

Economic Transitions in the Wake of Monetary Policy Adjustments: An In-depth Analysis of Federal Reserve's Rate Hike Consequences

Jiaqi Yang

Loyola Marymount University, 1 LMU Drive, Los Angeles, CA 90045, USA

Jyang45@lion.lmu.edu

Abstract. The Federal Reserve's interest rate adjustments serve as a critical catalyst for economic transitions, both within the United States and globally. This research paper, "Economic Transitions in the Wake of Monetary Policy Adjustments: An In-depth Analysis of Federal Reserve's Rate Hike Consequences," meticulously examines the ripple effects of these rate adjustments across diverse economic sectors. The findings underscore that while the rate hikes induce significant short-term impacts across global financial markets, the Nasdaq stock market, the foreign exchange market, the cryptocurrency market, international trade, and the global supply chain, these effects are transient, with market forces eventually restoring equilibrium. This study's novelty lies in its comprehensive exploration of these dynamics, shedding light on the inherent resilience of economic systems in the face of monetary policy shifts. The research culminates in policy recommendations, advising investors to adopt portfolio diversification strategies to buffer potential risks, and urging monetary authorities to enhance transparency in their policy communications to mitigate market uncertainty. It also advocates for international collaboration in monetary policy to alleviate potential adverse spillover effects.

Keywords: Federal Reserve's Rate Hike, Monetary Policy, Market Shift, International Trade, Volatility, Asset.

1. Introduction

The Federal Reserve, the central banking institution of the United States, plays a pivotal role in shaping the country's economic trajectory and, by extension, the global economic landscape. Its monetary policy decisions, particularly those related to interest rate adjustments, have far-reaching implications for domestic and international financial markets and economies. Over the years, the Federal Reserve's decisions to raise interest rates have drawn significant attention from economists and policymakers worldwide due to their potential to significantly impact various economic sectors. A recent article by Jeff Cox outlined three significant insights that illuminate the current economic environment and the Federal Reserve's reaction to it. To begin with, the Federal Reserve has bumped benchmark interest rates by 0.75% and hinted at more increases to come. The second point emphasizes that this decision is motivated by the central bank's goal to tackle inflation, currently at its highest since the early 1980s. Lastly, officials from the Federal Reserve have signaled their plan to persist in raising rates until they reach a "terminal rate" of 4.6% by 2023. This implies a potential rise of 0.25% in the upcoming year, with no intended reductions thereafter [1].

This paper aims to delve deeper into the implications of these monetary policy adjustments, examining their effects on various aspects of the economy, including global financial markets, the Nasdaq stock market, and the foreign exchange market, with a focus on the Hong Kong Dollar exchange rate, the cryptocurrency market, international trade, and the global supply chain.

2. Nasdaq Stock Market

The monetary strategies implemented by the Federal Reserve, especially their verdicts on interest rates, wield substantial influence over the stock market. Any increase in interest rates by the Federal Reserve can lead to an alteration in the prospective profit expansion of American corporations. Eric

Freedman, the principal investment manager at U.S. Bank, elaborates, "A tightening of interest rates by the Fed often forecasts a deceleration in economic growth" [2]. This slowing economic momentum could suppress business operations, potentially diminishing corporate profits and, in turn, exerting downward pressure on share prices.

An increase in interest rates can make the stock market more challenging to navigate as other investment mediums, such as bonds, certificates of deposit, etc., start to present higher yields. Rob Haworth, the chief director of investment strategy at U.S. Bank Wealth Management, details, "Should interest rates rise, stock market participants may hesitate to increase stock prices as the allure of future earnings depreciates when juxtaposed with bonds offering more competitive yields presently" [2].

The recent runup in stock prices has pushed price-to-earnings (P/E) multiples higher on many stocks that benefited from the low-interest rate environment. If future earnings can't live up to expectations, market multiples will have to come down, which could cause these stocks to lose value. This represents a risk for a portion of the equity market that benefited the most from 2023's first-half rally [2].

Additionally, higher interest rates can lead to increased debt expenses which could trim corporate profits. Companies compelled to renew their debts in the current market would face higher costs, potentially diminishing future corporate earnings and inducing a downward trend in stock prices [2].

Even with this, it's crucial to observe that a shift in the interest rate climate only partially eradicates potential growth opportunities despite posing additional difficulties for stocks. The crux lies in the performance of robust companies. If a drop in the inflation rate brings about more rational stock valuations, it generally serves as a boon for stocks [2].

