

The Impact of the U.S. Rate Hike Cycle on China's Financial Market

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Abstract. The essay looks at how the changes in exchange rates in the United States affects financial markets' performance in China. First, the paper gives an overview of the dollar as a global exchange rate currency vis-à-vis financial markets' productivity. Then, the essay analyses the impact of US rate hike on yield gap, capital flow, the RMB, government bonds, and housing & real estate before drawing conclusions: the US rate hike will attract a huge amount of funds back to the United States, assert depreciation strain on the RMB, and effectively limit Beijing's fiscal policy softening, as an essential tool for assisting coronavirus-hit industries and meeting the government's estimated growth target.

Keywords: US exchange rate; Financial markets; Economic development; foreign direct investment.

1. Introduction

The US dollar is the world currency to the letter, and the United States is the main provider of global liquidity. The dollar cycle remains an important anchor benchmark for the global market cycle. Historically, the interest rate hike cycle in the United States has often been accompanied by fluctuations in the international market, and has also triggered market crises in some countries for several times, leading to local or global economic and financial crises. Since the 1980s, the United States has experienced five cycles of dollar interest rate hikes, which have more or less affected major markets in the world. The interest rate hike cycle from March 1983 to August 1984 led to the rapid decline of global commodity prices, coupled with the passive follow-up effect of interest rate hikes in Latin American countries, which led to a large number of capital pulling away from Latin American countries, a substantial devaluation of currencies, and high refinancing costs, which directly triggered the Latin American debt crisis; The interest rate hike cycle from March 1988 to May 1989 forced Japan to tighten monetary policy, which directly led to the collapse of Japan's real estate and stock market, and the banking industry also suffered heavy losses, which became an important fuse for Japan's economy to turn into depression. During the interest rate hike cycle from February 1994 to February 1995, Asia, especially Southeast Asian countries, suffered from capital flight and currency devaluation. The markets of Thailand, the Philippines, Indonesia, Malaysia and other countries became the focus of international speculators' attacks. Foreign exchange reserves were consumed in large quantities, and some countries had to give up fixed exchange rates, which eventually led to the Southeast Asian financial crisis; The interest rate hike cycle from June 2004 to June 2006 burst the US real estate and stock market foam, triggered a tsunami in the international financial market, and caused a global economic and financial crisis.

The economic development level and market openness of emerging market countries are higher than those of general developing countries, while the market maturity and stability are lower than those of developed countries. It is often easy to become the object of international capital competition in the cycle of dollar interest rate reduction, and it is also easy to become the object of sudden withdrawal of international capital in the cycle of interest rate increase. Therefore, the US dollar interest rate hike cycle has the most direct transmission effect and the greatest impact effect on the markets of emerging market countries. China has become the largest emerging market country in the world, and is gradually deeply integrated into the global economy. Under the background that the economy has gradually shifted from high-speed growth in the past to medium and high-speed growth, the domestic market is more vulnerable to external shocks than before. However, China is relatively

stable in terms of capital control, foreign debt control and foreign exchange reserves, and the openness of each market is not the same.

The latest hikes in U.S. dollar rates initiated by the Federal Reserve have continued the spate of disruptions on China's already COVID-19-disrupted economy. Still, for Hong Kong (HK), courtesy of its peg on the United States dollar, had to follow the trajectory, notwithstanding its weakening economy [1]. From 1983, Hong Kong has been pegging its currency to the United States dollar, helping it withstand economic volatilities, inclusive of the 1997 financial crisis that affected Asia, effectively underpinning its place as a primary international financial center [2]. Nevertheless, the implication is that China does not have much a choice than to join the US's latest aggressive rate increases. With the country battling a new Covid outbreak that is already negatively impacting growth, the last option on the table for Hong Kong would be an increasing interest rate. This was evident in Hong Kong's downward revision of the 2022 GDP growth prediction to about 1% and 2%, following a lower-than-anticipated 4% reduction in Q1 2022[3].

