Financial Impact from the Shanghai FTZ

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I. The decision to establish and run the China (Shanghai) Pilot Free Trade Zone

1. The China (Shanghai) Pilot Free Trade Zone began operating on 1 October 2013

At its 4th meeting on 30 August 2013, the Standing Committee of the 12th National People's Congress (equivalent to Japan's Diet) authorized the State Council to modify laws related to foreign capital in preparation for establishing the China (Shanghai) Pilot Free Trade Zone (Shanghai FTZ)[1]. The Shanghai FTZ is comprised of four special customs supervision areas within Shanghai's Pudong district: (1) Shanghai Waigaoqiao FTZ, (2) Shanghai Waigaoqiao Logistics FTZ (3) Yangshan Free Port, and (4) Shanghai Pudong Airport FTZ, covering a total area of 28.78 km2. This decision suspends for a period of three years from 1 October 2013 legislation affecting 11 areas in which investments by foreign corporations are examined, thereby launching Shanghai's free trade experiment.

2. Six service sectors will be opened to foreign competition on a trial basis

It is worth noting that only six months passed between Premier Li Keqiang's initial inspection visit of Shanghai and launch of the Shanghai FTZ. In the interim, the State Council approved the general scheme for the Shanghai FTZ, in principle on 3 July[2] and formally on 17 August, after which it was announced by the Commerce Ministry on 22 August[3]. Then on 27 September, the State Council announced in its Notice regarding Publishing the General Scheme of the China (Shanghai) Pilot Free Trade Zone[4] that it planned to open six service sectors and 18 service businesses to foreign firms: (1) financial services, (2) shipping services, (3) commercial and trade services, (4) professional services, (5) cultural services, and (27) social services sectors (education, job training, and healthcare).

After this, a ribbon-cutting ceremony for the Shanghai FTZ was held on the morning of 29 September, and the organization administering the FTZwas given its

1 China Daily, dated 30 September 2013.
2 See http://www.gov.cn/ldhd/2013-07/03/content_2439909.htm (in Chinese)
3 See http://www.mofcom.gov.cn/article/ae/ai/201308/20130800262548.shtml (in Chinese)
4 See http://www.gov.cn/zwgk/2013-09/27/content_2496147.htm (in Chinese)

formal name, the China (Shanghai) Pilot Free Trade Zone Administrative Committee[5]. The Committee is headed by Ai Baojin, who is also the vice mayor of the City of Shanghai. That afternoon, the central government (including the Ministry of Commerce) and Shanghai's municipal government held a press conference to explain future policy. Coinciding with the Shanghai FTZ opening ceremony, 36 companies, including 11 banks (noted below), announced they would establish operations in the FTZ.

II. Shanghai FTZ overview and the testing of financial services

1. Overview of the Shanghai FTZ

According to the series of announcements noted above, the pilot FTZ will first of all take on the government's role over the next 2 to 3 years. This signifies an easing of regulations governing corporate activity. In principle, corporate activity within the Shanghai FTZ will change from an ex ante inspection and approval process to an ex post supervision and monitoring system.

Secondly, China's inbound foreign direct investment (FDI) will be managed using a negative list approach. This means a loosening of the FDI regime, currently based on pre-approval, and a liberalizing of investment, in principle by eliminating sector-specific restrictions and instead applying restrictions on an exceptional basis.

Thirdly, it provides innovations to the open-door model, namely prior tests of a further opening of service sectors to foreign firms as well as efforts to make it easier for global firms to conduct trade and operate regional headquarters.

These tests are analogous to Japan's plan to establish national strategic zones, a component of its growth strategy encompassing significant deregulation for limited geographic regions, but in China's case the tests are limited to the services sector and a single geographic area in Shanghai's Pudong district.

2. The thinking behind testing financial services

One of the main targets of the Shanghai FTZ is the opening to foreign competition of financial services. The roadmap for testing financial services in the Shanghai FTZ includes speeding up the transition to freely convertible capital accounts and completely opening financial services.

The State Council Notice notes two types of financial services tests, the acceleration of innovation in financial systems and the strengthening of financial service functions (Figure 1). It appears that the former primarily consists of financial liberalization, while the latter looks at how the players are going to implement that liberalization.

