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Article

Research on Cross-Border Capital Flows and Financial Risk Prevention under Global Central Bank Monetary Policy Adjustments (Interest Rate Cut Cycle)

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Abstract: Against the background that major global economies have entered a cycle of interest rate cuts, the international financial environment presents a complex situation of liquidity easing, leverage expansion and asset price fluctuations. Cross-border capital flows show a trend of acceleration, reversal and structural differentiation, which has a double impact on the financial stability, exchange rate mechanism and macroeconomic management of emerging markets. Based on international financial transmission theory and the macroprudential management framework, this article systematically analyses the impact mechanism, transmission paths and risk spillover effects of the global central bank interest rate cut cycle on cross-border capital flows. It distinguishes between portfolio, banking and direct investment flows, and examines how interest rate differentials, risk appetite and expectations interact with domestic financial structures. In addition, the paper discusses policy countermeasures for financial risk prevention and control with reference to typical country experiences, highlighting the role of capital flow management tools, exchange rate flexibility and reserve buffers. The study finds that capital flows under an interest rate cut cycle are highly volatile and procyclical, and are prone to induce asset price bubbles, currency mismatches, maturity mismatches and systemic financial risks, especially in economies with shallow financial markets and weak regulatory capacity. Based on this, the article proposes a comprehensive governance strategy combining macroprudential regulation, cross-border capital flow management, foreign exchange reserve optimisation and international policy coordination, providing a reference for reconciling financial security with global monetary policy cycles in emerging markets.

Keywords: monetary policy; interest rates; capital flows; financial stability; systemic risk; emerging markets

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1. Introduction

1.1. Research Background

Since 2024, central banks across the globe, including the Federal Reserve and the European Central Bank, have initiated interest rate cuts. Global liquidity has significantly increased, leading to heightened volatility in cross-border capital flows. Amid a weak global economic recovery, inflationary pressures have eased, prompting widespread adoption of interest rate cut policies to stimulate economic growth. However, monetary policy easing introduces potential risks, such as over-inflated asset prices, increased exchange rate fluctuations, and rising external debt concerns. Emerging market countries are particularly vulnerable, facing challenges like substantial inflows of short-term capital, local currency appreciation, and overheating of financial asset prices. These issues not only threaten macroeconomic stability but also demand enhanced financial supervision.

Consequently, the resilience of financial systems and the effectiveness of policies are undergoing rigorous tests.

1.2. Research Significance

From a theoretical perspective, this paper aims to integrate the international transmission mechanism of monetary policy with the sensitivity model of capital flow. The research focuses on uncovering the endogenous dynamics of capital flow during interest rate cut cycles. It also examines how capital flows accumulate risks at various stages and the evolving characteristics of these risks within the financial system. Through theoretical analysis, the study seeks to better understand how monetary policy adjustments influence cross-border capital flows and financial stability via interest rates, exchange rates, and asset price channels. From a practical standpoint, the findings can offer systematic policy guidance for central banks and financial regulators worldwide [1]. This research supports the development of strategies for managing cross-border capital flows, guiding capital inflows and outflows effectively, and mitigating the disruptive impact of speculative funds on markets. Additionally, it enhances the capacity of nations to address external economic and financial shocks. The conclusions contribute to improving financial risk prevention and control measures, thereby reducing systemic risks associated with capital flow fluctuations. By providing theoretical insights and practical recommendations, this study supports the establishment of a more robust macro-prudential policy framework. Such advancements aim to strengthen the resilience of financial systems, enhance their ability to withstand crises and external shocks, and ultimately reduce systemic risks. This ensures economic stability and financial security while offering valuable references for the sustainable development of emerging markets and the global financial system.

2. Related Concepts and Theoretical Foundations

2.1. Related Concepts

The interest rate cut cycle refers to the phased policy process in which major central banks continuously lower policy interest rates over a certain period to stimulate economic growth. Interest rate cuts are typically accompanied by an expansion of global liquidity, guiding investors to reconfigure assets across borders. During this cycle, the relative yield of domestic assets declines, prompting capital to seek higher-yield international markets, thereby driving cross-border capital flows. The interest rate cut cycle is distinctly phased and influential, with impacts extending beyond domestic financial markets to potentially affect other economies through spreads, exchange rates, and asset price channels.

