The Investigation of the Impact of the Fed Rate Hike Cycle on the Chinese Stock Market

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Manuscript received October 8, 2024; revised December 14, 2024; accepted January 17, 2025; published February 25, 2025.

***Abstract*—The United States, as the world's largest economy, wields significant influence over global financial markets. Consequently, the actions of the Federal Reserve, particularly in the context of interest rate hikes, have become a recent focal point of research. China's stock market, like many others, has not been immune to the pronounced fluctuations brought about by the Federal Reserve's interest rate decisions. In the analysis of stock market factors, foreign exchange rates and government bond yields are frequently examined as these are among the most sensitive financial indicators, widely used to assess their correlation with stock markets. Therefore, this study has selected these two pivotal variables, namely foreign exchange rates and government bond yields, to conduct a thorough investigation into their impact on the Chinese stock market. Through the establishment of regression models and meticulous analysis, we have discovered that foreign exchange rates hurt the Chinese stock market, whereas government bond yields exert a positive influence. Based on these findings, this study provides corresponding explanations and investment recommendations.**

***Keywords*—Chinese stock market, interest rate hike policy, multi-regression**

I. Introduction

The performance of the Chinese stock market is closely tied to the dynamics of the American financial environment, which include the Federal Reserve's monetary policy, exchange rate fluctuations, and the broader global economic context. Although the influence is indirect, the intricate relationship between the Federal Reserve and the Chinese stock market is demonstrated through the complex interplay of various factors. The sensitivity of the Chinese market to changes in the American financial environment underscores this interdependency, with potential implications extending to global markets. Understanding this relationship necessitates a comprehensive analysis of the Federal Reserve's decisions, encompassing how adjustments in interest rates and policy shifts resonate in the international financial market, thereby influencing investor sentiment and capital flows, and ultimately affecting the performance of the Chinese stock market.

Changes in the Federal Reserve's monetary policy, such as interest rate hikes or cuts, can have a global impact, including on the Chinese stock market. A study analyzing the impact of Fed rate hikes on the Chinese A-share market and the U.S. S&P 500 found that a more elevated exchange rate had a relatively negative net effect on the Chinese stock market and a negligible influence on the U.S. stock market (Han, 2022). This suggests that the Federal Reserve's actions can indirectly affect the Chinese stock market through exchange rate dynamics. Exchange rates play a crucial role in the relationship between the Federal Reserve and the Chinese stock market. Changes in exchange rates can affect the competitiveness of Chinese exports and the profitability of Chinese companies, which can, in turn, impact the stock market. The study mentioned earlier also found that changes in the foreign exchange rate between the Chinese yuan (CNY) and the U.S. dollar (USD) had a significant impact on the Chinese stock market (Han, 2022). Global economic conditions: The Chinese stock market is also influenced by global economic conditions, including those influenced by the Federal Reserve. For example, during the global financial crisis in 2008, the Federal Reserve's actions to stabilize the U.S. economy had a significant impact on global financial markets, including the Chinese stock market. Similarly, the COVID-19 pandemic and the Federal Reserve's response to it have had global implications for stock markets, including in China. In summary, the relationship between the Federal Reserve and the Chinese stock market is complex and influenced by various factors, including monetary policy, exchange rates, and global economic conditions. While the Federal Reserve's actions can have indirect effects on the Chinese stock market, the relationship between the two is multifaceted, and other factors, such as domestic policies and global economic conditions, also play a significant role in shaping the Chinese stock market.

The Federal Reserve's interest rate hike in 2022 was a response to the inflation problem in the United States, which was exacerbated by the outbreak of the COVID-19 epidemic (Kang, 2023). The original intent of the interest rate hike was to provide some disincentive to inflation (Zhou, 2023). While interest rate hikes can dampen inflation to some extent, they also hurt employment and investment (Zhou, 2023). The impact of the interest rate hike was not limited to the United States, as it also affected other countries such as China and Singapore (Shang & Zhou, 2023). The interest rate hike had various implications for the US and global economies. In the US, higher interest rates led to higher interest rates in the interest rate market, and money flowed from the stock market to the bond market, dealing a significant blow to banking funds (Kang, 2023). The interest rate hike also had an impact on the foreign exchange market and the global capital market (Kang, 2023). In China, the impact of the US dollar interest rate hike on asset prices, foreign debt repayment, RMB exchange rate, and monetary policy was still under control, but the world economy, which was already experiencing a weak recovery, was facing a recession crisis (Shang *et al.*, 2023). The interest rate hike also affected capital flow in emerging markets. The US economic growth rate was declining, and the decline in the equilibrium interest rate had slowed down the interest rate hike (Yong, 2016). The macroeconomic risk of emerging markets was under control,

