

The Impact of Fed Rate Hikes on The Chinese Economy

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Abstract: The United States is the world's largest economy and a major financial center. As the central bank of the United States, the Federal Reserve's monetary policy decisions not only have a significant impact on the country's economic and trade development, but also lead to changes in global capital flows, exchange rate fluctuations, and international trade conditions. Since March 2022, persistent high inflation and overheating of the economy have led the Federal Reserve to raise interest rates dozens of times. As of September 2023, the Federal Reserve's interest rate has increased from 0 to 5.5%. The total rate hike by the Federal Reserve has reached 550 basis points. As the US dollar is the world's reserve currency, China's economy inevitably experiences varying degrees of impact. Therefore, studying the impact of the Federal Reserve's rate hikes on the Chinese economy will help our country formulate better response measures and reduce its adverse effects on our economy.

Keywords: Federal Reserve interest rate hike, Chinese economy, Impact, Response.

1. Introduction

In the globalized economic system, the monetary policies of various countries interact with each other, especially the policy decisions of the Federal Reserve System of the United States (referred to as the "Fed"), which have a significant and attention-grabbing impact globally. Since 2022, the Fed's tightening cycle has not only had a significant impact on the US domestic economy but also caused fluctuations in global financial markets and the real economy. China, as the world's second-largest economy, has close economic and trade relations with the United States. Therefore, the Fed's tightening actions have an undeniable spillover effect on China's macroeconomy, financial markets, and industrial economy. The main reason for the Fed's tightening is to reduce inflation in the market, curb existing market speculation, and, in addition, raising interest rates can also serve as an indirect means of raising the exchange rates of other currencies [1]. From a macroeconomic perspective, tightening and easing are tools for central banks to regulate the economy. Fed tightening, as a policy tool, aims to maintain the stability and growth of the US economy. When the US economy shows signs of overheating or rising inflation, the Fed will use tightening to cool down the economy, control inflation, and ensure sustained and healthy economic development. This action reflects its prompt response and regulation of the economic situation to safeguard the long-term interests of the US economy.

2. Overview of the Background of The Federal Reserve's Interest Rate Hike Policy

At the beginning of 2022, the U.S. economy is in a strong recovery phase post-pandemic, but also faces unprecedented inflationary pressure. For example, global supply chain disruptions, the Russia-Ukraine conflict, and the first rate hike in the US dollar. At the same time, the Consumer Price Index (CPI) has exceeded the Federal Reserve's 2% target for several months in a row, raising concerns about overheating the economy. To address the high inflation rate, the Federal Reserve adopted an aggressive interest rate hike strategy in 2022, implementing multiple rate hikes with a cumulative

increase of up to 425 basis points, demonstrating its determination to curb inflation. By September 2023, the Federal Reserve's interest rate had risen to 5.5%. The total rate hike by the Federal Reserve had reached 550 basis points. The large-scale rate hike policy implemented by the Federal Reserve is aimed at increasing the attractiveness of the US dollar and attracting capital inflows into the US market worldwide. This approach may lead to currency depreciation in other countries and a certain degree of economic contraction. Subsequently, the Federal Reserve may release a large amount of US dollar liquidity by lowering interest rates, allowing US investors to purchase assets in other countries at lower prices when their asset values are depressed due to previous economic pressures, thereby effectively acquiring global assets to achieve the goal of harvesting global assets.

3. The Impact of The Fed's Rate Hikes on The Chinese Economy

The Fed's rate hike move is like placing a heavyweight chess piece on the global economic chessboard, with its influence spreading worldwide. As the USD interest rates rise, the attractiveness of US assets increases, prompting global capital to flow back to mature economies like the US from developing countries and emerging markets. This phenomenon is a capital homecoming for the latter, but a capital outflow for the former, exacerbating the funding shortage in emerging markets and leading to financial market turbulence. In this process, the bond market and stock market bear the brunt, facing volatility tests that not only impact domestic investors but also stir global capital markets. For countries and companies burdened with USD-denominated debt, the rate hike means higher debt servicing costs, heavier financial burdens, and a potential plunge into more severe debt crises, especially for economies relying on external financing, it's like adding insult to injury.

At the same time, the dominance of the US dollar is further consolidated, becoming the hegemon on the international currency stage, not only making other currencies pale in comparison, but also posing a challenge to export-oriented countries. Although currency depreciation may stimulate exports in the short term, in the long run, it weakens their competitiveness in the international market, shrinks export

income, and hinders economic growth. The chain reaction of Fed rate hikes also reflects the potential suppressive effect on global economic growth. Tightening financial conditions reduce investment willingness, cut consumption capacity, weaken global demand, and directly impact emerging market countries, whose economic growth expectations are downgraded and face further economic risks.

3.1. Capital Outflow from China

From the perspective of China, the main impact of the Fed's rate hike is mainly negative, such as short-term capital outflows, which are not conducive to the steady progress of the overall economy and lead to increased pressure on China's economic development[2]290, especially in terms of capital flows, leading to a series of chain reactions. First, the rate hike raises the attractiveness of US dollar assets, prompting global capital to flow back to the United States, putting pressure on China's capital outflow. Capital outflows not only reduce China's foreign exchange reserves, but may also lead to depreciation of the renminbi, further stimulating capital flight. Although the depreciation of the renminbi may boost exports in the short term, in the long run, it will increase the external debt burden of Chinese enterprises, especially those entities relying on overseas financing. Therefore, the Fed's rate hike cycle poses a significant challenge to China's capital flows.

