaoqiao Free Trade Logistics Park（外高橋保稅港區）
  3. Yangshan Free Trade Port Area（洋山保稅港區）
  4. Pudong Airport Comprehensive Free Trade Zone（浦東機場綜合保稅區）
FTZ 2.0: The Shanghai FTZ (phase II)

- In April 2015, the Shanghai FTZ expanded to 120.7 km², with 3 new areas:
  - Jinqiao Export Processing Zone (金橋開發片區) (20.48 km²): area of advanced manufacturing
  - Lujiazui Financial Zone (陸家嘴金融片區) (34.26 km²): core area of financial, shipping, and trade centre
  - Zhangjiang Hi-tech Park (張江高科片區) (37.2 km²): base for innovation oriented industries
FTZ 2.0: The Guangdong FTZ

- Launched in April 2015
- 116.2 km² with 3 areas
  - Guangzhou Nansha Area
  - Shenzhen Qianhai & Shekou Area
  - Zhuhai Hengqin Area
- To attract investments into selected industries from Hong Kong and Macau and help upgrade Guangdong’s industrial structure

Source: http://usa.chinadaily.com.cn/business/2015-01/06/content_19245605.htm
Three areas of the Guangdong FTZ

Guangzhou Nansha
- An advanced shipping and logistics hub; a showcase of modern producer services
  - 60 km²
  - Advanced shipping and logistics
  - Trade and logistics related finance and services
  - High-end modern manufacturing

Shenzhen Qianhai & Shekou
- A modern service industry zone; a pilot and demonstration portal for the liberalization and opening-up of the financial industry
  - 28.2 km²
  - Advanced finance
  - Modern logistics
  - IT and related services

Zhuhai Hengqin
- A pilot for the opening-up of culture and education; an international business service and tourism hub
  - 28.2 km²
  - Financial services
  - Tourism
  - Culture, education and high-tech industries
  - International trade hub for Portuguese-speaking countries
Guangzhou Nansha

- The largest among three areas: 60 km²
- Existing industries: manufacturing, ports and logistics facilities
- Targeted industries
  - Advanced logistics and international shipping services with bonded zones
  - Finance
  - High-tech and innovation
  - Modern services
Shenzhen Qianhai

- 28.2 km²
- Located in the western part of Shenzhen, next to the estuary of the Pearl River
- 4 main clusters
  - Qianhai commercial service zone
  - Qianhai bounded area
  - Shekou area 1
  - Shekou area 2

Qianhai commercial service zone
Finance, information services, technological services, professional services and strategic industries

Qianhai (bounded area)
International trade, supply chain management, shipping services, finance

SheKou Area 1
Information, technology, and cultural & creative industries

SheKou Area 2
Port, logistics and Shipping center
Zhuhai Hengqin

- 28 km²
- An island located next to the Macau Special Administrative Region
- Major clusters under planning:
  - International business services hub
  - Financial innovation zone that supports Macau’s gambling industry
  - International tourism base
  - Education and innovation base
FTZ 2.0: the Tianjin FTZ

- 119.9 km²
- the only FTZ in Northern China
- To facilitate the coordinated development between Beijing-Tianjin and Hebei
Three areas of the Tianjin FTZ

<table>
<thead>
<tr>
<th>Areas</th>
<th>Size (km²)</th>
<th>Focuses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tianjin Airport Area</td>
<td>43.1</td>
<td>• Aviation and spacecraft</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Advanced manufacturing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Electronic information</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Pharmaceutical</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Logistics</td>
</tr>
<tr>
<td>Tianjin Port Dongjiang Area</td>
<td>30</td>
<td>• Bonded areas</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Shipping logistics</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Shipping finance and logistics finance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Financial leasing</td>
</tr>
<tr>
<td>Binhai CBD Area</td>
<td>30</td>
<td>• Financial services - leasing, international financial clearance and offshore banking services</td>
</tr>
</tbody>
</table>
FTZ 2.0: The Fujian FTZ

- 118.04 km²
- To attract investments from Taiwan and overseas to upgrade Fujian’s economic structure
- To foster cross-strait economic co-operation between mainland China and Taiwan
Three areas of the Fujian FTZ