but the economic growth rate of some emerging market countries had dropped dramatically, which deserved more attention (Yongf, 2016). The Federal Reserve's balance sheet was also impacted by the interest rate hike. As part of its implementation of monetary policy, the Federal Reserve holds Treasury securities and agency mortgage-backed securities in the System Open Market Account (SOMA). The market value of these securities and the Fed's income fluctuate with changes in interest rates. The ongoing increases in policy rates to address inflationary pressures were expected to put downward pressure on the Fed's net income (Anderson *et al*., 2022).

In recent years, the Chinese stock market has experienced various influences, including the trade conflict with the United States. The US-China trade war, which began on March 22, 2018, has had a significant impact on the Chinese stock market. The US government announced a list of tariff-imposed commodities, imposing 25% tariffs on 1,333 items worth $50 billion of goods exported from China to the US (Liu, 2022). This trade war has lasted for 4 years and 5 months, with the US government increasing tariffs 6 times, leading to a substantial impact on capital flows and dynamic changes in the Chinese stock market (Liu, 2022). The trade war between China and the US has changed the topological structure of China's stock market network, making it denser and more likely heading toward a crisis (Yao *et al*., 2019). However, after 30 years of development, China's stock market has become more mature, and its ability to resist external risks has improved (Yao *et al*., 2019).

In addition to the trade war, the outbreak of COVID-19 has also had a significant impact on the Chinese stock market. A study analyzing the impact of COVID-19 on China's stock market found a significant leverage effect and a major impact on stock market volatility (Liu, 2022). The outbreak of COVID-19 had a considerable impact only on the stock market in early 2020, while other assets, such as bonds, gold, and oil, were less affected (Liu, 2022). The applicability of the classic Capital Asset Pricing Model (CAPM) in the Chinese stock market has been a topic of discussion. The CAPM model, which was developed for the US market, may not be suitable for the Chinese market due to its different system and younger age compared to the US financial market (Chen, 2022). The US and Chinese stock markets have shown both hedging and safe-haven properties against economic and trade policy uncertainty. The US stock market indexes have demonstrated hedging properties against Chinese economic and trade policy uncertainty, while among the Chinese stock markets, only DJShenzhen and DJShanghai stock indices might provide strong hedging and safe-haven properties against US economic and trade policy uncertainties (Ghosh *et al*., 2022).

The structure of this article is as follows: The introduction section serves as the first part, introducing the impact of the Federal Reserve's policies on the global economy, with a specific focus on their influence on the Chinese financial market. In the second part, related work, the relationships between exchange rate prices, bond prices, and the stock market will be delineated. The raw analysis section, as the third part, will present the trends of the US exchange rate prices, US bond prices, and China's CSI300 prices from January 3, 2022, to June 30, 2023. The results section will present the model of this article. In the results and discussion sections, numerical results of the model and discussions based on the results will be presented, respectively. The seventh and eighth parts consist of the conclusion and evaluation, summarizing the entire article and providing a comprehensive overview of the issues throughout the course period.

