



The Impact of Continuous Fed Rate Hikes on the Chinese Economy

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Abstract. In the post-pandemic economic recovery period, the Chinese government faces the wide-ranging economic impact of the Federal Reserve's continuous interest rate hikes, driven by soaring inflation rates in the United States. This study conducts an in-depth analysis of these effects, encompassing direct and indirect factors such as the continuous depreciation of the Chinese RMB exchange rate, sluggish employment markets, and decelerating economic growth. Although the Chinese government has taken several countermeasures, certain aspects of the economic recovery have not been as effective as expected. Based on this, it is recommended that the Chinese government adopt a more flexible monetary policy and actively engage in international economic cooperation, among other things, to adjust its coping strategies to better adapt to the economic development situation under the dual challenges of the post-epidemic situation and the Federal Reserve's continued interest rate hikes, to ensure that China's economy achieves sustainable growth and long-term stability.

Keywords: Federal Reserve interest rate hikes, Chinese economy, monetary policy

1 Introduction

Since 2022, the United States has announced the relaxation of pandemic control measures and embarked on post-pandemic economic recovery. Simultaneously, the Federal Reserve has initiated a series of interest rate hikes. These two factors have had a dual impact on the global economy. During the pandemic period (from January 2020 to January 2022), the Federal Reserve adopted an accommodative monetary policy. The inflation rate in the United States, which had been close to zero, began to rise and reached its highest level in 30 years, standing at 9.1% by June 2022. The persistence of high inflation rates has led to a continuous decline in consumers' purchasing power, with rapid increases in prices of essential goods such as food, energy, and housing. Meanwhile, large enterprises have been laying off employees, and commercial banks have faced the risk of bankruptcy. Additionally, economic issues such as the U.S. debt ceiling have emerged. To maintain stable employment growth and control the inflation rate within an acceptable range of 2%, the Federal Reserve has implemented substantial and sustained interest rate hikes.

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From the perspective of historical experience, the continued interest rate hikes by the Federal Reserve have had a far-reaching effect on countries that are amid an economic upswing. Before the Fed began to raise interest rates, the economies of various countries were booming and developing rapidly, but as the Fed began to raise interest rates for national economic reasons, most countries also followed the policy of raising interest rates to maintain their monetary stability, resulting in the bursting of their economic bubbles. Therefore the Chinese government needs to pay close attention to the potential impacts of the Fed's continued interest rate hikes on the Chinese economy. Through in-depth research and assessment of these impacts, the Chinese government can formulate appropriate economic policies and strategies to address potential economic dilemmas and leverage opportunities for ensuring the stability and sustainable development of the economy.

2 Literature Review

In the global economic landscape, the monetary policy of the Federal Reserve has always attracted a lot of attention, and countries would adjust their economic conditions according to the easing or tightening of the Monetary Policy of the Federal Reserve. As the second-largest economy in the world, the measures taken by China to respond to the impact of the Continual Federal Reserve Interest Rate Hikes have received a lot of attention from scholars. Early studies have illustrated some of the challenges to be posed to the Chinese economy by the Continual Federal Reserve Interest Rate Hikes, and the government of China has been continually reforming the economy in response to the problems it has been experiencing. [1] argued that China has been relatively successful implemented a monetary policy independent of the United States, but also pointed out the shortcomings in the use of interest rate tools in the regulation of the economy. [2] Analyzes how U.S. monetary policy shocks affect Asian economies through the financial and trade channels, and how these shocks lead to large fluctuations in the economies of Asian countries, enhancing the ability of Asian economies to withstand economic shocks brought about by changes in U.S. monetary policy. [3] Demonstrates, through the study of a global vector autoregressive model, that U.S. monetary policy spillovers have different impacts on the output of countries around the world in terms of the degree of financial and trade integration, exchange rate regimes, and the level of development of financial and labor markets. [4] emphasizes the impact of Continual Federal Reserve Interest Rate Hikes on China's financial market while suggesting the opportunity for RMB internationalization as a means of stabilizing the RMB exchange rate market. [5] used the VAR model to analyze the depreciation effects of Continual Federal Reserve Interest Rate Hikes on the RMB exchange rate. However, with China's rise in the global economy, [6] reminds us that Federal Reserve monetary policy will have profound impacts on the Chinese financial market and trade activities, so China should actively adjust and monitor the risks in the financial market to maintain the stability of the economy. [7] found that the impact of the Fed Reserve's interest rate hike presents time-varying characteristics, shifting gradually from a negative shock to

