# Analysis on the Influence of FED Interest Rate Adjustment on China's Economy

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**ABSTRACT**

During the time between 1980 and 2020, there were a lot of significant changes in the U.S. interest rate, the federal funds rate. Since the changes of interest rates in one country, especially in the United States, can affect fluctuations in the global economy, this paper focuses on how the U.S interest rate can affect the Chinese economy and what reasons or transmission mechanisms make those results. When discussing the relationship between the U.S. interest rate and the Chinese economy, this paper focuses on three fundamentals of the Chinese economy: Chinese macroeconomy, import and export, China-US exchange rate. The main result is that: the U.S interest rates and the Chinese economy are inversely related, especially in import, export, and China-US exchange rate. By exploring the causes of this result, the study finds out many determinant factors, and the degree of correlation depends on the net sum of the impacts of all factors. Eventually, based on the global economic environment, we get the conclusion that many key factors can make changes to the country's economy. Although Chinese economies will fluctuate as the federal reserve makes changes to the U.S. interest, the government can resist negative shocks by strengthening the internal driving force of economic growth. It can stabilize the economy through flexible monetary policy and intermediate variables, such as the commodity price level, consumption and investment, international capital flows, and so on.

***Keywords:*** *U.S. interest rate, Chinese economy, Transmission Mechanism.*

## 1. INTRODUCTION

### *1.1. Background*

Nowadays, the United States still plays a leading role in leading the dynamic adjustment of the global economy. When the federal reserve makes changes to the federal funds rate through different monetary policies, the global economy will be affected. For example, the global financial market, import and export market, monetary policy will all show varying degrees of variation according to the fluctuation of the U.S. interest rate. Therefore, the adjustment of the U.S. interest rates is bound to have a significant impact on China's economy.

Since the time between 1980 and 2020, there were a lot of significant changes in the U.S. interest rate, the correlation between the Chinese and US financial markets will be shown more clearly through this study. For instance, the 1980 economic crisis made the U.S. interest rate decrease suddenly, and the 2020 Covid-19 also made the economy depressed. Therefore, this article chooses the time from 1980 to 2022. It will be easier for the researcher to discuss the relationships between Chinese economy and the U.S. intersest rate.

As the relationship between the Chinese economy and the U.S. economy grows closer and closer, the extent and depth of the Chinese economy are affected by U.S. monetary policy will grow stronger and stronger. Therefore, if the article can get some conclusion of the relationship between the U.S. interest rates and the Chinese economy, the government can put forward targeted strategies when the U.S. financial market fluctuated. This is a key step for China to stabilize its domestic economy and withstand external shocks.

### *1.2. Related Research*

Xu based on the economic cycle model and the usage of the time-varying parameter model TVP-VAR-SV to analyze the spillover effects of US monetary policy changes on China's economic growth, fixed asset investment, and foreign trade since 1999. U.S. monetary policy had a negative spillover effect on China's macroeconomy, but its negative effects show a decreasing trend. Under the action of easing, the United States imports increased which is conducive to China's exports. In the process of implementing quantitative easing monetary policy, the interest rate in the United States drops, resulting in the depreciation of the dollar and inducing capital inflow into China which increases the import volume to China [1].

