

Problems and Countermeasures of China's Foreign Exchange Derivatives Market

Rujia Yan^{1,a,*}

¹*School of Finance and Investment, Guangdong University of Finance, Guangzhou, China*

a. 211521145@m.gduf.edu.cn

**corresponding author*

Abstract: China's foreign exchange derivatives market continues to develop, but some problems remain. This essay predominantly analyzes the shortcomings in China's foreign exchange derivatives market and proposes corresponding countermeasures. This essay mainly focuses on the following four issues in China's foreign exchange derivatives market. They are trading scale and liquidity problems, insufficient product innovation, market participant structure problems, and insufficient market trust and risk awareness. Four corresponding countermeasures are proposed, which are proposed from four angles: appropriately lowering the threshold for foreign exchange derivatives business of small and medium-sized financial institutions, promoting innovation of market derivatives, strengthening market diversification, and foreign exchange derivatives supervision. This article aims to analyze China's derivatives market from multiple angles and put forward appropriate suggestions for optimizing China's foreign exchange derivatives market structure.

Keywords: Foreign exchange derivatives, liquidity, product innovation, risk awareness, market participants.

1. Introduction

The foreign exchange market plays an important role in the national economy. It supports international economic development and trade activities to a certain extent. It also plays an indispensable role in the global financial system and has a profound impact on the stability and development of the economies of various countries. The foreign exchange market is a bridge for international trade and investment, providing a platform for enterprises and individuals to conduct cross-border transactions and capital flows. In the foreign exchange market, countries can buy and sell goods and services, promoting the interaction and development of the global economy. The foreign exchange market is also an important transmission mechanism for the country's macroeconomic policies. The stability and fluctuation of the exchange rate directly affect the country's economic growth, inflation level, and international competitiveness. The central bank intervenes in the foreign exchange market to adjust the exchange rate level, achieve the goals of monetary policy, and maintain economic stability. The foreign exchange market is also an important part of the financial market, playing a key role in the risk management and asset allocation of financial institutions and investors. A large number of foreign exchange transactions provide market participants with diversified investment opportunities and enhance the liquidity and efficiency of the market.

As the world's second-largest economy, China has a significant impact on the development of the world economy. China's foreign exchange market plays a vital role in China's economic development. Through the foreign exchange market, Chinese companies can trade goods and services across borders, which has promoted the export-oriented growth of China's economy. The stability and development of China's foreign exchange market directly support the Chinese government's macroeconomic management. China's foreign exchange reserves are large in scale, providing an important guarantee for the risk resistance of the Chinese economy. These foreign exchange reserves not only support the liquidity and stability of the domestic market but also play an important role in times of global economic instability, laying a solid foundation for the continued growth of China's economy.

This article focuses on China's foreign exchange derivatives market. This article deeply analyzes the market size and liquidity, lack of product innovation, market participant structure, and market trust and risk awareness. In response to these issues, relevant policy recommendations are put forward, including: lowering the threshold for foreign exchange derivatives business of small and medium-sized financial institutions, thereby promoting the diversification and activity of market participation; actively promoting the innovation and development of market derivatives, stimulating the market's momentum and competitiveness; optimizing the structure of market participants, improving the efficiency and stability of market operations; strengthening the supervision of the foreign exchange derivatives market, and improving the market's trust and risk management awareness.

2. Overview

2.1. Market Size and Structure

At present, China's foreign exchange derivatives trading products include forwards, foreign exchange swaps, currency swaps, ordinary European options and their combinations. In recent years, the trading volume of China's foreign exchange derivatives business has continued to increase. In April 2024, China's foreign exchange market had a total turnover of RMB 23.04 trillion, equivalent to US\$3.24 trillion. Among them, the derivatives market had a cumulative turnover of RMB 15.65 trillion, equivalent to US\$2.20 trillion. From January to April 2024, China's foreign exchange market had a cumulative turnover of RMB 89.21 trillion, equivalent to US\$12.56 trillion [1].

