

70 years of China's foreign exchange market development: history and experience

China's foreign
exchange
market

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Received 8 May 2020
Revised 15 June 2020
Accepted 15 June 2020

Abstract

Purpose – The development of China's foreign exchange market and the reform of Chinese yuan (hereinafter "CNY") exchange rate are closely linked with each other. Their respective journey through the past 70 years can both be divided into three historical periods; as follows: China's foreign exchange market underwent a difficult exploration period, a formation and development period and an innovative development period; in the meanwhile, the formation mechanism of CNY exchange rate also witnessed three periods marked successively by a single exchange rate system with administrative pricing, an explorative formation mechanism of CNY exchange rate and a reformed, marketized CNY exchange rate mechanism.

Design/methodology/approach – In the present world, the development of almost every country is closely linked to the international community, which is the result of the heterogeneity in system, market, humanity and history, in addition to the differences in natural resource endowments and the diversity in technology, administration, information, experience and diplomacy. International economic exchanges require foreign exchange, which gives rise to the existence and development of the foreign exchange market.

Findings – The 70-year history of China's foreign exchange market has proven the need to continue safeguarding national sovereignty and interests of the people, stick to the general direction of serving economic development, adhere to the strategy of steadily and orderly promoting the construction of the foreign exchange market, keep on making innovation in monetary policy operation and unbendingly stay away from any systemic financial risks.

Originality/value – During the 70-year history of the new China, as an indispensable economic resource in China's economic development, the foreign exchange mechanism bolstered each stage of economic development and was always an important manifestation of China's economic sovereignty. It is argued that during the 30-year planned economy that preceded reform and opening-up, China pursued a closed-door policy with few international economic exchanges. The subtext of such argument is that China did not have (or hardly had much of) a foreign exchange mechanism during this period, which is clearly in conflict with historical evidence. In fact, although China did not have an open foreign exchange market before the reform and opening-up, it had a clear foreign exchange management system and exchange rate system.

Keywords Foreign exchange market, Exchange rate marketization reform

Paper type Research paper

In the present world, the development of almost every country is closely linked to the international community, which is the result of the heterogeneity in system, market,

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Funding: This paper reports the phased research result of a key emergency response management project of the National Natural Science Foundation of China (71850009). The authors thank the anonymous reviewers for their comments and solely bear all responsibilities arising out of this article.



China Political Economy
Vol. 3 No. 1, 2020
pp. 3-17
Emerald Publishing Limited
2516-1652
DOI 10.1108/CPE-05-2020-0007

humanity and history, in addition to the differences in natural resource endowments and the diversity in technology, administration, information, experience and diplomacy. International economic exchanges require foreign exchange, which gives rise to the existence and development of the foreign exchange market. During the 70-year history of the new China, as an indispensable economic resource in China's economic development, the foreign exchange mechanism bolstered each stage of economic development and was always an important manifestation of China's economic sovereignty [1]. It is argued that during the 30-year planned economy that preceded reform and opening-up, China pursued a closed-door policy with few international economic exchanges. The subtext of such argument is that China did not have (or hardly had much of) a foreign exchange mechanism during this period, which is clearly in conflict with historical evidence. In fact, although China did not have an open foreign exchange market before the reform and opening-up, it had a clear foreign exchange management system and exchange rate system. After the reform and opening-up in 1978, the foreign exchange market grew gradually in the process of institutional transformation and took its initial form from 1994 onwards. In contrast, the marketized formation mechanism of the exchange rate system took its first decisive step after the exchange rate reform in 2005, and it still needs to be further reformed. China's 70-year practice has proven the foreign exchange mechanism relies on and serves the real economy and is severely restricted by the economic system. However, it is ultimately determined by the inherent requirements of economic development and the level of internationalization.

1. Historical evolution of China's foreign exchange market development

During the 70-year history of the new China, China's foreign exchange market underwent three periods, namely, a difficult exploration period, a formation and development period and an innovative development period. Based on their developmental characteristics, each historical period can be divided into several stages.

The first historical period is the 29 years from 1949 to 1978, which witnessed the difficult process of exploration. The basic context of this period is where, under the planned economy system, the central government implemented highly centralized, directive-based and planned management of receipts and payments in foreign exchange, and there was no foreign exchange market. Along with the economic system undergoing three major adjustments regarding the retaking and delegation of management powers, the allocation of foreign exchange resources changed accordingly. The "retaking" can be seen in the policies demanding that various foreign exchange incomes must be sold to the State so that planned distribution can be implemented through foreign exchange, and the "delegation" can be seen in the "sharing of foreign exchange earnings" policy. This period can be roughly divided into three stages:

The first stage (from 1949 to 1953) was the stage of centralized foreign exchange management during the establishment of the legal status of CNY.

