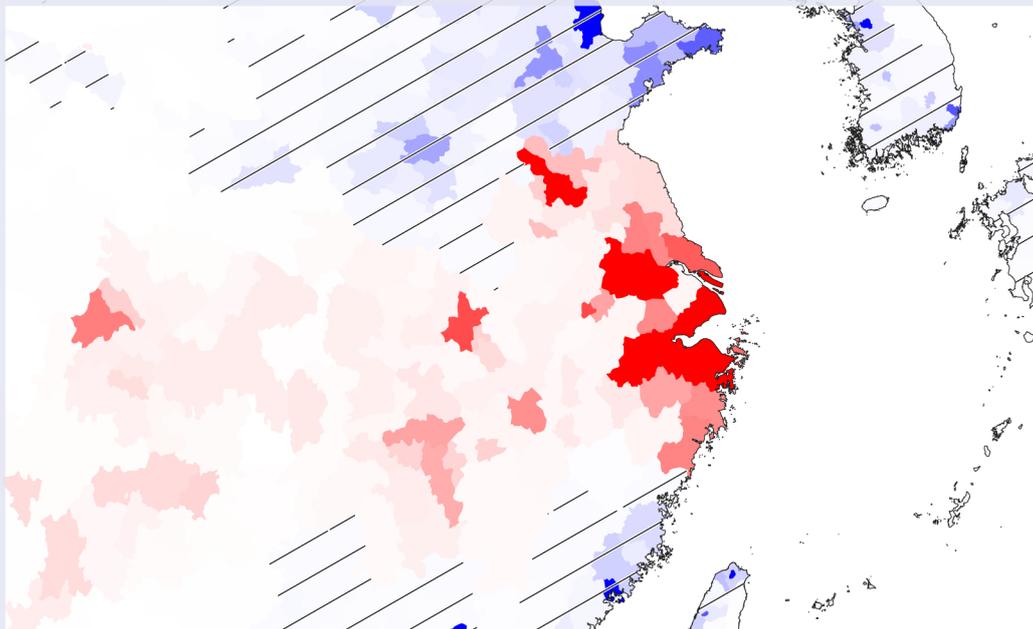




IDE-JETRO

# China (Shanghai) Pilot Free Trade Zone and the Future of Asia

## Executive Summary



Joint Research:  
Institute of Developing Economies, Japan External Trade Organization (IDE-JETRO)  
Shanghai Academy of Social Sciences (SASS)

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Since the China (Shanghai) Pilot Free Trade Zone (hereinafter referred to as “SHFTZ”) officially opened on September 29, 2013, in accordance with the requirements of the CPC Central Committee and State Council, SHFTZ has enjoyed good progress as well as initially set up a basic institutional framework and begun to show the effects of the reforms (Table 1). Starting from four hot spots with a total area of less than 30 square kilometers, the Chinese Government sowed the seeds for a new round of reform and opening up.

## Global Value Chain and Service Trade

On February 27, 2013, the United Nations Conference on Trade and Development (UNCTAD) issued its latest research report, *Global Value Chains and Development: Investment and Value-added Trade in Global Economy*. This report investigates the added value of international trade in global distribution and gives a new perspective for understanding the pattern of global value-

added trade. From this report, three important conclusions can be drawn. First, trade within the global value chain, which is mainly dominated by multinational companies in developed countries, accounts for about 80% of global trade. Second, the existence of a global value chain leads to repeated “double counting” of current global trade data according to customs statistics. According to new data, approximately 28% of gross exports is the value added to products or services which are initially imported into the exporting country. Therefore, of the gross global exports of USD 19 trillion in 2010, double counting amounted to USD 5 trillion. Finally, the global value chain contains a large amount of service trade. Service trade currently accounts for only 20% of gross global exports according to customs statistics, but the service trade industry creates nearly half (46%) of the imported added-value of global exports because the manufacturing of products for export requires extensive services.