<table>
<thead>
<tr>
<th>Areas</th>
<th>Size (km²)</th>
<th>Focuses</th>
</tr>
</thead>
</table>
| Pingtan| 43         | • International trade  
                      • Tourism  
                      • Finance               |
| Fuzhou | 31.26      | • Advanced manufacturing  
                      • Aviation  
                      • Professional services |
| Xiamen | 43.78      | • Advanced manufacturing  
                      • Cross-Strait financial services and regional aviation |
Why the FTZs?: the macro background

• China has entered a “new normal” of slower growth, with an emphasis on economic restructuring and institutional reforms to achieve sustained and quality growth.

• New mega-regional Free Trade Agreements negotiations (e.g. TPP, TTIP, TiSA), in which China is not included, will potentially change fundamentally the rules and standards of international trade and investment.

• Negotiations for a China-US Bilateral Investment Treaty (BIT) aim to grant each other the pre-establishment national treatment with a “negative-list” approach to market access.

• Bonded Areas in China, first established in Shanghai in 1993, are seeking breakthrough to help overcome bottleneck constraints.

A new stage of China’s economic opening up and reform.
Why the FTZs?: the rationale

- “Li Keqiang Economics”: to further open up the economy and allow external forces to put pressure on internal **structural reform**
- FTZs: “testing grounds” for new structural reforms, institutional innovations, and new trading rules aimed at further opening up the economy, whilst **confining** the reform measures to small geographical areas to manage risks and ease resistance from established interest
- Successful outcomes from these experiments will later be applied **nationwide** to build “an upgraded version of the Chinese economy”

*FTZs are widely seen as a priority project of Premier Li Keqiang*
(Part II) Major reform initiatives
6 major reform measures in the FTZs

1. Liberalization of trade
2. Liberalization of investment
3. Transformation of the administrative system
4. Financial reform
5. Pilot policies for cross-border e-commerce
6. Special tax policies in certain FTZs

Tianjin FTZ
Shanghai FTZ
Fujian FTZ
Guangdong FTZ
Liberalization of trade

• A strategy of “opening the 1st-tier border and controlling effectively the 2nd-tier border” is implemented in bonded areas/ports

• 1st-tier border:
  ✓ Tariff and non-tariff barriers to trade between the FTZ and overseas markets to be lifted
  ✓ Customs procedures to be streamlined towards a “single window” of customs declaration
  ✓ New rules of inspection and quarantine to make it easier to import and export, while maintaining strict quality and safety risk control
  ✓ Goods can be imported, manufactured, and re-exported under centralized, categorized and electronic customs supervision

• 2nd-tier border:
  ✓ Customs duties will apply when the merchandize leaves the zone and enters the domestic market
Liberalization of investment: the negative-list approach to market access

- Under the negative-list approach to market access, foreign investors enjoy *equal treatment* to that of Chinese domestic enterprises in *any industry* not explicitly restricted or prohibited on the list.

- In theory, sectors in gray areas not covered in the list are free to be *released to foreign investment*.

- If fully implemented, the negative-list approach is a *significant departure* from other regulatory approaches taken by China during the past 35 years of reform.
A single negative list applied to all FTZs, with gradual liberalization

The 2013 Negative List
- 193 areas of restriction and prohibition
- Comment from the business: "no significant improvement in terms of liberalization of foreign investment"

The 2014 Negative List
- 139 areas of restriction and prohibition
- Further liberalization measures in financial services, healthcare, legal services, manufacturing, transportation, warehousing and postal services
- Comments from the business: "still too many restrictions"

The 2015 Negative List
- 122 restrictions in 50 industry categories
- Further liberalization in manufacturing, wholesale, retail, and e-commerce
- Business welcomed the changes, but commented that "the restrictions are still very vague and not specific enough"
# The 2015 negative list VS. the 2014 negative list