Before the founding of the new China, China's currency sovereignty had been severely violated by imperialist powers, with as much as USD300m in dollar notes circulating in major cities such as Shanghai, Beijing and Tianjin. After the founding of the new China, nationwide establishment of the CNY local currency system became a top priority. In order to make CNY quickly dominate the Chinese markets of production, trading and consumption as the only legal currency, the central government and the governments at all levels adopted a range of measures to rectify the currency system. After the implementation of these measures, the long-term deficit of foreign exchange receipts and payments in the Old China was soon fundamentally eliminated, gaining China the initiative in international trade. In 1950, the People's Bank of China announced unified CNY exchange rate across the country. Among them, CNY/USD exchange rate is determined based on the

weighted average of the price ratio of export commodities, the price ratio of import commodities and the price ratio of daily necessities of overseas Chinese, with additional adjustments made according to changes in the relative price level of the international market. In 1951, the then Ministry of Trade of the Central People's Government classified export goods into categories A, B, and C based on an importance system and formulated corresponding policies that demanded category A export goods be exchanged with import goods of primary importance, category B export goods be exchanged with import goods of secondary importance and category C export goods either be exchanged with goods or exported for foreign currencies such as Swiss franc and GBP; the bookkeeping foreign exchange was thus generated.

The second stage (from 1953 to 1958) was the stage of exploring foreign exchange equilibrium mechanism. In 1953, China entered the implementation period of the "first five-year plan". Considering that the foreign exchange required for various imported industrial equipment and construction equipment was mainly obtained by exporting agricultural products, CHEN Yun stressed in 1955 that the trade of industrial product export for foreign exchanges should be enhanced to support import of machinery used in development. In 1957, to encourage local governments' active fulfilment of export plans and strive for excess exports, the central government decided to implement the policies that allow the sharing of foreign exchange earnings and give local governments a certain percentage of the proceeds. Meanwhile, a "foreign exchange equilibrium" item was added to the old "three major equilibrium" of economic construction works (i.e., the equilibrium between of "finance, credit and materials" and the comprehensive equilibrium among them), thereby forming the new guiding ideology of four major equilibriums of the national economy (i.e. the comprehensive equilibrium among "finance, credit, materials, and foreign exchange").

The third stage (from 1958 to 1978) was the stage of a difficult journey filled with twists and turns. In the nearly 20 years since 1958, China's economy underwent ups and downs through the "Great Leap Forward", the "Great Chinese Famine" and the "Cultural Revolution", and the proportions of major sectors of the national economy had been seriously imbalanced. Internationally after 1971, the collapse of the Bretton Woods system led Western countries to adopt the floating exchange rate system; yet China's foreign exchange mechanism was still tenacious in its formation, which is mainly manifested in three aspects. First, the CNY exchange rate was generally stable except for public depreciation or appreciation of certain foreign currencies. Second, foreign exchange earnings grew. In 1963, 1964 and 1965, with the recovery of foreign trade, the bank loans for foreign trade purposes continued to increase (CNY2.7bn in 1963, CNY3.9bn in 1964 and CNY5.3bn in 1965), and the foreign exchange earnings of banks increased rapidly, actively supporting the funds needed for foreign trade to expand imports and exports. Third, the exchange rate pricing mechanism was adjusted accordingly. In 1968, China began experimenting with using CNY to price and settle foreign trade to avoid exchange rate risks. On 23 June 1972, with the floating of GBP, China changed its CNY exchange rate calculation based on "a currency basket" and made corresponding adjustments to CNY exchange rate based on maintenance of generally stable nominal effective exchange rate of CNY.

The second historical period is the 35 years from 1978 to 2013, which witnessed the process of formation and development of China's foreign exchange market. The context of this period is where, by the end of 1978, China had taken steps towards reform and opening-up. In the process of establishing a new system of socialist market economy, the establishment of China's foreign exchange market is an indispensable part of the open economic system. The foreign exchange market construction in this period can be roughly divided into three stages.

The first stage (from 1978 to 1989) was the tentative development stage for China's foreign exchange market. Before 1979, China's foreign exchange business was operated by the Bank

of China in a unified manner. After 1979, with the reform and opening-up, China began to gradually establish and improve foreign exchange management authorities and a number of financial institutions to operate the foreign exchange system. In the meanwhile, it began to implement the foreign exchange retention system (where enterprises were allowed to retain part of their foreign exchange quota or cash foreign currency). In October 1980, the Bank of China began to handle foreign exchange swaps. In August 1981, a trading market characterized by paid swaps for foreign exchange quotas began to take shape. In 1985, with the cancellation of trade settlement price, the foreign exchange swap market's development accelerated. In November 1985, Shenzhen took the lead to set up a foreign exchange swap centre; and in September 1988, Shanghai opened an open market for foreign exchange swap and implemented a system of open auction trading and centralized clearing while liberalizing the market exchange rate of foreign exchange swaps so that it would float according to market supply and demand. With the liberalization of the exchange rate of swapped foreign exchange, the People's Bank of China guided the usage of swapped foreign exchange (or access to the foreign exchange market) by formulating the "Guidance Sequence on Exchange Use for Foreign Exchange Swap", and the role of market regulation had been on the rise. As a result, the tentative form of China's foreign exchange market (foreign exchange swap market) had preliminarily taken shape.

