Proceedings of ICFTBA 2024 Workshop: Finance's Role in the Just Transition
DOI: 10.54254/2754-1169/143/2024.GA18937

The Impact of the Fed's Monetary Policy Adjustment on China's Macro-economy

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Abstract: In the context of highly integrated global economies, the Federal Reserve (Fed), as the central bank of the United States, exerts widespread and profound influence through its monetary policy adjustments. This paper systematically analyzes the mechanisms and extent of the Fed's monetary policy adjustments on China's macroeconomy. First, this paper explored the main tools and recent adjustment paths of the Fed's monetary policy, including interest rate policies, quantitative easing (QE), and balance sheet reduction. Second, this paper analyzed how these policy adjustments are transmitted to the Chinese economy via international capital flows, exchange rate fluctuations, and changes in trade conditions. The study finds that Fed rate hikes can lead to a stronger U.S. dollar, prompting capital to flow back to the United States and exerting depreciation pressure on the Chinese yuan. This, in turn, affects China's export competitiveness and inflation levels. Additionally, increased volatility in global financial markets may pose challenges to China's financial stability. Finally, this paper propose policy recommendations for China to effectively respond to the Fed's monetary policy adjustments, including strengthening macro-prudential management, improving the exchange rate mechanism, and deepening financial market reforms.

Keywords: Federal reserve monetary policy, China's macroeconomy, capital flows, exchange rate fluctuations, policy recommendations.

1. Introduction

In the context of economic globalization, the United States dollar has been playing a central role in international trade as the dominant currency, safeguarding the hegemony of the United States. All countries of the world are closely watching the movement of the interest rate on the dollar and the related monetary policy, as it affects the trade and financial dynamics of individual countries. “On September 18, 2024, the Federal Reserve Board decided to lower the target range for the federal funds rate by 50 basis points to 4.75% to 5%” [1]. According to the Forbes news site, this is the Fed's first rate cut since 2020, a period (from March 2022 through July of last year) during which the Fed hiked rates 11 consecutive times over a year, accumulating a total of 525 basis points [2]. This policy change marks the shift of U.S. monetary policy from a tightening cycle to an easing cycle, showing the Fed's determination to stimulate the domestic economy and the trend of monetary policy adjustment in the coming period [1]. This initiative will not only change the domestic economic trends in the United

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States but will also affect the financial markets of countries around the world in the globalized environment of United States hegemony.

As a member of the World Trade Organization, China also certainly cannot escape the impact of the Fed's interest rate cut. This paper will analyze the impact of the Fed's monetary policy adjustment on China's macroeconomy, focusing on observing several important macroeconomic indicators. Specifically, the Fed's decision to cut interest rates creates opportunities and challenges for China at the macro level in terms of monetary policy, RMB exchange rate, imports and exports, inflation, stock market, and real estate. Analyzing these impacts will help people understand how China should use this window of policy adjustment to promote macroeconomic growth and development.

2. Implications for Monetary Policy

The most immediate impact of the Fed's rate cut announcement is that it will prompt China to adjust its monetary policy. Among them, the concept of the U.S.-China interest rate spread is very important for the formulation of China's monetary policy. According to an article by Wei Hongxu, the US-China spread refers to the economic phenomenon where 10-year Chinese Treasury yields are higher than US Treasury yields, and usually, a gap of 80 - 100 BP is normal by market consensus [2]. However, as mentioned earlier before the current Fed rate cut, the US dollar interest rate has gone through 11 rate hikes, which has led to a narrowing of the US-China interest rate spread and even an inversion. In general, a narrowing or inversion of the U.S.-China interest rate spread is more challenging for China and could lead to a narrowing of the currency arbitrage space, resulting in capital outflows [3]. In other words, an inverted interest rate differential between China and the U.S. would lead to a depreciation of the RMB, allowing institutions holding RMB assets to reduce their holdings of the RMB and invest in U.S. dollars instead. At the same time, RMB assets will become less attractive to foreign institutions. Further, inverted US-China interest rate differentials have compressed the PBOC's monetary policy space. If China continues to cut interest rates in the case of higher U.S. interest rates, this will not only not stimulate the economy, but will also lead to a decline in China's export growth and capital outflows, a decline in China's foreign exchange reserves, exchange rate depreciation, capital market volatility and even panic [3,4]. However, the Federal Reserve interest rate cuts have changed the status quo of the U.S.-China spread inversion, so that the U.S.-China spread to the “comfort zone” return. It means that China is facing less pressure from capital outflows. China's monetary policy will also be able to adjust to a more accommodating environment. Against this backdrop, China's central bank could introduce a more flexible monetary policy, by focusing more on the domestic economic situation. For example, on September 27, China's central bank announced to cut of the standing lending rate by 20 basis points, the largest rate cut in nearly four years, to boost consumption and investment demand and promote economic growth [5]. As a macro-control tool, changes in China's monetary policy can best be visualized as a reflection of the impact of the Fed's monetary policy on the Chinese economy.