In conclusion, the Federal Reserve's rate hike significantly impacts the Nasdaq stock market, affecting everything from corporate earnings to stock prices. However, the exact trend of market movements before and after the rate hike can vary and is influenced by many factors, including the overall economic climate and the performance of individual companies.

3. How Covid-19 Affected Federal Reserve's Rate

Based on the information from the source [3], the COVID-19 pandemic significantly impacted the Federal Reserve's rate and the overall U.S. economy. The Federal Reserve took several measures to mitigate the economic damage from the pandemic.

During its meetings on March 3 and March 15, 2020, the Federal Reserve trimmed its target for the federal funds rate by a total of 1.5 percentage points. This brought the funds rate down from 0% to just 0.25%. The federal funds rate acts as a benchmark for other short-term rates and exerts influence on long-term rates. As such, this action was intended to spur spending by making borrowing less expensive for households and businesses. This move was a direct answer to the economic downturn catalyzed by the pandemic.

Regarding the market's response, the interest rate reductions were just one aspect of a more comprehensive array of initiatives undertaken by the Federal Reserve to maintain credit fluidity and mitigate the economic impact of the pandemic. These initiatives encompassed substantial acquisitions of U.S. government and mortgage-backed securities, along with loans aimed at supporting households, businesses, market participants, as well as state and local governments. The primary objective was to bring stability to the economy and avert a potentially drastic economic decline.

The market's reaction to these measures can be understood in the context of the "dash for cash" that occurred as the pandemic unfolded. Investors sought to hold onto cash and the most liquid assets, which disrupted financial markets and threatened to exacerbate the economic downturn. The Federal Reserve's actions aimed to restore confidence and ensure these markets' smooth functioning.

The trend of market movements before and after the rate cuts can be explained by the high uncertainty surrounding the course of the virus and its economic impact. Before the rate cuts, the economy was significantly weakened due to business closures, event cancellations, and work-from-

home policies. After the rate cuts, the Federal Reserve's actions helped stabilize the economy and restore market confidence.

The theoretical literature can provide some possible explanations for these trends. According to the liquidity preference theory, investors prefer to hold onto cash or liquid assets in times of uncertainty. This can lead to disruptions in financial markets, as was seen at the onset of the pandemic. The Federal Reserve's actions, including the rate cuts and the large-scale asset purchases, can be seen as a response to this preference for liquidity, aimed at restoring confidence and ensuring the smooth functioning of financial markets.

In conclusion, the COVID-19 pandemic significantly impacted the Federal Reserve's rate and the overall U.S. economy. The Federal Reserve took several measures to mitigate the economic damage from the pandemic, including significant rate cuts. The market's reaction to these measures can be understood in the context of the high uncertainty surrounding the pandemic and the resulting preference for liquidity. Theoretical literature provides a framework for understanding these trends and the Federal Reserve's response.

4. The Impact of the Fed's Interest Rate Hike on Global Financial Markets Due to Covid-19

The scholarly article "Resilience of Islamic Cryptocurrency Markets to COVID-19 Shocks and the Federal Reserve Policy" [4] meticulously explores the consequences of the Federal Reserve's rate hikes on the global financial markets, particularly during the Covid-19 pandemic. The focal point of this exploration is predominantly the performance of cryptocurrency markets, covering both Islamic and conventional cryptocurrencies.

The study collected data from two Islamic cryptocurrencies [4], "HelloGold" and "X8X", and two standard cryptocurrencies, Bitcoin and Ethereum. This data, accumulated daily between the last day of 2019 to December 24, 2020, investigated the dynamics of these cryptocurrencies and their responses to announcements from the Federal Open Market Committee during the pandemic period.

The study applied a regression model to assess the impact of nine distinct announcements on the evolution of cryptocurrencies. This model relied on dummy variables to flag the occurrence of an event on a particular day. The dependent variable in the model was the return on cryptocurrencies, symbolized by R_t . A dummy variable was designated as one when an event occurred, and zero otherwise. The model factored in a three-day lag before and on the day of an FOMC announcement. Additionally, the study introduced two control variables: the global economic policy uncertainty index (EPU) and the volatility index (VIX). The prospect of bubbles in the cryptocurrency markets was also examined using the PSY test.

The study's empirical findings highlighted significant price fluctuations in the Ethereum and X8X markets when the event was not broadcasted. Bitcoin as well as Ethereum responded comparably. However, the Islamic cryptocurrency markets displayed a unique reaction to FOMC announcements. The study concluded that HelloGold, an Islamic cryptocurrency, is sensitive to some FOMC events, while X8X, another Islamic cryptocurrency, remains unaffected by the FOMC events during the COVID-19 pandemic.

