Shanghai Free Trade Zone: practical constraints yet policy values

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The China (Shanghai) Pilot Free Trade Zone (the "SFTZ") was officially launched on 29 September 2013. Although the press has applauded many policy breakthroughs in respect of the SFTZ, the SFTZ may not be appealing to many international businesses initially due to some practical constraints. But the SFTZ will function as a policy reform test field, and could have significant impact if it proves to be successful and the policies are replicated outside the SFTZ.

The SFTZ was officially launched on 29 September 2013. The press has applauded many policy breakthroughs in respect of the SFTZ, including the abolishment of the foreign investment approval system. Foreign companies can now set up subsidiaries or joint ventures in the SFTZ without having to apply for prior approvals from the Chinese government, as long as the business does not fall under the negative list published for the SFTZ.

Despite favourable changes of direction in policy, the SFTZ currently lacks many implementing rules for its policies. At this stage, the SFTZ may not be appealing to many international businesses due to two major practical constraints, the customs control and foreign exchange control.

Customs control

The SFTZ is a special customs supervision area, which is considered "outside" China for customs control purposes. Though movement of goods between the SFTZ and abroad is duty free, goods moving between the SFTZ and the rest of China is considered importation or exportation. This is why customs checkpoints surrounding the SFTZ are necessary to ensure that duty-free products from abroad into the SFTZ are not illegally brought into China without import duty being paid.

The customs control could be an administrative burden if a business needs to frequently move goods and products in or out of the SFTZ within China. Chinese customs authorities have indicated that they will adopt a smart duty-free product monitoring system for the SFTZ, the effect of which is yet to be tested.

Foreign exchange control

Foreign exchange control has been a major restriction on international businesses's operations in China. This is why the Renminbi capital account convertibility in the SFTZ has attracted so much attention.

Disappointingly, the SFTZ has not released any implementing rules for the financial liberalisation policies regarding Renminbi convertibility, market interest rates and Renminbi cross-border settlement. In the State Council's General Plan for the SFTZ, any pilot programme regarding financial liberalisation must be under the condition of "risks being controllable." General understanding is that any liberalisation of foreign exchange control may be strictly "ring-fenced" in the SFTZ. It remains unlikely that an international business can achieve free convertibility of Renminbi for its China operations by setting up a subsidiary in the SFTZ.

These constraints are largely due to the SFTZ still being at an early stage of development. Many implementing rules need to be developed to clarify those new policies. Despite this, the SFTZ will function as a policy reform test field. Policies such as replacing foreign investment approvals with the negative list can be easily rolled out to the entire country if the government views the experience in the SFTZ positively. For now, the best approach is to be aware of the limitations of the SFTZ and to stay abreast of policy developments in the SFTZ.