

A Tale of Two Cities – the Development and Reform Experiences of Shenzhen and Shanghai

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Abstract: Following *gaige kaifang*, the twin strategy of reform and opening up, Shenzhen has been designated as a Special Economic Zone. The city appeared to have bright future and would serve as the growth engine in China. Despite having an impressive record of economic development since 1979, the prestige of Shenzhen as a commercial centre has always been overshadowed by Shanghai and Hong Kong. A breakthrough finally came when the State Council of China decided to develop Qianhai, a town near Shenzhen, into an international commercial centre. However shortly after, the China (Shanghai) Pilot Free Trade Zone representing an unprecedented degree of openness in relation to foreign investment and international trade was launched. No one seems to remember the once hopeful Qianhai area. The aim of this paper is to examine the path of development of the two leading commercial centres in China amidst the wider context of Chinese economic reform. A common issue facing both cities is, although the state generally has no problem in outlining a vision of reform, a translation of this vision into actual credible measures that could be implemented is often problematic.

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A. Introduction

China has experienced rapid economic growth since 1978 when the whole process of economic reform was initiated.¹ Various policies have been introduced over more than three decades of development. The most important policy to Shenzhen arguably was its inclusion on the list of first four Special Economic Zones (SEZs), where special and flexible policies would be granted to attract and encourage foreign investments. Although Shanghai had been left out of the list, its Pudong New Area was subsequently able to enjoy many of the policies previously available only in the SEZs. On the face of it, the two cities have been prospering equally well since the inception of their 'preferential' economic status. As shown in this article later, their GDP per capita have consistently been well above the national average since 1978 and are now catching up with leading Asian cities like Singapore and Hong Kong. Two recent policies might potentially further strengthen their role as the leading commercial centres in China. The *Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone* was launched in 2012, and the *Shanghai Free Trade Zone* in the following year. Hopefully the momentum of growth would continue thanks to these policy initiatives.

The aim of this paper is to examine the path of development of the two leading commercial centres in China amidst the wider context of Chinese economic reform. The next part will give an overview the process of China's economic reform since 1978, and discuss how Shenzhen and Shanghai have benefited from the reform and experienced a sustained period of impressive growth up thus far. The third part will investigate impact of the two recent policy initiatives, namely the *Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone* and the *Shanghai Free Trade Zone*, on the two cities respectively. The final part concludes, which argues that although the state generally has no problem in outlining a vision of reform, a translation of this vision into actual measures that could be implemented eventually is often problematic, unless some wider reforms are formally recognised and made first.

B. Factors Instrumental to Economic Growth

Institutions are important for economic growth (Acemoglu et al, 2002: 1262; Acemoglu et al, 2005). Institutions, as put by North (1990: 3), are 'the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction'. More specifically, institutions are 'systems of established and prevalent social rules that structure social interactions' and thus 'language, money, law, systems of weights and measures, table manners, and firms (and other organisations)' are all institutions (Hodgson, 2006: 2).

As shown later in this article, Shenzhen and Shanghai have been effective in attracting foreign investments and developing their financial markets. Proper regulation is important in this regard.² La Porta and colleagues (1997, 1998 & 2006) have examined legal rules

¹ The average annual GDP growth rate in the period of 1978 to 2014 was 9.82 percent. Those of developed economies like the US and UK were 2.75 percent and 2.24 percent respectively; and those of emerging economies like Brazil, Russia and India were 2.93 percent, 0.8 percent (from 1990 onwards) and 5.95 percent respectively. Data available from the World Bank.

² To put all this into the specific context of China, see Allen et al (2005) and Yeung and Huang (2013).

covering the protection of investors and creditors, the origin of these rules and the quality of their enforcement in 49 countries. They have alleged that the legal environment, including both legal rules and their enforcement, matters for the size and extent of a country's economy. It is because a good legal environment protects the potential financiers against expropriation. Investors are more willing to invest as a result. In the context of China, the early Company Law was designed to pursue a distinctive mission in the socialist state of China, which was, to build an economic system that maintains socialist principles and goals (Art and Gu, 1995). More fundamentally, the law focused on SOEs rather than on entrepreneurial, capitalist businesses. Shareholders' rights as a result were neglected. In sharp contrast, the Company Law since 2005 has clearly stated that its aims are to 'protect the legitimate and interests of companies, shareholders and creditors' and, at the same time, 'to promote the development of the socialist market economy'.³ The recent company law amendments in 2013 removed the requirement for companies to have a minimum level of capitalisation. It is expected to encourage more entrepreneurs to start their own businesses fostering the growth of the individual economic sector (PwC China, 2014).

Yet, the Chinese piecemeal approach to reform means that not only do the legislations formally promulgated by the National People's Congress have to be read, other rules and regulations issued by bodies such as the State Council and municipal authorities are also important (Zhang, 2012: 41). Also, the study of Chinese regulation must be done in conjunction with politics. As claimed by Lubman (1991: 317), 'the primacy of policy [in China] makes law as merely an instrument of administration'. Traditionally, institutional innovations in China were supposedly consistent with a Marxist-Leninist-Maoist ideology that could not be challenged (Lubman, 1991: 318). However, Jiang Zemin's 'Three Represents' legitimised the inclusion of capitalists and private entrepreneurs within the Chinese Communist Party. More recently, Hu Jintao's 'Harmonious Society' slightly adjusted China's focus from economic growth to overall societal balance and harmony. His 'Scientific Outlook on Development' aims to achieve 'coordinated development, all-round development, and sustainable development'.⁴ The current leader, Xi Jinping, reaffirmed in 2013 the position of *Deng Xiaoping Theory*, *Three Represents* and *Scientific Outlook on Development* in pursuing 'socialism with Chinese characteristics' (Xi, 2013). Despite these ideological changes, regulation has just been viewed as an effective tool in controlling economic activities such that the state would benefit in the process (Kirby, 1995: 58-59).

In particular relation to the financial sector, the political explanation for the growth of western securities markets given by Roe (2005: 199) has been that if a society's institutions do not promote shareholder value, then dispersed ownership, which can influence the depth of a financial market, ought to be narrower than elsewhere. Non-interventionism is also regarded as one aspect of good government by economists (La Porta et al, 1999). These factors of 'good governance' might not be compatible with China's status as a socialist state.⁵

³ See Company Law 2005, art 1.

⁴ Hu's own explanation of his idea during a trip to Jiangxi, as quoted in Fewsmith (2004).

⁵ Despite the coining of the term 'socialism with Chinese characteristics', the Chinese Constitution essentially recognised only socialist ownership. See Constitution of China, art 6. In 1988, an amendment of the constitution

Politics particularly affects the debates and shift of regional policy (Fan, 1997: 620). Deng Xiaoping's influence over regional development was his public endorsement of prioritising efficiency over equity (Fan, 1997: 623). Deng's idea was some people and regions should get rich first so that they can provide 'demonstration effects' for other people and regions to follow. This phenomenon of uneven regional development is indeed common in development and is considered as 'inevitable' (e.g. Hirschman, 1958). In light of the Chinese government's determination to nurture Shenzhen and Shanghai, in the following sections, the article will aim to compare and contrast the development and reform experiences of the two cities. Two major issues will be examined: firstly, the actual measures arising out of the city's preferential status; secondly, a general picture of its development using common economic indicators such as FDI, GDP and size of financial market.

C. China's Over Three Decades of Economic Reform

It was all started in December 1978 when the Third Plenary Session of the 11th Central Committee of the Communist Party of China (CPC) marked a new historical period of *gaige kaifang*, the twin strategies of economic reform and opening up. Before that, the traditional socialist system of China and the development strategy of prioritizing heavy industry, together with different political campaigns such as the Great Leap Forward and the Cultural Revolution had not brought China prosperity.⁶ The process of economic reforms was introduced and implemented slowly and pragmatically, as famously illustrated by the Chinese old saying of 'crossing the river by feeling each stone'.⁷

A policy initiative, most important in the context of this paper, was the establishment of four Special Economic Zones (SEZs) in Shenzhen, Shantou, Zhuhai of Guangdong Province (all in late 1979) and in Xiamen Fujian Province (October 1980). The SEZs are formally defined as:

A small area demarcated within a country's territory and suitably insulated for adopting special and flexible policies in external economic activities to attract and encourage foreign investments (Leung, 1986: 10).

There were several considerations regarding the choice of location of the SEZs. First the government intended to take advantage of Guangdong Province's and Fujian Province's position as neighbours to Hong Kong and Macau in order to create special export zones (Lu et al, 2013: 98). Second, traditional industrial centres of Shanghai and Liaoning were not selected because Guangdong and Fujian were considered under-industrialised and therefore little damage would be done if the idea of SEZs ultimately failed (Bramall, 2009: 333). Third, the selection was consistent to the characteristic of Chinese reforms. The Chinese state has a

expressly authorised the development of a private economy. See art 11 of the Constitution, which provides the following, 'the state permits the private sector of the economy to exist and developing within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy'.

⁶ For more about the calamity of pre-reform era, see for example, Chapter 2 of Gang (2012).

