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The Guiding Effect of RMB Exchange Rate Expectations on Short-Term Cross-Border Capital Flows during the Federal Reserve Interest Rate Hike Cycle and Policy Responses

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Abstract: During the Federal Reserve interest rate hike cycle, higher returns on U.S. dollar assets, tighter global liquidity and shifts in risk appetite jointly reshape cross-border portfolio allocation. RMB exchange rate expectations therefore become a key guiding variable for short-term cross-border capital flows. This paper examines the transmission chain of "external tightening shock - exchange rate expectation adjustment - short-term capital flow response" from four mechanisms: interest-rate differential repricing, exchange-rate risk premium, asset price revaluation and corporate foreign exchange settlement behavior. Based on the two-way fluctuation of the RMB exchange rate and changes in China's cross-border payment structure since 2022, the paper finds that depreciation expectations have a stronger triggering effect on short-term capital outflows and can resonate with offshore market sentiment, securities investment volatility and corporate hedging behavior. Appreciation expectations, by contrast, tend to restore settlement willingness and RMB asset allocation more gradually. Policy responses should focus on expectation monitoring, macroprudential adjustment, risk-neutral exchange-rate management and regional supply-chain finance services, so as to improve the forward-looking and refined governance of cross-border capital flows under external shocks.

Keywords: Federal Reserve interest rate hike, RMB exchange rate expectations, short-term cross-border capital flows, macroprudential regulation, supply-chain finance.

1. Introduction

Under the global financial cycle, monetary policy adjustments by major reserve currency issuers are no longer merely domestic macroeconomic choices. Instead, they spill over to emerging markets through asset yields, risk appetite, US dollar financing costs and the reallocation of international capital. Starting from 2022, the Federal Reserve implemented consecutive interest rate hikes to curb soaring inflation, raising the target range for the federal funds rate to 5.25%–5.50% in July 2023. The high-interest-rate environment boosted the attractiveness of US dollar assets, while the China-US interest rate differential, US Dollar Index and global risk aversion became major external factors weighing on the RMB exchange rate and cross-border capital flows. For China, as the RMB exchange rate formation mechanism grows more market-oriented, capital account opening advances steadily, and links between onshore and offshore markets deepen, external tightening shocks no longer only affect market prices; they penetrate trading decisions of enterprises, financial institutions and domestic and foreign investors via shifts in market expectations.

Existing research falls into three strands: the spillover effects of US monetary policy, risks of cross-border capital flows, and volatility of the RMB exchange rate. The global financial cycle theory highlights that US monetary policy influences international capital flows and asset prices in emerging economies via the risk-taking channel [1, 2]. Domestic scholars further document non-linear and regime-switching interactions between the RMB exchange rate, exchange rate expectations and short-term cross-border capital flows. Capital flows are not determined solely by interest rate differentials, but jointly shaped by forward and spot exchange rates, market sentiment and policy communication [5, 6]. These studies lay a foundation for understanding external spillovers. Nevertheless, in practical regulatory practice, the rapid surges and withdrawals of short-term capital are driven less by current exchange rate levels than by market participants' judgments on the future direction of the RMB, its fluctuation range and policymakers' response frameworks.

Against this backdrop, this paper analyzes how RMB exchange rate expectations guide short-term cross-border capital flows, bridging external tightening shocks from Fed rate hikes and micro-level behaviors in China's foreign exchange market. Rather than simply forecasting RMB appreciation or depreciation, this study explains how the formation, amplification and reversal of expectations alter the rhythm of cross-border capital movements, and proposes operable risk management solutions accordingly.

