QINWEI WANG

FTZ a test ground for reform

The free trade zone (FTZ) set up in Shanghai is expected to be a testing ground for new policies, with focus on liberalizing China's service sector, financial services in particular. Successful innovations will ultimately be rolled out nationwide, but probably only after many years. As such, this is an experiment worth watching but probably not the game-changer some believe it to be.

The imminent establishment of FTZ, covering 29 square kilometers in eastern Shanghai, has been welcomed as an important step forward in China's economic liberalization. The details of how the FTZ to operate remain sketchy and many details will probably remain so for some time. But the overall plan and general rules, which have been released, as well as comments in the official media have given a broad outline of what to expect.

The FTZ amalgamates four existing trade areas in Shanghai that are home to many trading companies. The key new development will be wide-ranging liberalization of the zone's service sector, including opening it up to foreign companies. This focus on liberalization of services marks a key difference with the special economic zones (SEZs) set up in the 1980s, which targeted manufacturing.

Three sets of reforms have been proposed. First is the lifting of controls on investment in service sectors, including healthcare, education, shipping and other business services in the FTZ. Across China, these sectors remain dominated by State-owned enterprises and are largely protected from foreign competition.

Second, financial services will be covered by the reform. According to the plan, the government will consider to ease capital controls on companies operating in the FTZ (allowing renminbi convertibility and access to global financial markets), to remove restrictions on bank interest rates, and to allow both domestic and foreign banks to offer a broader range of financial services. Further details are still missing.

And third, the government's role in administering the FTZ will be curtailed. For example, all forms of investment will be allowed unless explicitly prohibited by the "negative list". This would be far less restrictive than the usual practice of limiting investment to areas that have explicitly been permitted.

This is the latest effort of the new leadership to promote the role of the service sector, which has remained relatively small given the country's level of development. With other cities vying to set up FTZs, the presumption is that successful innovations in Shanghai will then be adopted by FTZs in other cities, and subsequently rolled out across the country. This process, therefore, has the potential to transform China by opening up large parts of the economy to competition and reducing the role of the State.

Several global banks have warmly welcomed the plans. This should be no surprise. For them and other foreign companies, FTZs in Shanghai and hopefully in other cities could offer a bridgehead into markets in China that they have been trying to penetrate.

But there are stumbling blocks that are likely to prevent as rapid a transformation as some commentaries have suggested.

For a start, it looks likely that reform measures will be introduced over a period of years in Shanghai rather than at one go. One reason for that is that officials will want to avoid the instability that could follow a "big-bang" approach. Besides, simply reaching an agreement on how to proceed will prove difficult given the various ministries, regulators and levels of government involved.

The slow take-up of the property tax, still being tried out on only a limited scale in just two cities, is a reminder that pilot reforms can fall by the wayside when key interest groups don't agree on how to proceed.

Perhaps the most important difficulty for the FTZ's architects is the challenge of experimenting with new models on a meaningful scale while also containing their impact. It looks much more difficult than it is for traditional SEZs focusing on the manufacturing sector.

Proposals to loosen capital controls, for example, would open massive arbitrage opportunities for companies able to shift money in and out of the zone. There will be regulatory arbitrage too if FTZ-based companies are able to offer services to businesses elsewhere in China. If the zone does embrace significant liberalization then regulations will have to be put in place to govern transactions with the rest of China, such as quotas for lending from FTZ-based banks. In that case, the benefits will take time to spread.

In sum, the Shanghai FTZ will probably act as a test ground for reforms before they are rolled out elsewhere. In this regard, it is a means to achieving the government's long-stated plan of gradually opening up the service sector and the capital account without in itself accelerating either process. A great deal still remains uncertain. The Third Plenary Session of the 18th Communist Party of China Central Committee, scheduled for November, should provide a clearer picture.

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KEVIN P. GALLAGHER

TPP has inherent financing flaws

Many world leaders who gathered for the Asia-Pacific Economic Conference meetings in Bali, Indonesia, had hoped to sign the Trans-Pacific Partnership Agreement. The pact would have brought together key Pacific Rim countries into a trading bloc that the United States hopes could counter China's growing influence in the region.