Because the dollar dominates the global monetary system, the US's rate rise is sure to have a ripple impact on other countries, limiting the room for flexibility regarding their financial to varied levels. However, owing to China's independent monetary policy, the effect of the US's rate rise has been diminishing. Nonetheless, the People's Bank of China must strengthen the macroeconomy using a balanced financial policy, particularly as increasing financial credit and lowering the cost of capital constitute the two crucial interim aims [4].

2. Narrowing Yield Gap

As per the Bank for International Settlements' statistics, the China-US policy rate of interest spread oscillated in around a 3.3%-point range as April elapsed. However, the US's plan of raising rates by fifty basis points beginning early June will decrease the policy interest rate differential amongst the two nations. As a result, China will find it challenging to encourage economic development by decreasing their interest rates. Nonetheless, China might stimulate the economy by implementing actions such as lowering the required reserve ratio [5].

As far as cross-border bond investment goes, the yielding differential involving China and the United States has significantly shrunk, sometimes resulting in inversion. The ten-year United States Treasury bond yielded just 1.52% by close of 2021. However, the return on the ten-year US Treasury bond surpassed 2% in February 2022, peaking at 3.12% in early May, before falling to 2.84%. Yet, from the other end of the spectrum, the return on China's ten-year treasury bond can be described as rather constant, essentially remaining in the 2.5-3.2 percent area from 2020. Case in point is the month of May, where China's ten-year government bond yielded 2.81%, indicating that the interest rate differential involving the United States and China had flipped [6].

3. Capital Flow

With regard to long-term flow of capital, China has played an integral part in the global economy pertaining growth since, notwithstanding the COVID-19 epidemic, the nation has continued opening up its economy. China is also a major destination for FDI, garnering \$144.37 billion and \$173.48 billion in 2020 and 2021 in that order. According to its Ministry of Commerce's data, China's real usage of foreign money was \$55.9 billion or 379.87 billion yuan in Q1 2022, a rise of 25.6 percent year on year. In the context of short-term flow of capital, statistics from the CCDC (China Central Depository and Clearing) firm, the value of bonds owned by foreign institutional investors at close of Q1 2022 was around 3.57 trillion yuan, down 110-billion-yuan year on year [7].

4. Reduced Government Bond Holdings

The yuan dropped by nearly 3% in early Q2 2022 following strengthening of the United States dollar. Likewise, Protracted Covid-19 restrictions coupled with concerns of economic expansion in

China continued weakening discourse about the yuan. Meanwhile, in the same period, the People's Bank of China (PBOC) declared 1 percentage point in deposit cuts to reach 8 percent. This effectively lowers the level of dissipating pressure on the yuan. Similarly, pundits indicated that the PBOC increased its foreign reserves ratio two times to stem rapid yuan strengthening. Overseas institutions lowered their government-based bond holdings by 21.56 billion yuan with related policy bank bonds recording a drop of 79.59 billion yuan between the close of Q4 2021 and close of Q1 2022. The share of bonds owned by foreign institutions throughout the interbank bond marketplace has decreased to 4.16% at Q1 2022 from 4.41% at Q4 2021. Considering difference in interest rates involving the United States and China has shrunk, if not "inverted," it is logical for foreign institutions to cut their Chinese bond holdings [8].

5. Stable Cross-border Capital Flow

As per the WIND Information's statistics, foreign capital had approximately 2.96 trillion yuan (3.95%) by Q4 2021, while the same had about 2.31 trillion yuan (3.71%) in early Q2 2022 of the circulating market value of A shares. This shows that China's cross-border capital flow remained essentially steady, with some relatively brief rise in capital outflows. Hong Kong permits its currency to trade between 7.75 and 7.85 against the United States dollar. Lately, capital outflows coupled with heavy selling of the HK dollar have driven it near the bottom of that trading zone. The Hong Kong Monetary Authority (HKMA) committed HK\$8.53 billion (\$1.08 billion) in early Q2 2022 towards spurring the local currency in three rounds, being the first intervening since 2019. Forging ahead, the RRR cut is expected to reduce the rate of depreciation of the CNY for the short term, although it would likewise be based upon the wider path of the US dollar as well as the overall perceptions of growth in China. For instance, uncertainties remain high as Shanghai continues to face a long-drawn-out lockdown in addition to fresh Covid-19 cases escalating across Beijing. This comes against the backdrop of new 6.5598-yuan midpoint against the dollar, representing the weakest fixing since last year April.

