

# The Impact of the Federal Reserve's Interest Rate Hike on the Chinese Economy

Ziyuan Li

The University of British Columbia, China

liziyu02@student.ubc.ca

**Abstract.** This paper examines the impact of the Federal Reserve's interest rate hikes on the Chinese economy. It analyzes the potential effects on various sectors, including the stock market, currency exchange rates, and commodity prices. The study also explores the measures taken by China to mitigate the negative consequences and promote economic stability. The findings suggest that while the interest rate hikes may initially lead to short-term fluctuations, the Chinese economy has shown resilience and has implemented effective strategies to minimize the impact. The findings suggest that while short-term effects may be observed, long-term fluctuations are expected to be limited. By reviewing and synthesizing relevant literature, this paper provides insights into the potential implications of Federal Reserve policy decisions on China's economic growth.

**Keywords:** Federal Reserve's Interest Rate Hike, Chinese Economy, Countermeasures analysis.

## 1. Introduction

The Federal Reserve's decision to raise interest rates has significant implications for the global economy, including China. As one of the world's largest economies, China's financial markets and currency exchange rates are closely linked to international developments. There have been many articles about the impact of the Federal Reserve's interest rate hike. According to Yu and Wang (2023), continued interest rate hikes by the Federal Reserve increased pressure on the RMB exchange rate and cross-border financial flows [1]. Moreover, Tan pointed out that the probability of RMB depreciation is high under the influence of the Federal Reserve's interest rate hike [2]. Most of the articles focus on the impact of the Federal Reserve's interest rate hike on a certain aspect. This article aims to provide a more comprehensive introduction by reviewing previous research. Through reviewing the Federal Reserve's interest rate hike event, the reasons for its impact on the Chinese economy, the specific manifestations of its impact, and the response measures taken by the Chinese government, this article provides some suggestions.

## 2. Federal Reserve Rate Hike Event

Since the outbreak of the pandemic, as the United States has been handing out money to Americans in order to sustain the economy, people have more money than ever to buy more services and goods, which in turn has led to demand outstripping supply. Prices rose as a result, leading to inflation.

Since March 2022, the Fed has raised its benchmark interest rate by a whopping 5 percentage points, the fastest rate hike in 40 years [3]. After 10 consecutive rate hikes, the Fed decided to pause last month, even though the market expects it to still raise rates this month. When the Fed began raising interest rates last year, many economists expected a significant rise in unemployment to keep inflation in check. Although inflation is not yet fully under control, some economists believe it will fall closer to the Fed's 2% target level sooner than they previously expected [3].

As a result, on July 14th, the inflation numbers were down sharply from May's 4% annualized rate, but still above the 2% target set by the Fed [3]. Headline prices rose 0.2% in June from a year earlier, up from 0.1% in the previous month, but the rate of increase remained relatively modest [3]. The core CPI rose just 0.2% from a year earlier, the smallest monthly increase in nearly two years [3]. Compared to a year ago, core inflation remains relatively high at 4.8%, but is down from 5.3% in May [3]. The national average price of gasoline in the U.S. has fallen to about \$3.54 a gallon from a

peak of \$5 a gallon last year [3]. Grocery prices have leveled off over the past three months and were unchanged from May to June [3]. Milk prices have fallen for the third consecutive month, down 1.9 percent from a year ago [3].

### **3. Reasons for the Impact of the Federal Reserve's Interest Rate Hike**

Firstly, an interest rate hike by the Federal Reserve will lead to a tightening of global liquidity and trigger volatility in the international capital market [4]. As the United States is the world's largest economy and financial center, the Fed's decision to raise interest rates will have a significant impact on the global financial market. When the Fed raises interest rates, global investors may withdraw funds from other countries to the United States, leading to a reduction in global funding liquidity. This will have a negative impact on China's economy, which is an economy highly dependent on foreign capital, the inflow of which is critical to China's economic growth and financial market stability.

Secondly, a Fed rate hike will cause global interest rates to rise, increasing the cost of financing for Chinese companies. When U.S. interest rates rise, global borrowing costs rise as well. Chinese companies usually finance their operations by issuing bonds or loans, and if interest rates rise, the cost of financing for companies will increase. Mirza demonstrates that this will have a negative impact on the profitability and willingness to invest of Chinese companies, which in turn will affect the growth of the Chinese economy [5].

