

Research on the Development of China's Foreign Exchange Derivatives Market and Countermeasures

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Abstract: This paper discusses the current situation, development problems and countermeasures of China's foreign exchange derivatives market based on the problems of backward development, mismatch between volume and economic scale, structural imbalance, low participation of enterprises, single variety, lack of innovation and related talents, single participating body, inadequate supervision and lack of risk prevention ability since the birth of China's foreign exchange derivatives market, and proposes countermeasures to improve the participation and financial literacy of enterprises, increase innovation, enrich clearing methods, expand the scope of participating bodies in the foreign exchange derivatives market, improve the regulatory system and system, and enhance market transparency.

Keywords: Foreign Exchange Derivatives Market; Corporate Participation; Innovation; Regulation

Introduction

According to the definition of foreign exchange derivatives by the International Swaps and Derivatives Association, foreign exchange derivatives are essentially a financial contract that transfers risk for traders and is a foreign exchange trading instrument. The Chinese foreign exchange derivatives market was born in 1997, and compared to other countries in the international arena, China started late. Initially, the market was not active in terms of exchange rate stability. Since the exchange rate reform in 2005 began to implement a managed floating exchange rate system based on market supply and demand, China's foreign exchange derivatives market began to develop rapidly. From the opening of RMB foreign exchange swaps in 2007, to allowing the purchase of RMB to foreign exchange options in 2011, to the ability of options to be delivered in the form of difference in 2014, to the successive liberalization of forward and foreign exchange sales in 2016 and 2018. Therefore, it is crucial to study the current situation, problems and countermeasures of China's foreign exchange market for the development of China's foreign exchange market.

1. An introduction to the current state of china's foreign exchange derivatives market

With the gradual exchange rate reform, the gradual opening of China's financial market and the advancement of RMB internationalization, China's foreign exchange derivatives market is gradually moving from closed to open to the outside world, and its scale is expanding and its types are getting richer day by day. Although the foreign exchange derivatives market is developing rapidly, there is still a certain distance from the foreign exchange derivatives market of developed countries in the world. Compared with the internationally developed foreign exchange derivatives market, China's market has problems such as structural imbalance, single species and inadequate regulatory system. At present, the expansion and opening of foreign exchange derivatives in China is catering to the trend of today's economic globalization, and its own development has ushered in new opportunities. Therefore we need to find out the existing problems from the market and study the countermeasures to solve them for smoother development.

2. Development issues of china's foreign exchange derivatives market

2.1 Backward development, volume does not match the size of the economy

From the experience of developed foreign exchange derivatives market internationally, an important indicator to measure whether the volume of foreign exchange derivatives market matches the size of the country's overall economy is the volume of foreign exchange market and the ratio of foreign exchange derivatives trading volume to GDP. According to statistics from the State Administration of Foreign Exchange and the Ministry of Commerce, the country's GDP in 2020 amounted to 1,013,567.0 billion yuan, accounting for approximately 17% of the global GDP. The daily turnover of the global foreign exchange market is about USD 6.6 trillion, which can be converted into RMB 45,537.36 billion according to the average exchange rate in 2020 (USD 1 = RMB 6.8996). The foreign exchange market in China will trade a total of RMB 206,033.1 billion in 2020, and the average daily turnover will be RMB 786.39 billion in 2020 excluding weekend days (262 days), accounting for about 1.73% of the global foreign exchange trading volume. 2020 foreign exchange derivatives trading volume in China will be RMB 123,975.1 billion, and the foreign exchange derivatives trading volume will be about 122% of GDP. In developed countries, the average value of the ratio can exceed 150%. Although China's foreign exchange derivatives market is developing steadily and rapidly, it is clear from the above data that we are lagging behind compared to developed countries. Compared to our GDP share of global GDP, the volume of our foreign exchange market is not in line with our economic status in the international arena and needs to be developed more vigorously.

