Brief Analysis of the Development of China's Foreign Exchange Market

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Abstract. The foreign exchange market is a crucial component of China's financial market system, wherein the current iteration is a closed market system centered around the inter-bank market. Over the past four decades of China's reform and opening up, the nation's foreign exchange market has undergone four stages of development: initiation of foreign exchange adjustment business, evolution into a foreign exchange adjustment market, transition into an open foreign exchange adjustment market, and ultimately, the establishment of a unified inter-bank foreign exchange market. In recent years, the continuous improvement of the foreign exchange market and management system reforms has led to the development of a foreign exchange market and trading mode that is tailored to the domestic and international economic climate and the trend of globalization. As the foreign exchange market continues to grow steadily, it is essential for China's foreign exchange development to continually refine and expand the foreign exchange market. This piece commences with an exploration of the inadequacies inherent in the foreign exchange market, delving into potential strategies for enhancing our nation's foreign exchange market.

Keywords: China, foreign exchange, market.

1. Introduction

Since China's reform and opening up and its entry into the WTO, China has followed the trend of economic globalization, continuously opened wider to the outside world, and actively carried out economic and trade cooperation with other countries on the basis of equality and mutual benefit. As of 2022, China is the world's second largest economy (in current dollar terms), ranking first in total exports and second in total imports. In 2023, China's total import and export of goods will be about 41.8 trillion yuan (See Fig. 1). That's about 0.2 percent more than last year [1]. At the same time, China's foreign exchange market has experienced three periods of difficult exploration, formation and development, and innovation and development. Despite the decline in efficiency witnessed in the foreign exchange market during the outbreak of COVID-19, China's foreign exchange market has demonstrated overall stability, accompanied by significant transformations in terms of scale and operational methodologies [2]. The Chinese market exhibits a fundamental equilibrium between supply and demand for foreign exchange, with a gradual increase in reserves and an expanding array of foreign exchange products. Moreover, there is a progressive diversification of currencies involved in foreign exchange trading, coupled with an escalating demand for such transactions from banks. These developments present both opportunities and challenges for Chinese commercial banks as they navigate through broad prospects for growth while simultaneously addressing numerous issues and obstacles. This is both an opportunity and a challenge for China's commercial banks. Foreign exchange business has a broad prospect, but at the same time there are many problems and obstacles to be solved and overcome.

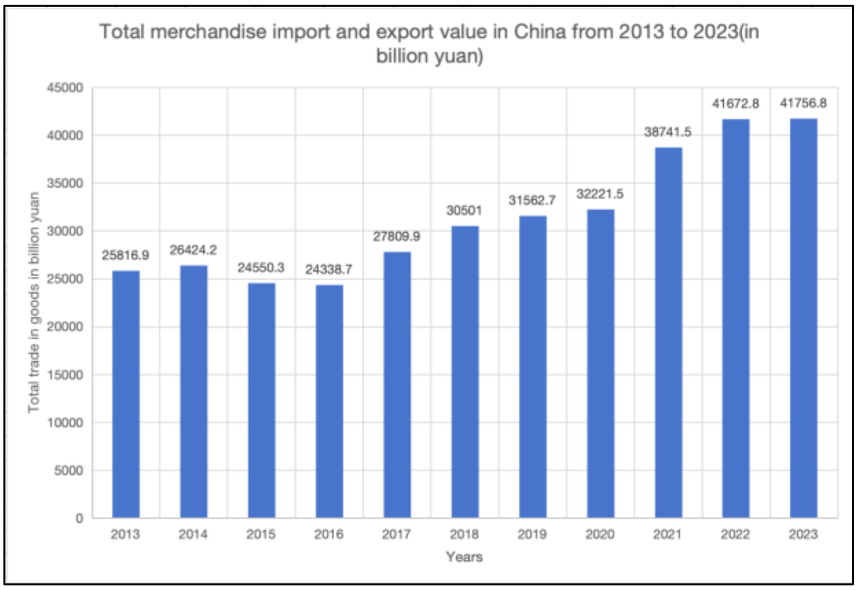

Fig. 1 Total merchandise import and export value in China

2. Problem

2.1. Risk Management

The high proportion of USD assets in foreign exchange reserves exposes China to a number of risks to China's economic development, such as real returns, exchange rate risks and potential government economic and credit crises. First, the data show that the vast majority of China's foreign exchange reserves are held in dollars, with about two-thirds of official reserves held in dollar assets. China's foreign exchange reserves reached $3,219,320.0 million on January 1, 2024. As of the end of July 2019, China's holdings of US Treasury bonds ranked first in the world's total holdings of US Treasury bonds [3]. Taking into account factors such as the dollar's depreciation and the US inflation rate, real yields would be lower on this basis. Secondly, in the context of economic globalization, the economic situation of various countries is closely related, and the economic crisis in the United States will have a great impact on China's economic market, making China face serious exchange rate risks. Excessive reserves can lead to a corresponding increase in the amount of money the People's Bank of China is pumping out, which risks inflation in China. Finally, because there is an oversupply of existing renminbi in the form of foreign exchange reserves, invoice data, government bonds, and deposits employed by the PBOC need to be adjusted for inflation. Once central bank bills reach the maturity of government bonds, these funds will have a huge impact on domestic debt. If these domestic debts are not repaid on time, this will impose an unimaginable economic and credit burden on the government [3].