Similarly, studies from Xu and Wang also analyze the influence of the U.S. interest rate on the Chinese trade and the macroeconomy. Siripurapu analyzed the rising of U.S. bond interest rates. Since 2021, U.S. bond interest rates have risen rapidly. Affected by the rapid rise in U.S. bond interest rates, some previously highly valued stocks have fallen sharply, such as U.S. stock technology stocks and domestic white horse blue-chip core assets. The Chinese bond market interest rates have also seen a slight increase. However, this article points out that the rise in U.S. bond interest rates is nearing the end, and the Chinese market may welcome a breathing window [2]. Xu researched how the U.S. interest can affect Chinese Foreign trade and GDP. He characterized the mechanism of U.S. monetary policy affecting China’s macroeconomy through the Sino-U.S. interest rate differential. Then he got three conclusions: (1) U.S. monetary policy has a significant impact on China’s macroeconomy but with the further deepening of U.S.-China trade the negative effects show a decreasing trend. (2) Under the effect of loose policies， US imports increase and are conductive to China's exports. (3) In the process of implementing quantitative easing monetary policy in the U.S.-Chinese exports suffered from negative to positive shock effects during this period [3]. Wang studied the dynamic impact of US monetary policy shocks on China's macroeconomy as reflected by market interest rates and us dollar liquidity adjustment. On the one hand, the positive impact of the US interest rate will lead to the same direction change of China's interest rate and have a certain negative impact on China's GDP, but the positive impact of the US interest rate promotes the increase of China's export to a certain extent. On the other hand, the negative impact of dollar liquidity will lead to the decline of China's money market interest rate and have a certain negative impact on China's export [4]. Gray studies the Behavioral Spillovers of U.S. Monetary Policy. The models and data suggest that the U.S. lowering its policy rate, either in general or about a monetary policy rule, influences other central banks to lower their policy rates and intervene in currency markets, even when controlling for worldwide macroeconomic trends [5]. Xu researched whether the adjustment of the US interest rate can have a significant impact on Chinese economics. He discussed the mechanism and transmission channel of the Fed's interest rate adjustment affecting China's macroeconomic fluctuations. Then he got the conclusion that The adjustment of the US benchmark interest rate will have a significant impact on China's macroeconomic fluctuations, among which trade channels and interest rate spreads are the most core transmission channels [6].

Other factors like the federal reserve’s actions can also affect China’s economy. Chen and Chen analyzed the external environment of China's economic development after the impact of the interest rate hike announced by the Federal Reserve. The research focuses on the global major economies, commodity market, as well as the impact on China's domestic transnational capital flow, exchange rate, stock market and real estate market. Some countermeasures are listed in the end. In the context of global economic and financial integration, the economic downturn of other countries worsens the external environment of China's economic development. The exchange rate of many countries' currencies fluctuated greatly so the RMB was under pressure to depreciate. The depreciation of RMB was conducive to enhancing the competitiveness of domestic products in the international market which stimulated exports. But the increased interest rate is a negative factor for A-shares. For China to resist these negative shocks, the key is to enhance the internal impetus of its economic growth, maintain cautious expectations of the Federal Reserve's interest rate hike, and improve the ability of China's economy to cope with external shocks through flexible monetary policy [7]. Luo conducted a qualitative analysis, using the ADF unit root test, cointegration test, Granger causality test to check if there is causality between fed funds rate changes and yield to maturity of RMB Treasury bonds. There are cointegration relationships among RMB bonds yields to maturity and the federal funds rate, the money supply size, inflation level, and the speed of economic development. In addition, in the long run, the federal funds rate and RMB bonds yield to maturity rate are relevant and positive, raising the federal funds target rate will cause the RMB bonds’ yields to rise [8].

Another important factor is the policy made by both governments. Tan researched the CPI and the characteristics of monetary policy in both China and the US. Model SVAR with short-term and long-term constraints was used to compare and further verify that monetary policy has a greater impact on housing price in the United States where the financial industry and real estate industry are more market-oriented, and the impact of interest rate on housing price is much greater than that of the money supply. Rising house prices in China will lead to an expansion of housing loans and an increase in the money supply. A flexible inflation monetary policy system maintains effectively the price stability, but it does not inhibit the housing bubble. China should continue to use the current monetary policy [9].

Specialists in Asian trade and finance studied China's government intervention in the Chinese economy and whether China's economic policies have any influence on the U.S. economy. They analyzed the effect of currencies of RMB on the U.S. economy which is complex. The undervalued RMB could limit the level of exports in the U.S. They also concluded lots of comparative graphs that can show the economic relationship between the two countries. China's intervention in currency markets causes it to accumulate large levels of foreign exchange reserves, especially U.S. dollars, which it then uses to purchase U.S. debt. Such purchases help the U.S. government fund its budget deficits and help keep U.S. interest rates low. These factors suggest that an appreciation of the RMB to the dollar benefits some U.S. economic sectors, but negatively affects others [10]. Kapadia analyzed China's foreign exchange policies and the relationship between China's interest rate and U.S. interest rate, which is when China's interest rate increases, U.S. interest decreases [11].

