

# Financial Reform in the Shanghai Pilot Free Trade Zone: Review and Outlook

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As the first free trade zone in China, the Shanghai Pilot Free Trade Zone (SHFTZ) has implemented a series of reform and opening-up measures in many areas such as trade, investment and government function transformation. Of these measures, financial reform has also been an important part. Over the past five years, the People's Bank of China (PBC) and other financial regulators have strongly supported the building of the SHFTZ by launching the free trade account system and pushing ahead with financial reform and opening up focused on marketization and

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internationalization. With a series of financial innovations being replicated and applied nationwide or in other free trade zones, the role of Shanghai has been brought into full play as a pioneer and testing ground for financial reform in China. In November 2018, President Xi Jinping announced at the first China International Import Expo that the SHFTZ would be expanded to include a new area. This symbolizes a new historical starting point for SHFTZ development and will surely bring financial reform in the SHFTZ to a new stage.

## **Establishing a free trade account system and promoting financial reform and opening up focused on marketization and internationalization**

Following the launch of the SHFTZ in September 2013, the State Council issued successively, in September 2013, April 2015, and March 2017, plans for SHFTZ development, all of which set forth requirements for financial reform and opening up.

First, an integrated RMB and foreign currency free trade account system that can help prevent financial risks and facilitate cross-border financial activities was established as a safe "regulatory sandbox" for financial reform. Given that the biggest challenge facing financial reform in an unenclosed area is to guard against risks and risk spillovers, the PBC initiated

a free trade account system soon after the launch of the SHFTZ. This system provides conditions for electronic fence-like interim and ex post management that features prudential supervision on the first line and limited infiltration on the second line so that financial risks can be effectively isolated, monitored and managed. In recognition of its functions in preventing risks and offering convenience, central government leaders have required that the system be introduced to qualified places in due course. Having been promoted in Shanghai among science and technology innovation enterprises and other eligible enterprises where it is needed, the free trade account system will be replicated and introduced in Hainan with the PBC's approval.

Second, with market-oriented reform making new breakthroughs, the decisive role of the market in resource allocation has been brought into full play. A self-regulatory pricing mechanism for market interest rates was set up, and the SHFTZ led the country in achieving market-oriented interest rates on foreign currency deposits; with the pilot issuance of cross-border interbank certificates of deposit in the SHFTZ, the interest rate pricing mechanism was improved and financing channels were broadened for banks in the zone. The pilot program of integrated RMB and foreign currency overseas financing based on the mechanism of capital restraint and

macroprudential management made it possible for enterprises and financial institutions in the SHFTZ to access more financing channels by conducting cross-border RMB and foreign currency financing at their discretion without having to get administrative approval. Strong measures were taken to streamline financial administrative procedures and delegate power. Some of the entry requirements for banks and insurance institutions in the SHFTZ were removed, so were the administrative approval procedures for incoming senior executives. As reviews and approvals in foreign exchange administration were cut or simplified, the SHFTZ took the lead in launching the pilot program of self-regulatory management of foreign debt proportions, and that of discretionary conversion of foreign currency capital and foreign debt into the RMB. Controls were eased on foreign claims and liabilities management, and eligible leasing companies were allowed to collect rentals in foreign currencies. These measures, which better enable economic entities to fully capitalize on domestic and international markets as well as their resources, have significantly brought down currency conversion costs and financing costs.

Third, internationalization has been making progress and financial opening up has picked up pace. The lack of internationalization is a noted weakness in the building of Shanghai

into an international financial center. To overcome this weakness, financial reform in the SHFTZ has been focused on capital account convertibility, opening up of financial market, and RMB internationalization. Efforts were made to internationalize financial asset trading platforms by launching the Shanghai Gold Exchange international board and the RMB-denominated “Shanghai gold” so that China has gained more say in gold pricing in the international market. Work was done to support the successful launch of the Shanghai–Hong Kong Stock Connect and Bond Connect. The Shanghai International Energy Exchange was established and RMB-denominated crude oil futures were launched. The China Europe International Exchange was set up as a joint venture. The Shanghai Insurance Exchange, Shanghai Commercial Paper Exchange, and a national institution for trust product registration were set up. Central counterparty clearing services were introduced for foreign exchange options trading in the over-the-counter market. A filing-based system has replaced the approval-based system for investment in the interbank bond market by overseas investors, with filing procedures continuing to be simplified; bond holdings of overseas investors such as foreign central banks and the issuance of panda bonds by overseas entities have been both on the rise. Overseas