2.2 Structural imbalance and low participation of enterprises

According to the official data released by the State Administration of Foreign Exchange (SAFE) in 2020 in China's foreign exchange market trading profile, it is easy to know that in 2020, in China's forward market, the bank-to-customer market and the interbank foreign exchange market accounted for 81% and 19% of the total volume, respectively; in the foreign exchange and currency swap market, the bank-to-customer market and the interbank foreign exchange market accounted for 1% and 99% of the total volume, respectively; in the options market, the bank-to-customer market and the interbank foreign exchange market accounted for 33% and 67% of the total volume respectively. This shows that in China's foreign exchange derivatives market, customers prefer to invest in foreign exchange forwards, and in the foreign exchange and currency swap market and options market, the volume of the customer-to-customer market is much lower than that of the interbank market, resulting in structural imbalance and affecting the liquidity in the market. In addition, enterprises have weak hedging concepts and lack in-depth understanding of derivatives expertise, and know little about what derivatives are and how to use them. Moreover, since the financial crisis in 2008, some enterprises caused huge losses due to excessive speculation, which brought panic to other enterprises and made them less receptive to foreign exchange derivative instruments, further making the instrument insufficient for specific risk-averse operations, resulting in low participation of enterprises in the derivatives market, which seriously affects the development of China's foreign trade related industries and hinders the development of enterprises towards internationalization.

2.3 Single species, lack of innovation and related talents

In our foreign exchange derivatives market, foreign exchange futures contracts have not been introduced and the variety of foreign exchange derivatives is not complete. The foreign exchange futures contract is a standardized contract traded on the floor, which has less risk of default compared to forwards. Compared with developed countries, the absence of foreign exchange futures contracts in China raises the risk of default on foreign exchange derivatives, which could potentially bring losses to our traders. China's foreign exchange derivatives market lacks diversified exchange rate hedging tools, and the hedging needs of small and medium-sized enterprises cannot be met. According to statistics, only 14% of China's import and export trade is hedged through forward settlements provided by banks. [1]There is a problem of high homogeneity of financial products and single form of tools, which can not well meet the requirements of customers. China is also very short of highly qualified personnel regarding the design, development and marketing of foreign exchange derivatives, which also leads to a single variety of foreign exchange derivatives and insufficient innovation in China. As a result, there are few products that can match the hedging needs of different enterprises, which in turn makes enterprises give up using foreign exchange derivatives to hedge their risks, thus further reducing the participation of

enterprises. According to the relevant regulations in China, banks must obtain the innovative business qualifications approved by the CBI before they can participate in foreign exchange derivatives business approval. The weak basic capacity of many small and medium-sized banks also leads to the hindrance of innovation ability as well as the failure to open the audience.

2.4 Single participant

As of mid-October 2021, there were 267, 263, 216 and 161 members in China's forward market, foreign exchange swap market, foreign exchange currency swap market and foreign exchange option market, respectively. Taking the forward market as an example, there are only 31 non-commercial banks (including Chinese and foreign banks) among the 267 members, accounting for about 12%. From the viewpoint of membership composition, the structure is seriously disproportionate, reflecting the relatively single participant in the foreign exchange derivatives market. China's entry standards for the foreign exchange derivatives market are too strict, resulting in many small and medium-sized investors not qualified to enter the market, and a serious lack of individual investors. In the current situation, if the market participant is single, it is easy to cause market stampede and herding effect. That is, once the volatility of the foreign exchange derivatives market is large, it is easy to cause some investors to panic, which in turn leads to more and more investors do not trust the market. It can be seen that the market stampede and herding effect is extremely unfavorable to the stability of the foreign exchange derivatives market, and will also increase its riskiness.