Cross-border capital flows involve the movement of capital for investment, lending, and financial transactions between countries, encompassing direct investment, securities investment, and short-term capital flows. These flows are influenced by various factors, including interest rate differentials, exchange rate expectations, market risk preferences, and the global economic environment [2]. Changes in their direction and scale directly impact financial market stability, exchange rate fluctuations, and foreign exchange reserve management. In the short term, rapid capital inflows may drive up asset prices, while rapid outflows can tighten liquidity, increasing financial market volatility and systemic risks.

Financial risk prevention and control aim to mitigate the adverse effects of international capital fluctuations on the stability of the financial system through macro-prudential supervision, cross-border capital flow management, foreign exchange reserve adjustments, and other policy measures. The core objective is to reduce systemic risks and ensure the smooth functioning of financial markets. This involves not only preventing asset price bubbles caused by capital inflows but also addressing liquidity constraints and exchange rate fluctuations resulting from capital outflows. Effective risk prevention and control enhance the resilience of the financial system and improve its capacity to manage external shocks and uncertainties [3, 4].

2.2. Theoretical Foundations

International capital flow theory primarily encompasses the Mundell-Fleming model and the open capital account theory. The Mundell-Fleming model examines the relationship between interest rates, exchange rates, and capital flows under open economic conditions [5]. This model indicates that the independence of national monetary policy may diminish if capital flows freely between countries. Changes in interest rates influence cross-border capital flows as they also impact exchange rates. The open capital account theory posits that the unrestricted movement of capital enhances resource utilization efficiency. However, it also heightens instability and increases overall financial market risks.

The theory of monetary policy transmission includes interest rate channels, asset price channels, and expectation channels. The interest rate channel asserts that adjustments to policy interest rates directly affect commercial banks' loan interest rates, subsequently influencing corporate investments and household consumption, thereby altering cross-border fund flows. The asset price channel suggests that monetary policy impacts investors' asset allocation and risk preferences through fluctuations in stock, bond, and real estate prices. The expectation channel highlights that market expectations regarding future monetary policy influence investor confidence and behavior, further affecting capital flows and financial market volatility.

The macro-prudential supervision theory emphasizes countercyclical adjustment mechanisms and systematic risk prevention frameworks. Its central concept involves using policy tools to mitigate cyclical fluctuations within the financial system and strengthen its resilience against risks. Key tools include dynamic capital buffering, leverage constraints, liquidity regulation, and stress testing [6, 7]. In conditions of high capital flow volatility, macro-prudential supervision effectively prevents the accumulation and spread of systemic risks, ensuring financial system stability and safeguarding macroeconomic security.

3. Analysis of the Impact Mechanisms of Global Interest Rate Cut Cycles on Cross-Border Capital Flows

3.1. Interest Rate Differential and Capital Reallocation Mechanism

The interest rate cuts implemented by major central banks globally directly reduce the yield of domestic assets, thereby diminishing the appeal of domestic investment. Investors often seek countries or markets offering higher returns, channeling their funds overseas. This spread-driven effect not only facilitates substantial inflows of short-term capital into high-yield countries but also prompts the reallocation of international assets. During this process, investors may adjust the composition of their portfolios across stocks, bonds, real estate, and other asset classes, altering the capital structure of the global financial market. The rapid movement of capital can heighten financial market volatility, potentially impacting exchange rates and asset prices directly. Furthermore, the spread effect may encourage arbitrage trading, intensifying short-term market liquidity pressures and price fluctuations, thereby increasing the instability of the financial system.

3.2. Exchange Rate Expectations and Risk Preference Transmission

Monetary policy easing reduces the interest rate of the local currency, leading to market expectations of potential depreciation of the currency. Simultaneously, with increased global liquidity and a rise in investors' risk appetite, there is a tendency to favor short-term investments in emerging markets. The rapid inflow of capital can drive up asset prices in these markets and may also exert upward pressure on the local currency's value. However, if expectations regarding interest rate cuts shift or global capital begins to reverse its flow, the local currency may depreciate rapidly, resulting in significant fluctuations in exchange rates and capital markets. Changes in exchange rate expectations influence the investment and financing decisions of banks and enterprises. For instance, enterprises might opt for increased foreign currency debt financing, while financial

institutions could adjust their cross-border portfolios. These adjustments further impact the scale and direction of capital flows [8, 9]. Additionally, investors' uncertainty about future interest rates and exchange rates can intensify the volatility of cross-border capital flows in the short term.

