

The Ternary Marginal Extension of China's Free Trade Zone Development

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Abstract: This paper attempts to establish a framework of upgrading mechanism in China's foreign economic opening strategy in order to conclude the new connotation of upgrade for China's foreign economic opening, with the basic starting point of ternary marginal extension on extensive growth, in the perspective of corporate heterogeneity theory. It also involves the new path of the transformation from "quantity" to "quality" regarding the amounts, models and locations of China's foreign trade and investment. At last, this theoretical frame is complemented upon a case study of free trade zone and regional cooperation of Guangdong, Hong Kong and Macao.

Keywords: Free Trade Zone; Integration of Trade and Investment; Ternary Margin

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1. Introduction

At present, there are enormous challenges in our foreign economic opening as a whole. The simplex policy, which leans on stimulation of domestic consumption, will confront periodical institutional resistance. Therefore, it seems to be the most straight and effective path in a long-run perspective by deepening foreign economic opening which will force internal systematic reform to release domestic demands. On Sep. 29th in 2013, the Shanghai Free Trade Zone was set up with a strategic mission of expanding China's foreign economic cooperation and "opening to promote reform". A resolution was officially formed during the 3rd plenary session of the 18th CPC central Committee to accelerate the construction of Free Trade Zone. It was made abundantly clear that, besides the on-going pilot projects, other free trade zones (ports) should also be initiated in places with proper conditions. The resolution, accelerating the development of domestic Free Trade Zone, has long-run and great strategic significance.^[1] According to the nature of establishment of Shanghai Free Trade Zone, the author

believes that the core mission is to force deepening reform and change government functions through opening up. "Opening up" means it should not be limited to only the commitments under WTO, but a wider fields, especially in the service industry (such as finance, medical treatment, education, etc.); "Forcing deepening reform" is the reform and innovations on laws and regulations, system, mechanism forced by opening; "Changing government functions" means that government should undertake its functions on public administration, service and supervision (especially on-site supervision) based on objectives of public policy and enhance its ability of doing that.

With the improvement of China's foreign economic opening, how to use the platform effect of Free Trade Zone? What extension will be explored through Free Trade Zone? The author believes that, with development of Free Trade Zone, it will further stimulate the vitality of production and management of all kinds of corporations and ultimately lead to coordination and unity of development of both domestic and external economy. The author also puts forward that, the establishment of Free Trade

Zones will trigger the shift from internal extensive development to external in China's foreign economic strategy with the effects of free trade, space and network of high-end platform. It is also appeared as the export increase on existing patterns due to the increase of the numbers of corporations with export activities. All these phenomena are collectively known as the effect of expansion of enterprises internalization. In China, especially the coastal area like Guangdong, internal extensive foreign economy development has been playing a major role since the opening policy was initiated 35 years ago. When kinds of disadvantages emerge, the internal extensive export pattern becomes unsustainable. The external extensive pattern will thrust it to a higher top.

There's been a great deal of researches worldwide about the effect and benefit from Free Trade Zones. The author's research indicates that the development of free trade will eventually come to an integration of trade and investment and it will come true through the following three routes :

1) intermediary effect resulted from integration of trade and investment, such as Bernard et al. (2010), Blum et al. (2010), Lu et al. (2010) and Ahn et al. (2010). Data from many countries shows that intermediary trade makes it possible of integration of foreign trade and investment.^[2,3,4]

2) Export platform effect of OFDI (outward foreign direct investment). With a comprehensive consideration on the space effect, market potential and production cost, etc., foreign investment through export platform makes it interacted between foreign trade and investment (Ekholm et al., 2007).^[5,6,7,8]

3) Trade-arising Effect of OFDI. Because there are intermediate trade and circulation-oriented industries, such as wholesales and retails, the trade-arising OFDI may lead to both export and outward investment. For example, Head and Ries (2001) investigate the complementary effect of intermediate trade and investment. Hanson et al.(2001) inspects circulation-oriented outward foreign investment. Krautheim(2009) puts forward the double functions of trade-arising OFDI and Kleinert and Toubal (2010) constitute a trade-arising OFDI model based on the Firm Heterogeneity.^[9,10,11]

Therefore, based on the above research perspective, this paper builds a theoretical framework of the construction of FTA and the increasing the openness of China's opening up. It introduces the free trade zone exogenous space integration variables, and with the corporate heterogeneity theory, it interprets the extensive marginal development of the integration of trade and investment, as well as the dynamic mechanism of stimulating China's opening up.