2. Theoretical Mechanisms through Which Exchange Rate Expectations Guide Short-Term Cross-Border Capital Flows

2.1. Interest Rate Differential Repricing and Transmission of Return Expectation

Fed rate hikes first alter the relative returns of Chinese and US assets. Higher US dollar risk-free yields erode or even reverse the yield advantage of RMB assets, prompting short-term capital to reassess whether the returns on holding RMB assets offset exchange rate fluctuation costs. If the market simultaneously forms RMB depreciation expectations, anticipated exchange losses will eat into total returns even when nominal yields on domestic assets remain stable,

leading arbitrage and allocation-focused short-term capital to reduce holdings of RMB assets. This mechanism explains why capital flows are highly sensitive to interest rate changes in the early stage of rate hikes, and demonstrates that interest rate differentials alone cannot operate independently — they function in tandem with exchange rate expectations.

2.2. Exchange Rate Risk Premium and Transmission of Risk-Aversion Expectations

When the RMB enters a phase of depreciation, market participants demand higher risk compensation. Foreign investors may cut allocations to RMB bonds, equities and deposits to hedge currency risks; domestic enterprises may accelerate foreign exchange purchases, delay foreign currency settlement or expand foreign currency asset holdings. Concentrated execution of such behaviors in a short period boosts foreign exchange demand and further depresses the spot exchange rate, creating a procyclical feedback loop: depreciation expectations → rising foreign exchange purchases → renewed exchange rate depreciation. Existing literature confirms that short-term capital flows are driven by multiple motives, and their sensitivity to shocks evolves with policy regimes and market conditions [7]. Therefore, managing exchange rate expectations aims not only to smooth price volatility but also to curb irrational surges in exchange rate risk premiums.

2.3. Asset Price Revaluation and Transmission of Risk Appetite

Fed tightening also impacts cross-border capital flows via asset price channels. Amid contracting global liquidity, investors' risk appetite for emerging market assets declines, triggering repricing of equity valuations, bond yields and property market outlooks. RMB exchange rate expectations act as a signal amplifier in this process: if RMB depreciation is interpreted as a sign of intensifying external pressure, investors will simultaneously downgrade valuations of domestic assets, magnifying volatility in securities investment flows. If the RMB maintains two-way fluctuations with stable market expectations, asset price adjustments are more likely to be perceived as valuation corrections rather than systemic capital flight. Interactions among cross-border banking capital flows, the RMB exchange rate and foreign exchange regulation also indicate that balance sheet adjustments by financial institutions amplify exchange rate shocks [3, 4].

3. Phased Observations during the Federal Reserve Interest Rate Hike Cycle

3.1. Exchange Rate Expectations Shift from One-Sided to Two-Way

Since 2022, a strong US Dollar Index and inverted China-US interest rate differentials once fueled broad RMB depreciation expectations, with market participants showing cautious settlement and early foreign exchange purchase behaviors in onshore and offshore foreign exchange markets. Sustained domestic growth-stabilizing policies, resilient foreign trade and targeted expectation guidance by foreign exchange authorities prevented a prolonged one-sided depreciation trend; instead, the RMB fluctuated two-way around its reasonable and balanced level. The People's Bank of China emphasized in its 2024 Q4 Monetary Policy Implementation Report that it would uphold the market-determined exchange rate regime, strengthen expectation guidance and guard against excessive exchange rate volatility. This statement signals a policy shift from defending specific exchange rate levels to stabilizing market expectations and preserving the market's self-correcting capacity.

3.2. Structural Divergence in Short-Term Cross-Border Capital Flows

Short-term cross-border capital flows are heterogeneous. Trade-related flows, backed by real economic activity, remain relatively stable; securities investment flows are highly sensitive to interest rate differentials, exchange rate expectations and global risk sentiment; cross-border bank lending and corporate external debt are mainly affected by US dollar financing costs and debt repayment expectations. Data on bank foreign exchange settlement and sales, as well as cross-border receipts and payments on behalf of non-bank entities released by the State Administration of Foreign Exchange (SAFE) for 2024 show large-scale annual cross-border transactions, alternating between surpluses and deficits across months. This suggests that analyzing capital flows requires distinguishing capital sources, maturity structures and transaction motives, rather than merely tracking aggregate net inflows or outflows.