positive shocks, with a certain relationship to the reasons and real-time economic background.

Recent studies have shown that Federal Reserve rate hikes have also brought some positive impacts on the Chinese economy. [8] stated that the Federal Reserve has a lagged impact on China's economy through the interest rate channel, while the exchange rate and asset price channels have relatively small effects, allowing China's economy to maintain relative stability. [9] argued that Continual Federal Reserve Interest Rate Hikes could incentivize research and development investment in Chinese enterprises, particularly for smaller-scale and lower-innovation enterprises, although they would also face significant operating cost shocks and capital flows disruption. However, [10] finds that international commodity prices were negatively correlated with U.S. interest rates. But for China, short-term cross-border capital outflows were positively correlated with the U.S.-China interest rate differential, and currency depreciation was occurring at the same time.

While these studies have employed various methods and models to verify the impact of continuous Federal Reserve rate hikes on the Chinese economy and proposed some coping strategies, there has been relatively less research on the measures adopted by the Chinese government, particularly in the backdrop of the post-pandemic economic recovery and continuous rate hikes by the Federal Reserve. Hence, this paper aims to delve deeper into the actual impacts of continuous Federal Reserve rate hikes on the Chinese economy and explore strategies that can be considered and investigated by the Chinese government in response.

3 Analysis of Federal Reserve Interest Rate Hikes

The Federal Reserve refers to the Federal Reserve System, or simply the Fed, which is the central bank and monetary Policy-making institution of the United States. The Federal Reserve was founded in 1913 and is headquartered in Washington, DC. The Federal Reserve comprises multiple entities, including the Federal Reserve Board and 12 Regional Reserve Banks. They assist the Federal Reserve Board in executing monetary policy and providing financial services to commercial banks, regulating financial institutions, and promoting regional economic development.

Federal Reserve interest rate hikes as a measure of the U.S. Federal Reserve System to influence the overall market interest rate level by adjusting the target Federal Funds Interest Rate (FFIR). The Federal Funds Rate is the rate at which the Federal Reserve lends short-term liquidity to commercial banks and serves as the benchmark rate for the U.S. financial market. In more specific terms, it represents the interest rate at which commercial banks in the United States engage in short-term borrowing from each other. This policy decision is made by the Federal Open Market Committee (FOMC). The FOMC convenes eight times a year to assess the U.S. economic conditions and discuss adjustments to the monetary policy, with decisions on changes to the Federal Funds Rate announced after the meeting.

Federal Reserve interest rate hike typically entails the Federal Reserve raising the federal funds rate, leading to increased borrowing costs, and impacting multiple areas

of the economy, including economic growth, employment conditions, inflation levels, and financial market stability. Each rate-hiking cycle may have a different duration and objectives. The main reason analyzed in this paper for this round of Continual Federal Reserve Interest Rate Hikes is the high inflation rate in the United States, averaging 6%, which is significantly elevated. To address this inflationary pressure and maintain the stability of the job market in the U.S., the Federal Reserve has implemented Continual Federal Reserve Interest Rate Hikes. By lifting interest rate levels, the Federal Reserve aims to reduce borrowing activity, decrease consumer spending, and restrain the risk of overheating and inflation in the economy.

