

The Problems and Solutions in the Chinese Exchange Market

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Abstract. Against the backdrop of potential interest rate cuts by the Federal Reserve, this paper delves into the issues that may be exposed in China's foreign exchange market at any moment, such as increasing capital flow risk and exchange rate volatility. This article scrutinizes the challenges laid bare by these policy adjustments and puts forth viable solutions to address them. By exploring some economic strategies such as adjusting national currency trades, diversifying portfolio risks, and augmenting foreign exchange trading quotas, this analysis aims to effectively mitigate some exposed issues of the Chinese exchange market due to the Fed's interest rate cuts and to equip stakeholders with insights to navigate these challenges effectively. Ultimately, the goal is to address and cover up the problems exposed in China's foreign exchange market under the background, and further ensure the continued stability and smooth functioning of China's foreign exchange market amidst evolving global economic dynamics.

Keywords: China, foreign exchange, interest rate cuts.

1. Introduction

Since the US Department of Commerce released the Personal Consumption Expenditure price index for November on December 22nd, 2023, the Fed's interest rate cut bias in 2024 has been exposed. The PCE, as one of the most important measures of inflation, rose 3.2 percent in November from a year earlier, which is the smallest increase since 2021. In the second half of the six months of 2023, the annualized rate of the PCE index in the United States dropped to 1.9% year-on-year, coming below the Federal Reserve's 2% target control line, which means that the US inflation is cooling down, the Fed is ready to cut interest rates in 2024. The Federal Reserve's interest rate cuts have had far-reaching implications for the global economy, including the foreign exchange market in China [1].

This shift in monetary policy direction by the Federal Reserve not only impacts the domestic economy but also reverberates across international markets. In response to the anticipated rate cuts, investors worldwide are adjusting their strategies, causing fluctuations in global currencies. In particular, the Chinese foreign exchange market is closely monitoring these developments, as changes in US interest rates often influence capital flows and exchange rate dynamics in China. As investors recalibrate their positions, Chinese authorities may need to implement measures to manage potential volatility and maintain stability in their currency market.

2. Problems

2.1. Increased Exchange Rate Volatility

The impact of the Federal Reserve's interest rate cuts on China's foreign exchange market cannot be overstated. For instance, against the backdrop of multiple interest rate cuts by the Federal Reserve in 2019, the sustained depreciation of the US dollar has led to significant fluctuations in the exchange rate between the Chinese Yuan and the US dollar. This volatility has intensified the level of uncertainty in China's foreign exchange market, making it increasingly challenging for businesses and investors to predict future exchange rate trends. Consequently, this heightened uncertainty has amplified the unpredictability of foreign exchange risks, posing considerable challenges for market participants.

Moreover, the exacerbation of exchange rate fluctuations has had profound implications for businesses engaged in cross-border trade and investment activities. The increased volatility in

exchange rates has exposed these businesses to greater currency risk, potentially leading to escalated operating costs. As a result, businesses may experience diminished profitability and reduced competitiveness in the global market. The heightened exchange rate volatility has also prompted businesses to reassess their risk management strategies, as they seek to mitigate the adverse effects of currency fluctuations on their financial performance and operations.

In essence, the exacerbation of exchange rate fluctuations has emerged as a pressing issue confronting China's foreign exchange market. It has introduced unprecedented levels of uncertainty, making it increasingly challenging for businesses and investors to navigate the complexities of the global currency landscape. As such, addressing this issue requires comprehensive measures to enhance market stability, strengthen risk management frameworks, and foster a conducive environment for sustainable economic growth and development.

2.2. Increased Capital Flow Risk

When external factors such as changes in international economic policies or increased volatility in global financial markets, capital liquidity may be directly affected, increasing capital flow risk and a Fed rate cut could lead to increased volatility in global financial markets [2]. That volatility can cause investors to panic, causing them to shuffle portfolios and move money around [3]. This frequent flow of funds will increase the uncertainty and volatility of the market, making the market more susceptible to external factors, thus increasing the risk of capital flow. A Fed rate cut could change investors' expectations and risk appetite for the global economy. If investors expect slower growth or uncertainty in the global economy, they may seek to move money to relatively stable markets or assets. Such flows may lead to an increase in market liquidity and increase liquidity risks [4].