Thirdly, the Fed's interest rate hike may lead to increased pressure for RMB depreciation. When the U.S. raises interest rates, the interest rate of the U.S. dollar rises, which will attract global investors to flow their funds into the U.S., leading to the appreciation of the U.S. dollar. And the exchange rate between the RMB and the US dollar usually has a certain negative correlation, when the US dollar appreciates, the RMB may face depreciation pressure. The depreciation of the RMB will lead to a decline in the competitiveness of China's exports, which will have an adverse impact on China's foreign trade and economic growth.

Finally, the Fed's interest rate hike may trigger a slowdown in global economic growth, which in turn will affect China's export demand. When the U.S. raises interest rates, global economic growth may be dampened because the U.S. is one of the world's largest consumer markets. If global economic growth slows, for China, export demand may weaken, which would negatively affect China's manufacturing sector and export-oriented economy.

## **4. Impact of the Federal Reserve's Interest Rate Hike on Chinese Economy**

### **4.1. The Impact on the Stock Market**

One of the potential consequences of the Federal Reserve's interest rate hikes is the impact on China's stock market. Zhang et al argue that “Higher interest rates in the United States may lead to capital outflows from emerging markets” [6], including China. This could result in a decline in stock prices and increased market volatility. However, China has implemented measures such as market stabilization funds and circuit breakers to mitigate these risks and maintain stability in its stock market.

### **4.2. The Effect on Currency Exchange Rates**

Another area of concern is the effect of interest rate hikes on currency exchange rates. When the Federal Reserve raises interest rates, it strengthens the U.S. dollar, which may lead to a depreciation of other currencies, including the Chinese yuan. This can have implications for China's export competitiveness and import costs. To address this, China has implemented measures to manage its exchange rate, including allowing greater flexibility in its currency and diversifying its foreign exchange reserves.

### 4.3. The Influence on Commodity Prices

Interest rate hikes by the Federal Reserve can also impact commodity prices, which have implications for China as a major consumer and producer of commodities. Higher interest rates may lead to a stronger U.S. dollar, making commodities priced in dollars more expensive. This can affect China's import costs and inflation levels. To mitigate these effects, China has implemented measures to diversify its sources of commodities and enhance domestic production capabilities.

As the world's two largest economies, the United States and China are closely interconnected through trade, investment, and financial linkages. Changes in U.S. interest rates can have significant effects on China's economic performance, given the country's reliance on exports, foreign direct investment, and capital flows. This paper aims to explore the potential channels through which Federal Reserve interest rate hikes can impact the Chinese economy and provide insights for policymakers to navigate these challenges. Tian et al state that "China's real output and capital inflows will be decreased while there is one increase in US nominal interest rate" [7]. They also suggest that this kind of "negative spillover impact on China's economy possesses zero structural time-varying characteristics" [7].

## 5. Analysis on the Countermeasure of China

In response to the impact of Federal Reserve's interest rate hikes on the Chinese economy, the Chinese government has implemented several measures to address the challenges. These measures aim to achieve various objectives and mitigate the potential negative effects. However, some issues remain unresolved, and further suggestions can be considered.

One of the key measures taken by China is the implementation of structural reforms. These reforms aim to enhance the resilience of the economy and reduce its dependence on external factors. For instance, China has been promoting innovation and technological advancements to upgrade industries and improve productivity [8]. This adjustment is made to address the problem of overreliance on low-cost manufacturing and to foster sustainable economic growth.

Another important measure is the maintenance of a stable and flexible exchange rate policy. China aims to mitigate the potential negative effects of interest rate hikes by ensuring a stable exchange rate. This helps to maintain export competitiveness and stabilize capital flows [9]. The objective is to prevent excessive capital outflows and maintain financial stability.

Furthermore, China has strengthened financial regulation and supervision to address potential risks associated with interest rate hikes. This includes measures to control shadow banking activities, manage debt levels, and enhance risk management practices [10]. The purpose is to prevent financial imbalances and maintain stability in the banking sector.

These measures have achieved certain effectiveness in mitigating the impact of Federal Reserve's interest rate hikes on the Chinese economy. For example, the structural reforms have contributed to a shift towards a more innovation-driven and consumption-led growth model [8]. The stable exchange rate policy has helped to maintain export competitiveness and stabilize capital flows [9]. The strengthened financial regulation has improved risk management practices and reduced systemic risks [10].

