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The Impact of Interest Rate Hikes on the Capital Markets

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Abstract: As the COVID-19 pandemic continues to spread globally, the economic situation of countries has captured significant attention. The resulting inflation has prompted countries to implement monetary policies to stabilize economic activity. As the leading economic power in the world, the United States has a significant influence on the global economy. This study aims to analyze the interest rate hike policy implemented by the United States, its plan and purpose, and its social impacts. Comparative analysis is used to examine the interest rate policies of China and the European Union, two significant trade partners with which the United States has a positive commercial relationship. Also, this paper further analyzes the domestic effects of the trading partners of the interest rate policy. It is found that both the US and the EU have also implemented the policy of interest rate hikes, whereas China has implemented the policy of interest rate cut. The different policy decisions are related to the extent of economic recovery after the pandemic, the political context, and the cultural background of each country.

Keywords: Interest Rate, Monetary Policies, Financial Stability

1. Introduction

The arrival of the COVID-19 virus has not only posed new challenges to healthcare systems worldwide, but it has also prompted a significant worldwide economic upheaval. The COVID-19 pandemic precipitated a significant downturn in global economic dynamics, characterized by acute disruptions in both developed and emerging markets due to extensive lockdown measures. It led to a marked contraction in global GDP, trade activities, and employment, compounded by diminished consumer expenditure and corporate investment amid pandemic-induced uncertainties [1]. During the COVID-19 pandemic, the governments implemented a lockdown to control the spread of the virus. Most people were forced to change their work and lifestyle to work remotely from home. The situation is even more difficult for those who need help to work remotely. Many industries, especially tourism and the food-service industry, have reached a standstill because of the lockdown and changes in consumer behavior. It has led to many layoffs, and many people have unfortunately lost their jobs. The unemployment rate rose sharply in a short period of time, which has brought a heavy blow to the economies of various countries. In response to the recession, many countries increasingly focus on inflation as a key strategy to stimulate economic recovery. The annual inflation rate in the United States in May 2022 reached the highest since 1981. The inflation surge is not just happening in the United States but also in 44 advanced economies. These countries have experienced significant

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consumer price rises since before the pandemic. Dealing with inflation, which Americans consider the biggest national problem, has become the key domestic focus [2].

To understand in detail how the government is responding to the challenge of inflation, it is necessary to look at monetary policy. Inflation usually occurs with increased prices, which makes the cost-of-living rise. The instability can lead to an inability of consumers and businesses to predict future trends, which affects economic development. Therefore, governments and central banks, such as the U.S. Federal Reserve and the European Central Bank, step in to stabilize the economy and prices by controlling inflation through monetary policy. Contractionary monetary policy, used by central banks like the US Federal Reserve, aims to decrease inflation by slowing down economic activity by reducing the nation's money supply. The approach is typically employed when inflation exceeds its target rate, indicating that the economy may be overheating, necessitating measures to moderate the price increase for goods and services [3]. Controlling interest rates has become a frequently-used tool adopted by almost every country. This paper examines the interest rate implemented by countries, particularly the United States, in response to high inflation rates during the COVID-19 pandemic. Throughout the analysis of articles and cases, this paper is especially intended to understand the plans and purposes of the interest rate hike policy in the United States. This paper assesses the positive and negative impact of raising interest rates in the United States during the COVID-19 pandemic. Besides that, this paper also briefly analyzes the measures taken by the European Union and China in case of high inflation.

2. The Impact of Fed’s Interest Rate Hikes on the U.S. Markets

The COVID-19 crisis caused a quick contraction in the U.S. economy, but later, the economy recovered faster than the target. The U.S. government had to step in because if the situation continued as it did, the nation's economy would be in serious trouble. Thus, the first thing is to understand the reason why people do not like inflation. The presence of inflation implies a decrease in people's purchasing power. For example, ten years ago, people could buy a gallon of milk for about three dollars. But in recent years, people have to spend four dollars to buy a gallon of milk. The price difference is an indication that inflation is occurring. So, society will experience great stress if the price gap increases and consumers are forced to pay more for a product, such as a gallon of milk.