⁷ Although such a Chinese mentality of prudence was adopted by Deng Xiaoping, it was indeed proposed and said repeatedly by Chen Yun as early as 1950, who was the Chairman of the CPC Central Advisory Commission between 1988 and 1992, one of the most influential leaders of China known as 'the Eight Elders' during the 1980s and 1990s. See Xinhua News (2014).

conservative attitude towards introducing new policies and rules. As a result, the use of experimental legislation in regional areas as precedents for drafting new national laws has long been a characteristic of Chinese legal reform (De Jonge, 2008: 29). Finally, the selection was consistent to Deng Xiaoping's vision of 'allowing some regions and some people to become prosperous before others is to enable them to prosper eventually' (Deng, 1993: 195). There is no intention to create imbalance or polarisation of society. However, in retrospect, Deng regretted not giving SEZ status to Shanghai sooner (Bramall, 2009: 333). In his opinion, if Shanghai had been included in the launch of the four SEZs, the situation with regard to reform and opening in the Yangtze River Delta and indeed the whole country could be quite different, despite the fact that the Yangtze River Delta and Shanghai were able to enjoy the same preferential policies eventually. In 1988, Hainan was established as the fifth SEZ. The opening up to the outside world in the eastern coastal regions not only promoted economic development in these areas but also pushed forward the process of nationwide economic opening up (Lu et al, 2013: 98).

In a nutshell, the characteristics of SEZs are as follows (Nishitateno, 1983: 177): 1) Various public utilities such as water supply and electricity are well prepared and it is expected that the investment climate will be very favourable for foreign investment; 2) Preferential treatment in regard to tax, use of land, etc., is given to enterprises in order to attract their investments; 3) The manufactured goods are intended to be exported; 4) The Special Zones operate in a manner similar to a free market economy; 5) In relation to the accompanying legal framework, China's enactment of the *Joint Venture Law*⁸, which permitted overseas enterprises to undertake joint ventures with Chinese nationals, enabled the possibility of direct foreign investment.

To further enhance credibility to outside investors, officials in Guangdong wanted to write the SEZs into law (Coase and Wang, 2012: 62). The response from the National People's Congress was the approval of the *Regulations for the Special Economic Zones in Guangdong Province* ('SEZ Regulations' hereinafter) on 26 August 1980. The law consisted of six chapters and 26 articles. There were three main provisions. First, goods produced in the SEZ are primarily for export and the operation of these enterprises would be free from state intervention.⁹ Second, foreign investors were entitled to preferential treatment in the form of low tax rates and exemption from duties.¹⁰ Third, the enterprises are free to manage their labour as they would in a free market economy.¹¹

According to Article 1 of the SEZ Regulations, the SEZs would encourage foreign citizens, overseas Chinese, people from Hong Kong and Macau and their companies and enterprises to open factories and set up enterprises and other establishments with their own investment or in joint ventures with Chinese nationals. In other words, the Regulations effectively sanctioned the existence of wholly-foreign-owned enterprises on Chinese soil for the first time since

⁸ The full name is *Law of the People's Republic of China on Sino-Foreign Equity Joint Venture Companies*. The law was adopted by the Second Session of the Fifth National People's Congress on 1 July 1979 and became effective on 6 July.

⁹ SEZ Regulations, arts 9-10.

¹⁰ SEZ Regulations, Chapter III.

¹¹ SEZ Regulations, Chapter IV.

1949. Although most of the investors engaged in labour-intensive industrial production, they were actually allowed to participate in ‘all projects that have positive significance for international economic cooperation and technical exchanges’.¹² Despite the apparent freedom, there remained ‘theme of strongly guarded socialist political authority and national sovereignty as key prerequisites to the zones’ deliberate loosening of socialist economic principles’ (Fenwick, 1984: 381). Enterprises and individuals in the SEZs must still abide by the laws, decrees and pertinent provisions of China.¹³ Also, a new, omni-competent organ, the Guangdong Provincial Administrative Committee for the SEZs was established to ensure retention by the government of the broadest possible administrative, political, and judicial authority in the zones.¹⁴ Investors wishing to open factories or set up various economic undertakings were required to apply to the Committee for approval.¹⁵

As regards preferential treatment, the preferential rate of income tax levied on the enterprises in the SEZs was 15 percent, much lower than the 33 percent rate levied on joint ventures outside the SEZs with the progressive taxation from 20 percent up to 40 percent for foreign enterprises.¹⁶ Furthermore, raw and semi-processed materials, machinery and equipment, and other capital goods necessary for production that are imported by enterprises in the SEZ would be exempted from import duties.¹⁷ The lawful profit that an investor receives could be remitted abroad through the Bank of China or other banks in the special zones, despite the existence of tight currency control in China.¹⁸ As regards labour management, like other countries, the terms in an employment relationship would be defined by an employment contract and the employees would be protected by various measures for labour protection.¹⁹ However, one distinctive socialist feature was contained in Article 19 of the SEZ Regulations. Whilst the investors had the autonomy to hire foreign personnel for their needs, a labour service company was set up centrally in each of the SEZs to handle the recruitment of Chinese workers. The investors themselves might be able to recruit local workers only if consent was given by the SEZ Administrative Committee.

However, despite some regulations were in place, Nishitateno (1983: 178) believed the law remained short on specifics and also contained ambiguities. Fenwick (1984: 384) went further to allege that inadequacies in the Regulations led to several major problems in SEZ development. First, the zones were meant to attract global foreign investment, but the reality was investors almost solely came from Hong Kong, largely owing to the unwillingness for international investors to accept the absence of a detailed, comprehensive legal framework for SEZ investment. Second, the sectoral concentration of foreign investment in the SEZs was unbalanced. A disproportionate amount of Shenzhen's investment was concentrated in real estate projects, as opposed to industrial development which the state hoped to focus on. Third, a substantial number of foreign firms withdrew from Shenzhen shortly after the

¹² SEZ Regulations, art 4.

¹³ SEZ Regulations, art 2.

¹⁴ SEZ Regulations, art 3. The functions and powers of the Committee were stipulated in Article 23.

¹⁵ SEZ Regulations, art 7.

¹⁶ SEZ Regulations, art 14 and Nishitateno (1983: 178-79).

¹⁷ SEZ Regulations. art 13.

¹⁸ SEZ Regulations. art 15.

¹⁹ SEZ Regulations. arts 21-22.

promulgation of the Regulations. In response to these problems, the National People's Congress introduced new sets of supplementary SEZ regulations, covering the problem areas of immigration, business registration, labour and land issues (Fenwick, 1984: 386).²⁰

Despite some pitfalls in the idea of using SEZs to spearhead nationwide economic development, China's economic performance over the past 30 years has been remarkable.²¹ The World Bank attributed this impressive growth record to various unique factors (World Bank, 2013: 4-6). First, China was praised to carry out market-oriented reforms in a gradual, experimental way and by providing incentives for local governments. The pre-existing SOEs remained supported whilst the development of private enterprises was encouraged. Also, localities were often allowed to adopt their own unique institutions tailored to their specific situations. Second, economic reforms and growth were made a national objective and therefore collective efforts were mobilised for that, whilst social stability was successfully maintained amid a period of rapid economic and structural change. Third, steady integration occurred at both domestic and international levels. For the former, major infrastructure investments were made to connect regions and the interior to the coast. For the latter, with the establishment of SEZs and accession into the WTO, China was able to bring in foreign investments, advanced technologies, and managerial expertise. This is consistent to the idea of 'appropriating capitalism for the good of socialism'. Finally, local governments at various levels were allowed to compete with each other in attracting investment, developing infrastructure, and improving the local business environment. The resulting fierce competition between local governments and regions became a strong driver of growth.

Having understood a big picture, the following subsections will examine the path of development of Shenzhen and Shanghai respectively.

1) Shenzhen

Before 1978, Shenzhen was merely a 'sleepy border town' lying north of the then British colony, Hong Kong, in southern China (Ng, 2003). It was the major source of illegal immigrants into the then booming capitalist haven of Hong Kong, where the GDP per capita was HKD 25,081 in 1979 (as opposed to RMB 606 in Shenzhen).²² At that time, Shenzhen's size was merely three square kilometres with a population of over 30,000 people, when

²⁰ These regulations were *Provisional Entry/Exit Regulations (Guangdong Special Economic Zones)*; *Provisional Regulations for Business Registration (Guangdong Special Economic Zones)*; *Provisional Labour and Wage Regulations (Guangdong Special Economic Zones)*; and *Provisional Land Regulations for Shenzhen Special Economic Zone*.

²¹ China surpassed Japan in terms of nominal GDP in 2010, making the Chinese economy the world's second largest, only behind the United States. China has grown at a rate of 9.9 percent over the past 30 years. The poverty rate fell from more than 65 percent to less than 10 percent, meaning that some 500 million people were lifted out of poverty. Other growth indicators include: three of the world's top 5 banks are now Chinese; 89 Chinese companies were on the Global Fortune 500 list in 2013. China is home to the world's second-largest highway network, the world's 3 longest sea bridges, and 6 of the world's 10 largest container ports. See World Bank (2013: 4).

²² See Ng, 2003: 430 for the GDP data of Hong Kong. The data for Shenzhen came from Di Tommaso et al, (2012: 67). In 2013, the GDP per capita for two cities were HKD 295,701 (up 1,179 percent) and RMB 136,947 (up 22,599 percent) respectively. The 2013 data came from the Census and Statistics Department of Hong Kong and Shenzhen Economic and Social Development Report 2013 (via ChinaKnowledge.com).

nowadays it occupies 1,991.64 square kilometres of land with a population of 10.63 million.²³ The drivers of economy have changed dramatically too. While the agricultural sector made up 37 percent of GDP in 1979, it dropped to 0.1 percent in 2012.²⁴ On the contrary, secondary industries have grown dramatically over the years. In 1979, secondary industries contributed only 20.5 percent of GDP but in 2012 the figure increased to 44.3 percent. The tertiary sector's contribution to GDP had increased from 42.5 percent to 55.6 percent over the same period.