clearing banks have participated in interbank lending transactions, and eligible foreign institutions have been allowed into the interbank foreign exchange market. Work was done to further facilitate cross-border securities investment and reform the system of qualified foreign institutional investors. Steady steps were taken to promote innovations such as overseas RMB borrowing, two-way cross-border RMB cash pooling, and RMB-denominated SDR bonds. With the first and second generations of the Cross-Border Interbank Payment System put into operation, the RMB cross-border payment and settlement network saw further improvement. These reform measures have contributed to the rising participation of more and more overseas investors and enhanced the influence of China’s financial markets, which is conducive to the establishment of globally recognized market pricing power as well as the advancement of RMB internationalization.

Fourth, with SHFTZ development closely aligned with support for national strategies, the radiant effect of SHFTZ financial reform has been rising. SHFTZ financial reform is essentially characterized by its intensive interconnection with the building of Shanghai into five centers such as the international financial center and the science and technology innovation center, and with support for national strategies such as the Belt and Road

Initiative (BRI). Regarding services for science and technology innovation enterprises, entities that can open free trade accounts have been expanded to include all the science and technology innovation enterprises and eligible individuals in Shanghai; the pilot program interconnecting investment and loan has led to the rapid growth of lending to science and technology innovation enterprises. With regard to support for the BRI, efforts have been made to improve the currency exchange, cross-border investment and finance, and other financial services of Belt and Road partner country. So far, 34 currencies of Belt and Road partner countries have been listed for trading. Cash pooling has played a part in facilitating cross-border settlement, investment and financing by enterprises going abroad under the BRI. Work was done to support the issuance of panda bonds worth RMB11.7 billion by seven governments and enterprises. An RMB-denominated gold futures contract settled on the Shanghai gold benchmark price was listed on the Dubai Gold & Commodities Exchange so that the international influence of the “Shanghai gold” was enhanced. Due to SHFTZ financial reform in some key fields, Shanghai has become one of the cities in the world with the most diversified financial markets and a financial center widely recognized both at home and abroad, with its global influence starting to show and world

rankings on the rise.

Financial reform in the SHFTZ has facilitated investment and trade, sped up the development of Shanghai as an international financial center, and played an important role in supporting national strategies such as the BRI and the building of Shanghai into a science and technology innovation center. Over 30 financial systems pioneered in the SHFTZ have been replicated and expanded nationwide or to other pilot free trade zones, fully demonstrating its role as a vanguard in China’s reform and opening up. At the same time, due to financial market volatilities, exchange rate fluctuations and other factors, some reform measures already decided on have not been fully implemented so as to fall short of the demands of the central government such as freedom of currency exchange, and call for more work to do in the future.

**Standing at a new starting point for SHFTZ development and promoting financial reform in key fields by giving priority to free fund flow**

In early November 2018, President Xi Jinping inspected Shanghai and attended the first China International Import Expo. During his inspection tour, he stressed that Shanghai plays a vital role in the overall deployments of the Party and of the country, that for work to be done effectively in

Shanghai, big-picture thinking and a holistic approach are necessary, and that Shanghai should achieve its own development while serving the country. He also entrusted Shanghai with three major tasks, i.e., expanding the SHFTZ to include a new area, launching a science and technology innovation board with a pilot registration-based system on the Shanghai Stock Exchange, and carrying out integrated development of the Yangtze River Delta region.

