March 5, 2025

Bank of Japan

Cross-border Capital Flows and the Role of the IMF and Central Banks in the Evolving International Monetary System

Remarks at the IMF Event
"Asia and the IMF: Resilience through Cooperation" in Tokyo

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Introduction

Thank you for inviting me here to celebrate this important milestone. As we discuss the future challenges and opportunities of the International Monetary Fund (IMF), it is worth noting that the 80 years since the creation of the Bretton Woods system has witnessed economic growth with the unprecedented expansion of trade in world history. Throughout this period, the IMF has consistently played a key role in promoting global cooperation and maintaining the stability of the international monetary system, even after the collapse of the Bretton Woods system in 1971.

I will start my remarks by reviewing the response of central banks and the IMF to the Asian economic crisis in the late 1990s. Then, I will explore how we can reap the benefits and avoid the pitfalls of cross-border capital flows in an era of geopolitical uncertainty.

I. Capital Flows and the Asian Economic Crisis

Cross-border capital flows have benefits and drawbacks. There is a broad consensus that inflows of capital are beneficial to recipient countries, as they can make up for deficiencies in long-term risk capital for financing investment. Indeed, by attracting foreign direct investment (FDI) from advanced countries, Asian emerging economies have been on a strong growth trend as a global hub for manufacturing supply chains. Capital flows can also be beneficial to the sending countries, offering investment opportunities for the savings generated by aging populations that have been typically seen in Japan.

Meanwhile, capital flows can also pose risks. They can be volatile and procyclical, amplifying economic and financial cycles in recipient countries. During "risk-on" periods, capital inflows into emerging markets tend to surge, adding further credit to an investment boom and fueling an asset-price bubble with increased leverage. This process can reverse dramatically during "risk-off" periods. If severe negative shocks are propagated through global financial markets, even countries with stable performance may get caught up in sudden stops and sharp reversals, falling into a recession accompanied by deleveraging. Research has shown that "global financial cycles," mainly driven by U.S. monetary policy, strongly affect risky assets in small open economies through international capital flows, which in turn limits their policy space to

maintain macro-financial stability.[1]

Indeed, the Asian economic crisis in the late 1990s is a powerful reminder of the economic turmoil that can be triggered by disruptive capital outflows. It is important to note that, in this respect, the Asian crisis differed crucially from classic balance-of-payments crises or currency crises previously seen in emerging economies. In the run-up to the Asian crisis, "gross" rather than "net" capital inflows surged amid financial liberalization and globalization, and they acted as an amplifier of double mismatches -- currency and maturity mismatches -- which had built up in the domestic banking system. In this situation, the dramatic reversal of gross capital flows triggered the banking crisis and currency crisis simultaneously with large-scale deleveraging. Moreover, the crisis spread from one country to several other countries through successive capital outflows, raising fears of a worldwide economic meltdown due to financial contagion.

Drawing lessons from this traumatic experience, Asian central banks and the IMF have both taken a variety of actions to deal with capital flows and prevent a financial crisis. Asian central banks have strengthened prudential regulation and supervision to reduce foreign currency-denominated liabilities, the so-called original sin, which was one of the underlying vulnerabilities in their financial systems. They have also introduced capital flow management measures (CFMs), some of which could work as macroprudential policy tools to prevent destabilizing capital flows. Moreover, they have shifted away from hard pegs and increased flexibility in their exchange rate regimes, so that exchange rate movements will be able to absorb external shocks. On the monetary policy front, many Asian central banks have adopted an inflation-targeting framework as a nominal anchor, thereby enhancing transparency and credibility. They have also accumulated ample FX reserves as self-insurance to avoid resorting to the IMF's liquidity assistance. At the same time, the Asian authorities have set up a regional financial safety net, the Chiang Mai Initiative Multilateralisation (CMIM).

The IMF, the guardian of free capital flows, also recognizes that disorderly capital flows could pose a serious risk to financial stability.[2] Specifically, the IMF has enhanced its capacity to

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[1] Early examples include Rey (2013).

