GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

EM External Positions: Stronger Balance Sheets, Changing Vulnerabilities

MONDAY, NOVEMBER 2, 2026

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KEY TAKEAWAYS

- **Emerging Market (EM) external positions have improved, led by private net external assets.** Historically, stronger external positions often reflected reserve accumulation, current-account adjustment, or reductions in external debt. Recently, however, an increasing share of external strengthening has come from residents' accumulation of foreign assets and valuation gains. The improved resilience could therefore be associated with changing sources of vulnerabilities.
- **Composition of EM external buffers is becoming more market sensitive.** Recent gains in net international investment positions have been driven increasingly by portfolio equity holdings, including rising exposure to U.S. equity markets. While these positions support risk sharing, diversification and wealth accumulation, they may be more sensitive to common global valuation shocks than traditional reserve-based buffers.
- **Resident foreign assets can provide a buffer against external financing shocks, but only partly.** During periods of market stress, residents often reduce foreign asset accumulation or repatriate foreign holdings, partially offsetting declines in nonresident financing. However, this cushion does not fully offset nonresident outflows and depends critically on the composition of foreign asset holdings, with non-equity foreign assets generally providing a stronger source of repatriation during stress than portfolio equity holdings.

EM external positions have improved, led by private net external assets

Major EMs enter the current period of elevated global uncertainty with stronger external balance sheets than in past stress episodes.[1] Current account deficits have narrowed in many cases (Figure 1, panel 1), resident foreign assets have risen, and NIIP positions have improved. Yet most major EMs remain net debtors (liabilities to nonresidents remain larger than resident assets abroad) and net capital inflow recipients (Figure 1, panel 2), making them vulnerable to changes in global financial conditions.[2] They also face tighter financing constraints than reserve-currency issuers, which benefit from safe-haven flows during periods of global financial stress. The key question is therefore whether the improvements in external positions provide usable resilience when global financial conditions tighten.

Recent improvements in external position reflect gains in net private assets. Historically, improvements in external resilience often reflect reserve accumulation, current account adjustment, or reductions in external debt. More recently, a growing share of improvements in EM external positions has reflected the accumulation of residents' foreign assets and net valuation gains on those assets (Figure 1, panel 4).

EM external positions are more exposed to global equity markets

Recent NIIP gains increasingly reflect portfolio equity positions. Portfolio equity holdings account for an increasing share of recent improvements in NIIPs, while reserve accumulation and reductions in external liabilities have played a smaller role (Figure 2, panel 1). As a result, the source of external strength is shifting from policy-controlled liquidity and liability reduction toward market-valued private foreign assets.

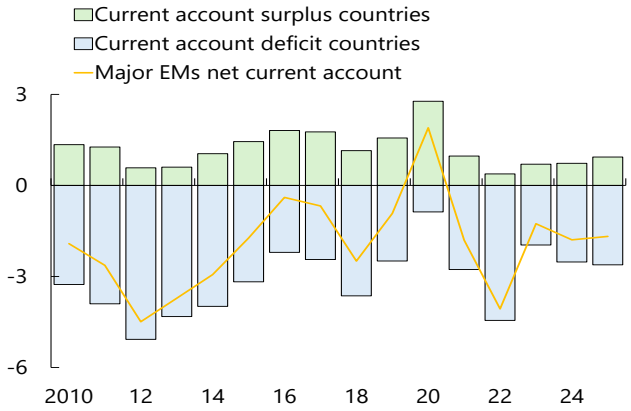
Equity-driven improvements differ from reserve accumulation. Reserve accumulation provides readily available liquidity under the control of policymakers, and official reserves are usually held in assets that tend to rise in value during periods of global stress. By contrast, improvements driven by portfolio equity positions (Figure 1, panel 3) depend heavily on market valuations and investor behavior. While such positions support diversification and wealth accumulation, they may provide less reliable protection during periods of global stress.

[1] The sample country in this background note covers the major EMs consisting of Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Malaysia, Peru, Philippines, Poland, Romania, South Africa, and Thailand.
[2] See annex A for definitions of key terms (net capital inflows, gross inflows, gross outflows etc) used in the note.

