The Impact of the Fed Rate Cut on the Chinese Economy

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Abstract: As the world's largest economy, the monetary institution of the United States has a great impact on the global financial market, current account and capital account, economic development and other fields. The US interest rate hike will increase the attractiveness of US dollar assets, and the world capital will gather in the US, and the liquidity of various countries will continue to tighten. The Fed's rate cuts will cause dollar assets to become less attractive and capital to flow into other countries and markets. In the past few decades, the US Federal Reserve has influenced the international capital flow through the operation of raising interest rates and lowering interest rates, and many countries, especially emerging markets, have experienced brief economic booms and sharp fluctuations in financial markets. Therefore, the interest rate cut of the Federal Reserve brings opportunities but also some risks, which need to be studied deeply. Therefore, this paper analyzes the impact of the Fed's interest rate cut on China's economy, hoping to provide useful insights for the development of China's monetary system.

Keywords: Cut Interest Rates; Coping Strategy; Risk and Challenge

1. Introduction

Interest rate hike/interest rate cut usually refers to the behavior of the central bank of a country or region to raise or lower the market guidance interest rate, which transmits the borrowing cost of commercial banks to the central bank to the market interest rate, thereby changing the borrowing cost of the whole society[1]. Generally speaking, higher interest rates will lead to higher borrowing costs and lower private investment, while higher deposit rates will increase the opportunity cost of consumption, which can restrain consumption and lead to an economic slowdown. On the contrary, interest rate cuts will lead to increased investment and stimulate consumption, leading to overheating of the economy[2].

2. The Federal Reserve Begins Its Rate-cutting Cycle

On Wednesday, September 18, 2024, local time, the US Federal Reserve system announced a sharp cut in interest rates by 50 basis points, the first rate cut since the tightening of monetary policy since November 2021, and the target range was lowered to 4.75%-5%. After the outbreak, the United States implemented about $2 trillion in stimulus programs, while the global supply chain disruptions led to rising consumer prices in the United States, and inflation (PCE) growth topped 7.2% (July 2022). In order to curb inflation, the Federal Reserve started the interest rate hike cycle in March 2022, until the last interest rate hike in July 2023, 11 consecutive interest rate hikes in 5 quarters, the cumulative range reached 525 basis points, is the most aggressive interest rate hike cycle in half a century, the fund rate target range increased from 0% to 0.25% to 5.25% to 5.5%. By the time of the cut on September 18, 2024, interest rates had remained high for about 13 months.

2.1 Weak Employment Demand

The Fed's policy focus has shifted from fighting inflation to maintaining employment[3,4]. Although the US unemployment rate in 2024 is stable at around 4%, at a relatively low level, the number of new jobs is significantly lower than market expectations, especially the demand for low-skilled jobs continues to be sluggish. On August 21, 2024, the Bureau of Labor Statistics released a baseline revision of the nonfarm payrolls data, which significantly revised down the total number of nonfarm jobs created between April 2023 and March 2024 by 818,000 (2.9 million to about 2.1 million), the largest decline since 2009. In September 2024, the United States added 254,000 non-farm jobs, 142,000 new jobs in August, lower than the market expectation of 165,000, the new jobs in July was revised down from 114,000 to 89,000, the reliability of the employment growth data is poor, fully showing the current weak labor market in the United States.

2.2 The US Economy has Slowed Down Significantly

On August 5, 2024, the VIX index rose to 38.57, the highest since March 2020, and has been above 20 several times since then. At the same time, although the Federal Housing Finance Agency house price index has climbed to a high of 425.2, but the growth rate continues to slow, from February to July 2024 house price growth fell from 7.1% to 4.5%, the US housing market is losing momentum to continue to rise. On the one hand, mortgage rates are at a high level, with 15-year mortgage rates at 5.25 and 30-year mortgage rates at 6.12% on October 2, which inhibits the ability of American homebuyers to purchase homes and reduces effective demand for commercial real estate. On the other hand, relatively weak housing starts have led to fewer new jobs in related sales and construction, further weakening consumer spending[5].

3. Impact on China's Economy

The Fed's interest rate cut cycle has improved the global liquidity environment and created a complicated situation for China's capital markets. The narrowing of the interest rate differential between China and the United States in the future will provide more room for China to implement active economic policies, and may have the impact of RMB appreciation, international capital inflows and increased foreign exchange reserves.