### 1.3. Objective

This study aims to find out the relationship between the US economy and the Chinese economy regarding interest rate, GDP, and related policies.

## 2. RELATIONSHIPS RESEARCH

This paper explores how the change of the US interest rate can affect the Chinese economy so we need to consider a lot of influence factors. However, the linkage between the two countries is related to macroeconomic indicators, exchange rate movements, and imports and exports. Therefore, this article focuses on three significant indicators: the Chinese macroeconomy, China and US exchange rate, and Chinese import and export. And then the article discusses the relationship between the change of US interest rate and those three indicators. Because of the 1980 economic crisis, there was a large collapse in the US market so the government adopt a loose monetary policy, and the US interest rate decreased significantly. Therefore, the sample time interval of the selection in this paper is from 1980 to the present because it is easier and clearer for us the study the relationship mentioned before.

### 2.1. The relationship between US interest rate and the Chinese economy

GDP is the Gross domestic product, or value-added, is the value of the goods and services produced by the nation's economy less the value of the goods and services used up in production. GDP can be a measure of the country's condition of the country's economic market. To study the relationship between China and U.S., GDP is an important index that can compare their correlation.

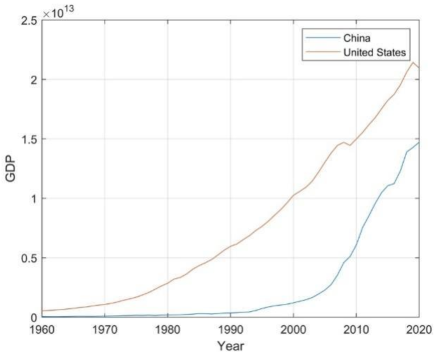


**Figure 1** The relationship between China and U.S. GDP

Figure 1 shows that China's GDP trend is following the U.S GDP trend. However, the gap between China and U.S. is narrowing down as years passed by. China's GDP increasing rate is slower than the U.S. and China's GDP has not increased at the same rate until the year 1980. There are some significant changes in U.S. GDP between the years 1998 and 2000 and China's GDP between 2010 and 2019. These changes might result from some significant historical events or some policies that appeared. Also, the change was the same but lagged for nearly 10 years. This can also show that China's economy is following the U.S. economy.

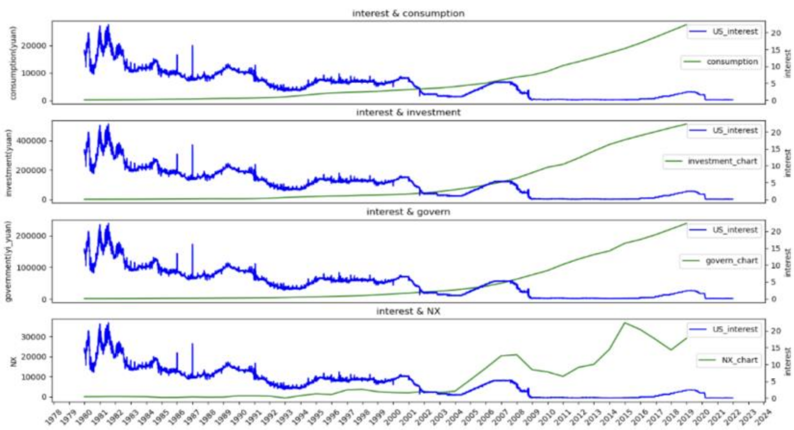


**Figure 2** The relationship between US interest rate and the compositions of GDP

There are a lot of factors that influence GDP. consumption, investment, government purchasing, and net export. Figure 2 shows the relationship between these indexes and the U.S. interest rate.

