

# Problems and Solutions of China's Foreign Exchange Market

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**Abstract.** As the largest foreign exchange reserve country in the world, the stability of China's foreign exchange market has an important impact on domestic economic development and global financial market. This study focuses on the main problems in China's foreign exchange market, including the volatility of foreign exchange reserves, the lack of free circulation of capital and the lack of foreign exchange risk management tools, and puts forward corresponding solutions. First, the volatility problem of foreign exchange reserves is mitigated by diversified allocation of foreign exchange types. Secondly, in view of the lack of free circulation of capital, this study proposes to gradually relax foreign exchange control and promote the opening of capital account, so as to promote the internationalization of RMB and the deepening of the capital market. In addition, improving foreign exchange derivatives and related management mechanisms is the key to solving the problem of insufficient foreign exchange risk management tools, which requires financial regulators, governments and market participants to work together to improve the risk management capabilities of enterprises and financial institutions by innovating financial products and optimizing the market environment. The implementation of this study will help to enhance the stability and international competitiveness of China's foreign exchange market and provide support for the sustainable and healthy development of the economy. At the same time, these measures will also promote the opening and internationalization of the domestic financial market and attract more foreign capital inflows, thus promoting the high-quality development of the Chinese economy.

**Keywords:** Foreign exchange; China; RMB.

## 1. Introduction

In the context of global economic integration, the stability of the foreign exchange market is crucial to the financial stability and economic development of any country. This is especially true for China. As the world's second largest economy and holder of the world's largest foreign exchange reserves, China's foreign exchange market is not only an important part of the domestic economic operation, but also a key factor in global financial stability [1]. China's foreign exchange market has experienced a process from initial formation to rapid development and then to gradual improvement, which reflects the continuous expansion of China's economic openness and the gradual improvement of its international status. Since the reform and opening up, the development of China's foreign exchange market can be described as rapid. In the early days, China's foreign exchange management system was based on the planned economy, and the allocation and use of foreign exchange resources were strictly controlled by the state. With the deepening of the reform of economic system and the implementation of the policy of opening to the outside world, China's foreign exchange market began to relax the control gradually, and the market mechanism began to play its role [2]. In 1994, China implemented a major reform of its foreign exchange rate formation mechanism and established a managed floating exchange rate system based on market supply and demand, which marked the true opening of China's foreign exchange market. Since then, with the accession to the World Trade Organization (WTO) and the inclusion of the RMB in the Special Drawing Rights (SDR) currency basket, the internationalization of China's foreign exchange market has accelerated significantly, with the market size expanding, the trading mechanism and products becoming more abundant, and the regulatory system becoming more and more perfect [3]. However, despite remarkable progress and development, China's foreign exchange market still faces many challenges and shortcomings. The volatility of foreign exchange reserves, the limitation of the free circulation of capital and the

insufficiency of foreign exchange risk management tools not only affect the stability and efficiency of the market, but also restrict the in-depth development of China's economy and the process of internationalization. Especially in the context of increasing global economic volatility, how to further optimize the structure of the foreign exchange market, improve the openness and transparency of the market, and enhance the effectiveness of foreign exchange risk management has become a top priority for the development of China's foreign exchange market. Therefore, an in-depth analysis of the current situation of China's foreign exchange market, the main problems it faces, and the corresponding solutions are of great significance for promoting the healthy development of China's foreign exchange market and ensuring national financial stability.

## **2. Problem**

### **2.1. Foreign Exchange Reserves are Volatile**

As we all know, China is the largest foreign exchange reserve country in the world, and its foreign exchange reserve enables the RMB exchange rate to achieve relatively stable development [4]. The fluctuation of foreign exchange reserves can be divided into stock fluctuation and exchange rate fluctuation. However, the recent sharp fluctuations in the price of foreign exchange and the size of reserves have brought some adverse effects on the value of foreign exchange reserves. When the volatility of foreign exchange reserves is too large, it will lead to the increase of volatility in the financial market, and then affect the investment decisions of enterprises and the market, and finally trigger the panic in the financial market. In addition, when the foreign exchange reserves are greatly reduced, the government may take measures to raise interest rates to attract capital inflows, which can alleviate the urgent need, but will slow down the economic growth rate. If a country's foreign exchange reserves are too low, it will affect the country's ability to service its foreign debt. The foreign exchange market plays a key role in supporting international economic activity, providing financial stability and contributing to global economic growth. Its depth and liquidity ensure the efficient functioning of the global economy, enabling market participants of all sizes to find value and opportunity in this market, and allowing governments or investors to earn returns in international financial markets commensurate with their capabilities [5]. Therefore, the relevant departments of the state need to take certain measures to alleviate or even solve this problem.