2.5 Inadequate supervision and lack of risk prevention

Most of our foreign exchange derivatives transactions are traded over-the-counter, i.e., privately agreed by both parties to the transaction, which lacks transparency and has greater risk of default than the OTC market. This is unfavorable for China to regulate this market and affects the smooth and orderly development of China's foreign exchange derivatives market. In this market, the relevant rules and regulations also need to be improved. China's legislation in the foreign exchange derivatives market is relatively lagging behind, some in the implementation of the rules and regulations followed still exist in the implementation of the situation is not in place. From the perspective of enterprises, some of them do not have an in-depth understanding of foreign exchange derivatives and are unable to make an objective assessment of their own risk tolerance. When the exchange rate fluctuations come, only passive acceptance, it is difficult to use foreign exchange derivatives to effectively hedge the risk, resulting in certain losses. Theoretically, the development of foreign exchange derivative market is conducive to reducing the impact of exchange rate fluctuations on corporate profits. And arbitrage in a volatile foreign exchange derivatives market, easy to lead to exchange rate risk exposure, increasing the cost of enterprises, but also hedge the operation of China's monetary policy, for the whole market are unfavorable.

Countermeasures research on the development of china's foreign exchange derivatives market

3.1 Improving business engagement and financial literacy

On the one hand, in China's foreign exchange derivatives trading market, banks are the main participants, and the proportion of enterprises in it is much lower than that of banks, which creates an imbalance in the membership structure. China should encourage the relaxation of access qualifications for enterprises facing huge risk exposure to diversify market participants, promote transaction diversity and increase market liquidity. At the same time, we should simplify the administrative approval process, reduce market transaction costs, optimize the standards of contract elements, and improve the efficiency of market operation, thereby facilitating enterprises' participation in hedging foreign exchange derivatives transactions. [2]On the other hand, many enterprises lack theoretical knowledge, lack rational judgment on the expectations of foreign exchange derivatives, and blindly follow the trend, which will also aggravate the instability of the market. Therefore, enterprises themselves should also understand and learn relevant financial knowledge, improve their awareness of risk prevention, and use foreign exchange derivatives to hedge the risks brought by exchange rate fluctuations. Enterprises focus on risk at the same time, the construction of a complete risk prevention system is also very important. Need to use foreign exchange derivatives to establish a stop-loss system and encourage the use of a variety of foreign exchange derivative instruments to better control the relevant risks within a certain range. It is also necessary to introduce relevant talents to really put in place to control risks. In addition, enterprises should establish the concept of "financial neutrality" to avoid excessive speculation that brings unnecessary risks and losses to enterprises. This will not only help enterprises to reduce the cost of

foreign exchange, but also help them to improve the scale of import and export, enhance their core competitiveness and develop steadily, and create a level playing field that will help China's financial derivatives market to develop in the direction of a high level and high quality market.

3.2 Increase innovation and enrich clearing methods

At present, China's foreign exchange derivatives market only forward products, foreign exchange and currency swap products and options products, futures products have not been launched. China should consider the timely launch of foreign exchange futures market. Futures are standardized products, need to be traded on the floor, its trading process is more standardized, the risk is also smaller than the forward products. In addition, should also increase innovation, the introduction of diversified products, with a view to more closely match the needs of customers. At the same time, it is necessary to strengthen the linkage between onshore and offshore markets, fully absorb the advantages of overseas markets and learn from the experience of mature markets to shorten the gap between them, so as to meet the needs of multiple hedging and speculation. It can also promote the marketization of exchange rates, increase the flexibility of exchange rates, and better reflect the relevant exchange rate movements in real terms, so that the international status of the RMB will continue to improve and steadily promote the process of RMB internationalization. In a foreign exchange transaction, clearing is very important, and it involves the management of credit risk before settlement after the transaction. The enrichment of clearing methods can promote comprehensive risk management and better adapt to the diversified needs of today's investors. The digital economy is widely used in various consumer scenarios in today's technologically advanced society. Therefore, "Internet+" can be applied not only to the innovation of foreign exchange derivatives products, but also to the innovation of clearing methods, so as to achieve the purpose of improving efficiency and saving costs.