The second stage (from 1989 to 1994) was the stage of formation of the basic framework of the foreign exchange market, which is mainly manifested in three aspects. First, the exchange rate dual-track system was formed. With the expansion of foreign exchange swaps, China has actually formed a situation in which the official exchange rate and the market exchange rate coexisted. After 9 April 1991, the official exchange rate changed from large one-time adjustments to small- and slow-paced adjustments. In the second half of 1992, the CNY exchange rate depreciated sharply in the foreign exchange swap market. On 12 July 1993, the People's Bank of China intervened in the foreign exchange swap market for the first time to stabilize the exchange rate, generally keeping the CNY/USD exchange rate at where 1USD could buy CNY8.6–8.8. Second, individual residents were allowed in foreign exchange transactions. In November 1991, restrictions on individual residents' participation in foreign exchange swaps were lifted to meet their demands for foreign exchange. Third, the function of the foreign exchange swap market was enhanced. By the end of 1993, 80% of foreign exchange receipts and payments were regulated by the exchange rates in the foreign exchange swap market. At this stage, although the foreign exchange swap market developed significantly and its functions also expanded, it was still a foreign exchange market in its primary form and not yet a foreign exchange market with financial institutions as the main bodies to fully implement the market mechanism. In November 1993, the *decision of the Central Committee of the Chinese Communist Party on setting up the socialist market economy system* adopted in the 3rd Plenary Session of the 14th Central Committee of the Communist Party of China explicitly requested to "reform the foreign exchange management system, establish a market-based regulated floating exchange rate system and a unified and standardized foreign exchange market, and gradually make CNY a convertible currency".

The third stage (from 1994 to 2013) was the stage of marketization development of the foreign exchange market. On 1 January 1994, China implemented the unification of CNY exchange rate (i.e. transition from the "dual-track" pattern in which the official exchange rate and the market exchange rate coexisted to a single market exchange rate) and introduced a single regulated floating exchange rate system based on market supply and demand. Meanwhile, China implemented the bank system of foreign exchange settlement and sales so that foreign exchange receipts and payments of eligible enterprises and individuals could be carried out at banks subject to market exchange rates, forming a retail foreign exchange market between banks and customers. In April 1994, the unified national

interbank foreign exchange market (i.e. the China Foreign Exchange Trade System) was officially established in Shanghai. Since then, China's foreign exchange market has entered a new development stage.

China's foreign exchange market after 1994 was a two-tier market system, in which the bank retail foreign exchange market (where enterprises and individuals handle the foreign exchange, settlement and sales at banks) and the unified national interbank foreign exchange market (where settlement and sale of exchange positions among banks and proprietary trading are carried out) coexist; however, after the exchange rate reform in 2005, the system underwent a transition from centring on bank retail foreign exchange market to centring on the interbank foreign exchange market.

The exchange rate reform on 21 July 2005 was a key point in the development of China's foreign exchange market towards marketization. After the reform, the People's Bank of China introduced a series of supporting measures to promote the construction of the foreign exchange market, and the foreign exchange market mechanism has gradually taken shape. These measures include improving the indirect CNY exchange rate regulation system by establishing a system of primary foreign exchange dealers and improving the formation of CNY central parity rate and promoting the development of the interbank spot foreign exchange market by introducing internationally accepted inquiry trading method and market maker system. Thanks to these measures, the interbank CNY forward market and swap market achieved great progress. From the perspective of trading tools, there were only spot and forward products before 2005, but now the portfolio has been expanded to include spot, forward, foreign exchange swap, currency swap and option products, which is a basic product system in the international market. From the perspective of trading currencies, it gradually added tradable currencies from the previous CNY against four trading currencies of USD, EUR, JPY and HKD to coverage of major settlement currencies for China's cross-border receipts and payments. The continuous diversification of trading varieties and currencies has met the needs of diversified exchange rate risk management. From the perspective of market entities, China's foreign exchange market was relatively closed before the exchange rate reform in 2005. After the reform, the interbank foreign exchange market has broken the original structure of a single bank participant, and the participation of market entities have been continuously expanding, forming a diversified level of market entities. From the perspective of trading modes, the interbank foreign exchange market adopted a single mode of centralized electronic bidding before 2005, and now a model allowing diverse modes of centralized electronic bidding, bilateral electronic inquiry, market maker system and voice brokerage services of currency brokers has taken shape. From the perspective of infrastructures, China's foreign exchange market has attempted centralized netting in OTC trading since 2005. The construction of the trading report database has begun to take shape, and the professional service functions with China Foreign Exchange Trading Center as the main trading platform and pricing centre and with Shanghai Clearing House as the central counterparty clearing house are becoming increasingly mature.

In terms of trading volume, after 10 years of development from 1994 to 2004, the trading volume of China's foreign exchange market reached USD958.3bn in 2004 (among which bank retail foreign exchange market and interbank foreign exchange market accounted for USD749.3bn and USD209bn, respectively). In contrast, after nearly 10 years of development from 2004 to 2013, the trading volume of China's foreign exchange market reached USD11.2 trillion in 2013 (among which bank retail foreign exchange market and interbank foreign exchange market accounted for USD3.72 trillion and USD7.53 trillion, respectively, which increased by 4 times and 35 times compared with those in 2004, respectively) (Wang and Jia, 2014).

The third historical period, which started in 2013 and is now going onwards, is the innovative development period of China's foreign exchange market. So far, this period can be roughly divided into two stages as follows: the steady development of the foreign exchange

market under the new normal of the economy and the deepening reform of the foreign exchange market in the new era.

