SHANGHAI PILOT FREE TRADE ZONE: A TEST FOR RENMINBI INTERNATIONALIZATION?

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Abstract

China（Shanghai）Pilot Free Trade Zone (“SHFTZ”) as well as other Pilot Free Trade Zones established in China carries on the mission to make the test for, inter alia, China’s strategic financial reforms and for Renminbi(“RMB”) internationalization in particular. However, the financial reforms in SHFTZ according to its design and relevant provisions can only provide very limited rather than fully effective test for the reforms of free convertibility, international capital transactions as well as risk hedging needed by RMB internationalization. The aim of the paper is to investigate the test effect that SHFTZ have on the above capital account reforms. It argues that the main reason for the test failure lies in “outward free and inward control” mode designed for SHFTZ which makes it an insulated customs territory, a situation which differs from the circumstances in which a currency gets internationalized. Moreover, SHFTZ runs the risk of evolving into an offshore RMB market set up inside China, a trend China should prevent because it cannot serve the testing missions mentioned above.

Keywords: SHFTZ, Financial Reform, RMB Internationalization, Capital Account Liberalization

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1. INTRODUCTION

China has been searching for the establishment of socialist market economy with its own characteristics in the nearly past four decades. In the transition from formerly highly central-planned economy to market economy, China has been pursuing reforms and open polices cautiously by adopting the method of “crossing the river by touching the stone”. Recently, China initiated a new round of reform and opening to implement its important strategies for developing its economy. By its tradition, China adopts Pilot Free Trade Zone (hereafter referred to as PFTZs or PFTZ) programs to test the water before spreading the reforms tested in PFTZs nationwide. Thus reforms in PFTZs offer signals that such reforms are intended to be implemented nationwide in China in the next step.

Since the launching of China (Shanghai) Pilot Free Trade Zone (hereafter referred to as SHFTZ) in September 2013, the next three PFTZs were established in Guangdong, Tianjin and Fujian in March 2015, followed by seven new PFTZs which were approved by the State Council, the central government of China, to be set up in Liaoning, Zhejiang, Henan, Hubei, Chongqing, Sichuan and Shanxi in August 2016. The ten PFTZs established after SHFTZ follow policies and reforms similar to SHFTZ. SHFTZ and other PFTZs in China are different from traditional free trade zones. A traditional free trade zone is usually either a geographic region in a country where goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities(Zhou, Wang, & Ren, 2014), or a region or an arrangement that reduces or eliminates trade barriers between two or more political units while maintaining barriers against imports from outside regions(Jackson, Davey, & Sykes, 2002). But PFTZs in China are reform testing areas implementing policies which differ from other parts within China but outside PFTZs (hereafter mostly referred to as other parts of China) in the fields of international trade, investments, finance and their administration etc.

Although PFTZ program is a comprehensive reform package having various prongs, financial reform test for Renminbi (hereafter referred to as RMB) internationalization, the top national strategy of China, is a very important target. Taking SHFTZ as an example, the *Framework Plan for SHFTZ* (hereafter referred to as *Framework Plan*) issued by the State Council in September 2013 points out that “SHFTZ has the mission to explore new paths and accumulate experiences on deepening reforms and further opening the economy, and is out of the need of national strategies"(State Council, 2013a), and that "SHFTZ should become an experimental field for promoting reforms and raising the level of the opening economy that can be replicated and extended nationwide"(State Council, 2013b). To implement the above strategies, People's Bank of China (China's Central Bank, hereafter referred to as PBOC), upon approval by the State Council, released *Opinions of PBOC on Financial Measures to Support the Construction of SHFTZ* (hereafter referred to as *Financial Measures*) in December, 2013. Two years later, in October 2015, PBOC in conjunction with Ministry of Commerce, Banking Regulatory Commission, Securities Regulatory Commission, Insurance Regulatory Commission, State Administration of Exchange Control and Shanghai Municipal Government, upon approval by the State Council, issued a new plan on financial reform in SHFTZ which is entitled *Plan for Further Promoting Financial Opening and Innovation in SHFTZ and Speeding up Construction of Shanghai International Financial Center* (hereafter referred as *Financial Plan*). Although the *Financial Plan* contains few substantive reform measures except for mostly repeated reform targets or projections, it reaffirmed that SHFTZ should explore new paths, accumulate experiences, make timely conclusions, replicate and extend them to other parts in China to better serve the purpose of nationwide deepening of financial reform and broadening financial openness (People's Bank of China et al., 2015). So PFTZs, different from traditional free trade zones which concentrate on free trade, are designed as the test field for China's nationwide financial and other reforms.

However, the crucial issue is whether PFTZs cast within its current design can provide a really effective test for China's further and overall financial reforms and opening, hence serving nationwide need. This issue matters much in that it determines whether China's important financial reforms in the next step can be tested via their "rehearsal" in PFTZs. In the following, the paper takes SHFTZ, the earliest and most full-fledged PFTZ, as the sample and representative of all PFTZs to try to find whether reform measures tested in SHFTZ can provide an effective capital account liberalization test for RMB internationalization. Besides this part, Part II traces the response of financial reforms in SHFTZ to the need of RMB internationalization, paving the way for the investigation of core issues in the following parts. Then Part III, Part IV and Part V are organized following the main content of both capital account liberalization needed by RMB internationalization and financial reforms in SHFTZ, and examine whether SHFTZ can provide an effective test for free convertibility, capital transactions as well as risk hedging needed by RMB internationalization in turn. On the above basis, Part VI draws the conclusion combined with the warning that SHFTZ may slip into an offshore RMB market inside China due to SHFTZ's status as a segregated customs territory caused by the above testing measures.