2.1. Impact on the Exchange Rate of the RMB

Another direct impact of the Fed's rate cut on China's macro-economy is the RMB exchange rate. One important measure of this is economic policy uncertainty. According to Scott R. Baker et al., Economic Policy Uncertainty is an index developed to reflect the relationship between policy and the economy based on the frequency of newspaper coverage, noting that changes in policy can affect business investment decisions and consumer confidence, which in turn affects overall economic activity [6]. In other words, economic policies, although formulated by the state in accordance with economic trends, in turn affect investors' confidence in investing in a country. When the Fed cuts interest rates, people will be keenly aware of the weakening economic situation in the United States.

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This trend will reduce the probability of investors holding US dollars. Through the change in demand, investors will look to currencies unexpected for the dollar, including the RMB, which will affect the RMB's exchange rate against the dollar. Markets always chase profits. People will look for higher-return investment opportunities because of lower dollar interest rates. This market behavior may contribute to the appreciation of the RMB. However, not every Fed rate cut will lead to an appreciation of the RMB, as this effect may be offset by China's monetary policy and global economic conditions. According to Shawkat Hammoudeh et al, the People's Bank of China (PBOC) uses not only price instruments (e.g., interest rates) to control the domestic economy, but also quantitative instruments (e.g., money supply M2) to achieve its monetary policy objectives. This combination of approaches could have an impact on global commodity prices and offset the effects of the Fed's interest rate cuts [7]. Under the influence of various factors, although the Fed's interest rate cut does not necessarily cause a significant appreciation of the RMB, it will make the RMB exchange rate fluctuations to a certain extent.

2.2. Impact on China's Trade

Fed rate cuts through the impact of China's monetary policy and exchange rate will also indirectly affect China's import and export trade. In the context of the globalization of capital, the terms of trade are an important measure of a country's ability to operate in international markets. According to Bharat et al., the terms of trade can be defined as the ratio of the price of a country's exported goods to the price of imported goods, reflecting the movement of the prices of the country's imported and exported goods [8]. In other words, if the price of exported goods rises while the price of imported goods falls, the country's terms of trade are better, and vice versa, the terms of trade decline. As mentioned in the previous section, a Fed rate cut could lead to a relative appreciation of the RMB. This means that goods exported from China will become relatively expensive in dollar terms. It will reduce the price competitiveness of Chinese exports internationally. Thus, a Fed rate cut would weaken the terms of trade for Chinese exports. The relative appreciation of the RMB also means that Chinese foreign trade enterprises can import raw materials, intermediate products or production equipment at lower prices. It will significantly reduce the cost of production lines for these companies, thus increasing their profits. In short, the Fed's rate cuts have had the exact opposite effect on China's imports and exports. It creates a positive situation for Chinese imports and weakens export trade. However, by monitoring changes in the terms of trade, China can also come up with targeted trade policies to balance the prices of import and export trade and thus China's economic growth.