During the pandemic, the Federal Reserve adopted a series of monetary policy measures to combat economic recession and promote recovery. These measures included two emergency rate cuts in March and May 2020, reducing the federal funds rate from a range of 1.0%-1.25% to a range of 0-0.25%. The objective was to provide more liquidity and support economic activity. These rate cuts were intended to alleviate the economic impact of the pandemic and stimulate consumption and investment. In 2021, due to the ongoing effects of the pandemic and uncertainty surrounding economic recovery, the Federal Reserve decided to maintain the federal funds rate in the range of 0-0.25% to stabilize the markets and support economic recovery. The maintenance of this ultra-low interest rate level aimed to provide stable borrowing costs to encourage investment and lending activities.

However, with the arrival of 2022, the United States faced a high inflation rate, averaging 6%, which is significantly elevated. To address inflationary pressures and maintain stability in the job market, the Federal Reserve decided to commence rate hikes. The rate-hiking cycle began in March 2022, starting from 0-0.25% and reaching 5.25%-5.50% by July 26, 2023, with four interest rate increases, including intervals as high as 75 basis points, reaching the highest level in 20 years.

4 Impact of Continual Federal Reserve Interest Rate Hikes on the Chinese Economy

4.1 Direct Impacts

4.1.1 Increased Pressure in the Exchange Rate Market.

As the Federal Reserve continues to implement continual interest rate hikes, the RMB exchange rate market in China experiences significant fluctuations. This is because continual Federal Reserve interest rate hikes raise the interest rate levels of the U.S. Dollar, attracting capital inflows into the U.S. market and reducing international demand for the RMB. This has led to substantial depreciation pressure on the RMB. The exchange rate of the RMB against the U.S. Dollar increased from 6.37 in March 2022 to 7.25 and even reached a high of 7.34 in November 2022.

Continual Federal Reserve interest rate hikes have led to a strengthening of the U.S. Dollar index. The exchange rate of the U.S. Dollar against the RMB experienced significant fluctuations in 2022. However, in 2023, with the continual Federal Reserve interest rate hikes, the exchange rate of the U.S. Dollar against the RMB continued to

rise. The U.S. Dollar has a higher savings rate and relatively high selling rates, but overall lower buying rates. The RMB is being sold off in international financial markets due to excess supply, as the supply of RMB exceeds its demand. Most of China's trade settlement currencies still primarily use the U.S. Dollar. Since the value of exported goods exceeds that of imported goods, there is an increase in the quantity of U.S. Dollars in the Chinese market, leading some investors to convert their assets into U.S. Dollars. Additionally, most surplus trade enterprises retain their earnings in U.S. Dollar deposits and do not convert them into RMB, further intensifying the depreciation pressure on the RMB. This imbalance in supply and demand has driven the depreciation of the RMB.

4.1.2 Weakened Export Trade Demand.

Continual Federal Reserve interest rate hikes lead to factors such as a decrease in U.S. demand for goods, reduced consumer confidence, rising loan costs, and a slowdown in economic growth. Federal Reserve interest rate hikes lower the willingness of the U.S. population to consume. According to the University of Michigan Consumer Confidence Index, consumer confidence has somewhat recovered but remains at a low level, not exceeding 90, with a minimum index of 75 during the pandemic. Rising loan costs and interest rates put consumers under increased repayment pressure, potentially leading to reduced purchasing power and expenditures, especially for high-value and luxury goods.

Moreover, the decline in U.S. demand for goods significantly affects China as a manufacturing and exporting nation. China's manufacturing sector relies heavily on export markets, particularly the demand from the United States. Therefore, the weakening of U.S. demand for goods directly pressures China's manufacturing sector and trade exports, leading to contraction. The current value of U.S. imports has decreased from approximately \$350 billion to \$318.8 billion since the onset of continual Federal Reserve interest rate hikes.