2. The Theoretical Framework of China's Free Trade Zone Construction and Increasing of the Economy Opening-Up

Based on the theory of firm heterogeneity, from the perspective of the enterprises, there are two important factors to be examined in the process of producing and management, endogenous factors and exogenous factors. Endogenous factors are revealed by the production capacity of enterprises, namely productivity; and external factors are mainly reflected in the cost of production and transportation. The level of productivity is the core variable of the number and mode of production and operation activities and Location expansion, and by the extension of the ternary margin, it will finally improve the competitive advantage of the whole nation. The higher the level of productivity is, the stronger the ability to afford the ternary margin extension will be. But this does not mean that the productivity level is the only factor which determines the ternary marginal extension. Exogenous cost factories also an important factor to determine the ternary marginal expansion of the firm. From the perspective of corporate heterogeneity, the establishment of the free trade zone dedicates to reduce the cost of producing and operating, and through expanding in the amounts, models and location of the enterprises, the overall level of China's opening up has been improved ultimately, and the national competitive advantage is strengthened, and thus the domestic demand is stimulated fully. Therefore, how to realize the extension mechanism of the ternary margin under the condition of free trade zone? Based on these, the author constructs a framework of the construction of the FTA and the ternary marginal theory of the opening up. The theoretical mechanism is shown in Fig1.

First, there is marginal extension of the amount. The construction of the free trade zone will increase our foreign trade and investment significantly, including import, export, FDI and OFDI. The implementation of "negative list approach" and "inside the territory while outside the customs" helps the free trade zone increase its free and efficient management system to an international level, much higher than the level of openness of previous "bonded area". Thus, according to the firm heterogeneity, with the weakening of the role of customs supervision, the cost of the enterprises' overseas economic strategies will be reduced at the utmost extent. And then, it will be easier for the enterprises to conduct foreign trade and investment. Therefore, the free trade zone platform not only encourages more and more Chinese enterprises to invest overseas, but also leads the enterprises which have entered the overseas markets to achieve larger amount and quantity of overseas exports and investment. For foreign-funded en-

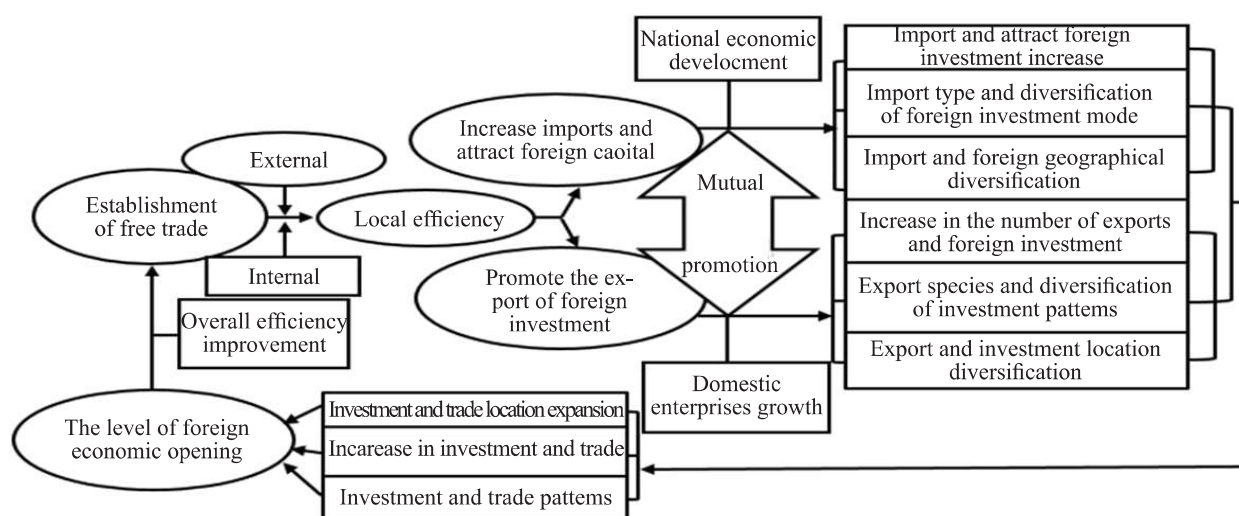


Figure 1. Free Trade Zone Construction and Foreign Economic opening level theoretical framework

