

Analysis of the Current Situation, Problems and Countermeasures of China's Foreign Exchange Market

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Abstract. The foreign exchange market is critical to national economies, trade, and financial security. The foreign exchange market provides trade liquidity and means of payment and is an important channel for capital flows and risk management, as well as a risk-transfer channel in the global economic system and has an important impact on central bank monetary policy. As the world's second-largest economy, China has attracted large amounts of overseas investment, bringing new opportunities to the global market. Against the backdrop of the new crown epidemic and geopolitics, China's economy has maintained a good momentum of development, providing impetus for world economic growth and boosting confidence in the global market. Based on the current situation of China's foreign exchange market in recent years, this paper analyses and concludes that there are currently cross-border capital flow restrictions, capital flow pressure, a single trading body, imperfect market supervision and other problems, and finally puts forward a feasible future development path and reform countermeasures for China's foreign exchange market in view of the above problems, which is of great significance for the healthy development of China's foreign exchange market.

Keywords: China, foreign exchange, financial system, economic growth.

1. Introduction

The foreign exchange market is of vital significance to the country's economic development, international trade and financial security, and is an indispensable part of the modern national economic system. First, the foreign exchange market for international trade provides the necessary liquidity and means of payment, is an important channel of international capital flows and risk management tools, but also the global economic system in the risk transfer channel, and the stability of the foreign exchange market for the country's central bank's monetary policy has an important impact.

As the second largest economy in the world, China's sustained economic development and huge market size have attracted a large amount of foreign investment, providing new opportunities for the global market. In addition, the stability of the Chinese economy is a shot in the arm for global markets. Against the backdrop of and new crown epidemic and geopolitics, China's economy has stabilized itself and continues to deliver growth momentum to the world economy. The Chinese economy has made an important contribution to the prosperity of the world economy.

Based on the background of China's booming economy, this paper studies the status quo of China's foreign exchange market in recent years, analyses and concludes that there are cross-border capital flow restrictions, capital flow pressures, a single trading body, imperfect market supervision and other issues, and finally puts forward a feasible future development path and reform countermeasures of China's foreign exchange market in view of the above problems.

2. Current Situation

The scale of China's foreign exchange market is expanding. With the rapid rise of China's economy, the scale of China's foreign exchange market grows year by year. According to the data of China Foreign Exchange Trading Centre, the transaction scale of China's foreign exchange market from January to December 2023 reached USD 35.85 trillion (See Fig. 1). The expansion of this scale not

only reflects the strength of China's economy, but also the activity and attractiveness of China's foreign exchange market.



Figure 1. Total transactions in China's foreign exchange market

The situation in China's foreign exchange market is stabilising. Over the past few years, China's foreign exchange market has experienced some volatility, but has generally shown a stable trend. The Chinese government has adopted a series of policy measures to strengthen the supervision and management of the foreign exchange market, which has promoted the smooth operation of the market. At the same time, the scale of China's foreign exchange reserves grew steadily, providing the market with sufficient foreign exchange reserve support (See Fig. 2). These factors make the situation of China's foreign exchange market relatively stable, providing investors with a certain degree of protection.



Figure 2. China's total foreign exchange reserves

At the same time, China's foreign exchange market policy has been gradually liberalized. In recent years, the Chinese government has gradually liberalized its restrictions on the foreign exchange market and promoted the opening and development of the market. Especially in terms of capital items, the Chinese government has increased the opening of the foreign exchange market, allowing more free flow of capital. This policy liberalization has brought more opportunities and challenges to the foreign exchange market, while also promoting market activity and innovation.

3. Issues

3.1. Cross-border Capital flows

The internationalization of the RMB can reduce China's economic dependence on the US dollar, alleviate the pressure generated by China's high foreign exchange reserves to a certain extent, and help to prevent and reduce the exchange rate risks faced.

However, foreign exchange control is one of the main obstacles to RMB internationalization [1]. At present, the Chinese government still implements relatively strict capital flow management measures, including restrictions on the purchase of foreign exchange by individuals and enterprises, and restrictions on cross-border capital flows. This has limited the use of RMB globally.