[2] See Ariyoshi (2024) for the details of the IMF's initiatives following the Asian economic crisis.

analyze financial stability issues, and since 2003 has published the biannual *Global Financial Stability Report* (GFSR) as a companion flagship report to the *World Economic Outlook* (WEO). At the same time, it has strengthened bilateral and multilateral surveillance on financial sector by conducting the Financial Sector Assessment Program (FSAP) in 5- or 10-year cycles, in addition to the annual Article IV Consultations. As for capital controls, the IMF made an epoch-making shift in its "Institutional View," published in 2012 and updated in 2022: this acknowledged that under certain circumstances, capital flow management measures were useful as a macroprudential policy toolkit to prevent the buildup of financial vulnerabilities. Moreover, the IMF enhanced its role of providing liquidity support for member countries in times of crisis by increasing the size of its lending capacity and introducing precautionary lending facilities, such as the Flexible Credit Line (FCL).

II. Resilience So Far and the Way Forward

There is no doubt that these actions by Asian central banks and the IMF, as a whole, have contributed to the resilience of Asian economies to large and disruptive capital flows. In the face of the global pandemic and the subsequent aggressive monetary tightening in advanced economies, Asian countries have remained largely resilient to turbulence in capital flows. Indeed, researchers at the Bank for International Settlements (BIS) have recently shown that financial crises in emerging markets have become noticeably less frequent since 2000.[3] They point out that a set of structural factors has played a role in insulating domestic economies from global shocks. Among them, the improved monetary policy and prudential frameworks I have just outlined seem to be key.

It is true that several fortunate developments may also have contributed to the stability of Asian economies in the most recent episode. Because the COVID-19 pandemic was a common, global shock that caused synchronized inflation fluctuations worldwide, Asian central banks had no need to steer their monetary policies in a different direction from advanced economies, thereby pre-empting large capital outflows. Moreover, we should note that the stronger U.S. economy relative to the previous monetary tightening episodes may have benefited emerging economies by increasing their external demand.[4]

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[3] See Hardy, Igan, and Kharroubi (2024).

[4] See Chen and Tillmann (2025).

In any case, we should not be complacent. Looking ahead, the resilience of Asian emerging market economies will be tested by rising geopolitical tensions in several ways. First, as suggested by the IMF's GFSR,[5] an increase in geopolitical tensions among countries could cause a sudden reversal of cross-border capital flows. Furthermore, this effect could be larger for emerging countries than for advanced countries. Second, global economic fragmentation could widen the divergence in monetary policy stance by reducing business cycle co-movements across countries. This could potentially increase the volatility of cross-border capital flows with destabilizing effects on exchange rate dynamics. Third, investors should take into account geopolitical factors in addition to conventional risk-return calculations, which could complicate capital flow dynamics. Now that non-bank financial intermediaries (NBFIs) are playing an increasingly important role in global financial markets, this could further lower the predictability of capital flows.

III. Importance of Global Cooperation

Given the possible implications for macro-financial stability of rising geopolitical tensions, Asian central banks and the IMF should continue deepening their cooperation. In terms of crisis prevention, we can improve our ability to identify and quantify financial vulnerabilities by exchanging research insights from, for example, stress testing exercises or scenario analyses of geopolitical risks, through the IMF's surveillance. Should a crisis arise, Asian central banks and the IMF could explore how to use regional financial safety nets and lending facilities to address liquidity shortages in an effective and coordinated manner.

As former IMF chief economist and former Governor of the Reserve Bank of India, Professor Raghuram Rajan stresses,[6] central banks tend to follow the "own house in order doctrine" because their domestic mandates do not legally allow them to take the full extent of adverse spillovers abroad into account. Consequently, the global economy may be led into a suboptimal collective path. In this respect, the IMF has the unique role of promoting multilateralism and resolving coordination failures to improve the overall welfare of the global economy.

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[5] See Chapter 3 of IMF (2023).

[6] See Rajan (2023).

The international monetary system can be seen as a "global public good."[7] When it works well, everyone benefits; if it works poorly, everyone suffers. About 80 years ago, delegates from more than 40 countries gathering at the Bretton Woods Conference created a new international monetary system for global prosperity, reflecting on the mistakes of the competitive devaluations and restrictive trade policies that worsened the Great Depression. The Bretton Woods system itself ended in 1971, but its spirit is alive and well.

I believe it is time once again to renew our commitment to global economic cooperation in this era of heightened geopolitical uncertainty.

Thank you for your attention.

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[7] See Camdessus (1999).