China's Foreign Exchange Market: Research on Problems and Countermeasures

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Abstract. The foreign exchange derivative market plays a vital role in the global economy. As one of the world's largest economies, China has already recognized the significance of establishing a well-regulated foreign exchange market. However, the Chinese foreign exchange market still faces several challenges. There are four main challenges: regional disparities in development, low level of diversification, high market risks, and inadequate regulation. These issues should draw public's further attention and get resolution. This paper aims to analyze the four problems above in China's foreign exchange derivatives market and propose feasible solutions, including alleviating the imbalance problem, strengthening market diversification, reducing information asymmetry and strengthening the government supervision, which help to address the identified problems. The research findings are also helpful for some market participants and policymakers to understand the shortcomings of China's foreign exchange derivatives market better, and thus designate more rigorous trading strategies and improve the environment for China's foreign exchange derivatives market.

Keywords: Foreign exchange derivatives, risk, regulation.

1. Introduction

The foreign exchange market plays a crucial role in the global economy, facilitating international trade and investment. As one of the world's largest economies, the Chinese government has been committed to establishing a well-regulated foreign exchange market, promoting the marketization of interest rates and exchange rates, and enabling the two-way opening of the interbank market [1].

As a bridge connecting domestic and international markets, the foreign exchange market allows market participants to engage in currency trading. Developing the foreign exchange market is beneficial for strengthening the nationalization of the Chinese economy, enhancing the country's influence in the international arena, and aiding in risk management. The Chinese foreign exchange market exhibits three distinctive features: low entry barriers, high profitability, government support, and a significant shortage of professionals [2].

In 1978, China initiated its reform and opening-up policy, which led to the implementation of the foreign exchange retention system to meet the demands of import and export trade. This resulted in a regional demand for foreign exchange adjustment. Subsequently, cities, such as Shenzhen, Beijing, and Shanghai, established foreign exchange adjustment markets, becoming the primary venues for foreign exchange trading in China at that time. These regional adjustment markets were relatively scattered and independent until April 1994 when the China Foreign Exchange Trading Center officially opened, marking the emergence of a standardized and unified foreign exchange market in China. The market-oriented reform of the renminbi (CNY) exchange rate began in July 2005, leading to an increased supply of products in the foreign exchange market, including renminbi foreign exchange forwards, swaps, and options. China's foreign exchange market has gradually diversified and internationalized [3]. However, challenges remain in addressing issues such as regional disparities, limited diversification, high market risks, and inadequate government regulation. Ensuring effective regulation is crucial for maintaining the stability of the market and protecting the interests of investors.

Therefore, this study aims to thoroughly analyze the four issues existing in the Chinese foreign exchange market and propose corresponding solutions to address the problems. The findings and recommendations of this study can guide policymakers and market participants in improving the regulatory framework and promoting the healthy and efficient development of the Chinese foreign exchange market.

2. Problems

In recent years, the internationalization of Chinese enterprises' trade activities has been increasing, accompanied by a rise in the complexity, severity, and uncertainty of the economic external environment [4]. To safeguard their earnings, more and more companies and financial institutions are utilizing foreign exchange derivatives, such as spot transactions, forward transactions, and foreign exchange futures to hedge against exchange rate risks. Even though the Chinese foreign exchange derivatives market has made some progress, there are still several issues that need to be addressed.

2.1. Regional Disparities

The development of the Chinese foreign exchange derivatives market exhibits uneven regional growth. Currently, China's financial trading market is still primarily concentrated in major cities like Beijing, Shanghai, Guangzhou, and Shenzhen [5]. These developed cities attract a larger number of advanced financial institutions and high-quality investors, making it easier to attract international financial organizations. In contrast, financial market development in second- and third-tier inland cities lags behind, resulting in a less mature foreign exchange derivatives market, with limited trading volume and fewer product varieties. This creates a vicious cycle where low-quality traders in the foreign exchange market hinders innovation in foreign exchange derivatives, leads to rigid business models, and weakens risk management capabilities. Uneven regional development of the financial market restricts the diversification and innovation of the Chinese foreign exchange derivatives market.