5 The China (Shanghai) Pilot Free Trade Zone Administrative Committee now has its own website in English: http://en.shftz.gov.cn/

Figure 1: Testing financial services in the Shanghai FTZ

Category		Details
Accelerating innovation of financial systems	①	On the assumption that this control is possible, conduct advanced tests of the free convertibility of yuan-denominated capital accounts, the liberalization of interest rates in financial markets, and yuan- denominated cross-border transactions.
	②	Use market-based price formation for financial institution assets.
	③	Turn globally in search of ways to test the reform of exchange-rate controls, build an exchange-rate regime suitable to pilot FTZs, and comprehensively facilitate trade and investment.
	④	Encourage companies to use both domestic and overseas resources and markets and liberalize cross-border funding methods.
	⑤	Reform the model for managing foreign debt and make the cross-border procurement of funds easier.
	⑥	Deepen tests of global companies' concentrated management of foreign currency-denominated funding and encourage those companies to establish local or global funding management centers.
	⑦	Reform the financial system of the pilot FTZ and build a mechanism to link it with the construction of a Shanghai international financial center.
Make financial services more functional	①	Encourage the comprehensive opening of the financial services business to foreign financial institutions and private-sector capital that meets certain conditions and support the establishment of foreign capitalized banks and Chinese-foreign bank joint ventures in the pilot FTZ.
	②	Allow financial markets to establish global trading platforms within the pilot FTZ.
	③	Allow foreign firms to participate in commodity futures trading on a phased-in basis.
	④	Encouraging the innovation of financial market products.
	⑤	Assist stock custodial and trading organizations in establishing comprehensive financial services trading platforms within the pilot FTZ.
	⑥	Assist in the development of the cross-border, yuan-denominated reinsurance business.

Note: Based on the Notice regarding Publishing the General Scheme of the China (Shanghai) Pilot Free Trade Zone dated 18 September 2013 and promulgated on 27 September 2013.
Source: Nomura Institute of Capital Markets Research, based on data from the State Council

A second element contained in the State Council Notice is an easing of regulations governing the establishment of financial institutions involved in the tests (Figure 2).

Thirdly, in the banking industry's response to the State Council Notice, the China Banking Regulatory Commission (CBRC) published on 28 September 2013 its Notice from the CBRC on Banking Regulation in China (Shanghai) Pilot Free Trade Area[6], wherein it outlined its plans within the FTZ concerning (1) support for the development of Chinese-capitalized banks, (2) support for establishing nonbanks, (3) management support for foreign banks, (4) support for participation in the privately-capitalized banking industry, (5) support for the opening of cross-border lending businesses, (6) support for opening offshore services, (7) a simplification of ways to participate, and (8) systemic improvements to the regulatory oversight of services.

6 See http://www.cbrc.gov.cn/EngdocView.do?docID=3B8AD3A67F854E0D9E6BDBD8A9BDC803

Figure 2: Details of financial sector tests in the Shanghai FTZ

Affected services	Sector	Details	
Financial services	Banks	①	Establishment of foreign-capitalized banks by qualified foreign financial institutions.
			Establishment of Sino-foreign joint venture banks by qualified private-sector capital and foreign financial institutions.
			The timely establishment on a trial basis of partially licensed banks when conditions are met.
		②	On the assumption that administrative rules are in place and effective regulatory oversight is strengthened, allow qualified Chinese banks to handle offshore business.
	Insurance	·	Establish on a trial basis foreign-capitalized institutions specializing in health insurance.
	Financial leasing	①	Do not apply a minimum registered capital requirement when a financial leasing company establishes a subsidiary to lease a single aircraft or ship.
		②	Allow financial leasing companies to also offer factoring services related to their main business.
Specialized services	Corporate credit research	·	Allow the establishment of foreign-capitalized credit research companies.
	Investment management	·	Allow the establishment of foreign-capitalized joint stock companies.

Note: Based on the Notice regarding Publishing the General Scheme of the China (Shanghai) Pilot Free Trade Zone dated 18 September 2013 and promulgated on 27 September 2013.

Source: Nomura Institute of Capital Markets Research, based on data from the State Council

Fourth, in the securities industry's response, the China Securities Regulatory Commission (CSRC) published on 29 September its Policy Measures for the Capital Market to Support and Promote the Shanghai Free Trade Zone[7], including (1) energy futures products, (2) cross-border investment in securities and futures by firms (financial institutions and corporations) and individuals, (3) the issuance of yuan-denominated bonds by overseas parent companies (nonresidents), (4) establishing subsidiaries of securities and futures companies, and (5) the OTC trading of commodity futures and derivatives.