Judging from the first stage, after the 18th National Congress of the Communist Party of China, China's economic development has entered a stage of new normal where it has to simultaneously deal with the slowdown in economic growth, make difficult structural adjustments and absorb the effects of previous economic stimulus policies. General Secretary Xi Jinping (2016 cited in P. 2016) pointed out: "as the bottom line that governs the entire development process". Under the new normal, China's foreign exchange supply and demand tend to be generally balanced in fluctuations. This stage's main characteristics are as follows:

First, the direction of foreign exchange market reform was further clarified. In November 2013, the *decision of the CCCPC on some major issues concerning comprehensively deepening the reform* adopted by the 3rd Plenary Session of the 18th Central Committee of the Communist Party of China emphasized the following: "Establishing a unified, open, competitive and orderly market system is the basis for the market to play a decisive role in the allocation of resources" so as to "establish and improve a management system of foreign debt and capital flow within the framework of macro-management". In fact, this further clarified the goals and functions of foreign exchange management and the direction for further deepening the development of the foreign exchange market.

Second, the willingness of enterprises to settle foreign exchange has weakened. From the perspective of the willingness of banks and enterprises to settle foreign exchange after 2014, influenced by the withdrawal of the Federal Reserve's quantitative easing policy and the strengthening of the USD index at that time, the willingness of banks and enterprises to settle foreign exchange declined. However, their willingness to purchase foreign exchange strengthened, the growth of foreign exchange deposits in the private sector and financial institutions became more obvious and the fluctuations went significantly higher than those in previous periods. In summary, although the supply and demand of the foreign exchange market was basically balanced, cross-border funds have undergone a transition from net inflow to basic balance and then to net outflow.

Third, steady development has encountered challenges. After the second half of 2015, China's foreign exchange market experienced a high-intensity external shock as the central parity rate of CNY against USD depreciated by nearly 2% on 11 August 2015, with the adverse effects of depreciation of CNY exchange rate and the abnormal fluctuations of China's stock market from December 2015 to January 2016 combined. China's foreign exchange reserves rapidly declined, raising the risk of external shocks from exchange rate fluctuations and cross-border capital flows. For the purpose of staying away from any systemic financial risks, the irrational fluctuations in the foreign exchange market constitute one of the sources of systemic risks in macro-prudential management. Since the middle of 2016, China's foreign exchange authorities have taken decisive measures to stabilize the CNY exchange rate trend.

Fourth, CNY was added to the special drawing rights (SDR) basket. On 1 October 2016, the addition of CNY into SDR basket took effect, which not only provided a good opportunity for CNY internationalization but also required China's financial market to intensify its opening-up. In order to support CNY's joining, the People's Bank of China opened the interbank bond market to overseas central banks, international financial organizations and sovereign wealth funds in July 2015 and opened the interbank foreign exchange market to these international institutions in September 2015. As of September 2015, 27 overseas central bank-type institutions have entered the interbank foreign exchange market.

Fifth, the functions of the foreign exchange market were further clarified. The outline of the "Thirteenth Five-Year Plan" adopted in March 2016 clearly stated that China should strive to "continue to increase the depth and breadth of its opening-up to the outside world, further enhance its ability to allocate resources globally, continuously optimize import and

export structure and achieve a basic equilibrium in balance of payments.” Therefore, higher requirements were imposed on foreign exchange management and foreign exchange market.

Judging from China's performance in the second stage, after entering the new era, China's foreign exchange market reform and development has been paying more attention to institutional construction and prevention of systemic financial risks so as to effectively safeguard national financial security.

In May 2017, *China's Foreign Exchange Market Self-Discipline Mechanism*, a foundational system for China's foreign exchange market self-discipline mechanism, was officially promulgated, which meant the internationalization of China's foreign exchange market rules have taken another important step for further improving the degree of marketization of the formation mechanism of CNY exchange rate.

In July 2017, General Secretary Xi Jinping (2017 cited in Shanghai Zhengquan Bao [Shanghai Securities New](#), 2017) stressed at the 5th National Financial Work Conference the following: “We must firmly deepen financial reform, optimize the financial institution system, improve the management of state-owned financial capital and the foreign exchange market mechanism”.

On 22 February 2019, when presiding over the 13th collective study of the Political Bureau of the Central Committee, General Secretary Xi Jinping (2019 cited in Jingji Ribao [Economic Daily], 2019) pointed out the following: “Preventing and defusing financial risks, especially systemic financial risks, is a fundamental task of financial work.” In terms of foreign exchange market, the main task is to give greater importance to the diffusion of various risks and hidden dangers in the foreign exchange field, adhere to the principle of comprehensive equilibrium and scientific supervision and earnestly maintain the equilibrium in balance of payments and stability of the foreign exchange market.

2. Historical evolution of the formation mechanism of CNY exchange rate

The CNY exchange rate and China's foreign exchange market are complementary to and closely linked with each other. On the one hand, foreign exchange market is the main place to display and verify the formation mechanism of CNY exchange rate which directly restricts the degree of effectiveness of the formation mechanism of CNY exchange rate; on the other hand, an exchange rate formation mechanism corresponds to a specific foreign exchange market. Therefore, the formation mechanism of CNY exchange rate directly restricts the development direction and function playing of China's foreign exchange market. In the 70 years of the new China, along with the generation, cultivation and development of China's foreign exchange market, the formation mechanism of CNY exchange rate is also adjusting and changing. Without a foreign exchange market under the highly centralized planned economic system, the CNY exchange rate only serves as an accounting tool rather than economic leverage, and the adjustment of CNY exchange rate level is mainly determined by the administrative mechanism. After the reform and opening-up, the CNY exchange rate system has evolved from the official exchange rate to a market exchange rate and from the fixed exchange rate to a managed floating exchange. Over the 70 years, the formation mechanism of CNY exchange rate has roughly undergone three historical periods.