Take RMB as a payment currency as an example. According to SWIFT statistics, the RMB's share of international payments shows an overall growth trend, but the overall share is still low [2]. In 2019, the RMB's share of international payment currencies is below 2.00% in most months, and during the period from January 2020 to November 2021, the RMB's share of international payment currencies gradually increases from 1.65%, and fluctuates around 2.00% up and down; during the period from December 2021 to January 2023, the share continued to climb and reached a peak of 3.20% in January 2022, once surpassing the Japanese yen and ranking fourth; after this, the share of RMB as a proportion of international payment currencies quickly fell back and stabilized to above 2.00%, but in the statistics of January 2023 the share of RMB as a proportion of international currencies was 1.91%, which appearing a new low [2].

From the point of view of the ranking of payment currencies in the world, the RMB can basically remain in the world's fifth largest payment status, the top four are the US dollar, the euro, the pound sterling and the Japanese yen. Although the RMB has made greater progress in payment currencies, it is still far from the proportion of the mainstream payment currencies mentioned above. This shows that the degree of RMB internationalisation is still low.

3.2. Pressure of Capital Flows

China faces the pressure of international capital flows, and the volatility of capital inflows and outflows caused by changes in the external environment in recent years has aggravated the instability of the foreign exchange market.

Since the 1990s, emerging market cross-border capital flows "fast in and fast out" "big in and big out" features more and more obvious, a large inflow of international speculative capital to promote credit expansion and asset price appreciation, so that the appreciation of the RMB pressure to increase. If the "hot money" short-term large-scale flight, asset price bubbles may burst, so that the depreciation of the pressure of the yuan, visible cross-border capital inflows and outflows led to the international demand for the local currency continues to change, resulting in a depreciation or appreciation of the pressure to aggravate the instability of the foreign exchange market [3].

China's foreign exchange market in 2007-2008, 2015-2016 had violent fluctuations, and the short-term extreme outflow of international speculative capital has a close relationship [3]. As the two-way opening process of China's financial market continues to deepen, cross-border capital flows, mainly in the form of securities investment, have become increasingly frequent. 2019, since 2019, the northward capital inflow through the Shanghai Stock Connect and the Shenzhen Stock Connect has continued to increase, and the amount of single-day buying and selling turnover and the amount of net buying turnover have increased year by year, and the short-term fluctuations of cross-border capital have also expanded accordingly [4]. 2020, the second half of the year the inflow of foreign capital was fiercer, and China's Balance of payments began to show a "double surplus" situation, a large amount of cross-border capital inflows into the Chinese stock market, bond market [5]. Choice data statistics show that, as of the close of December 31, 2020, the northward capital in December net inflow of A shares of 57.239 billion yuan; IIF data show that, in December 2020, international capital inflows into the stock market of 29.3 billion yuan; IIF data show that the international capital

inflows into the stock market of 293 million yuan. capital inflows into the stock market were \$29.3 billion, of which \$13.2 billion went to the Chinese stock market [5].

Due to the current round of US dollar interest rate hike cycle in China's interest rate level and the developed economy interest rates show "inverted" trend, speculative arbitrage hot money selling China's domestic financial assets may be further strengthened, on the foreign exchange market, the stability of the financial market poses a threat [3].

3.3. Trading Body

The Chinese government's control of the foreign exchange market restricts the liquidity of the market and the freedom of behaviour of market participants, and the main body of transactions is illiquid.

China has long implemented a strict control system for the foreign exchange market, resulting in many market trading subjects do not have the qualification to participate [6]. In the early days, China's small and medium-sized enterprises and small and medium-sized banks, some Chinese investment institutions and foreign investment institutions are excluded, resulting in the foreign exchange derivatives market to participate in the transaction of the main body is small and single [6]. Individual foreign exchange derivatives are subject to even more restrictions, unable to carry out derivatives business like enterprises to meet their own needs, resulting in derivatives are not only few varieties, but also quite lacking. Therefore, the investment needs of many investors are difficult to be satisfied resulting in insufficient liquidity of the trading body, triggering the herd effect of convergence [6].