<table>
<thead>
<tr>
<th>Financial Services</th>
<th>Cultural, Sports and Entertainment</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Restriction measures increased from 4 to 14</td>
<td>• Restriction measures increased from 8 to 24</td>
</tr>
<tr>
<td>• New newly added restrictions are mostly to clarify relevant rules:</td>
<td>• Examples of new restrictions:</td>
</tr>
<tr>
<td>✓ E.g., clarification of restrictions on the banking industries</td>
<td>✓ Administrative approval needed for foreign correspondence and financial information services</td>
</tr>
<tr>
<td>• Some new restrictions introduced:</td>
<td></td>
</tr>
<tr>
<td>✓ E.g., foreign ownership prohibited for futures</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Manufacturing</th>
<th>Wholesales and Retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Restriction measures reduced from more than 50 to 17</td>
<td>• Restriction measures reduced from 9 to 4</td>
</tr>
<tr>
<td>• Manufacturing of consumer goods are largely opened up</td>
<td>• Restrictions and capital requirement on direct sales removed</td>
</tr>
<tr>
<td>• Restrictive measures on strategic industries and heavy industries reduced, but still quite restrictive</td>
<td>• Restrictions on online sales removed in both FTZs and nationwide, which means a complete opening-up of e-commerce to foreign companies nationwide</td>
</tr>
</tbody>
</table>
However, foreign investment in FTZs remains subject to national-level regulations

- With the implementation of negative list in the FTZs, existing national regulations on investor qualification, shareholding, and business operation are supposed to be suspended within the FTZs.
- In practice, however, the negative list stipulates that foreign investments in FTZs shall comply with “current relevant national regulations” under certain circumstances (see right), without spelling out the specific circumstances and the detailed regulations, making the list very vague and opaque.
- The overlapping of the nation-level rules and negative list has left the investment environment in FTZs complex, unclear and uncertain.

### The 2015 Negative List

- “For investments that might have bearing on national security, public order, financial stability, public culture, government procurement and subsidies, special tax policies, **current national regulations should apply**.”
- “Foreign investments/foreign stake control are prohibited/restricted in sectors which are prohibited or **restricted by the National Catalogue Guiding Foreign Investment** (《外商投資產業指導目錄》).”
- “Relevant regulations shall be applied for activities including mergers and acquisitions by foreign investors, strategic investments in listed companies by foreign investors, foreign investors using equity interest in domestic enterprises for capital contribution purpose, **relevant regulations shall be applied**.”
Recent opening-up measures do little for immediate expansion of market access

- In July 2016 the State Council announced some liberalization measures in the 2015 *National Catalogue Guiding Foreign Investment*, temporarily allowing investors to found wholly-owned enterprises within the FTZs in a number of sectors including agriculture, iron and steel production, gas exploration, auto batteries, and shipping.

- Since foreign companies are *unlikely to invest in most of these newly-opened sectors* like steel production and gas exploration within the FTZs, the new measures do little immediately to expand market access.

- Of course, these areas *may be of interest if rolled out nationally* in a later stage.

- The new measures also show that the *negative list is, in fact, playing only a marginal role in governing foreign investment in FTZs*, since all the new measures were introduced via the *National Catalogue Guiding Foreign Investment*, instead of the negative list.
The negative-list approach is expected to be applied nationwide.

- **A pilot negative list** for both local and foreign investors released in April 2016 is expected to be applied in the full territories of Shanghai, Guangdong, Fujian and Tianjin by 2017, and then to selected provinces in central, western and northeastern China in a later stage.

- **A unified national negative list** for market access will thus be in force nationwide after the pilot implementation; the complete timetable, however, remains unknown.
The FTZ Negative List *vs.* the provincial-level Pilot Negative list

<table>
<thead>
<tr>
<th>Scope of application</th>
<th>The FTZ Negative List</th>
<th>The Pilot Negative list</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign investments</td>
<td>Both local private and foreign investments</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Restriction measures</th>
<th>122</th>
<th>328</th>
</tr>
</thead>
<tbody>
<tr>
<td>more brief yet vague</td>
<td>more detailed with specific restrictions</td>
<td></td>
</tr>
</tbody>
</table>

- According to the Chinese government, once the Pilot list becomes effective at the provincial/municipal level, companies in FTZs must “comply with both lists”

- **Observations:**
  - Foreign investors are likely to be confused by the existence of two negative lists, especially if it means that *the stricter list could override the other*
  - Because of *the vague way the government has worded the negative lists*, investments are at the same time restricted or prohibited according to “other law, legislations and decisions of the State Council”
Transformation of administrative system: the business-filing mechanism

• A *business-filing mechanism* replaces the mandatory administrative approval system for establishing companies in the FTZs in business areas not included in the negative list.

