

Research on the Problems and Solutions of China's Foreign Exchange Market

Xinlu Ran *

Business School, Soochow University, Suzhou, China

* Corresponding author: 2210503026@stu.suda.edu.cn

Abstract. This study delves into the intricate dynamics of China's foreign exchange (FX) market, emphasizing its essential role in the global financial ecosystem and China's economic architecture. Recognizing the FX market's critical importance, the Chinese government has carefully managed its transaction from a tightly controlled system to one progressively influenced by market forces since its foundation in the early 1990s. Despite significant advancements, the RMB FX market confronts challenges including limited responsiveness of the RMB exchange rate to market demands, capital flow restrictions, and external vulnerabilities, especially the impact of U.S. monetary policies and global economic uncertainties. Through comprehensive analysis, this research identifies these core issues and proposes targeted strategies for addressing them, such as gradual liberalization of the exchange rate mechanism, enhancing the openness of capital accounts, and promoting RMB internationalization. These solutions aim not only to address the current challenges but also to strengthen RMB FX market against future external shocks, contributing to its stability and integration into the global financial system. This thesis offers valuable insights for policymakers and stakeholders, guiding endeavors to enhance the functionality and adaptability of China's foreign exchange market in the face of changing national and global landscapes.

Keywords: RMB internationalization, capital account liberalization, exchange rate mechanism.

1. Introduction

The foreign exchange (FX) market is a cornerstone of the global financial system, facilitating international trade and investment by enabling the exchange of currencies. Within this global framework, China's FX market holds a position of critical importance, demonstrating the nation's expanding economic influence worldwide. The Chinese government has historically placed a high priority on the regulation and development of the FX market, recognizing its implications for national economic security and stability. From the early 1990s, when RMB FX market first emerged, following the economic reforms initiated in 1978, there has been significant evolution from a rigidly controlled system towards one that increasingly incorporates market dynamics.

Considering the crucial role played by the FX market, this paper focuses on identifying and addressing the main challenges faced by RMB FX market. These challenges include the RMB exchange rate's limited responsiveness to supply and demand fluctuations—a consequence of the managed float system that restricts the currency's natural adjustment capability. Furthermore, capital flow restrictions emerge as a substantial barrier, achieving as deviations from the Covered Interest Parity (CIP) and resulting in inefficiencies and market illiquidity. External vulnerabilities, particularly the influence of U.S. monetary policy and global economic uncertainties, further aggravate the market's challenges, indicating an urgent requirement for robust solutions.

Therefore, this study is dedicated to exploring the existing issues within RMB FX market and proposing feasible strategies for overcoming these challenges. By delving into solutions such as the gradual liberalization of the exchange rate mechanism, increasing openness of capital accounts and advancing RMB internationalization, this research aims to shed light on effective pathways towards a more stable, efficient, and globally integrated FX market in China. Through comprehensive analysis and strategic recommendations, this thesis contributes to the ongoing discourse on optimizing RMB FX market operations in the face of evolving domestic and international economic landscapes.

2. Problems

2.1. RMB Exchange Rate

The RMB exchange rate's insufficiency in responding to the fluctuations of supply and demand in the foreign exchange market highlights a critical chink within China's economic architecture, which not only discloses the limitations of the current exchange rate mechanism in China but also accentuates the potential for adverse effects on stability of the RMB FX market through mechanisms such as exchange rate expectations and risk spillover.

The primary issue facing the RMB FX market today is the exchange rates' inadequate reaction to changes in supply and demand [1]. This trouble can be attributed to the managed float system, where the People's Bank of China (PBOC) aims to control volatility and guide economic stability. While such a system may alleviate short-term market fluctuations, it in essence restricts the exchange rate's natural adjustment capability, essential for aligning the currency's value with underlying economic fundamentals. This misalignment can lead to persistent imbalances in the balance of payments, affecting the country's external sector sustainability.