The first historical period, the 29 years from 1949 to 1978, was characterized by the single exchange rate system with administrative pricing. During the planned economy, China's economy had limited international exchanges, let alone any external equilibrium. The CNY exchange rate system experienced the evolution from a single peg to GBP and the currency basket to a single peg to USD, and meanwhile it underwent the following three stages of adjustment:

The first stage, the 4 years from the eve of 1949 to the beginning of 1953, was the stage of implementation of a single floating official exchange rate. Since its creation, CNY has never

established a direct connection with gold (i.e., not tied to a gold standard). In January 1949, USD was once listed in Tianjin, mainly based on the ratios of values of China's bulk import and export commodities to that of the same kind of American commodities and adjusted with the changes in prices in the two countries. In the period of economic recovery before 1953, the "price comparison method" was adopted, which first calculates the theoretical parity of export commodities, the theoretical parity of import commodities and the purchasing power parity of overseas remittances separately and then determine CNY exchange rate level based on the theoretical parity of export commodities plus a certain profit and with reference to the theoretical parity of import commodities and the parity of overseas remittances purchasing power. From 1949 to early 1953, the CNY exchange rate was "suppressed before rising" and adjusted continuously with changes in relative prices at home and abroad.

The second stage, the 19 years from 1953 to 1972, was the stage of implementing a single fixed official exchange rate. After 1953, China entered the "First Five-Year Plan" period and began to implement a highly centralized planned economy. Against such backdrop, the exchange rate was not primarily used as an economic lever to adjust imports, exports and foreign exchange receipts and payments but more as an internal accounting tool for foreign trade operations. Based on the basic requirements for the fixed exchange rate system under the prescriptive plan management of foreign exchange receipts and payments and the Bretton Woods system, China implemented a single GBP-pegged fixed exchange rate system (while maintaining the exchange rate of USD1 = CNY2.46). The official exchange rate was only used for the settlement of non-trade foreign exchange but did not have a regulating effect on imports and exports. The official CNY exchange rate stuck to the principle of stability and made limited adjustments based on the original exchange rates and by referring to the exchange rates announced by Western countries, resulting in its gradual deviation from the domestic price level.

The third stage, the six years from 1972 to 1978, was the stage of implementation of a single floating official exchange rate based on the "currency basket". In August 1971, the United States unilaterally announced that USD was depegged from gold, marking the disintegration of the Bretton Woods system. The prices of major foreign exchanges began to fluctuate frequently, in view of which China began to calculate and adjust the mechanism of CNY exchange rate by following the currency basket on 23 June 1972, where the main currencies constituting the currency basket are USD, JPY, GBP and Deutsche Mark (DEM). By November 1975, the CNY exchange rate was mainly fixed on the intermediate line between the currency exchange rate of the USD group and the then DM group; finally a weighted average of 13 currencies including USD and DEM (later gradually dominated by USD) was selected. The single floating official exchange rate calculated based on the currency basket was adjusted by referring to changes in the exchange rates of major Western countries to ensure that export receipts would not suffer losses due to currency depreciation of Western countries.

The second historical period, the 27 years from 1978 to 2005, was the period of exploration of the formation mechanism of CNY exchange rate. After 1979, with the expansion of China's opening-up to the outside world and the development of its foreign economic activities, the issue of external balance gradually emerged. As a result, the exchange rate became an increasingly important issue. This period could be roughly divided into two stages.

The first stage, the 16 years from 1978 to 1994, was the stage of exchange rate dual-track system. In 1979, the State Council decided to reform the exchange rate system, in addition to the official CNY exchange rate, but also to implement the internal trade settlement price; thus the exchange rate dual-track system was formally formed. Under this system, China implemented the foreign exchange retention system, which means the foreign exchange was centrally managed, uniformly balanced and emphatically used by the State. However, in

order to motivate foreign exchange earnings, foreign exchange earners might retain a certain proportion of foreign exchange and participate in the “swaps”. In 1980, the State Council approved the Bank of China to start foreign exchange swaps; in 1985, foreign exchange swap centres were set up in various places, marking the market-oriented mechanism's gradual introduction of an exchange rate formation process.

From 1978 to 1985, China's exchange rate dual-track system mainly manifested as an internal dual-track fixed exchange rate system. Under such an exchange rate system, the official exchange rate ($\text{USD1} = \text{CNY1.5}$) was used for non-trade foreign exchange settlement, while trade followed internal settlement price ($\text{USD1} = \text{CNY2.8}$). As a result, the official exchange rate was calculated and adjusted according to the previous currency basket, while the internal settlement exchange rate was formulated based on export cost in terms of foreign exchange. After entering the 1980s, CNY exchange rate appreciated as USD weakened, reaching $\text{USD1} = \text{CNY1.5}$ in 1980; with the appreciation of USD, the exchange rate of CNY against USD was reduced from CNY1.50/USD1 in July 1981 to CNY2.30/USD1 in July 1984 (decreased by 34.8%) and then to CNY2.79/USD1 in December 1984 (basically the same as the internal settlement price).