II. Related Work

A. Exchange Rate & Stock Market

The Federal Reserve's interest rate hikes led to the appreciation of the U.S. dollar, causing fluctuations in the foreign exchange market, which in turn affected the stock market. Wu *et al.* (2020) found the behavior of the RMB Index, and the stock market demonstrates a pattern of alternating transformation, whereas the exchange rate of an individual currency and the stock market display a unidirectional flow from the stock market to the exchange rate. Suriani *et al.* (2015) found that there is no discernible connection between exchange rates and stock prices, and both of these factors appear to operate independently from one another. These conclusions are based on data spanning from January 2004 to December 2009, where the KSE-100 index represents stock prices, and the exchange rate exposure is measured using the Pak Rupee's value against the US Dollar. Robert *et al.* found that a durable cointegration connection is identified between exchange rates and Shanghai A-share prices, as well as for nine out of ten industry indices. Furthermore, for four of the industry-specific indices. While Granger causality is detected, either in one direction (from exchange rates to stock prices or vice versa) or in both directions (Rutledge *et al*., 2014). Yang *et al.* discovered that the exchange rate of the Chinese Renminbi (RMB) against the U.S. dollar has a positive impact on the Chinese stock market. When the RMB appreciates, it attracts foreign capital inflows into the Chinese stock market, leading to an increase in stock market indices. Yang selected 627 samples, using the RMB to U.S. dollar mid-point exchange rate data from August 1, 2007, to February 27, 2010, along with the Shanghai Composite Index and Shenzhen Component Index as representatives of stock prices (Yang & Ma, 2012). Ma *et al.* did research and discovered that the majority of the time, U.S. economic policy uncertainty tends to increase the fluctuation in China's stock market while simultaneously reducing volatility in the bond and money markets. Its effect on other markets is generally inconspicuous. Notably, during the period from 2008 to 2012, there was a remarkable surge in the dynamic correlation coefficient between U.S. economic policy uncertainty and various financial submarkets. This anomaly may be attributed to the 2008 financial crisis and a set of new policies introduced by the Obama administration in 2009 (Ma, *et al*., 2023).

B. Bonds & Stock Market

As the world's primary currency, the U.S. dollar, due to interest rate hikes by the Federal Reserve, experiences a reduction in circulation in the market. Bitcoin, as a new form of currency, may potentially gain a greater store of value because of the decreasing availability of the U.S. dollar, as a hedge against the higher volatility associated with the U.S.

dollar. Additionally, numerous studies have found significant interrelations between Bitcoin and the stock market. Jiang *et al.* researched how the Quantitative Easing (QE) policy implemented by the United States during the 2020 pandemic outbreak affected China's multi-tiered bond market. While they simultaneously investigate the study period encompasses the duration of the U.S. QE program, which commenced in March 2020 and concluded in October 2021. To analyze this, the study examines the yields of one-year Treasury bonds, financial bonds, and local government bonds issued during this period, each representing distinct bond issuers. Additionally, the research employs U.S. non-borrowed reserves as an indicator to gauge the extent of capital spillover. To conduct empirical analysis, the study adopts a Vector Autoregressive (VAR) model (Jiang *et al.*, 2023). Ji *et al.* (2022) did research on the Federal Reserve's actions to raise interest rates and reduce stimulus due to persistently high inflation are expected to bring about significant consequences for various global markets, including stocks, bonds, currencies, and commodities. This is evident in the potential divergence in performance among different sectors of the U.S. stock market, with the growth sector experiencing some challenges. Additionally, interest rates on U.S. bonds are poised to increase substantially. In the case of China, it is crucial to be vigilant against the adverse effects of the spillover impact from the Fed's interest rate hikes on the economy (Ji *et al.*, 2022). Kang analyzed stock data from the two years post-Great Depression until one month before the first rate hike, an ARIMA model was constructed to gauge the influence of rate hikes on the stock markets and make a forecast, and found that the increase in the federal funds rate on March 16, 2022, had adverse effects on both the Chinese and U.S. stock markets while boosting the exchange rate of the U.S. Dollar relative to the Chinese Yuan (Kang, 2023).

III. Raw Analysis

In this part, the data of U.S. treasury bonds, the exchange rate of China and the U.S., and the CSI300 from the 3rd Jan. 2022 to 30th June 2023 are presented by line graph, all the data comes from investing.com.

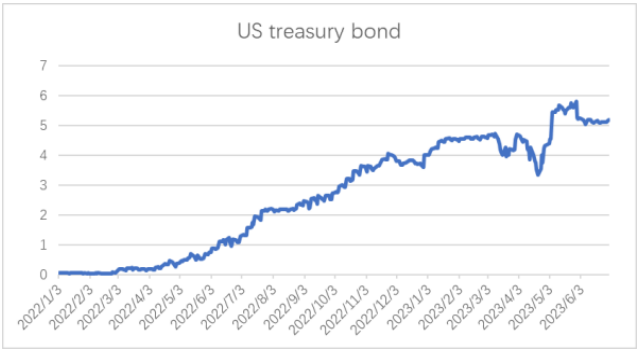

Fig. 1. The trend of U.S. treasury bonds.