4.1.3 Capital Market Outflows.

Continual Federal Reserve interest rate hikes have elevated U.S. dollar interest rates, boosting investor confidence in the U.S. dollar market and increasing the attractiveness of capital inflows into the United States while diminishing expectations for the Chinese market. This results in additional foreign capital and speculative funds leaning toward the United States, exerting pressure on capital outflows from China. Some offshore speculative funds aim to purchase government bonds and bet on the appreciation of the RMB. However, if the RMB depreciates, these speculative funds will swiftly exit the Chinese market. Furthermore, a significant amount of hedge funds is flowing into the U.S. dollar market, augmenting the risk of China's domestic capital market being influenced by external factors.

Since the commencement of Federal Reserve interest rate hikes in March 2022, there was a total outflow of \$267.8 billion in 2022, with equity funds experiencing an outflow of \$13.3 billion. This marked the first significant capital outflow from the Chinese stock market since September 2020. In 2022, China's net inflow of foreign direct investment

amounted to \$30.5 billion for the whole year, which was lower compared to the net inflow of \$165.3 billion in 2021. Despite the outflow of U.S. dollars, China attracted over \$51 billion in foreign direct investment in January 2023. This indicates that China still possesses considerable investment appeal. However, capital flows remain highly volatile.

4.2 Indirect Impacts

4.2.1 Restructuring and Shift in China's Trade Structure.

China's trade structure is changing due to the continual Federal Reserve interest rate hikes. The increased exchange rate of the RMB to the U.S. dollar poses challenges for China in terms of the rising costs of importing some high-tech products from the United States. This challenge could potentially hinder the development of China's high-tech industries. Additionally, influenced and inspired by the pandemic, China is accelerating the development of its digital industries to address the requirements of economic transformation and structural adjustment.

Furthermore, the slowdown in economic growth has led to a shift in China's trade export focus. The share of the United States as China's primary export destination has continuously decreased, declining from approximately 16% since the outbreak of the pandemic to around 13%. Meanwhile, China's export proportions to ASEAN, Russia, and Africa have rapidly increased. Data shows that China's exports to Russia, Africa, and Latin America grew by 136.4%, 46.5%, and 18.8%, respectively, in March 2022. China has also increased the proportion of exports to countries along the "Belt and Road" route. This indicates that China is actively adjusting its trade structure, seeking new trade partners, and achieving a shift in its trade focus. Despite the pressure from the continual Federal Reserve interest rate hikes, China is poised to mitigate its reliance on the U.S. dollar market and achieve sustained and stable growth in its trade by enhancing trade cooperation with other regions and signing bilateral currency swap agreements.

4.2.2 Changes in Asset Prices.

As the Continual Federal Reserve Interest Rate Hikes persist, China has lowered interest rates to maintain economic stability, resulting in an inverted China-U.S. interest rate differential. In the low-interest-rate environment in China, foreign investors may seek higher returns by purchasing assets in China, such as real estate, bonds, or stocks. However, when there is an inverted China-U.S. interest rate differential, they are more likely to sell Chinese assets, convert funds into U.S. dollars, and withdraw from the Chinese market. They then redirect their investments toward the U.S. market, where they can obtain higher interest rate returns. This capital outflow also impacts changes in Chinese asset prices.

In the stock and bond markets, the Continual Federal Reserve Interest Rate Hikes may temporarily reduce investor confidence in the Chinese stock and bond markets. Funds flow into the U.S. financial market. Simultaneously, the rising U.S. dollar interest rates reduce the attractiveness of Chinese bonds, resulting in price decreases and

higher borrowing costs. In the commodities market, reduced demand for commodities may lead to decreased exports and falling prices. Global economic uncertainty and geopolitical risks can also trigger price fluctuations in commodities. For example, crude oil futures prices have dropped from 116.23 to 71.96 since the rate hikes. In the gold market, the Continual Federal Reserve Interest Rate Hikes increase the attractiveness of the U.S. dollar, reducing the demand for gold as a safe-haven asset, leading to price declines. For example, in March 2022, the price of gold per ounce dropped from 1985.29 to 1641.76. In the real estate market, the combined impact of the post-pandemic recovery and the Continual Federal Reserve Interest Rate Hikes has led to a decline in China's national property prosperity index, dropping from 95.56 in May 2022 to 94.37. This has resulted in economic difficulties for businesses, increased financial pressure for individuals, and some borrowers choosing to sell their properties to repay loans. Meanwhile, overseas real estate investors may not only opt to sell Chinese properties but also choose to invest funds in more stable income-generating sectors.