The anticipation of future exchange rate movements plays a pivotal role in investment decisions and capital flows, thus leading to problems in the FX market. The wealth effect hypothesis suggests that if the expectation is for the RMB to depreciate, the perceived wealth of foreign investors in terms of the RMB diminishes [2-3]. The dynamic demonstrates the complex relationship between exchange rate expectations and investments, leading to challenges in managing stable foreign capital inflows and stabilizing the whole FX market. Moreover, the inconsistent views on the impact of exchange rate expectations on cross-border M&As complicate the problem [4]. Due to the heightened perceived risks, the volatility in the exchange rate may hinder the direct international investments, negatively affecting to the RMB FX market [5-6].

The concept of risk spillover is particularly relevant in the context of foreign exchange markets. Vulnerabilities in the financial system, exacerbated by leveraged positions or currency mismatches, can lead to contagion effects, where disturbances in one market spill over into others. The rigidity of the RMB exchange rate mechanism increased these risks, as it limits the economy's ability to absorb external shocks, increasing the potential for systemic risk [7].

2.2. Capital Flow Restrictions

The issue of the capital flow restrictions is one of the biggest problems in RMB FX market, the core of which lies in the impact of capital controls.

Capital controls, such as conversion restrictions, can lead to the disconnection between domestic and international financial market, resulting in deviations from the Covered Interest Parity (CIP), an indication that capital is not moving freely across borders to balance the interest rates and forward interest rates [8-9]. These deviations disclose the low efficiency of the FX market, as they hinder the seamless arbitrage processes, which align the financial variables between the domestic and international markets. As a result, the market becomes less liquid, the cost of the capitals may be distorted to jeopardize the investment decisions. Sadly, overall, the CIP divergence from the Chinese foreign exchange market persists, with capital control dominating.

As shown in Fig. 1, utilizing the Trilemma, or the Impossible Trinity, which underscores the challenging balancing act between capital mobility, exchange rate stability, and monetary policy autonomy, provides a new perspective to analyze the capital control problem in the RMB FX market. Mathematically, this can be represented as $x+y+z=1$, where x , y , and z denote the degrees of capital mobility, exchange rate stability, and monetary policy autonomy, respectively. In China's case, the government has historically emphasized exchange rate stability (y) and monetary policy autonomy (z) to promote domestic economic stability and growth. Such priorities inherently require the implementation of capital controls ($1 - y - z = x$), bringing lots of policy dilemmas. Also, the scenario poses challenge to the process of transition towards a more open capital account.