However, there are still some unresolved issues. One of the challenges is the potential spillover effects of interest rate hikes on China's financial markets and capital flows. Despite the measures taken, there is a need for continued vigilance and proactive management of potential risks. Additionally, the ongoing trade tensions between China and the United States pose uncertainties and challenges to the Chinese economy.

To address these unresolved issues, several suggestions can be considered. Firstly, China can further enhance its financial regulation and supervision to ensure the stability of the banking sector and prevent systemic risks. This includes strengthening risk assessment and stress testing frameworks. Secondly, China can continue to diversify its export markets and reduce reliance on any single market to mitigate the impact of trade tensions. This can be achieved through the promotion of free trade

agreements and the development of new trading partners. Lastly, China can further promote domestic consumption and reduce its dependence on external demand. This can be done through measures to increase household income, improve social welfare, and stimulate domestic consumption.

## 6. Conclusion

In conclusion, the Federal Reserve's interest rate hikes have the potential to impact various aspects of the Chinese economy, including the stock market, currency exchange rates, and commodity prices. However, China has demonstrated resilience and implemented effective measures to mitigate these risks. Through market stabilization funds, currency management, and diversification strategies, China has maintained stability and promoted economic growth. While challenges remain, China's proactive approach positions it well to navigate the potential consequences of interest rate hikes and ensure sustainable economic development. This paper highlights the importance of understanding the potential effects of Federal Reserve interest rate hikes on the Chinese economy. The findings suggest that Chinese policymakers need to carefully monitor and manage the spillover effects of U.S. monetary policy decisions. By considering the implications for economic growth, inflation, exchange rates, and financial stability, policymakers can implement appropriate measures to mitigate risks and promote sustainable economic development. Further research is needed to deepen our understanding of the specific transmission channels and their magnitudes in order to develop effective policy responses.

## References

- [1] Yu, R. J., Wang D. X. (2023). Wind Rises and Wrinkles Water: How the Federal Reserve's Interest Rate hike Affects China's Exchange Rate and Cross border Capital Flows. *Financial Market Research*, 1, 8.
- [2] Tan, Y. L. (2022). The Internal Causes of the Federal Reserve's Interest Rate hike and Its Impact on China-A Shockwave. *China Economic Review*, 3, 80-84.
- [3] Reference message. (July 14, 2023). The lower inflation rate in the United States has boosted financial markets, and the Federal Reserve may raise interest rates again this year. Retrieved on July 16, 2023 Retrieved from: <https://mbd.baidu.com/ma/s/OI76Ne5N>.
- [4] Yi, Y. H., Pan, M. (2022). A Study on the Coordination of China's Dual Pillar Regulatory Policies under the Impact of the Federal Reserve's Interest Rate hike in 2022-From the Perspective of "Stable Growth" and "Risk Prevention". *Finance, Trade and Economics*, 43(11), 16.
- [5] Mirza, A. (April 6, 2021). How U.S. Treasury Interest Rates Impact Economy and China's Market Situation. *Data Driven Investor*. Retrieved on July 16, 2023. Retrived from: <https://medium.datadriveninvestor.com/how-u-treasury-interest-rates-impact-economy-andchinas-market-situation-95423905a763>.
- [6] Zhang, D., Guo, Y., Wang, Z., and Chen, Y. (2020). The impact of US monetary policy on chinese enterprises' R&D investment. *Finance Research Letters*, 35, 101301.
- [7] Tian, S. H., Wang, D. H., and Li, W. (2023). Spillover Impact of the U.S. Monetary Policy Shock on China's Economy: Capital Flow Channel. *Ekonomiska Istraživanja*, 36(2).
- [8] Zhang, Y. (2018). Structural reforms in China: A new growth model? *China Economic Journal*, 11(3), 257-276.
- [9] Cheung, Y. W., Chinn, M. D., and Qian, X. (2019). The impact of US interest rates on exchange rates: Evidence from the futures markets. *Journal of International Money and Finance*, 90, 1-18.
- [10] Huang, Y., Wang, J., and Zhang, M. (2019). Financial regulation and shadow banking: A small open economy DSGE perspective. *Journal of International Money and Finance*, 96, 1-19.