terprises, the marginal effects in amount are more obvious. The "Negative List" management model of the free trade zone aims to simplify the administrative examination and approval, improve the efficiency of the government, and reduce the cost of production and operation, as well as absorb more foreign investment. In short, as the effect of the FTA increase by unit, the marginal increase effect in the number of import and export, the absorption of FDI and OFDI will be more obvious.

Second, there is marginal extension of the model. The construction of the free trade zone provides a more convenient service platform for both the domestic and foreign enterprises. For example, the construction of the international trade single window platform and free trade account, as well as the connection of trade and investment platform and financial services platform enable the enterprises to implement a more diversified opening-up strategy. First of all, the firm heterogeneity theory argues that if the threshold of productivity is low, the enterprises preferring to trade overseas before may also conduct their businesses through investment overseas. The establishment of the free trade zone reduces the cost of the trade and investment so extremely that it lower the threshold of productivity for the enterprises to enter the markets. And this creates more opportunities to those enterprises which involves trading activities before, which means they may conduct their businesses overseas through indirect investment and even FDI. The FDI model can be subdivided into three levels. First, the enterprises will invest in those more suitable countries and regions with larger markets, because the productivity thresholds for investing in these countries are relatively low. Second, the pattern of FDI depends on the level of productivity. For enter-

prises conducting FDI activities, those companies with low productivity tend to enter the host market in the form of cross-border mergers and acquisitions, and enterprises with intermediate productivity may enter the host country through joint ventures, and the companies with the highest productivity will choose green land investment in the host country with sole proprietorship. Thirdly, even the host countries' trade and investment environment is relatively poor, those enterprises with the highest productivity will also increase their overseas investment by establishing more branches.

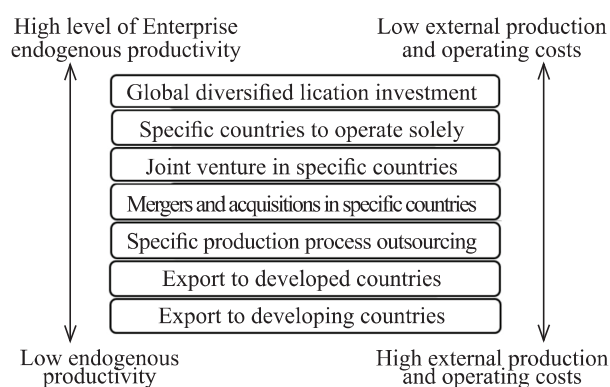


Figure 2. Trade and investment liberalization and enterprise model, location marginal expansion

Third, there is marginal extension of the location. The regional expansion effect of the establishment of the FTA is mainly manifested through the intermediary effect played by the middlemen, which also occurs in both foreign-funded enterprises and Chinese enterprises. On one hand, foreign-funded enterprises have expanded the location choice of the trade and investment to China.

In the free trade zone, due to the development of the logistics network services, especially the large number of distribution and retail brokers, with the help of internet information and big data analytics, the goods from foreign enterprises can be distributed to local demands in different area easily. Furthermore, foreign enterprises make use of their global production and business net, as well as the advantage of China as the core of Asia and treat the Free Trade Zone as a location platform. Through the Free Trade Zone, the production, sales and services are connected and the location diversification of trade and investment is realized, which will bring an obvious effect of development of local demands. On the other hand, Chinese enterprises have more regions to trade and invest abroad. First of all, due to the special arrangement of Free Trade Zone, a close and direct effect of space network has been formed with the other countries in the world. That's to say, since the Free Trade Zone has the function to connect different countries and regions in the world to realize the spillover effect of trade and investment, more co-operations with larger markets has been realized. In the Free Trade Zone, the business network of the larger amount of trade intermediaries have increased the possibility to form a solid business partnership with business organization, Chinese organizations, enterprises alliance abroad, and then the space of foreign trade and investment has been expanded.