2.2. Market Development History

The development of China's foreign exchange market can be roughly summarized into three parts, namely the initial growth stage, the mature and perfect stage, and the activeness improvement stage. In the initial growth stage, China launched foreign exchange derivatives in 1997, but the exchange rate was relatively stable at that time, and foreign exchange derivative transactions were not active. In 2005, China's interbank market launched the RMB-foreign currency forward foreign exchange business for the first time, marking the official launch of China's foreign exchange derivatives market. In the mature and perfect stage, with the normalized two-way fluctuations of the RMB exchange rate, the transaction demand of the domestic foreign exchange derivatives markets gradually stabilized, and the system gradually matured and improved. In 2017, among the transactions in China's interbank foreign exchange market, the transaction volume of foreign exchange spot transactions and foreign exchange derivatives accounted for 31.5% and 68.5% respectively. In the activeness improvement stage, since 2021, China's import and export trade has shown a good situation of sustained growth, and foreign exchange transactions and investments have also become more active. The annual transaction volume of the foreign exchange derivatives market has increased to 22.65 trillion US dollars, a year-on-year increase of 25.87%. In 2022, affected by the strong US dollar, the bilateral fluctuation of the RMB exchange rate increased. Foreign exchange derivatives were widely used in

foreign investment and foreign trade transactions between financial and real enterprises, effectively reducing exchange rate risks [2].

3. Problems

3.1. Transaction Size and Liquidity

To measure whether a country's foreign exchange derivatives market is consistent with its economic development level, two types of evaluation indicators are usually used. One is the ratio of foreign exchange derivatives trading volume to foreign exchange spot trading volume, and the other is the ratio of foreign exchange derivatives trading volume to foreign trade scale and GDP. In recent years, China's foreign exchange derivatives market has developed, but it is still not in line with the economy that maintains medium-to-high-speed development. Compared with other developed countries, China's foreign exchange derivatives coverage is still relatively low. It can be seen that the volume of China's foreign exchange derivatives is far smaller than the scale of economic development [3].

Compared with the international foreign exchange market, the trading volume is relatively low. In terms of the ratio of over the counter and on-exchange derivatives, in major developed markets, the scale of the over-the-counter derivatives market is generally larger than the scale of the on-exchange derivatives market, while the total nominal amount of China's over-the-counter derivatives transactions is less than half of that of on-exchange derivatives [4]. China's foreign exchange derivatives market transactions are homogeneous, which prevents the expansion of derivatives transactions, resulting in a loss of trading activity, which leads to the problem of low liquidity of China's foreign exchange derivatives.

3.2. Insufficient Product Innovation

The variety of derivatives directly affects the enthusiasm of market participants and the liquidity of the market. China's foreign exchange derivatives are few in variety and have a lower trading volume than the international foreign exchange market. Compared with mature markets, the domestic derivatives market has weak innovation capabilities, and the product homogeneity of various institutions is serious, lacking cross-product portfolio innovation. In response to the widespread lack of foreign exchange futures and options in the international market, the Chinese market has not yet launched foreign exchange futures contracts, and the existing trading types are far from meeting the requirements of risk avoidance [5]. This is not conducive to the optimization of price discovery and the improvement of market liquidity.

3.3. Market Participant Structure

At present, China's foreign exchange derivatives market is dominated by commercial banks. Many large institutional investors or large enterprises involved in foreign exchange transactions want to enter the foreign exchange derivatives market to avoid exchange rate risks, but they are not qualified to enter due to the system. This leads to the inactivity of the foreign exchange derivatives market and the singleness of the trading subjects. Since the main types of foreign exchange derivative contracts in China are traded over the counter, the over-the-counter market has the characteristics of low transparency and strict market access. Therefore, China's foreign exchange derivatives trading has a low utilization rate and insufficient market participation.

The relatively single participants and trading strategies affect the supply and demand balance of products and reduce market liquidity. For example, most of the participants in the over-the-counter derivatives market are commercial banks. Their trading purposes and strategies are similar, resulting in a lack of counterparties for opposite transactions in the market. These market structure

characteristics are because my country's derivatives market is still subject to strict regulatory restrictions, including strict approval for product listing, the inability of certain institutions to participate in specific derivatives trading markets, and the real need principle and short selling transactions being restricted.