But the talks remain stalled. Among the sticking points is the US' insistence on TPP trading partners dismantling regulations for cross-border finance. But many TPP countries will have none of it, and for good reason.

Not only does the US stand on the wrong side of experience and economic theory, it is also pursuing a policy that runs counter to International Monetary Fund guidelines. This is especially noteworthy, because the IMF was considered the handmaiden of the US government in such matters until recent years. Unfortunately, the IMF's newfound independence and insight have not yet rubbed off on the US government.

The surprising development aside, the US could learn a few lessons from the TPP countries when it comes to overseeing cross-border finance. As shown in a new report that I co-authored with Katherine Soverel (of Boston University), Chilean economist Ricardo French-Davis and Malaysian economist Mah-Hui Lim, TPP countries such as Chile and Malaysia — one in the Americas, the other in Asia — regulated cross-border finance in the 1990s to prevent and mitigate severe financial crises.

Their experience proved critical after the 2008 global financial crisis, when a global rethink started to find the extent to which cross-border financial flows should be regulated. Many countries, including Brazil and the Republic of Korea, have built on the example of Chile and Malaysia and re-regulated cross-border finance through instruments such as tax on short-term debts and foreign exchange derivative regulations.

It is only prudent that, after the global financial crisis, emerging market economies want to avail of as many tools as possible to protect themselves from future crises. And new research in economic theory justifies this.

Economists at Peterson Institute for International Economics and Johns Hopkins University have demonstrated how cross-border financial flows generate problems because investors and borrowers do not know (or ignore) the effects their financial decisions have on the financial stability of a given country.

In particular, foreign investors may well push a country into financial difficulties — and even a crisis. Given that constant source of risk, regulating cross-border finance can correct this market failure and also make markets function more efficiently.

This is a key reason why the IMF changed its position on the crucial issue of capital flows; it now recognizes that capital flows create risks — particularly waves of capital inflows followed by sudden stops — which can cause devastating financial instability. To avoid such instability, the IMF now recommends the use of cross-border financial regulations.

I observed this entire process up close when I led a Boston University task force that examined the risks of capital flows between developed and developing countries. Our main focus was on the extent to which the regulation of cross-border finance was compatible with many of the trade and investment treaties across the globe.

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The task force consisted of former and current central bank officials, IMF and World Trade Organization functionaries, members of the Chinese Academy of Social Sciences, scholars, and representatives of civil society. We found that US trade and investment treaties were the ones least compatible with new thinking and policy on regulating global finance. The report was published earlier this year.

US treaties still mandate that all forms of finance move across borders freely and without delay, even though that was a key component in triggering the global financial crisis. Deals like the TPP will only make it worse, because they would allow private investors to directly file claims against governments that regulate them. This would be a significant departure from a WTO-like system where nation-states (that is, the regulators) decide whether claims can be filed.

Therefore, under the so-called investor-state dispute settlement procedure, a few financial companies would have the power to sue others for the cost of financial instability to the public that the companies themselves were instrumental in creating.

Can there be a more pernicious way to deal with these issues? It seems like a repeat of the classic trope, "heads, I win; tails, you lose".

Such provisions also fly in the face of recommendations on investment by a group of 250-odd US and globally renowned economists in 2011. The IMF decided to embrace this new thinking in 2012, saying: "These agreements in many cases do not provide appropriate safeguards or proper sequencing of liberalization, and could thus benefit from reform to include these protections."

If even a traditionally conservative institution like the IMF can get its head around these new realities, why can't the US government?

Until Washington sees more clearly the connection between the problems carelessly created by financial companies, which are often headquartered in the US, and what their actions mean for the economic and social fate of hundreds of millions of people, there can be only one logical consequence. Emerging market economies should refrain from taking on new trade and investment commitments unless they have in place proper cross-border financial regulations.

Leaked text from a TPP document reveals that Chile and other countries have given suggestions that could provide such safeguards. If the US really intends to establish a trans-Pacific partnership, then it should work with Chile and Malaysia to devise an approach that gives all of the potential TPP member countries the tools they need to prevent and mitigate financial crises.