3. The Path to Increase the Level of Opening up Strategy: Guangdong Free Trade Zone as an Example

The primary task of Guangdong Free Trade Zone is to incentive the liberalization of service trade among Hong Kong, Macau and Guangdong, so that the facilitation and integration of trade and investment should be realized and a new strategic platform of Guangdong's foreign economic opening up should be formed through the Free Trade Zone. In the Free Trade Zone, Nansha District has an advantage of developing the integration of trade, investment and logistics because of its large area. Hengqin will focus on service trade, while Qianhai will co-operate more with Hong Kong in finance. As a whole, all of these three areas have their own foundation and advantages to become part of Guangdong Free Trade Zone. For many years, Hong Kong has always been Mainland's largest service export destination, origins of imported good trade surplus.^① Hong Kong is under a model of "inside the territory while outside the customs" and its "Pre-establishment National Treatment" and "Negative List Approach" may be learned by Guangdong to establish Guangdong Free Trade Zone.^② [15] For Hong Kong and Macau, the deepening development can motivate their development

greatly. For example, the implement of cross-border Renminbi loans significantly strengthen Hong Kong's position as the center of off-shore RMB. Since the implementation of cross-border loans in Qianhai, the amount of off-shore Renminbi in Hong Kong has increased from 6200yi dollars to 8200yi dollars.^③ Nowadays, the industry preferential catalogue in Qianhai has been approved by the State Council. Some of the policies are more favorable than Shanghai Free Trade Zone, including the policies of corporate income tax and the individual income tax which are managed referring to the standards in Hong Kong and Macau. With the implementation of relative arrangement, the relationship between Guangdong and Hong Kong and Macau will be closer.

The trade and investment liberalization effects achieved through the establishment of the Guangdong-Hong Kong-Macao Free Trade Zone have achieved differences in trade and investment patterns at the enterprise level, while at the industrial and national levels, the integration of trade and investment has been achieved. At the same time, since the trade in services in the FTA will occupy an increasingly high proportion, and WTO regards service trade as FDI, from this perspective, the liberalization of trade and investment in Guangdong, Hong Kong and Macao has realized the integration of trade and investment integration ultimately. The liberalization effects played by Guangdong Free Trade Zone will lead to huge differences among heterogeneous firms. Generally speaking, through the play of the three places of trade and investment liberalization effect, the construction of Guangdong free trade zone can produce four effects, namely, self-selection effect of the enterprises, learning effect, spillover effect and merger effect (see Figure 3). Through the mechanism of these four levels, the ternary margin extension of the amount, model and location will be achieved in the free trade zone.

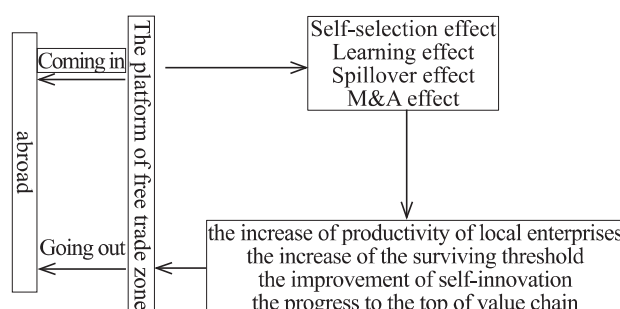


Figure 3. The extension effect of the liberalization of trade and investment

First, there is the self-selection effect. The first change comes from the double increase in imports and amount of foreign enterprises. While domestic enterprises with low