In recent years China has gradually liberalized foreign exchange control, however, the current foreign exchange market in mainland China is still the main body of the transaction in the bank, although on the surface of the foreign exchange financial products have been more comprehensive, such as foreign exchange spot, forwards, options, swaps, swaps, etc., but the overall participation in the main body is relatively single, mainly involved in foreign exchange enterprises, so the liquidity of the poor, the transaction costs are too high. Therefore, the foreign exchange bureau also needs to continue to expand the scope of the main participants, the introduction of individual investors, increase liquidity, so that the real hedge enterprises can get lower transaction costs.

3.4. Weak Risk Prevention and Market Supervision

China's foreign exchange market in the development process there are imperfect regulatory system, undermining the stability and transparency of the foreign exchange market, not conducive to the healthy development of the foreign exchange market. Specifically, there are the following aspects of the problem:

The foreign exchange market regulatory system is not sound enough, the regulatory responsibilities are not clear, the regulatory means are insufficient, and the regulatory measures and penalties of the regulatory authorities are insufficient, resulting in the maintenance of market order is not effective, the spread of illegal cross-border financial activities, such as underground money changers, export tax fraud, cross-border gambling and other illegal acts are more, which undermines the healthy order of the foreign exchange market.

Insufficient information disclosure in the foreign exchange market makes it difficult for market participants to obtain accurate and comprehensive market information. Markets that lack transparency are prone to information asymmetry, market manipulation, insider trading and other problems, increasing market risks. For example, some large institutions and investors have more information resources and trading advantages, and small investors face an unfair competitive environment.

The financial risk monitoring, assessment and prevention and control system is not perfect, the lack of tools and instruments to prevent and resolve systemic risk, there is the possibility of insolvency caused by individual currency mismatch risk and exchange rate risk, which in turn triggers systemic risk [7].

4. Solution

4.1. Liberalise Account Funding

The proportion of RMB international currency settlements is still relatively small. To address this problem, the Chinese government can gradually relax foreign exchange controls while strengthening supervision and risk management and take measures to encourage more cross-border transactions as well as promote the free flow of capital. Strengthen cooperation with other countries and regions to promote the use of RMB for cross-border trade settlements, and actively participate in international financial institutions and organisations to increase channels for the use of RMB globally. Specifically:

The Chinese government can increase its investment in financial infrastructure development and strengthen cooperation with other countries and regions to interconnect payment settlements and clearing institutions. In addition, it needs to improve its technical level and information security guarantee capacity to ensure that cross-border transactions are safe and reliable.

Actively carry out local currency settlement of bilateral trade and expand the proportion of RMB settlement in the international market. In recent years, the number of central bank members joining the "RMB Settlement Club" continues to increase [5]. At present, the buyers who take the initiative to use RMB to pay mainly come from Russia, Iran, Egypt, Algeria, Venezuela and other countries with less US dollar foreign exchange or some regions under US sanctions, as well as ASEAN or neighboring countries in Asia, such as Malaysia, Vietnam, India, Pakistan, Japan and so on [5]. China should make full use of the opportunity to further strengthen the cooperation with other countries and regions to promote the process of RMB internationalisation, to strengthen the stability of the foreign exchange market.

4.2. Strengthening Cross-border Capital Flow Management

In response to the pressure of capital flows, the short-term inflow and outflow of hot money can be mitigated, and the stability of the foreign exchange market can be maintained through cross-border capital flow management and risk prevention.

The central bank must beware of the sudden influx/withdrawal of speculative short-term capital, which may increase the risk of RMB appreciation/depreciation and make market-based adjustments in due course. The central bank should intervene decisively to stabilize market expectations in the face of abnormal cross-border capital fluctuations and prevent the risk from being transmitted to the domestic financial market [3].

In response to the fierce inflow and outflow of capital from abroad, it is necessary to deepen the market-oriented reform of the exchange rate, increase the flexibility of the exchange rate, and maintain a mild colour, which, in doing so, will help to smooth out the risk-free arbitrage capital flows [5];

To strengthen two-way monitoring of cross-border capital inflows and outflows, especially to improve the quality of the balance of payments statistics to improve the country's macroeconomic analysis and decision-making to provide an accurate and reliable basis; to further improve the foreign exchange market, "macro-prudential + micro-regulation," the two integrated management framework, to maintain a healthy order of the foreign exchange market [5].

