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# Research on the Shanghai Free Trade Zones for the Financial Policy Reform, Effects, and Implications

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## Abstract

**Shanghai symbolizes China's economic rise following the implementation of Reform and Opening-up policy, and a series of strategic decisions have been implemented, such as the announcement of the opening of Pudong New Area in 1990 and the establishment of the Shanghai Pilot Free Trade Zone (or the Shanghai FTZ). In 2013, the Shanghai FTZs were officially approved by the State Council and officially established. The Shanghai FTZ is one of the key developments in Shanghai's efforts to become an worldwide economic, financial, trade and shipping center, also known as the "Four-Centers" Initiative, have driven the city in the direction of these four aims and accomplishments. As China's first free trade zone, the Shanghai FTZs have assumed critical functions such as serving as a test site of China's financial reform, fostering institutional innovation, and facilitating foreign trade and investment. This paper focuses on the premise of the government policies, their impact on Shanghai's economic achievements through its tried and tested financial policy reforms, and their implications for China's economic development in the post-epidemic era.**

## Keywords

**The Shanghai Free Trade Zones; Financial Policies; Economic Growth and Globalization; Economic Shock under the Epidemic.**

## 1. Introduction

The Shanghai Pilot Free Zones are located in Pudong New Area, the eastern part of Shanghai. The Shanghai FTZ is the first batch of the only free trade zone in China, covering 8 areas. It includes Shanghai Waigaoqiao Free Trade Zone, Waigaoqiao Free Trade Logistics Park, Yangshan Free Trade Port and Shanghai Pudong Airport Comprehensive Free Trade Zone, Jinqiao Export Processing Zone, Zhangjiang High Tech Park, Lujiazui financial and trade zone and Lingang Special Area of the Shanghai FTZ. [1]

Many factors have contributed to the establishment of this zone, partly due to historical factors, but more so to the level of economic development in Shanghai and the government policies. Shanghai was once the cradle of modern China's financial sector, and Shanghai recovered after the war and political circumstances that led to the reform and opening-up of the city. The Shanghai Pilot Free Trade Zone was formally established at the end of September 2013 as a trial zone for implementing China's national strategy of Reform and Opening-up, particularly in the financial sector.

The Shanghai FTZ is a set of unilateral policy liberalization initiatives with the primary goals of liberalizing capital controls, increasing financial liquidity and facilitating trade. The paper examines the evolution of the Shanghai FTZ since its inception. As an experimental zone for policy exploration, its primary function has not been to merely attract more foreign investment, but rather to innovate and experiment with fiscal and monetary policies.

The implementation of financial reform policies surrounding trade and investment facilitation, the formal operationalization of a risk management system centered on the FT Account and the

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beginning of experimentation with financial reforms to increase capital liquidity and the efficiency of capital account transformation and financial services[2].

The paper assesses the role of the Shanghai FTZ, notably in terms of financial liberalization and policy reform, and its impact on Shanghai's economic growth through data. The Shanghai FTZ focuses mostly on capital deregulation and capital efficiency enhancement. If additional reform policies can be duplicated in other regions of China, this could further improve economic performance in terms of interest rate and exchange rate liberalizations, capital account opening and RMB internationalization, an experience that is especially relevant in the post-epidemic era when economic globalization has suffered setbacks.

### 1.1. The Premise of the Shanghai FTZ

After the termination of the Cultural Revolution, China implemented Economic Reform and Opening-up policy on the national level. China joined the World Trade Organization (WTO) in 2001 and the Regional Comprehensive Economic Partnership (RCEP) in 2020, as the trend of economic globalization, reflecting its growing integration into the world trade market.

The actual use of Foreign Direct Investment (FDI) in China reached RMB 1,149.36 billion in 2021, becoming the greatest recipient of foreign investment in the world. However, due to political and independence considerations, China's financial system and foreign investment restrictions have always been strictly regulated, thus the Shanghai FTZ has become an experimental location for loosening regulations and enhancing financial efficiency.