Table 1: The Progress of SHFTZ

	2013	2014	2015
Area	28.78km <sup>2</sup> <ul style="list-style-type: none"> <li>➢ Waigaoqiao Bonded Zone</li> <li>➢ Waigaoqiao Bonded Logistics Zone</li> <li>➢ Pudong Airport Free Trade Zone</li> <li>➢ Yangshan Free Trade Port Area</li> </ul>	120.72km <sup>2</sup> <ul style="list-style-type: none"> <li>➢ Lujiazui Financial District, Zhangjiang High-Tech Park and Jinqiao Development District are included</li> </ul>	To be newly established: <ul style="list-style-type: none"> <li>➢ China (Guangdong) Free Trade Zone</li> <li>➢ China (Tianjin) Free Trade Zone</li> <li>➢ China (Fujian) Free Trade Zone</li> </ul>
Negative List	190	139 <ul style="list-style-type: none"> <li>➢ 110 restrictions and 29 prohibitions</li> </ul>	Planned to be less than 100
Institutional Innovation	<ul style="list-style-type: none"> <li>➢ Introduce a “single window” system</li> <li>➢ Establish a system for market supervision with social audits</li> <li>➢ Improve the system for sharing information and comprehensive legal enforcement</li> </ul>	<ul style="list-style-type: none"> <li>➢ Establish a system for announcing the company’s annual report and the names of poorly managed companies</li> <li>➢ Improve the social credit system</li> <li>➢ Improve the professional auditor system</li> </ul>	<ul style="list-style-type: none"> <li>➢ Start to replicate the reform measures of SHFTZ nationwide</li> </ul>

Source: Authors.

## Mega FTAs and the Role of SHFTZ

The emphasis in the negotiations for global trade and investment rules is changing and diversifying to reflect the need to redesign global production. The WTO Global Multilateral Trade System, which makes up the negotiated trade rules, is gradually being replaced by various bilateral, plurilateral and regional institutional arrangements for trade and investment, with equal emphasis on negotiation for trade rules and negotiation for investment rules. Among these agreements, the US-led Trans-Pacific Partnership Agreement (TPP) and Transatlantic Trade and Investment Partnership Agreement (TTIP) are the most prominent. The Sino-US Bilateral Investment Treaty (BIT) being negotiated between China and the United States may implement so-called “American-style high standards”, and it may become a threshold that China must cross in order to change its role in international investment, promote the Chinese free trade zone strategy, and develop global trade and investment rules in the future. In the current global economic restructuring process, China, the world’s second largest economy and growing, inevitably needs to play a pivotal role. There is an urgent need for SHFTZ, with its solid foundation, to advance with the pioneer spirit of “First Try, First Pilot” and acquire reform experience, adjust to the subjects’ expectations for reform earnings, and reduce the reform risk.

## Key Elements of SHFTZ

As China’s Minister of Commerce Gao Hucheng has pointed out, the purpose and central task of SHFTZ is to pilot the next round of transformation of government functions, liberalization of investment review and approval, facilitation of investment and trade and further opening up. SHFTZ is also an experiment in the creation, replication and promotion of institutions and mechanisms for the next round of reform and opening up. Unlike traditional industrial parks and special economic zones, which rely on preferential

policies, SHFTZ is designed to focus on system innovation and distribute the fruits of that system innovation and opening-up through policy adjustments and transformation of government functions.

The core feature of SHFTZ is system innovation, which highlights innovation in investment administration, trade regulation, finance and integrated supervision. First, it is necessary to further open up the investment field and administer foreign investment through a “negative list plus pre-establishment national treatment”. Second, it is necessary to advance the transformation of the trade development, create a favorable regulatory environment, and innovate the regulatory system. Specifically, it is necessary to encourage multinational companies to set up regional headquarters in Shanghai. Third, it is necessary to further opening-up and innovate the financial sector, including RMB-denominated capital account convertibility, interest rate marketization and RMB cross-border use. Fourth, it is necessary to speed up the transformation of government functions. SHFTZ has implemented “in-process and ex post” administration and changed from “emphasizing review and approval and neglecting supervision” to “broad access and strict supervision”.

## Achievements of SHFTZ

At the end of September 2014, SHFTZ celebrated its first birthday. As announced at the information briefing session held by the China (Shanghai) Pilot Free Trade Zone Administration Committee, the overall economic operation of SHFTZ was good. As of September 15, 2014, SHFTZ was home to 12,288 new enterprises, thereby exceeding total number of enterprises in the original Shanghai Comprehensive Free Trade Zone over the past 20 years (8,996).