2. THE RESPONSES OF FINANCIAL REFORMS IN SHFTZ TO THE NEED OF RMB INTERNATIONALIZATION

It is important to find in the first place for what kind of China's strategic financial reforms that SHFTZ is intended to provide the test before we investigate whether the test is fully effective or not. If the intentions contained in the *Framework Plan,* the *Financial Measures and* the *Financial Plan* mentioned above for establishing SHFTZ are narrowed to financial area, it's easy to conclude that SHFTZ is established to make exploration on financial reform and openness reflecting the demands of China's national financial strategy to be implemented. Then what is such a strategy? There is no doubt that RMB internationalization deserves such a fame since both China's Twelfth Five-Year Plan (2011-2015) and Thirteenth Five-Year Plan (2016-2020) stipulate that China would enlarge the international use of RMB and push forward RMB internationalization (State Council, 2011, 2016). And what's more, RMB internationalization is crucial both to the rising of China as a big power and to global economic and political landscape. Thus RMB internationalization constitutes China's key strategy at which the financial reform test in SHFTZ targets. Whether the reforms in SHFTZ have responded to the need of RMB internationalization depends heavily on their reaction to the barriers confronting RMB internationalization.

2.1 Barriers in Current Development of RMB Internationalization

Currency internationalization is essentially the international extension of the monetary functions of the currency in question. Thus RMB internationalization could be defined as a process and phenomenon that RMB plays its international monetary functions and is used worldwide, serving as unit of account, medium of exchange and store of value (Han, 2016). An international currency manifests its above functions in both private and public sectors, and in both trade and finance. Currently, RMB internationalization confronts legal barriers which may be found in the gradual attenuation pattern in the chain of the pricing and settlement of trade – pricing, settlement of financial transactions – pegged currency, foreign exchange market intervention and foreign reserves in public sector in RMB internationalization (Han, 2016). Table 1 outlines the monetary functions of an international currency and the above attenuation pattern.

Table 1. Performance of International Monetary Functions by RMB

	Private Sector	*Public Sector*
Unit of Account	Trade : Enormous development with government support. Financial Products: limited	Currency pegged by other countries: no. Pricing for international bonds by governments: limited.
Medium of Exchange	Trade and financial transactions: Enormous development of trade settlement with government support, but limited use in financial transactions.	Intervention currency in foreign exchange market: no. Currency swap between governments: much developed. Circulation outside China: in neighboring countries to varying extent.
Store of Value	Cross-border deposits and securities investments: limited.	Foreign reserves held by other countries: limited.

Source: Han (2015).

The above pattern has largely revealed the main barriers of RMB internationalization. In the private sector, the reasons why RMB plays a significant role in the pricing and settlement of trade lie not only in that China has removed legal barriers for the current account transactions, but also in that there was a strong expectation for RMB appreciation in the first few years following the launching of RMB internationalization strategy. So foreign exporters were willing to accept RMB in their trade with their Chinese partners expecting to benefit from RMB appreciation(Han, 2015). In contrast, RMB has a poor performance in the pricing, settlement of financial transactions. The reasons lie in that financial products constitute the main form of wealth for their investors. The willingness of the investors to hold the financial assets in a currency depends, to a large extent, on the liquidity of the financial market of that currency, i.e., capability for the assets to be easily transacted, liquidated and transferred. Because China still imposes capital controls to prohibit free capital flow between domestic and foreign market, foreign capital is deprived of opportunities to make access to China's domestic financial market freely, so is domestic capital for foreign market. In this situation, China has to push forward RMB internationalization mainly by developing offshore RMB market oversea. But, due to the existence of the capital controls, the liquidity of offshore RMB market relies on the amount of offshore RMB other than the liquidity support from PBOC, thus RMB's function as investment currency is restricted(Han, 2015). The poor performance by RMB in financial transactions together with the denial of offshore RMB's access to China's onshore market as well as the liquidity frustration suffered by offshore RMB market points to China's capital controls as the main barrier of RMB internationalization.

In public sector, the reason why RMB performs limited international functions is closely related to its limited use in financial market mentioned above. The less RMB is used in financial transactions, the less motivation the international community has to hold RMB as foreign reserve. RMB's deficiency as a reserve currency in turn makes it difficult for other countries to peg their currencies to RMB, or use RMB to intervene in the foreign exchange markets.

The general survey of RMB internationalization underway clearly demonstrates that capital controls constitute the major barrier for RMB internationalization. Therefore, China needs to reform its capital control system for the sake of RMB internationalization. Without capital account liberalization by which RMB can be converted, transacted and used freely, RMB would lose the basic condition and qualification to be accepted by international community as an international currency. Have reforms in SHFTZ made responses to this main barrier of RMB internationalization？

2.2 The Responses of Financial Reforms in SHFTZ to Capital controls

The *Framework Plan* points out that under proper risk control, SHFTZ may pilot RMB capital account convertibility, interest rate liberalization, and the cross-border use of RMB(State Council, 2013a). Part I of the *Financial Measures* requires SHFTZ to push forward strongly the cross-border use of RMB, capital account convertibility, interest rate liberalization and foreign exchange administration(People's Bank of China, 2013). The *Financial Plan* further states to speed up capital account convertibility, cross-border use of RMB, opening of financial sectors and construction of internationally oriented financial market(People's Bank of China et al., 2015). In the above financial reform measures or policy statement, more cross-border use of RMB could be regarded as the direct declaration of piloting RMB internationalization while capital account convertibility and transactions constitute a prerequisite because RMB cannot be accepted as an international currency if it is not accessible to international community. Capital controls would deny the access by international community to RMB and RMB assets and thus deny the opportunity of RMB internationalization.

As mentioned above, capital controls constitute the main barrier of RMB internationalization. SHFTZ, an experimental field for RMB internationalization strategy, contains measures or policy statement for the liberalization of capital account, thus seemingly responding to the need of RMB internationalization. But what really matters is whether the reforms in SHFTZ can provide an effective test for RMB internationalization. The answer depends on whether the test environment is the same as or comparable to that of RMB internationalization. The following of the paper probes into this issue by unfolding along the two constituent parts of capital account liberalization, i.e. currency convertibility and capital transactions to examine whether relevant reforms in SHFTZ can accommodate the needs of

RMB internationalization. Then, the paper further stretches to financial derivative transactions which, as a part of capital transactions, constitute a prominent content of the *Financial Measures*. Currency convertibility is the precondition for capital transactions including derivative transactions, and thus should be tackled first.

3. CAN SHFTZ PROVIDE AN EFFECTIVE FREE CONVERTIBILITY TEST FOR RMB INTERNATIONALIZATION？

No currency can achieve its internationalization under strict capital controls(Shi & Cheng, 2012). Therefore, it is necessary for China to liberalize its capital account to achieve RMB internationalization. As mentioned above, capital account liberalization first requires removal of convertibility restrictions, otherwise cross-border capital transactions and RMB internationalization are not possible. As shown below, the *Financial Measures* as well as the *Financial Plan* seems to be aware of the barrier of capital account convertibility, but has failed to provide a successful test.