productivity may withdraw from the market, and those with high productivity will continue their producing and operating. Thus, both the import and amount of foreign enterprises have increased which leads to the increase in the threshold of productivity for our enterprises. Second, there is the learning effect. The second change is based on the impact of foreign advanced production management technology on domestic enterprises. As mentioned earlier, companies that can continue to produce and operate have always been those with a high level of productivity. While some of these enterprises import foreign products with higher levels of productivity. And some of the new imported enterprises may significantly improve the productivity. Third, there is the spillover effect. The spillover effect is based on the intangible influence of the existence of the outstanding foreign enterprises on the domestic enterprises and it increases the productivity of the domestic enterprises. In particular, these factors, such as the development of human resources, the origin of transnational corporations, the FDI model (export-oriented or market-oriented), and the absorptive capacity of domestic enterprises have a great influence on the spillover effect. Finally, the M&A effect. The mergers and acquisitions effect should be based on the M&A of the mainland enterprises from the foreign companies. When foreign-funded enterprises enter the domestic market, through the merger with domestic enterprises, the productivity of the merged domestic enterprises will be increased. If the foreign mergers are from developed countries, or if the merged domestic enterprises have a moderate level of productivity, the increase of productivity is more obvious.

3.1 The Amount Marginal Extension Effect of the Construction of Guangdong Free Trade Zone

The amount marginal extension effect of the construction of Guangdong Free Trade Zone is shown from the increasing amount of both Chinese-funded multinational enterprises and foreign enterprises in the Pearl River Delta. With the development of the integration of trade and investment, the basis of international labor division has been transformed from comparative advantage to the competitive advantage arising from the amount of MNEs and the ability to integrate resources in the international context. The establishment of Guangdong Free Trade Zone enables some outstanding Chinese enterprises explore the international market with the help of Guangdong Free Trade Zone as a platform and helps our enterprises "going out". In addition, after the establishment of Guangdong Free Trade Zone, many outstanding MNEs enter the Chinese market, and fierce competition will force Chinese enterprises to improve technological innovation, which will improve the capacity of the enterprises to develop

overseas markets, and thus the amount of Chinese MNEs abroad will be increased.

Taking Qianhai as an example, the establishment of Guangdong Free Trade Zone also promotes the "coming in" of foreign MNEs. Till Jan.2014, 2642 enterprises invested in Qianhai, and the amount of registered enterprises has surpassed 11 times of the total cumulative amount in the past. Among which, the amount of financing companies increases obviously and accounts for 70% of total and more new types of financing business have appeared, such as internet finance, factoring, factor trading market, public funds subsidiaries, microfinance companies, and so on. It is shown that from 2012 on, nearly one quarter of funds companies approved by China Securities Regulatory Commission have come into Qianhai, and one third of the subsidiaries in funds and futures industries have been active to enter too. At the same time, due to the reform of the commercial registration system since 2012 in Hengqin, there are more than 3000 enterprises registered in Hengqin and The amount of the enterprises increases at a rate of 8% per day. At present, there are more than 100 Hong Kong and Macau enterprises. Guangdong Free Trade Zone will be more open than Qianhai and Hengqin, and it can be expected that more MNEs will be attracted here.

3.2 The Marginal Extension Effect of the Model of Constructing Guangdong Free Trade Zone

Guangdong Free Trade Zone has facilitated the trade and investment, and with the reduction of producing and operating costs in the Free Trade Zone, the enterprises may carry out overseas strategies through diversified integration of trade and investment. For example, to foreign enterprises which invest in the Free Trade Zone, they may set a branch or subsidiary, and export their commodities to the other areas or provinces in Mainland. More than that, the location effect of Free Trade Zone to overseas may be played, and more flexible and complicated investing models based on trade-platform may be put into effect. The enterprises may make use of the Free Trade Zone to build a closer business network with the other countries or areas.^[18] What's more, Mainland enterprises may take the advantage of the efficient and transparent platform of Guangdong Free Trade Zone and set subsidiaries or branches abroad to invest overseas based on Trade-arising Effect. Thus, there will be more spaces for Mainland enterprises to distribute and trade overseas and play the integration effect of foreign trade and investment.