## Further Reform of the Negative List

Currently, the work on the negative list continues, and the 2014 edition of the negative list shows significant progress. In accordance with national laws and

regulations, SHFTZ complied and issued the first negative list in 2013. It covered 1,069 sub-categories in 18 industry categories in the national economy, set out 190 special administration measures, and achieved openness of over 80%. By the end of June 2014, SHFTZ embraced 1,245 newly established foreign-capital enterprises, of these 1,136 enterprises were established through the filing and notification system (91.2%). Foreign-capital enterprises which are not listed in the negative list and can thus complete filing on the spot and thereby shorten the original average duration of eight days.

On this basis, SHFTZ has compiled and issued the 2014 Revised Edition of the Negative List, which has the following features compared with 2013 Edition of the Negative List. Reflecting the keynote of the Third Plenary Session of the 18th CPC Central Committee, the negative list focuses on First Try, First Pilot for commerce, trade, logistics, accounting, auditing, medical care, general manufacturing and other industries. In addition, the 190 special administration measures has been decreased to 139, and of the 51 measures removed, 14 substantially opened up or removed restrictions, 14 were identical restrictions applied to domestic investors and the other 23 were a result of consolidating the classifications.

### ***Governmental Administration***

The establishment of the mode of administering the negative list requires the relevant government authorities to shift from Prior Approval to In-process and Ex-post Supervision in terms as the administration for domestic and foreign-funded enterprises. In order to shift from an approval system to a filing and notification system, SHFTZ has innovated the commercial registration system, launched a registered capital subscription system and implemented other reforms, and it also referred to an international license system. A single window system has been implemented to achieve online and offline interaction as well as process optimization. Systems for anti-monopoly reviews, security

reviews and publication of annual reports and a directory for enterprises with abnormal operations were developed.

### ***Logistics and trade facilitation***

SHFTZ can achieve an efficient, rapid flow between people and goods by simplifying regulatory procedures, reducing costs and implementing an administration mode of “being within the border of but outside the reach of customs”, and thus, SHFTZ is the first special customs supervision zone to comply with international practices. SHFTZ is currently actively implementing “gradual and thorough deregulation in the front line, as well as safe and efficient control in the second line and a free flow of goods within the free trade zone”. The so-called “front line” refers to the national border, and the “second line” refers to the dividing line into domestic markets, i.e., the spatial line between the free trade zone and the domestic market. In this regulatory mode, the front-line supervision focuses on only the supervision of people.

### **Impact of SHFTZ on the Economic Development of the Yangtze River Delta**

It is noted that the establishment of SHFTZ is expected to have spillover effects on economic development in the Yangtze River Delta, afford new opportunities for development in other cities in the Yangtze River Delta and promote the reform, opening up, transformation and development of the Yangtze River Delta. As one of the frontrunners in opening up and one of the most economically developed regions in China, the Yangtze River Delta is an important zone in China’s economic restructuring and development, but it also boasts an important position in the national economy. In fact, the economic output from the Yangtze River Delta accounts for nearly one-fourth of nationwide economic output.

In recent years, the Yangtze River Delta region has worked to make structural reforms. However, there remain major

structural contradictions. For example, the proportion of secondary industry dropped from the peak 52.6% in 2006 to 48.0% in 2013, which is still higher than that in developed countries. Throughout 2013, the development of key industries was characterized by low growth in traditional industries and strong development momentum in the advanced manufacturing industry, modern service industry and strategic emerging industries. Among the six pillar industries in the Shanghai-based manufacturing sector, the electronic information industry, high-end steel industry, and equipment manufacturing industry had negative growth. On the other hand, the service industry developed faster than the manufacturing industry, the information technology industry, finance industry and other modern services industries achieved double-digit growth, and the strategic emerging industries outperformed their performance in 2012 and achieved growth of 7% in 2013.

#### ***Four spillovers effects on the Economic Development of the Yangtze River Delta***

In view of the impact on the economic development of the Yangtze River Delta, it is believed that four spillover effects have occurred: dynamic effect of reforms and opening up, demonstration effect of institutional innovation, platform effect of service development and linkage effect of regional cooperation.

*From the perspective of the dynamic effect of reform and opening up*, the establishment and development of SHFTZ effectively propelled a new round of opening up, investment management system innovation, financial system reform and innovation, trade regulatory system innovation and innovation of governmental administration functions across the Yangtze River Delta. First, the pioneering institutional innovations of SHFTZ has put pressure on the surrounding regions, thereby triggering momentum for reform, and second, the expectations for a dividend from the opening-up that has occurred in SHFTZ has prompted the surrounding regions to seize

the opportunity and take the initiative for reform and opening up.