6. Weakening RMB

Regarding the RMB's exchange rate, the dollar index has risen as a result of the US's rate hike even as the United States' dollar index's economies' relatively lax monetary policy. From start of Q1 2022 through early Q2 2022, the United States' dollar index grew by around 9.2%, while the RMB sank by approximately 6.8%, however the RMB's loss versus the dollar was compared to those of the pound, yen, and euro. If the United States makes another rate hike, the interest rate differential involving them and China would shrink further, raising the likelihood of short-term capital outflows. Nonetheless, China's market indicators remain solid, both in the medium- and long-term. As a result, macroprudential supervision must be implemented throughout the Fed's interest rate raise window to minimize extreme short-term swings in the financial market and to alleviate worries of the RMB swiftly devaluing.

Furthermore, because the epidemic has put negative pressure on the economy and depressed market expectations, it is critical that it be contained as quickly as possible in order to restart regular economic activity, stabilize growth, and increase employment. Furthermore, stable employment and financial markets, a stable currency rate, and sustained growth would mitigate the ripple effects of the United States' rate hikes and reduce financial concerns generated by extreme volatility in asset values.

7. Impact on housing market

Analysts predict that Hong Kong banks would feel the pinch in 3-6 months if their top lending rates remain stable. Considering the US's quicker speed along with the shift in global risk perception, interest rates may rise quicker than normal. First in line to feel the impact will be homebuyers with

their mortgages tied to the Hong Kong interbank offered rate (HIBOR). It normally has a negative impact on house values, that are poised to fall in 2022 through 2023, more so should mainland China investors' demand stay modest.

The Hong Kong authorities announced in early Q2 2022 that it expects indications of recovery in the subsequent 2022 quarters, after the loosening of coronavirus restrictions that slowed the economy in Q1 2022. However, rate rises may weaken the domestic recovery since the increased burden borne by homeowners would cut into their purchasing power. Small and medium-sized enterprises may also face a "very difficult time" if rising interest rates combine with a Covid revival. Hong Kong is still adhering to a softer iteration of China's zero-Covid policy, which has made a significant impact on the city's enterprises.

8. Conclusion

Many experts predict the RMB's exchange rate might hit 7.0 versus the United States dollar by Q4 2022, as the US tightens fiscal system. Among external challenges that China's economic authorities had fore-warned have materialized, with the Federal Reserve in the United States introducing the most significant interest-rate raise in over 20 years, which is predicted to be followed by tighter control measures through 2022. Economists warn, however, that the central bank's assertive endeavor towards taming the strongest inflation in forty years will attract a huge amount of funds back to the United States, assert depreciation strain on the RMB, and effectively limit Beijing's fiscal policy softening, as an essential tool for assisting coronavirus-hit industries and meeting the government's estimated growth target.

In the face of the impact and impact of the U.S. interest rate hike cycle on China's market risks, we should maintain strategic concentration, adhere to self-focus, implement sound macroeconomic policies and prudent micro market management policies through "short-term stability and long-term promotion", consolidate the real economic foundation and regulatory system framework for the smooth operation of China's market, and form a good monetary and financial environment and market investment expectations, It not only solves the risk impact of the US interest rate hike on China's market in the short term, but also forms a stable zone and buffer to deal with market risks in the medium and long term, so as to avoid systemic financial market crisis and ensure the smooth operation and healthy development of China's major markets.

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