### 2.2. The relationship between US interest rate and import and export

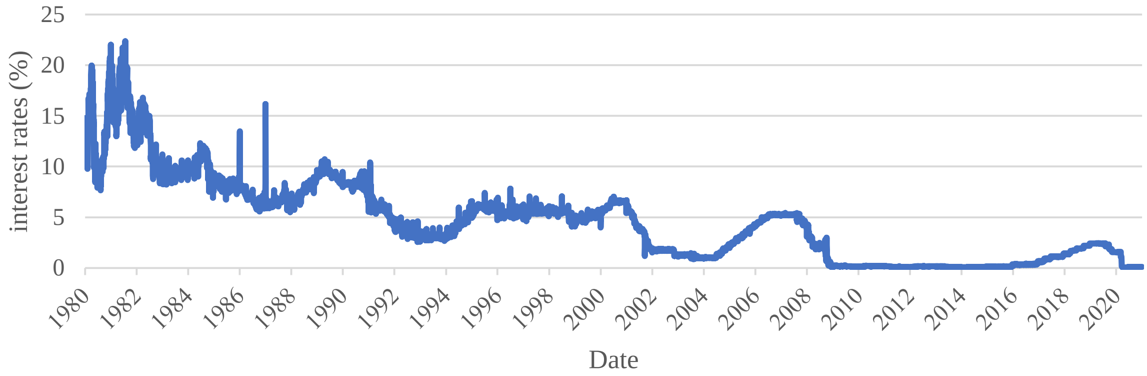


**Figure 3** U.S.'s Interest Rate from 1980 to 2020

As shown in Figure 3, the Fed has raised rates five times in its history. From October 1982 to September 1984, the federal benchmark interest rate increases a rate of 2%. The second time was in 1989 has an increased rate of 3.25%. A 3% increase happened in 1994. In June of 1999, the federal benchmark interest rate raised 1.75%. The latest increase was in 2004 about 4.25%. It seems there are always slight boosts in the Chinese economy with the sign of increasing imports and export. Moreover, interest rates in the US fell from 15% in 1981 to 0.5% in 2020.