*From the perspective of institutional innovation*, SHFTZ is not simply an experiment conducted by Shanghai, but it is also an experiment of the Central Government to help China better respond to the changes and challenges in the international economy, trade and investment rules. SHFTZ is not only a pilot and demonstration area, but it also undertakes the important responsibility of achieving reforms and opening-up.

*From the perspective of the platform effect of service development*, SHFTZ provides a new environment for open, service-oriented economic development in the Yangtze River Delta, as well as builds a platform for external liaison and supply chain integration. On the other hand, it does have a “siphon effect” to some extent as it attracts enterprises running overseas businesses in other cities in the Yangtze River Delta to establish financial centers, operations centers and marketing centers and other function-based corporate headquarters within SHFTZ, and it exerts great pressure on the headquarters economy in other cities in the Yangtze River Delta.

*From the perspective of the linkage effect through regional cooperation*, SHFTZ is the backbone for the Yangtze River Delta to establish a higher level of open economy, which will enable a large-scale interconnected system with SHFTZ. Jiangsu, Zhejiang, Anhui and Shanghai have taken different positions in the regional division of work. Escalating cost of doing business in SHFTZ will result in the forced outward transfer of the manufacturing industry. Shanghai is a world-class economic center, financial center, trade center and shipping center that is oriented towards internationalization, and thus, some non-internationalized and non-high-end industries will be forced out of Shanghai, which is conducive for Jiangsu, Zhejiang and Anhui to undertake industrial transfer and promote a new round of industrial transfer within the Yangtze River Delta.

## Simulation Analysis by IDE-GSM

The Geographical Simulation Model by the Institute of Developing Economies, JETRO (IDE-GSM) was applied to analyze the ripple effect of the reforms and experience from SHFTZ to other regions. It took into account the differences in national and regional GDPs between the Baseline scenario and an alternative scenario, and calculated the economic impacts of SHFTZ.

### *The Most Likely Scenario*

First, we estimated the service barriers in other countries around the world and found that service barriers were much in China and other Asian countries compared to the barriers in the manufacturing sector and developed countries. Based on official documents and interviews with experts, we set the Most Likely scenario as follows where the Shanghai, Guangzhou, Tianjin and regions in the Yangtze River Economic Belt will gradually lower the service barriers.

1. Shanghai City as a whole, as well as the areas in SHFTZ will lower the service barriers from 2014 to 2025 by half the level of difference in the barriers between China and Hong Kong. The NTBs to manufacturing goods will gradually decrease as well.
2. Guangzhou and Tianjin will lower the service barriers from 2016 to 2025 by half the level of difference in the barriers between China and Hong Kong. The NTBs to manufacturing goods will gradually decrease as well.
3. The regions in the Yangtze River Economic Belt will lower the service barriers from 2021 to 2025 by half the level of difference in the barriers between China and Hong Kong. The NTBs to manufacturing goods will gradually decrease as well.