Wu Nansheng, the ex-mayor of the Shenzhen SEZ outlined the three functions of Shenzhen in 1981: first, to understand capitalist society; second, to experiment with different policies; and third, to study foreign advanced technology and management (Kwok, 1986: 40). The successor of Wu, Lang Xiang later further elaborated the advantages of the SEZ. Through preferential policies, Shenzhen could use large amounts of foreign investment in a better way, which would eventually benefit the country as a whole. Furthermore, by dealing regularly with foreign capital, China could observe and understand the operation of the modern capitalist world. Finally, through co-operation, China could learn modern management methods and train professionals.

According to Yeung and colleagues (2009: 224), Shenzhen was the most 'special' among the four SEZs, first, with the greatest freedom to explore innovations; second with its success. Among Shenzhen's innovations were the implementation of a new contract labour and wage system, a tender system for projects and a land auction system. In 1981, the four zones accounted for 59.8 percent of total FDI in China, with Shenzhen accounting for the lion's share at 50.6 percent and the other SEZs roughly three percent each, although the four zones just represented about 20 percent of the national total FDI by the end of 1985 (Yeung et al, 2009: 224).²⁵ From 1980 to 1984, Shenzhen grew at a phenomenal 58 percent annual rate and its economy expanded sixfold during the period (Yeung et al, 2009: 225).²⁶ The secondary sector has been the primary source for the phenomenal growth (Ge, 1999: 1272). Industrial production, especially the labour-intensive, light industrial manufacturing, has been mainly responsible for the speedy expansion in the secondary sector. In addition to the input of capital, one advantage of fostering foreign investment is the input of technological know-how. Shenzhen used to be an important base of the production of low-end electronic products.²⁷ Over time, the city has been steadily upgrading in terms of technological sophistication (Wei, 2000: 203). Shenzhen is becoming a centre for high-technology industries and the base of leading domestic high-tech firms or subcontractors manufacturing world-renowned branded

²³ Data from Di Tommaso et al (2012: 66) and Shenzhen Government.

²⁴ Data from Shenzhen Statistical Yearbook.

²⁵ This could be understandable as by 1984, the four zones no longer enjoyed their exclusive status. In that year China further opened 14 coastal cities to overseas investment: Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai.

²⁶ The comparable annual growth rates during the same period were 32 percent, 9 percent and 13 percent for Zhuhai, Shantou and Xiamen respectively. Over the same period, China as a whole expanded 1.5 times, 3 times for Zhuhai, 1.4 for Shantou, and 1.6 for Xiamen.

²⁷ For example, as early as 1985, Shenzhen's output of television sets and radio-cassette recorders accounted for one-sixth and one-third, respectively, of the national total. See Yeung et al (2009: 229-230).

products, such as Huawei Technology, ZTE Corporation, Tencent, and Foxconn Technology Group.²⁸

It has been envisaged that Shenzhen would become a regional centre of commerce, trade, finance and transportation (Ng and Tang, 2004: 206). Supporting high-tech and other advanced industry will be modern service sectors such as logistics and finance. The primary container ports are Yantian in the east, and Shekou and Chiwan in the west. For a long period of time, Hong Kong has been viewed as the Chinese Mainland's main gateway to the rest of the world, thanks to its strategic location and modern facilities such as financial system and transportation network, thereby enabling it to take advantage of a large volume of entrepot trade (Song, 2002: 100).²⁹ However, from 1979 to 2004, the Shenzhen Port invested over RMB 30 billion into port infrastructure and related areas boosting its profile and usability (McKinnon, 2011). According to the Eleventh Five-Year Plan (2006-2010), Shenzhen was committed to improving the infrastructure of the logistics industry, to build the city into a key supply chain service base in South China, as well as an influential logistics hinge city in Asian Pacific Region. According to the statistics of 2012 from the World Shipping Council (2013), although Hong Kong was still amongst the top three world container ports, Shenzhen was catching up very quickly and ranked closely behind at the fourth. This largely illustrates that Hong Kong's role as the middleman has been diminishing.

As for the financial sector, it is undeniable that like most countries in the world including many developed countries (except the US and UK), China has been relying much more heavily on financial intermediaries such as banks than markets to channel capital to business.³⁰ For example, bank credit still accounts for close to 90 percent of funds raised by the corporate sector (World Bank, 2013: 116). However, the non-performing loans problem in the Chinese banking system meant that the state had to find a way out.³¹ The over-reliance on a single mode of finance has apparently driven China to consider a diversification of domestic fund-raising channels. Long before the establishment of a formal establishment,

²⁸ According to Gartner (2014), a leading technology research and consulting firm, among the top ten best-selling mobile phone companies in 2013, ZTE and Huawei were ranked the fifth and sixth respectively, behind Samsung, Nokia, Apple and LG Electronics. Indeed, there were three more Chinese companies on the top ten list, including TCL Communication, Lenovo and Yulong. Tencent is the fourth largest internet company behind Google, Amazon and Ebay in terms of market capitalisation. Internet companies refer to those that conduct the majority of its business on the internet. See BBC (2014). Foxconn is the world's largest contract manufacturer, known for assembling famous electronic goods like Apple's iPhone and iPad. Its Shenzhen Longhua campus, covering 2.5 square kilometres, employed 240,000 people. See Economist (2012).

²⁹ In essence, Hong Kong would import the goods manufactured in China and re-export them to the rest of the world.

³⁰ See for example, the charts of bank credit and stock market capitalisation to GDP of selected economies in Winters and Yusuf (2007: 114).

³¹ The problem of the Chinese bank-centred system can be explained by several factors. First, state-controlled banks have remained dominant in the banking sector. The state ownership of banks has reduced competition and lessened the pressure on banks to operate on a commercial, profit-oriented basis. Second, there is a lack of good internal credit assessment capabilities in many banks. The reason behind most of the non-performing loans in the past was the directed lending policies of the government to fund SOEs regardless of their profitability. Third, these state-owned banks have a decentralised structure. Lending decisions are made at the local branch level, which is susceptible to influence from local government and favouritism towards local SOEs. This diffuse structure of banks and many SOEs makes it difficult for banks to collect and share useful information to make an informed lending decision. For more discussions, see McKinsey Global Institute (2006).

there was an attempt from a company in Shenzhen to raise funds from the public. In July 1983, United Investment Corporation of Bao'an County in Guangdong Province placed a public offering advertisement in the Shenzhen Special Economic Zone Daily, announcing the issuance of shares guaranteed by the county government to raise USD 6.6 million (China Securities Regulatory Commission, 2008: 156). This was the first company to place a public offering advertisement in newspaper after 1949. Furthermore, in September 1987, Shenzhen Special Zone Securities Firm, the first professional securities firm in China, was established (China Securities Regulatory Commission, 2008: 160). Finally, the Shenzhen Stock Exchange was established in December 1990. As a formal set of securities law was not in place, Shenzhen Municipal Government introduced a series of administrative measures.³²

On 19 January 1992, Deng Xiaoping arrived at Shenzhen as part of his Southern Excursion and was believed to be with a view to finding out the success of his economic experiment (Coase and Wang, 2012: 116). Deng made the following remarks:

‘We should be bolder than before in conducting reform and opening to the outside and have the courage to experiment.... Once we are sure that something should be done, we should dare to experiment and break a new path. That is the important lesson to be learned from Shenzhen.’ (People’s Daily, 1992)

According to Coase and Wang (2012: 96), the resistance to market reform throughout the 1980s did not come from the people or government officials, but originated from China’s remaining commitment to socialism. The idea of establishing a *socialist market economy* was confirmed by the 14th Central Committee of the CPC in 1992. The whole process of reform proceeded into the 1990s and beyond. The establishment of two formal securities exchanges took place at around the same time. The Shanghai Stock Exchange was founded on 26 November 1990 and opened for its first trading day on 19 December 1990. The Shenzhen Stock Exchange was founded in the same year, on 1 December, and formally opened for trading on 3 July 1991. There have been numerous concerns over reinterpreting Marxism and leaping into a ‘socialist market economy with Chinese characteristics’. Would the introduction of a capital market be consistent with socialist economic division and production? Deng Xiaoping once made the following remarks:

‘Securities, stock markets, are they good or evil? Are they dangerous or safe? Are they unique to capitalism or also applicable to socialism? Let’s try and see. Let’s try for one or two years; if it goes well, we can relax controls; if it goes badly, we can correct or close it. Even if we have to close it, we may do it quickly, or slowly, or

³² These were introduced in May 1990 and included: banning illegal off-floor trading; imposing a 0.5 percent stamp duty on both sellers and buyers; setting a daily price change ceiling and floor limits of 10 percent; increasing the number of branches; and enhancing the disclosure of market information and the provision of proper guidance to the public. Later, in May 1991, the Government introduced the *Provisional Measures of Shenzhen Municipality for Administration of the Issuance and Trading of Shares* and subsequently in January 1992, the *Provisional Regulations of Shenzhen Municipality Concerning Joint Stock Limited Companies*. See China Securities Regulatory Commission (2008: 161).

partly. What are we afraid of? If we maintain this attitude, then we will not make big mistakes.³³