Table 1. Phased Observations on RMB Exchange Rate Expectations and Capital Flows amid Fed Rate Hikes

Stage	External Environment	Characteristics of Exchange Rate Expectations	Characteristics of Capital Flows
Accelerated rate hike phase	Strong US Dollar Index, widening inverted China-US interest rate differentials	Widespread depreciation expectations, weak settlement willingness	Heightened sensitivity in securities investment and corporate foreign exchange purchase activities
High interest rate maintenance phase	Persistently elevated overseas interest rates, uncertainty over policy pivots	Divergent expectations shaped by policy communication and domestic fundamental improvements	Stable aggregate flows with prominent structural volatility
Pricing-in rate cut phase	Markets price in expected Fed rate cuts	Enhanced two-way RMB volatility, fading one-sided expectations	Gradual recovery in RMB asset allocation and corporate settlement willingness

3.3. Asymmetric Impacts of Expectation Shocks

Market behaviors reveal that depreciation expectations trigger capital outflows far faster than appreciation expectations attract capital inflows. Once depreciation expectations take hold, synchronized adjustments occur across corporate foreign exchange operations, household asset allocation, institutional foreign exchange risk hedging and offshore speculative trading. In contrast, recovery of

appreciation expectations relies on steady fundamental improvements, consistent policy frameworks and gradual rebuilding of market confidence. Research on RMB exchange rate regime evolution also confirms that exchange rate expectations and volatility exert time-varying directional and magnitude effects on short-term capital flows [8]. Accordingly, policy design must prioritize preventing self-fulfilling depreciation expectations while allowing sufficient exchange rate flexibility within a reasonable band, as excessive intervention would erode the market's price discovery function.

3.4. Practical Performance in Regionally Open Financial Scenarios

Eastern coastal regions and western inland areas differ sharply in the scale of export-oriented enterprises, trade composition and adoption of financial hedging tools. Many western manufacturers face long order cycles and thin profit margins, relying heavily on bank credit and trade financing amid exchange rate swings. Cross-border e-commerce, port logistics and energy resource trading generate small-value, high-frequency capital flows featuring lengthy settlement chains and frequent currency conversions. During Fed tightening cycles, while RMB depreciation may temporarily boost export revenues when converted into domestic currency for firms lacking hedging instruments, it simultaneously raises costs for imported equipment, raw materials and US dollar-denominated financing. Regional financial services should therefore integrate exchange rate expectations into supply chain cash flow forecasting and credit pricing, rather than merely reminding enterprises to adopt hedging strategies.

4. Key Risks and Practical Constraints

4.1. Risks of One-Sided Expectations Spilling Over to Offshore Markets

Sustained high US interest rates and periodic US Dollar Index strength easily lead markets to interpret RMB depreciation as a passive structural trend. The offshore RMB market features more flexible trading and faster information pricing; early depreciation in offshore markets may spill over to onshore markets via arbitrage, hedging and public sentiment diffusion. If enterprises and financial institutions misinterpret short-term price swings as a long-term depreciation trend, they will adjust foreign exchange positions en masse and exacerbate spot market pressures. In such cases, exchange rate expectations cease to merely reflect economic fundamentals and instead become a joint driver of capital flows and exchange rate volatility.

4.2. Risks of Short-Term Arbitrage and Procyclical Trading

A portion of short-term capital engages in cross-border arbitrage centered on interest rate spreads, currency spreads and asset price gaps, unlinked to real trade or long-term investment. Fed rate hikes increase US dollar financing costs, triggering rapid unwinding of existing carry trades. Under strong RMB depreciation expectations, capital may evade supervision by accelerating or delaying trade payments, executing financing without genuine trade backgrounds or transferring funds via affiliated enterprises. Although China has established a comprehensive macroprudential and transaction authenticity review framework, the rapid expansion of digital payments, cross-border e-commerce, offshore accounts and supply chain platforms complicates the identification of abnormal capital flows.