Article 6 of *the Financial Measures* stipulates that RMB and foreign currency in the Free Trade Accounts (hereafter referred to as FTA or FTAs) opened in financial institutions by residents and non-residents in SHFTZ can be exchanged freely when conditions are ready(People's Bank of China, 2013). This provision seems to cast a light on removing the convertibility control under capital account in SHFTZ, but such a light is shadowed by the restriction of "when conditions are ready". The *Financial Measures* does not clarify the criteria for judging "conditions are ready", nor the time when conditions will be ready. Therefore, free convertibility in SHFTZ is still shrouded with uncertainty. Of course, before above-mentioned conditions are clarified, the enterprises in SHFTZ holding FTAs can make use of the provisions in the *Financial Measures* that funds can be freely transferred between FTAs and foreign accounts to evade the above restriction by transferring RMB in FTAs to oversea accounts, exchanging it into other currencies outside China, and then transferring the foreign currencies back into FTAs in SHFTZ. The same applies to foreign currencies which can be transferred oversea and converted into RMB there, and then transferred back to SHFTZ. Only by beating around the bush can the convertibility between RMB and foreign currencies be accomplished. Otherwise, free convertibility is still subject to restriction in SHFTZ. Moreover, the *Financial Measures* further provides that even if conditions are ready, free convertibility shall be confined to FTAs, and be blocked from the other parts of China (People's Bank of China, 2013). This is different from the situation of RMB internationalization in which China will certainly not confine the free convertibility to just one area and China will no longer be segregated into different parts prohibiting capital flows between them. The *Financial Plan* released in 2015 does not make obvious progress in term of free convertibility. It vacuously claims to pilot the capital account convertibility and gradually raise the extent of convertibility in every sector of capital account in SHFTZ, and administer RMB and foreign currencies in FTAs in accordance with the principle of macro-prudential convertibility (People's Bank of China et al., 2015), contributing almost nothing except creating new vagueness such as principle of macro-prudential convertibility etc.

Is the above test capable of accommodating the need of RMB internationalization for free convertibility? According to Krugman, the international structure of exchange depends crucially on transaction costs(Krugman, 1979). Thus, the issuing country wishing its currency to become internationalized should reduce the transaction cost. The lower currency transaction cost is, the more inclined to be internationalized the currency will be. The history of U.S. dollar's internationalization has provided persuasive proof of evidence. Although U.S. GDP and export exceeded those of UK respectively in 1870 and 1912, and became the first economic power and the biggest exporter worldwide, neither did U.S. dollar circulate abroad, nor did it play any international roles in foreign trade at that time(Eichengreen, 2011). An important reason for this is that there were cost disadvantages in trade financing in New York. By contrast, the financial market in London was very liquid with a well-developed population of investors to trade financial instruments like trade acceptances, making liquidity risk and interest rate low(Eichengreen, 2011). To advance U.S. dollar internationalization, the Federal Reserve, established in 1914, instructed its regional branches around the U.S. to purchase trade bills and acceptances to stabilize the market and reduce their discount rate, thereby attracted foreign commercial banks and central banks to invest in them(Eichengreen, 2011). In the 1920s, interest rate that importers and exporters paid in New York was as much as a full percentage point lower than in London, attracting the merchants worldwide to flock to New York(Eichengreen, 2011). So it is the enhancement of liquidity, cost reduction and improvement of efficiency in the U.S. financial market that have contributed to the internationalization of U.S. dollar.

If China desires to internationalize RMB, it should also obey the same law, that is, reducing transaction costs of RMB transactions including the cost of its convertibility. According to the survey conducted by the IMF in its Annual Report on Exchange Arrangements and Exchange Restrictions in recent years, China imposes varying controls on all seven categories of capital account, namely capital and money market instruments, derivative and other instruments, credit operations, direct investments, liquidation of direct investments, real estate transactions and personal capital transactions (IMF, 2012, 2014). Although there is no accurate benchmark for the level of convertibility that accommodates the needs of currency internationalization, yet judging from the world top currency issuer—the U.S. practice, it does not have restrictions on the convertibility between dollar and other currencies though it has two kinds of restrictions on capital transactions as will be discussed in Part 4 of this paper. In contrast, the convertibility restrictions contained in the *Financial Measures* and the *Financial Plan* would obviously render the conversion between RMB and foreign currencies costly and time consuming, which runs counter to the requirement of low converting cost for currency internationalization.

In conclusion, on the one hand, free convertibility is indispensable to RMB internationalization, and for this sake, China should make the test of lifting restrictions to make RMB fully convertible in SHFTZ. But, on the other hand, such a test in SHFTZ is still handicapped with new sets of restrictions mentioned above. The sharp contrast between convertible restrictions existing in SHFTZ and convertible freedom in case of RMB internationalization implies that the convertibility design in SHFTZ cannot provide much valuable experience for establishing a fully convertible system compatible with RMB internationalization in the future.

4. CAN SHFTZ PROVIDE AN EFFECTIVE CAPITAL TRANSACTION TEST FOR RMB INTERNATIONALIZATION?

Apart from convertibility, capital account liberalization also includes opening market for international capital transactions, allowing foreign funds to be invested in domestic financial market and domestic funds invested in foreign financial markets. Currency conversion is a means, making capital transactions including investments and financing is the end. According to the *Financial Measures*, Investments consist of direct and indirect investments. As capital controls make SHFTZ an enclave separated from other parts of china and even the rest of the world, so both direct and indirect investments in SHFTZ are classified as investments made abroad from SHFTZ and from abroad in SHFTZ (hereafter referred to as cross-border investments), and as investments from SHFTZ to other parts of China and from other parts of China to SHFTZ (hereafter referred to as cross-Zone investments). In the same vein, financing is divided into cross-border financing, i.e., financing from/to overseas, and cross-Zone financing, i.e., financing from/to the other parts of China. The following first streamlines and reviews the rules on investments and financing in SHFTZ, then analyzes their test effects on RMB internationalization.