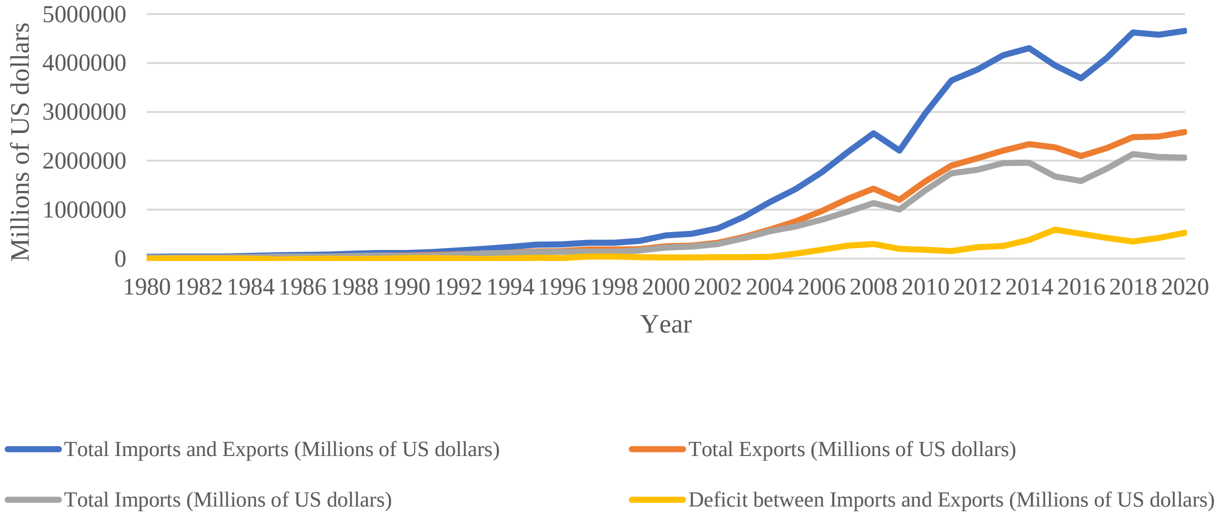


**Figure 4** China's Imports and Exports from 1980 to 2020

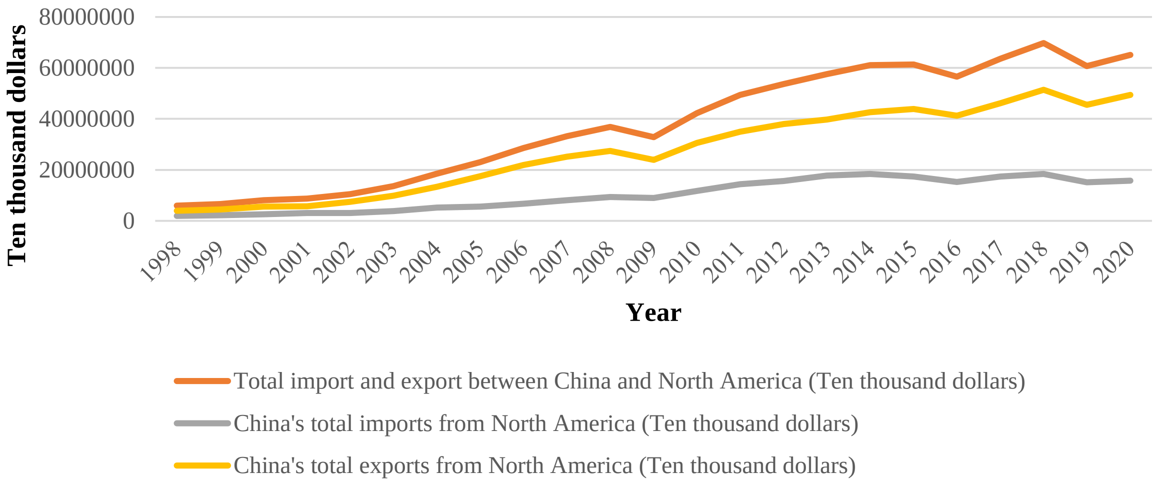


**Figure 5** Import and Export between China and North America from 1998 to 2020

However, in Figures 4&5, the imports and exports between China and America as well as the rest of the world are shown a general upward trend. I assume there is a negative relationship between the US interest rate and total imports and export.

## *2.3. The relationship between US interest rate and China-US exchange rate*

According to the statistics from the National Bureau of Statistics and Yahoo Finance, we select the data of the US interest rate and the China-US exchange rate from 1980 to 2022. Through data processing and visual analysis, we get Figure 4.