2.2. Trading Personnel

In China's current situation, high-quality talents cultivated by education are still in short supply, and the professional quality of foreign exchange trading personnel cannot fully meet the needs of the foreign exchange market. Since each bank must have relevant foreign exchange trading personnel to participate in foreign exchange trading, it requires banks to reserve relevant foreign exchange professionals. Although most of the employees of foreign exchange business in China's commercial banks have a bachelor's degree or above, many employees still have problems such as unsuitable majors, weak professional skills, and short working time. They even have the phenomenon that one person has multiple jobs, and lack a professional foreign exchange business management team [4]. In the actual operation of foreign exchange business, most employees can only operate according to the process, and cannot flexibly apply according to the actual situation. This neither reflects the professional level of the individual, nor can it adapt to the real situation of the actual existence.

Moreover, when encountering emergencies, most employees lack the ability to solve problems independently, to think about countermeasures independently, and to solve problems independently.

2.3. Business of Banks

Take the Bank of China as an example. Although the Bank of China is the earliest commercial bank engaged in foreign exchange business, the development of foreign exchange business is still relatively backward compared with commercial banks in developed countries. In terms of foreign exchange products, the main foreign exchange products of Bank of China include Jinjinbao, Foreign Exchange Bao, Hualibao, etc. Customers can use the Bank of China foreign exchange trading client to conduct convenient, fast, safe and efficient online transactions for these foreign exchange products. From the perspective of product types, banks are mainly engaged in foreign exchange products such as settlement and sale of foreign exchange, foreign exchange deposits and loans, which are less technical, and most of them are spot trading products. Such products are less risky, so the return is also lower, so the bank's profit on such foreign exchange products is also low. But such as foreign exchange futures, foreign exchange options, currency swaps and other technical, high-risk and high-yield forward foreign exchange varieties are relatively few. According to the trading overview of China's foreign exchange market in 2023, the total transaction volume of China's foreign exchange market reached 35,848 billion US dollars, of which the spot transaction reached 12,736.6 billion US dollars, while the forward transaction was only 626.7 billion US dollars, and the option was 1,450.7 billion US dollars [5]. Due to the small trading scale of China's foreign exchange market, the market turnover is also small, even lower than some small countries around. The low returns that banks can get from foreign exchange products make banks not pay too much attention to foreign exchange business.

2.4. Illiquid and Closed Market

At present, the interbank foreign exchange market has copied the securities trading mode of Shanghai and Shenzhen stock exchanges, and adopted the bidding trading mode of "separate quotation and matching transaction" [6]. But in fact, this model is only suitable for standardized contracts, continuous trading volume, counterparties are relatively easy to match transactions. And the transaction can only be carried out when the buyer and seller exist at the same time, and the sale price can match [7]. Although this approach better reflects fairness, fairness and price optimization, the transaction is not necessarily continuous, and the scale will be limited. In this system, banks do not have full autonomy in foreign exchange transactions. Many transactions require layers of reporting, layers of approval, complicated and cumbersome procedures, which makes a foreign exchange transaction long cycle, low efficiency, and even make customers lose patience in trading, resulting in transaction interruption and customer loss. The inter-bank foreign exchange market is the exchange trading, trading all fixed business hours, there are certain restrictions on the counterparty, which will affect the continuous conduct of foreign exchange trading. The discontinuous trading leads to the instability of market expectations, such as the foreign exchange rate is prone to violent fluctuations at the opening and closing, and the risk of the foreign exchange market will increase.