4.3. Insufficient Exchange Rate Risk Management among Regional Export-Oriented Enterprises

Western export-oriented enterprises have expanded operations in energy chemicals, agricultural processing, equipment manufacturing and cross-border e-commerce, yet many small and medium-sized enterprises (SMEs) treat exchange rate management as a passive financial task rather than embedding it into full-cycle operations covering order placement, financing, settlement and inventory management. When depreciation expectations intensify, firms may blindly accumulate foreign currency assets or prepay foreign exchange purchases; when exchange rates reverse, they face surging financial costs and volatile profit margins. If regional financial institutions only focus on collateral and core enterprise credit in supply chain finance while ignoring exchange rate exposures, external currency risks will be transmitted into credit risks.

4.4. Constraints in Policy Coordination and Market Communication

Exchange rate expectation management spans monetary policy, foreign exchange administration, cross-border investment regulation, capital market stability and real economy financial services. Inconsistent policy signals may lead market participants to overinterpret single indicators. For instance, inverted interest rate differentials do not inevitably trigger large-scale capital outflows, yet insufficient systematic communication regarding economic fundamentals, current account balances, foreign exchange reserves and policy tools may lead markets to simplistically link interest rate gaps to sustained depreciation pressure. Expectation management must therefore shift from post-hoc explanations to preemptive guidance, adopting granular communication tailored to different market participants, capital channels and business scenarios.

4.5. Boundary Risks in Data Identification and Governance

Regulating short-term cross-border capital flows faces challenges in distinguishing transaction types. Real trade flows, supply chain financing and arbitrage transactions often follow identical capital transfer paths. Overreliance on post-hoc transaction-by-transaction audits raises compliance costs for enterprises, while full market self-regulation enables speculative capital to disguise itself behind trade records, platform split settlements and related-party transactions. Regulators must strike a clear balance between facilitation and risk prevention: streamline procedures for creditworthy enterprises with genuine transactions and clear hedging demands, while strengthening verification for transactions marked by severe maturity mismatches, closed-loop capital transfers and operations inconsistent with core business lines.

5. Policy Recommendations

5.1. Establish an Integrated Monitoring Framework Linking Exchange Rate Expectations and Capital Flows

Building on existing cross-border capital monitoring

systems, expand coverage to indicators including forward foreign exchange settlement and sales volumes, implied volatility of foreign exchange options, onshore-offshore RMB spreads, corporate settlement and purchase ratios, cross-border RMB settlement shares and foreign currency liabilities of key industries. This creates a multi-dimensional monitoring framework covering market prices, expectations, capital flows and micro-agent behaviors. Conduct penetrating analysis of abnormal concentrated foreign exchange purchases, delayed settlement, rapid growth in short-term external debt and large swings in securities investment, cross-referencing transaction backgrounds and corporate profiles to avoid misclassifying legitimate trade flows as speculative capital and prevent arbitrage from hiding within real trade chains.

5.2. Refine a Portfolio of Macroprudential and Countercyclical Tools

Responding to external tightening shocks requires a diversified toolkit rather than sole reliance on spot exchange rate intervention. Deploy countercyclical instruments including foreign exchange deposit reserve ratios, forward foreign exchange sale risk reserve ratios, cross-border financing macroprudential adjustment parameters, offshore central bank bill issuances and window guidance. Tool implementation should adhere to three principles: first, intervene only against abnormal expectation swings rather than normal market volatility to preserve exchange rate flexibility; second, differentiate short-term speculative capital from real trade capital to maintain facilitation of cross-border trade and investment; third, accompany tool adjustments with transparent policy communication to clarify intervention boundaries and objectives and reduce speculative trading driven by market speculation.

