The Impact of the Federal Reserve's Interest Rate Cuts on the China's Financial Development

Zhang Shuhan, Shanghai Customs University, School of Customs and Public Administration (Shanghai, China)
student;
e-mail: zhangshuhan1031@163.com

Academic Supervisor:
Elena V. Zhiryaeva, North-West Institute of Management of the Russian Presidential Academy of National Economy and Public Administration; Department of Economics (Saint Petersburg, Russian Federation)
Professor of the Department, Doctor of Economics Sciences, Associate Professor;
e-mail: zhiryaeva-ev@ranepa.ru

Abstract
The article investigates the impact of the Federal Reserve's interest rate cut in September 2024 on China's financial development, especially policy adjustment in the context of slowing economic growth. The article primarily employs such methods as historical data analysis, policy analysis, capital flow analysis, and exchange rate impact analysis. The paper investigates the impact of the Fed's interest rate cut on RMB exchange rate, capital flows and foreign exchange reserves, and also analyses the specific impact on China's stock market and foreign exchange market. By using historical and financial market data in 2024, the direct impact of the interest rate cut on the stock market and exchange rate is assessed, and the risks caused by increased capital liquidity are discussed. The paper concludes that interest rate cuts can attract capital inflows and push up asset prices in the short term, but they also increase market volatility. The RMB exchange rate has been facing upward pressure, and foreign exchange reserve management has encountered challenges. China should strengthen financial market risk management and maintain the flexibility of monetary policy and exchange rate management to cope with the new opportunities and challenges caused by global monetary policy changes and ensure economic and financial stability.
Keywords: Interest Rate; Financial Development; Exchange Rate; Capital Flows; Market Volatility; Economic Stability.

Влияние снижения процентных ставок Федеральной резервной системой

Чжан Шухань, Шанхайский таможенный университет, Школа таможенного дела и государственного управления (Шанхай, Китай)
студент;
e-mail: zhangshuhan1031@163.com

Научный руководитель:
Жиряева Елена Васильевна, Северо-Западный институт управления Российской академии народного хозяйства и государственной службы при Президенте Российской Федерации; кафедра экономики (Санкт-Петербург, Российская Федерация)
профессор кафедры, доктор экономических наук, доцент;
e-mail: zhiryaeva-ev@ranepa.ru

Аннотация
В статье исследуется влияние снижения процентной ставки ФРС в сентябре 2024 года на финансовое развитие Китая, особенно корректировку политики в контексте замедления экономического роста. Автор в основном использует ряд методов, таких как анализ исторических данных, анализ политики, анализ потоков капитала и анализ воздействия обменного курса. В статье исследуется влияние снижения процентной ставки ФРС на обменный курс юаня, потоки капитала и валютные резервы, а также анализируется конкретное влияние на фондовый рынок и валютный рынок Китая. С помощью исторических данных и данных финансового рынка в 2024 году оценивается прямое влияние снижения процентной ставки на фондовый рынок и валютный курс, а также обсуждаются риски, вызванные повышенной ликвидностью капитала. В статье делаются следующие выводы: снижение процентной ставки может привлечь приток капитала и подтолкнуть цены на активы в краткосрочной перспективе, но оно также увеличивает волатильность рынка. Обменный курс юаня сталкивается с давлением повышения, а управление валютными резервами — с проблемами. Китаю следует усилить управление рисками на финансовом рынке и сохранить гибкость денежно-кредитной политики и управления валютным курсом, чтобы справиться с новыми возможностями и вызовами, вызванными глобальными изменениями денежно-кредитной политики, а также обеспечить экономическую и финансовую стабильность.
Ключевые слова: процентная ставка; финансовое развитие; курс; потоки капитала; волатильность рынка; экономическая стабильность.