Fig. 1 shows the trend of how the US treasury bound changed in the recent one and a half years, from the third day of 2022 to the 3rd of June 2023. According to the diagram, the data generally increased, while there was a fall between March to May 2023. The data started with nearly 0, which was around 0.05 at first. And fluctuated in this range until the end of February. From that, the bonds dramatically rocked 40 times to 2 in the following five months. After that, the bonds remained similar for roughly a month and then had a further growth to 4 until December. While there was a decline from that time to January. But the index rebounded back and increased slowly after that. In March 2023, the bonds reached 4.7 but it faced a significant plunge then which fell to 3.2. Nevertheless, the bonds grew back to nearly 6 in the next 2 months which reached the peak.

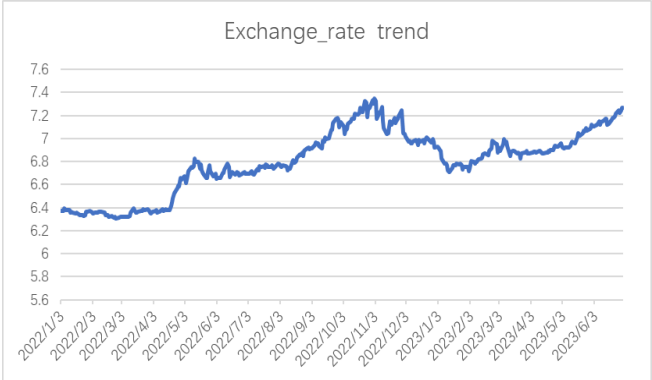

Fig. 2. The trend of exchange rate.

Fig. 2 illustrates the records of the exchange rate of 1 USD to CNH in the recent one and a half years, from the third day of 2022 to the 3rd of June 2023. According to the diagram, the records started with 6.4 and the trend fluctuated before April 2022. While there was a significant growth then from the midmonth of April to the November same year. The price continuously grew to around 7.33 from 6.4 in this period which was a 14.5% increase in exchange rate in total and it reached the peak. The trend, however, decreased after this by about 0.6 in the exchange rate in the following three months. While the rate rebounded from February to the end, which is 3rd June 2023.

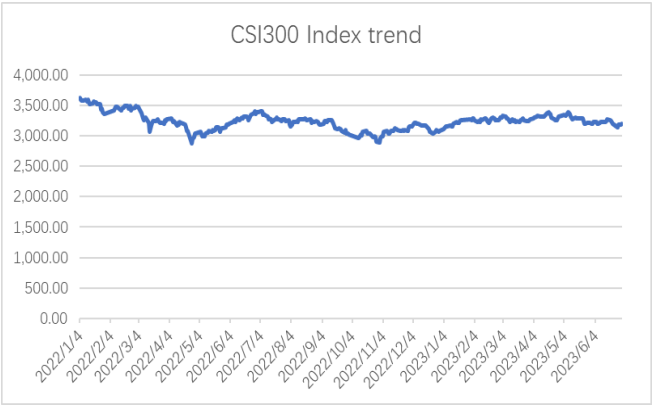

Fig. 3. The trend of the CSI300 index.

The trend of the China Securities Index 300 last one and a half years is shown above as the line graph. Generally, the trend bonded around 5000 to 4000. At the beginning of the year, there are approximately 5000. However, this index started falling in the next five months. Until May of the same year, the price was lower than 4000. And it rose to roughly 4500 in following two months. While it decreased again for 800 in total which was the minimum of the trend. After that, the index had a slight rebound and started fluctuating around 4000.

IV. Methodology and Results

A. Methodology

In this part, the multiple-regression model in this task is shown as follows:

$$CSI300 = a_0 + a_1 * exchange\_rate + a_2 * bonds. \quad (1)$$

where the CSI300 is the Chinese stock market index, the exchange_rate is the exchange rate between China and the U.S., the bonds are the U.S. treasury bond. The a_0 is the constant, $a_1 a_2$ and the and is the coefficient of the exchange_rate and bonds.

Null hypothesis: $a_0 = a_1 = a_2 = 0$

This null hypothesis assumes that none of the coefficients ($a_0 a_1$ and a_2) have any effect on the CSI300. In other words, the constant and the coefficients for both bonds and exchange rates are all equal to zero, implying that none of these variables contribute to the variation in CSI300.