• *One-stop service* for corporate registration in which red tape and paperwork are significantly simplified.

• The filing system also applies to Chinese enterprises engaged in outbound investment registered in FTZs.

• However, *government approval* will still apply in restricted areas in the negative list.

*The principle behind administrative reforms in the FTZs is to reduce bureaucracy and remove unnecessary interventions by the government in the market.*
However, FTZs’ more liberal approach to foreign investment is subject to a more stringent national security scrutiny regime

- A new and enhanced national security scrutiny regime for FTZs came into effect in April 2015

- The regime is, in some respects, more stringent than that outside the FTZs, indicating China’s intention to counterbalance the FTZs’ more liberalized approach to foreign investment

- The new regime may require applications for national security clearance for investment in the FTZs, which might not be necessary if the same investment is made outside the FTZs

Under the new national security scrutiny regime, a national security review is required for any foreign investment in FTZs which may affect national security or the nation’s ability to defend itself and is made by a sensitive investment vehicle, or is in a sensitive target, territory, or sector
Newly-released measures further clarified the implementation of the filing system

- In July 2016 the State Council announced a series of new administrative regulations in the FTZs, temporally changing the administrative approval requirements for some sectors in the *2015 National Catalogue Guiding Foreign Investment* into the business-filing mechanism.

- In actuality, the business-filling mechanism was supposed to have been implemented since the establishment of the first FTZ in Shanghai in 2013.

- Thus, the new initiatives might be seen as a move to secure adherence to the lawful business-filing mechanism in the FTZs.
Financial reforms in FTZs

• FTZs are widely seen as laboratories for testing deregulation of China’s interest rates and capital account, with the RMB’s internationalization as the objective

• The financial industry is gradually being opened to private capital and foreign financial institutions

• Innovations in the FTZs will be implemented nationwide gradually

• However, financial security and stability is emphasized as the prerequisite for any reform in the zones
Free Trade Accounts (FTAs)

- Companies operating in FTZs are allowed to open FTAs.
- Funds can be freely transferred between FTAs, non-residents accounts outside the FTZs but within mainland China, and offshore accounts.
- Fund transfers between FTAs and accounts within mainland China are treated as cross-border transactions.
Cross-border RMB cash pooling

- MNCs are allowed to transfer funds between their China subsidiaries and their overseas entity via **two-way cash pooling**

- Cash pooling enables multinational corporations to centralize and allocate funds between entities in their group, and better manage any surplus fund.

- Intra-group lending allows a corporation to control liquidity across the group and realize same currency balance sheet reductions.

- **Requirements:**
  
  ✓ Funds in the cash pool can only be obtained from business operations and industry investment (e.g. dividends) rather than financing.

  ✓ Funds transferred into China via the cash pool must be used for the company's working capital.
Cross-border RMB/FX financing

• **Inbound flow of RMB/FX:**
  
  ✓ **Pilot companies** (non-financial institution companies incorporated in FTZs) and **pilot financial institutions** (24 domestic banks and 3 foreign invested banks) have the discretion to **raise RMB or FX denominated financing from offshore under unified regulations**

  ✓ Must comply with the cross border **restrictions** based on the borrowing entities’ capital or net assets which have been designed in accordance with the macro-prudential policies

  ✓ PBOC has the jurisdiction over adjusting the cross-border financing leverage ratio and macro-prudential adjustment ratio; SAFE has the jurisdiction of cross-border financing administration and accounting monitoring

• RMB cross-border financing policy in **Qianhai area of the Guangdong FTZ** is leading others in terms of openness - with no quota limitation on funds and more flexible terms - although the gap is narrowing
Cross-border RMB/FX financing expanded to the whole nation

The pilot program of prudent macro management of cross-border RMB/FX financing in FTZs (Jan 2016)

The program of prudent macro management of cross-border RMB/FX financing expanded nationwide (April 2016)
Liberalization of interest rates

- Deposit *interest rate ceilings* on smaller foreign currency deposits below USD 3 million were removed since March 2014.