From 1 January 1985, China officially abolished the trade internal settlement price. With the establishment of foreign exchange swap markets and the formation of foreign exchange swap prices, the formation mechanism of CNY exchange rate has begun to change, and the adjustment function of exchange rate has gradually formed. By the end of 1993, China had 121 foreign exchange swap centres (18 of which were open swap markets), allowing those units holding retained foreign exchange to transfer excess foreign exchange quotas to those units lacking foreign exchange. The exchange rate was negotiable between buyers and sellers based on foreign exchange supply and demand. With People's Bank of China intervening in the market appropriately, the transaction scale of the foreign exchange swap market reached four times that of the official market, and over 80% of all import and export receipts, payments and remittances in the country were settled according to foreign exchange swap market prices.

The second stage, the 11 years from 1994 to 2005, was the stage of marketization exploration based on the single exchange rate. On 1 January 1994, the official CNY exchange rate was officially unified to the foreign exchange swap price, and a unified interbank foreign exchange market was established across the country, which marked the formation mechanism of CNY exchange rate, which began to shift to a new stage based on market supply and demand, during which enterprises and individuals could buy and sell foreign exchange with designated banks as regulated, and banks entered the interbank foreign exchange market for trading to promote the formation of market exchange rates. Meanwhile, the People's Bank of China applied the administrative mechanism to set the floating range of exchange rates and maintained the stability of CNY exchange rate by regulating the market. Since then, although there have been some technical follow-up reform measures, two basic features of foreign exchange holding restrictions and foreign exchange trading restrictions on corporate and residential sectors have never been changed.

Since 1994, China began implementing the single and managed floating exchange rate system based on market supply and demand. In terms of exchange rate changes, the exchange rate was $\text{USD1} = \text{CNY8.7}$ at the time of exchange rate unification in 1994 and appreciated to $\text{USD1} = \text{CNY8.28}$ after the Asian financial crisis in 1997, a cumulative appreciation of 5%. From 1997 to July 2005, CNY was actually pegged to USD alone and fluctuated within a narrow range. In terms of foreign exchange management, the basic convertibility of CNY current accounts was realized in December 1996, but meanwhile the foreign exchange management mechanism of compulsory settlement of foreign exchange and conditional sale of foreign exchange was implemented.

In October 2003, the 3rd Plenary Session of the 16th Central Committee of the Communist Party of China determined that the overall goal of CNY exchange rate reform was to establish and improve a managed floating exchange rate system based on market supply and demand and to maintain the basic stability of CNY exchange rate at a reasonable and balanced level. Since 21 July 2005, China has taken a key step in the reform of exchange rate marketization and begun to implement an adjusted and managed floating exchange rate system on the basis of market supply and demand and with reference to the currency basket. CNY against USD appreciated by 2% (adjusted from the previous USD1 = CNY8.28 to USD1 = CNY8.11), CNY exchange rate stopped pegging solely to USD but instead to the actual development conditions of China's foreign trade and began to choose several major currencies to which corresponding weights are given, forming the currency basket. The effective exchange rate of CNY was then calculated based on the currency basket as well as market supply and demand. On this basis, the CNY exchange rate (CNY/USD nominal exchange rate) was managed and adjusted to maintain the basic stability of CNY exchange rate at a reasonable and balanced level. Since then, the flexibility of the formation mechanism of exchange rate has been continuously improved, the flexibility of CNY exchange rate continuously strengthened and the foreign exchange market continuously developed.

The third historical period, after 2005, was the advancement period of marketization reform of the formation mechanism of CNY exchange rate, when China introduced a series of measures to reform and improve the formation mechanism of CNY exchange rate marketization, mainly including the following:

On 24 November 2005, the State Administration of Foreign Exchange introduced the *guidelines for market maker on the interbank FX market (Provisional)* and the *notice on relevant issues of promoting spot inquiry dealing in interbank foreign exchange market* before introducing the market maker system to the interbank foreign exchange market and decided to introduce OTC to the interbank spot foreign exchange market on the first trading day of 2006 (i.e. January 4). On 3 January 2006, the People's Bank of China issued the *public announcement on further improving the interbank spot foreign exchange market*, announcing the introduction of an over-the-counter (OTC) approach to the interbank spot foreign exchange market with effect from 4 January 2006 and the retention of a matchmaking approach.

On 18 May 2007, the People's Bank of China issued the *announcement on expanding the floating range of trading price of CNY/USD in the interbank spot foreign exchange market*, announcing that the floating range of CNY against USD in the interbank spot foreign exchange market would expand from 0.3% to 0.5% on trading days since 21 May 2007.

In August 2007, China began to implement the system of willing settlement and sale of foreign exchange. After the impact of the international financial crisis in 2008 expanded, the CNY exchange rate has actually begun to peg to USD since July 2008, and the CNY exchange rate has once again narrowed its floating range (fluctuating in a small range of CNY6.81 to 6.86/USD1). On 19 June 2010, the People's Bank of China announced that it would further advance the formation mechanism reform of CNY exchange rate, strengthen the flexibility of CNY exchange rate, normalize exchange rate fluctuations and withdraw from the policy of temporary pegging to USD, as well as adhere to market supply and demand, adjust with reference to the currency basket and continue to dynamically manage and adjust CNY exchange rate according to the announced floating range of foreign exchange market exchange rate.