The Shanghai FTZ are located in the Pudong New Area, which was established in 1990 as part of the reform drive in the city. On the one hand, through opening up to the world's highest and best standards, the development and opening up of Pudong will raise the level of requirements and standards. On the other hand, through opening up, the most advanced and cutting-edge technologies, industries, talents and standards from around the world will be introduced, providing support to achieve high requirements and high standards [3].

The city has a long history of international trade and investment and is currently China’s commercial and financial center. The headquarters of numerous multinational corporations and major banks are located in Shanghai. With a gross domestic product (GDP) of RMB 2,160,212 million in 2013, the year the Shanghai FTZ was established, Shanghai accounts for 0.06% of the country's area but 3.8% of its GDP, meeting the economic requirements for the establishment of the Shanghai FTZ.

## 2. The Economic Effects of the Shanghai FTZ

China has had the fastest economic expansion in human history during the past four decades. Until 2014, its average annual GDP growth was close to an outstanding 10 percent year-on-year. A 40-fold increase in per capita income, from USD155 in 1978 to USD7590 in 2014, helped 700 million people rise above the poverty line. [4]

Nine years have passed since the Shanghai FTZ was established. The Shanghai FTZ has successfully attracted investment and fostered economic growth. In its first three years of operation, the Shanghai FTZ attracted more than 3,700 enterprises and generated more than USD50 billion in investment. The Shanghai FTZ has also contributed to the growth of the city’s economic growth, with the city's GDP increasing 7.4% in 2016. The Shanghai FTZ is a crucial experiment for China and will continue to play a crucial role in the country's economic reform and development.

Since its inception, the Shanghai FTZ has been operating efficiently and growing rapidly. In 2013, the total scale of operation of the Shanghai FTZ's investment enterprises reached RMB 144.24 billion, with a total import and export value of USD113.43 billion and industrial and commercial tax revenue of RMB 47.58 billion. From the beginning of the year to its conclusion,

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the total business income of the Shanghai FTZ was RMB 378 billion, comprised of RMB 326 billion in merchandise sales, RMB 29.5 billion in shipping and logistics services, USD 29.6 billion in total import and export value, and RMB 12.70 billion in total industrial and commercial tax revenue.

31 banks (including 20 foreign banks, 10 Chinese banks and one financial leasing company) set up 34 branches in the Shanghai FTZ with a total capitalization of RMB 120.56 billion by the end of the first quarter of 2014. [5]

## 3. The Reform of Financial Policies

The innovation of the financial system in the Shanghai FTZ is primarily represented in the establishment of financial institutions and markets such as banks, securities, futures, and insurance. These financial institutions and markets have been set up to better meet market demand and to facilitate the investment and trading activities of market participants.

At the same time, the Shanghai FTZ has also set up a financial services platform, which provides market participants with more convenient and complete financial services. The Shanghai FTZ has introduced a number of reform measures to create a more open and business-friendly environment. These measures include simplifying investment procedures, easing restrictions on foreign investment, and facilitating the free flow of capital.

### 3.1. The Financial Environment in the Shanghai FTZ

The Shanghai FTZ has further loosened restrictions on the development of the banking and financial leasing sectors, creating a framework for a freer and more open business environment in accordance with market economy standards.

In the FTZ, qualified foreign financial institutions can set up foreign banks, and other qualified private investors and foreign financial institutions can jointly set up Sino-foreign joint venture banks. In order to integrate into the international trading environment as soon as possible, the FTZ should actively promote a more open and liberal economic policy, attract more foreign banks to establish branches in the FTZ, and significantly increase the frequency of trade between the RMB and major international currencies.[6]

### 3.2. Easing Foreign Exchange Controls

The State Administration of Foreign Exchange (SAFE), China's foreign exchange regulator, took an initial step towards liberalizing the yuan capital account in the zone by easing controls on foreign currency conversions for foreign direct investment (FDI), while attracting multinational corporations to establish foreign exchange asset pools inside the zone. [7]

In accordance with Article VIII of the Agreement of the International Monetary Fund, China has abolished exchange controls on the current account and achieved unfettered convertibility of the RMB on the current account.