Apart from ideological conflict, the operation of the exchange was not without any problems. For example, on 10 August 1992, a serious shortage of IPO subscription application forms, combined with poor organization and other irregular practices, resulted in violent protests by potential retail investors in Shenzhen (China Securities Regulatory Commission, 2008: 160). The incident triggered the Chinese government's decision to set up a national regulatory body to supervise activities on the equity market. The response was the establishment of the State Council Securities Committee (SCSC) and the China Securities Regulatory Commission (CSRC) in October of the same year.³⁴ The exchange has been steadily developing since then. Towards the new millennium, there was an idea from the State Developing Planning Commission to establish a market for growth enterprises, the Chinese equivalence of Nasdaq.³⁵ This certainly coincided Shenzhen's position as a centre for high-technology industries. The Growth Enterprise Board of China was eventually launched in 2009. Apparently, comparing to its counterpart in Shanghai, the Shenzhen Stock Exchange has been relatively lacklustre. For example according to the statistics as of the end of 2013, Shenzhen was just the 11th largest stock exchange in the world (in terms of market capitalisation), comparing to Shanghai at seventh and Hong Kong at sixth.³⁶ However, according to the most recent Global Financial Centre Index which measures the competitiveness of a financial centre, Shenzhen was placed at the 18th position, two above Shanghai at the 20th.³⁷ More importantly, Shenzhen has the Growth Enterprise Board, like other junior bourses around the world, which has less stringent admission standards and is capable of providing emerging businesses with a valuable fund-raising channel.³⁸

Since 1978, amidst over three decades of economic reform in China, the city has never hesitated to innovate. It was one of the first SEZs, and has one of the two stock exchanges in China. Without doubt, it has evolved from a tiny border town of just over 30,000 people into a modern international metropolis. However, how it fares against another major city, Shanghai, is to be revealed below, when the development of Shanghai is examined and at the same time Shenzhen is brought in as a comparison whenever appropriate.

³³ Speech made by Deng Xiaoping on his Southern Excursion in 1992. See China Securities Regulatory Commission (2008: 161).

³⁴ The two bodies were set up to oversee the securities market on behalf of the State Council. The SCSC was composed of the heads of ministries and commissions such as the State Commission for Restructuring and Economic Reform, the State Planning Commission, the Ministry of Finance, and the People's Bank of China. It was responsible for higher level oversight for securities market to develop long-term strategies, draft relevant laws, rules and regulations, and coordinate different levels of government. On the other hand, the CSRC was responsible for frontline regulation by supervising the trading activities, securities firms, and listed companies. In April 1998, the two were consolidated into one regulator, the CSRC.

³⁵ For the full story, see Yeung (2010).

³⁶ Data from the World Federation of Exchanges.

³⁷ Visit the website of Global Financial Centres of Index Z/Yen Group <<http://www.zyen.com/research/gfci.html>>.

³⁸ According to the World Bank (2008: 18), smaller businesses which contributed some 60 percent of China's GDP, accounted for only 15 percent of outstanding credit, most of which from banks. This showed that the financial market could have allocated resources more fairly.

2) Shanghai

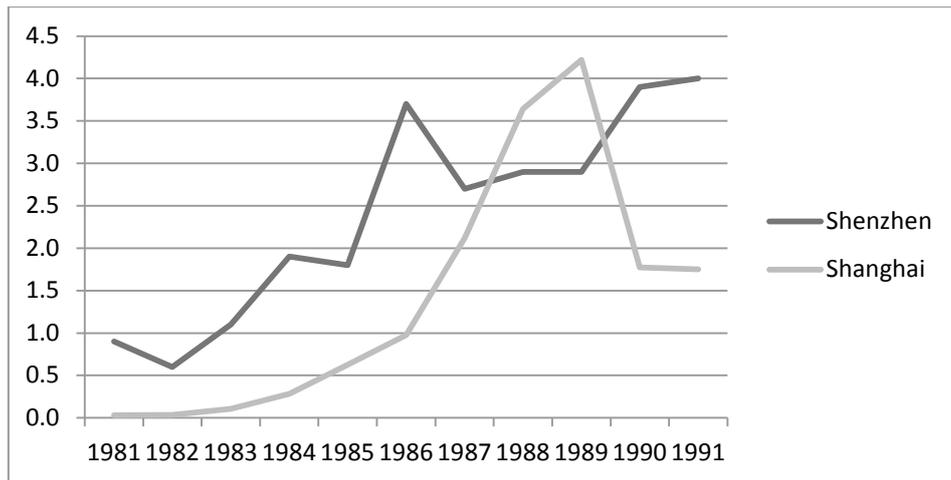
Unlike Shenzhen, Shanghai was not able to take advantage of the first mover advantage during the initiation of economic reform. But different from Shenzhen, Shanghai used to boast the most highly developed urban amenities in Asia outside of Tokyo (Wu, 1999: 207). Therefore, the city just needed to recover its pre-1949 glory, rather than building everything from scratch. For example, the first stock market was established in Shanghai in the 1890s. At that time, Shanghai was considered one of the premier international finance centres of the Far East. At its peak, the shares of 76 companies were admitted for trading, 22 of them banks (Brayshaw and Teng, 1995: 93). In 1949, when the communist government came to power, stock exchanges were viewed as one of the most prominent symbols of an oppressive capitalist regime and were forced to close down. After 1949, the city experienced more than 30 years of neglect and disinvestment (Wu, 1999: 208).

Like Shenzhen, the drivers of economy in Shanghai have evolved over time since the start of economic reform. But as opposed to Shenzhen where agriculture used to be the focus of the economy in the past, in Shanghai there has been a shift of reliance from secondary industries to the tertiary sector. The agricultural sector made up only 4 percent of GDP in 1979 and dropped to 0.6 percent in 2012.³⁹ Meanwhile, tertiary industries have grown dramatically over the years. In 1979, the sector contributed only 18.8 percent of GDP but in 2012 the figure increased to 60.4 percent. In contrast, the secondary industries' contribution to GDP had decreased from 77.2 percent to 39 percent over the same period.

Despite being designated as a coastal open city in 1984, during the first decade of the reform era, Shanghai fell behind other major coastal cities in attracting FDI (Wei and Leung, 2005: 20). One obvious reason is that Shanghai was not able to receive the same preferential policies of the four SEZs in Guangdong and Fujian provinces. Furthermore, there was a 'winner takes all' situation. The more successful cities were able to attract more inflow of foreign capital and therefore invest in its infrastructure to attract more FDI. For example, in the period from 1981 to 1991, except in the years of 1988 and 1989, Shenzhen was always more capable of attracting FDI than Shanghai (see Chart 1).

Chart 1: Direct Foreign Investments of Shenzhen and Shanghai (1981-1991) (in USD 100 million)

³⁹ Data from Shanghai Statistical Yearbook.



Source: Shenzhen and Shanghai Statistical Yearbooks

A breakthrough finally came when Jiang Zemin and Zhu Rongji, former mayors of Shanghai came to power. On 18 April 1990, the Chinese State Council declared that it would open Pudong New Area to foreign investment and promised to apply many of the policies previously available only in the five SEZs (Sang, 1993: 136).⁴⁰ This decision began the revival of Shanghai as the financial and commercial centre of China. Shanghai is divided by the Huangpu River into eastern and western parts. At that time, the western part, Puxi, was the developed centre whilst the eastern part, Pudong, was largely undeveloped. Pudong, effectively recognised as the sixth SEZ, would enjoy the same preferential policies as discussed before, such as a more market orientated business environment than the rest of China, reduced tax rates, exemptions from customs, etc.⁴¹ However, in some instances Pudong was able to go even beyond them to demonstrate China's commitment to reform, in line with the decision of the 14th Central Committee of the CPC in 1992 to establish a 'socialist market economy'. The applicable policies were contained in the *Regulations of the Shanghai Municipality for the Encouragement of Foreign Investment in the Pudong New Area* ('Pudong Regulations' hereinafter) issued by Shanghai Municipality on 10 September 1990.

Pudong is an investment area consisting of four distinct zones: Lujiazui Finance and Trade Zone, Waigaoqiao Free Trade Zone, Jinqiao Export Processing Zone, and Zhangjiang High-Tech Development Zone. These four zones were designed to take their locational advantage, and differ in investment emphasis (Wei and Leung, 2005: 26). Lujiazui is a finance and trade zone intended for financial institutions and regional headquarters of foreign firms, forming the economic core of Shanghai together with the Bund, the traditional financial centre across the river. On the other hand, the other three zones are oriented toward manufacturing activities. Whilst the policies at par with those offered to the five SEZs could potentially provide a favourable business environment to the manufacturing zones, investors in Pudong have been offered particularly favourable conditions for operating financial and business services (Zhang, 2003: 1557).

⁴⁰ The official approval came two years later in 1992.

⁴¹ Refer to the discussions of the SEZ Regulations above.