3.3 Expanding the scope of participating entities in the foreign exchange derivatives market

The threshold of China's foreign exchange derivatives market is high for small and medium-sized banks and SMEs, which deters many companies with hedging needs from participating in it. In turn, there are problems in the market such as low utilization of resources, lack of active market, and imbalance in membership structure between banks and enterprises. Therefore, the entry threshold can be appropriately relaxed to bring in some small and medium-sized banks and enterprises that meet the conditions, so as to diversify the market participants. Market makers play an important role in derivatives trading, enabling the market to better balance supply and demand and reflect equilibrium prices. The newly revised Interbank Foreign Exchange Market Maker Guidelines in January 2021 mention that the relevant market making system should be strengthened and improved, and the management system of attempted market making institutions should be used to optimize the market liquidity stratification structure. Continue to strengthen the access and exit of attempted market-making institutions and the refined management of trading business, tap the quoting potential of market members on advantageous products, encourage their participation in market-making business, strive to diversify the types of attempted market-making institutions, enrich the sources of liquidity and effectively meet the liquidity needs of the market.[3]

3.4 Sound regulatory system system

China's foreign exchange derivatives market regulators should learn from the reference of the international advanced market in the regulatory system system, so as to take the essence of its dross, to a more complete system to manage our market. Although foreign exchange derivatives have a hedging function, but its own highly leveraged accompanied by high risk, so a sound foreign exchange derivatives regulatory system is essential. The regulatory system of foreign exchange derivatives market needs to be set up from both micro and macro aspects. On the micro side, although relevant laws and regulations have been introduced, they have not been covered, and the relevant departments still need to improve the laws and regulations. In the macro part, it is necessary to move closer to the government-led type and establish a system mainly based on self-regulation and supplemented by external supervision. The foreign exchange derivatives market needs to clearly delineate the authority and responsibility, and improve the internal control system. Need to combat excessive speculation, a large number of transactions for speculative purposes into the market is not conducive to the supervision and stable development of China's foreign exchange derivatives market, is likely to disrupt the market order, affecting the

normal operation of the market. It is also necessary to strengthen the assessment of market maker's behavior and ability. As one of the very important links in trading, market maker is crucial to the smooth operation of the market. China's foreign exchange derivatives market needs to pay attention to the quoting ability of market makers and the standardization of trading behavior to improve the orderliness and effectiveness of the market.

3.5 Enhance market transparency and improve monetary policy transmission mechanism

Foreign exchange derivatives also bring a positive effect on the accounting of financial statements. A more scientific financial system can provide reasonable conditions for the development of derivatives business, and good statements can reduce financing costs for companies. Improving market transparency requires not only that companies and banks disclose their own statements to investors in a complete and honest manner, but also that the foreign exchange derivatives market itself disclose indicators related to investors' investment strategies to the public. For trading and regulatory links to improve the transparency and effectiveness of disclosure information. The market should establish a perfect information disclosure system, promote the industry and enterprises to jointly self-regulate, promote the market from the system of restrictions to self-regulation, and build a highly transparent foreign exchange derivatives market structure. At the same time, exchange rate is an important transmission mechanism of monetary policy affecting the real economy, and in September 2017, China adjusted its foreign exchange risk reserve policy, reflecting the shift of foreign exchange macro management from unilateral management to neutral management, and will start the prelude of subsequent neutralization policy, and the unilateral restriction on capital outflow may also be diluted. [4]According to research, in developed countries, the foreign exchange derivatives market has almost no influence on monetary policy regulation; while in emerging market countries, the existence of foreign exchange derivatives market has a non-neutral influence on monetary policy regulation. [5]Therefore, China should incorporate foreign exchange derivatives instruments into monetary policy tools, improve the relevant monetary policy transmission mechanism, and play its regulatory role more effectively.

Conclusion

In conclusion, China's foreign exchange derivatives market started late and developed slowly, coupled with the influence and constraints of various factors, it has encountered many difficulties in the process of development. Therefore, we must continue to explore and learn from the experience and practices of other advanced foreign exchange derivatives markets, and actively seek efficient and effective measures to deal with them. At present, the RMB is moving towards internationalization and many enterprises are going global, it is very necessary to build and improve the foreign exchange derivatives market. At the same time, it is also necessary to pay attention to prevent possible financial risks in order to make the foreign exchange derivatives market in China develop smoothly and rapidly in a sustainable manner.

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