1. INTRODUCTION

The Federal Reserve's monetary policy adjustments have profound and far-reaching effects on global financial markets, particularly on emerging economies that are closely tied to U.S. capital flows and exchange rate dynamics. In September 2024, the Federal Reserve initiated an interest rate cut[1], marking a shift from its previous tightening cycle aimed at curbing inflation. Prior to this rate cut, in order to combat soaring prices, the Federal Reserve had raised the benchmark interest rate to 5.5% through 11 rate hikes, and inflation fell from a peak of 9.1% in June 2022 to 2.5%[1]. This policy change represents a new phase in global monetary policy, influencing capital allocation, exchange rate stability, and investor sentiment on a global scale.

Historical trends suggest that U.S. rate cut cycles have led to notable fluctuations in global asset prices, capital flows, and currency valuations. For instance, past rate cut cycles in 2001–2003, 2007–2008, and 2019–2020 demonstrated initial downturns in the U.S. stock market, followed by eventual recoveries as liquidity conditions improved. These patterns highlight the significant impact of U.S. monetary policy on global financial markets, including emerging economies such as China.

The influence of U.S. monetary policy on China's financial sector can be understood through several key factors. First, as the world's largest economy, the U.S. serves as a benchmark for global interest rates and financial stability, shaping cross-border capital flows. Second, the U.S. dollar's status as the dominant global reserve currency affects trade balances and international investment decisions. Third, China's increasing integration into global financial markets exposes it to external monetary fluctuations, amplifying the spillover effects of U.S. policy shifts.

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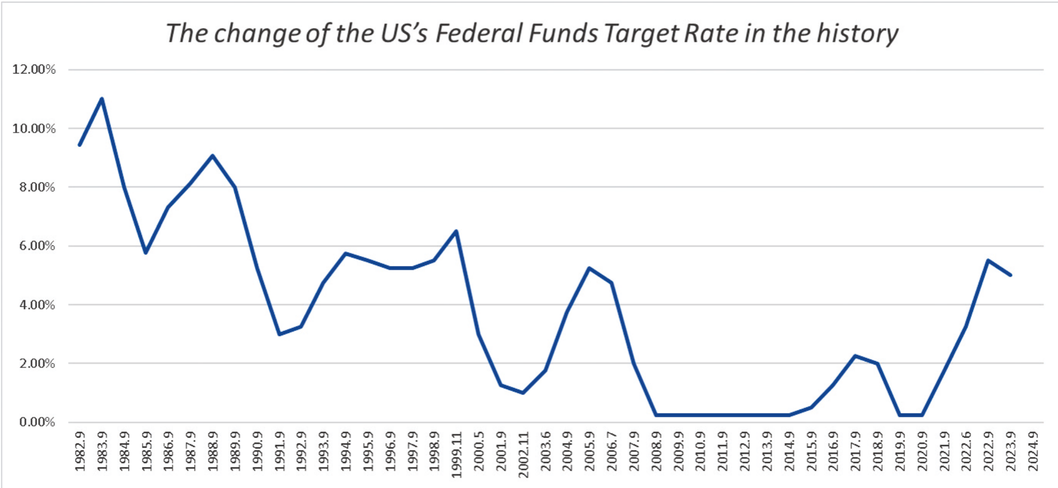
1 Указ Federal Reserve Announcement on September 18, 2024. URL: https://www.federalreserve.gov/newsevents/pressreleases/monetary20240918a.htm (Visit date: 20.09.2024.)

Figure 1: The change of the US's Federal Funds Target Rate in the history[2]



Drawn by the author

Based on historical evidence and market responses, the Federal Reserve's 2024 rate cut is expected to have significant implications for China's financial development. Specifically, its impact will be observed in three key areas: exchange rate dynamics, capital flows, and foreign exchange reserves. The RMB exchange rate may face appreciation pressure, potentially weakening the competitiveness of China's exports and increasing the operational costs for enterprises. Additionally, the rate cut could attract international capital inflows into China, temporarily boosting asset prices while also heightening financial market volatility. Lastly, the depreciation of the U.S. dollar may introduce risks related to fluctuations in the value of China's U.S. dollar-denominated assets, complicating foreign exchange reserve management.