3.2. The Renminbi Depreciation

At the crucial moment of the revitalization and transformation of the US economy, the Fed's interest rate hike policy plays a central role. It not only drives the US dollar towards strength but also indirectly leaves other global currencies behind, thereby consolidating the dominance of the US dollar in the global economic landscape. Since the 2008 financial crisis, the relationship between long-term bond yields between the US and China has become increasingly close. Although the Fed's interest rate hikes are not directly targeted at the RMB exchange rate, through influencing the flow of global capital, it still significantly affects the movement of the RMB.

Drawing lessons from history, during the last phase when the Federal Reserve gradually withdrew its quantitative easing policy, from mid-2014 to the end of 2016, the Euro, Indian Rupee, Brazilian Real, and South African Rand all suffered from the impact of currency depreciation. Similarly, the Renminbi was not spared from the effects of the strengthening US Dollar, leading to a downward trend in the USD exchange rate, highlighting the general vulnerability of the global currency system in the face of the Fed's interest rate hikes.

It is important that, given the misalignment of economic cycles between China and the United States, the Fed's rate hike may deepen the depreciation pressure on the renminbi and potentially trigger capital outflows. This mismatch of economic cycles is rooted in the structural differences of the two economies, the independence of monetary policies, and the fluctuation of global investors' preference for US dollar assets. In this context, the fluctuations of the renminbi exchange rate and the dynamic changes in capital flows have become important indicators to measure the interaction between China and the US economies and the stability of the global financial system.

Based on current analysis, if the United States continues to adopt such a tightening policy, the U.S. dollar will enter an upward phase in the short term, which will increase the

depreciation pressure faced by the Chinese yuan during the U.S. dollar's upward cycle [3].

3.3. Increased Financial Risks

Since 2022, the Federal Reserve has implemented multiple rounds of interest rate hikes to curb inflation. These actions have had profound effects on global capital flows and interest rate levels. The Fed's rate hikes have driven global capital back to the U.S. market in search of higher returns. As the world's second largest economy, China faces pressure from capital outflows, affecting the balance of supply and demand in the foreign exchange market and intensifying fluctuations in the renminbi exchange rate, increasing the difficulty of managing exchange rate risks. At the same time, the rapid flow of capital has increased uncertainty in China's financial markets (especially the stock market and bond market), affecting investor confidence, increasing market volatility, and posing challenges to the asset quality and profit models of financial institutions. With the rise in global benchmark interest rates, China's domestic borrowing costs have also increased. For entities in the real economy sector, especially small and medium-sized enterprises that rely on credit expansion, higher financing costs may restrain investment activities and impact economic growth. For Chinese companies holding a large amount of U.S. dollar debt, the Fed's rate hikes directly lead to higher debt costs, increasing the risk of debt defaults and potentially posing a threat to the quality of bank credit assets. China's financial markets may be impacted by external shocks, the sentiment of capital market investors may be affected, investors may become more cautious, thus limiting financial market activities [4].

4. How China Should Respond to The Next Round of Federal Reserve Interest Rate Hikes

4.1. Enhance the Internationalization of The Renminbi and Strengthen Its Risk Aversion Capabilities

Persist in the monetary policy of "putting ourselves first" and support the development of the real economy [5]. Promote the relevant supporting reforms for the internationalization of the RMB. The internationalization of the RMB will inevitably be accompanied by financial market reforms and opening up to the outside world. Frequent exchange rate fluctuations and changes in the prices of RMB assets will have a considerable impact on financial risk prevention and control [6]. Therefore, the government should consider increasing the variety and quantity of financial products such as bonds and stocks to enhance market liquidity, attract more international investors, and provide guarantees for the stability of our country's economic development. Adhering to the path of high-quality economic development, ensuring sustained and stable economic growth, plays a role in maintaining the new normal of our economic growth [2] 291. Even in the face of downward pressure on the economy, it can cope with the issue of the Federal Reserve raising interest rates. To optimize the regulatory mode and ensure the stability of the financial market, we need to rely on market-oriented means to guide the market exchange rate, reduce administrative intervention, and make market supply and demand relations the main factor determining the exchange rate. At the same time, we also need to prevent the rapid

narrowing of the domestic and foreign interest rate differentials to avoid possible instability in capital flows. In addition, we should deeply participate in the reform of the international financial governance framework, advocate and promote the coordination of international economic and financial policies, and establish a regular high-level consultation mechanism to address the spillover effects of major developed countries' policies on emerging economies and developing countries.

4.2. Enhance the Collection of Information on The Foreign Exchange Policy of The Federal Reserve

From the current economic situation in China, the negative impact of the Fed's interest rate hike on China is basically controllable [7]. However, we need to strengthen our ability to collect and analyze information on the Fed's foreign exchange policies so that our country can adjust domestic policies promptly when facing potential external changes. By establishing a more perfect monitoring mechanism, focusing on the trends of the Fed in this area, we can more accurately predict the direction and pace of the Fed's policy adjustments, and then take more effective policy measures to maintain the stability of our domestic financial market, ensuring that the economy can maintain a healthy development trend. In addition to these methods, China can also strengthen information sharing and cooperation with international partners to explore together the sustainability and stability of financial markets in the rapidly changing global economic environment. On one hand, this can not only collect information from various sources but also create a more favorable external environment for the internationalization of the Renminbi, further promoting the positive development of the economy.

5. Conclusion

In the short term, the Fed's interest rate hike policy has had

various impacts on the economies of countries and regions around the world. For our country, the financial market and foreign exchange market are also facing significant challenges. In order to effectively cope with the negative impact of the Fed on our country's economic environment, we can conduct in-depth analysis of the relevant information released by the Fed, and at the same time, we should also develop supporting facilities to promote the internationalization of the Renminbi. This is to minimize adverse effects as much as possible. We need to be vigilant against various pressures to promote the sustained and good development of our country's future economy.

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