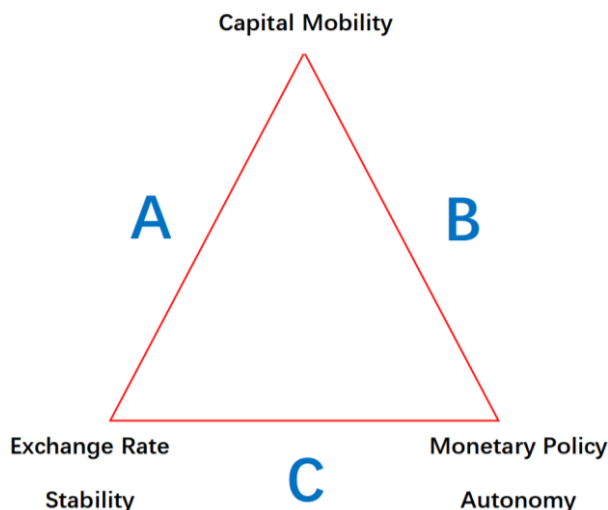


Figure 1. Capital mobility

2.3. The External Vulnerabilities

The external vulnerabilities of RMB FX market, particularly to U.S. economic policy shifts and global uncertainties, highlight a significant challenge: the difficulty in insulating the market from international threats. The dominance of the U.S. dollar in global finance increases the impacts of the Fed’s policies in the global scale, especially to China. For example, the Fed’s QE policies, designed to stimulate U.S. economy through expanded monetary base and lowered interest rate, indirectly threatened the China’s foreign exchange market. Just as the Fig. 2 shows, starting in March 2022, the Fed embarked on a rapid series of interest rate increases: 25 basis points in March, followed by 50 basis points in May, and then an unprecedented 75 basis points in June, July, September, and November, before slightly slowing the pace with a 50-basis point hike in December, and continuing with 25 basis points increases in both February and March 2023. These actions, aimed at curbing the U.S. inflation rate, which hit 7.7% in October 2022—below the expected 8%—have far-reaching implications. These U.S. policies, by lowering interest rates and expanding the monetary base, push global capital towards higher-yielding assets in emerging markets. Such capital inflows can lead to an unwanted appreciation of the RMB, complicating China's efforts to maintain targeted exchange rate levels and leading to trouble of the size and structure of China's foreign exchange reserves. Furthermore, the anticipation of changes in the Fed's policy direction can induce speculative activities, creating additional volatility in the RMB FX market.

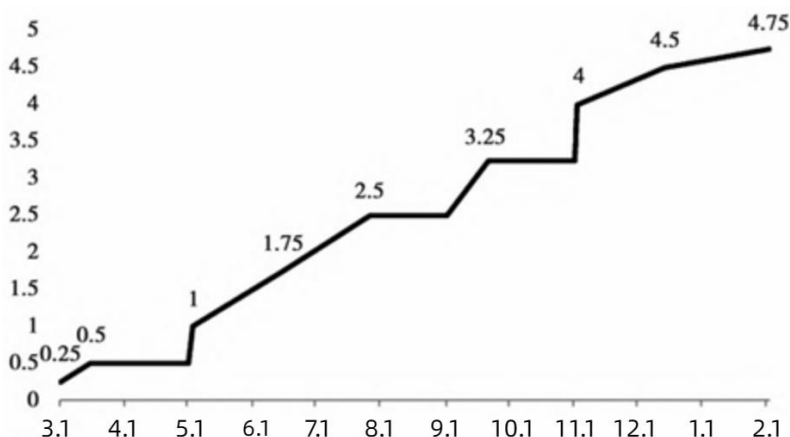


Figure 2. Interest rate

Uncertainty in the global economy prospect, especially U.S. inflation expectations and its fluctuations, lead to another problem of the RMB FX market. The RMB's journey towards internationalization, while progressing, is still in stages where external shocks, driven by policies

from economies like the U.S., can significantly impact China's foreign exchange market. The ongoing challenge for RMB FX market lies in navigating these external pressures in an environment where the dollar's dominance and U.S. economic policies continue to play essential roles. As long as the RMB's internationalization remains incomplete, China's foreign exchange market will likely continue facing challenges in fully shielding itself from the changes of global economic policies and uncertainties.

3. Solutions

3.1. Gradual Liberalization of the Exchange Rate Mechanism

Gradual liberalization of the exchange rate mechanism is a strategic approach to resolving the issues surrounding the RMB exchange rate by enhancing its responsiveness to market dynamics. This method involves steps to ensure a smooth transition towards a more flexible exchange rate system without inducing unwanted market volatility or risking financial stability.

Begin with reducing the frequency and scale of the People's Bank of China's (PBOC) interventions in the foreign exchange market. This step should be communicated clearly to market participants to manage expectations and reduce uncertainty. The goal is to gradually shift from a predominantly policy-driven mechanism to one where market supply and demand dynamics have a greater impact on the exchange rate.

Secondly, it is suggested to incrementally widen the daily trading band of the RMB. This allows for greater fluctuation in the exchange rate, providing a buffer that enables the market to absorb shocks more effectively. As the market adjusts to these changes, the band can be expanded further, increasing the exchange rate's flexibility.

Thirdly, China can consider incorporating a broader set of market determinants in the exchange rate formation process. This could include factors such as inflation differentials, interest rate spreads, and balance of payments positions. Integrating these indicators helps align the RMB's value more closely with underlying economic conditions and global financial market trends.

Moreover, China should adopt a transparent approach to policy changes and interventions in the foreign exchange market. Regularly communicate policy objectives, intervention criteria, and economic rationale behind exchange rate adjustments. Transparency helps build confidence among domestic and international investors, reducing speculative trading and market overreaction.