The second step is to comprehend how the central bank of the United States, the Federal Reserve, intervened and reduced inflation. Influencing interest rates is the Fed's primary tool for reining in inflation. Known as the federal funds rate, the Fed's benchmark rate is subject to change in response to economic conditions. The federal funds rate influences a bank's or other financial institution's borrowing costs, which then impacts companies and individuals [4]. There needs to be more supply compared to demand during inflation, which means that while consumer demand for commodities grows, the market cannot meet their needs. The Federal Reserve primarily manipulates interest rates to limit consumer demand for products by gradually decreasing consumer demand for commodities. When the Federal Reserve raises the benchmark interest rates, borrowing becomes more expensive than before because companies or individuals will think twice before spending or borrowing money. The Federal Reserve initially viewed the inflation surge during 2021 as a transient effect of the COVID-19 recovery and delayed taking action. However, as inflation persisted, they acknowledged their mistake and aggressively raised interest rates in March 2022. Despite these measures, inflation continued to rise, prompting the Fed to intensify its response, even though it risked triggering a recession by significantly slowing down the economy [4]. According to the data, the Federal Reserve has increased interest rates 11 times since 2022. Before the pandemic, roughly from 2015 through 2018, the Federal Reserve was very cautious in its rate hikes, with the federal funds rate almost always in the target range of 2% or so. But after the Fed announced the rate hike, the federal funds rate exceeded its target of 2%, surging straight to 5% [5].

Regarding inflation, from 2015 to 2018, the Consumer Price Index—one of the most widely used measures—ran between 0% and 3%. On the contrary, when the Federal Reserve announced an interest rate hike, the Consumer Price Index in the United States began to rise gradually, even reaching a maximum of 9%. Although the CPI gradually declined after 2022, it was still above 3% [6]. There is a close correlation between interest rate adjustments and inflation rates. After comprehending the economic circumstances, it is critical to understand the influence of interest rate rises on different sectors of society because it is closely related to people's lives.

From a consumer perspective, the escalation of interest rates will significantly influence their purchasing decisions. Borrowing is a common way for households to pay for expenses, particularly when it comes to housing, services, nondurables, and durables. With lowering interest rates and easy access to credit playing major roles in family consumption, credit has become an essential component of modern economies in industrialized nations. Whereas lower interest rates promote consumption, higher rates discourage it. With its continued growth anticipated, credit has emerged as a critical component of contemporary economies [7]. Nowadays, almost everyone has a credit card. The rise in interest rates means that the debt each person has to pay off is much higher than before. For this reason, consumers are spending less today.

From workers' perspective, they are most concerned about how changes in interest rates affect the job market. Interest rates are not only an indicator of the economy; they may also have a significant effect on employees' earnings and career paths. Ofer et al. investigate the connection between unemployment and interest rate spread. They contend that an increase in interest rates causes businesses to make less money, increases the cost of capital per employee, and raises unemployment rates. Moreover, higher interest rates make working capital more expensive, raising the expense of opening positions and unemployment rates. The reluctance of businesses to take on new workers in the case of bankruptcy might exacerbate the correlation between unemployment and interest rate spread [8]. Increasing interest rates not only reduces consumer spending but also reduces companies' investment. The impact on business investment also indirectly affects the career of the employees. Many North American companies have made layoffs between 2022 and 2023, including well-known companies such as Amazon and Google. The issue of layoffs in real life reflects the negative impact of increasing interest rates on the job market.

Furthermore, an adjustment in interest rates also has significant implications for the stock market and banking sector. Stock price volatility is the factor that matters most to investors in the stock market. Investors investment returns will likewise fluctuate in tandem with changes in stock prices. Numerous research in the literature concludes that there is a negative correlation between interest rates and stock returns [9]. While an increase in interest rates stimulates more savings in banks, which lowers the flow of capital to the stock markets, a fall in interest rates results in more capital flows to the market and higher projected rates of return [9]. Therefore, when the U.S. policy of raising interest rates is implemented, stock prices become less optimistic, and investors' expectations of future returns become lower because they feel that the current returns will be higher than the future ones. When interest rates rise, some investors will sell their stocks; if they decide to hold on to these stocks, their returns will decline. Thus, investors would prefer to save rather than face continuous investment losses. A large number of deposits will flow into banks. Even though there was a large inflow of deposits into the banks, it did not stop some of them from collapsing recently, such as the Silicon Valley Bank, which was the worst outcome. The Silicon Valley Bank witnessed substantial expansion during the pandemic, with tech businesses using it for payroll and business expenditures. The bank's failure, however, was linked to its substantial investment in long-dated U.S. government bonds, which lost value because of the Federal Reserve's rapid rate hikes. As the economy deteriorated, many clients drew on their savings, forcing SVB to sell certain bonds at significant losses, resulting in a brief collapse [10]. An upsurge in interest rates promotes earnings, but the attendant cost significantly reduces the current economic value of equities. The risk associated with interest rates rose significantly throughout the pandemic [11]. Like investors in the stock market, bank customers withdraw their money from the bank when they realize that the bonds they have purchased have become worthless due to fluctuating interest rates. When the bank's savings are not enough to keep the banking system working, the result is a move towards failure.