Figure 1. EM external positions have improved but remain vulnerable to external financing conditions

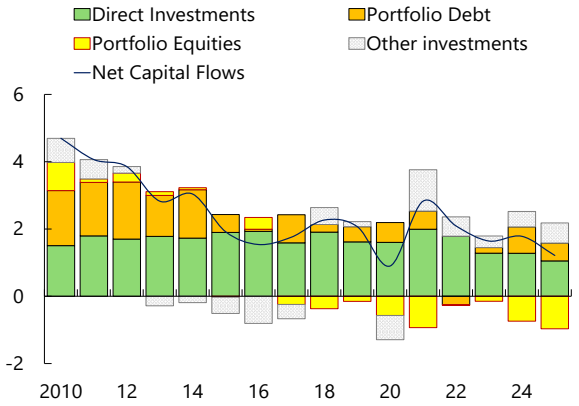
Most major EMs current account deficits have narrowed in recent years…

Current account balance
(Percent of GDP)



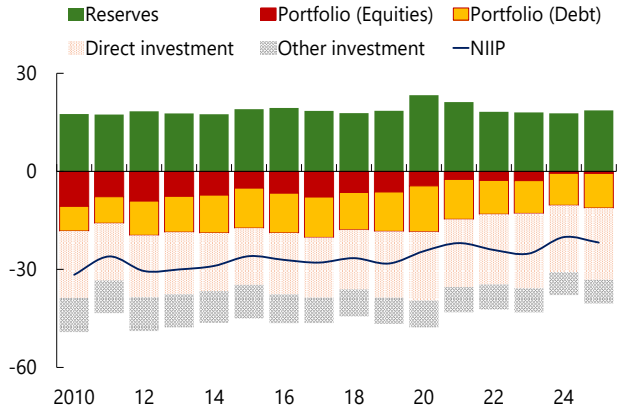
…and they continue to be net capital inflow recipients, except for portfolio equities

Net capital inflows
(Percent of GDP)



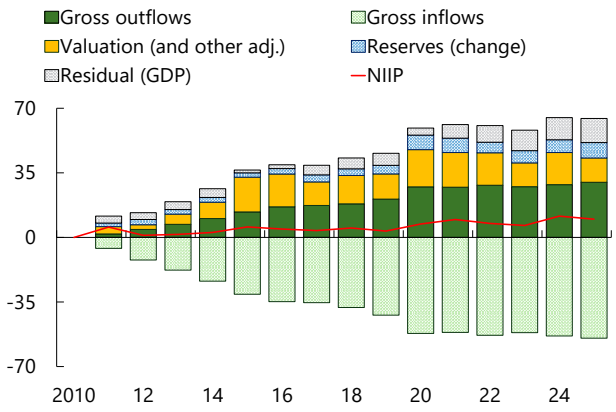
Major EMs' continued reliance on net capital inflows accumulates NII liability position…

Net international investment position
(Percent of GDP)



… but there have been improvements in external position from increased residents' outflows

Cumulative change to NIIP
(Percent of GDP)



Source: IMF's WEO, BOP and IIP databases; and IMF staff calculations
Note: Panel 1: Net capital inflows = Gross inflows – Gross outflows. Gross inflows = net incurrence of liabilities to nonresidents; Gross outflows = resident's net acquisition of foreign assets. In Panel 4, the decomposition is based on BOP and IIP data compiled by national authorities. As with most stock-flow reconciliations, the estimates are subject to data revisions, coverage differences, statistical discrepancies, and other non-transaction adjustments that are not fully captured in the reported data.

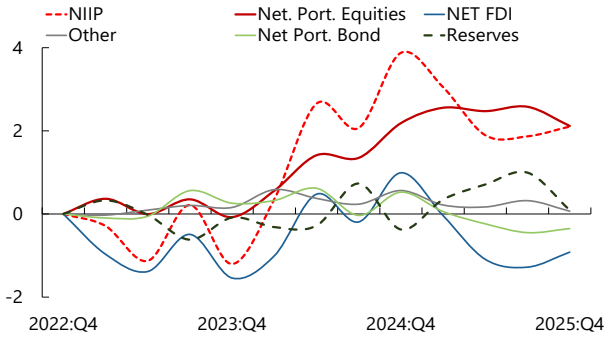
Growing exposure to U.S. equities creates a new channel of vulnerability. Residents in many EMs have become increasingly exposed to U.S. equity markets, which account for a growing share of foreign equity holdings (Figure 2, panel 2). These positions benefit from the depth and performance of U.S. markets but also increase exposure to synchronized global valuation shocks.

The composition of external buffers is becoming as important as their size. Recent improvements in external positions offer genuine benefits from consumption risk sharing, diversification and integration and should not be discounted. However, the increasing importance of private foreign assets and valuation gains means that headline measures of external strength may not fully capture resilience during periods of stress.