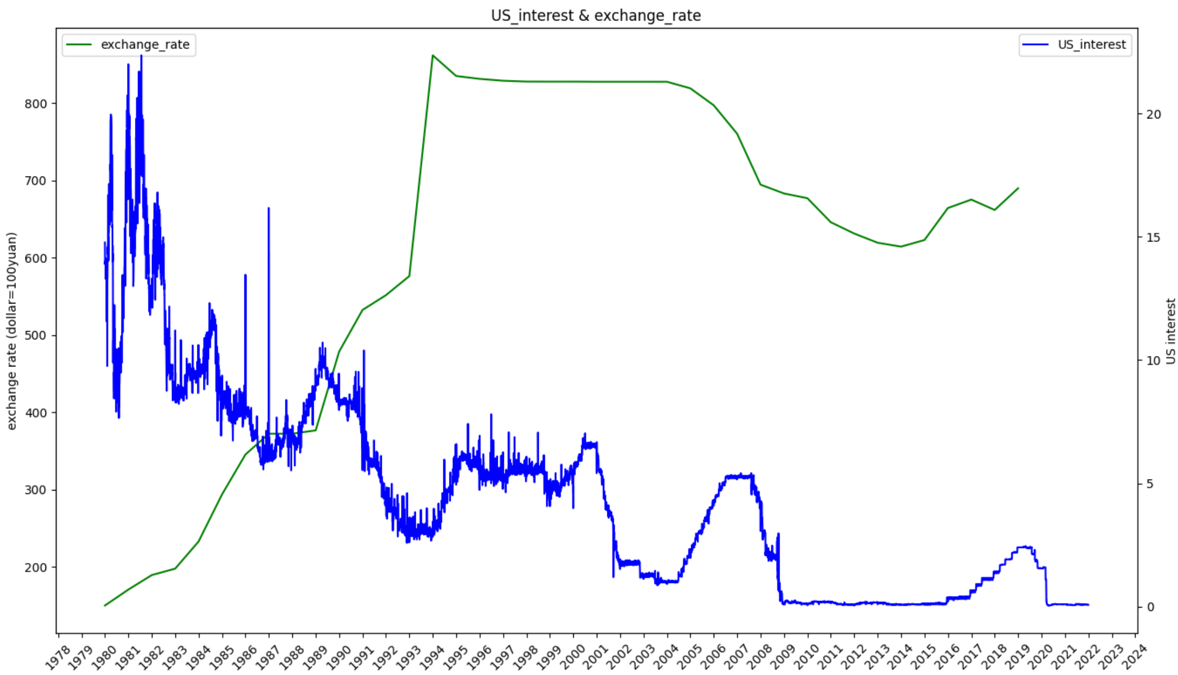


**Figure 6** The relationship between US interest and the China-US exchange rate [13]

As shown in Figure 6, it shows that there was some significant negative correlation between the US interest rate and the China-US exchange rate. Since the US government decreases the US interest rate, the cost of import and export will decrease so that the net export will also have a positive perspective, which leads to the increase of the exchange rate. To sum up, when the US interest decreased, the China-US exchange rate increased.

## 3. REASONS FOR THE CORRELATION

### *3.1. US interest rate and import and export*

The Fed's rate hike will have a mixed impact on China's import and export trade, with the net direction being difficult to judge. This is reflected in the following aspects: First, the interest rate hike by the Federal Reserve has a supportive effect on the exchange rate of the US dollar, which is conducive to the increase of China's exports to the US. However, under the protectionist trade policy, the increase in China's exports to the US should not be obvious. Second, some vulnerable emerging economies will suffer the negative impact of the Fed's interest rate hike, which will reduce their import demand for Chinese goods. Third, the appreciation of the US dollar will help restrain commodity prices. With the world's largest demand for commodities, China has significantly reduced its import costs for resources and energy.

Once the Fed withdraws from QE and the dollar strengthens, emerging markets will immediately shift from capital inflow to outflow, and high house prices, which have been supported by dormant international capital for years, will be dealt a real blow. China's housing price bubble is quite serious, especially in the cities below the second-tier. Under the background of a net outflow of population, the housing price has downward adjustment pressure. The interest rate hike by the Federal Reserve may affect people's expectations of China's economy, thus accelerating the adjustment of housing prices in these cities. But a correction in the property market is unlikely to trigger a banking crisis in China.

The interest rate hike by the Federal Reserve narrows the interest rate gap between China and the US, increases the return on US capital investment, and attracts international capital to flow across the border, thus increasing the demand for US dollars and the appreciation of the US dollar under the condition that the supply of US dollars remains unchanged. At the same time, part of China's capital outflow, coupled with the fact that the People's Bank of China continued to cut interest rates and reserve requirements, resulted in the depreciation of the RMB. Between China and the United States, the appreciation of the dollar, the devaluation of the RMB, and the cost of imports to the United States decreased, which increased imports. China's exports to the United States increased, and China's trade balance improved.

In 2018-2019, the US Federal Reserve has experienced the negative impact of unilateral trade protectionism, the China-US trade war, and Brexit, and the world economy is weak. In response to the downward economic pressure, the Federal Reserve has cut interest rates four times since July 2019. To offset the negative impact brought by the spread of COVID-19, the Federal Reserve announced an emergency interest rate cut of 50 basis points on March 3, 2020. The Federal Benchmark interest rate was lowered to 1.25%. The Fed cut interest rates to expand aggregate demand and boost the economy.

The Fed's interest rate cut boosted the money supply, leading to a rise in the price of risky assets and foreign investors' negative view of US assets. Although the domestic A-share market will be affected by global risk aversion in the short term, in the long run, as A-shares have already experienced the impact of the epidemic, the market's reaction to the epidemic has already been reflected in the stock market. As the epidemic in China is gradually brought under control, foreign investors will increase their holdings of A-shares.

Fed rate cuts mean the dollar is less valuable and less attractive. As the gap between China and the US dollar expands further, international capital will flow from countries with low interest rates to countries with high interest rates. The exchange rate of the US dollar will naturally fall, and the corresponding RMB exchange rate will rise.

