

Chapter 2 Summary

Capital Flows to Emerging Markets: The Role of Global Nonbank Investors

Cross-border portfolio flows to emerging markets have risen sharply since the global financial crisis, driven largely by nonbank financial investors. These flows bring important benefits, such as supporting the development and deepening of financial markets and expanding financing opportunities but they also introduce vulnerabilities, such as heightened sensitivity to shifts in global risk sentiment.

Using granular data on cross-border holdings of global non-bank financial investors, this chapter provides a novel and comprehensive analysis on how global financial shocks transmit to emerging markets through portfolio flows and outlines policy options to strengthen resilience to capital flow volatility.

The 2008 global financial crisis marked a turning point in the relative sensitivity of cross-border bank and portfolio liability flows to global risk sentiment. Since then, cross-border bank lending has become less sensitive to shifts in global risk, reflecting in part post-crisis regulatory reforms that constrained global banks' risk-taking capacity. By contrast, portfolio debt liability flows have remained more sensitive to changes in global risk conditions. This sensitivity is particularly pronounced in emerging markets compared to advanced economies, especially in countries with weaker institutional quality, less adequate international reserves buffers, or higher public-debt-to-GDP ratios.

Among nonbanks, the sensitivity to global risk varies significantly across investor types. Hedge funds and investment funds react more strongly to shifts in global risk sentiment than other nonbanks, with passive mutual funds and exchange-traded funds showing the greatest sensitivity within the investment fund sector. During periods of global market stress, issuers in countries that tend to rely more on such risk-sensitive investors face tighter financial conditions, such as reduced debt issuance and wider sovereign and corporate bond spreads, with potential adverse implications for macrofinancial stability.

The composition of a country's nonbank financial investor base should therefore be an important consideration in policymaking. Emerging markets, especially those reliant on more risk-sensitive investors, could benefit from strengthening institutional quality, building robust fiscal and external buffers, and pursuing proactive risk management consistent with the IMF's Integrated Policy Framework. In addition, systemwide stress tests can further help gauge the resilience of the financial system to sudden capital flow reversals and ensure that financial institutions hold adequate capital and liquidity buffers. International cooperation is essential to close regulatory and data gaps and limit the propagation and amplification of global financial shocks.

The rapid expansion of private credit markets and stablecoins in emerging markets warrant continued, proportionate monitoring, particularly where interlinkages with regulated financial institutions are material.

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