5.3. Foster Corporate Awareness of Exchange Rate Risk Neutrality

Effective corporate exchange rate management does not rely on predicting exchange rate peaks and troughs, but converts currency volatility into predictable, affordable and diversifiable operating costs. Financial institutions should offer comprehensive hedging packages covering export receipts, import payments, foreign currency loans, order financing and accounts receivable factoring, promoting forwards, swaps, options and combined hedging products. Regulators and industry associations can deliver training supported by case libraries and cash flow simulation models to discourage unhedged foreign exchange exposures and speculative hedging, embedding risk neutrality into contract pricing, credit approval and financial performance evaluation systems.

5.4. Upgrade Foreign Exchange Risk Services within Regional Supply Chain Finance

Align supply chain financial services with western China's opening-up strategy by integrating exchange rate risk management into core supply chain products. Drawing on transaction data from core manufacturers, cross-border e-commerce platforms and port logistics providers, banks can quantify upstream and downstream firms' foreign currency revenues, costs and settlement cycles, designing integrated products such as "order financing + forward settlement", "accounts receivable pools + currency hedging" and "cross-border RMB settlement + supply chain credit facilities". For SMEs reliant on single US dollar invoicing with weak bargaining power, incentivize cross-border RMB settlement and staged forward locking to mitigate dual pressures from exchange rate losses and high US dollar financing costs amid Fed tightening cycles, enhancing financial stability for regional open economies.

5.5. Strengthen Policy Communication and Market Expectation Governance

Exchange rate expectation management demands greater transparency and regular communication. At the macro level, release timely data on foreign exchange market operations, cross-border capital flows and foreign exchange reserve changes to elaborate the fundamental logic of two-way RMB volatility. At the micro level, deliver differentiated outreach to foreign trade enterprises, financial institutions and investors to clarify that regulatory tools uphold market-oriented exchange rate formation and only curb one-sided expectations and excessive depreciation/appreciation. Accelerate official responses to market rumors, abnormal public sentiment and offshore speculative pressures to suppress panic-driven trading via authoritative information disclosure.

5.6. Expand Cross-Border RMB Settlement and Local Currency Financing

Mitigate the amplifying effect of exchange rate expectations on cross-border capital flows by reducing corporate reliance on US dollar-only settlement and financing. Scale up RMB invoicing and settlement for commodity procurement, cross-border e-commerce and trade with neighboring economies, and encourage banks to provide RMB trade financing, cross-border capital pools and integrated local/foreign currency cash management services. For western enterprises with intensive trade links with Belt and Road Initiative partner countries, develop hybrid settlement schemes combining RMB, local currencies and multi-currency credit facilities to lower sensitivity to US dollar interest rate volatility and strengthen the stability of regional open financial systems.

6. Conclusion

During the Federal Reserve interest rate hike cycle, RMB exchange rate expectations act as a core intermediary variable linking external monetary policy shocks to short-term cross-border capital flows. They alter capital allocation patterns via four channels: interest rate differential repricing, exchange rate risk premium, asset price revaluation and corporate foreign exchange settlement and sales behavior, with depreciation expectations generating stronger procyclical amplifying effects. Analyzing capital flows through the lens of market expectations better explains concentrated short-term capital swings, structural divergence and cross-market spillovers than merely tracking spot exchange rate levels.

Moving forward, China must strengthen expectation management while preserving RMB exchange rate flexibility. On one hand, deploy macroprudential tools, cross-border capital monitoring and transparent policy communication to prevent self-fulfilling one-sided exchange rate expectations. On the other hand, extend exchange rate risk management to real corporate operations and regional financial services, with targeted efforts to boost hedging capacity among export-oriented SMEs, supply chain financial platforms and

grassroots financial institutions. Coordination between macroeconomic stability, market self-discipline and micro-level financial services will sustain orderly cross-border capital flows amid recurring shifts in overseas high-interest-rate environments, establishing a secure institutional foundation for higher-level financial opening-up.

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