The following sections will analyze the specific transmission channels through which the Fed's rate cut impacts China's financial development. These include capital flow dynamics, exchange rate adjustments, and the policy responses necessary to manage associated risks and leverage potential benefits.

2. METHODS

This study uses a multi-dimensional approach to analyze the impact of the Fed's September 2024 interest rate cut on China's financial development. The methods used in this study include historical data analysis, policy analysis, capital flow analysis, and exchange rate impact analysis. The following sections provide details on the specific methods used in each research area.

1. Historical Data Analysis

Historical data analysis involves studying past interest rate cuts by the Fed and their subsequent impact on the US and global economies, with a particular focus on stock market

[2] Source: Fed's interest rate history: The federal funds rate from 1981 to the present. URL: https://www.bankrate.com/banking/federal-reserve/history-of-federal-funds-rate/ (Visit date: 06.12.2024.)

Source: Federal Funds Rate History 1990 to 2024. URL: https://www.forbes.com/advisor/investing/fed-funds-rate-history/ (Visit date: 06.12.2024.)

performance and economic indicators. This approach provides a comparative context against which the impact of the current interest rate cut can be assessed.

2. Policy Analysis

Policy analysis seeks to understand the Fed's monetary policy decisions and their impact on China's financial sector. This includes reviewing official statements, policy documents, and academic literature to explain the policy's intentions and potential outcomes.

3. Capital Flow Analysis

Capital flow analysis involves tracking international capital flows following an interest rate cut. The approach uses financial market data, including stock indices and foreign direct investment statistics, to measure capital inflows and outflows and their impact on China's financial markets.

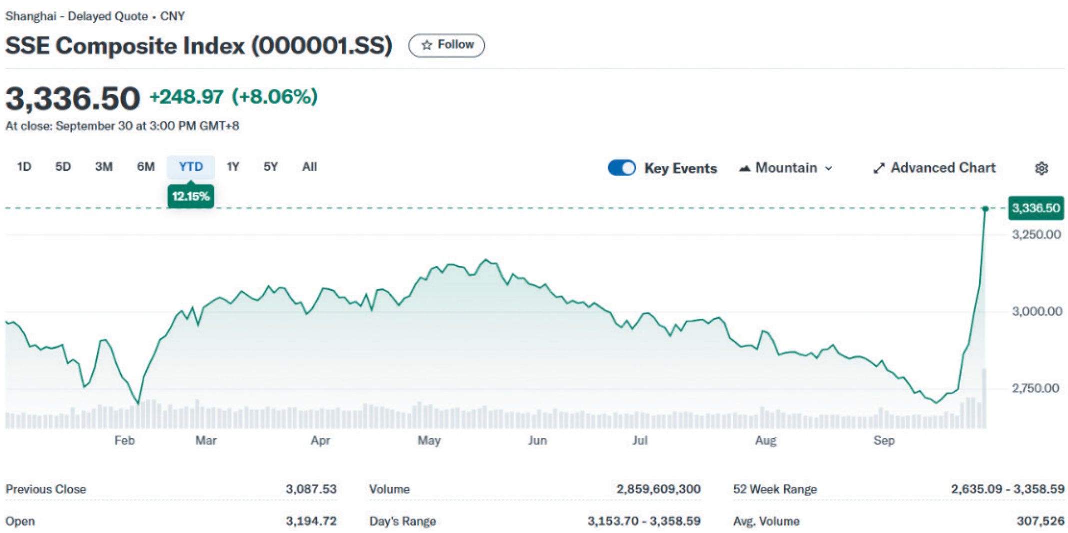
4. Exchange Rate Impact Analysis

Exchange rate impact analysis focuses on the impact of interest rate cuts on the RMB/USD exchange rate. The approach uses foreign exchange market data, including historical exchange rates and current market trends, to assess potential appreciation or depreciation pressure on the RMB.

3. RESULTS

Financial development is the process of expanding the scale of financial transactions and upgrading the financial industry, leading to a continuous improvement in financial efficiency[2]. Stock market the foreign exchange market is an important part of the financial market, so we have selected some data from China's stock market and foreign exchange market since 2024 to illustrate the impact of the Federal Reserve's rate cut on the development of China's financial industry.