3.3. Asset Price and Debt Expansion Effects

The low interest rate environment has driven up the prices of stocks, bonds, and real estate. As asset prices increase, businesses and families are incentivized to take on more leverage and borrowing in pursuit of higher returns. When asset prices continue to rise, the overall leverage level of the financial system also escalates. Over time, this process can create potential systemic risks. In the long term, high leverage and asset price bubbles may render the financial system more fragile. If capital flows reverse or market expectations shift, asset prices could decline sharply [10]. A drop in asset prices places repayment pressure on enterprises and financial institutions, potentially triggering a series of reactions such as asset sales, credit contraction, and broader market instability. Debt expansion and leverage accumulation heighten the financial system's vulnerability to external shocks, thereby exacerbating financial fluctuations and systemic risks.

3.4. International Spillover and Recirculation Mechanism

Interest rate cuts in major economies have spillover effects on other countries through trade, financial channels, and market expectations. These policy spillover effects particularly influence the capital accounts, exchange rates, and macroeconomic stability of emerging markets. Short-term capital inflows may drive up asset prices and exchange rates, but when global capital retracts or market confidence declines, capital withdrawals occur rapidly, creating a cyclical effect. The international spillover mechanism indicates that the global interest rate cut cycle not only impacts developed countries but also amplifies systemic risks in emerging markets through capital flows. Furthermore, the interest rate cut policy can be transmitted via cross-border financial institutions, leading to the accumulation of financial risks across different countries and markets, thereby heightening the instability of the global financial system.

4. Manifestations and Transmission Channels of Cross-Border Capital Flow Risks

4.1. Cyclical Volatility of Capital Flows

Cross-border capital flows exhibit pronounced cyclical characteristics. During periods of monetary easing, substantial capital tends to flow into emerging markets and high-yield assets, fostering short-term market prosperity. Conversely, during monetary tightening or when risk preferences decline, funds are rapidly withdrawn. These cyclical fluctuations result in sharp changes in foreign exchange reserves, significant adjustments in exchange rates, and heightened liquidity pressures in financial markets. The instability of capital flows also impacts investment and consumption behaviors, thereby amplifying macroeconomic volatility. Furthermore, frequent inflows and outflows of capital impose liquidity management challenges on financial institutions and increase the uncertainty surrounding credit supply.

4.2. Financial Asset Price Bubbles and Structural Risks

Excessive capital inflows can drive up the market prices of stocks, bonds, and real estate, causing asset prices to deviate from their underlying fundamentals. This phenomenon, often referred to as a "capital illusion," not only heightens the vulnerability of the financial system but also disrupts the balance of the market structure. Such imbalances concentrate the exposure of financial institutions and investors on specific asset classes, thereby increasing systemic risks. A sudden reversal of capital flows may lead to a sharp decline in asset prices, triggering chain reactions such as market panic, credit tightening, and capital outflows, which further intensify financial instability.

4.3. Currency Mismatch and External Debt Risk

When interest rates are low, companies and financial institutions often increase their borrowing in foreign currencies to reduce overall financing and borrowing costs. However, if exchange rates shift unfavorably, these entities may encounter significant challenges. Currency mismatches can impact individual enterprises or institutions and potentially trigger a chain reaction in the market, leading to asset sales, credit contraction, and tightened market liquidity. The risks associated with external debt are particularly pronounced in emerging markets, where capital flows are highly volatile. Depreciation of the local currency can rapidly intensify repayment pressures, thereby increasing the overall vulnerability of the financial system.

4.4. Cross-Market Transmission of Systemic Risk

Capital outflows can transmit risk through mechanisms such as currency depreciation, asset sales, and credit contraction. This cross-market transmission process amplifies systemic financial risk and has the potential to trigger regional or global financial instability. Fluctuations in capital flows impact not only financial markets but also the real economy, exerting dual pressure on both the financial system and economic operations. As systemic risks increase, the interconnectedness among financial institutions intensifies, potentially escalating isolated issues into a comprehensive financial crisis.