4.2.3 Increased Labor Market Pressure.

In 2023, it is expected that the number of Chinese college graduates will exceed 11.6 million. Combined with the current high unemployment rate, the youth unemployment rate in China has already exceeded 20%. This exacerbates the challenges faced by China's labor market. China's industries are still predominantly focused on manufacturing, providing a significant source of employment opportunities. However, due to the impact of Continual Federal Reserve Interest Rate Hikes, negative growth in exports has emerged. Manufacturing-oriented enterprises face difficulties, including downsizing and reduced production, which consequently leads to a decrease in the number of job openings.

Continual Federal Reserve Interest Rate Hikes indeed have an impact on post-pandemic business development and operational strategies. The high-interest rate environment has made Chinese trade and financial investment enterprises more cautious in their investment and hiring decisions. After the pandemic, signs of economic recession, soaring energy prices, and the rapid appreciation of the U.S. dollar have reduced consumer demand among residents. As a result, many enterprises have scaled back their projects, leading to widespread layoffs, with stabilizing business development becoming a primary goal. During the pandemic, remote work became one of the predominant forms of office work, promoting the rapid development of digital enterprises, particularly in the technology sector. Many U.S. companies embarked on large-scale hiring, maintaining relatively high employment rates. However, this hiring often exceeded the actual needs of the companies. Due to the global economic slowdown and an increased number of overseas students returning to China, this has created dual employment pressures on China's talent market.

5 Challenges

5.1 Lack of Coordination between Economic Adjustment and Pandemic Control

Against the backdrop of Continual Federal Reserve Interest Rate Hikes, the measures taken by the Chinese government to control the pandemic have not been conducive to economic development, resulting in a slowdown in economic growth. To safeguard the lives of the people, the Chinese government implemented pandemic lockdown measures for over two years, impacting the development of some small and medium-sized enterprises. During the lockdowns, many businesses were forced to halt operations, shut down, or reduce their production capacity. The limited financial resources of these small and medium-sized enterprises were insufficient to sustain prolonged cost expenditures, leading to disruptions in the supply chain and hindrances in production activities. This has placed significant pressure on key economic sectors such as manufacturing, services, and retail, with a substantial decline in output and sales, resulting in sluggish economic growth and even a trend toward negative growth. Data on industrial enterprise profits and industry profits show relatively poor performance, with a negative growth rate of up to 20%. This indicates that businesses are finding it challenging to expand reproduction and investment, posing certain obstacles to economic recovery and development.

Furthermore, the pandemic has had adverse effects on people's income and employment, further weakening domestic demand. The Chinese government has also initiated reforms in the education and internet industries, causing significant disruptions to related companies, which face forced transformation or bankruptcy. This has led to an increase in China's unemployment rate. Against the backdrop of an economic downturn, large enterprises have embarked on layoffs, with some companies choosing salary reductions to reduce expenses. As a result, the Chinese populace generally has lowered their wage expectations, leading to reduced consumer demand and a contraction in the domestic consumption market. The decrease in the CPI index reflects lower consumer prices, indicating a weakened consumer willingness to spend. Moreover, the outbreak of the pandemic and inadequate pandemic control measures has also had a significant impact on international trade, severely affecting China's exports. The sharp decline in the trade surplus indicates a substantial reduction in export volumes and trade activities, negatively impacting China's economic growth and foreign exchange income.