One of the major characteristics of Pudong that distinguish them from the five SEZs is the specific mentioning of the special policies granted to foreign financial institutions. For example, according to the *Pudong Regulations*, like companies in other SEZs, they are entitled to a reduced tax rate of 15 percent.⁴² However, in addition to that, these financial institutions are entitled to tax exemption during their first profitable year, and enjoy a 50 percent reduction subsequently in the second and third profitable years.⁴³ Indeed, Shanghai has a strong root in finance. As mentioned before, during the 1920s and 1930s, Shanghai was a leading financial centre in the Far East with active trading on its securities market. After the economic reform in 1986, the Jing'an District Branch of the Shanghai Trust & Investment, a subsidiary of the ICBC, started over-the-counter trading of shares and underwrote for the Feile Audio Equipment, probably 'the first share' in new China (CSRC, 2008: 158).⁴⁴ After the establishment of a stock exchange in Shanghai, an important reform was a pilot scheme to issue RMB-denominated shares to foreign investors aimed at attracting foreign capital to the securities market (CSRC, 2008: 170).⁴⁵ These shares, known as B-shares, are domestically-listed shares, denominated in RMB but subscribed to and traded in USD or HKD by overseas investors. In November 1991, Shanghai Vacuum Electron Devices Company issued 1 million special RMB-denominated shares at par of RMB 100 each to overseas investors. The company was listed on the Shanghai Stock Exchange in February 1992, becoming the first B-share in China's securities market. Whilst the Shenzhen Stock Exchange apparently has catered for small and medium-sized enterprises by setting up a special board for them in May 2005, the Shanghai Stock Exchange's focus has always been large state-owned enterprises. For example, the big four state-owned banks are listed in Shanghai (and Hong Kong), as opposed to Shenzhen. Agricultural Bank of China's IPO was the world's largest in 2010 (Financial Times, 2010). For the trend of growth of the two exchanges, see Chart 2.

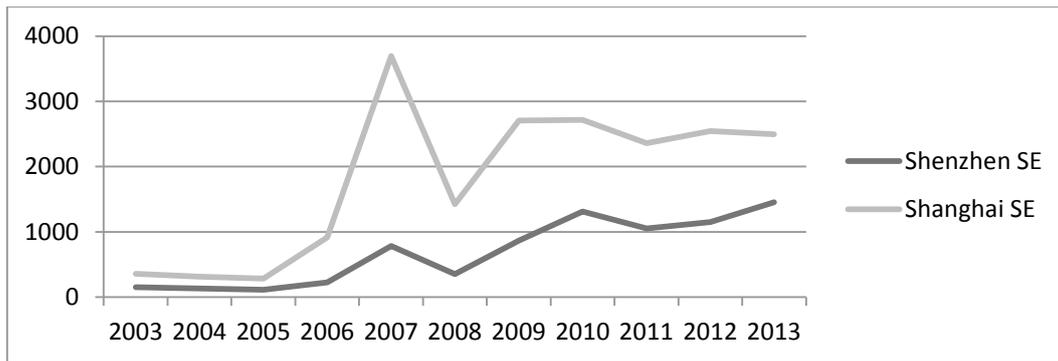
Chart 2: Market Capitalisation of Shanghai and Shenzhen Stock Exchanges (2003-2013)
(in USD billion)

⁴² Pudong Regulations, art 7.

⁴³ Pudong Regulations, art 7.

⁴⁴ On 14 November 1986, Deng Xiaoping met a New York Stock Exchange delegation and especially gave them a share of Shanghai Feile Audio Equipment Company as a gift.

⁴⁵ From a legal perspective, A-shares issued by Chinese companies that are listed and traded in the Shanghai or Shenzhen Stock Exchanges can only be sold to and held by Chinese investors. See the *Standard Opinion for Companies Limited by Shares*, an early version of China's company law, which outlined the nature of different types of shares. An exception to this will be those under the Qualified Foreign Institutional Investors (QFII) scheme. The scheme, launched in 2003, allows licensed foreign investors to buy and sell RMB-denominated A-shares in Chinese stock exchanges (in Shanghai and Shenzhen). The Chinese stock market remains largely closed off to foreign investors owing to China's exercise of tight capital controls which restrict the movement of assets in-and-out of the country.



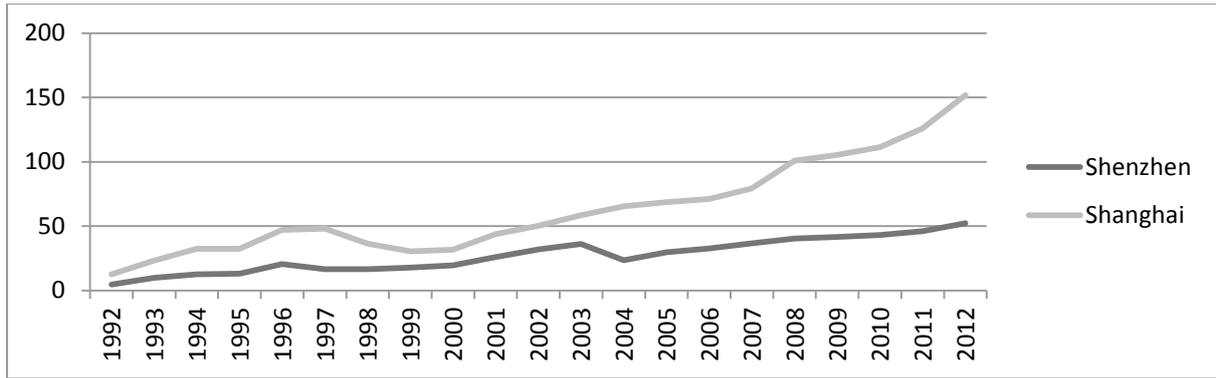
Source: World Federation of Exchanges

Shanghai invested an accumulative amount of RMB 1,384 billion in fixed assets in the 1990s, building the infrastructures required to attract investors (Zhang, 2003: 1554). For example, Shanghai port only began to handle container shipping in 1983, but now it is the largest port in the world.⁴⁶ As a result, the city's ability to attract foreign investments has been growing from strength to strength, dwarfing Shenzhen's position as the first official SEZ (see Chart 3). In 2000, 254 of the Fortune 500 companies invested or established offices in Shanghai, including Alcatel, Volkswagen, General Motors, NEC, DuPont and IBM (Yusuf and Wu, 2002: 1226-27). International financial and banking institutions include Citibank, Standard Chartered, Bank of America, and HSBC also established a base there to provide important financial services (Wei and Leung, 2005: 23).

After more than three decades of economic reform in China, Shanghai might have dwarfed Shenzhen in various aspects. The indicators above (such as FDI, size of stock exchanges and ports) all pointed to the conclusion that Shanghai has developed better than Shenzhen. Yet, the picture is a bit different when looking at the GDP per capita of the two cities (see Chart 4). In over three decades of reform, Shenzhen's GDP per capita has always been more than that of Shanghai. Whilst it might be difficult to say which city is better than another, it is clear that both have developed in a faster pace than China overall and are catching up with, but not having yet reached, the state of some most developed cities in Asia (see Charts 4 and 5).

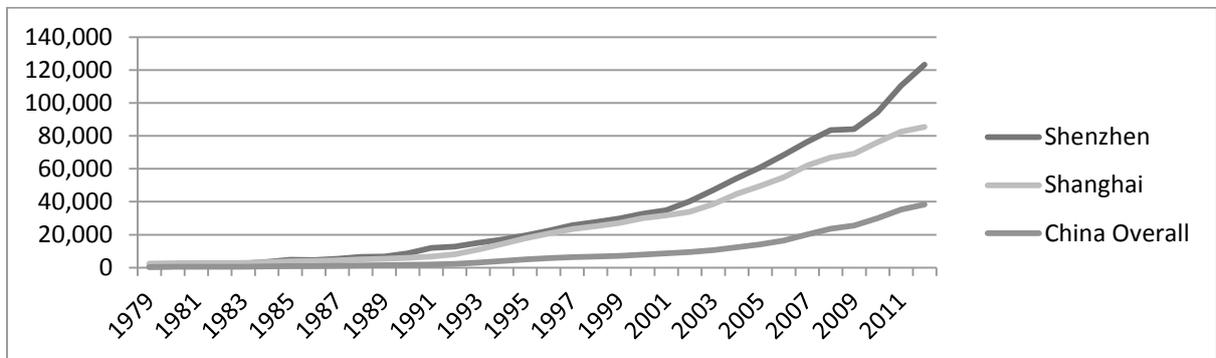
Chart 3: Direct Foreign Investments of Shenzhen and Shanghai (1992-2012) (in USD 100 million)

⁴⁶ Before 1983, Shanghai was essentially a domestic economy and had little direct trade with the outside world except for the former Soviet Union. Occasional trade was handled through Hong Kong. See Wang and Slack (2004: 362). Recent figure from the World Shipping Council (2013).



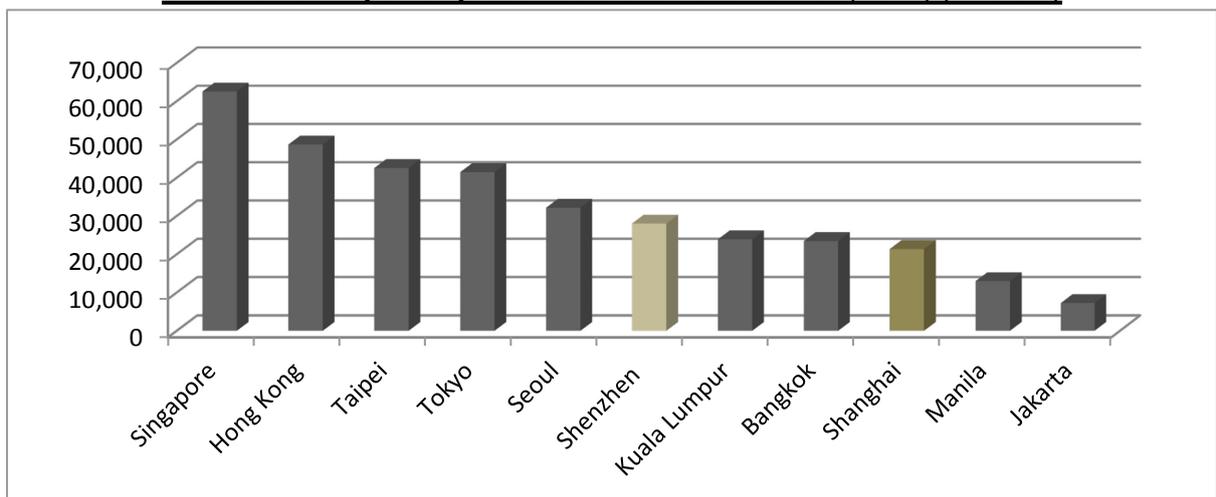
Source: Shenzhen and Shanghai Statistical Yearbooks

Chart 4: GDP per Capita of the Two Cities and China Overall from 1979 to 2012 (in RMB)



Source: Shanghai and Shenzhen Statistical Yearbooks and National Bureau of Statistics China

Chart 5: GDP per Capita of Selected Asian Cities (2012) (in USD)



Source: Brookings Institution (2012)

D. Recent Policy Initiatives

As stressed by Deng Xiaoping⁴⁷, the lesson to learn from Shenzhen as one of the first SEZs for the whole China is the courage to experiment. Recent policy initiatives largely follow this pattern with a view to deepening the degree of reform and opening up the economy further to outside.

1) Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone

The *Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone* ('Qianhai' hereinafter), covering an area of 15 square kilometres, is located in the western part of Shenzhen, at the mouth of the Pearl River, and borders Hong Kong and Macau. The idea was first initiated in August 2010 when the *Overall Development Plan for Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Area* was released. In March 2011, the development plan was included in China's twelfth Five-Year Plan. In March 2012, the National Development and Reform Commission published the *Shenzhen Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Area Preferential Industry List*. The list included six major industries that are designated to be developed in Qianhai: finance, logistics, information services, technology services, professional service and public services. Subsequently in June 2012, the State Council released the *Official Reply of the State Council on Policies Concerning the Development and Opening of Qianhai Shenzhen-Hong Kong Modern Service Cooperation Zone of Shenzhen* ('Official Reply' hereinafter), announcing 22 measures, which cover six main aspects including finance, tax, law, talents, education, medical care and telecommunications, for the development and opening-up of Qianhai. According to Xi Jinping, the current Chinese leader, Qianhai is meant to be 'more special than a special economic zone' (Credit Suisse, 2013). The vision of the twelfth Five-Year Plan is that Qianhai is planned to be developed by 2020 into an important production service centre. The development strategy is two-fold. Just like the development of SEZs, preferential policies are granted. However, a new dimension is the state's intention to take advantage of the more developed institutions in Hong Kong by forming a collaborative relationship.

In relation to tax incentives, just like those in SEZs, companies are able to enjoy a 15 percent corporate tax rate, which is much lower than the standard national rate of 25 percent.⁴⁸ Furthermore, professionals may receive a provisional subsidy from the Shenzhen government that waives their salary tax requirement.⁴⁹ To attract talents, there is a plan to foster the mutual recognition on professional qualifications, such that qualified professionals in Hong Kong are allowed to provide services in Qianhai.⁵⁰ Services providers in Hong Kong, such as those in the education, medical, legal and accounting sectors, are encouraged to strengthen their presence in various forms.⁵¹ However, all these are hardly ground-breaking measures indeed. As said, companies in SEZs have long enjoyed a reduced tax rate. Also, mutual recognition on professional qualifications and preferential treatment to Hong Kong

⁴⁷ Refer to a quote above from People's Daily (1992).

⁴⁸ The Official Reply, section 3.1.

⁴⁹ The Official Reply, section 3.2.

⁵⁰ The Official Reply, section 5.

⁵¹ The Official Reply, sections 4-7. For example, Hong Kong service providers are allowed to set-up fully owned international schools or hospitals. But for law firms and telecommunications services, only joint-operation or joint venture is permitted.

service suppliers could be understood in the context of the *Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA)*, which was signed on 29 June 2003.⁵² Under the CEPA, mutual recognition on professional qualifications was in principle achieved for construction and related engineering, securities and futures, insurance, patent agents, professional accounting services and estate agents services.⁵³ Also, under CEPA, service suppliers in Hong Kong are already able to enjoy preferential treatment when setting up business in various service sectors in Mainland China.⁵⁴

Quite arguably, the only meaningful section in the *Official Reply* is the promise to explore the innovation of financial reform in Qianhai, and make the zone a demonstration window of China opening up its financial industry.⁵⁵ Qianhai is designated as the domestic frontier and the external backup base for RMB internationalisation (Credit Suisse, 2013). It is tasked to establish a channel for the inflow and outflow of RMB under the capital account between the on-shore and off-shore RMB markets. As for the former aspect, the innovation includes allowing Hong Kong banks to lend to RMB directly to companies in Qianhai. For this, the People's Bank of China (PBOC) published the *Provisional Rules for Cross-border RMB lending in Qianhai* in December 2012. The related *Implementation Rules* in February 2012 issued by the PBOC Shenzhen branch imposed strict control on the direction of fund use (Hong Kong Trade and Development Council, 2013). The rules on the one hand permit companies registered and doing business or making investment in Qianhai to borrow RMB loans from Hong Kong-based banks. On the other hand, the rules banned loans from being invested in negotiable securities and other financial derivatives, entrusted loans, wealth-management products, and property not for the borrowers' own use. Another innovation is the permission to allow the parties to negotiate loan rates, which is also an experiment for the Mainland's interest rate reforms.⁵⁶ Furthermore, the state encourages Qianhai-based companies to issue RMB bonds in Hong Kong in parallel to the twelfth Five-Year Plan to promote the wider use of RMB in cross-border transactions and supporting the development of Hong Kong as the offshore RMB business centre.⁵⁷ As for the outflow, the establishment

⁵² For more about this, see Trade and Industry Department of Hong Kong, 'Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA)' <http://www.tid.gov.hk/english/cepa/cepa_overview.html>. Ten Supplements have been signed since then to expand market liberalisation and further facilitated trade and investment for the economic cooperation and sustainable development of the two places.

⁵³ For example, the Financial Services and the Treasury Bureau of Hong Kong and the Ministry of Finance of China signed on 27 August 2004 an agreement on the mutual exemption of certain examination papers for Mainland and Hong Kong accountants.

⁵⁴ The preferential treatment takes various forms, including allowing wholly-owned operations, relaxing restrictions on equity shareholding, reducing registered capital requirements, relaxing restrictions over geographical location and business scope, etc. As of 30 June 2014, 2,806 service suppliers have applied for the Certificates of Hong Kong Service Supplier to take advantage of CEPA treatment. Data from the Trade and Industry Department of Hong Kong.

⁵⁵ The Official Reply, section 2.

⁵⁶ See Wei (2014: 408). Normally, Chinese lenders must adhere to official lending rates. But on 20 July 2013, the PBOC ended all restrictions on lending rates, which previously had a floor of 70 percent of the PBOC benchmark rate. Banks are now free to set lending rates (except for residential mortgages) at any level they want. See Economist (2013).

⁵⁷ The Official Reply, section 2.3. See also Hong Kong Monetary Authority (2013). In June 2007, the National Development and Reform Committee (NDRC) issued the *Interim Measures for the Administration of the Issuance of RMB Bonds in Hong Kong by Onshore Financial Institutions*, marking the beginning of RMB bonds in Hong Kong. At that time, only China incorporated financial institutions were allowed to issue RMB bonds in

of Qianhai-based equity investment funds is supported.⁵⁸ Under a proposed third Qualified Domestic Institutional Investor scheme (QDII3), banks, brokers and insurers in Qianhai are allowed to invest RMB 50 billion plus USD 5 billion directly in Hong Kong stocks, bonds and RMB investment products.⁵⁹ In the opinion of Wei (2014: 408), Qianhai is a milestone for the opportunities to remove capital controls on the Mainland, boosting the two-way flow of funds and making the Mainland currency more convertible.

Qianhai was initially hailed as the prospective ‘Manhattan of the East’ (China Daily, 2014). By the end of 2013, 3,553 companies had registered, in which more than 60 percent were financial institutions such as HSBC, Hang Seng Bank and Standard Chartered, and para-financials (China Daily, 2014). The zone expected the number of companies registered there to exceed 10,000, yielding a combined GDP of RMB 10 billion by 2014. This is apparently somehow falling short of the original vision that the zone’s GDP would reach RMB 50 billion in 2015 (and RMB 150 billion in 2020) and all infrastructures would be completed by the same year.⁶⁰ More problematically, domestic and global firms that had originally planned to set up in Qianhai were re-assessing their options with the launch of a free-trade zone in Shanghai (South China Morning Post, 2013a). The future of Qianhai may best be summarised by the following quote:

The impact of Shanghai will be felt in the whole of China or even the rest of the world, but Qianhai's impact will be limited to Hong Kong-related businesses. (South China Morning Post, 2013a)

2) Shanghai Free Trade Zone (FTZ)

In April 2009, the State Council made an official announcement on its goal of turning Shanghai into an international finance and shipping centre by 2020.⁶¹ In line with this national strategy, a report concerning the construction of China's first FTZ in Shanghai was submitted to the regulatory authorities and attracted great attention in 2011 (China Daily, 2011). The State Council official approved to establish the China (Shanghai) Pilot Free Trade Zone in August 2013, the Shanghai Pilot FTZ will first span 28.78 square kilometres in the city's Pudong New Area, including Waigaoqiao Free Trade Zone, Waigaoqiao Bonded

Hong Kong and were required to remit the proceeds from such issues back to China. In May 2012, the NDRC published the *Circular on the Matters relating to the Issuance of RMB Bonds in Hong Kong by Onshore Non-Financial Institutions*. Non-financial institutions in China are formally permitted to issue RMB bonds in Hong Kong.