At present, the overall tone of China's monetary policy is flexible and moderate. The Fed's interest rate cut is equivalent to broadening the space of China's monetary policy. There is no need to worry about the flow of funds to the United States after the central bank's interest rate cut. The central bank can use policy interest rates to lower financing costs for real enterprises, cut taxes and fees for private and small and medium-sized enterprises, and provide special subsidies to industries hardest hit by the epidemic to help tide over difficulties.

### *3.2. GDP and trade policies between China and US*

The US has benefited from trade and investment flows with China. Trade, investment, and supply chain integration have supported both China and U.S. economic growth, consumer choice, and job creation. U.S.-China trade has started for two decades because China joined the World Trade Organization. This trade has benefited U.S. consumers and companies. Therefore, China and U.S GDP are strongly correlated in many ways. Also, the United States imports more from China than other countries.

GDP consists of consumption, investment, government purchasing, and net export. If we want to study how the federal funds rate can affect the Chinese market, we need to study how these factors can affect U.S GDP individually. In our study, we focus on the macroscopic transmission mechanism to study the relationship between the change of federal funds rate and the Chinese market. In the macroscopic transmission mechanism, we need to consider how the US interest rate can influence China's fundamentals, the macroeconomic indicators.

Also, China’s economy is a market-oriented mixed economy and incorporated with government planning. Therefore, China’s government decision and the government relationship between these two countries also affect their trade and GDP. For example, under the leadership of Xiaoping Deng, China boosted the private industry. Beijing rejoined the General Agreement on Tariffs and Trade in 1986 and China joined the WTO in 2001. Trade between the two countries is also increasing before China joined the WTO. From 1979 to 2018, China's annual real GDP averaged 9.5%. This has meant that on average China has been able to double the size of its economy in real terms every eight years. The global economic slowdown, which began in 2008, had a significant impact on the Chinese economy. China's media reported in early 2009 that 20 million migrant workers had returned home after losing their jobs because of the financial crisis and that real GDP growth in the fourth quarter of 2008 had fallen to 6.8% year-on-year.

### *3.3. The transmission mechanism of US interest rate affecting exchange rate*

In an open economic market, there are direct and indirect transmission mechanisms of the influence of the China-US exchange rate caused by the US interest rate. The direct transmission mechanism is reflected in the direct influence of the US interest rate on China-US exchange rate fluctuations. The indirect transmission mechanism is reflected in the indirect impact of the US interest rate on China-US exchange rate fluctuations through intermediate variables such as import and export trade, commodity price level, stock prices, international capital flows, money supply, and so on.

#### *3.3.1. The direct transmission mechanism*

In the direct transmission mechanism, this paper follows the interest rate parity theory: Under full capital flows, the China-US interest rate differential is equal to the difference between the forward exchange rate and the spot exchange rate. Since the fluctuations of the US interest rate will make the gap between the US interest rate and Chinese interest rate become widened in the short term, the China-US exchange rate will make a change. According to the interest rate parity function $Rd - Rf = (Ee - E)/E$ (The left-hand side of the equation shows the China-US interest rate spreads, the right-hand side of the equation shows the expected appreciation of the forward exchange rate against the spot exchange rate one year from now), when the China-US interest rate spreads become widened, international capital will flow into the country with higher interest rates. Then the spot exchange rate of the local currency fell and the forward exchange rate will rise.

#### *3.3.2. The indirect transmission mechanism*

In the indirect transmission mechanism, the change of US interest rate will affect the intermediate variables, and then make changes to the China-US exchange rate. This paper will take the commodity price level, consumption and investment, international capital flows, and the stock price as the intermediate variables to explain the indirect transmission mechanism.

First, for the commodity price level, when the fluctuations of the US interest rate make the China-US interest rate spreads become widened and make foreign capital flow into the country. The increase of the foreign exchange will cause the money in circulation to increase, which will promote the relative commodity prices raise or even inflation. Therefore, the devaluation of the currency will lead to an appreciation of the exchange rate under the direct quotation method. However, when the domestic interest rate rises and China-US interest rate spreads, the demand for credit funds will decrease, which will reduce the market liquidity, and then lead to the decline of the commodity price level, the appreciation of the local currency, and the decline of the exchange rate. Therefore, the effect of US interest rate changes on the China-US exchange rate through the commodity price level depends on the net value of the two effects.