Fed rate cuts usually lead to a decline in the value of the dollar, which makes U.S. assets relatively less attractive and assets in other countries more attractive. As a result, investors may be more inclined to put their money in relatively stable assets under such circumstances, increasing liquidity in the market, and some investors may move their money from the United States to other countries[5], including China, in search of higher returns. Such inflows could increase liquidity in the Chinese market and exacerbate liquidity risks. To sum up, the impact of external factors on capital liquidity may lead to an increase in capital flow risk, exacerbate the uncertainty and volatility of the foreign exchange market, and bring challenges to market participants.

2.3. Capital Movement Restriction

Since the Fed cuts the interest rate, the US dollar and market will become less attractive, and people are more willing to put another market with higher interest rates, such as the Chinese exchange rate market [6]. The relative attractiveness of investing in China is likely to increase, leading to an influx of international funds or “hot” money. But it also exposes another problem, which is capital movement restriction.

Capital movement restrictions refer to a series of regulatory measures implemented by the Chinese government aimed at limiting the free flow of capital. These measures include foreign exchange controls, capital controls, restrictions on domestic and overseas investments, and so on. Foreign exchange controls typically restrict individuals and businesses from transferring funds abroad or converting foreign currency into other currencies. Capital controls involve limitations on foreign investors' investments in the Chinese market or restrictions on Chinese investors' activities in overseas markets.

Capital flow restrictions may have various impacts on China's foreign exchange market. Firstly, they may lead to diminished interest among foreign investors in the Chinese market since they are unable to freely transfer funds to or from China. Such restrictions could reduce the attractiveness of the Chinese market, affecting foreign direct investment (FDI) and other capital inflows, thus impacting the supply-demand dynamics and stability of the foreign exchange market. Secondly, capital flow restrictions may also limit Chinese companies' activities in overseas markets. These companies may face difficulties such as being unable to freely remit funds overseas or being subject

to restrictions imposed by foreign countries on foreign investors, thus diminishing their competitiveness and flexibility in the global market.

3. Solutions

3.1. Addressing Escalating Exchange Rate Volatility

The most effective way for the Chinese government to relieve the situation of increased exchange rate volatility is active intervention by monetary authorities can manage exchange rate fluctuations and maintain market stability, which means taking a series of measures to ensure the stability of the exchange rate and reduce unnecessary fluctuations. These measures are usually implemented by the country's monetary authorities, such as the central bank, to influence the market through their active intervention to keep the exchange rate fluctuating within a reasonable range and to ensure market stability.

Monetary authorities can intervene in exchange rate markets in several ways, including buying or selling the national currency, adjusting the level of interest rates, and intervening in the foreign exchange market.

Buying or selling the national currency: The Chinese central bank can influence market supply and demand by buying or selling their currency, thereby changing the level of the exchange rate. If the Chinese central bank think their currency is too devalued, they can buy it in order to boost its value. Conversely, if the Chinese central bank believe their currency has appreciated too much, they can sell it to reduce its value.

Adjusting the level of interest rates: The Chinese central bank can influence investor demand for their currency by adjusting the benchmark interest rate or other monetary policy interest rates. Raising interest rates may make a home currency more attractive, causing it to appreciate. Lower interest rates can make a domestic currency less attractive, causing it to depreciate.

Intervening in the foreign exchange market: The Chinese central bank can directly intervene in the foreign exchange market to influence market supply and demand by buying and selling foreign exchange, thereby changing the exchange rate level. They can conduct large-scale foreign exchange buying and selling operations to curb exchange rate fluctuations or guide exchange rate movements.