⁵⁸ The Official Reply, section 2.4.

⁵⁹ The original Domestic Institutional Investor (QDII) scheme was launched in May 2006, allowing licensed domestic institutional investors to invest in overseas markets. In 2012, the Mainland authorities said they planned to introduce a Domestic Individual Investor (QDII2) scheme to allow some individual investors to trade directly in Hong Kong securities, but that scheme has yet to materialise as of 2014. See South China Morning Post (2013).

⁶⁰ As of 2014, officials acknowledge there have been problems with transportation, land reform, and cross-border management. International companies are still trading in temporary two-story and three-story buildings as opposed to high-rise office blocks, as originally envisaged. See China Daily (2014).

⁶¹ The *Opinions of the State Council on Promoting the Development of Shanghai's Modern Service Industry and Advanced Manufacturing Industry, and Promoting the Construction of Shanghai International Financial Centre and International Shipping Centre* were issued on 14 April 2009.

Logistics Park, Pudong International Free Trade Zone and Yangshan Free Trade Port Area. The zone was officially launched on 29 September 2013.

Indeed, after his appointment as General Secretary of the Chinese Communist Party in March 2012, Xi Jinping chose Shenzhen as the destination for his first inspection tour. Shenzhen is symbolic in a sense that it is one of the first SEZs and one of the significant stops on Deng Xiaoping's 'Southern Tour' in 1992. Xi's visit signalled his approval of historical reform models and his decision to use the Shanghai FTZ as a testing ground for economic reform echoes Deng's use of similarly purposed SEZs (American Chamber of Commerce in Shanghai, 2013: 26).

Right before its official launch, the *Framework Plan for the China (Shanghai) Pilot Free Trade Zone* ('Framework Plan' hereinafter) was issued to outline the first batch of initiatives that set the tone and scale of the FTZ.⁶² The Framework Plan first affirmed 'socialism with Chinese characteristics' to promote reform and development by opening up the economy. Other than Deng Xiaoping Theory, Jiang Zemin's 'Three Represents' and Hu Jintao's 'Scientific Outlook on Development', Xi Jinping's 'China Dream' was formally recognised in the plan.⁶³ The vision is, the FTZ will be developed into a zone with convenient investment and trading procedure, full convertibility of currencies, effective and efficient goods supervision, and investor-friendly regulatory environment. To achieve the aim, a list of tasks and measures was set out. For example, to transform government functions, administration transparency and information disclosure mechanisms would be enhanced.⁶⁴

As for trade in services and goods, various measures are also in place. Financial services, transportation services, commerce and trade services, professional services, cultural services, and public services sectors are selected to be enlarged and opened, and market access restrictions such as requirements concerning the qualification of investors, limitations on foreign participation, restrictions concerning business scope, etc., will be suspended or cancelled.⁶⁵ The innovation is a 'negative list', a key reform in the zone, which shows sectors where foreign investment is banned or restricted within the zone. There are no restrictions for anything not on the list. In relation to trade in goods, initiatives such as upgrading the international shipping services and developing the joint effect of the Waigaoqiao port, the Yangshan port, and Pudong airport were laid out.⁶⁶ For financial innovation, the aim is to promote RMB capital account convertibility, financial market liberalisation, cross-border use of RMB and a market approach to financial asset pricing.⁶⁷ Favourable legal and tax measures would also be introduced to promote investment and trade, for example,

⁶² The English version of this Framework Plan is available from the official website of the FTZ, available at: <<http://en.shftz.gov.cn/FrameworkPlan.html>>.

⁶³ Framework Plan, section 1.1. The term 'China Dream' was first used by Xi in November 2012. He used the term numerous times in his first address to the nation as head of state on 17 March 2013. See BBC (2013).

⁶⁴ Framework Plan, section 2.1.

⁶⁵ Framework Plan, section 2.2. A detailed list of services sectors to open up is contained in the appendix of the Plan. Market access restrictions will be relaxed in most sectors, except in respect of banks, information and communication services.

⁶⁶ Framework Plan, section 2.3.

⁶⁷ Framework Plan, section 2.4.

adjustments to the laws of business associations involving foreign parties and tax deferral payment on income derived from asset valuation appreciation.⁶⁸

Despite both having a focus on financial liberalization, the scale of reforms and functions of Qianhai and Shanghai FTZ are different in degrees. In contrast to Qianhai, Shanghai FTZ reforms are more comprehensive. In particular, Shanghai FTZ is said to carry on more comprehensive financial reforms while Qianhai focuses on the RMB inflows and outflows in the cross-border context (Wei, 2014: 428). It is worth noting that the Framework Plan merely provides an outline of measures which should be put in place. Detailed regulations and guidelines following the Framework Plan are necessary with respect to the practical implementation issues going forward. In March 2014, Xi Jinping joined a panel discussion by Shanghai lawmakers, where he urged Shanghai to make bold reform moves in the FTZ and come up as early as possible with policies applicable nationwide (China Daily, 2014a). This indicates that, first, Shanghai has yet to come up with a feasible implementation plan for the zone and, second, the zone, if successful, is to be used as a spearhead for sweeping economic reforms nationwide in the future. In relation to the former, the absence of clear-cut policy direction has largely dented investors' confidence in the zone thus far (South China Morning Post, 2014). For example, until March 2014, only 6 percent of businesses registered in the zone were foreign-funded. Uncertainties include the fact that the state has yet to unveil long-awaited guidelines to make RMB convertible in the zone. As of July 2014, ten foreign banks have opened subsidiaries in the zone, but none has obtained a key permit that would allow them to take advantage of the liberalisation offered (South China Morning Post, 2014a). Also, no tax incentives, as promised, have been implemented. As for the plan to use the Shanghai FTZ to spearhead nationwide reforms, in the beginning of 2014, the State Council had given preliminary approval for 12 new FTZs around the nation, including one in Tianjin and another in Guangdong, despite all applications were subsequently frozen in June (South China Morning Post, 2014b). This to a large extent cast doubt on the success of the Shanghai FTZ and therefore the state might have hesitated to take the trial to the next level.

Only until April 2015, the State Council finally decided to announce the policy frameworks for pilot FTZs in Guangdong, Tianjin and Fujian as well as plans to further reform and open up the Shanghai FTZ (Xinhua News, 2015). It is worth noting that Shenzhen falls under the remit of the Guangdong FTZ, together with Guangzhou and Zhuhai. It is expected that the new FTZs are largely based on the model in Shanghai, apart from the fact that each of the new zones has a distinctive geographical focus, the Tianjin FTZ to integrate the northern municipality with Beijing and Hebei Province, the Guangdong FTZ to deepen economic cooperation between the Mainland and the neighbouring special administrative regions of Hong Kong and Macau, and the Fujian FTZ to foster economic cooperation between the Mainland and Taiwan. It will take time to see how these new zones will fare against Shanghai, which is said to enjoy 'the greatest openness' (Xinhua News, 2015a).

⁶⁸ Framework Plan, sections 2.5 and 3.2. Certain administrative examination and approval requirements under *Law of the People's Republic of China on Wholly Foreign Owned Enterprises*, *Law of the People's Republic of China on Sino-Foreign Equity Joint Venture Companies*, and *Law of the People's Republic of China on Sino-Foreign Cooperative Joint Venture Companies* will be temporarily adjusted.

3) Concluding Remarks – the Outlook of Development for Both Cities

Both the SEZs and FTZs are regarded a testing ground for the Chinese government to experiment with policies ahead of significant changes that are expected to be rolled out gradually, but their strategic roles seem to vary (Shen and Vanhullebusch, 2015). In the early days, the main objective of the SEZs was to push for the growth of exports in the region and to develop an outward-oriented economy. In contrast, the plan for the FTZs goes far beyond greater liberalisation of trade and spans across investment and financial services. This view reinforces the findings above that there are hardly any new tricks in fostering trade but rather innovative measures are seen in relation to investments and finance. Whilst a freer Chinese economy will certainly lead to a question of whether Hong Kong's middleman role is sustainable and therefore the city's demise, at least at this stage the Mainland cities are urged to cooperate with Hong Kong. Apart from Qianhai whose official full name 'Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone' explicitly calls for such cooperation, similarly Shanghai has not chosen to do it alone. The recently launched 'Shanghai-Hong Kong Connect' is an example. On 10 April 2014, the Securities and Futures Commission of Hong Kong and the CSRC made a joint announcement regarding the approval for the development of the pilot programme for the establishment of mutual stock market access between Mainland China and Hong Kong. Under the Shanghai-Hong Kong Stock Connect scheme, the Hong Kong and Shanghai Stock Exchanges have established mutual order-routing connectivity and related technical infrastructure to enable investors of their respective market to trade shares listed on the other's market. This arrangement is regarded as an initiative to pave 'the way for further opening up of China's capital account and RMB internationalisation' (Hong Kong Stock Exchange, 2015). However, it is still far from a full integration for both markets.⁶⁹ It is expected that 'Shenzhen-Hong Kong Stock Connect' will be launched in 2016, despite a 2015 start was envisaged originally (Reuters, 2015).