Figure 2: Shanghai Composite Index YTD. (Shows the index trend for the past 9 months)[3]



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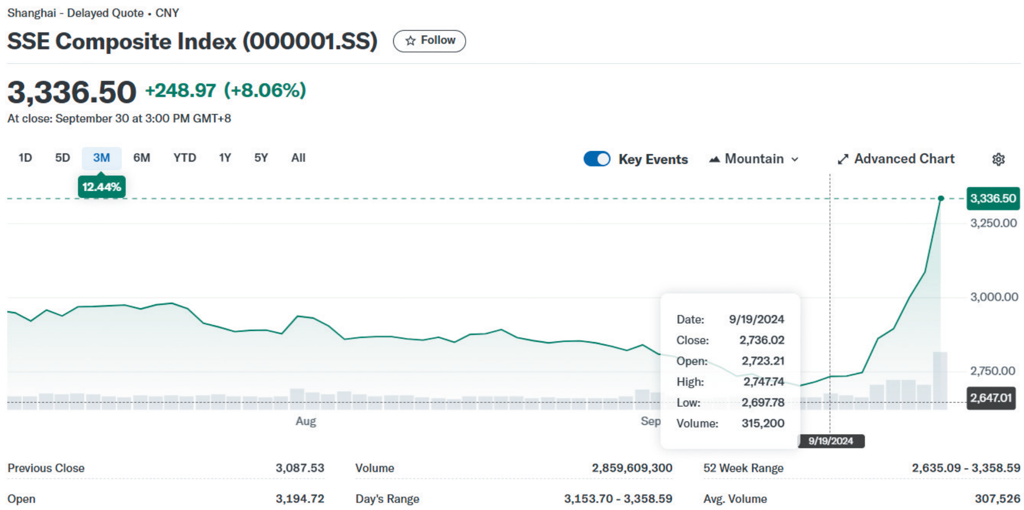
3 Source: YAHOO FINANCE. URL: https://finance.yahoo.com/quote/000001.SS/ (Visit date: 20.09.2024.)

Figure 3: Shanghai Composite Index: 3M. (Shows the index trend for the past 3 months)[4]



1. The impact of the Fed rate cut on China's domestic stock market.

From the perspective of capital flows, the Fed's interest rate cut will also help ease external pressure on emerging market economies and boost risk appetite [3].

Data on China's A-shares show that on September 19, after the Federal Reserve announced a 50 basis point interest rate cut, the three major A-share indices bottomed out and rebounded in the morning. As of the close of the day, the Shanghai Composite Index rose 0.59 %, the Shenzhen Component Index rose 1.25 %, and the ChiNext Index rose 0.99 %. From the market perspective, the big consumer sector performed well, with liquor, dairy and other sectors leading the gains [4].

We can find from the above, the Shanghai index since September 19, 2024, both volume or gains, ushered in the larger gains, the cause of this situation must contain multiple aspects, I think one of the reasons is that after the Federal Reserve's capital overflow, part of the American capital is optimistic about the Chinese stock market and is willing to invest. For example, Goldman Sachs showed strong investment interest in China after the Fed cut interest rates and further purchased Chinese assets. Its analyst Lau believes that "Chinese stocks are still trading at a valuation discount to other benchmarks[5]. "In addition, China's stock market has been slightly weak since May 2024, and the stock value of various enterprises is low, which more attracts foreign capital to invest. Before the fed to cut interest rates, China's domestic central bank has lower deposit rates, deposit rates in China into the era of 1 %, and the entry of foreign capital in China's domestic stock market caused a chain reaction, ignited the passion for stock investment, China's stock market into the "bull market", ushered in the wave shown in the figure 3. On the last trading day before China's October 1 holiday (September 30, 2024), the trading volume even exceeded RMB 2.6 trillion, which was in sharp contrast to July 30, when the single-day trading volume was only around RMB 500 billion.