3.1 There is More Room for Monetary Policy, and There is Much to be Done in fiscal Policy

Since September, a series of monetary and fiscal policies have been introduced in China. Including cutting interest rates, adjusting the interest rate of housing loans, creating monetary policy tools to support the stock market, 2 trillion yuan of state consumption subsidies, and other positive policies that exceed market expectations.

On September 26, China held a meeting to emphasize greater support for the economy, promising stronger fiscal and monetary measures, and introducing policies in the property market, capital market and consumption. In 2008, during the global financial crisis, China launched a 4 trillion yuan government investment stimulus package, equivalent to 1/10 of GDP that year. In the fourth quarter of 2023, an additional 1 trillion yuan of government bonds will be issued, and only 1 trillion yuan of ultra-long-term special government bonds will be issued in 2024. Compared with the GDP of 123 trillion yuan in 2023, there is still room for large-scale financing by using government bonds. There is room for strong fiscal policies in the areas of sending home appliances to the countryside, cars to the countryside, education subsidies, maternity subsidies, cheap public housing, renovation of old residential areas, and new infrastructure[6].

3.2 The Stock Market Increased Significantly

The People's Bank of China announced on October 10 that it had decided to create the Securities, Funds and Insurance companies Swap Facility (SFISF). Support qualified securities, funds and insurance companies to exchange bonds, stock ETFs, CSI 300 constituent stocks and other assets as collateral from the People's Bank of China into high-level liquid assets such as government bonds and central bank bills. This is the first time that the central bank has set up a structural policy tool to support the capital market, and the funds it obtains can only be used to invest in the stock market. The liquidity of bonds, stock ETFs and other assets held by institutions is poor. Through the convenience of swap, the liquidity of assets can be significantly improved, and the ability of institutions to obtain funds and increase their stock holdings can be improved.

The Fed launched the Term Securities Lending Facility (TSLF) during the 2008 financial crisis to auction Treasury securities to and from dealers in order to boost liquidity in the market for Treasury bonds and other collateral. The facility was first launched on March 27, 2008. It closed on February 1, 2010 and lasted for about 22 months. The Primary Dealer

Credit Facility (PDCF), set up by the Federal Reserve during the COVID-19 pandemic to allow primary dealers to borrow from the Fed against securities (including commercial paper) and equity, begins on March 20, 2020 and ends on March 31, 2021. It lasted 12 months. These policies have effectively improved the liquidity of securities, boosted the stock market, and bought more time for subsequent new policies.

The active macro policies of the decision-makers reflect the firm attitude of supporting the economy, enhance the confidence of many investors in economic development, and the market risk appetite rises rapidly[7]. From September 19 to October 8, the stock market soared one after another. The Shanghai index rose from the closing price of 2717.28 points on September 18 to the closing price of 3301.93 points on October 10, a cumulative increase of 19.93% in 12 opening days.

On October 5, Goldman Sachs upgraded the Chinese stock market to "overweight" in its latest report, estimating that there is 15%-20% more room to rise: the price-to-earnings ratio has risen from about 8 times in early September to 11 times, close to the high of January 2023, when the Chinese economy began to fully restart after the COVID-19 pandemic.

3.3 Increasing Pressure on RMB Appreciation Has Affected the Competitiveness of Export Commodities

The Federal Reserve opened the monetary easing cycle based on a 50 basis point sharp interest rate cut, and the dollar index fell significantly, from 106.8 at the end of January 2024 to around 100.29 at the end of September 2024. In the third quarter, the yuan performed strongly. As of the close of September 30, the offshore yuan rose 2900 basis points, or about 4%, against the US dollar. According to the cumulative rise of RMB against the US dollar of more than 2500 basis points, an increase of about 3.44%. Although the US dollar index has recovered since October, and the central parity rate of the RMB exchange rate was reduced by 635 basis points to 7.0074 yuan on October 8, it is only a technical correction for the rapid decline of the US dollar index. From a long-term perspective, after the US dollar interest rate cut cycle, the RMB exchange rate will be a trend of rising volatility.