We look next at the specifics and the significance of the major financial services tests scheduled, based on the announcements made by the government.

3. Specifics of the financial services tests

1) Accelerating the innovation of financial systems

(1) The market-oriented reform (liberalization) of interest rates

The State Council Notice includes a plan for testing interest rate liberalization in the Shanghai FTZ. That plan was also confirmed in Article 21 of the Measures for the Administration of the China (Shanghai) Pilot Free Trade Zone , promulgated by

7 See http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201311/t20131126_238765.htm

Shanghai's metropolitan government on 29 September and implemented 1 October 2013[8].

Interest rates in China's interbank market (money market) and bond market have already been liberalized, leaving only deposit and loan rates that are regulated. Of those, there are no longer restrictions on yuan-denominated loan rates, for which the ceiling was abolished in October 2004 and the floor was abolished in July 2013. The deposit-rate ceiling was made variable in October 2004, and the variability band was widened in June 2012 to an upper limit of 1.1X the benchmark rate.

Because of the large impact that the liberalization of deposit rates would have on financial institutions, we expect it to be phased in, beginning with the deposits of large customers. The People's Bank of China (PBOC) indicated on 26 September 2013 that it would begin by allowing the resumption of certificate of deposit (CD) issuance[9], putting the spotlight on future tests aimed at liberalizing rates within the Shanghai FTZ.

(2) Liberalizing yuan-denominated capital accounts (assuming risk controls)

The State Council Notice contained proposals for liberalizing yuan-denominated capital accounts, as did Articles 20 and 22 of the City of Shanghai's FTZ Measures. In concert with that, both the CBRC and the CSRC also announced the direction of their policies for liberalizing yuan-denominated capital accounts. Consequently, market participants expect the Shanghai FTZ tests could impart significant momentum to the yuan's globalization.

<Banking sector>

In the banking sector, the CBRC's measures aim first of all to support the provision of financial services related to cross-border lending and cross-border investing in the Shanghai FTZ.

Secondly, as already noted, there are plans to eliminate within the Shanghai FTZ rules preventing Chinese banks from offering offshore services. A big question in this regard is to what extent restrictions on the movement of yuan between onshore (the Chinese mainland) and offshore, particularly the "real demand" requirement, will be eased.

Third, related to the establishment of foreign banks and Sino-foreign bank joint ventures as described below, the PBOC on 10 October 2013 published a notice allowing nonresident investors with regulatory approval to make yuan-denominated investments in domestic financial institutions, including through new establishments,

8 See http://www.shanghai.gov.cn/shanghai/node2314/node2319/node12344/u26ai37037.html (in Chinese)

9 See http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2013/20130926165920072575593/0926165920072575593_.html (in Chinese)

capital increases, acquisitions, and equity participation[10]. This should make it easier for nonresident investors to make yuan-denominated investments in domestic financial institutions.

<Securities sector>

In the securities sector, the CSRC aims to deregulate investment in cross-border securities and futures by firms (financial institutions and corporations) and individuals who meet certain conditions.

First, financial institutions and companies in the Shanghai FTZ will be allowed to trade on Shanghai's securities and futures exchanges. The State Council Notice calls for phasing in foreign firms' participation in commodities futures trading.

Second, nonresident individual investors who work in the Shanghai FTZ and meet certain conditions will be allowed to open nonresident individual domestic investment accounts with securities and futures companies within the Shanghai FTZ, through which they will be able to invest in domestic securities and futures. The restriction on investing in A shares by mainland residents with Hong Kong, Macau, or Taiwan nationality was removed in April 2013, and this will be broadened to include nonresidents of all nationalities, and for the first time will also be expanded to include investments in futures.

Third, financial institutions and corporations within the Shanghai FTZ will be allowed to invest in overseas securities and futures. This marks the first time that corporations are eligible to become qualified domestic institutional investors (QDII).

Fourth, individuals working in the Shanghai FTZ and meeting certain conditions will be allowed to invest in overseas securities and futures. One of the key financial reforms that the State Council focused on in 2013 was establishing rules allowing for qualified domestic individual investors (QDII2), and this will be tested in the Shanghai FTZ. Thus individual investors in the Shanghai FTZ will be allowed to make foreign investments before individual investors in other regions of China.