3.2. The Strategic Opening of the Capital Account

Capital account liberalization emerges as a compelling strategy to address the challenges imposed by capital account restrictions within RMB FX market. This viewpoint is grounded in the premise that opening the capital account can catalyze significant benefits for China's economy, enhancing its integration with global financial systems while mitigating existing inefficiencies and limitations [10].

The liberalizations of the capital account is essential to realize optimal returns on savings and investments by facilitating access to global capital markets. This openness allows for more favorable interest rate for borrowing and provides diverse ways to stay away from specific country risks, thereby improving the overall efficiency of capital allocation within the whole market. Such a shift towards free capital mobility can stimulate economic growth by attracting foreign investments and enhancing domestic financial market competitiveness.

Moreover, opening the capital account is associated with a reduction in the persistence and magnitude of Real Exchange Rate (RER) misalignments, fostering quicker adjustments to equilibrium values. This increased flexibility and openness to capital flows can contribute to a more stable and predictable foreign exchange market, thereby enhancing economic stability. By allowing the RMB exchange rate to reflect market fundamentals more accurately, capital account liberalization helps in reducing the potential for speculative attacks and the resultant volatility.

The transition towards a liberalized capital account should be marked by gradualism to ensure economic stability is maintained [11]. This cautious action allows for the necessary adjustments in

regulatory frameworks and financial infrastructure, ensuring that the financial system's resilience is strengthened in anticipation of increased capital flows. Additionally, it provides opportunities for the development of robust monitoring mechanisms to oversee and manage these flows effectively.

3.3. Promoting RMB Internationalization

Promoting RMB internationalization stands as a strategic solution to mitigate the external vulnerabilities of RMB FX market.

Firstly, China is recommended to strengthen financial cooperation with countries along the Belt and Road by establishing RMB clearing banks in key regions. This initiative would enhance the efficiency of RMB transactions and provide more opportunities for the use of RMB in cross-border trade and investment. Collaborating on financial infrastructure projects, such as the development of payment systems that facilitate RMB transactions, would also support this goal.

Secondly, to diminish the RMB's dependency on the USD, China should actively promote the use of the RMB in international trade and finance. This involves encouraging both Chinese companies engaging in international trade and their global partners to settle their transactions in RMB. Additionally, China could incentivize multinational corporations to issue RMB-denominated bonds, known as "Panda Bonds," in Chinese markets, enhancing the RMB's status as a global investment currency.

Thirdly, the exploration and adoption of digital RMB for cross-border transactions present a unique opportunity to enhance the efficiency, security, and convenience of international payments. The digital RMB, with its inherent advantages of decentralization and transparency, could revolutionize cross-border settlements by making them more cost-effective and accessible. This initiative could significantly boost the RMB's appeal as a transaction currency, reducing China's vulnerability to external financial shocks and pressures.

4. Conclusion

In summarizing the focal points of this investigation into China's foreign exchange (FX) market, it is evident that the issues of RMB exchange rate responsiveness, capital flow restrictions, and external vulnerabilities significantly challenge the market's stability and efficiency. This study has identified these core problems and proposed targeted strategies aimed at addressing them. Through a detailed analysis, strategies such as the gradual liberalization of the exchange rate mechanism, enhancing the openness of capital accounts, and promoting RMB internationalization have been highlighted as essential measures. These proposed solutions are not only essential for addressing the current challenges but also crucial for protecting the RMB FX market from external shocks in the future, thereby contributing to its stability and fostering greater integration into the global financial ecosystem. The information presented here supports efforts to improve the resilience and functionality of China's foreign exchange market in the face of changing economic conditions by providing policymakers and other market stakeholders with useful suggestions.

However, this research is not without its limitations. The analysis mainly focuses on macro-level strategies without delving deeply into the microeconomic implications and operational details of implementing such reforms. Further studies could benefit from a more detailed examination of the specific policy processes, considering the domestic and international economic environment's fluidity. Furthermore, an empirical assessment of previous liberalization initiatives and their results may provide more substantial proof for the suggested approaches, guaranteeing that future policy paths are based on sound theoretical foundations and practical effectiveness.

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