Further, considering the favorable condition of locating near Hong Kong and Macau, Guangdong Free Trade Zone may innovate the co-operation model between Mainland and Hong Kong and Macau. Taking finance innovation as

an example, through the innovation of cross-board CNY business in the Free Trade Zone, RMB offshore market in Hong Kong will interact well with RMB in-shore market in Mainland, and this will benefit the effective circulating of a large amount of RMB stock in Hong Kong, and then guide the off-shore capital to support the development of economy in Guangdong Hong Kong and Macau. And this will have profound influence on Hong Kong to build a more effective and diversified cross-board trading settlement platform, and will develop Hong Kong's comprehensive business model of trade and finance. For instance, through the innovation of RMB investment products in Hong Kong and the guidance of the circulation mechanism, there will be more diversified RMB circulating channels in Mainland, through which, the enterprises and individuals may carry out M&A, greenfield investment and security investment, etc., so as to realize diversified overseas investment strategies.

3.3 The location extension effect of constructing Guangdong Free Trade Zone

As for the location extension effect of constructing Guangdong Free Trade Zone, with the integration of international trade and investment, on one hand, since the barrier of factor movement is lowered, Mainland China will attract more foreign MNEs to enter China to get more profits because of its comparative advantages in endowment. Foreign MNEs set up new companies in Mainland with direct investment and make use of our superior resources to incentive the MNEs to realize location expansion in Mainland. If Guangdong can take advantage of its bordering on Hong Kong and Macau and further explore and innovate new ways and models to co-operate with Hong Kong and Macau, the enterprises in Hong Kong and Macau will invest more to Mainland to explore more investment region in Mainland and this will incentive the development in Mainland after the completion of Guangdong Free Trade Zone. The location extension of Guangdong Free Trade Zone enables the foreign enterprises expand their investment location in China. Making the Free Trade Zone as a platform, the enterprises may realize their diversified choices in location.

On the other hand, with the Free Trade Zone, Mainland enterprises may explore more trading and investing spaces in a more free way. Taking Guangdong Free Trade Zone as a platform to link the domestic and overseas countries and areas, Mainland enterprises may expand their foreign investment location to allocate the world resources in a long-term strategic planning, and create their own competitive advantages. With the development of integration of trade and investment, MNEs carry out vertical M&A in an industry chain in the world, and some intra-industry

trade among MNEs may happen within the MNEs. The statistical Bulletin of China's FDI in 2013 published by the Ministry of Commerce has revealed that at the end of 2013, China's stock FDI to Asia and Latin America has reached 432,620,000,000 dollars, which amount to 81.3% of total stock at the end of that year. While China's FDI appeared insufficient in some other areas in the world. The establishment of Guangdong Free Trade Zone will help the growth of China's MNEs, and motivate them to integrate the global resources. With the expansion of FDI location, the space of import and export will be expanded, and the import and export will also be increased. Guangdong Free Trade Zone can not only play the location extension effect, but also it may promote the co-operation of the governments of Guangdong, Hong Kong and Macau. And then, the governments will play a role of intermediaries to provide trade and investment information to the enterprises.

4. Policy support to improve China's open economy with the construction of Free Trade Zone

This paper has constructed a framework of China's open economy base on the Free Trade Zone and it concludes that with the Free Trade Zone our foreign trade and investment amount, models and location may be transformed from "quantity" to "quality", and then the foreign economy will be improved in a whole. Thus, nowadays a number of inland Free Trade Zones have been in vigorous arrangement. Based on the analysis above, from the perspective of the ternary marginal extension, some suggestions are given from the viewpoint of the government, the industry and the enterprise.

For the government, different cities in Guangdong Free Trade Zone should coordinate their laws and regulations and remove the market entrance barriers to incentive the liberalization of investment. Recently, the state council has approved the Preferential Industry Catalogue of Qianhai, including the policies of enterprise income tax and individual income tax. The latter may be managed referring to Hong Kong and Macau and this will incentive some Hong Kong businesses to invest in Mainland. This should be popularized also in Hengqin, Nansha, Baiyun Airport and some other areas in Guangdong Free Trade Zone. Furthermore, cities in the Pearl River Delta should cooperate more and avoid local protectionism. They may make the city's industrial development plan jointly and develop their own competitive industries so as to realize a coordinated development. For Guangdong Free Trade Zone, the construction of "platform economy" should be put emphasis on. The government should make use of the radiating and diffusion effects of the Free Trade Zone to