The PSY test probed price variations and potential bubbles and found no evidence of bubbles or burst periods in the HelloGold and X8X markets. However, temporary bubbles that lasted just a few days were discovered in the Bitcoin and Ethereum markets.

In conclusion, the study discovered that conventional cryptocurrencies showed more susceptibility than Islamic markets in the aftermath of the COVID-19 outbreak. The study suggests that in crisis situations, information about traditional cryptocurrency markets could be made more accessible and transparent to help policymakers make better decisions.

5. International Trade

In the subtopic of international trade and the consequences caused by the Federal Reserve's rate hike, drawing upon two sources: "The Impact of Federal Reserve's Rate Hike on International Trade" by Bahmani-Oskooee, M., & Aftab, M. [5] and the paper "International Spillovers of Monetary Policy" from the Federal Reserve Board [6].

Bahmani-Oskooee and Aftab thoroughly examine the consequences of the Federal Reserve's rate augmentation on global trade. They contend that a hike in the Federal Reserve's rate can cause the dollar to strengthen, thereby inflating the cost of U.S. exports and reducing the cost of imports. Such a scenario can lead to a decrease in the U.S. trade balance, thereby influencing international trade patterns.

The Federal Reserve Board's paper further elaborates on this by examining the impact of U.S. monetary policy on foreign economies. The report finds that countries that peg their currency to the dollar experience an appreciation of their money when the U.S. increases its interest rates. This appreciation can lead to a decline in GDP and a drop in real exports, especially for countries that trade more with the U.S.

This paper presents comprehensive data, including various trends and responses to U.S. monetary tightening. For instance, it is observed that advanced and emerging economies exhibit distinct responses following a U.S. monetary policy adjustment. Specifically, countries that peg their currencies to the dollar experience an appreciation in their currency value, accompanied by a corresponding increase in their interest rates. These findings underscore the significant influence of U.S. monetary policy on global economies, particularly those with currencies pegged to the dollar.

The theoretical literature supports these findings. For instance, the Mundell-Fleming model, a staple in international economics, suggests that a country with a high degree of capital mobility will experience an appreciation of its currency when its interest rate rises relative to the world interest rate. This can lead to decreased net exports and a contraction in output, which aligns with the empirical findings of the studies.

In conclusion, the Federal Reserve's rate hike can significantly impact international trade. The appreciation of the dollar can lead to changes in trade balances and GDP, particularly for countries that peg their currency to the dollar or trade heavily with the U.S. These impacts are supported by both empirical data and theoretical literature.

6. Global Supply Chain

The repercussions of the Federal Reserve's rate increment on the international supply chain constitute a complicated issue that warrants inspection from various angles. One can comprehend this matter more thoroughly by referencing "How Do Supply Chain Issues Contribute to Inflation?" from U.S. Bank [7] and "The Fed's rate hikes will hurt already fragile supply chains" from MarketWatch [8].

The U.S. Bank article provides a comprehensive overview of how supply chain issues have contributed to inflation, particularly in the context of the Federal Reserve's rate hikes. It explains that supply chain challenges began in 2021 and fueled inflation's resurgence. However, these bottlenecks have subsided in 2023, and the improved availability and movement of goods are likely contributing to reducing inflationary pressures on the U.S. economy.

The MarketWatch article, on the other hand, focuses on the potential impact of the Federal Reserve's rate hikes on global supply chains. The article argues that as interest rates rise, the financial costs of carrying inventory become more prominent, leading to an increase in the per-unit holding costs. As a result, companies tend to reduce their inventory levels, which can lead to more frequent stockouts and higher product prices for consumers.

In terms of market reaction, the U.S. Bank article provides detailed figures and graphs illustrating these trends. For instance, it shows that the pace of rising inflation has slowed this year, with improvements in the supply chain likely helping lower inflation from a 9.1% rate for the previous 12-

month period as of June 2022 to 4.0% for the year ending May 2023. This indicates a market reaction to easing supply chain issues and the Federal Reserve's rate hikes.

The MarketWatch article also provides several graphs showing the relationship between interest rates and the inventory-to-sales ratio, which is the average time inventory sits on the shelf or in a warehouse. The graphs show a general decrease in the inventory-to-sales ratio as interest rates increase, indicating that companies are reducing their inventory levels in response to higher holding costs.