- Financial institutions in FTZs can price the foreign currency deposits *independently*.

- The rule applies to bank accounts opened by companies and organizations registered in FTZs and individuals working there for longer than a year.

- Seen as a significant step towards implementing a complete, market-based system for setting interest rates.
Tightening of rules on the outbound flow of RMB

• In the early stage, FTZs provided a more liberalized channel for the *outbound flow of RMB*
  ✓ A filing system replaced the administrative approval for outbound investments under USD 300 million and in non-sensitive industries and projects
  ✓ The currency exchange and payment system for outbound investment was also liberalized
  • Outbound investment from the Shanghai FTZ tripled in 2015

• However, the recent tightening up by authorities on capital outflow amidst a depreciating currency suggests that they are reluctant to push ahead with measures in FTZs that would enable even greater outflows

• Outbound RMB flow of now restricted to:
  ✓ Projects that are related to China’s “go aboard” strategy
  ✓ Individual Industrial and Commercial Household lending to overseas business operations
Further liberalization of RMB capital account *put on hold*

- **Capital account liberalization** allows capital flows not generated by trade, and is seen as the final step to achieve RMB free convertibility.

- A pilot scheme (Qualified Domestic Individual Investor - *QDII2*), under which local residents would be allowed to invest directly in overseas equities and properties through bank accounts opened in the zone, was expected to become effective in Shanghai FTZ in 2015 as part of China’s efforts to further liberalize its capital account.

- The pilot scheme was intended to then be rolled out to the rest of Shanghai and other cities.

- However, this scheme has been *put on hold* as China attempts to rein in capital outflows, given the volatility and downward pressure to the currency.

- Although the market volatility will unlikely prevent the launch of the QDII2 investment scheme, it’s hard to predict when it will be implemented.
Cross-border e-commerce and FTZs

- In 2015 and 2016 the State Council approved the establishment of Comprehensive Pilot Cross-border E-commerce (CEBC) Experiment Zones in **13 cities**, including: Hangzhou, Zhengzhou, Ningbo, Shanghai, Chongqing, Guangzhou, Shenzhen, Tianjin, Hefei, Chengdu, Dalian, Qingdao, Suzhou
Governments in the pilot cities are streamlining and amending customs regulations to support and regulate CBEC.

In Shanghai, Guangzhou, Shenzhen and Tianjin, FTZs have become the major platforms for policy initiatives aimed at promoting CBEC because of their advantage in trade liberalization, since several models of import and export e-commerce involve access to bonded areas (e.g. the bonded import model and bonded export model).
Special tax policies in Qianhai, Hengqin and Pingtan

- There is no common special tax treatments for all FTZs
- Until the end of 2020, qualified enterprises in Qianhai and Hengqin of the Guangdong FTZ and Pingtan of the Fujian FTZ may enjoy a reduced corporate income tax (CIT) rate of 15%, instead of the standard 25%
- Accredited high-end foreign professionals working in Qianhai, Hengqin, and Pingtan may enjoy an individual income tax capped at 15%

<table>
<thead>
<tr>
<th>Area</th>
<th>Hengqin</th>
<th>Qianhai</th>
<th>Pingtan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main industry categories</strong></td>
<td><strong>High and new technology</strong></td>
<td><strong>Science and technology services</strong></td>
<td><strong>High technology</strong></td>
</tr>
<tr>
<td><strong>Commercial services</strong></td>
<td><strong>Modern logistics services</strong></td>
<td><strong>Services</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Cultural innovation</strong></td>
<td><strong>Cultural innovation</strong></td>
<td><strong>Agricultural and marine sectors</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Education and R&amp;D</strong></td>
<td><strong>Information services</strong></td>
<td><strong>Ecological and environmental protection</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Pharmaceutical industry and healthcare</strong></td>
<td></td>
<td><strong>Public facility management</strong></td>
<td></td>
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</tbody>
</table>