Many investors and enterprises have a low degree of acceptance of foreign exchange derivatives. China's foreign exchange derivatives trading is mainly concentrated between banks. For other markets, the participation level is low, and trading is not active. The development of option trading and swaps is relatively slow, and they are mainly concentrated in forward contract trading, and their trading volume is far lower than that of spot business. In addition, investors of different sizes have different understandings of foreign exchange derivative trading. Large-scale enterprises are more likely to use foreign exchange derivatives than small-scale enterprises, and the larger the scale of foreign exchange derivative transactions, the lower the average transaction cost and the greater the economic benefits. These factors have limited the demand for product diversification and the improvement of market liquidity [6].

3.4. Market Trust and Risk Awareness

There are various risks in China's foreign exchange derivatives market. The first is market risk, which refers to the uncertainty loss caused by changes in interest rates and exchange rates. Foreign exchange derivatives are based on exchange rates, and the risk of exchange rate fluctuations is its market risk.

Secondly, counterparty risk is also a very common risk. When the contract expires, the two parties to the transaction have no or cannot avoid the risks brought by the transaction. The trading system and regulatory mechanism of China's foreign exchange derivatives market are not perfect, which increases the possibility of risk. In addition, although only a low margin is required to fulfill its obligations to control risks and improve efficiency, this cannot guarantee the control of market risks that may be faced during the trading period. The margin system also makes transactions have a higher leverage ratio, and the gains and losses are correspondingly magnified, which is more risky. Thirdly, liquidity risk is the main risk faced by investors. It refers to the risk that the holder of the product contract cannot find an opportunity to sell or close the position in the market. The size of the risk depends on the standardization of the product contract, the size of the market, and changes in the market environment. Due to the difficulty of trading in the foreign exchange derivatives market, its liquidity risk will increase [6].

Operational risk should not be ignored. It refers to the risk of loss due to management errors, failure of the trading system or clearing system, or human error. China's foreign exchange derivatives market is in its infancy and lacks a large number of high-quality professional talents and professional equipment. In particular, there is a gap in product design and research and development, which increases the possibility of operational risks [7].

4. Countermeasures

4.1. Lower the Threshold

Related departments should continue to expand the market players of small and medium-sized financial institutions, continue to promote financial institutions to actively participate in the domestic foreign exchange derivatives market, and expand the development channels for foreign institutions to participate in the onshore market. At the same time, market should simplify the market access of foreign exchange derivatives, implement unified one-time market access centralized management for domestic and foreign derivatives businesses, and continue to lower the market access threshold for small and medium-sized financial institutions in foreign exchange options and other related businesses. All banking institutions must emancipate their minds, actively seek support from their

superiors, and strive to change the situation where bank credit products are single, and the threshold is relatively high and launch more financial innovation products. The government should actively guide and increase the training of enterprise management, actively organize enterprises to go abroad, learn from experience, and strengthen corporate governance. In this regard, banks can also exert external forces on China's foreign exchange derivatives through relevant supporting systems, forcing enterprises to continuously improve their management level. The government should do a good job in delegating management authority, simplifying and optimizing the access management of small and medium-sized financial institutions, vigorously promoting the government's efforts to streamline administration and delegate power, and lowering the participation threshold of small and medium-sized financial institutions [8].

4.2. Promoting Innovation

According to the current development status of China's foreign exchange derivatives market, to build a more multi-layered and diversified financial market system, China should increase the types of foreign exchange derivative transactions and enhance the influence of the domestic foreign exchange market. At present, China's existing foreign exchange derivatives transactions are all over-the-counter contracts, and compared with mature international markets, there are no on-site market contracts. Therefore, the construction of the on-site foreign exchange derivatives market will become a focus. And at the right time, it is possible to consider launching futures trading of foreign exchange derivatives [3].

