Standard Chartered

opinion

Lusaka, Zambia: 5th March 2015

Free trade zones – China's stepping stones to freely traded renminbi

By Carmen Ling, Head of RMB Solutions, Standard Chartered

China is stepping on the reform accelerator, opening its capital account much faster than expected.

Just one year after opening its first free trade zone in Shanghai, China is now liberalising offshore borrowing for firms registered there. The Shanghai free trade zone was originally billed as a three-year trial, but China is forging ahead, expanding Shanghai and launching three new zones on 1 March.

While not the sole conduit for reform in China, the trade zone scheme is crucial to the prospects of a fully convertible renminbi (RMB), and the speed at which China is expanding the scheme is surprising many observers.

Even more policy relaxations could be on the horizon in the run-up to the IMF's review of its Special Drawing Rights (SDR) later this year. The review, taking place every five years, will decide whether the RMB gets included in the SDR alongside the dollar, euro, pound and yen. If it does, this will be a major boost for RMB internationalisation.

The announcement on 12 February of that offshore borrowing for firms in the Shanghai free trade zone will be relaxed further – and that the new regulation will include banks – is a significant breakthrough and suggests China is committed to achieving full convertibility of the RMB. Other pilot schemes are likely to follow.

The latest policy changes follow China's announcement last December that it would expand the pilot Shanghai free trade zone, by including sites such as the Lujiazui financial district, and establish three new hubs in Tianjin of northern China, Fujian in the southeast and Guangzhou in the south.

Launched in September 2013, the Shanghai free trade zone has been an important test bed in China for freer trade, and a more liberal business and financial environment. The fact that China is now expanding the zone and replicating it in other cities confirms that the government considers it a success:

First, the zone is bringing real benefits to China's economy and corporates. According to official data, export-import trade passed through the zone between January and August rose 11 per cent compared to the same period of 2013, before the zone was established. Logistics and inventory costs were lowered by an average of 10 per cent and average time required to clear customs was reduced by three to four days.

Second, the Shanghai trade zone is contributing to China's financial reform. Initiatives such as interest-rate liberalisation and the cross-border RMB sweeping programme – a scheme that allows corporates to repatriate their trapped cash onshore to offshore through a linked cash pool, are crucial to promoting RMB internationalisation. Between January and August last year, two-way RMB flows arising from cross-border sweeping reached more than CNY27.2 billion.

Third, the risks associated with the zone are proving manageable. A negative list was put in place to restrict foreign funds from investing in specific industries within the zone, such as sensitive or overheated sectors. This list has since been shortened, demonstrating the Chinese government's growing level of confidence in the zone. Also, commercial banks are enforcing know-your-customer procedures to ensure that the funds moving in and out of China are supporting genuine trade.

Bearing in mind this track record in Shanghai, launching new free trade zones seems a sensible way given China's sheer size.

The Guangdong free trade zone, including Qinghai, will mainly serve corporates from the high-end financial services industry located in Hong Kong, Pearl River Delta and Macau. The Tianjin zone targets those located in the northern area, where some 80 Fortune 500 companies have established their presence, including many international multinational firms. Meanwhile, the Fujian zone will leverage its strength on trade with Taiwan, and in international logistics business.

While details have yet to be ironed out, the three zones are expected to implement similar policies to Shanghai, which will continue to cater for corporates in eastern part of China and overseas.

The Shanghai zone is likely to remain a testing ground for new initiatives, such as RMB-denominated commodity contracts, starting with crude oil futures which were approved last December. These contracts can be traded by both domestic and international investors, and should support the partial redenomination of commodity pricing quotation into RMB.

Corporates that have embraced China's liberalisation via the Shanghai zone are befitting from first-mover advantage, but the free trade zones are not without challenges. Many multinational corporates feel uncomfortable with the piecemeal and unpredictable way in which China announces its policy changes. Some are reluctant to set up an entity in a free trade zone, only to find another new, more user-friendly policy around the corner.

In addition, RMB appreciation is no longer seen as a one-way bet, posing an even bigger challenge for corporates as they will have to start hedging their RMB exposure.

Expansion of China's free trade zones is likely to take time. Their scale will be small compared to the broader economy and it is unlikely that the zones will have a huge impact on activities beyond their boundaries.

What is clear, though, is that China is committed to driving financial reform in a bid to reach the endgame of full convertibility in the RMB, and more free trade zones will act as stepping stones along the way.

--- ENDS ---

Note to Editors:

This is an opinion piece from Standard Chartered, available for publication. For more articles like this, visit our content hub, www.sc.com/beyondborders

Standard Chartered

We are a leading international banking group, with more than 86,000 employees and a 150-year history in some of the world's most dynamic markets. We bank the people and companies driving investment, trade and the creation of wealth across Asia, Africa and the Middle East, where we earn around 90 per cent of our income and profits. Our heritage and values are expressed in our brand promise, Here for good.

Standard Chartered PLC is listed on the London and Hong Kong Stock Exchanges as well as the Bombay and National Stock Exchanges in India.

For more information please visit www.sc.com. Follow Standard Chartered on Twitter, LinkedIn and Facebook.