Alternative hypothesis: o.w.

The alternative hypothesis essentially states that at least one of the coefficients $a_0 a_1$, and a_2 is not equal to zero. It suggests that at least one of these variables (constant, bonds, or exchange rates) has a non-zero effect on the CSI300.

The objective of this hypothesis test is to ascertain the statistical significance of the independent variables, namely, bonds and exchange rates, about their impact on the dependent variable, CSI300. In essence, the aim is to assess whether there exists sufficient empirical evidence to justify the rejection of the null hypothesis in favor of the alternative hypothesis. The discovery of statistical significance would imply that at least one of the coefficients differs significantly from zero, substantiating the assertion that the respective independent variable holds a substantive and noteworthy predictive influence on the CSI300.

B. Results

In this part, the result of the function (1) is displayed.

OLS Regression Results

Dep. Variable:	csi	**R-squared:**	0.480
Model:	OLS	**Adj. R-squared:**	0.476
Method:	Least Squares	**F-statistic:**	109.0
Date:	Thu, 07 Sep 2023	**Prob (F-statistic):**	5.26e-50
Time:	14:54:31	**Log-Likelihood:**	-2149.0
No. Observations:	358	**AIC:**	4306.
Df Residuals:	354	**BIC:**	4322.
Df Model:	3		
Covariance Type:	nonrobust		

	coef	std err	t	P>|t|	[0.025	0.975]
const	6609.6420	275.137	24.023	0.000	6068.533	7150.751
exchange_rate	-512.6194	38.981	-13.151	0.000	-589.283	-435.956
bonds	42.2767	4.607	9.177	0.000	33.217	51.337
btc	0.0002	0.001	0.250	0.803	-0.002	0.002

Omnibus:	12.952	**Durbin-Watson:**	0.109
Prob(Omnibus):	0.002	**Jarque-Bera (JB):**	15.929
Skew:	-0.340	**Prob(JB):**	0.000348
Kurtosis:	3.777	**Cond. No.**	1.51e+06

Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.
[2] The condition number is large, 1.51e+06. This might indicate that there are strong multicollinearity or other numerical problems.

Fig. 4. The result of the multi-regression model.

Based on Fig. 1, the a_0 is 6609.6420, a_1 is −512.6194, a_2 is 42.2767. The p-value of all three parameters is 0, which means the null hypothesis is rejected, and the a_0 a_1 a_2 y are conceivable. The a_0 is 6609.6420, which means that when the exchange_rate and bonds are 0, the CSI300 is 6609.6420. The a_1 is −512.6194, which means the CSI and exchange_rate have a negative relationship, that if exchange_rate rises 1 unit and the a_2 is 0, the CIS300 will decrease 512.6194 units. The a_2 is 42.2767. which means the CSI and bonds have a positive relationship, when a_1 = 0, CIS300 will rise 42.2767 units if bonds rise 1 unit.

V. Discussion

In this section, in the context of a Federal Reserve interest rate hiking cycle, this analysis will provide insights into the factors affecting the fluctuations in Chinese stock market prices related to exchange rates and U.S. Treasury yields. Additionally, based on the identified factors, some investment recommendations for Chinese stock investors during a Federal Reserve interest rate hiking cycle will also be presented.

Firstly, the reasons are related to the debt, inflationary, and trade, the details of these aspects are as follows:

Debt Issues: Many Chinese companies have debt denominated in foreign currencies, typically in U.S. dollars. If the Chinese yuan depreciates, the repayment amounts may increase. This could place financial pressure on companies, affecting their operations, profitability, and subsequently, stock prices.

Inflationary Pressure: Currency depreciation is often accompanied by inflationary pressure. If inflation intensifies, it can lead to rising costs for businesses, potentially hurting their profits. Investors are usually sensitive to inflation concerns, which can, in turn, negatively affect the stock market.

Trade Issues: Yuan depreciation can enhance China's export competitiveness, but it may also result in trade tensions, as trading partners may perceive China as engaging in currency manipulation to gain a trade advantage. Trade disputes can have adverse effects on global markets and investor confidence, potentially impacting the stock market.