### **2.2. Insufficient Free Circulation of Capital**

The inadequacy of China's foreign exchange market in terms of the free circulation of capital is mainly reflected in the control of cross-border capital flows. These controls cover outward direct investment, offshore investment, portfolio investment, loans and many other forms of capital account transactions. Although China has taken a series of measures in recent years to gradually relax the restrictions on the capital account to promote the internationalization of the RMB and the opening up of the capital market, the openness of China's capital market is still limited compared with developed countries. The existence of this situation has multiple implications for China's economy and financial markets. In a mature country, its foreign exchange market should be regulated and relaxed in tandem. A highly flexible foreign exchange market can make it easier for foreign capital to invest in China and develop the domestic economy [6]. Of course, a mature foreign exchange market cannot completely leave foreign funds unchecked, and efficient supervision can effectively reduce the risk of foreign capital reaping domestic benefits. Controlling the degree of free circulation of capital is a great science, which needs to consider the rights and interests of different stakeholders and find their own critical points in which to maximize the interests of all parties. Therefore, we need to find an effective way to improve the lack of free circulation of capital in China's foreign exchange market.

### **2.3. Insufficient Foreign Exchange Risk Management Tools**

Although the development of China's foreign exchange risk management tools has made some progress, compared with the market system of developed countries, there are still shortcomings.

These deficiencies are mainly reflected in the limited types of foreign exchange derivatives, the lack of participants and market depth, and the lack of understanding of foreign exchange risk management by enterprises [7]. Although the Chinese market provides basic foreign exchange derivatives, such as forward contracts, options and swaps, the types and complexity of these products are lower than that of the international market, and they cannot fully meet the diversified risk management needs of enterprises. Although the policy has been gradually relaxed to allow more companies and financial institutions to participate in the foreign exchange derivatives market, overall participation remains low, and the market depth and liquidity are insufficient, limiting the effectiveness of risk management tools. Due to the lack of effective FX risk management derivatives, companies are exposed to increased foreign exchange risk, especially for those that rely on imports and exports, where exchange rate fluctuations can directly affect their costs and profits [8]. Moreover, inadequate foreign exchange risk management tools limit the willingness and ability of foreign investors to enter the Chinese market, and also affect the degree of internationalization and attractiveness of the Chinese capital market. When a large number of enterprises and financial institutions are unable to effectively manage foreign exchange risk, national financial markets may face greater stability risks, especially when global economic or political events cause large-scale exchange rate fluctuations. Therefore, it is very important to improve our foreign exchange risk management tools.

### **3. Solution**

#### **3.1. Diversified Allocation of Foreign Exchange Types**

Foreign exchange reserve diversification is a strategy to diversify risk and increase returns by investing in different currencies and asset classes. It involves adjusting the proportion of assets in different currencies and investing in a variety of financial instruments in the international financial market, such as government bonds, corporate bonds, stocks, gold and other precious metals, in order to protect foreign exchange reserves from fluctuations in a single currency or asset. This strategy not only enhances risk management capabilities, but also provides additional security for national economic and financial stability when the global economic and financial environment changes. Through refined asset allocation and dynamic investment strategy adjustment, diversified allocation helps achieve steady growth in the value of foreign exchange reserves while reducing potential economic and financial risks. Diversifying the currency mix and asset allocation of foreign exchange reserves is the key to reducing volatility. By holding a variety of currencies and asset classes, such as major international currencies, gold, international institutional bonds, etc., it can spread risks to a certain extent and reduce the overall volatility of foreign exchange reserves caused by fluctuations in the value of specific currencies or assets [9]. The diversification of the types of foreign exchange reserves can disperse the adverse effects of exchange rate fluctuations of a single foreign exchange variety to a certain extent. When there are multiple foreign exchange varieties rather than a single currency, it can effectively use other foreign exchange varieties to hedge against it and reduce systemic risks.