In the first half of 2024, China's total export value was 12.13 trillion yuan, a year-on-year growth of 6.90%, further continuing the growth momentum. In the export, the value of mechanical and electrical products was 7.14 trillion yuan, accounting for 58.90% of the total export, these products have high added value, capital and technology intensive, strong bargaining power, and are less affected by the RMB exchange rate; However, China's labor-intensive products account for 17.10% of exports, and will be under greater pressure in the Fed's interest rate cut cycle. In addition, the appreciation of the yuan for foreign trade enterprises is a positive, dollar-denominated debt will be reduced.

4. Increased Capital Inflows Have Helped Industrial Upgrading

According to the Ministry of Commerce, China's actual use of foreign capital in the first half of 2024 was 498.91 billion yuan, down 29.1% year-on-year. This does not mean that China is less attractive to foreign investment, the actual use of foreign investment in 2022 more than 1.2 trillion yuan, the high base is the main reason for the actual use of foreign investment in the first half of 2024, which is still at the highest level in nearly a decade. Moreover, the investment introduction of high-tech manufacturing industry and manufacturing industry both increased by 2.4 percentage points year-on-year, indicating that foreign investors actively optimize the investment structure and bring more high-quality capital to our country. At the same time, in the first half of the year, nearly 27,000 new foreign-funded enterprises were established, an increase of 14.2% year-on-year, continuing the trend of rapid growth of newly established foreign-funded enterprises since 2023.

The influx of external high-tech investment and internal positive economic policies can significantly promote the endogenous driving force of China's economic growth, accelerate the formation of new quality productivity, and develop rapidly in emerging industries such as new energy vehicle manufacturing, lithium batteries, photovoltaic manufacturing, and intelligent robots[8,9]. From January to August 2024, the output of new energy vehicles was 7.008 million, an increase of 29% year-on-year;

The national output of solar cells (photovoltaic cells) was 369.94 million kilowatts, an increase of 12.6%; The cumulative production of service robots was about 674.4466 million tons, an increase of 25.4% over the previous year.

5. Policy Implications

5.1 Strengthen Risk Management and Optimize Monetary Policy

On the one hand, China should strengthen the prevention of financial market risks, significantly improve the capital strength of financial institutions through government injection, merger of small and medium-sized financial institutions, and absorption of small institutions by large institutions, so as to effectively cope with the impact of international capital flows[10-12]. The financial regulatory authorities should also strengthen supervision, order relevant institutions to optimize the asset structure, maintain reasonable liquidity, and operate prudently in compliance, so as to effectively enhance the stability of the financial system. On the other hand, it is necessary to introduce targeted fiscal policies and monetary policies, including fiscal means such as consumption subsidies, local debt, education subsidies, and monetary tools such as central bank reloans, capital market reloans, and special national bonds, to turn risks into opportunities and boost China's economic transformation and upgrading.

5.2 Promote the Internationalization of RMB and Maintain Exchange Rate Stability

On the one hand, it is necessary to steadily and solidly promote the internationalization of the RMB, build a good policy environment and market environment for domestic and foreign entities, and strive to enhance the competitiveness and influence of the RMB in the global market[13,14]. We will continue to deepen work on local currency swaps, building an offshore RMB market, and building overseas infrastructure for the digital RMB to lay a sound foundation for the basic and institutional arrangements for the RMB. On the other hand, faced with the pressure of exchange rate fluctuations caused by the US Federal Reserve's interest rate cut and the depreciation of the US dollar, we should continue to strengthen the monitoring and analysis of cross-border capital flows and real-time early warning, maintain flexible monetary policies and foreign exchange management mechanisms, and maintain the overall stability of the RMB exchange rate.

5.3 Deepen International Cooperation and Improve International Competitiveness

The US Federal Reserve rate cut cycle, the Sino-US economic decoupling, the Russia-Ukraine conflict, the Middle East war, the fourth technological revolution, the world economy is full of uncertainties, China needs to deepen international cooperation, do not give up all opportunities to pursue world peace and development, strive to achieve external security and internal stability, and maintain the smooth operation of the economic and financial system[15,16]. In the context of global monetary policy easing, Chinese enterprises should improve their international competitiveness, strive to climb up the value chain, create their own irreplaceable advantages, in order to maintain an invincible position in international competition.

6. Conclusion

To sum up, the US interest rate cut has had a complex impact on China's economy and finance, and while there are many positive aspects, we need to pay more attention to risks and challenges, especially efforts in optimizing monetary policy, maintaining exchange rate stability and enhancing the international competitiveness of the RMB.

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