Related departments can strengthen product research and development and gradually innovate products to promote the development of the foreign exchange derivatives market. In recent years, China's foreign exchange products have shown a trend of diversification. On this basis, related departments can appropriately relax the foreign exchange products of banks and further promote the development of foreign exchange futures. The government can consider appropriately relaxing the control of foreign exchange derivatives investment, reducing some unnecessary procedures, and promoting corporate innovation; it can also strengthen the management of offshore products and promote the development of option trading, to better solve the problems of domestic and foreign market development. In addition, China can also join other countries to continuously increase and expand the variety and scale of transactions and establish a comprehensive real economy [8].

4.3. Strengthen Market Diversification

More commercial banks and other institutions should be encouraged to participate in transactions, conduct transactions with investors, and allow more non-bank financial institutions to participate, to continuously enrich the trading entities in the market. This requires the adoption of effective measures: the trading mechanism of enterprises needs to be improved in advance so that investors can actively participate in the trading process; commercial banks should give full play to their intermediary role, help enterprises reduce transaction costs, find institutional investors to trade with, provide them with high-quality services, and reduce the volatility of the foreign exchange market; in combination with the different needs of investors, more trading varieties and products should be innovated for investors to meet the development needs of the real economy. For example, foreign exchange-related enterprises, financial leasing companies, trust investment companies and other entities should be allowed to enter the foreign exchange derivatives market. By drawing on international experience, innovative research and development of domestic foreign exchange products, and vigorously introducing foreign exchange mutual funds, ETFs, and other foreign exchange derivatives [9]. It is necessary to meet the personalized needs of investors in the domestic market and to improve the enthusiasm of the entire market for investment [10].

4.4. Foreign Exchange Derivatives Regulation

A good foreign exchange derivatives market cannot do without government participation, and government supervision is also the key to solving these problems. Government supervision first needs to improve legislation, establish and improve the regulatory system of the foreign exchange derivatives market, clearly define the powers of each regulatory agency, divide the responsibilities of each regulatory agency, and ensure that there is a law to follow. The introduction of a series of relevant laws will greatly improve the disorder of the derivatives market, make transaction requirements clearer, fully improve transaction efficiency, and reduce losses. Secondly, it is necessary to enhance market effectiveness and improve market transparency [6].

Firstly, there are currently few laws in China related to the foreign exchange derivatives market, which has led to a regulatory vacuum. A sound regulatory system should be based on a solid legal foundation. The introduction of a law specifically targeting the foreign exchange derivatives market will help form an integrated financial regulatory framework.

Secondly, Regulatory authorities should ensure that market players are transparent about foreign exchange derivative transactions and try to avoid losses caused by factors that cannot be fully disclosed during the transaction process.

Thirdly, Crackdown on excessive speculation. Although speculation is common in derivatives trading, and the degree of speculation is positively correlated with the size of corporate assets, the proportion of export revenue, and corporate solvency, many transactions for speculative purposes are not conducive to the healthy development of the financial market. If inadequate supervision leads to excessive speculation and thus creates risks, it will disrupt market order and affect the normal operation of the market. Therefore, regulatory authorities should strictly control possible excessive speculation [3].

5. Conclusion

At present, China's foreign exchange derivatives market is in a stage of rapid development, however, the market still faces many challenges. This article deeply analyzes the core issues such as market size and liquidity, insufficient product innovation, market participant structure, and market trust and risk awareness. In response to these challenges, a series of corresponding countermeasures are proposed: lowering the threshold for foreign exchange derivatives business of small and medium-sized financial institutions, thereby promoting the diversification and activity of market participation; actively promoting the innovation and development of market derivatives, stimulating the market's momentum and competitiveness; optimizing the structure of market participants, improving the efficiency and stability of market operations; strengthening the supervision of the foreign exchange derivatives market, and improving the market's trust and risk management awareness. These analytical countermeasures aim to provide useful strategic guidance and suggestions for the healthy development and structural optimization of China's foreign exchange derivatives market.

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