Pan Gongsheng: Situation and development of China’s foreign exchange market

Speech by Mr Pan Gongsheng, Deputy Governor of the People's Bank of China, at the 13th Lujiazui Forum, Shanghai, 10 June 2021.

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Honorable Secretary Li Qiang, Mayor Gong Zheng, Governor Yi Gang, Chairman Guo Shuqing, Chairman Yi Huiman, Ladies and Gentlemen,

Good morning.

At today’s forum, I would like to talk about the situation and development of China’s foreign exchange market.

I. The RMB exchange rate has seen two-way fluctuations and the foreign exchange market operates stably

1. The operation of the foreign exchange market is a subject of common concern. Since the beginning of this year, the RMB exchange rate against the US dollar has seen two-way fluctuations and is generally stable.

Developments in international financial markets, especially the fluctuations in the interest rate and the exchange rate of the US dollar, have had some impact on other currencies, including the RMB. At the same time, with the Chinese economy continuing to recover steadily, the RMB exchange rate has remained basically stable at an adaptive and equilibrium level.

At present, China’s current account surplus remains in a reasonable range; supply and demand in China’s foreign exchange market are basically in equilibrium; and China’s foreign exchange reserves are stable and rising.

China adopts a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. It has proved to be an institutional arrangement suitable to China’s national conditions and will be pursued persistently.

2. Factors influencing the RMB exchange rate are complicated and two-way fluctuations will become normal.

The RMB exchange rate is more stable than other currency exchange rates; RMB exchange rate expectations are stable; and trading in China’s foreign exchange market has been rational and orderly.

There are multiple factors home and abroad that influence the movements of the RMB exchange rate. On the one hand, China’s economy has been stable and improving; it has maintained a normal monetary policy; its balance of payments is sound and stable; and its foreign exchange market is maturing. All these factors will continue to provide strong support for the stability of the RMB exchange rate. On the other hand, there are a number of destabilizing factors and uncertainties in the external environment affecting the RMB exchange rate. First, economic recovery is still uneven around the world, with the US and other developed economies undergoing faster recovery and narrowing the gap with China’s economic growth. Second, with the rise of inflation and inflation expectations in the US, market expectations have been running high for monetary tightening by the US Federal Reserve, and pressure is mounting on it for monetary policy adjustment, which will have major impacts on global foreign exchange markets and cross-border capital flows. Third, since the outbreak of the pandemic, stimulated by the ultra-loose monetary policy, valuations in international financial markets have been rising and deviating from the fundamentals of the real economy. Heightened vulnerabilities and the risks of downward adjustment in international financial markets may lead to rising risk aversion globally and change cross-border capital flows. Fourth, in the post-pandemic era, the intensifying rivalries in the international political and economic arenas may impact financial markets, particularly the foreign exchange market. One thing to add, China's foreign exchange market has apparent seasonal features. June to August each year usually see large amounts of foreign exchange purchases as foreign-invested enterprises as well as companies listed overseas pay dividends and repatriate profits, and many Chinese students studying overseas pay their tuition fees and living expenses for the coming semester.

II. Market entities should adapt to the normalityof two-way exchange rate fluctuations and be risk-neutral in exchange rate risk management

In an environment characterized by two-way exchange rate fluctuations, exchange rate risk management is highly important to the financial performance of enterprises, especially those active in international businesses. In recent years, China's foreign exchange market has achieved substantial development. A foreign exchange derivatives market with depth and width has been in operation, which offers a variety of products, such as forwards, foreign exchange swaps, currency swaps and currency options, and has diversified market participants. In 2020, transactions in China's foreign exchange market totaled USD30 trillion, 60 percent of which was from foreign exchange derivatives trading. Chinese enterprises have continuously raised their awareness to be "exchange rate risk-neutral" and improved their management of exchange rate risks. So far this year, the hedge ratio of enterprises has exceeded 20 percent, up by 5 percentage points from last year. Nonetheless, there is still much room for improvement.

To reduce exchange rate risks requires the joint efforts of enterprises, banks and regulators. First, with regard to foreign exchange risk management, some enterprises act procyclically and some expose themselves completely to risks. As their procyclical financial operations build up risk exposure via currency mismatches in their balance sheets, they may gain profits from the rises and falls in exchange rates while inevitably bearing the risks coming along. As far as financial soundness is concerned, an enterprise should adhere to the principles of serving its main business and being risk-neutral in exchange rate risk management; it should make prudential arrangements on the currency structure of its assets and liabilities while avoiding procyclical behavior and complete exposure to risks; and it should never bet on the appreciation or depreciation of the RMB since gamblers are bound to loose someday. Second, we will work towards an open and competitive foreign exchange market. Third, we will push financial institutions to diversify hedge products and reduce hedge costs for enterprises. Fourth, we will improve market transparency so that market entities are better informed to make rational judgments on foreign exchange market situation. Fifth, we will enhance macro-prudential management and the guidance of market expectations to keep the RMB exchange rate basically stable at an adaptive and equilibrium level.

III. We will steadily advance the reform of foreign exchange management and enhance the liberalization and facilitation of cross-border trade and investment

China's current account achieved full convertibility in 1996. Since the beginning of this century, we have been steadily moving ahead with the liberalization of our capital account, which has become highly convertible according to international standards. The capital account represents cross-border capital and financial transactions, which mainly fall into three categories, i.e., cross-border direct investment, cross-border securities investment and cross-border lending/borrowing, involving cross-border trading, currency exchange and cross-border inward/outward remittance. Currently, direct investment has basically achieved convertibility. As for securities investment, institutional arrangements for cross-border investment have been put in place, which mainly include institutional investor schemes, interconnectivity mechanisms and direct market access for overseas investors. Cross-border debt financing can be conducted at the discretion of market entities under the macro-prudential management policy framework for full-scale cross-border financing.