Market Uncertainty: Currency depreciation typically comes with increased market uncertainty. Investors become uncertain about future exchange rate movements and government currency policies. This uncertainty can lead to decreased investor sentiment and heightened stock market volatility.

Investor Risk Preference: U.S. two-year treasury bonds are typically considered low-risk investment choices due to their shorter maturity. When the Federal Reserve raises interest rates, it may increase the yield on these bonds, making them more attractive. However, some investors might shift their investments from the stock market to the bond market to mitigate risks, which could lead to a positive correlation between bond yields and stock market indices.

Global Capital Flows: The Federal Reserve's rate hikes may attract international capital inflows into the U.S. market, including the bond market. These inflows may drive up U.S. treasury bond yields while also increasing investments in the Chinese stock market as part of diversified portfolios. This

global demand can contribute to a positive correlation between bond yields and stock market indices.

Export Competitiveness and Trade Pressure: A depreciation of the Chinese yuan (an increase in the exchange rate) may enhance China's export competitiveness as Chinese export goods become more attractively priced, attracting international buyers. This can lead to an increase in exports but may also result in trade pressure.

Based on the reasons above, there are some advice is given as follows:

Monitor Exchange Rate Risk: Stay informed about the dynamics of the Chinese yuan's exchange rates against other currencies, especially with major trading partner nations. Exchange rate fluctuations can have a significant impact on the profitability of Chinese companies.

Keep an Eye on International Trade Developments: Pay close attention to the international trade environment, particularly China's trade relations with its major trading partners. Trade issues can potentially affect the Chinese stock market, so understanding global trade dynamics is crucial for investors.

Understand Inflationary Pressure: Consider the impact of inflation on different industries and companies. Some sectors (such as basic materials and energy) may be more susceptible to inflation, while certain companies may have better inflation hedging strategies in place.

Prudent Debt Management: If investing in stocks of companies with foreign currency-denominated debt, ensure that these companies effectively manage foreign exchange risks and have robust financial positions to withstand currency fluctuations.

Diversify Your Portfolio: Consider implementing a diversified strategy in your portfolio, including different asset classes such as stocks and bonds, and also diversify across different geographic regions. This can help mitigate risks since different asset classes and markets may respond differently to various factors.

Stay Informed about Fed Policy: Keep a close eye on the policies of the Federal Reserve, as its monetary policy decisions have widespread implications for global financial markets. Stay informed about Fed policy decisions and official statements to gauge potential market dynamics.

VI. Conclusion

The United States, as the world's largest economy, exerts significant influence on the financial markets of nations worldwide. Consequently, the actions of the Federal Reserve, particularly in the context of interest rate hikes, have become a focal point of recent research. China's stock market, like many others, has experienced noticeable fluctuations in response to the Federal Reserve's interest rate decisions. In the realm of financial market analysis, two of the most sensitive indicators, exchange rates, and government bond yields, are frequently examined to understand their impact on stock markets. Therefore, this study has chosen to investigate the influence of these two crucial variables, exchange rates and government bond yields, on the Chinese stock market.

Through the establishment of regression models and meticulous analysis, our research has revealed a negative correlation between exchange rates and the Chinese stock market, indicating that currency depreciation tends to have an adverse impact. Conversely, government bond yields have demonstrated a positive influence on the Chinese stock market.

This study has focused its investigation on the influencing factors affecting the Chinese stock market within the context of the Federal Reserve's interest rate hike cycle. A comprehensive multivariate regression analysis was conducted, utilizing data spanning from January 2022 to June 2023. This data encompassed key variables, including the CSI300 index, the exchange rate of the Chinese yuan against the U.S. dollar, and the prices of two-year U.S. Treasury bonds.

The findings derived from this analysis yielded intriguing insights. Notably, the study revealed a discernible adverse impact on the Chinese stock market stemming from the depreciation of the Chinese yuan. Conversely, an observable positive effect was noted in response to an increase in U.S. Treasury bond prices.

In light of the aforementioned conclusions, investors in the Chinese stock market are presented with valuable insights to inform their investment strategies. The interplay between currency dynamics and U.S. Treasury bond prices serves as a critical reference point, yet further research and a nuanced approach should be considered to navigate the complexities of this ever-evolving financial environment effectively.

Conflict of Interest

The author declares no conflict of interest.

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