3. The Impact of Fed’s Interest Rate Hikes on Other Markets

As a prominent economic force and global leader, the policies and decisions taken by the United States also have an impact on other economies, such as the European Union and China.

As US interest rates rise, foreign capital seeks to invest in the US, which causes the dollar to gain value and the euro to weaken. The depreciation of the euro has an impact on the economic development of Europe by driving down the cost of European goods in the US and boosting exports and GDP growth. The need for European businesses to pay in US dollars for foreign inputs and raw materials, however, forces them to spend more on imports, which raises production costs and lowers GDP and employment. Also, when consumers' spending power declines, so does the demand for consumer products in Europe, further lowering GDP and employment. Furthermore, this situation can pressure the European Central Bank (ECB) to hike interest rates, which might hurt the EU's economy [12]. The European Union and the United States are the most significant commercial partners due to globalization and have a tight working relationship. Accordingly, when a company in one nation has modified its strategy due to domestic policy, the company in the other nation is likewise impacted. After the US announced an interest rate hike, the EU followed suit shortly after. The EU has also announced consecutively 10 times for interest rate increase since 2022. The consequences of interest rate increase in the US and the EU are similar since both countries have the same target of curbing inflation and lowering investment and spending. Lower bond prices, greater cost of borrowing, and increased bank deposits is among the repercussions facing the European Union member countries. The euro has also increased in value due to the recent interest rate hike.

Even though the United States and China are each other's most significant trading partners, China has chosen to cut interest rates, which is a radically different approach from the United States. Despite a delayed recovery from the lockdown and supply chain obstructions during the pandemic, Chinese commercial banks have lowered interest rates to spur economic development. With China's real estate industry still experiencing prolonged slowness and excessive levels of debt, the measure is intended to strike a balance between stabilizing the housing market and preventing the emergence of another housing bubble [13]. The Evergrande Group and its competitor, Country Garden, have faced financial crises. Both businesses have created countless housing projects around China, and their financial problems threaten many Chinese families because many have already bought into their projects. Many families face losses if the companies cannot finish them on schedule. Therefore, the implementation of interest rate cuts may put out the fire in the burning real estate sector. Interest rate differentials between China and the US shrink due to the Federal Reserve's interest rate rise, which raised US capital investment returns and attracted cross-border global capital flows. It expanded the demand for the US dollar and the value of the US dollar. However, China's capital outflow and the People's Bank of China's continued interest rate cuts led to the yuan's depreciation. China's trade balance did not have been worse because of the interest rate cut but improved. The cost of importing Chinese goods into the United States has decreased due to the rising value of the dollar and the falling value of the yuan, which has increased Chinese exports [14]. It is interesting to see if the People's Bank of China will implement the same strategy consistently as the Federal Reserve or the European Central Bank, such as continuing to cut the interest rate.

The Federal Reserve initially underestimated the inflation spike due to the COVID-19 recovery. However, as it continued, the Fed raised interest rates and adjusted its response, though it may hurt the economy. As a result, the Fed has increased interest rates by more than 10 times. There have been several repercussions for American society from the interest rate hikes. Consumer spending declined, workers were laid off, the stock market was less optimistic, and banks faced insolvency. The European Union and China have also adjusted their interest rates because of the influence of the United States. The EU and the US made the same decision, but China chose to act the opposite: lower interest rates. The rationale behind China's decision was attributed to the sluggish economic growth coupled with the unstable nature of the real estate market.

4. Conclusion

In conclusion, the United States' role as an economic leader significantly influences its trading partners, with impacts shaped by the diverse interplay of political, economic, and cultural factors. Analyzing interest rate hikes in various nations provides a valuable lens through which businesses and researchers can anticipate market trends and make informed decisions. While this study delves into the immediate post-pandemic period, it crucially lacks an exploration of future interest rate policies. A notable avenue for future research lies in scrutinizing both the current interest rate policy and potential future trajectories set by the government and central bank. Recognizing that economic expectations sway market dynamics, such research would offer a comprehensive understanding of the evolving economic landscape. Anticipating and adapting to potential shifts in interest rate policies becomes paramount for stakeholders navigating the intricacies of global trade. By extending the analysis into the future, researchers can contribute insights crucial for strategic planning, fostering economic resilience, and fortifying partnerships.

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