We will work to ensure both development and security, making continued efforts to reform and improve the foreign exchange management system and mechanisms to align with the new systems for a higher-standard open economy under the new development paradigm. First, we will improve cross-border trade facilitation under the current account while reform of the foreign exchange sector will move ahead to streamline administration, delegate power, improve regulation and upgrade services; and a foreign exchange supervisory system will be established, which focuses on credit risk assessment and ex-post verification. Second, prudent and orderly steps will be taken to advance high-standard opening-up of the capital account. By making coordinated planning for trading, exchange and remittance, for cross-border RMB and foreign currency management, and for capital account liberalization and risk prevention, we will liberalize the remaining few non-convertible items step by step while enhancing facilitation measures under the items already convertible. Focusing on RMB internationalization and two-way opening-up of the financial sector, we will actively support Shanghai in its building of an RMB-denominated financial asset allocation and risk management center to improve the width and depth of the RMB financial market. Third, continued efforts will be made to enhance our abilities for economic and financial management as well as risk prevention and control in an open environment. We will improve the framework for foreign exchange market administration featuring “macro-prudential management plus micro supervision” and enhance the review mechanisms for combating money laundering, terrorist financing and tax evasion so as to safeguard the stable and sound operation of the foreign exchange market.

The near-term priorities in the reform and opening-up of the foreign exchange sector are as follows. First, we will diversify market products and participants home and abroad, and improve the infrastructure systems as well as service capacities of China Foreign Exchange Trade System and Shanghai Clearing House so that they are better able to provide services globally from Shanghai. Second, measures will be taken to advance reform regarding cross-border investment by private equity investment funds to support their cross-border industrial investment. Moreover, we will expand the pilot programs of Qualified Domestic Limited Partnership (QDLP) and Qualified Foreign Limited Partnership (QFLP) to support Shanghai becoming a major market in the world for wealth management and asset management. Third, Chinese residents will have more options for asset allocation overseas. Through the mechanisms interconnecting financial market infrastructures, such as the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and Bond Connect, we will scale up the Qualified Domestic Institutional Investor (QDII) scheme, improve QDII management mechanisms, and launch the pilot program of Cross-Boundary Wealth Management Connect in some regions. Fourth, we will facilitate cross-border financing for enterprises. In recent years, the People’s Bank of China (PBC) and the State Administration of Foreign Exchange (SAFE) have established and improved the macro-prudential management policy framework for full-scale cross-border financing, allowing enterprises to borrow from abroad at their own discretion within quotas based on their net assets. As some innovative enterprises, especially the micro, small and medium-sized enterprises among them, only have small net assets initially and hence low quotas for cross-border financing, we have launched pilot programs in areas, such as Zhongguancun of Beijing and the Shanghai Pilot Free Trade Zone, to facilitate external debt financing for them. Eligible high-tech enterprises are granted facilitation quotas for external debt financing, which they can use at their discretion. This measure is supportive to the development of Shanghai as a sci-tech innovation center. Fifth, work will be done to support cross-border receipts and payments for new forms of trade, such as offshore trade, cross-border e-commerce and market procurement trade. Sixth, we will facilitate coordinated use of cross-border funds in large conglomerates, having launched the pilot program of integrated RMB and foreign currency cash pooling for multinational corporations.

Moreover, in the near future, pilot programs for high-standard opening-up of foreign exchange management will be launched in the Lin-gang Special Area of Shanghai and in some parts of the

Guangdong-Hong Kong-Macao Greater Bay Area and the Hainan Free Trade Port in order to gain experience for advancing high-standard institutional opening-up of the foreign exchange sector.

IV. We will improve the management of foreign exchange reserves and build world-class asset management institutions

Regarding the investment of foreign exchange reserves, China is an important investor in global financial markets, and a responsible investor as well. We conduct relevant operations in line with market-based principles, respect international market rules and industry practices, and maintain and promote the stability as well as development of international financial markets.

Since 2007, we have incorporated environmental, social and governance (ESG) elements into the processes of foreign exchange reserves management. In China's foreign exchange reserves, green bonds, which we have invested in through multiple channels, have recorded a compound annual growth rate of around 60 percent for the past five years. The ESG criteria have also been incorporated into investment decision-making and risk management processes.

Going forward, premised on security, liquidity and value preservation and appreciation, it will be our long-term objective to invest foreign exchange reserves sustainably. We will continue to implement the ESG concept in the course of investment and enhance the depth and width of ESG investing and risk management. In addition to stepping up green bond investment, we will take active steps to try making sustainable investments through entrusted investment, cooperation with international financial organizations, or outbound direct investment via equity investment institutions such as the Silk Road Fund. And we will improve the framework for the analysis and assessment of risks posed by climate change to reserves investment. China will strengthen international exchanges and cooperation on foreign exchange reserves management, firmly support worldwide green low-carbon development, and work together with the international community to promote global climate governance and foster a community of life for man and nature.

Ladies and gentlemen, as proved by the development of China's financial market, unswervingly carrying out reform and opening-up is a strong driving force and important guarantee for the realization of China's financial market development that is based on market principles, governed by law and up to international standards. It is also key to enhancing the international competitiveness of China's financial market as well as its capabilities to serve the real economy.

We will better coordinate development and security, make coordinated planning for capital account liberalization, two-way opening-up of financial markets and RMB internationalization, improve the liberalization and facilitation of cross-border trade and investment, and effectively guard against shocks from cross-border capital flows. By so doing, we will safeguard financial stability and national economic and financial security, support the new systems for a higher-standard open economy, and promote the development of Shanghai as an international financial center.

Thank you.