4.1 Rules on Investments and Financing in SHFTZ

Rules on cross-border and cross-Zone investments and financing in SHFTZ can be classified into those for institutions and for individuals respectively.

4.1.1 Institutions

4.1.1.1 Direct and Indirect Investments

a) Direct Investments

Institutions in SHFTZ refer to the China/foreign-invested enterprises, non-bank financial institutions and other economic agents that are registered in SHFTZ. As for cross-border direct investments, institutions in SHFTZ can directly engage in cross-border receipt and payment of funds and currency conversion for such purposes without pre-approval(People's Bank of China, 2013). Judging from the wording such as "cross-border direct investments" and "receipt and payment of funds", this provision covers the direct investments made in SHFTZ from abroad and direct investments made abroad from SHFTZ. The receipt and payment of funds for this type of investments can be directly handled in banks without restrictions such as pre-approval. In addition, as for direct investments made in RMB, Article 8 of the *Financial Measures* provides that financial institutions in Shanghai can directly handle cross-border RMB settlement of such direct investments upon the receipt or payment instructions from institutions and individuals in SHFTZ(People's Bank of China, 2013). Making such investments just by delivering receipt or payment instructions to financial institutions is much more streamlined in comparison with the tedious process in other parts of China. Moreover, according to "Overseas Investment Projects Approval and Record Management Rules" and "Overseas Investment Management Rules" issued respectively by National Development and Reform Commission and by Ministry of Commerce in April 2014, except for sensitive investments made in sensitive countries, regions and industries which are still subject to approval by ministries of the State Council, all investments made abroad from SHFTZ, irrespective of amount, are only subject to filing requirement (Wang, 2016). Thus the direct investments made abroad from SHFTZ as well as direct investments in SHFTZ from abroad have been quite liberalized. Probably for this reason, the *Financial Plan* released in 2015 contains no more reform projection for cross-border direct investments.

As for cross-Zone direct investments, Article 5 the *Financial Measures* provides that funds can be transferred between a resident FTA and other bank settlement accounts held by the same non-financial institution for the purpose of current account transactions, loan repayment, investments in the real economy and other cross-border transactions according to relevant rules(People's Bank of China, 2013). Thus, Article 5 provides a cross-Zone payment channel for direct investments and other purposes mentioned above. On its surface, this facilitation is limited to the same non-financial institutions, it does not extend to cross-Zone fund transfer between different institutions. However, Chinese-invested institutions in SHFTZ can make free investments in other parts of China without the need to resort to SHFTZ. At the same time, China's foreign investment law welcomes the foreign direct investments (hereafter referred to as FDI), and the foreign investors can make such investments in China directly and relatively freely although China has certain FDI restrictions. So the restriction of the above same non-financial institution does not make much sense.

For the above reasons, no essential barriers exist for the cross-border and cross-Zone direct investments, such an investment test is closely as real as needed by RMB internationalization, thus reforms of direct investments in SHFTZ can provide valuable experience for RMB internationalization which requires free direct investments.

b) Indirect Investments

Indirect investments also include cross-border and cross-Zone dimensions. As regards cross-border indirect investments, Article 12 of the *Financial Measures* permits eligible enterprises in the SHFTZ to make overseas securities and derivative investments in conformity with rules(People's Bank of China, 2013). In other words, enterprises in SHFTZ wishing to make the above investments should be eligible and conform to rules. The *Financial Measures* does not clarify what the requirements of eligibility and the rules are. Yet Article 5 of the *Financial Measures* providing that funds can be transferred freely between resident FTAs and non-domestic accounts including oversea accounts casts doubt on the effectiveness of the above restrictions imposed by Article 12. Since funds can be transferred freely between FTAs and oversea accounts, it is actually ineffective to restrict the securities and derivative investments made abroad after the funds are transferred to a foreign jurisdiction. In addition, the *Financial Measures* does not provide whether indirect investments can be made in SHFTZ from abroad. According to the legal doctrine of "permissible unless prohibited", such investments should be permitted. But China observes the contrary tradition of "impermissible unless authorized", thus the answer seems to be the opposite. The *Financial Plan* in 2015 does not make any progress in such investments except that it claims to support the establishment of project companies in SHFTZ to specially engage in the oversea stock investments and support eligible investors to set up funds for overseas stock investments (People's Bank of China et al., 2015), but China still lacks specific measures to put this policy statement into operation.

As regards cross-Zone indirect investments by enterprises in SHFTZ to other parts of China, Article 10 of the *Financial Measures* provides that financial institutions and other enterprises in the SHFTZ can make investments and transactions in the securities and futures markets in Shanghai in accordance with relevant rules(People's Bank of China, 2013), thus opening a channel for inward indirect investments by the above institutions and enterprises. But the channel is only confined to Shanghai and is subject to unclear rules. The progress made by the *Financial Plan* for this matter is to introduce the so called Transaction Platform for International Financial Assets (hereafter referred to as TPIFA) to SFFTZ. The *Financial Plan* does not define TPIFA, but judging from relevant provisions of the *Plan*, it seems that TPIFA is an extension of financial transaction platforms existing in Shanghai to SHFTZ so that economic agents in SHFTZ can participate in the transactions such as foreign exchange, gold, stocks, bonds and funds (People's Bank of China et al., 2015). However, it's not clear whether capital flow between SHFTZ and other parts of China arising from TPIFA transactions is liberalized or not. According to the basic design doctrine of "outward free and inward control" for SHFTZ as well as strict capital controls between SHFTZ and other parts of China, it is most likely that the above capital flow is still blocked, causing the funds participating in TPIFA transactions either to remain in SHFTZ or flow abroad. So, in contrast with direct investments, both the cross-border and cross-Zone indirect investments confront various restrictions and uncertainties in SHFTZ.