drive the economic development in Pearl River Delta. At the same time, the government should provide efficient, transparent and clean administrative services. From the experience in Qianhai, part of the provincial management authority should be decentralized to the Free Trade Zone, so that the efficiency of project approval should be improved. From the experience of Hengqin, the commercial registration system should be reformed in the Free Trade Zone to improve the registration efficiency for the business. In the Free Trade Zone, the protection of intellectual property rights should be strengthened. Nowadays, domestic intellectual property protection is not enough, and the incentive for innovative talent is also not enough and this is one of the reasons for the lack of innovation talents in China. In addition, learning from the "negative list approach" of Shanghai Free Trade Zone, Guangdong Free Trade Zone should also fully consider the achievement from the development of service trade liberalization with Hong Kong and Macau and simplify the negative list.

For the industry, the development of finance, trade services, shipping and logistics industry, as well as some other productive services should be the focus. Industry preferential catalogue should be made to encourage their development. The government should encourage the development of the finance and leasing industry, through some measurements, such as abolishing the minimum registered capital limit of the financing and leasing companies, giving them some tax preferential policies and relaxing the business scope of the financing and leasing businesses. Thus their function to serve the real economy should be played. In order to improve the opening lever of finance industry in the Free Trade Zone, the cross-board RMB business should be tried first to join the finance with the real economy, so as to incentive finance to serve for the economy. Also, the industry entry should be relaxed, so that the development of the Mainland's service industry should be promoted by Hong Kong's advanced service industry. In addition, industry environmental protection standards should be made to create a livable environment for the people.

For the enterprises, they should improve their ability to innovate independently and enhance their international competitiveness. The cooperation with universities and institution may also incentive the integration of production, education and research. And the introduction of high-level innovation talents may help to upgrade the enterprises' technological innovation. Also, the enterprises should develop in some high value-added industries and put more funds in R&D to get the independent intellectual property rights and arrive at the top of the industry chain, to obtain more profits. Finally, with the Free Trade Zone Chinese

enterprises layout a global industry chain, and integrate cheap resources and make use of other countries' comparative advantages, so as to realize the vertical integration of industry chain.

5. Conclusion

Above all, the ternary extension of amount, models and location of the Free Trade Zone has further deepened the integration of China's foreign trade and investment. The optimization of China's foreign economic structure has been realized and the level of the strategy of opening up has been promoted. At the same time, through competitive effect of foreign enterprises in China and the learning effect of Chinese enterprises overseas, the productivity of Chinese enterprises has been increased further, and the national competitive advantage has been further highlighted. While accelerating the construction of the platform of the Free Trade Zone, governments at all levels can guide their own enterprises to make their own decisions according to different situations (i.e. model marginal extension) and local conditions (i.e. location marginal extension). The enterprises should combine their international strategies and their own competitiveness, as well as the external environment to express the ternary marginal extension effects of the Free Trade Zone, and ultimately the overall level of opening up of China's economy will be improved to realize the international participation of more enterprises (i.e. the amount marginal extension).

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Annotation

- ① Data from the General Administration of Customs of the People's Republic of China reveals that the import and export in China in Feb. 2014 amounts to 260.4 billion dollars with an increase of 29.4% year over year. Among which, the export is 114.5 billion dollars with an increase rate of 18.4%, and the import is 145.9 billion dollars with an increase rate of 39.6%. While in Jan. 2014, the import decreases 15.3%. In Feb. 2015, there is a deficit of 31.5 billion dollars in China's global trade and in January, the surplus is 27.3 billion dollars, which is the largest monthly trade deficit since 1990s. And this shows the importance of China's trade surplus to Hong Kong.
- ② "Pre-establishment National Treatment's to provide national treatment for foreign capital during the entry stage, which means the capital importing country should provide foreign capital treatment that is no less than domestic capital in the pre-establishment stage. "Negative List Approach" identifies sectors and businesses that are off-limits or restricted for investment. All fields not on the negative list are accessible to foreign capital without governmental approval.
- ③ Nowadays, in China the benchmark interest rate of loans per year is 6% and the rate may float upwards or downwards according to the enterprises' credit rating. Taking a multi-national company with powerful financial strength as example, the rate may float downwards 10% to 5.4% approximately. While, in Hong Kong the on-shore market rate may be 4% or so with a comparative advantage in financing.