2.2. Limited Diversification

The Chinese financial market predominantly focuses on traditional businesses, such as trading and credit activities. The major foreign exchange derivatives in China include forward contracts, swaps, and options [2]. However, compared to the size of the Chinese economy, the variety of its tradable foreign exchange derivatives is relatively limited. It fails to fully meet the increasing demand for diverse foreign exchange derivatives, hindering market development. China still lags behind international financial centers like the UK, the US, and Japan in this aspect [6]. There is also limited innovation in foreign exchange derivatives, and the overall quality of products is average.

2.3. Market Risks

The Chinese foreign exchange derivatives market entails significant trading risks. Currently, the market continuously introduces new types of foreign exchange derivatives, resulting in an increasing variety of products. However, the introduction and quality control of these derivatives are not adequate. Foreign exchange derivative transactions involve leverage, which implies potential substantial losses for investors. In leveraged trading, investors only need to deposit a small portion of the trade as margin. However, if investors fail to assess the market correctly and experience investment failures, they may suffer from significant financial losses. The immaturity of the market leads to a significant amount of opaque information, resulting in information asymmetry between the trading parties [7]. Given the cross-border nature of foreign exchange derivatives trading, involving participants from two or more countries, the degree of information asymmetry exacerbates risks.

2.4. Inadequate Regulation

The Chinese foreign exchange derivatives market lacks sufficient government regulation to provide traders with adequate risk mitigation measures. Current regulations and norms related to foreign exchange derivatives in China are relatively limited and lagging behind. Although there are some regulatory provisions, there are still deficiencies in specific operational guidelines. The regulatory authorities face challenges due to insufficient technological resources and personnel, and a lack of efficient monitoring tools. Market information disclosure is also inadequate. With the application of digital technology and the internationalization of the market, regulatory agencies are facing increasing difficulties in supervision, including the rise of cross-border criminal activities. The regulation of the Chinese foreign exchange derivatives market is an ongoing learning and improvement process, with regulatory bodies such as the China Securities Regulatory Commission (CSRC), China Banking and Insurance Regulatory Commission (CBIRC), and State Administration of Foreign Exchange (SAFE) gradually strengthening their supervision over the Chinese financial market, including the foreign exchange market.

3. Measurements

3.1. Mitigating Imbalances

To address the regional imbalances in the development of China's foreign exchange derivatives market, it is recommended to cultivate professionals in foreign exchange derivatives trading and risk management within local financial institutions. This will enhance the competitiveness of local financial institutions in the Chinese foreign exchange derivatives market. Local governments can provide necessary technical and financial support to facilitate this process. Local governments in tier 1, tier 2, and tier 3 cities should implement policies that tilt towards the foreign exchange derivatives market to encourage and ensure its further development. Additionally, strengthening the infrastructure of local financial markets by improving hardware facilities and software systems will provide a better trading environment for local financial institutions, thus attracting more participation from both institutions and investors.

To better address the varying qualifications of traders and the scarcity of top-tier traders in the Chinese foreign exchange market, it is suggested to conduct regular knowledge dissemination activities for foreign exchange derivatives. This includes providing professional training for derivative traders on market knowledge, trading strategies, risk management, and other relevant aspects. This will help traders establish a systematic knowledge structure and skill set. Detailed introductions should be provided when market participants buy or sell foreign exchange derivatives. Consideration can also be given to attracting high-quality trading personnel or introducing foreign exchange derivatives-related courses in higher education to increase the pool of highly qualified talent domestically [8]. Providing a daily information platform for derivative traders is also recommended. Given the rapid changes in the derivative market, traders need to stay updated with the latest information to adjust and refine their trading strategies.

3.2. Strengthening Market Diversification

Efforts should be made to enhance the diversification of the foreign exchange derivatives market and to establish a robust mechanism to guide market diversification. This can be achieved by encouraging innovation in foreign exchange derivatives, promoting the participation of various financial institutions in market activities, fostering market competition, and driving innovation. The government can implement a series of favorable policies to incentivize innovation in foreign exchange derivatives, such as providing subsidies for derivative innovations or facilitating the entry and legitimate trading activities of small and medium-sized enterprises in the foreign exchange derivatives market. Gradually expanding the tradable scope of foreign exchange derivatives and improving related regulatory measures will ensure that supply gradually matches the demand in the foreign exchange derivatives market. Learning from more mature foreign exchange derivatives markets abroad, such as the foreign exchange derivatives trading market in the United States, can help adopt advanced experiences and technologies to gradually improve China's foreign exchange derivatives market and enhance its diversification. Incentives can be provided for high-quality and high-quantity innovative behaviors in foreign exchange derivatives while ensuring regulatory measures are in place.