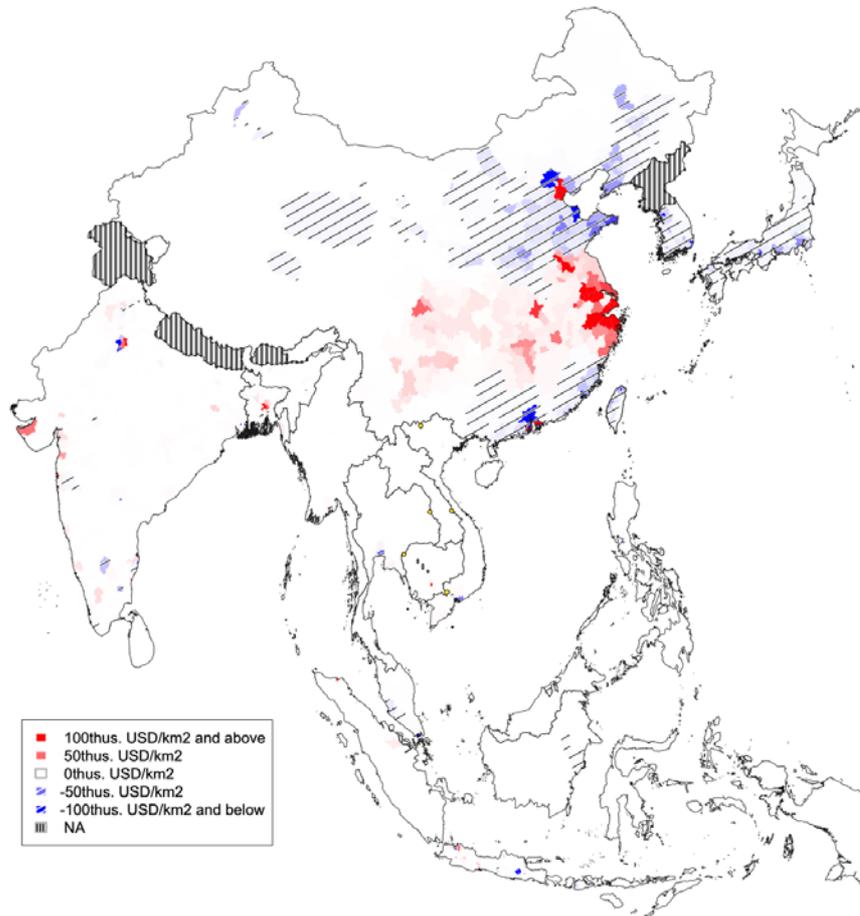
The level of the barriers for the service sector in China is slightly higher than that in Thailand and slightly lower than that in Finland. The level of the barriers in Hong Kong is 84.5% of that in China. Thus, in the most likely scenario, we assumed the barriers for a city or region will drop by 7.75%, or in order terms, decrease from 34.5

to 31.8 in the index. Shanghai City, Guangzhou, Tianjin and the regions in the Yangtze River Economic Belt will lower the barriers to a level between that of Brazil and Greece. In addition to the reduction in the barriers in the service sector, we assumed the NTBs for the manufacturing sector will be reduced as well in order to take into account that services are used as an input to the manufacturing sector. We took the ratio of domestic service input against the output value for each industry from the input-output (IO) matrix for China in the ASIA Input-Output Matrix 2005 published by IDE-JETRO.

Figure 1 shows the economic impact of the Most Likely scenario on the regional GDP in 2030 compared with the Baseline scenario. The red regions are projected to experience positive impacts, and the blue regions will likely experience negative impacts. We used the criteria of “impact density”, which is derived by dividing the economic impact by the area of the affected region. The more intense the red color (or blue color) of a region, the more positive (negative) the aggregate impact is in the region. The figure clearly shows the trade creation effect in those regions that lower the barriers and the trade diversion effect in those regions that do not. The red regions will increase their competitiveness through purchasing parts and components at relatively lower prices. This will enable consumers to benefit from lower prices for goods and services. These regions will see an inflow of firms and households from other regions, which will lead to increased competitiveness of the firms. The blue regions will face increasingly fierce price competition with red regions, lose some customers, and see an outflow of firms and households in comparison with the economic situation in the Baseline scenario.

The reforms in Shanghai City and other areas in China will boost the economic activities in the electronics and electric appliances sectors in other countries thanks to the formation of links. In contrast, we see a trade diversion effect in the service sectors with the outcome that regions which do not adopt

Figure 1: GRDP Differences, Most Likely Scenario vs. Baseline (2030, Impact Density)



Source: Calculated by IDE-GSM

reforms will see negative impacts. In particular, there are heavily blue regions in Japan and Korea, as well as large cities in other East Asian countries. The service sector has a relatively higher share of the economy in Japan, Korea, Malaysia, and Singapore, which results in the negative impacts on their GDPs.

### ***Alternative Scenarios and Policy Implications from the Simulation***

We also proposed several alternative policy scenarios with different conditions than those in the Most Likely scenario in order to study the implications of the policy.

#### ***De-regulation in Services Related to the Manufacturing Sector***

First, in order amplify the impact of the policy, de-regulation in the service sector

should be allowed to impact the manufacturing sector. We constructed a fictitious scenario, No Barrier Reduction in the Manufacturing Sector, in which none of the barriers in the manufacturing sector are lowered. The overall impact of that services-only scenario on the country will be only 31.7% of the impact under the Most Likely scenario. In other words, when the policy also facilitates barrier reduction in the manufacturing sector, the overall economic impacts are as much as triple in size.