However, the capital account has not yet been fully liberalized. In other terms, capital account liberalization is the absence of constraints on cross-border long-term and short-term capital flows, including direct investment, portfolio investment, loans, and foreign currency deposits. In contrast to the current account, the application of exchange controls to the financial balance of payments is left to the discretion of each country, without the involvement of international agreements or the International Monetary Fund.

One way to reduce financial restrictions is to set up a FT account. Enterprises and individuals in the FTZ can freely enter and exit the FTZ and overseas through the free trade account, including RMB and foreign currencies. Foreign investments are facilitated through the Free Trade Accounts. Financial institutions set up separate Free Trade Accounting Units (FTUs), which are created within municipal institutions to separate risks from domestic operations. A free trade account is an account opened in the pilot zone's sub-accounting unit with uniform rules in both domestic and foreign currencies.

FT accounts are multi-currency accounts with a combination of local and foreign currencies, with a single opening and closing account, and are largely convertible.

The RMB account can be linked to a sub-account, which is a multi-level sub-account to achieve a combination of local and foreign currencies. The exchange rate for settlement and sale of foreign exchange in the FT account is applied to the offshore rate, i.e., the RMB exchange rate. Domestic enterprises can make full use of the onshore RMB exchange rate and the offshore RMB exchange rate to seek the best rate. Enterprises can choose the timing of foreign exchange settlement and sale independently according to their own reality and the fluctuation of the international exchange rate market, implying a certain degree of free convertibility. It facilitates the flow of investment and financing between businesses and creates the groundwork for the internationalization of the RMB.

**Table 1.** The main economic indicators of the Shanghai FTZ in 2020

| Indicator | Unit | Value | Year-on year Growth rate (%) |
|---|---|---|---|
| Local general public budget revenue | RMB 100 million | 608.25 | -1.8 |
| Actual capital of FDI | USD 100 million | 84.38 | 10.5 |
| Total social fixed asset investment | RMB 100 million | 1524.88 | 44.8 |
| Total industrial output value | RMB 100 million | 5446.56 | 13.9 |
| Total retailing of social consuming goods | RMB 100 million | 2094.17 | 1.5 |
| Total merchandise sales | RMB 100 million | 45810.17 | -3.3 |
| The number of emerging financial institutions | Number | 997 | 2.8 |

Source: Shanghai Statistical Yearbook

As shown in Table 1, liberalized financial reforms have contributed to the expansion of FDI, which reflects the increase in foreign investment in the FTZ. Through the Shanghai Free Trade Zone, the financial market was able to open up further.

Free trade accounts continued to function, with 132,000 FT accounts opened in total by the end of 2020. The total annual cross-border RMB settlement amounted to RMB 5,431.18 billion, an increase of 4.3% from the previous year and representing 41.4% of the city's total; cross-border RMB offshore borrowings totaled RMB 670 million, a decrease of 84.2% from the previous year, while Shanghai's first single RMB bond for the FTZ was approved for issuance. [8]

### 3.3. The Advent of a Market-based RMB Exchange Rate

The marketisation of the RMB exchange rate primarily entails simplifying the management of foreign currency pools, simplifying the foreign exchange registration procedures for direct investment; reforming the settlement of international trade; and expanding the scope of cross-border use of RMB, with local and foreign currency free trade accounts permitting flexible use of RMB for cross-border transactions.[10]

The implementation of financial reforms in the Shanghai Free Trade Zone has promoted the commoditization of the RMB exchange rate, simplified the foreign exchange pool management model and streamlined foreign exchange registration procedures for direct investment, thereby easing the burden on multinationals and foreign operating institutions in conducting financial transactions in the Free Trade Zone.

The commoditization of interest rates has given commercial banks greater leeway and the right to make business decisions. Fierce competition between sectors in corporate finance transactions and reduced net interest margins have enabled banks to invest more credit in minor enterprises, hence reducing funding costs.