Figure 2. The composition of NIIP matters for external resilience

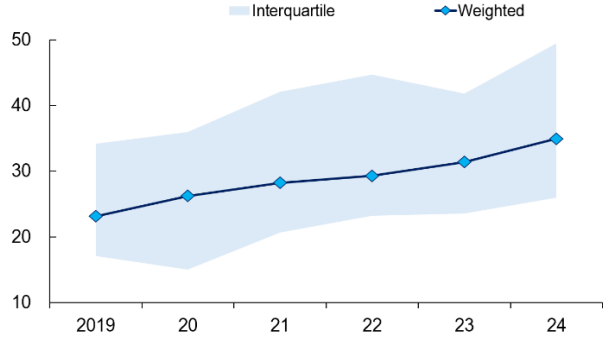
Portfolio equities contributing the largest share to NIIP improvement in recent years …

Cumulative change to NIIP since 2022
(Percent of GDP)



…alongside increasing residents' direct holdings of US equities

Resident holdings of US equities
(Percent of foreign equity holdings)



Source: IMF database; and IMF staff calculations
Note: In Panel 2, holdings exclude the indirect holdings through major financial centers.

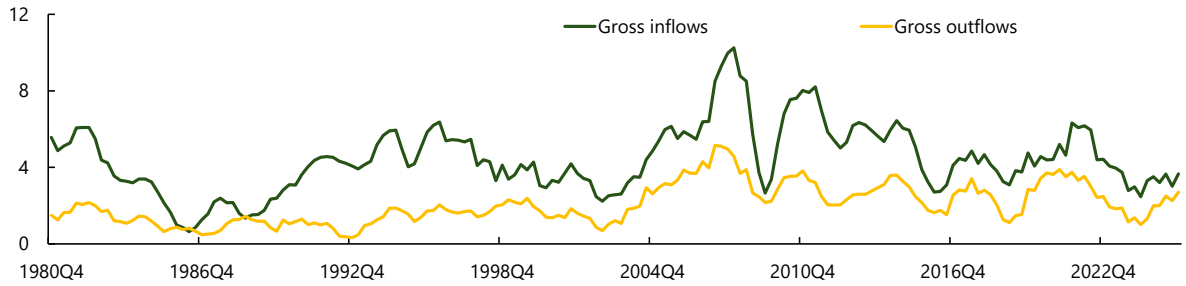
Resident foreign assets provide a partial shock absorber during stress

Resident retrenchment acts as a shock absorber during sudden stops. Evidence from both advanced and emerging economies suggests that stops and retrenchments frequently occur simultaneously, particularly during periods of elevated global stress (Figure 3). As EMs have become more financially integrated, this synchronization has become more pronounced. The implication is that resident foreign assets can provide a degree of self-insurance by generating offsetting inflows when external financing conditions deteriorate.

Figure 3. Episodes of stops and retrenchments increasingly occur simultaneously

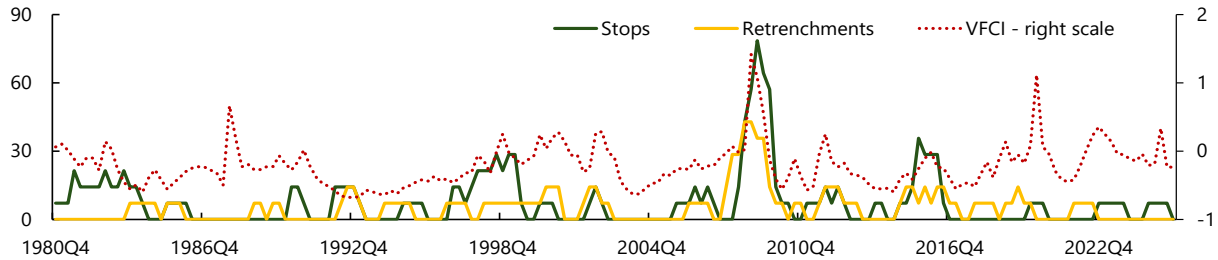
Countercyclical resident flows increasingly help mitigate, but do not fully offset nonresident outflows

Gross inflows and outflows
(4Q moving average as a percentage of GDP)



Consequently, sudden stops in nonresident inflows have coincided with resident retrenchment and partially mitigating net capital outflow pressures

Stops and retrenchment episodes and Volatility Financial Conditions Index (VFCI)
(Percent of countries in episodes, Index)