3. Solution

3.1. Improve the Relevant Prevention System

Excessive and unilateral foreign exchange reserves will bring great risks to a country's economy, so it is necessary to take a number of targeted measures to curb the abnormal growth of China's foreign exchange reserves, including adjusting the currency structure of foreign exchange reserves and establishing a two-level foreign exchange reserve management system. On the one hand, from the perspective of adjusting the currency structure of foreign exchange reserves, first of all, foreign exchange reserves are the primary tool for stabilizing the financial system. China should adjust the currency structure of foreign exchange reserve assets from both aspects of national economy and international trade. Second, change the settlement system and the currency structure of external debt, including an increase in foreign exchange reserves in euros, yen and other currencies. On the other hand, from the perspective of the foreign exchange reserve management system, China must conduct foreign exchange management from various aspects to achieve the management of the central bank and the Ministry of Finance. At the same time, China could establish a foreign exchange parity fund, which would be owned by the Ministry of Finance and managed by the central bank, with the market exchange rate determined by the operation and management of the fund [3]. This way can improve the independence of monetary policy, but also can effectively control the risk of foreign exchange reserves. In general, improving the relevant prevention system is the most fundamental point to improve China's excess foreign exchange reserves.

3.2. Improve the Professional Quality of Employees

First, vigorously cultivate foreign exchange brokers. Foreign exchange broker is an important link between the buyers and sellers of foreign exchange, which is conducive to the facilitation of foreign exchange trading, the development and support of non-financial institutions to enter the market, and the diversification of market participants. Because foreign exchange brokers have rich market experience and intensive information, it is because they can act as agents for investors without taking higher risks [8], which is conducive to improving the efficiency of market transactions. Secondly, after the introduction of highly educated talents, banks should strengthen the professional skills training of these talents, so as to avoid these talents becoming highly educated and low-skilled employees. Since most highly educated talents lack practical experience in foreign exchange business, banks can organize exchange and sharing meetings for new and old employees to facilitate the exchange and improvement of practical experience in foreign exchange business among new and old employees. Third, in order to cope with the rapid development of the foreign exchange market and improve the competitiveness of foreign exchange business of commercial banks, banks need to establish a team of high-quality foreign exchange business talents with excellent business skills and high professional level [4]. The bank can establish an incentive mechanism for employees, and select excellent talents with a solid theoretical foundation, rich operational experience and keen insight into the domestic and foreign economic situation to form this team of high-level and high-tech talents.

3.3. Foreign Exchange Products

In order to develop China's foreign exchange business, it is necessary to be customer-oriented and develop more foreign exchange products suitable for market demand. For example, foreign exchange financial products suitable for financial management, hedging, speculation and other needs can be developed according to the different requirements of domestic customers on exchange rate risks. For overseas customers, it is necessary to narrow the gap between China's foreign exchange derivatives and foreign commercial banks' foreign exchange derivatives, and improve the ability of supporting services. In addition, bank management can also formulate various incentive policies to encourage product R&D departments to research and develop innovative foreign exchange products. At the same time, the branch banks in each region should also adopt the operation mode suitable for the development of banks according to their own regional environment and local characteristics and culture, combine the relevant value concepts, develop foreign exchange products or foreign exchange business with their own characteristics, and form their own unique foreign exchange business culture [9].

3.4. Currency Dealer System

Liquidity is the main index to measure the quality of market operation. The more liquid the market, the smaller the market maker's price spread. This is because active trading reduces the time market makers hold their positions, thereby reducing inventory risk, and enables market makers to achieve economies of scale when trading, thereby reducing costs and thus narrowing quotation spreads [10]. To be fair, the liquidity of RMB/USD transactions in China's inter-bank foreign exchange market is not low, mainly because of the strict restrictions on exchange rate volatility, which makes the order matching success rate under the bidding trading mechanism is high, and the background of turnover of foreign exchange settlement and sales positions also limits the number of single foreign exchange transactions. Once the exchange rate fluctuation range is relaxed or large amounts of investment and speculative transactions are allowed, market liquidity will be affected due to the heterogeneity of market entities' expectations, and the cost of liquidity risk to traders will also increase, and the superiority of the market maker system will appear.

4. Conclusion

In summary, China's foreign exchange market has undergone rapid development; however, it is imperative for relevant authorities to address the existing issues in the current state of the market. The aforementioned analysis highlights several shortcomings in China's foreign exchange trading: a substantial proportion of dollar assets in reserves poses significant risks; there is a need to enhance the professional competence of bank personnel engaged in foreign exchange trading; limited variety and lack of innovation prevail within the realm of foreign exchange business; and finally, China's foreign exchange market suffers from illiquidity and isolation. To meet market demands, contribute to further financial system improvement, and enhance China's financial vitality, it is crucial to introduce pertinent policies that expedite the enhancement and development of the foreign exchange market.

A series of policies and measures should be implemented to establish and improve our foreign exchange market system by addressing excessive dollar reserves through an improved prevention system; enhancing training programs aimed at improving professional skills among bank staff involved in foreign exchange operations; continuously enriching and developing innovative products within the domain of foreign exchange transactions; as well as improving overall liquidity within the market. These efforts will facilitate improvements within China's socialist-market economic system while ensuring that domestic entities are capable of meeting global requirements.

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