Through active policy intervention, the Chinese central bank can control exchange rate fluctuations to a certain extent, ensure market stability, and provide a stable foreign exchange market environment for the economy, which is conducive to the planning and decision-making of investors and enterprises.

3.2. Addressing Increasing Capital Flow Risk

When investors strengthen risk management and diversify their portfolios, they try to reduce the risk that their portfolios are exposed to and increase the chances of potential returns. This means that they diversify their investments across different asset classes and geographies to reduce their dependence on a single market or asset and thus better withstand market volatility and risk.

Diversification of portfolio risk: By investing money in different types of assets, such as stocks, bonds, real estate, etc., investors can reduce the risk that a particular asset class may bring. When one asset class is affected, other asset classes are likely to perform better, balancing the overall risk of the portfolio [7].

Geographic diversification: Investors can also invest their money in markets in different regions to spread geographical risk. The economic environment, political stability and level of market development can vary from region to region, so diversification into different regions can reduce exposure to the risks of a single region [8].

Reducing dependence on specific markets and assets: By diversifying your portfolio, investors can reduce their dependence on specific markets or assets. This means that even if an adverse situation occurs in a particular market or asset, the investor's overall portfolio still has some stability and return potential [9].

Overall, strengthening risk management and portfolio diversification is an effective strategy for investors to adopt in the face of uncertainty and market volatility. By diversifying their portfolio, investors can reduce the risk of their overall portfolio and improve the stability and return potential of their investments over the long term.

3.3. Addressing the Capital Movement Restriction

Since the Chinese government is too strict with capital controls, the Chinese government is likely to gradually ease restrictions on capital flows to allow money to move more freely in and out of the country [10]. Such initiatives are aimed at promoting a more open economic environment, attracting more international investment, and strengthening China's ties to global financial markets.

Increasing the foreign exchange trading quota: China can gradually increase the foreign exchange trading quota for individuals and enterprises, so that they can make cross-border transactions and investments more flexibly. This means that individuals and businesses can more easily buy foreign currency, make international payments, and invest overseas.

Ease restrictions on overseas investment: The Chinese government could ease restrictions on overseas investment by individuals and companies, allowing them to invest more freely in overseas markets. This could include easing restrictions on foreign exchange purchases, streamlining approval procedures for overseas investments and raising quotas for overseas investments.

By gradually easing these restrictions, the Chinese government can create a more relaxed environment for capital flows and facilitate more international capital flows into the Chinese market. As a result, the government should implement these reforms in a gradual and orderly manner to balance the free movement of capital and financial stability.

4. Conclusion

In conclusion, the ramifications of the Federal Reserve's interest rate cuts reverberate beyond domestic borders, impacting global economies and financial markets. For China, these adjustments pose multifaceted challenges in managing exchange rate volatility, capital flow risks, and capital movement restrictions. To navigate these complexities effectively, proactive measures are imperative. The Chinese government can intervene actively in the foreign exchange market, adjust interest rates, and gradually ease capital flow restrictions to mitigate the adverse effects of exchange rate fluctuations and enhance market stability. Simultaneously, investors can adopt strategies such as portfolio diversification and risk management to safeguard against heightened volatility and capitalize on emerging opportunities in a dynamic global landscape. By implementing a combination of policy interventions and prudent investment strategies, China can bolster resilience in its foreign exchange market and foster sustained economic growth amidst evolving external pressures.

Furthermore, fostering collaboration and coordination among global stakeholders is essential to address the interconnected nature of these challenges. International cooperation can facilitate the development of regulatory frameworks that promote transparent and efficient capital flows while safeguarding against systemic risks. By fostering an environment conducive to open dialogue and shared objectives, policymakers and market participants can collectively navigate the complexities of a rapidly evolving global financial landscape. Ultimately, by embracing proactive measures and fostering collaborative efforts, China can position itself to navigate the uncertainties posed by shifts in monetary policy dynamics and ensure the continued stability and resilience of its foreign exchange market in the face of evolving global economic dynamics.

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