5. Financial Risk Prevention and Policy Response Mechanisms under Interest Rate Cut Cycles

5.1. Macroprudential Management and Countercyclical Adjustment

Macroprudential management focuses on enhancing the resilience and stability of the financial system through policy measures. In the context of an interest rate cut cycle, a dynamic capital buffer mechanism can be established, requiring financial institutions to adjust capital reserves based on economic cycles to address potential risks. Additionally, countercyclical loan supervision should be implemented to prevent the rapid increase of financial leverage by restricting excessive credit expansion. Stress testing systems, which simulate various market shock scenarios, are also critical tools for assessing the tolerance of financial institutions under extreme conditions. These measures help mitigate systemic risks arising from fluctuations in cross-border capital flows and strengthen the financial system's ability to withstand external shocks.

5.2. Cross-Border Capital Flow Management

Cross-border capital flow management primarily relies on policy tools to regulate the movement of short-term speculative funds. Measures such as capital inflow taxes, foreign exchange controls, and the macro-prudential assessment (MPA) system can guide the direction and structure of capital inflows. Additionally, strengthening the supervision of short-term foreign debt helps prevent enterprises and financial institutions from becoming overly dependent on short-term external financing. These measures not only restrict the inflow of speculative capital but also mitigate fluctuations in financial markets. Furthermore, they enhance the positive role of capital flows in supporting macroeconomic and financial systems. Effective cross-border capital flow management requires coordination with macro-prudential policies to maximize their impact. Such coordination contributes to the establishment of a comprehensive and systematic risk prevention framework.

5.3. Foreign Exchange Policy and Reserve Strategy Optimization

Monetary policy plays a crucial role when interest rates decline. A controlled floating exchange rate can help mitigate the effects of international capital flows and prevent significant or abrupt changes in the exchange rate. Additionally, enhancing the management of foreign exchange reserves can optimize asset utilization and achieve

higher returns [11, 12]. Maintaining a balanced level of foreign exchange reserves supports exchange rate stability during periods of rapid capital inflows and outflows. Such stability is essential to reducing the adverse effects of local currency fluctuations on the broader economy.

5.4. International Monetary Policy Coordination and Regional Cooperation

The global interest rate reduction is affecting countries that cannot independently manage all associated risks. Major economies should enhance their exchange of policy information to collectively ensure financial stability [13]. International organizations, such as the International Monetary Fund, along with regional financial groups, can offer support when capital flows fluctuate or financial markets face pressure. Regional monetary policies also play a crucial role in mitigating the effects of cross-border capital movements and promoting market stability. Through international cooperation, countries can address short-term financial risks more effectively while providing stronger safeguards for the global financial system in the long term.

5.5. Fintech and Risk Early Warning System Development

The advancement of financial technology has introduced innovative tools for managing and mitigating risks associated with cross-border capital flows. By leveraging big data, artificial intelligence, blockchain, and other technologies, a real-time monitoring platform can be established to dynamically track and analyze international capital movements. Through data mining and risk modeling, regulators can proactively identify potential risks and detect abnormal flows. Additionally, financial technology enhances the speed and precision of policy responses, enabling regulators to intervene promptly during periods of abnormal capital flows or heightened financial market volatility, thereby reducing the likelihood of systemic risks. Developing a robust financial technology-based risk early warning system will serve as a critical mechanism for financial risk prevention and control, particularly during periods of interest rate reductions [12].

6. Conclusion

This article systematically examines the characteristics, impact mechanisms, and financial risk prevention strategies associated with cross-border capital flows during the global interest rate cut cycle, based on theoretical analysis and case studies. The findings indicate that the global interest rate cut cycle accelerates cross-border capital flows through mechanisms such as interest rate spreads, asset price changes, and expectation channels. This results in a rapid influx of funds into high-yield markets, thereby increasing financial market volatility. Cross-border capital flows exhibit pronounced cyclicity, amplifying the transmission effects of external shocks and exposing emerging markets to heightened systemic risks. To address these challenges, a "three-dimensional prevention and control system" integrating macro-prudential management, cross-border supervision, and international policy coordination is essential. Measures such as dynamic capital buffering, capital flow management, foreign exchange reserve optimization, and international cooperation are critical to enhancing financial system resilience and mitigating risk accumulation. Future research could employ quantitative models and panel data to empirically analyze the effects of interest rate cut policies on capital flows and risks across different countries. This would provide actionable theoretical and policy insights for global monetary policy coordination, financial risk management, and the promotion of financial stability in emerging markets.

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