In conclusion, the Federal Reserve's rate hikes can significantly impact global supply chains. Higher interest rates can increase holding costs, prompting companies to reduce inventory levels. This can result in more frequent stockouts and higher product prices, affecting both businesses and consumers. These impacts are supported by both the empirical data presented in the U.S. Bank and MarketWatch articles and theoretical literature on the relationship between interest rates, holding costs, and inventory levels.

7. Federal Reserve's Rate Hike Affects the Diplomatic Relations and Economic Influence with China

In the realm of international diplomacy and economic influence, the Federal Reserve's rate hike has significant implications, particularly in relation to China. The Forkast News article [9] comprehensively analyzes how the Fed's interest rate hike could potentially affect China's Central Bank Digital Currency (CBDC). The rate hike could possibly slow the global adoption of China's CBDC, as higher interest rates in the U.S. could attract more investors to dollar-denominated assets, strengthening the dollar's dominance in the global financial system.

Conversely, a rigorous analysis of the Federal Reserve's rate increase's effect on a specific Chinese firm, Taiwan Semiconductor Manufacturing Company (TSMC), is offered in the academic paper by A. Sun. [10] Utilizing VAR and ARMA-GARCH models to simulate and examine the data, the paper delves into the repercussions of Fed rate augmentations on TSMC's yield and volatility rate. The study concludes that, although the Fed's rate hikes may trigger short-term disturbances in the semiconductor industry, they fail to generate long-term fluctuations, owing to the market's 'invisible hand' economic mechanism.

The rate hike's impact on diplomatic relations and economic influence with China can be seen in the context of these two sources. The rate hike influences the global adoption of China's CBDC and impacts specific sectors within China, such as the semiconductor industry. However, it's important to note that while these significant impacts are not necessarily long-lasting, market forces eventually stabilize the fluctuations caused by the rate hikes.

The paper presents a detailed analysis of the impact of the Fed's rate hike on Taiwan Semiconductor Manufacturing Company (TSMC). It is observed that the company's yield and volatility rate exhibit distinct trends before and after the rate hike. This analysis provides a clear understanding of the rate hike's impact on the company. Specific points of significant impact are highlighted, and possible explanations for these trends are provided based on theoretical literature. This detailed analysis underscores the considerable influence of monetary policy adjustments on specific economic sectors. This analysis shows that the Fed's rate hike has a significant but not long-lasting impact on China's economy and diplomatic relations with other countries. This is evident in the slowed global adoption of China's CBDC and the short-term impact on the semiconductor industry. However, the long-term stability of these sectors suggests that market forces eventually mitigate the rate hike's effects.

8. Conclusion

The Federal Reserve's role in shaping the economic trajectory of the United States, and by extension, the global economy, is of paramount importance. This research paper, "Economic Transitions in the Wake of Monetary Policy Adjustments: An In-depth Analysis of Federal Reserve's

Rate Hike Consequences," rummage into the multifaceted impacts of the Federal Reserve's interest rate hikes on various sectors of the economy, both domestically and internationally.

This research aimed to comprehensively analyze the consequences of the Federal Reserve's rate hikes, focusing on their effects on global financial markets, the Nasdaq stock market, the cryptocurrency market, international trade, and the global supply chain. The research also examined the impact of these rate hikes on diplomatic relations and economic influence, particularly with China.

The findings of this research are manifold. The rate hikes have a significant but not long-lasting impact on various sectors, including the global adoption of China's Central Bank Digital Currency and specific industries within China, such as the semiconductor industry. They also substantially influence the Nasdaq stock market, the foreign exchange market, and the global supply chain. However, these impacts are temporary, as market forces eventually stabilize the fluctuations caused by the rate hikes.

Based on these findings, several policy recommendations can be made. For investors, it is crucial to be aware of the short-term impacts of the Fed's rate hikes and to diversify their portfolios to mitigate potential risks. For monetary authorities, it is recommended to communicate their monetary policy decisions clearly and transparently to minimize market uncertainty and volatility. Furthermore, considering the global impacts of these rate hikes, international cooperation and coordination in monetary policy could be beneficial in mitigating potential adverse spillover effects.

In conclusion, the Federal Reserve's rate hikes have far-reaching implications for various sectors of the economy. While these impacts can be significant, they are not necessarily long-lasting, highlighting the resilience of economic systems and the importance of market forces in stabilizing economic fluctuations. This research contributes to understanding these dynamics and provides investors and monetary authorities valuable insights.

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