4.1.1.2 Financing

As regard to cross-border financing, Article 6 of the *Financial Measures* provides that resident and non-resident FTAs can be used for cross-border financing and guarantee(People's Bank of China, 2013). Residents and non-residents include natural persons, legal persons and other institutions, and cross-border financing includes financing from/to overseas, thus Article 6 leaves the ostensible impression that the restrictions on cross-border financing in SHFTZ have been lifted. It should be noted, however, that although institutions in SHFTZ can borrow RMB and foreign currency-denominated funds from overseas markets, Article 11 of the *Financial Measures* provides that they could do so just for the purpose of satisfying their operational need and in accordance with relevant rules(People's Bank of China, 2013). The delineation of operational need and relevant rules determines the scale of financing from abroad. Furthermore, if we combine the above Article 6 and Article 11 together, the *Financial Measures* could be read as that it restricts institutions in SHFTZ to finance from abroad while liberalizing financing to overseas from SHFTZ because similar restriction on this type of financing cannot be found in Article 11 of the *Financial Measures* or elsewhere. However, this conclusion does not carry much conviction when capital controls still exist in China, so the relationship between Article 6 and Article 11 need further clarification by authorities.

As regard to cross-Zone financing, i.e. financing between SHFTZ and other parts of China, the *Financial Measures* provides that funds can be transferred between a resident FTA and other bank settlement accounts held by the same non-financial institution for the purpose of current account transactions, loan repayment, investments in the real economy and other cross-border transactions according to relevant rules(People's Bank of China, 2013). Funding by a non-financial institution in SHFTZ for its units in other parts of China, or vice versa means that cross-Zone financing is liberalized or restricted within certain scope (confined to the same non-financial institution) and to certain extent (subject to relevant rules of cross-border business). In addition, Article 10 of the *Financial Measures* provides that the overseas parent companies of enterprises located in the SHFTZ may issue RMB-denominated bonds in China's domestic bond market in accordance with relevant rules(People's Bank of China, 2013). Such parent companies, though located overseas, can transfer abroad the funds raised by the above means, then provide the funds to their enterprises in SHFTZ. The *Financial Plan* made a progress by further providing that both overseas parent companies and subsidiaries of enterprises located in the SHFTZ may issue the above bonds inside China for their uses in China and abroad(People's Bank of China et al., 2015), thus expanding the issuers from the overseas parent companies of enterprises in SHFTZ to their oversea subsidiaries and clarifying the funds raised can be used directly in China including in SHFTZ. Apart from the above channels, other channels for financing between SHFTZ and other parts of China are still closed. In brief, cross-border and cross-Zone financing restrictions still exist.

4.1.2 Individuals

Article 9 of the *Financial Measures* on facilitating cross-border investments by individuals actually not only applies to both individuals and individually-owned businesses, but also combines investments and financing for individuals together. So in the rest of the paper, "individual" has the above meaning unless the context indicates otherwise. So far as individuals are concerned, the following aspects of Article 9 warrant attention:

First, according to Article 9 of the Financial Measures, eligible individuals who are employed in the SHFTZ may make various kinds of overseas investments including securities investments in accordance with rules(People's Bank of China, 2013). "Individuals" should include Chinese and foreign individuals, they may make the above investments as long as they work in SHFTZ, satisfy eligibility criteria and obey the rules that remain to be set. Actually, foreigners employed in SHFTZ have convenient channels to make the investments outside China, and these channels may not be shut down merely due to their employment in the SHFTZ. Thus, the real breakthrough of the above provision lies in that it has opened a new path for Chinese individuals employed in SHFTZ to make foreign investments directly, without having to resort to Qualified Domestic Institutional Investors (QDII) program as before, a program under which institutional investors that meet necessary requirements and get authorizations from regulatory agencies may pool together the funds from investors and make investments in securities abroad.

Secondly, another highlight of the provision lies in that eligible foreign individuals employed in SHFTZ may open non-resident special accounts for various kinds of investments in China including securities investments in accordance with rules. Previously foreign investors wishing to invest in China's securities market had to resort to Qualified Foreign Institutional Investors (QFII) programs which allow licensed international institutional investors to buy and sell RMB denominated "A" shares in China's stock exchanges subject to specified quotas and amount. But, according to the *Financial Measures*, as long as overseas individuals are employed in SHFTZ and meet eligible criteria, they may make securities investments or other investments in China. In a word, the *Financial Measures* has made a breakthrough in that eligible Chinese or foreigners employed in SHFTZ may invest abroad or inside China without resorting to QDII or QFII, but the extent of the above liberalization depends on how the eligible requirements and rules are delineated.

The *Financial Plan* in 2015 contains more powerful reform efforts for individuals by claiming to initiate the test of qualified domestic individual investors (QDII 2) to make investments abroad, and to promulgate implementation rules at proper time to allow the above investors to make industrial, real assets and financial investments abroad(People's Bank of China et al., 2015). The *Financial Plan* further states to speed up the promulgation of relevant method to allow qualified intuitions and individuals to make securities and futures investments at home and abroad(People's Bank of China et al., 2015), causing confusion as to the relation between the above two provisions as they overlap and differ obviously. In addition, the *Plan* also claims to initiate the test of fund transfers by individually-owned businesses in SHFTZ to their overseas units after the establishment of relevant administration system(People's Bank of China et al., 2015). Thus, although the *Financial Plan* seems to try to push forward the investment and financing reform for individuals in SHFTZ, relevant statements are still vague, hollow, confusing, and depend on further implementation rules that remain to be set. In this sense, the *Financial Plan* is repeating the lessons that propel its birth.

4.2 Analysis on Investment and Financing Test in SHFTZ

As shown above, the provisions on direct investments in SHFTZ are quite liberalized, in contrast, those on indirect investments and financing are obstructed or obscure. It may reflect the Chinese government's intension that finance should serves real economy. Actually Part 1(General Principles) of the *Financial Measures* makes it as the leading principle that finance should serve the real economy(People's Bank of China, 2013). Similar repetition appears in Part 1(General requirements) of the *Financial Plan* (People's Bank of China et al., 2015). The disparity between direct investments on one hand and indirect investments as well as financing on the other hand may also be out of the consideration of the sequencing of capital account reforms. Part 2 of the *Financial Plan* stating to pilot capital account convertibility in SHFTZ by adhering to the principles of overall planning and serving entities seems to reveal such a consideration (People's Bank of China et al., 2015). RMB internationalization requires not only the liberalization of direct investments, but also the free flow of indirect investments and financing. So the test of indirect investments and financing in SHFTZ for the sake of RMB internationalization warrants close review.