5.2 Inadequacy of Foreign Exchange Control Measures in Addressing Prolonged Fed Rate Hikes

To control the volatility of the foreign exchange market, the government of China has adopted a series of risk control measures. Firstly, increasing the risk reserve ratio for forward foreign exchange sales from 0 to 20%. This initiative aimed to restrict banks from engaging in large-scale short RMB transactions to maintain the stability of the USD-RMB exchange rate. This move reduced the USD-RMB exchange rate from 7.2 to 6.7 in the two months of November and December 2022. Secondly, in July 2023,

several commercial banks in China cut their interest rates on U.S. dollar deposits sharply from 4.5%-5% to 2.8%. Thirdly, the Chinese Central Bank decided to raise the macro-prudential adjustment parameter for cross-border financing for enterprises and financial institutions from 1.25 to 1.5. This move imposes stricter prudential limits on cross-border financing, requiring enterprises and financial institutions to consider related risks and compliance requirements more carefully. This affects the scale and speed of cross-border financing, thereby controlling capital flows. However, with Continual Federal Reserve Interest Rate Hikes and USD gaining strength, the USD to RMB exchange rate has continued to increase, remaining at a high level of above 7.1. This indicates that the method used by China in addressing the effects of Continual Federal Reserve Interest Rate Hikes on the forex market has been relatively mild, and China may be less timely in making decisions about the timing of its exchange rate management interventions.

5.3 Lack of Strong Market Confidence Among the Chinese Population

Against the backdrop of Continual Federal Reserve Interest Rate Hikes, the post-pandemic economic recovery, and various other uncertainties, economic growth has been sluggish not only globally but also in China. Most Chinese citizens hold pessimistic views regarding the country's economic prospects, leading to changes in economic behaviors and decisions. At the individual and household level, faced with an uncertain economic environment, people tend to prioritize savings over significant consumption. When the Federal Reserve began raising interest rates in March 2022, consumer confidence plummeted to around 82. Individuals seek to ensure they have a sufficient financial safety net to cope with potential economic hardships. Therefore, they may reduce unnecessary expenses or decrease high-risk investments. Simultaneously, the uncertain economic environment may lead businesses to doubt market demand and prospects. This, in turn, might result in delayed investment plans, reductions in new projects or expansions, and a greater focus on cost reduction and efficiency improvement. Businesses may also pay more attention to cash flow management to ensure financial stability and resilience against potential risks.

6 Conclusion

China faces multiple challenges in addressing both the Continual Federal Reserve Interest Rate Hikes and the post-epidemic economic recovery process. While current measures have yielded some results, underlying issues persist. Pandemic-related lockdowns have impacted small and medium-sized enterprises (SMEs), disrupting supply chains and production, thereby slowing economic growth. Foreign exchange control measures have struggled to counter the RMB depreciation pressure following the Federal Reserve's interest rate hikes during the recovery phase. Moreover, the post-pandemic recovery includes economic rehabilitation and considerations of health, factors that may reduce consumer willingness.

Therefore, I propose that the government of China take a multi-pronged approach to improve the Chinese economy. Firstly, The Government of China needs to strike a balance between pandemic control measures and economic adjustments, strengthen healthcare management, sanitary investments, and health education. Secondly, provide financial and fiscal support to SMEs for their recovery, ensuring employment stability. Improve vocational training and skills promotion for industrial change and structural adjustment. Thirdly, the government of China should encourage higher R&D investments to enhance industrial competitiveness, countering economic growth pressures from continual Federal Reserve interest rate hikes. Fourthly, enhance financial oversight and risk management while adopting a more flexible monetary policy. Facilitate early issue detection and intervention, promote RMB digitalization, reduce U.S. Dollar dependence, and decrease demand for it. Encourage domestic consumption and service industry growth to achieve these goals. Fifthly, Promote diverse foreign trade strategies and active participation in international economic cooperation. Uphold trade liberalization and multilateralism as priorities. Lastly, Effective government-public communication is vital. Increase policy transparency and incentivize consumer spending and investment to stimulate economic recovery and boost market confidence.

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