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[4] Source: YAHOO FINANCE. URL: https://finance.yahoo.com/quote/000001.SS/ (Visit date: 20.09.2024.)

[5] Source: Why China's stock market may be poised for further gains. URL: https://www.goldmansachs.com/insights/articles/why-chinas-stock-market-may-be-poised-for-further-gains (Visit date: 6.12.2024.)

Figure 4: The RMB against the US dollar is 3M. (Shows the price trend for the past 3 months)[6].

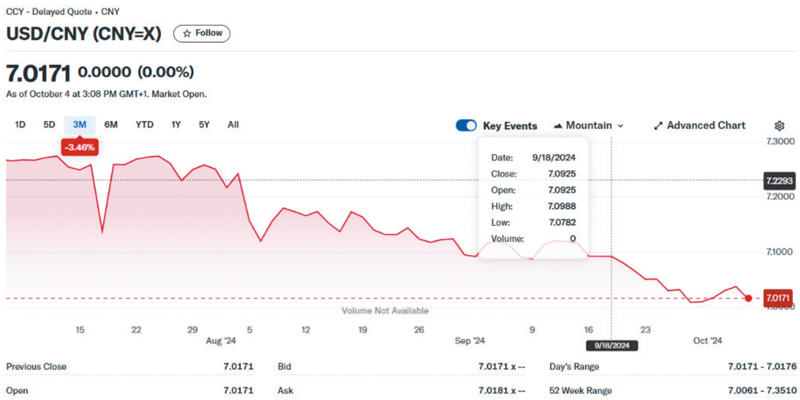

Figure 5: RMB / USD exchange rate YTD. (Shows the price trend for the past 9 months)[7]

2. The impact of the Fed rate cut on China's foreign exchange market.

The Fed's interest rate cut has eased the depreciation pressure on the RMB, and there has been a certain appreciation since August 2024. As the United States enters an interest rate cut cycle in the future, the interest rate gap between China and the United States will further narrow. Under the premise that other conditions remain unchanged, such as trade frictions not significantly escalating, geopolitics becoming stable, and the domestic economy continuing to recover, The exchange rate of the RMB against the US dollar will be relatively easy to maintain within a stable range, thus supporting Sino-US trade in the future [5].

In the foreign exchange market, the Fed rate cut causes the development of China's foreign exchange market: first, the economic recovery will be further consolidated and strengthened; second, the balance of payments will continue to remain basically stable; third, the construction of the foreign exchange market has made great progress.

On the micro level, the recent foreign exchange market supply and demand is more balanced. According to the foreign exchange data released by the SAFE, the cross-border payments of enterprises and banks such as enterprises and individuals have changed from a previous deficit to a surplus of us $15.3 billion in August [6]. At the same time, in recent years, the

[6] Source: YAHOO FINANCE. URL: https://finance.yahoo.com/quote/CNY=X/ (Visit date: 20.09.2024.)
[7] Source: YAHOO FINANCE. URL: https://finance.yahoo.com/quote/CNY=X/ (Visit date: 20.09.2024.)

resilience of China's foreign exchange market has been increasing, and the hedging rate of enterprises and the proportion of cross-border RMB settlement have increased significantly. Market participants are more rational in the face of exchange rate changes, which helps to reduce the possibility of large exchange rate fluctuations.

4. DISCUSSION

The Fed's interest rate cut is a "double-edged sword" in economic fluctuations. On the one hand, increased economic activity can create more jobs and promote moderate inflation when the inflation rate is below the target. On the other hand, interest rate cuts may also bring some potential risks and may stimulate the formation of asset bubbles [7].

China's financial market volatility has increased. The loosening of US monetary policy may lead to an increase in global capital liquidity, which may attract more hot money to flow into my country's financial market, and the financial market will face huge uncertainties [8].