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WANG YIQING

Education key to realizing dream

At the beginning of the new academic year, the percentage of rural students in Peking University's undergraduate courses was 14 percent. It's true that the ratio of rural students in institutions of Peking University has increased by 2-3 percent over the past two years. But it's also true that the overall percentage is still low.

China has made rapid progress in higher education in recent years. Last year, 9.15 million students took the national college entrance examination, out of which about 6.89 million got admitted to colleges. A large-scale increase in the number of seats in universities and colleges has raised the college admission ratio to 75 percent nationwide, providing greater opportunities to students to get higher education.

Yet not everyone in the country gets equal opportunity to seek quality higher education. In fact, rural students find it even harder to get admitted to one of the top universities.

Liu Yunshan, a research scholar in education in Peking University, has collected the household registration (*hukou*) data of all the students admitted to Peking University from 1978 to 2005. According to Liu, the ratio of rural students enrolled in the university from 1978 to 1998 was about 30 percent. But the ratio began to decline from the mid-1990s and had dropped to about 10 percent a couple of years ago.

A similar trend has been seen in other key universities. Educationist Yang Dongping's research on equality in higher education shows that rural students' ratio in China's key universities has been declining since 1990s. For example, just 17 percent of the freshmen in Tsinghua University in 2010 were from rural areas — the figure was once 50 percent.

The drop in the percentage of students in universities from the countryside has raised public concern, especially because rural residents still form the majority in China despite rapid urbanization and the dramatic rise in urban population. According to the 2010 census, rural residents account for 50.32 percent of the country's population.

Uneven distribution of education resources between rural and urban areas is mainly to blame for fewer rural students clearing the national college entrance exam. Because of limited and even deficient education resources in the countryside, rural students lag behind their urban counterparts in many aspects from the primary to the higher secondary level, and are thus handicapped when it comes to clearing the national college entrance exam. Some of them don't even get the opportunity to take the exam.

Actually, it's not uncommon to see rural students drop out of school and seek work in cities after finishing the nine-year compulsory education. The education resources available to rural education authorities for the mandatory education period are much less than what their urban counterparts get. For instance, Beijing's per capita public expenditure in primary schools in 2011 was 19,894.11 yuan ($3,022), and most of the students in the city were urban *hukou* holders. On the contrary, in Henan province where rural residents constitute the majority of the population, per capita expenditure in public primary school was only 2,736.91 yuan.

Higher education is not the only way to achieve success in life in today's fast-changing society. But it cannot be denied that higher education has helped many people (and will help many others) to realize their dreams. Many studies and experiences from across the world show that a person's education level plays a key role in his/her career development and income. Besides, Chinese people have traditionally regarded education as an effective and promising tool to climb up the social and economic ladder.

Moreover, higher education has a key role to play in realizing the Chinese Dream of rejuvenating the Chinese nation, because it cultivates talents. To realize the Chinese Dream, it is important that our society provides enough opportunities to all talented students, irrespective of whether they are from rural or urban areas, to pursue higher education and rise higher on the academic ladder. If some brilliant rural students are stopped from entering top colleges, it would be a great waste of talent for the country.

Fortunately, the authorities have realized the significance of quality education and implemented measures to change the situation. In 2012, the central government asked key colleges across the country to enroll 10,000 students from rural areas in advance. This year, Premier Li Keqiang further increased the rural students' quota in key universities to 30,000, which has raised the ratio of rural students in top universities such as Peking University. More importantly, it is expected to provide more opportunities for excellent students from the countryside.

But such projects can only temporarily make up for the unbalanced urban-rural education gaps. To strike the right balance in the distribution of education resources between urban and rural areas and provide better opportunities to rural students, education authorities have to make greater efforts to narrow the gap between urban areas and the countryside. This can be done by increasing the expenditure on education in rural areas, especially for the compulsory education period.

The Chinese Dream consists of countless individual dreams, which start from the moment they step into school. After all, guaranteeing everyone equal opportunity to pursue their dreams is what the Chinese Dream is really about.

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