2) Make financial services more functional

<Banking sector>

(1) Establishing foreign banks and Sino-foreign joint venture banks

In the banking sector, qualified financial institutions will be allowed to establish foreign banks, and private-sector capital meeting certain conditions will be able to establish joint venture banks with foreign financial institutions, in the Shanghai FTZ.

Although the CBRC measures for the establishment of foreign banks are predicated on certain conditions being met, in the Shanghai FTZ, branches can be

[10] See http://www.pbc.gov.cn/publish/huobizhengceersi/3131/2013/20131010151740582936277/20131010151740582936277_.html (in Chinese)

established and sub-branches (offices affiliated with a branch) can be promoted to branches. Additionally, they have been looking at shortening the period required to convert a foreign bank's representative office to a branch and shortening the length of time that foreign banks must be in business before handling yuan-denominated services. In the public comment version of its law related to authorizing operations by foreign banks published on 30 September 2013[11], the CBRC proposed shortening the length of time that Hong Kong, Macau, and Taiwan banks must do business on the Chinese mainland before they can apply for authorization to provide yuan-denominated services. How this is handled in the Shanghai FTZ will be closely watched.

In regards to the establishment of Sino-foreign joint venture banks, currently when foreign financial institutions invest in a Chinese-capitalized bank, each foreign company is limited to an ownership stake of 20% per company, with an overall cap on foreign ownership of 25%. In the Special Administrative Measures (Negative List) on Foreign Investment Access to the China (Shanghai) Pilot Free Trade Zone (2013) announced by the City of Shanghai government on 29 September 2013[12], the financial industry (including banking, insurance, securities, and asset management) was specifically cited as having certain restrictions and conditions placed on foreign capital participation. It will be interesting to see the extent to which these restrictions on establishing Sino-foreign joint venture banks will be eased (or left unchanged) in the Shanghai FTZ.

The CBRC measures also support the participation of private-sector capital in banks, financial leasing companies, and consumer finance companies in the Shanghai FTZ.

(2) Establishing partially licensed banks

It is possible that the establishment of partially licensed, rather than fully licensed, banks is aimed at online banking. Together with the private-capital and Sino-foreign joint venture banks noted earlier, new banks that do not adhere to the traditional business model focused on deposits and loans could also be established.

(3) Some Chinese banks to be allowed to provide offshore services

Related to the liberalization of yuan-denominated capital accounts noted earlier, the State Council Notice removes the restriction in the Shanghai FTZ on Chinese banks providing offshore services. In this case, rather than establishing the offshore market within the Shanghai FTZ proper, we think it is envisioning a model closer to that of the Japan Offshore Market (JOM), wherein trading is conducted through an offshore account established within the financial institution. Also of interest is when

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11 See http://www.cbrc.gov.cn/chinese/home/docView/ABF366775E64404EA78DD24FA73D7D77.html (in Chinese)

12 See http://www.shanghai.gov.cn/shanghai/node2314/node2319/node12344/u26ai37036.html (in Chinese)

this privilege will be extended to foreign banks, although that probably will not happen until Chinese banks have established a track record.

We note that the CBRC measures allow Chinese banks to establish new branches in the Shanghai FTZ as well as upgrade existing business offices to branch or sub-branch status. In step with this, the CBRC has indicated plans to allow business offices expanded or upgraded within the Shanghai FTZ to operate outside the normal branch rules to ensure they are not subject to those rules' limits on establishing new branches or expanding branches in a given fiscal year.

<Financial leasing>

(1) Promotion of and tax breaks for the financial leasing business

The State Council Notice has eased minimum registered capital restrictions for leasing companies established in the Shanghai FTZ to lease a single aircraft or ship. In China, the Measures for the Administration of Financial Leasing Companies (promulgated on 23 January 2007 and made effective on 1 March 2007) sets a minimum registered capital amount of 100 million yuan for leasing companies approved by the CBRC, while the Measures for the Administration of Foreign Investments in the Leasing Industry sets a minimum registered capital of $10 million on foreign leasing companies approved by the Commerce Ministry. In step with an easing of restrictions on establishing leasing companies in the Shanghai FTZ, some tax breaks are also planned. In addition, financial leasing companies will also be allowed to engage in the factoring business (purchasing and then collecting on Accounts Receivable). It will be interesting to see if these measures wind up facilitating trading activity.