4.2.1 Limitations of Indirect Investment and Financing Reforms in SHFTZ

Indirect investments are also referred to as financial investments due to the fact that such investments are made in financial instruments, expecting to make market earnings. A country wishing to internationalize its currency and to enhance its function as the store of value in particular must provide financial assets that are readily accessible to foreign investors. "For China, a conflict exists between the export-oriented growth strategy that forbids foreigners to obtain Chinese assets and the demands of promoting RMB's status as reserve currency to provide free access to Chinese assets to foreigners"(Subramanian, 2011). To realize RMB internationalization, China has to provide investors around the globe with various RMB financial assets, and these investors can hold and transact these assets efficiently. This objective can only be accomplished via the liberalization of inward and outward indirect investments and financing. However, restrictions and uncertainties hanging over indirect investments and financing in SHFTZ as mentioned previously hamper the test effects for RMB internationalization.

Take indirect investments made in other parts of China from SHFTZ as an example, though Article 10 of the *Financial Measures* stipulates that financial institutions and other enterprises in SHFTZ may invest and transact in securities and futures exchanges in Shanghai according to rules, Article 15 prohibits these institutions and enterprises from using RMB borrowed from abroad to make the above investments. It is really curious and a tough task for the supervisors to make the judgement on whether the funds from SHFTZ used in the above investments are borrowed abroad or not. Moreover, inability to use funds borrowed abroad would mean that these institutions and enterprises have to rely on their own capital or profits to make such investments, that is, they are not allowed to resort to leveraged transactions. This restriction surely differs substantially from the usual practice of financial and derivative investments which allow leveraged transactions when RMB becomes internationalized.

As for financing, one of the basic rationales behind the market economy is that enterprises may decide where and how they have their resource allocation and funding, so they should be able to raise funds anywhere they deem appropriate. As far as currency internationalization is concerned, one of the prerequisites for a currency to function as medium of exchange as well as unit of account in financial transactions is to allow cross-border financing in this currency. Excessive restrictions imposed on cross-border financing would only force the market to choose currencies other than RMB. Therefore, RMB internationalization requires the liberalization of cross-border financing. However, the above restrictions in SHFTZ clearly indicate that both cross-border and cross-Zone financing are restricted or entangled with ambiguity. Just take Article 5 of the *Financial Measures* as an example, although certain economic agents may transfer funds for loan repayments and other specific purposes between SHFTZ and other parts of China, such fund transfers are regulated as cross-border business(People's Bank of China, 2013), that is, capital controls existing in China applies to regulate such capital flow. Thus, the freedom of financing in the scenario of RMB internationalization is heavily distorted and suppressed in SHFTZ test program.

4.2.2 Why is Indirect Investment and Financing Test Ill-adapted for RMB Internationalization?

The ill-adaptation of indirect investment and financing test in SHFTZ for RMB internationalization is rooted in the design of SHFTZ contained in the *Framework Plan* and the *Financial Measures*. Part 3 of the *Framework Plan* establishes the mode of “outward open and inward control” for SHFTZ, a mode that is more liberalized for cross-border transactions while keeping tight controls on cross-Zone activities, separating SHFTZ and other parts of China into two segregated regions(State Council, 2013a). This policy stance is reinforced in Part 2 of the *Financial Measures* concentrating on financial and non-financial institutions in SHFTZ which are reviewed respectively as follows.

In respect of non-financial institutions, one of the inventions made by the *Financial Measures* is the creation of FTAs. According to the *Financial Measures*, residents and non-residents in SHFTZ may open resident and non-resident FTAs, and funds can be transferred freely between resident FTAs on the one hand and non-domestic accounts including oversea accounts, non-resident accounts opened in other parts of China, non-resident FTAs, FTAs of another resident on the other hand(People's Bank of China, 2013). While this provision turns the green light to the capital flow between FTAs and non-domestic accounts, it blocks such flow between SHFTZ and other parts of China. Although this design may be beneficial for preventing financial risks in SHFTZ as well as in foreign countries from spreading to other parts of China, it also isolates SHFTZ from other parts of China. The only leakage in the blockage between FTAs in SHFTZ and other parts of China is the fund transfer between a resident FTA and other bank settlement accounts held by the same non-financial institution for the purpose of current account transactions, loan repayment and investments in the real economy etc. But such fund transfers is treated and regulated as cross-border business(People's Bank of China, 2013). So it’s quite clear that the *Financial Measures* sticking to the mode of “outward open and inward control” treat “cross-Zone” as “cross-border”, strictly implementing the doctrine of “inward control”.

In respect of financial institutions, the *Financial Measures* has created Split Accounting Unit (hereafter referred to as SAU) which is set up inside Shanghai financial institutions at municipal level for the sole purpose of handling business in SHFTZ and shall be separated from the accounting of other business of the same financial institutions(PBOC Shanghai Headquater, 2014a). The *Financial Measures* provides that financial institutions in Shanghai may establish SAU in accordance with the rules of PBOC, open FTAs for eligible clients in the SHFTZ and provide financial services for them(People's Bank of China, 2013). SAU shall obey the rule of split accounting, operate separately and maintain the self-balance of liquidity on its own with liquidity aid from the next higher level bank only when necessary(People's Bank of China, 2013). SAU constitutes one of the core financial policies for financial institutions operating in SHFTZ. To put SAU into operation, PBOC Shanghai Headquarter issued “Rules for SAU Business Implementation” and “Prudential Management Rules on the Risk of Split Accounting Businesses in SHFTZ” in May 2014(PBOC Shanghai Headquater, 2014b). According to the above two Rules, all resident and non-resident FTAs in SHFTZ shall be specially marked, SAU shall be separately accounted, have independent balance of sheet and financial statements, and maintain its liquidity on its own(PBOC Shanghai Headquater, 2014b). In this way, the flow of all funds marked as from FTAs could be monitored in real time, SHFTZ is separated from other parts of China by this means, and SHFTZ is positioned as an insulated region in China as the result of such controls.