*Table source: http://www.wts.com/en/img/201405_Tax_News_China_04.pdf*

- The online tax filing system in FTZs
  - An online system for businesses to complete tax registration and manage invoices and to apply for electronic invoice
  - Tax filing can be done on a quarterly basis (rather than monthly nationwide)
  - An online credit evaluation system that offers enterprises in good standing additional tax services and processing options
Observations

(Part III)
China’s FTZs are about much more than free trade

They are designed as testing grounds for comprehensive institutional reform

- They go far beyond special customs supervision for promoting free trade
- They are generating institutional innovations
- They potentially presage a comprehensive overhaul of China’s existing economic management system, although presently confined within several small areas
- Successful experiences will later be applied nationwide to build “an upgraded version of the Chinese economy”
They point the direction of China’s ongoing reforms

- FTZs have become *sites of dynamic regulatory change*

- The reform initiatives in the FTZs reflect a commitment to lightening regulatory burdens and adjusting regulations to *upgrade the economy* in China

- In particular, the regulatory concept of the FTZs (e.g. the negative list and the business filing mechanism) marks a *fundamental shift* in principles by which China has regulated its economy over the past 35 years
Since their establishment, FTZs have attracted a large number of investors to incorporate in the zones. Domestic companies are much keener to tap into the special regimes in the FTZs than foreign companies and form the majority of companies incorporated in the FTZs.

Foreign companies in the zone have only limited and controlled access to China’s main market, which is the biggest limitation, given the small market size of FTZs.

FTZs still have a way to go to live up to the high expectations many foreign investors hold.

### Constraints and challenges: domestic vs. foreign investors

<table>
<thead>
<tr>
<th></th>
<th>SHFTZ</th>
<th>GDFTZ</th>
<th>FJFTZ</th>
<th>TJFTZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of companies incorporated in the FTZs</td>
<td>18,000</td>
<td>56,000</td>
<td>32,200</td>
<td>14,105</td>
</tr>
<tr>
<td>Number of foreign companies incorporated in the FTZs</td>
<td>3,326</td>
<td>N/A</td>
<td>1,552</td>
<td>657</td>
</tr>
<tr>
<td>Ratio of foreign-invested companies to all companies incorporated</td>
<td>18.4%</td>
<td>Estimated to be less than 10%</td>
<td>4.8%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Contracted foreign capital registered (billion RMB)</td>
<td>260</td>
<td>156.6</td>
<td>74.9</td>
<td>139.8</td>
</tr>
</tbody>
</table>

Data source: Governments of FTZs; 朱煜, “中国自由贸易试验区2015年改革发展报告”
Constraints and challenges: A bias towards caution

- Because reforms tested in FTZs are intended to be replicable and expandable nationwide, China’s leaders are exercising caution in advancing them.

- Customs regulations, which differ from area to area within FTZs, fluctuate between loosening and tightening.

- For financial reforms, there are concerns over arbitrage and financial risks:
  - Capital flows between the free trade accounts in the zones and accounts in the rest of China are still treated as cross-border transactions.
  - The government largely exercises its control by managing various accounts like free trade accounts.

- The border between the FTZ and rest of China is still carefully managed for flows of goods, allowing for only limited penetration of the domestic market.
Constraints and challenges: diminishing “first mover” advantage

- The “first mover” advantage FTZs presently enjoy, especially for pioneering financial reforms, will inevitably diminish over time as other parts of China catch up.

- Some FTZ pilot reforms have already been expanded to the whole nation or to selected provinces/cities (though they have yet to deliver concrete results).

- Other FTZ experiments may be rolled out across the country at a pace faster than expected, which is why foreign investors continue to watch developments in the Chinese economy as a whole.

<table>
<thead>
<tr>
<th>Cross-border RMB cash pooling</th>
<th>Interest rate marketization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementation in FTZs: Feb 2014</td>
<td>Implementation in FTZs: March 2014</td>
</tr>
<tr>
<td>Nationwide implementation: Sep 2014</td>
<td>Implementation in Shanghai: Jun 2014</td>
</tr>
</tbody>
</table>

| The new cross-border financing management regime |
| Implementation in FTZs: Jan 2016 |
| Nationwide implementation: May 2016 |
Constraints and challenges: translating FTZs into broader structural reform

• While a “special-zone approach” was crucial 35 years ago to developing export-manufacturing, China’s emphasis is now on services and consumption.