For nonbanks, the CBRC measures provide support for global corporations to establish financing subsidiaries, auto financing companies and consumer finance companies in the Shanghai FTZ, as well as for Shanghai registered trust companies to move to the Shanghai FTZ and nationwide financial asset management companies to establish branches there.

(2) Establishing foreign credit research companies

The entrance of foreign credit research companies, which research and administer the credit histories of corporations and individuals, is interesting for its potential to encourage consumer finance and the supply of funds to growth sectors.

<Securities and futures brokerage firms>

(1) Establishment of the Shanghai International Energy Trading Center

The CSRC, having indicated its agreement with establishing the Shanghai International Energy Trading Center in its notice, has been preparing for trading in international crude oil futures and has agreed to the full participation by nonresident investors in futures trading within China. This marks the first time for both the listing of crude oil futures and the participation of nonresident investors in trading on futures markets within China.

(2) Support establishing securities and futures brokerage subsidiaries

The CSRC Measures support the establishment of securities and futures brokerage subsidiaries in the Shanghai FTZ, and list specific examples of futures companies (Haitong Futures, Hongyuan Futures, GF Futures, and Shenyin & Wanguo Futures) and asset management companies (Huaan Fund) that have either established, or are preparing to establish, risk management and asset management subsidiaries.

(3) Support for OTC trading of commodity futures and derivatives

The CSRC Notice proposes to support the OTC trading of commodity futures and derivatives by domestic investors through securities and futures brokerage companies in the Shanghai FTZ.

4. Why domestic and overseas financial institutions are interested

Both foreign and Chinese financial institutions have a strong interest in the specifics of the financial services tests in the Shanghai FTZ, because the tests were not initiated by the local government and approved by the central government, but rather are a national undertaking led by the central government, and thus FTZs could be established in areas outside of Shanghai in the future. If that happens, then the experience gained from participating in the Shanghai test could possibly infer an advantage when participating in tests conducted in other regions.

The local press has reported that because of this, several foreign banks had been considering establishing offices since before the formal opening of the Shanghai FTZ, namely HSBC, Standard Chartered, and the Bank of East Asia. In fact, the Bank of East Asia has set up an internal team to look at its future business plan in the Shanghai FTZ (according to an article in the 13 September 2013 edition of the Securities Times). Ultimately, Citibank and Singapore-based DBS Bank received approval to open up sub-branches on 29 September, the day of the Shanghai FTZ opening ceremony (Chart 3)[13]. After that, it was announced that both HSBC and the Bank of East Asia had won approval to open sub-branches[14]. On 18 October, three foreign banks, including Hang Seng Bank and Nanyang Commercial Bank, gained approval to open sub-branches.

Among Chinese banks, on the day the FTZ opened on 29 September, the four major state-owned banks (Bank of China, China Construction Bank, Industrial &

13 See http://en.shio.gov.cn/presscon/2013/10/18/1152653.html
14 See http://cn.reuters.com/article/chinaNews/idCNCNE99D05A20131014 (in Chinese)

Commercial Bank of China, and China Agricultural Development Bank), the Bank of Communications, and Bank of Shanghai upgraded their sub-branches within the Shanghai FTZ to branch status, and the China Merchants Bank and Shanghai Pudong Development Bank gained approval to open new branches. The Bank of Communications' financial leasing subsidiary, BoCom Financial Leasing, also received approval to establish a subsidiary within the Shanghai FTZ.

Of Japan's financial institutions, two in the banking sector, the Bank of Tokyo-Mitsubishi UFJ and Sumitomo Mitsui Banking Corp., have established business alliances with Chinese banks in the Shanghai FTZ (Financial News China dated 10 October 2013)[15]. All three of Japan's megabanks, including Mizuho Bank, have indicated plans to open up offices in the Shanghai FTZ[16]. Additionally, SBI Holdings announced a strategic alliance with Chinese firms (the Shanghai Lujiazui Group and the New Hope Group) aimed at jointly developing an online financial business in the Shanghai FTZ (10 October 2013)[17].