It should be noted that even in respect of “outward open” in the mode of “outward open and inward control”, SHFTZ has not completely liberalized the channels for cross-border capital flow. Take cross-border capital inflow as an example, Article 11 of the *Financial Measures* provides that Chinese- and foreign-invested enterprises, non-bank financial institutions and other economic agents registered in the SHFTZ can borrow domestic and foreign currency-denominated funds from overseas, but they do so subject to the purpose of satisfying their operational need and in accordance with relevant rules(People's Bank of China, 2013). What's more, the incomplete "outward open" would surely reduce the amount of capital inflow from abroad, at the same time the cross-Zone capital control causes the capital flowed to be absorbed mainly in SHFTZ other than in other parts of China. Due to various restrictions in SHFTZ, the motivation for capital inflow from abroad to SHFTZ is much compressed. This situation is not comparable to the capital inflow when whole China liberalize the capital account for RMB internationalization.

Probably having realized the limited financial market space resulting from the above restrictions in SHFTZ, the *Financial Plan* in 2015 claims to introduce TPIFA to SHFTZ to provide more market space. But because the wording in the provisions on TPIFA such as "support the construction" is very soft(People's Bank of China et al., 2015), even meaningless in legal sense, such provisions cannot remove the legal obstacles frustrating the operation of TPIFA. So the reform projection contained in the *Financial Plan* still stay in the document.

Currency internationalization requires free capital flow and transactions other than restrictions. Take U.S. dollar as an example, America retains only two kinds of restrictions on capital transactions : certain direct investments by non-residents, use of small business registration forms and small issues exemption by non-resident issuers on American capital market(OECD, 2013). Beyond that, all are free. Judging by this benchmark, China, with extensive capital controls, has long way to go to accommodate the needs of RMB internationalization.

In conclusion, capital transactions next to convertibility in the dynamic chain of capital account operations are an integral part of capital account activities. Investments and financing by institutions and individuals are the two prominent contents in SHFTZ test package. As far as individuals are concerned, SHFTZ test package, while retaining certain restrictions and vagueness, offers new channels for domestic and oversea investments by foreign and Chinese individuals employed in SHFTZ. As far as institutions are concerned, SHFTZ test package offers differing test effects in different aspects for RMB internationalization. In the aspect of direct investment, SHFTZ test package contains no essential barriers for cross-border and cross-Zone direct investments, thus offering a valuable test for RMB internationalization. But in the aspects of cross-border and cross-Zone indirect investments and financing, the test in SHFTZ has not much value for testing the water for RMB internationalization because these reforms in SHFTZ are still stifled by various restrictions which need to be removed in the process of RMB internationalization. It is the mode of "outward free and inward control" that makes the environment for the above capital transactions in SHFTZ differ from that of RMB internationalization.

5. CAN SHFTZ PROVIDE AN EFFECTIVE RISK HEDGING TEST FOR RMB INTERNATIONALIZATION?

Part IV of this paper has not exhausted all capital transactions in SHFTZ reform package, the key omission is derivative transactions which perform the market functions of risk hedging and price discovery. Though financial derivative transactions, one of seven categories in IMF's classification of capital transactions(IMF, 2012), are logically a part of these transactions, nevertheless, their preeminent status in SHFTZ reform package justifies the exclusion of such transactions from the Part IV of this paper and forming an independent part for a better review.

Article 12 of the *Financial Measures* contains the key provision for risk hedging by non-financial institutions and financial institutions in SHFTZ. For the former, the *Financial Measures* allows these non-financial institutions to hedge risk in the SHFTZ or overseas markets based on authentic demand for managing currency and maturity mismatch and in accordance with relevant rules. The provision stresses the requirement that risk hedging transactions should be out of the real need. For the latter, SAU in financial institutions may hedge either oversea or in SHFTZ the open positions arising from domestic and foreign currency exchange. Based on the demand for risk management, SAU may conduct derivative transactions in overseas markets in accordance with relevant rules. And upon approval, SAU can borrow, lend or conduct repo transactions in the domestic interbank market within a prescribed quota(People's Bank of China, 2013). According to the above provisions, financial institutions which provide SAU services may engage in hedging and derivative transactions in SHFTZ or oversea markets, and may also conduct inter-bank lending or repurchase in domestic inter-bank market.

Risk hedging is indispensable for the business operations of financial and non-financial institutions in SHFTZ due to the risks inherent in their business operations. Moreover, in the process of RMB internationalization, economic agents irrespective of financial and non-financial institutions would suffer from more risk exposure as a result of more frequent uses of RMB and other currencies internationally. Thus, risk hedging reforms undergoing in SHFTZ should not only respond to the need of risk hedging resulting from the expansion of cross-border use of RMB and capital transactions in SHFTZ, but also be missioned with risk hedging test for RMB internationalization in the future. However, whether the test in SHFTZ can accommodate the needs of risk hedging for RMB internationalization deserves further examination. For the sake of efficiency, the following will only take non-financial institutions in SHFTZ as an example for further review.

As mentioned above, the *Financial Measures* requires that risk hedging by non-financial institutions should be based on authentic demand for managing currency and maturity mismatch. The motivation behind such a requirement is mainly to avoid speculation and serve real economy. If it is justifiable and reasonable to prohibit financial institutions from engaging in excessive derivative speculation so as to control their risks to financial stability due to their peculiar status in financial system, then the justifications to apply the same restrictions to non-financial institutions in SHFTZ are not so adequate and persuasive in that any type of market transactions contain speculative factors, not to mention financial derivative transactions. Excessive restrictions on these kinds of transactions would make the test different from relatively free derivative transactions under the condition of RMB internationalization. More importantly, it is difficult, even impossible for derivative market to perform its functions like risk hedging and price discovery without sufficient speculative trading and market liquidity that such trading generates. Without prosperous risk hedging market with indispensable speculative trading, it is difficult for RMB to be accepted as an international currency because risks in RMB internationalization cannot be mitigated.

Moreover and somewhat surprisingly, Article 12 of the *Financial Measures* provides that financial and non-financial institutions in SHFTZ may hedge risks in SHFTZ. Risk hedging in SHFTZ relies on the establishment of financial derivative market as a prerequisite. But it is well known that derivative market should have sufficient market coverage if it is expected to perform the above market functions. As SHFTZ is insulated by various restrictions from the other parts of China and even the rest of the world, it’s not feasible to establish a financial derivative market in SHFTZ, an enclave with very limited market coverage. Even if such a market is established, the price it discovers and its guidance for risk hedging would be misleading and differ from the realm of RMB internationalization due to its limited market coverage arising from the fact that institutions in SHFTZ are prohibited from speculative derivative transactions and that “inward control” prohibits capital in other parts of China from participating in financial derivative transactions in SHFTZ.