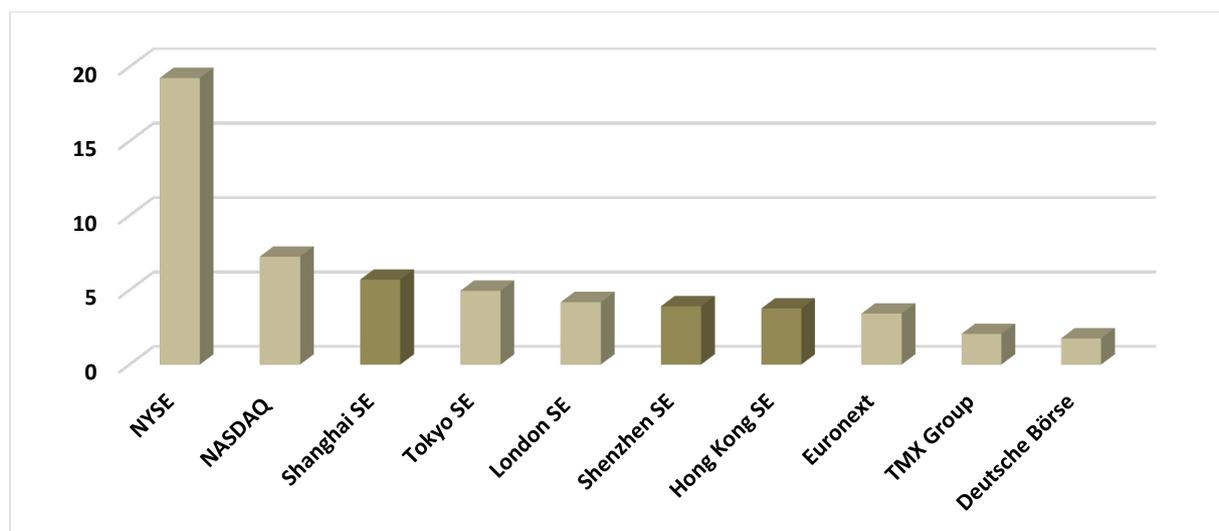
Whilst Huang and Yeung (2014: 189-213) set out a comprehensive historical account and roadmap regarding how the Chinese and Hong Kong stock markets can integrate, they predict that it is too soon to say Shanghai will usurp Hong Kong. Of course, in terms of market size (see Chart 6), it is quite clear that as of 30 June 2015, Shanghai Stock Exchange was the third largest stock exchange in the world (just behind New York Stock Exchange and Nasdaq).⁷⁰ Even the Shenzhen Stock Exchange was bigger than that of Hong Kong. However, there are still various aspects that Shanghai and Shenzhen are no match to Hong Kong, which contribute to the overall competitiveness of a financial centre, as confirmed by the Global Financial Centres Index (see Table 1). Hong Kong is perceived as a world class global

⁶⁹ Whilst all Hong Kong and overseas investors will be allowed to trade the Shanghai Stock Exchange's securities through Shanghai-Hong Kong Stock Connect, only Mainland institutional investors and those individual investors who satisfy the eligibility criteria (i.e. individual investors who hold an aggregate balance of not less than RMB 500,000 in their securities and cash accounts) will be accepted to trade securities in Hong Kong through the scheme. Also, trading under Shanghai-Hong Kong Stock Connect is currently subject to a maximum cross-boundary investment quota (i.e., Aggregate Quota), together with a Daily Quota. For more information regarding the scheme, see Hong Kong Stock Exchange (2015).

⁷⁰ Note the subsequent market crash in July 2015, to be discussed below, which put into doubt the Chinese authorities' ability to regulate a market.

financial centre, comparable to New York and London. For example, ‘Shanghai is unlikely catch up with Hong Kong in terms of international exposure’ (IFC Review, 2010). Shen and Vanhullebusch (2015) believe Shanghai is a ‘main contender’ of Hong Kong, but without free cross-border capital flows, they are not convinced that Shanghai can become a global financial centre. There are apparently still different constrains on the reform and further development of the cities.

Chart 6: Top Ten Exchanges in the World (June 2015) (Market Capitalisation in USD trillion)



Source: World Federation of Exchanges

Table 1: Global Financial Centres Index 2007-2015

	2007	2008	2009	2010	2011	2012	2013	2014	2015
London	1	1	1	=1	1	1	1	2	2
New York	2	2	2	=1	2	2	2	1	1
Hong Kong	3	3	4	3	3	3	3	3	3
Singapore	4	4	3	4	4	4	4	4	4
...
Shanghai	24	31	35	11	5	8	24	20	16
Shenzhen	N/A	N/A	N/A	9	15	32	38	18	22

Note: There were insufficient number of assessments for Shenzhen to be ranked in GFCI in early years.

Source: Global Financial Centres Index (GFCI)

E. Constrains on the Reform and Further Development of the Cities

A common major problem facing the two cities is, local legislators have to draft specific implementation rules to supplement the preferential policies granted to them by the Central

Government, but they dare not face the possibility of contravening the ministries and state regulators in Beijing (South China Morning Post, 2014). As a result, the local legislature is almost powerless to introduce anticipated reforms. Even if some rules are drafted, they contain nothing concrete.

The historical significance of the Third Plenary Session of the 18th CPC in November 2013 was similar to the one of the 11th CPC led by Deng Xiaoping to institute economic reform. The *Decision on Major Issues Concerning Comprehensively Deepening Reform* was adopted which requires reform to be completed by 2020. Undoubtedly, China's economy has never been as open as nowadays. For example, the amendments to Chinese company law in 2013 were intended to reduce the bureaucratic regulation environment with fairer and more transparent processes (Hogan Lovells, 2014).⁷¹

However, pervasive controls remain in key areas. According to the World Bank, the levels of state ownership in the banking sector and government intervention in the financial system are much higher than in other countries at a similar stage of economic development that later achieved high-income status (World Bank, 2013: 115). Its full commitment to market principles is questionable. The state remains sceptical on the full convertibility of RMB. Furthermore, there was a 14-month ban on IPOs in 2012-13, despite a subsequent promise to move from a review and approval system to a registration system for IPOs (Bloomberg, 2013).⁷² The recent stock market crash in 2015 and the resulting governmental interference into the market have even attracted worldwide criticisms.

The Shanghai Stock Exchange Composite Index plunged from its high of 5,166 in 2015 to just about 3,400 over the course of a few short weeks in June and early July, wiping out some USD 3 trillion worth of market value. The Chinese government enacted many unprecedented measures in an attempt to reverse the fall (CNN, 2015). For example, China's Securities Finance Corporation lent RMB 260 billion to 21 brokerage firms so they can purchase shares. Also, half of the companies on the stock exchange were allowed to halt trading in their shares and all new IPOs were suspended. Furthermore, controlling shareholders and board members were prohibited from selling their shareholdings via the secondary market for six months. Arguably, the most radical measure was threatening short sellers with arrest, which has 'raised eyebrows around the world' (Forbes, 2015).

First, as criticised by prominent economists like Paul Krugman and John Cochrane, government intervention in stock markets is unlikely to succeed (Financial Times, 2015). More importantly, the promise for international investors that the Chinese government was on track for overdue economic reforms, has suffered a serious blow (Guardian, 2015).

⁷¹ Major reforms to company registration and supervision were seen.

⁷² In general, there are two main types of systems for listing shares. One is the registration system while the other is the review and approval system. The former is simpler, and is found in the US, the UK, Hong Kong, Australia, Canada, Singapore, Germany and France. As long as the applicant complies with all the prescribed listing requirements, no further procedures are required. In this system, the market is the ultimate decisive factor. By contrast, under the review and approval system, the relevant authority will examine and verify the documents for listing, and if necessary, disallow the company's listing. Therefore, in practice, the authority has the power to decide whether a company can be listed or not. This system is adopted by China, New Zealand, Sweden and Switzerland. See Huang and Yeung (2014: 108).

Considering most of the recent policy initiatives in Shenzhen and Shanghai are financially oriented and outward looking, it seems a genuine and credible commitment from the Chinese regime to reform in wider context are necessary to restore investors' confidence and ensure the long term growth of China as well as the two cities.

F. Conclusion

Having enjoyed a first mover advantage in the economic reform, Shenzhen has been able to develop rapidly and has the highest GDP per capita amongst major Chinese cities. In contrast, despite having some relatively lack-lustre performance from around 1980 to 1990, Shanghai, which had had a long period of glory days before 1949, has been catching up very quickly since its Pudong New Area started to enjoy the preferential policies of other SEZs in the beginning of 1990s. Although strictly speaking the two cities are not in direct competition given their differences in geographical location (one in southern China, another in eastern China) and growth drivers (one more production-oriented, another services-oriented), Shenzhen's Qianhai area has been quickly overshadowed by the Shanghai FTZ since the latter's launch in September 2013. The two zones have a similar focus in finance and face the same hurdles of development stemming from the micro-implementation of the Central Government's vision. Detailed steps to push the reform forward in relation to Qianhai and the Shanghai FTZ were largely delegated to the municipal level, which somewhat hesitated to act. This hesitation was arguably stemming from the Central Government's dubious commitment to reform. Qianhai and the Shanghai FTZ were meant to liberalise the commercial and financial sectors. Yet, the state's conservative attitude and its attempt to lay hands on different aspects of its economy will inevitably undermine the efforts to reform thus far. This was best illustrated by the recent stock market crash and the resulting brutal state intervention in 2015, which could potentially put off foreign investors who are more used to a normal market economy, instead of a 'socialist market economy'. To sustain continued growth in both cities, some deep level comprehensive reforms are equally important, aside from merely offering some piecemeal concessions such as preferential tax rates.

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