4.3. Deepen the Reform of the Foreign Exchange Market

China needs to gradually liberalise foreign exchange control, promote the healthy development of the foreign exchange market and market-oriented process; improve the derivatives market construction to make the foreign exchange market trading body more diversified.

Introduce the market maker system into China's inland and make it perfect continuously to enhance the liquidity of the market. At the same time, it should actively improve the financial infrastructure market, which is conducive to the risk management of market makers, reduce their risks, so that the initiative and enthusiasm of their quotes are enhanced [6].

All kinds of financial enterprises and investment companies should be allowed to enter China's foreign exchange derivatives market, which helps to improve market activity and stability. Entering the market to participate in the diversification of foreign exchange derivatives trading subjects, can be a good balance of supply and demand in the derivatives market, improve the equilibrium of supply and demand prices [6]; At the same time, the entry of various competitive subjects into the foreign exchange market can disperse foreign exchange risk, enhance the overall competitiveness of China's foreign exchange market [8].

Market participants in the main body of the segmentation, innovation of foreign exchange trading tools, foreign exchange investors to provide more effective means of risk management. For different characteristics of market participants to design different foreign exchange derivatives, respectively, to meet their needs, can greatly enhance the enthusiasm of market players [6]. Such as listed companies not in China, as well as a large number of Chinese and foreign joint ventures, etc., can be recommended to support the forward or option products; for foreign currency cash inflows mainly committed to carry out overseas financing, domestic and foreign currency loans in real estate, aviation customers, can consider recommending forward settlement; for the beginning of the period need to transfer funds back to the territory, and the maturity of the need to cash the debt abroad of the overseas issuance of foreign debt companies, can be carried out in the currency swap Products [6].

4.4. Improve the Market Regulatory System

China should improve the foreign exchange market "macro-prudential + micro-regulation" two integrated management framework, improve the foreign exchange market regulations, strengthen the foreign exchange market trading behaviour supervision, regular foreign exchange market trading behaviour assessment, strengthen the foreign exchange market self-regulatory management, to prevent the potential risks of the foreign exchange market, so as to protect the rights and interests of investors, and maintain the normal order of the foreign exchange market. normal order of the foreign exchange market. Specifically:

Comprehensively apply macro-prudential management policies and counter-cyclical adjustment tools, reasonably guide market expectations, and maintain the basic stability of the RMB exchange rate at a reasonable equilibrium level, to cope with external shocks and maintain the stability of the foreign exchange market [9].

Improve micro-behavioral regulation in the foreign exchange field, including combating market manipulation and insider trading, anti-fraud and misrepresentation, information disclosure requirements, protection of personal financial information, anti-unfair competition/anti-monopoly, and consumer dispute resolution, etc., to maintain the order of the foreign exchange market, which is fair, just and effectively competitive.

Promote information sharing and regulatory co-operation among supervisory authorities and establish a monitoring system and risk alert mechanism regarding currency mismatch and exchange rate risks for enterprises active in cross-border trade and investment and financing, to avoid individual risks from triggering systemic risks and leading to volatility in the foreign exchange market [10].

Gradually reduce the degree of central bank intervention in the foreign exchange derivatives market and restrictions. Future monetary policy tools can include foreign exchange derivatives, strengthen the supervision of foreign exchange derivatives through laws and regulations, and play its role in regulating the foreign exchange market.

5. Conclusion

The foreign exchange market plays a crucial role in national economy, trade and financial security, and is an indispensable part of the national economic system. As the second largest economy in the world, China has attracted a large amount of foreign investment, bringing new development opportunities to the global market. Based on the current situation of China's foreign exchange market in recent years, this paper analyses the existence of cross-border capital flow restrictions, capital flow

pressure, single trading body and imperfect market regulation, and finally puts forward a feasible development path and reform countermeasures for China's foreign exchange market in the future.

However, there are some shortcomings in this study, such as some data are not easy to obtain, and the development history of China's foreign exchange market has not been explored and analysed in a comparative manner, which still need to be improved and upgraded.

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