Second, for the umption, when US interest rates rise or the interest rate spreads increase, domestic consumers tend to save rather than consume. The decline of consumer demand will reduce imports, while the increase of savings will promote the increase of exports by increasing credit. Ultimately, this trend will lead to the appreciation of the local currency and the decline of the spot exchange rate. For the investment, when the US interest rate rises or the China-US interest rate spreads increase, the production cost of domestic enterprises will rise, which will lead to the increase of domestic product prices. The increase of relative commodity price level will lead to the corresponding decrease of export scale, thus leading to the decline of the exchange rate.

Third, for the international capital flows: if capital flows freely and fully between countries, when the US interest rate changes, the China-US interest rate spreads increase, which will lead to a great amount of foreign capital flow into the country for arbitrage. Therefore, the demand for local currency in the foreign exchange market will increase, which will prompt appreciation of the local currency and increase the China-US exchange rate.

Finally, for the stock price, when the change of US interest rate made the China-US interest rate spreads widened, the foreign capital will flow into China for arbitrage, and the domestic stock price will rise, which will further attract international capital inflow. Thus, it will cause the appreciation of the local currency and the decline of the exchange rate by changing the domestic currency supply and demand structure. On the other hand, when the China-US interest rate spreads expand, the local interest rate will rise, and the residents will reduce their stock holdings so that the stock index will decline. Then the poor economic development expectation will promote the devaluation of the local currency and the rise of the exchange rate.

Therefore, when the US interest rate decreased, the gap between the Chinese interest rate and the US interest rate became widened. This phenomenon promotes the appreciation of RMB in the short term. But in the long term, the influence of the gap between the Chinese interest rate and the US interest rate became weakened and then became stable. Second, in the study of how China-US interest rate spreads affect the exchange rate fluctuations, the commodity price level, consumption and investment, international capital flows and the stock price will all play an important role.

## 4. CONCLUSION

The passage explores the change in US interest rates and how it affects the Chinese economy. We divided our discussion into three aspects: Chinese import and export according to the stock market and real estate market; Chinese macroeconomics concerning some trade policies in special periods; and exchange rates in China and the US by certain transmission mechanisms, respectively. The change in US monetary policy will have a significant impact on China's macroeconomy. The Fed's quantitative easing has increased dollar liquidity and increased US output, leading to increased import demand from other countries, including China, which ultimately has a positive overall impact on China's output. The interest rate hike narrows the interest rate gap between China and the US, increases the return on US capital investment, and attracts international capital to flow across the border, thus increasing the demand for US dollars and the appreciation of the US dollar. Because of the appreciation of the dollar and the devaluation of the RMB, the cost of imports to the United States decreased, which increased imports. However, the outflow of funds caused by the Federal Reserve rate hike and the further strengthening of RMB depreciation expectations have always been negative factors for A-shares. While a weaker yuan would dampen imports, higher Fed rates would also bring lower commodity prices. The impact of RMB depreciation on China's real economy will be partially offset by lower commodity prices, but the overall impact will not be significant.

Based on the above analysis of the impact of the Fed's interest rate hikes and interest rate cuts on China, the key for China to resist negative shocks is to enhance the internal driving force of its economic growth, keep a cautious expectation of the Fed's interest rate hikes, and improve the ability of China's economy to cope with external shocks through flexible monetary policies. First, China should strengthen the supervision of cross-border funds. To cope with the impact of the Fed's interest rate hike, it is necessary to improve the construction of risk monitoring, early warning, and relevant statistical systems for cross-border capital flows in China. Second, China should work with emerging market countries to strengthen policy coordination in dealing with the federal reserve to raise interest rates. Strengthen the management of cross-border capital flows and monitoring mechanisms of financial market are necessary. The nation is ought to be sensitive with the global capital flows as well as actively play a role as a BRICS to adjust foreign exchange reserve in the function of financial stability.

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