2.3. Impact on Inflation

The Fed's rate cuts will also indirectly lead to inflation in China, which is an important indicator of a country's macro-economy. Imported inflation is an important concept that deserves attention. According to Mary Amiti et al, imported inflation is the phenomenon of rising local prices due to rising prices of imported goods [9]. Fed rate cuts further contribute to Chinese inflation by affecting the yuan exchange rate. As previously mentioned, Fed rate cuts usually lead to a relative appreciation of the RMB. It means that the cost of raw materials imported by China from international sources rises. These costs ultimately lead to higher prices for these products in the Chinese market. Since China is a country heavily dependent on imports. According to an article in the Council on Foreign Relations, China's import rate on commodities such as soybeans, corn, wheat, rice, and dairy products is close to 40 percent, more than any other country in the world [10]. If no policy is adopted, the Fed's interest rate cuts will inevitably cause the prices of these commodities to rise, which in turn will lead to higher inflation in China. At the same time, interest rate cuts will also cause China's exports to become less competitive by affecting the exchange rate. When there are fewer orders for exports,

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economic growth and employment in China's foreign trade sector will decline. It can also indirectly lead to an imbalance between supply and demand, thus triggering inflation. On the other hand, as mentioned earlier, Fed rate cuts lead to capital flows to countries with higher yields, including China. Such capital inflows would increase the Chinese money supply. When there is an imbalance between supply and demand, inflation in China will also increase to some extent. If inflation stays high, Chinese assets are bound to face price bubbles and more risk. This could lead to the destabilization of the Chinese market. Therefore, a Fed rate cut would result in China having to adopt more flexible management tools or policies to control inflation.

2.4. Impact on Capital and Real Estate Market

The Fed's rate cut could have an impact on China's stock and property markets, which directly reflect China's macroeconomic conditions. According to an article by Joe Seydl, the Federal Reserve's interest rate cuts may stimulate more real estate transactions because the cuts lower mortgage rates, making home ownership less expensive [11]. While Seydl's analysis is based on the US market, however, it also applies to China. It is because China followed suit two months after the Fed cut rates. Similarly, interest rate cuts may affect people's spending on goods that involve financial borrowing, such as cars and appliances, because it will make the purchase less affordable. When a large number of buyers flood the real estate market, developers may raise prices to maintain the balance between supply and demand or to stimulate more transactions. This trend could lead to a boom in China's real estate market, which in turn could lead to related industries, such as renovation, construction, home furnishing, and so on. A boom in these industries will inevitably lead to macroeconomic growth in China.

On the other hand, in the context of global economic integration, the Fed's interest rate cuts will also have a direct effect on the Chinese stock market. According to a blog by the International Monetary Fund (IMF), interest rate cuts by the Federal Reserve usually lead to changes in global capital flows, which in turn affects the financial markets of emerging and developing countries, including China [12]. In other words, a Fed rate cut would cause U.S. investors to look to the capital markets of other countries, such as China. Compared to deposits and bonds, China's stock market will gradually receive favor from investors, who are more interested in seeking high yields to compensate for the losses caused by low interest rates. Therefore, the liquidity of the Chinese stock market will be increased. Rising stock markets often reflect confidence in the future development of the Chinese market. Companies also invest further in the stock market to seek financing. Overall, the Fed's rate cuts will boost China's stock and property markets, which will also boost China's macroeconomic growth.

3. Conclusion

Overall, the Fed's interest rate cuts are beneficial to China's macro-economy as a whole. This paper focuses on analyzing several indicators that reflect China's macro-economy, including monetary policy, renminbi interest rates, import and export trade, inflation, housing and property markets. Fed rate cuts can ease the inverted status quo of the U.S.-China trade spread, so that China's monetary policy can be adjusted to more space. It is beneficial for China to better take into account the domestic economic situation and introduce relevant monetary policies to promote economic growth. Another obvious area of impact is the exchange rate of the RMB. The Fed's interest rate cuts have reduced the investment attractiveness of the dollar but increased the relative value of the RMB. The value added to the RMB has had a further impact on China's exports and imports. China can import goods at lower prices, boosting import trade. However, the appreciation of the RMB has weakened China's export trade, leading to weaker price competitiveness of Chinese exports. Changes in the exchange rate and imbalances between imports and exports may also increase China's inflation rate, for example, when imports exceed exports and there is a large influx of foreign capital. Higher inflation is likely to bring negative macroeconomic impacts for China, such as economic bubbles. On top of that, the Fed's rate cuts have led to synchronized rate cuts in China. This means that China's stock and housing markets could be in for a new boom period. Combined with these areas, the Fed's rate cut is likely to boost China's macroeconomic growth.

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