On 14 April 2012, the floating range of the CNY/USD trading price in the interbank spot foreign exchange market expanded from 0.5 to 1% to facilitate the flexibility of CNY exchange rate.

On 11 August 2015, the People's Bank of China announced the improvement of the formation mechanism of CNY central parity rate, which entails a mechanism where, before

the opening of the daily interbank foreign exchange market, market makers would refer to the closing exchange rate of the interbank foreign exchange market in the previous day and comprehensively consider foreign exchange supply and demand and changes in exchange rates of major international currencies prior to providing a central parity rate to China Foreign Exchange Trading Center. On the same day, the CNY/USD central parity rate quotation depreciated by about 200 basis points on the basis of the previous closing exchange rate of CNY6.2097/USD1.

On 11 December 2015, China Foreign Exchange Trading Center released the CNY exchange rate index, stressing the need to intensify the reference to the currency basket to better maintain the basic stability of CNY against the currency basket. Based on this guidance, a CNY/USD central parity rate mechanism featuring “closing exchange rate + changes in exchange rates of currency basket” took its initial form.

On 29 April 2016, the Political Bureau of the Central Committee of the Communist Party of China stressed in a meeting that it was necessary to maintain the CNY exchange rate's general stability and gradually form a two-way floating and flexible exchange rate operating mechanism based on market supply and demand.

In May 2017, the foreign exchange market self-discipline mechanism introduced a “counter-cyclical factor” into the CNY central parity rate quotation model, and the CNY/USD central parity rate mechanism was adjusted from “closing price + changes in exchange rates of currency basket” to “closing price + changes in exchange rates of currency basket + counter-cyclical factor”. In August 2017, the *self-disciplining standards for quotation institutions' quotation of CNY/USD central parity rate* was promulgated, further clarifying the new model of CNY/USD central parity rate quotation, which requires quotation agencies to establish the calculation model of CNY/USD central parity rate based on the principle of “CNY/USD central parity rate = last closing rate + changes in exchange rates of currency basket + counter-cyclical factor” and provide quotations based on calculation results of the model.

In October 2017, the report of the 19th National Congress of the Communist Party of China stressed that the need to continue to deepen the “exchange rate marketization reform” not only pointed out the direction of CNY exchange rate reform but also pointed out that this reform still had a long way to go.

3. Historical experience of the development of China's foreign exchange market

To explore and establish a new system of socialist market economy in a large developing country that has been devastated by a hundred years of war is an unprecedented achievement in human history. In this process, the establishment of a foreign exchange market in line with the development of the real economy and the market economy is also an unprecedented feat in the international financial history. Over the past 70 years since the founding of the new China, the People's Republic of China has adhered to the general orientation of serving the development of the national economy – constantly explored and innovated in practice – and blazed a path for building a foreign exchange market suited to its national conditions, thus leaving a legacy of historical experience for other developing countries to learn from, as concluded in the following paragraphs.

First is to adhere to the sovereignty of the State and interests of the people. As an important part of a country's (or region's) economic sovereignty, the foreign exchange mechanism should be aimed at promoting sustainable economic development and continuous improvement of people's living standards. Examining the outcome of the introduction of a large amount of foreign capital (or even granting priority to foreign capital) to develop their national economies in some developing countries (especially Latin American countries), they had admittedly undergone relatively rapid economic growth and

improved people's lives in the early stage; however, as their key and major economic lifelines are ultimately controlled by foreign capitals, imperialist powers would not only impose on these countries harsh economic and non-economic requirements but also intervene and manipulate their political circles, thus resulting in political unrest, economic stagnation (or even retrogression), social life order instability and many other problems. In contrast, China has chosen a different path. Facing the shortage of foreign exchange, China opted to increase its ability to purchase advanced equipment from abroad through economic development and export earnings. After the reform and opening-up, China persisted with its adherence to the principle of self-reliance while increasing the introduction of foreign capital. In the mid-1990s, China continued to open up, introduce foreign investment and reform its exchange rate mechanism, even though the shortage of funds had turned into a relative surplus. In 2003, amid a wave of international calls for CNY to appreciate, China made it clear that its exchange rate regime was part of its sovereignty. The choice of exchange rate regime and the reform of exchange rate formation mechanism should be reviewed in light of all the latest developments and determined based on the specific requirements of various factors such as domestic economic development, the improvement of people's living standards and the need for international economic exchanges. Throughout the course of the past 70 years, compared with the emerging industrial countries that underwent rapid post-war development, although the construction of China's foreign exchange market and the adjustment of the exchange rate formation mechanism have been slow for a while, they have basically not gone astray and have not brought about serious negative impact on domestic economic growth and institutional reform.