#### **3.2. Gradually Relax Foreign Exchange Controls**

The key to solve the lack of free capital circulation is to gradually relax the capital account control and implement orderly market-oriented reform. First, policymakers should set a clear timetable and road-map to gradually liberalize cross-border investment and financing restrictions in line with national economic development and the maturity of financial markets. This includes expanding the scope of cross-border capital transactions and allowing more financial institutions and enterprises to participate in international capital markets. Second, strengthen the macro-prudential management system by introducing risk management tools and monitoring mechanisms to ensure sound and orderly capital flows. In addition, it will accelerate the opening and innovation of the financial market, attract foreign investors, improve the transparency and efficiency of financial services, and promote the deepening and broad participation of the foreign exchange market. At the same time, we will

strengthen international cooperation and communication, and coordinate policies with major trading partners and international financial institutions to reduce potential market volatility and financial risks. Through these comprehensive measures, we can effectively improve the free circulation of capital, promote the further opening of the economy, and enhance the competitiveness of the national financial market and the ability to withstand external shocks. An open and inclusive foreign exchange market can, to a large extent, attract more foreign investment into China's capital market, help China's economic construction, and achieve a win-win situation.

### **3.3. Improve Foreign Exchange Derivatives and Related Management Mechanisms**

In order to further improve and develop the forex derivatives market, the focus should be on innovating financial products, optimizing the market environment, upgrading the regulatory framework and establishing educational mechanisms. This requires the joint efforts of financial regulators, government departments, financial institutions and enterprises [10]. First, financial regulators and government departments should strengthen policy support and guidance, formulate policies and regulations conducive to financial innovation, and provide a clear and stable legal environment for financial institutions. For example, by providing incentives such as tax incentives and fiscal subsidies, financial institutions are encouraged to develop and promote new foreign exchange derivatives. Second, simplifying product approval processes and lowering market entry barriers are essential to stimulate market vitality. Enhance market tolerance, allowing financial institutions to test new products in a controlled environment, while ensuring that regulators can keep abreast of market dynamics and potential risks, thereby speeding up the product to market process. In addition, increasing the depth and liquidity of the market also requires attracting more types of market participants, including foreign investors, institutional investors and retail investors. This can not only improve the activeness of the market, but also help to form a more comprehensive and mature market ecology. Through the above measures, we can effectively promote the improvement and development of the foreign exchange derivatives market, provide more abundant and efficient risk management tools for enterprises and investors, and provide strong support for the stable growth of the national economy.

## **4. Conclusion**

This study explores in depth the major issues facing China's foreign exchange market, including the volatility of foreign exchange reserves, restrictions on the free circulation of capital, and the inadequacy of foreign exchange risk management tools, and proposes targeted solutions. Through diversified allocation of foreign exchange reserves, gradual relaxation of foreign exchange control and improvement of foreign exchange derivatives and related management mechanisms, the aim is to improve market stability and efficiency, and promote the in-depth development of China's economy and the process of internationalization. The implementation of these strategies will not only promote the healthy development of the foreign exchange market and guarantee the country's financial stability, but also strengthen China's position in the global financial system and provide solid foreign exchange support and guarantee for the country's long-term economic growth.

Although this paper has made some efforts to analyze the current situation of China's foreign exchange market and put forward solutions, there are still some deficiencies. First of all, the discussion of the complexity and dynamics of the forex market may not be in-depth and comprehensive enough. Especially in the context of a changing global economic environment, the challenges facing the forex market are also evolving, and more empirical research is needed to support the effectiveness of solutions. Secondly, when proposing the solution, the difficulty of implementation and possible challenges are not considered enough in this paper, and future research needs to be further deepened to ensure that the proposed strategy is both practical and effective to meet future challenges.

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