• Because of their intangible nature, it is difficult to segregate services from overall economic activity or to confine them, geographically, to small FTZs.

• Experience elsewhere suggests that service industry reform works best when carried out inside the market where actual service providers and customers can interact.

• In some cases, FTZ environments may prove to be too small and rarified for testing reforms intended ultimately for nationwide application.
(Part IV) Conclusions
Three years on: the jury is out on the long-term impact of China’s FTZs

- FTZs have become sites of dynamic regulatory change, with pilot measures in trade and investment liberalization, financial reforms, cross-border e-commerce facilitation, etc. launched and changed frequently.

- However, liberalization measures in FTZs go back and forth constantly, making it difficult for investors that expect a clear, transparent and stable business environment.

- It remains to be seen whether they will be able to create a genuinely free environment for flows of goods, capital and information.

- While keeping a close eye on the development of the FTZs, investors should not divert all their attention from the broader Chinese economy, since there is possibility that the experiments carried out in the zone be rolled out across the country at a faster pace than expected.
Despite constraints and challenges, FTZs remain pivotal to economic reform

- FTZs are set to **surpass** other special zones in terms of significance to China’s further economic reform and development

- A rich stock of capital investment, plus a concentration of new policies and strong backing from the State Council, provides a strong foundation for China’s FTZs to deliver on their objectives

- Experiments in the FTZs are helping to prepare the country as a whole for deeper economic reform and, in particular, to change the mentality of entrenched interest groups

- China has a record of success in testing reform measures in special zones before letting them touch or impact the mainstream economy. This approach has also helped to ease domestic resistance to reform while minimizing risk
Appendix
## Restrictions on foreign investments in selected industries: FTZs vs. nationwide

<table>
<thead>
<tr>
<th>Industry</th>
<th>The 2015 negative list for FTZs</th>
<th>The pilot negative list for Guangdong, Fujian, Tianjin and Shanghai</th>
<th>Nationwide (Positive list)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banking and Finance</strong></td>
<td>• Pre-approval required for banking and financial services</td>
<td>• Pre-approval required for banking, security companies, insurance company, RMB and FX loan issuance and a wide range of financial services</td>
<td>• Maximum foreign equity control for Banks (25%), Insurance (50%), securities (49%) and Futures (Chinese control)</td>
</tr>
<tr>
<td></td>
<td>• Restrictions on scope of business and foreign equity of commercial banks, insurance companies and security companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Wholesale and Retail</strong></td>
<td>• Cigarette forbidden</td>
<td>• Imports and exports of selected product categories, such as grain, medicine or dangerous goods required approval</td>
<td>• Cigarette forbidden</td>
</tr>
<tr>
<td></td>
<td>• Grain and cotton wholesale restricted</td>
<td>• Business in a number of industries such as auctions, direct sales and wholesale/retail of medicine and medical equipment required special permission</td>
<td>• Grain and cotton wholesale restricted</td>
</tr>
<tr>
<td></td>
<td>• Approval required for duty free retailing</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Logistics and Transportation</strong></td>
<td>• Entry restricted or foreign equity ownership restricted for road, railroad, maritime transportation and aviation</td>
<td>• Detailed and pro-longed restrictions on transportation and logistics industries</td>
<td>• Foreign equity restriction on shipping agent</td>
</tr>
<tr>
<td></td>
<td>• Domestic postal and courier forbidden</td>
<td>• Bonded warehouses required approval</td>
<td>• Domestic postal and courier forbidden</td>
</tr>
<tr>
<td><strong>Textile manufacturing</strong></td>
<td>• No restriction</td>
<td>• Detailed restrictions on using outdated and polluting manufacturing methods and equipment</td>
<td>• Encourage high-tech textile manufacturing such as integrated computerized garment manufacturing</td>
</tr>
</tbody>
</table>
## Cross-border RMB pooling: FTZs vs. nationwide