The inclusion of a new area stands for a new historical starting point for SHFTZ development. The orientation of the new area requires both top-level designs by the central government and active explorations from all sides. Preliminary ideas are that some opening-up policies and rules for exploration of differentiation, which are not applicable in other places for lack of conditions may be launched in the new area to give rise to a special economic function zone with greater influence and competitiveness in the international market. The function zone may be special mainly in the following ways:

First, it will lead economic globalization while its business environment will also take the lead. What we did in the past was to join economic globalization in line with international standards. However, against the current international background of rampant trade

protectionism, we need to understand what the highest standard really means so that the new area will be gradually built into an area with the highest openness to the world, a highland of opening up that will be leading globalization. Meanwhile, we should do our best to lift government controls and reduce government intervention in the market, increase Shanghai's capacity and core competitiveness, cut the institutional costs of transactions, and create a business environment that is most convenient globally.

Second, focus should be shifted from more convenience to more freedom. The focus of SHFTZ development in the past was on facilitating investment, trade and financial activities through transforming government functions and streamlining administration. In the special economic function zone, it is necessary to give more freedom to all types of economic activities and let factors flow as freely as possible, i.e., to achieve freedom in trade, investment, transportation, fund receipt and payment, internet access, and personnel mobility by removing as many hurdles as possible.

Third, replicability will temporarily not be regarded as a goal to pursue, and greater autonomy will be granted to the new area. The building of the new area is a new start of reform, which needs to stimulate people's creativity so as lead the trend, seize

market opportunities, and take risks that no one else dare. In addition, more flexible mechanisms, quicker responses and more efficient decision-making are called for to bring into shape a “Shanghai Plan” with Chinese characteristics. Accordingly, greater autonomy should be granted to the new area so that it can experiment with some reform programs that are temporarily not replicable. For instance, some regulatory exemptions should be considered for the new area; a tax system with international competitiveness can be put into trial practice in Shanghai; and more say can be given to economic entities in choosing the applicable laws and accounting standards.

Fourth, the development of the new area will be interconnected with the integrated development strategy for the Yangtze River Delta region, particularly the building of a demonstration zone. Priority can be given to implementing the reform measures that the central government has already decided on since the 18th National Congress of the Communist Party of China, but are yet to be implemented for various reasons. Hopefully, with breakthroughs and system integration, the new area of the SHFTZ and the demonstration zone for the integrated development of the Yangtze River Delta region will become one of the regions that enjoy the strongest drive and most

substantial benefits in China’s reform and opening up.

### **Making new breakthroughs in financial reform**

Financial reform in the new area of the SHFTZ needs to achieve new breakthrough particularly in the following aspects.

First, new breakthroughs should be made in capital account convertibility, which are the top priority and a challenge as well. For instance, the new area may basically lift capital controls and take the lead in achieving convertibility of the RMB under the capital account. When treated as an offshore area inside the national borders, it may also achieve freedom of fund transfer between the SHFTZ and overseas regions and freedom of currency conversion.

Second, new breakthroughs should be made in financial opening up. This is pivotal to the development of Shanghai as an international financial center, especially to the expansion of its radiant effect and influence. Currently an important time window is right there and will not stay long. For instance, efforts should be made to promote the listing in Shanghai of famous multinational companies or enterprises from Belt and Road partner countries (regions), to develop a global RMB services system in Shanghai, and to encourage more foreign central banks to include the RMB as a reserve

currency.

Third, new breakthroughs should be made in supporting high-quality integration of the Yangtze River Delta region. This is where the new area can be a driving force domestically. For instance, work can be done regarding cross-regional integrated statistics of the financial sector, green finance development, credit system building, and financial risk prevention.

Fourth, new breakthroughs should be made in the building of supporting financial systems. This is an important element and a safeguard as well. Work needs to be done to set up a financial tax system with international competitiveness based on Shanghai's characteristics as an international financial center and launch a pilot program on foreign-related financial tax reform. Entry and exit policies for

overseas financial talents should be eased. Financial laws and regulations, financial market operation rules, accounting and audit, and ratings should be aligned with international standards. Strong support should be provided for the development of service institutions that specialize in accounting and audit, law, credit rating, asset evaluation, investment consulting, and emerging financial areas.

Finally, one thing to note is that as the new area of the SHFTZ is a special economic function zone that implements national strategies, being "new" and "special" is inevitably accompanied by high risks. While the new area itself needs to effectively control and manage risks, more risk tolerance is called for in the top-level design for the new area.

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