5. Nonfinancial companies moving into the FTZ

A total of 25 companies received approval to establish companies within the pilot FTZ on the day of the Shanghai FTZ's opening ceremony on 29 September (China Securities Journal dated 29 September 2013). The list of 25 companies included two business offices of insurance companies, two subsidiaries of futures and fund management companies, one subsidiary of a private equity fund, and a trading subsidiary (with no disclosure of type business) funded by a foreign bank (BNP Paribas) (Figure 3).

There are several examples of nonfinancial companies having moved in ahead of the opening of the Shanghai FTZ.

In one example of this from a Chinese company, the privately run solar cell manufacturer Zhejiang Sunflower Light Energy Science & Technology announced that it will establish a wholly-owned logistics subsidiary in the Shanghai Waigaoqiao Logistics FTZ, which is inside the Shanghai FTZ[18].

In a second example, this one a foreign company, US-based Microsoft announced it will establish a joint venture with a local company in the Shanghai FTZ to manufacture and distribute game devices and game software[19]. This joint venture is included in the list of 25 companies noted above. The import and sale of game devices and game software had been prohibited in China since 2000, but the latest State Council Notice removes the prohibition on the manufacture of consumer game devices and large game machines by foreign firms, and also allows their domestic sales on an approval basis.

15 See http://www.financialnews.com.cn/yh/xw/201310/t20131010_42190.html (in Chinese)
16 Nikkei Shimbun dated 7 November 2013 and NHK dated 1 December 2013 (in Japanese)
17 http://http://www.sbigroup.co.jp/english/news/pdf/2013/1010_a_en.pdf
18 Nikkei Sangyo Shimbun dated 17 September 2013 (in Japanese)
19 Nikkei Shimbun dated 25 September 2013 (in Japanese)

Figure 3: First group of financial institutions doing business in the Shanghai FTZ

Type	Form of entry	Financial institution name	Notes
Chinese banks	Branches	Bank of China, China Construction Bank, Industrial & Commercial Bank of China, China Agricultural Development Bank, Bank of Communications, Bank of Shanghai	Upgrade from sub-branch
		China Merchants Bank, Shanghai Pudong Development Bank	New establishment
Financial leasing companies	Specialized subsidiary	BoCom Financial Leasing	New establishment
Foreign-capitalized banks	Sub-branches	Citibank, DBS Bank	New establishment
	Trade subsidiary	BNP Paribas	New establishment
Insurance companies	Branch	China Pacific Property & Casualty	Change in existing structure
	Branch office	Dazhong Insurance	New establishment
Fund management company	Specialized subsidiary	Huaan Fund Management	New establishment
Futures company	Specialized subsidiary	Shenyin & Wanguo Futures	New establishment
Private equity funds	Investment subsidiary	Hony Capital	New establishment

Note: Financial firms in the Shanghai FTZ the day it opened on 29 September 2013.
Source: Nomura Institute of Capital Markets Research, based on the City of Shanghai government and the China Securities Journal dated 29 September 2013

Moving forward, as trade restrictions are eased and as offshore transactions become easier after they are allowed, we can envision the possibility that global firms will start using the Shanghai FTZ as their regional headquarters in growing numbers. In fact, the State Council Notice deepens tests of the concentrated management of foreign currency funds and proposes policies to encourage global companies to establish local or global funding management centers. The CSRC Notice also supports the domestic issuance of yuan-denominated bonds by the overseas parent companies of foreign firms with operations in the Shanghai FTZ. The domestic issuance of yuan-denominated bonds by nonresidents (Panda bonds) has only been authorized thus far for international development financial institutions (the IFC and ADB). Whether the series of tests, along with reforms of the Shanghai FTZ's external debt management model, which relates directly to obtaining funding from overseas, make it easier for global companies to manage their cash will be a key determinant of whether global companies choose to set up their regional headquarters there.

III. Role of and outlook for the pilot FTZ

1. Events leading up to establishment and operation of the pilot FTZ

The establishment and opening of Shanghai's FTZ can be traced back to both domestic and overseas factors.

1) Domestic factors

Seeking to change the growth model from external demand and investment driven to internal demand and services driven in the 12th 5-year plan (2011–2015), China's new government seeks to "upgrade" the Chinese economy. We think it wants to kick start this upgrade by establishing a pilot FTZ in Shanghai to run tests in the trade, FDI, and services sectors.