Second is to adhere to the general direction of serving economic development. Over the past 70 years, China's foreign exchange mechanism has undergone great changes in the course of improving economic development, deepening reform of institutions and mechanisms and expanding economic exchanges with other countries. However, the foreign exchange management system, the exchange rate formation mechanism and the development of the foreign exchange market have all played their roles for the basic mission of "serving the real economy". In the period of planned economy, "foreign exchange equilibrium", together with "material, finance and credit", was listed as the four equilibrium goals, which not only reflects the important position of foreign exchange mechanism in the development of national economy but also reflects the orientation that seeks the foreign exchange mechanism's advancement based on the equilibrium of "material, finance and credit". During the reform and opening-up, along with the rapid expansion of foreign economic exchanges, from import substitution to export orientation and then to the open economy, from the introduction of foreign capital to the introduction of advanced technology and then to the introduction of modern management and from bringing in to going out and then implementing the "Belt and Road", the reform of China's foreign exchange management system, the construction of the foreign exchange market and the choice of exchange rate formation mechanism have all focussed on strengthening national economic strength, enhancing international competitiveness and improving people's living standards.

Third is to adhere to the strategy of steadily and orderly promoting development of the foreign exchange market. In October 1992, the 14th National Congress of the Communist Party of China explicitly proposed the establishment of a new system of socialist market economy. Reform of the exchange rate mechanism and construction of the foreign exchange market have since been put on the agenda. Facing various demands at home and abroad, China was in no hurry to pursue success; instead, it chose to steadily and orderly advance reform of the foreign exchange management system and construction of the foreign exchange market, mainly manifested as follows: responding to the changes in domestic and foreign

economic and financial conditions, China unified its originally dual-track system exchange rates in 1994 and established the foreign exchange trading market, which are followed by the realization of CNY convertibility under current account in 1996; after the exchange rate reform in July 2005, China accelerated the pace of foreign exchange management system, exchange rate formation mechanism and foreign exchange market construction, and meanwhile the trading restrictions on foreign capital entering China's stock market, bond market and other financial markets were gradually lifted. After 2015, in the context of the US withdrawal from quantitative easing and the USD appreciation, the fluctuations of CNY exchange rate intensified and showed a trend of accelerated depreciation. China immediately adjusted its foreign exchange management method, improved the CNY central parity rate formation mechanism and strengthened the "cornerstone" mechanism of foreign exchange reserves in supporting stability of the CNY exchange rate, so as to promote CNY exchange rate stability. Admittedly, there are still many imperfections and reforms awaiting to be deepened before China's foreign exchange market to fully serve the various functions of the international financial market and become an influential exchange rate market in international economic and financial activities, but it can be expected that these problems will be solved in an orderly manner in the process of "advancing in stability". Without "stability", any efforts will end up being another example of "haste makes waste", which is especially true in the face of the severe challenges of international economic and trade frictions.

Fourth is to adhere to the innovation of monetary policy operations. After the exchange rate reform in 2005, China's trade surplus expanded rapidly. According to Western economic theories, it would lead to a series of effects such as the growth of local currency issuance, economic overheating and inflation, leaving serious hidden dangers to the healthy operations of economy and finance. However, China has effectively carried out monetary policy operation innovation, applying such mechanisms as statutory deposit reserve ratio and issuance of central bank bonds to hedge the position for foreign exchange purchase, thus not only overcoming the impact of huge inflows of foreign exchange funds on economic and financial operations but also ensuring stable operations of the foreign exchange market. After 2015, China's foreign exchange reserves fell sharply, according to western theories, which would lead to a sudden drop in domestic currency issuance and a full-scale tightening of the economy and finance. However, while reducing the statutory deposit reserve ratio, China innovated in tools such as short-term borrowing facilities and medium-term borrowing facilities to strengthen the lending to commercial banks and other financial institutions, not only guaranteeing liquidity supply in economic and financial operations but also ensuring basic stability of the CNY exchange rate.

Fifthly is to adhere to the bottom line of not having systemic financial risks. Over the past 70 years, the international market has changed dramatically, and the international political and economic conditions and development trends have undergone great changes. The past decades have witnessed a considerable number of financial crises: to name a few, the Latin American debt crisis after 1982, the Japanese asset price bubble collapse after 1990, the Black Wednesday in 1992, the Southeast Asian financial crisis in 1997, the American financial crisis in 2008, the Greek sovereign debt crisis and the European sovereign debt crisis after 2009. The outbreak of systemic financial risks has not only brought disastrous consequences to the economy and society of the countries involved but also seriously impacted operations of the international economy and international finance. Facing the various risks global economic and financial conditions might pose to China's economy and finance, China has, based on the overall conditions of its economic development, adopted a series of effective countermeasures dedicated not only to the prevention of the spread of the international financial crisis in China but also actively promoted collaborative actions of relevant countries or regions in response to international financial crises. During the Asian financial crisis, China explicitly declared that "CNY will not depreciate", which supported the efforts of Southeast Asian countries to

cope with the financial crisis. After the American financial crisis broke out, China not only effectively made use of the G20 mechanism to actively intervene in international coordination and to apply exchange rate, interest rate, etc., to promote the stability of international capital flows but also promptly took measures to “boost domestic demand and stimulate the economy” to stabilize the domestic economy and bring international economy and international finance back within a stable operating range. On the whole, the reason China has not allowed its pace of reform and development to be hampered by the severe impact of international financial crises and has been operating and expanding its foreign exchange market steadily and orderly is that it has constantly maintained vigilance against financial risks, timely selected relevant measures to resolve corresponding financial risks and established strict supervision of its international capital flows.

Note

1. The foreign exchange mechanism is mainly composed of the following three parts: the foreign exchange management system, the exchange rate system and the foreign exchange trading market. Although they are closely linked, each has its focus and characteristics.

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