The commoditization of the RMB exchange rate, the reform of the RMB-based international trade settlement method, and the reduction of regulatory criteria for RMB trade settlement, so that RMB can be used for direct foreign exchange clearing. FT accounts in both domestic and foreign currencies offer the flexibility of utilizing RMB for cross-border transactions, which promotes more people to use RMB as a cross-border settlement instrument for business activities.

The financial policy reform has stimulated financial demand and increased the money supply, creating an endogenous interaction mechanism between the internationalization of RMB and the development of offshore canters, and the development of international investment demand has resulted foreign investments, including offshore RMB financial products and FDI in RMB.

## 3.4. Enhancing RMB Internationalization

The internationalization of the RMB requires an appropriate institutional environment and the opening up of the RMB should be able to adapt to the prevailing financial market conditions. As China's financial markets become more closely linked to international financial markets and the impact of China's foreign trade on the world economy becomes more apparent, the limitations of the original foreign exchange management system on China's foreign trade and financial markets become more apparent in the growing financial markets.

In order to limit the impact on the Chinese market, the Shanghai Free Trade Zone has opted for a number of financial reform measures.

The FTZ promotes the development of RMB internationalization in two main ways. One is to strengthen the construction of offshore financial center by expanding the functions and regional space of financial institutions, and the other is to strengthen the construction of RMB market-oriented system by expanding capital account opening and enhancing the space for free floating of interest rates and exchange rates.[9]

The financial liberalization of the Shanghai FTZ will gradually break down international trade barriers and promote the development of RMB international settlement business, which, if accompanied by financial innovation measures to remove its institutional barriers, will facilitate the transformation of RMB from a trade settlement currency to an international investment currency.

The procedures of currency exchange and handling in the zone will be simplified and regulated at will; the reform of the RMB exchange management system aims to liberalize trade in RMB and make it more acceptable, thus creating good conditions for it to become an anchor currency and a reserve currency.

Currently, the Shanghai FTZ allows the opening of a master account for international currency funds and a master account for domestic currency funds, which can be freely transferred in both directions. To encourage multinational companies to use RMB, the reserve for foreign

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currency assets has also been opened. In addition, leasing and guarantee operations in foreign currency and debt securities in foreign currency were also opened up.

## 4. The Implications for the Post-pandemic Era

From late March and early June, Shanghai was under a strict lockdown. From January to May, Shanghai attracted 1,173 foreign direct investment enterprises, down 56.1% compared to the same period last year; the actual amount of FDI in place was USD9.876 billion, down 3.8% compared to the same period last year.

According to the source, the actual amount of FDI in Shanghai from Hong Kong SAR, Singapore and the United States grew at 6.8%, -51.5% and -8.1% respectively.[11]

The epidemic prevention and control resulted a shock to foreign investment and a shock to market confidence, and it is difficult to re-attract the introduction of foreign investment and restore market confidence.

Additionally, geopolitical factors challenge the introduction of foreign investment. While this series of ostensibly global trends in the international risk structure may be ephemeral, the impact on capital flight and lack of market confidence in the post-epidemic era is profound.

The Shanghai FTZ should further reform its financial policies, further liberalize foreign capital flows and implement more policies to attract FDI in the future.

The financial reform of the Shanghai FTZ should continue to accelerate the construction of an international financial trading platform, introduce various financial institutions and investment enterprises, introducing both international and domestic resources into the economy.

On the other hand, the Shanghai FTZ should promote the close integration of finance with manufacturing, technological innovation and international trade, as well as disseminate the experience nationally.

## 5. Conclusion

In summary, the establishment of the Shanghai FTZ is an experimental site for reform in China, and many of the financial policy reforms have had experimental implications. It has assumed the essential role of attracting FDI and promoting the flow of capital as well as the internationalization of the RMB, and in the post-epidemic era it is even more crucial to strengthen the role of the FTZ.

Reforms within the FTZ should be carried out to further reform the financial system in order to advance the development of the FTZ, thereby providing experience for the reform of China's financial system and contributing to China's economic structure.

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