Meanwhile, the City of Shanghai has been promoting the concept of an international finance and logistic center[20], and China's new administration, having decided to use the CCP Central Committee's 18th Third Plenum held in November 2013 as a launching pad for the CCP Central Committee and State Council to lead an effort to change China's growth model, is promoting the Shanghai FTZ as the centerpiece of that effort.

2) Overseas factors

The new government apparently wants to use both bilateral and multilateral free trade agreements (FTAs) to enhance China's growth strategy. They will be using venues other than the WTO to ensure China's economy benefits from globalization and to use negotiations for joining these FTAs as a lever to achieve domestic reform.

Within the Asia-Pacific region, China has already concluded an FTA with the 10 countries of ASEAN (ACFTA), and negotiations are proceeding on the multilateral front with the RCEP (Regional Comprehensive Economic Partnership; for East Asia) and Japan-China-Korea FTA, and on the bilateral front with the China-Korea FTA. Meanwhile, progress with the Transpacific Partnership (TPP), which China is not a part of, has created the risk for China that it will be left out of an important framework for liberalizing trade and investment in the Asia-Pacific region.

In fact, on 30 May 2013, the Commerce Ministry announced prior to the US-China Summit that it would analyze the advantages/disadvantages of participating in the TPP and the potential for doing so. Because China will not immediately satisfy the requirements for participating in TPP negotiations, we think it wants to use the pilot

[20] See Eiichi Sekine, Reaffirmation and Reinforcement of Shanghai's Future as an International Financial Center, Nomura Journal of Capital Markets, Spring 2012.

FTZ to sound out the potential for TPP involvement. For the time being, negotiations should proceed between the US and China on an investment agreement[21].

2. Future outlook

Word has it that when the various government ministries were in the process of discussing the Shanghai FTZ, Premier Li Keqiang used his political muscle to squash opposition to the concept (China Economic Weekly dated 10 September 2013). In fact, we think the new administration, which included construction of the Shanghai FTZ while raising the flag of reform at the 18th Third Plenum in November 2013, will make this a long-standing theme over the next decade. China's domestic financial sector also has well entrenched expectations that the financial services tests in the Shanghai FTZ will accelerate the liberalization of yuan-denominated capital accounts, i.e., the globalization of the yuan.

Political developments since the Third Plenum include, first of all, the People's Bank of China announcing on 2 December 2013 their "Opinions of the PBC on Financial Measures to Support the China (Shanghai) Free Trade Zone[22]," which proposes 30 measures related to the direction of the tests of financial liberalization already announced by the State Council, CBRC, CSRC, and China Insurance Regulatory Commission (CIRC) ("the PBC's Opinion on 30 Measures"). Second, the City of Shanghai government established a group to promote cooperation in the Shanghai FTZ's financial sector. Third, the Shanghai Bureau of the PBOC indicated it plans to implement the majority of the 30 measures over the next three months (by March 2014), and over roughly the next year to build a financial administration model that can be replicated and promoted nationwide[23].

Meanwhile, Hong Kong already has an offshore yuan market, and a test for cross-border yuan-denominated loans in the Shenzhen Qianhai district adjacent to Hong Kong was launched in January 2013[24]. Other major cities/regions have already begun expressing an interest in becoming the next pilot FTZ after Shanghai, including Tianjin, Chongqing, Guangdong province (Hengqin, Qianhai, and Nansha), and Tsingtao. There are reports that Guangdong province has already filed an application with the State Council (China Securities Journal dated 15 October 2013). Including these domestic initiatives, the focus will initially be on the content of the tests being run in the Shanghai FTZ and their cumulative results.

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21 See Eiichi Sekine, *Daigoukai Beichuu Senryaku Keizai Taiwa kara Miru Chuugoku no Kin'yuu Kaikaku ni Muketa Tenbou* (Outlook for financial reform in China based on the Fifth US-China Strategic and Economic Dialogue), Fall 2013 (Website edition), Capital Market Quarterly (in Japanese).

22 See http://www.pbc.gov.cn/image_public/UserFiles/english/upload/File/FTA2.pdf.

23 See http://shanghai.pbc.gov.cn/publish/fzh_shanghai/2974/2013/20131203203424945282322/20131203203424945282322_.html (in Chinese)

24 See Eiichi Sekine, "Start of Chinese Experiment in Financial Deregulation," Summer 2013, Nomura Journal of Capital Markets.