#### ***Speed of Barrier Reduction***

Second, the sooner the barriers are reduced, the greater the economic impact is. Thus, it is better to enact reforms *en bloc* rather than in a long sequence. If the reforms are completed within 2 years, the economic impact on China will be almost double that

in the scenario where it takes 12 years to complete the same reforms.

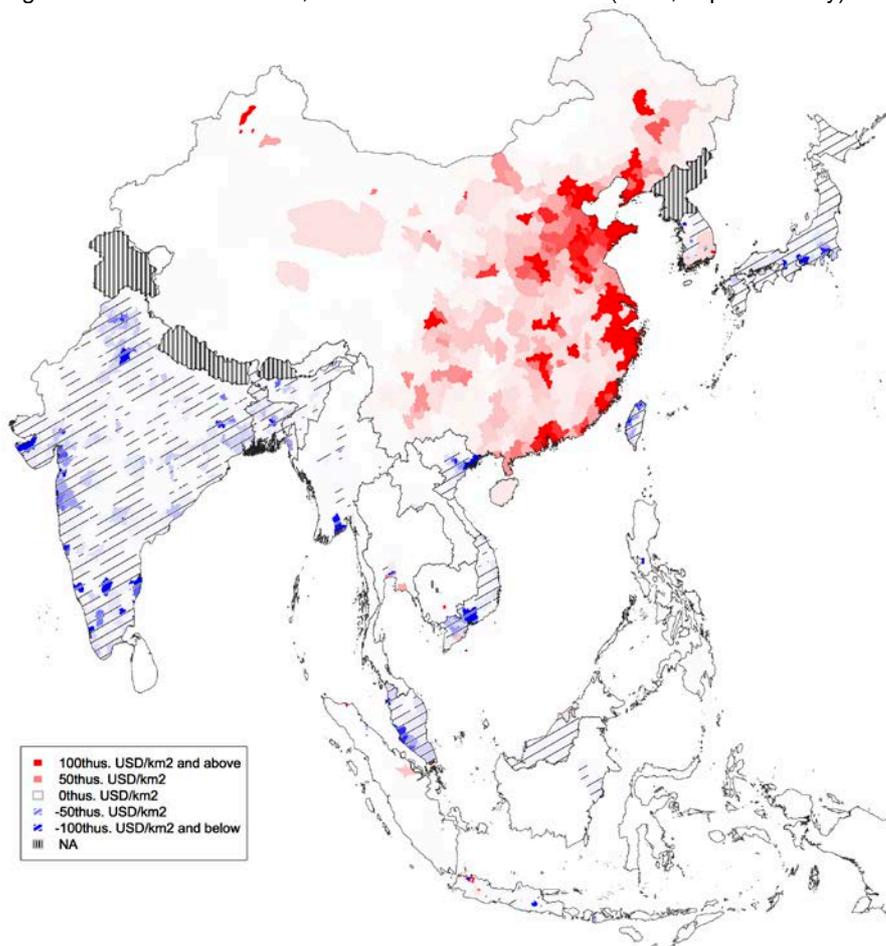
#### *Geographic Coverage of the De-regulation*

Third, the reduction of barriers in one region but not in other regions results in a kind of trade diversion effect. Thus, for the country as a whole, reforms are better adopted ubiquitously. In the Most Likely scenario, we assume the reforms resulting from opening FTZs will apply to Guangzhou, Tianjin, and the Yangtze River Economic Belt. If the reforms do not apply to those regions, the economic impacts in China will be less. The overall impact on China will be only 22.4% of that under the Most Likely scenario if the reforms are not applied to areas other than Shanghai City. Moreover, the economic impact in China under a scenario which there is no expansion of the reforms beyond the current area of SHFTZ will be one-

twentieth of that in the Most Likely scenario.

In fact, based on these findings, we present the Best scenario (Figure 2), where the reforms will spread across the whole country over the long-run. In this scenario, we assume that the other regions in China will also apply the reforms, and all cities and regions will reduce the barriers to the same level as that of Hong Kong. The impact on China will be about 8.16 times that of the Most Likely scenario. Figure 2 suggests that inclusive reform in which all regions apply the reforms will lead to inclusive growth where all regions in the country benefit from the reforms. This applies to other countries as well. Surrounding countries such as Japan, Korea, and the ASEAN countries should reduce the NTBs in their manufacturing sectors as well as the service barriers.

Figure 2: GRDP Differences, Best Scenario vs. Baseline (2030, impact density)



Source: Calculated by IDE-GSM

