Shanghai Free Trade Zone: China’s Reform Incubator

- Launched in September 2013, the Shanghai Free Trade Zone (FTZ) serves as a space for the national government to pilot economic reforms. These include the adoption of a “negative list” approach to investment, liberalization of capital controls, simplified customs clearance procedures, and the introduction of broader trial National Security Review procedures.
- U.S. companies continue to be skeptical about the business advantages of the FTZ. 73 percent of respondents to AmCham Shanghai’s 2015 China Business Report say that the FTZ offers no tangible benefits.
- Despite the lukewarm reception by the foreign business community, the central government continues to support the initiative. On April 20, 2015, the Shanghai FTZ was quadrupled in size by including many other areas of Pudong. China has also established new FTZs in Guangdong, Fujian, and Tianjin.

Since its establishment in September 2013, the Shanghai FTZ has introduced specific reforms in the areas of customs, financial services, and e-commerce. The FTZ is also where China first introduced the concept of the “negative list” to regulate foreign investment. This negative list approach is now being used in China’s negotiations with the United States on a Bilateral Investment Treaty (BIT). Over two years later, the expansion of the Shanghai FTZ and the establishment of new FTZs in Guangdong, Fujian and Tianjin demonstrate the government’s continued support for the FTZ model as an incubator for economic reforms that support China’s reform goals. The foreign business community, however, remains skeptical about the tangible benefits for businesses.

Economic Reform Testing Ground

The Shanghai FTZ and three new FTZs in Guangdong, Fujian, and Tianjin are central government driven initiatives to accelerate and pilot reforms. Reforms focus on five broad areas:

1. Transforming government functions and regulatory control to shift from a focus on approval to one of supervision
2. Facilitating trade and investment
3. Opening the financial sector
4. Improving the legal framework
5. Enhancing service sector market access in shipping and logistics, commercial trade, professional services, cultural and entertainment services, and social services (e.g., education and medical services)

Business Benefits Remain Unclear

These reforms, however, have not convinced the foreign business community that the FTZs are significant game changers. Over 120 U.S. companies are in the Shanghai FTZ and taking advantage of the zone’s special policies. But most companies have shifted their attention elsewhere. According to AmCham Shanghai’s 2015 China Business Report (CBR), 73 percent of respondents report that the FTZ offers no tangible benefits for their business and 48 percent report that there are no noticeable changes for business since its commencement. One problem remains the lack of clear information from FTZ authorities about the zone.

Negative List Approach

The FTZ’s most prominent reform is the introduction of the “negative list” approach to managing foreign investment, the first time China applied this approach. The
negative list is now also being used in the three new FTZs. Under a negative list, foreign investors may participate in any activity or investment not on the list to the same extent as Chinese domestic enterprises (except in projects that would compromise China's national or social security or the public interest). Since its introduction, the negative list has been reduced and simplified twice from an initial list of 190 items to the current list of 122 items. While the list has shrunk by nearly a third, many items on the list were regrouped or rephrased instead of eliminated. The list itself remains too long for most foreign observers.

Despite its length, the negative list has opened up more areas for foreign investors, including in agriculture, real estate, value added telecommunications, pharmaceuticals, direct sale, and distribution of audio-and-video products. In addition, foreign investors can fully own e-commerce firms, although other barriers render this opening less meaningful.

As a measure of the importance of the Shanghai FTZ for policy experimentation, the negative list approach is now being used in the U.S.-China Bilateral Investment Treaty (BIT) negotiations and in the EU-China investment trade agreement negotiations. There is no formal connection between these negative lists, but there is coordination within the Chinese government on the content of the lists.

**Key Reforms**

In addition to the introduction of a “negative list” approach to investment, the FTZ has ushered in a number of important reforms, many of which have been rolled out to the rest of the country.

**Free Trade Accounts (FTAs):** Companies registered in the Shanghai FTZ can use FTAs to conduct cross-border transfers of foreign currency and renminbi (RMB) free from existing restrictions on the movement of funds. This supports a range of services, such as RMB cash pooling, cross-border trade settlement, and international financing and investment. As of March 2015, there were 12,124 FTAs in the Shanghai FTZ and cross-border RMB settlement reached 128.737 billion.

**Trade Facilitation:** The Shanghai FTZ has implemented 23 regulatory measures that simplify the Customs and China Inspection and Quarantine (CIQ) clearance process. These reforms include paperless customs clearance, a single window approach for Customs and CIQ clearance, declaration after entry of goods, and acceptance of third-party testing results.

**Visa Regulations:** Foreigners working in the Shanghai FTZ can apply for a private affairs residence permit of up to 5 years. Those who have worked for three consecutive years can apply for a 2-year work residence permit.

Not all experimentation in the FTZ is viewed positively by foreign investors. For example, the State Council announced on April 20, 2015 that all FTZs will pilot procedures for a national security review of foreign investment. Unlike the current framework, this review is broader in scope, and covers not only foreign M&A but also greenfield investment, variable interest entity arrangements, arrangements involving share nominees, offshore transactions and other forms of foreign investment. The trial procedures also broaden the items for consideration under the review, including such considerations as the impact of a foreign investment on national cyber-security, cultural security and even public morality. This particular “reform” is not a welcome one, but it is an important indication of how the government uses the FTZ.

**Shanghai FTZ Expansion**

In April 2015, the Shanghai FTZ was expanded to 120.72 km² from 28.78 km² to include most of Pudong, including the Lujiazui Financial District, Zhangjiang High-Tech Park, and Jinqiao Development Zone. Each of these areas has a different focus. Jinqiao will focus on promoting the manufacturing service industry. Lujiazui will promote financial service reforms and Zhangjiang will focus on high-tech innovation. Companies already established in these areas will automatically be registered in the FTZ. The expansion provides Shanghai with more space to experiment with reforms, in particular financial sector reforms.

**New FTZs: Guangdong, Fujian, and Tianjin**

In April 2015, China established new FTZs in Guangdong, Tianjin and Fujian. These new zones include many of the same reforms and regulations as in Shanghai, but each new FTZ has a slightly different focus.

**Tianjin FTZ** includes areas around Tianjin port, Tianjin airport, and the Binhai New Area. It will promote inland economic integration and collaborative development among Beijing, Tianjin and Hebei Province. It will focus on shipping, financial leasing, and high-end manufacturing.

**Guangdong FTZ** will promote cooperation between Mainland China, Hong Kong and Macau. It will focus predominantly on the services sector, i.e. customs clearance and the finance industry, as well as making advancements in China’s manufacturing industry.

**Fujian FTZ** will support the cross-strait economy and trade with Taiwan. It will focus on producer services and the high-end service sector, as well as supporting the “One Belt, One Road” initiative (The 21st Century Maritime Silk Road originates from Fuzhou, the capital city of Fujian).