

The Impact of the Federal Reserve's Interest Rate Adjustment on Financial Market

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Abstract: Recently, although inflation in the U.S. has cooled down, the Federal Reserve is expected to cut interest rates only once this year. Powell remains open to the timing of the interest rate cut, which makes the entire financial system pay close attention to the Federal Reserve's interest rate adjustment. This paper aims to explore the impact of the Federal Reserve's interest rate hikes and cuts on the financial market, especially its impact on the banking system and stock markets. This paper also identifies the Federal Reserve's role in mediating the economy. It uses a combination of theoretical analysis and case analysis to explore the impact of the Fed's interest rate adjustments on the banking system and the stock market. After analysis, this paper found that the Federal Reserve has coordinated the financial system by using the monetary policy of raising and lowering interest rates and supervising banks, maintaining the health and stability of the economy.

Keywords: Federal Reserve, interest rate adjustment, financial system, banking system, stock market.

1. Introduction

The Federal Reserve is the central bank of the United States. It implements its monetary policy by adjusting the federal funds rate to prevent inflation and deflation. So far, research in the field of Fed rate hikes and rate cuts has continued to increase, and most representative economic events in the United States have driven the continuous development of research in this field. Since the early 1920s, the Federal Reserve has begun to influence the financial market to maintain economic stability [1]. The Federal Reserve's interest rate adjustment can be called a weather vane for the financial system. Its impact on the financial system is related to everyone and the entire economic environment. Therefore, this paper will use the two analytical methods of theoretical analysis and case analysis to specifically analyze the impact of the Federal Reserve's interest rate adjustment on the two financial sectors of the banking system and the stock market. In the case analysis, this paper uses two cases: the impact of the Federal Reserve rate hikes and cuts on the bankruptcy of Silicon Valley Bank and the impact on the stock market. The research in this paper is an integration of the impact of the Federal Reserve's interest rate adjustment on the financial system, which is clear and intuitive for subsequent related research.

2. Background of the Federal Reserve's Interest Rate Adjustment

The Federal Reserve's interest rate decision is usually based on an assessment of the economic situation, with the main purpose of stabilizing prices and maximizing employment. It can be said that the Federal Reserve has already implemented the forecast target system to a considerable extent [2]. The Federal Reserve communicates its policy intentions and economic outlook to the market through public statements and economic forecasts. This transparency helps reduce market uncertainty and stabilize the confidence of investors and businesses. Usually, when economic growth is strong, unemployment is low, inflation continues to rise, and the dollar is weak, the Federal Reserve will raise interest rates to prevent inflation. When economic growth is weak, unemployment is rising, and deflation continues to rise, the Federal Reserve will cut interest rates to prevent deflation and stabilize the economy. In the financial market, if there is excessive risk behavior such as a real estate bubble, the Federal Reserve may raise interest rates to cool down overheated market sentiment and prevent risks from occurring or expanding further. On the contrary, if there is a risk of a sharp drop in stock prices such as the 2008 financial crisis, the Federal Reserve may choose to cut interest rates to provide liquidity support and thus stabilize the financial market.

3. Impact of the Federal Reserve's Interest Rate Adjustment on the Financial Market

3.1. Impact on the Banking System

The impact of the Federal Reserve's interest rate adjustment on the banking system is complex, with both positive and negative effects. A rate cut will narrow the bank's net interest margin and increase loan demand; a rate hike will usually increase the net interest margin and reduce loan demand, while the risk of default will increase. For example, in the interest rate hike cycle after 2022, the Federal Reserve will quickly raise interest rates to respond to inflation, and some banks will face pressure from falling asset values and liquidity. The bankruptcy of Silicon Valley Bank is a typical example of the impact of the Federal Reserve's interest rate adjustment on the banking system. As a bank that focuses on providing financial services to start-ups and high-tech industries, the Fed's interest rate intervention indirectly led to the collapse of Silicon Valley Bank [3]. In 2021, the Federal Reserve's drastic interest rate cuts caused a large amount of funds to flow into Silicon Valley Bank. However, after 2022, the Federal Reserve began to raise interest rates. This has led to higher financing costs, increased operational pressure on Silicon Valley Bank, and higher default risks, which have affected Silicon Valley Bank's asset quality and profitability. On the other hand, Silicon Valley Bank holds a large amount of long-term bond assets. When the Federal Reserve raises interest rates, long-term bond prices fall. Silicon Valley Bank's investment portfolio faces a shrinking market value. Therefore, it led to a large loss. Silicon Valley Bank needed to sell its assets at a discount to meet liquidity needs, which further deteriorated Silicon Valley Bank's balance sheet and aggravated its financial difficulties. This shows that the Federal Reserve's interest rate adjustment has a huge impact on the banking system. Banks need to respond to changes in the Federal Reserve's interest rate adjustments through effective risk management and flexible strategies to maintain their stability and profitability. Similarly, the Federal Reserve needs to find a balance between profitability and risk management to adapt to the changing economic and financial environment.