<table>
<thead>
<tr>
<th></th>
<th>Shanghai FTZ</th>
<th>GDFTZ, FJFTZ (Xiamen Subzone), TJFTZ</th>
<th>Nationwide</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Quota</strong></td>
<td>No quota</td>
<td>Owners’ equity of all member companies x “macro-prudential adjustment ratio”, currently set at 1</td>
<td>Owners’ equity of all member companies x “macro-prudential adjustment ratio”, currently set at 0.5</td>
</tr>
<tr>
<td><strong>Type of business</strong></td>
<td>MNCs based in SHFTZ</td>
<td>MNCs based in respective FTZs</td>
<td>Non-financial MNCs only</td>
</tr>
<tr>
<td><strong>Source of fund</strong></td>
<td>Only funds within the group from business operations or industrial investments are permitted</td>
<td>Surplus funds of the member companies</td>
<td>Not specified. In theory funds shall come from business operation</td>
</tr>
<tr>
<td><strong>Application /Filing</strong></td>
<td>No prior registration and filing requirements</td>
<td>Prior registration required</td>
<td>Clearing bank shall file to local branch of PBoC at deputy provincial level city or above</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Information on owners’ equity of all member companies needed to be submitted to headquarter of PBoC</td>
</tr>
<tr>
<td><strong>Multiple Cash Pooling</strong></td>
<td>One cash pool in FTZ and one outside FTZ are permitted in accordance with national rules</td>
<td>Multiple cash pooling can only be set up when necessitated by business need</td>
<td>Prior registration with PBoC head-quarter required</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Domestic subsidiaries of MNCs can only join one cash pool</td>
</tr>
<tr>
<td><strong>Usage</strong></td>
<td>Not explicitly specified, but the principle of cash pooling is to facilitate business operations</td>
<td>“Notice regarding further facilitating cross-border two-way Renminbi (RMB) fund pool businesses for multinational corporation (MNC) groups (Yinfa [2015] No. 279)” prohibits the use of funds for investment in securities, derivatives, other financial products, non-self use property or lending to companies not in the group</td>
<td></td>
</tr>
</tbody>
</table>
# Cross-border RMB loans: FTZs vs. nationwide

<table>
<thead>
<tr>
<th>Shanghai FTZ</th>
<th>GDFTZ Qianhai Area</th>
<th>GDFTZ Nansha &amp; Hengqin Area; FJFTZ</th>
<th>Nationwide</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Quota</strong></td>
<td>• For enterprises, 1 time of the company’s paid-in capital; 1.5 times for non-bank financial institutions.</td>
<td>• No upper limit</td>
<td>• Net assets (for enterprises)/Tier 1 Capital(for banks)/Paid-in capital(for non-bank financial institutions) x cross border financial leverage ratio x macro-prudential adjustment ratio</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Cross border financial leverage ratio: now sets at 1 for enterprises and 0.8 for banks and non-bank financial institutions</td>
<td>• Macro-prudential adjustment ratio: now sets at 1</td>
</tr>
</tbody>
</table>

**Interest rate**

• Agree upon lender and borrower and report to PBoC before loan

**Terms**

• Longer than 1 year |
• No limit, can be short or long term (reasonable term)

**Lender**

• No specific requirements; banks and non-bank financial institutions are preferred |
• Hong Kong based banks |
• Hong Kong and Macau based banks and financial institutes in the banking industry in Nansha and Hengqin |
• Taiwan based banks in FJFTZ |
• Overseas enterprises/ financial institutions

**Borrower**

• Enterprises registered and operate/invest in the respective FTZs |

**Usage**

• Can only be used inside the SHFTZ or outside Chinese border |
• In principle can only be used in Qianhai for business operation or construction of real estate for self-use |
• However, Qianhai officials have claimed that funds can be used in other part of China after approval |
• Can only be used in Nansha and Hengqin (entire region, not just FTZs) or overseas for Nansha and Hengqin cross-border RMB loans and only in key investment projects in Nansha and Hengqin. |
• Can only be used in FJFTZ for cross-border RMB loans from Taiwanese banks |
• For business and production activities |
• Must comply with national or FTZ policies on macro economic control (if applicable) |

• Securities, derivatives, financial instruments and real estates for investment purposes are forbidden.