The *Financial Plan* in 2015 does not mention risk hedging except that it states to initiate the test for the institutions in SHFTZ to participate in overseas securities, futures and derivative transactions (People's Bank of China et al., 2015). Compared with the *Financial Measures*, the *Financial Plan* has made a breakthrough in that it has not repeated the requirement of authentic demand for managing currency and maturity mismatch contained in the *Financial Measures*. But, to implement the statement contained in the *Financial Plan*, specific measures need to be adopted to overcome the regulatory barriers that hinder such implementation, yet up to now, such measures are still vacant.

In a word, the above restrictions hanging over derivative transactions make the risk hedging and speculative trading test in SHFTZ not only differ from the usual practices prevailing in normal derivative markets, but also from the expected derivative market operation compatible with RMB internationalization because speculation cannot be eliminated if a derivative market performs its functions of risk hedging and price discovery. So the test in SHFTZ can provide little reference for RMB internationalization because the test obviously diverges from the future market reality when China fully opens its capital account and sets up full-fledged financial derivative market for RMB internationalization.

6. CONCLUSION

China has cautious tradition in its reform and openness, and the new round of reform and openness in the form of PFTZs is no exception. RMB internationalization, the most important strategy for China, requires China to change its mode of development, modify its laws and policies so as to make them compatible with RMB internationalization(Han, 2016), so it is necessary and reasonable for China to make a test for such a strategy in SHFTZ and other PFTZs. But the precondition for a successful test is that the condition for capital liberalization reform in SHFTZ is the same as or comparable to that accommodating RMB internationalization which requires capital account liberalization.

Is the condition for capital account reform in SHFTZ the same as or comparable to that for RMB internationalization？As far as RMB convertibility is concerned, the test in SHFTZ is not successful for RMB internationalization because when the *Financial Measures* tries to make RMB convertible between and among FTAs, it imposes new set of restrictions at the same time. Similarly, capital transactions such as cross-border and cross-Zone indirect investments, financing and risk hedging in SHFTZ are also shrouded with various restrictions and uncertainties which run counter to the basic need of free capital transactions in case of RMB internationalization. The only exception is the cross-border and cross-Zone direct investment reform in SHFTZ because no essential barriers exist for such investments, making the test nearly as real as that in the realm of RMB internationalization. So except the direct investment reforms, other reform tests in SHFTZ do not have much experimental value for RMB internationalization because these tests obviously diverge from the reality under the condition of RMB internationalization.

Be necessary as the above tests may, SHFTZ as well as other PFTZs should not be overly relied upon to produce the reference and experience for RMB internationalization because such reference and experience may also be drawn from currency internationalization in other countries and from offshore RMB markets. By now the major method adopted by Chinese government to push forward RMB internationalization is to develop RMB offshore market oversea. This is partly because China still impose capital controls when pursuing RMB internationalization. Since more liberal measures than those applied in SHFTZ are adopted in many economies including issuing economies of internationalized currencies and have been repeatedly practiced, China may gather what it needs from these economies. What’s more, the development of offshore RMB markets in Hong Kong, London, Singapore and elsewhere and the prominent issues manifested in these hubs offers valuable guidance for RMB internationalization. With these experiences and guidance, RMB internationalization may be pushed more forcibly and audaciously forward instead of turning to SHFTZ for seeking test overcautiously and awkwardly.

Moreover, it warrants attention that the mode of "outward free and inward control" designed for SHFTZ not only causes the condition for capital account reforms in SHFTZ different from that of RMB internationalization, but also may lead SHFTZ astray from the intended test for RMB internationalization to a Chinese version of International Banking Facility (hereafter referred to as IBF). IBF was approved by the U.S. Federal Reserve in 1981 to be established on the territory of the United States as an offshore dollar market. Traditionally, an offshore financial market lies outside the issuing country of an offshore currency(Han, 2001). But, in order to avoid the competitive disadvantage suffered by American financial sector vis-à-vis the Eurodollar market, U.S. made a breakthrough by creating on its own territory the offshore dollar market with following features: (a) U.S. depository institutions including branches and agencies of foreign commercial banks in the U.S may apply to operate IBF and offer deposit and loan services to foreign residents and institutions other than domestic ones. (b)Financial transactions in IBF enjoy favorable treatments similar to those on Eurodollar market, and are exempted from reserve requirements of the Federal Reserve as well as some state and local taxes which apply otherwise. (c)The dollar deposited in IBF accounts is regarded as deposited abroad, and transactions in IBF must be maintained on separate books or ledgers (Han, 2001).

In comparison, the design and practice of financial reforms in SHFTZ share some similarities with IBF. Part 2 of the *Financial Measures* provided that financial institutions in Shanghai may establish SAUs to open FTAs for eligible Chinese and foreign clients in the SHFTZ and to provide financial services. FTAs can be used for cross-border financing and guarantee(People's Bank of China, 2013). And funds can be transferred between FTAs on the one hand, and non-domestic accounts on the other hand(People's Bank of China, 2013). So SAU and operation of FTAs constitute a separate block, bearing similarity to the first and the third feature of IBF mentioned above. Moreover, although funds can be transferred between a resident FTA and other bank settlement accounts held by the same non-financial institution in other parts of China for the purpose of current account transactions etc., yet such fund transfers are regulated as cross-border business(People's Bank of China, 2013), thus treating SHFTZ as outside China. This feature reinforces SHFTZ's similarity to the third feature of IBF. It is the similarities shared by SHFTZ and IBF that make SHFTZ run the risk of evolving into an offshore RMB market inside China. Thus it is no wonder that some scholars propose that SHFTZ should become an offshore RMB market as an insulated customs territory(Xu, 2014).

But the aim of financial reforms in SHFTZ is not to establish an offshore RMB market inside China as pointed out, so the Chinese version of IBF is far from what China's strategic financial reform pursues. More importantly, IBF was established against the background that U.S dollar has already become the world leading currency. Thus if China sets up SHFTZ just for the purpose of establishing its own IBF other than piloting for RMB internationalization, it will not only spoil the ship for halfpenny-worth of tar, but also put the cart before the horse.

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