Interest rate cuts usually bring about expectations of a depreciation of the US dollar, pushing up asset prices in China's domestic market, and interest rate cuts may drive local economic growth in the short term. However, the volatility of capital flows also brings risks. Once there is greater uncertainty in the global economy or a rebound in the US economy, capital may quickly withdraw from the Chinese market, causing violent fluctuations in domestic financial markets. Therefore, when facing the opportunities brought by interest rate cuts, China's domestic financial markets must also be vigilant about the short-term flow of speculative capital.

At the same time, the depreciation of the US dollar caused by interest rate cuts also increases the risk of competitive depreciation of global currencies. In response to the depreciation of the US dollar, some countries may adopt similar monetary easing policies to maintain the competitiveness of their currencies, forming a "competitive depreciation" situation, and the volatility of global exchange rates may increase.

With the Fed's interest rate cut, my country's monetary policy environment may face the following changes: First, the interest rate gap between China and the United States will narrow and my country's capital outflow pressure may be alleviated to a certain extent. In addition, the US dollar index will weaken after the interest rate cut. It is expected that the RMB exchange rate will stabilize and rebound. The pressure of stabilizing the exchange rate will gradually ease the constraints on the loose monetary policy orientation, and there may be more room for loose monetary policy in the future. Since the beginning of 2024, the People's Bank of China has successively adopted policies such as changing the monetary policy anchor, Loan Prime Rate(LPR) reform, and establishing a temporary interest rate corridor. Subsequently, it has further reduced the capital cost of the real economy through measures such as lowering the reserve requirement ratio and interest rates, which is conducive to the continuation of the economic recovery[9]. Loan Prime Rate(LPR) is a basic reference loan rate calculated and announced by the National Interbank Funding Center authorized by the People's Bank of China, based on the loan interest rates of the most high-quality customers of each quoting bank, in the form of open market operation interest rate plus points[10]. Second, with the appreciation of the RMB, the pressure of economic recession in the United States has increased, and the pressure on the export side is expected to rise, while the recovery of domestic demand cannot be achieved overnight. It is expected that the need to strengthen countercyclical regulation will remain high, and it will still be necessary to increase the use of loose monetary tools in the future.

5. CONCLUSIONS AND RESPONSE RECOMMENDATIONS

5.1. Conclusions

The findings from this analysis highlight the substantial impact of the Federal Reserve's 2024 interest rate cut on China's financial markets. The primary conclusions include:

Increased Capital Inflows with Elevated Market Volatility: The rate cut has facilitated greater capital inflows into China, leading to a temporary boost in stock market performance. However, the influx of speculative capital has also heightened financial market volatility.

RMB Appreciation and Export Competitiveness Challenges: The depreciation of the U.S. dollar has placed upward pressure on the RMB, potentially reducing China's export competitiveness and exacerbating trade balance uncertainties.

Foreign Exchange Reserve Management Complexity: Changes in U.S. monetary policy influence the valuation of China's U.S. dollar-denominated assets, complicating foreign exchange reserve management and increasing exposure to currency fluctuation risks.

5.2. Recommendations

Strengthening Financial Market Stability Measures: China should enhance regulatory oversight and risk mitigation frameworks to manage increased capital inflows and reduce speculative market activity.

Implementing Adaptive Monetary Policies: Policymakers should maintain flexibility in monetary policy to counteract exchange rate fluctuations and sustain macroeconomic stability. Targeted interventions in the foreign exchange market may be required to alleviate excessive RMB appreciation.

Diversifying Foreign Exchange Holdings: Reducing dependence on U.S. dollar-denominated assets by incorporating other stable currencies and commodities in foreign exchange reserves can help mitigate risks associated with U.S. monetary policy shifts.

Advancing RMB Internationalization Efforts: Expanding the global use of the RMB can decrease reliance on the U.S. dollar, improving China's resilience to external monetary policy changes.

Stimulating Domestic Investment and Economic Growth: To counterbalance external financial volatility, China should promote domestic capital investment, particularly in technology, infrastructure, and emerging industries.

By implementing these strategic measures, China can enhance its financial stability, mitigate risks associated with global monetary shifts, and capitalize on new opportunities arising from changes in international capital flows.

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