3.2. Impact on the Stock Market

As an external manifestation of the economy, the stock market is greatly affected by the interest rate adjustment of the Federal Reserve. The interest rate adjustment of the Federal Reserve has a wide impact on the stock market by affecting corporate profits, investment attractiveness, economic expectations and market sentiment. Interest rate hikes usually lead to falling stock prices, while

interest rate cuts usually lead to rising stock prices. The interest rate adjustment policy of the Federal Reserve and asset prices can be described as nonlinear, The Federal Reserve will respond to changes in stock prices [4]. At the same time, the stock market will always pay attention to the interest rate trend of the Federal Reserve and make decisions on whether to buy or sell. Adjustments in interest rates will cause assets to flow in or out of the market, which in turn affects the stock market. Taking the stock market as an example, in order to maintain economic stability, the Federal Reserve has adopted multiple interest rate cuts and ultra-low interest rates close to zero, which has led to a large amount of capital flowing into the stock market. It caused significantly reduced borrowing costs for businesses and consumers, this low-cost funding environment supports business expansion and consumer spending, thereby promoting economic activity. It also caused an increase in consumer willingness to consume, the low interest rate environment makes fixed-income assets such as bonds less attractive, and investors turn to the stock market in search of higher returns. Funds flow from low-yielding assets to the stock market, pushing up stock prices. Finally it has a surge in stock prices. At the same time, it has also caused inflation and exacerbated the stock market bubble [5]. But in general, in 2021, the Federal Reserve had a significant positive impact on the stock market by rapidly cutting interest rates, implementing quantitative easing, providing liquidity support and forward guidance. These policies not only boosted market confidence and stabilized the financial market, but also promoted a rapid rebound in the stock market and promoted economic recovery.

4. Analysis of the Federal Reserve's Coordinating Role

The Federal Reserve implements its monetary policy by adjusting interest rates [6]. It uses monetary policy to control inflation, promote employment, and promote economic development. It regulates the inflow of capital costs, balances consumption and investment, and manages market expectations by raising and lowering interest rates, thereby stabilizing the financial system. The Federal Reserve adopts a tightening policy when the economy is overheating and an easing policy when the economy is depressed, thereby regulating the economic cycle. The Federal Reserve also provides liquidity support to stabilize financial markets. In times of financial crisis or economic instability, the Federal Reserve provides necessary liquidity support to financial institutions through means such as the discount window and emergency loan tools to prevent systemic risks and the overall collapse of the market. In addition, the Federal Reserve's policies also affect the global financial market and the global economy. For example, raising interest rates will usually lead to an appreciation of the US dollar, attracting international capital to flow into the United States; lowering interest rates may cause the US dollar to depreciate and promote capital outflows. In general, the Federal Reserve plays an important role in promoting economic growth, controlling inflation or deflation, promoting employment and stabilizing and balancing financial markets by adjusting interest rates and providing forward-looking guidance. This strategy is not only conducive to the healthy and stable development of the US economy, but also to a certain extent maintains the stability of the global financial system.

5. Conclusion

This paper mainly discusses the impact of the Federal Reserve's interest rate adjustments on the financial system, such as the banking system and the stock market, by analyzing the impact of the Federal Reserve's interest rate hikes and cuts on the bankruptcy of Silicon Valley Bank and the stock market. It can be concluded that the Federal Reserve has a strong impact on the financial market and has a strong coordinating role in the economy. This paper does not use data analysis methods to analyze the relationship between the Federal Reserve and the financial market, so it is limited in this regard. In the future, as people pay more attention to financial events, it can be predicted that research on the Federal Reserve's impact on the financial system will increase.

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