To increase the number of active participants and financial organizations in the foreign exchange derivatives market, it is advisable to appropriately lower the entry barrier. The major entry barrier in the foreign exchange derivatives industry lies in the initial stage, where significant capital investment is required. However, the high risks associated with foreign exchange derivatives make it challenging to guarantee returns, leading to a high entry barrier for the industry. Increasing the internationalization level of the Chinese foreign exchange derivatives market and involving foreign institutions specialized in derivatives can be beneficial. This will enhance industry activity, promote healthy competition, and stimulate participation. Historically, banks have been the major participants in the Chinese foreign exchange market. By simplifying the entry process and eliminating unnecessary procedures and requirements, smaller and medium-sized enterprises can be facilitated, and encouragement can be given to financial institutions of that scale to actively participate in the foreign exchange derivatives market [9].

3.3. Eliminating Information Asymmetry

To address the issue of information asymmetry, it is recommended to establish a public resource information sharing system that allows both foreign and native exchange derivative traders and financial organizations to share information and resources. This will reduce information gaps caused by market imperfections and enhance market efficiency. Initiatives can be taken to provide infrastructure for innovation in the foreign exchange derivatives market, such as increasing public data platforms and fostering relevant technical talents. Strengthening information disclosure requirements is necessary. Governments and regulatory bodies should establish regulations for information disclosure, requiring all enterprises and financial institutions to disclose necessary information as specified, which will provide investors and market participants with more accurate and comprehensive information. Improving relevant laws and regulations to restrain and regulate behaviors that create information asymmetry in the market is also essential. Utilizing technological means for supervision, such as artificial intelligence and big data analysis, will strengthen the monitoring and risk warning capabilities of the foreign exchange derivatives market to timely identify and rectify information asymmetry. Additionally, leveraging technology to provide more efficient methods of information transmission and communication will reduce delays and inaccuracies in information dissemination.

3.4. Strengthening Government Regulation

While providing technical and policy support to encourage the development of the Chinese foreign exchange derivatives market, strengthening regulation and control over foreign exchange derivatives should not be neglected. The central financial regulatory authorities need to enhance their coordination and control capabilities, and establish a sound regulatory mechanism for the foreign exchange derivatives market. Both macro and micro-level regulations should be implemented effectively. Learning from successful case experiences, adopt effective technological regulatory measures to replace manual supervision, and reduce the risks associated with human supervision errors. In order to address the entry of foreign financial institutions into the domestic market, it is necessary to adhere to the principle of licensed operations and implement a non-discriminatory financial regulatory policy that does not provide special treatment based on foreign identity. Strengthening regulation is crucial to prevent systemic risks in the foreign exchange market [10].

To manage risks, it is important to enhance awareness and capabilities for risk prevention in foreign exchange derivatives. Due to the inherent presence of systemic risks and information asymmetry, all market participants and the government need to be vigilant and cultivate risk prevention awareness and capabilities. It is necessary to establish a scientifically rational risk management system for foreign exchange derivatives, including the government issuing relevant policies, financial institutions conducting thorough risk assessments before introducing derivative innovations, and investors engaging in rational investment and proper allocation of capital when trading foreign exchange derivatives.

4. Conclusion

The significance of the foreign exchange derivatives market in the global economy has led to increased attention and development in China. However, the Chinese foreign exchange market faces several challenges, including regional imbalances, low diversification levels, high market risks, and inadequate regulation. These issues have garnered widespread public attention. To address these problems, this paper proposes solutions to mitigate regional imbalances in economic development and personnel qualifications, enhance diversification of foreign exchange derivative products and market participants, strengthen information sharing to reduce information asymmetry, and improve government regulation to ensure market safety. These solutions help address the identified issues and provide market participants and decision-makers with insights into the shortcomings of China's foreign exchange derivatives market, enabling the formulation of stricter trading strategies and further improvement and development of the market.

However, this study has certain limitations. Firstly, it has a limited scope and fails to comprehensively cover all aspects of the foreign exchange market. Additionally, due to data availability and time constraints, there may be limitations in data collection and analysis. To further enhance the research, future studies could consider expanding the sample size, strengthening data collection and analysis depth, and incorporating a combination of quantitative and qualitative research methods.

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