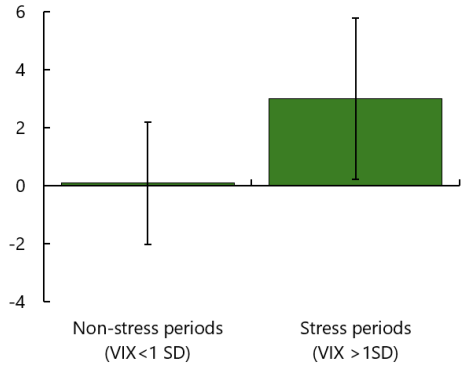
Source: Author's calculations; EUROPACE AG/Haver Analytics; and Adrian et al (forthcoming)
Note: Stops are large declines in gross inflows (by non-residents) and retrenchments are large declines in gross outflows (by residents). Definition of stops and retrenchment follows Forbes and Warnock (2012). See Annex for details. VFCI index (average of daily observations for the quarter), measures the market price of risk spanned by asset returns and is from Adrian et al (forthcoming).

Larger resident foreign asset positions strengthen this buffer. Panel estimates indicate that economies with larger resident foreign asset holdings are more likely to experience retrenchment during periods of elevated global risk aversion (Figure 4, panel 1). The relationship is weak during normal periods but becomes economically and statistically significant during stress episodes, suggesting that resident foreign assets can provide a source of countercyclical financing when external conditions deteriorate.

Figure 4. External positions provide buffer during stress period

A 1 ppts increase in IIP is associated with a 3 ppts increase in the probability for an onset of retrenchment episode during stress

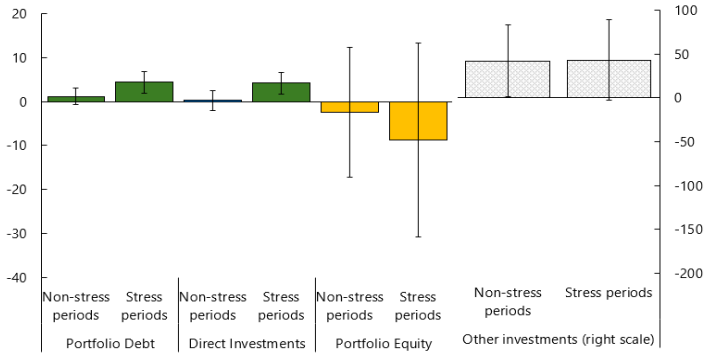
Marginal effect of IIP asset on probability of onset of retrenchment (Percentage points)



Direct investment and portfolio debt positions appear to contribute more strongly to retrenchment episodes than portfolio equity holdings

Marginal effect of IIP sub-components on probability of onset of retrenchment

(Percentage points)



Source: IMF staff estimates
Note: Panel 1 reports panel probit results using the overall IIP as explanatory variable, while Panel 2 uses its subcomponents: portfolio debt, direct investment, portfolio equity, and other investments. The dependent variable is identical across both panels, capturing the probability of the onset of a retrenchment episode. Further details on the data and methodology are provided in the Annex.

However, the composition of resident foreign assets influences their stabilizing role, with foreign equity holding less reliable. The retrenchment channel is not equally strong across asset classes. Non-equity foreign assets, including portfolio debt, direct investment, and other investment positions, appear more likely to generate offsetting inflows during periods of elevated global stress than portfolio equity holdings (Figure 4, panel 2). The smaller role of portfolio equity assets in driving the onset of a retrenchment episode could reflect the smaller share of these holdings in EM external assets in the past as well as the fact that risky assets decline in value during periods of global stress.

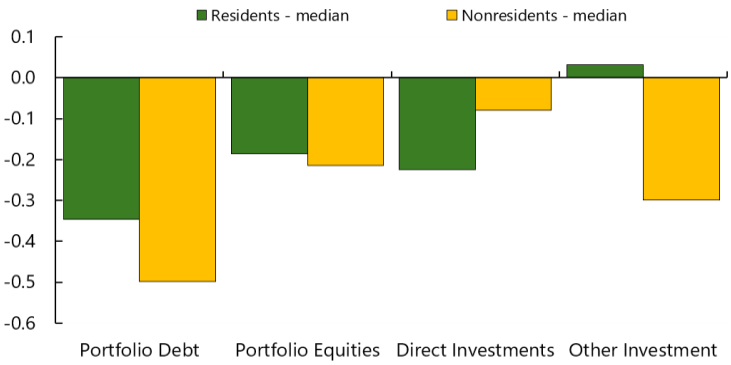
Moreover, while resident retrenchment cushions stops, the offset is usually incomplete. During periods of heightened global stress, declines in nonresident inflows are typically larger than reductions in resident outflows, implying that resident retrenchment only partly offsets external financing pressures (Figure 5).

Figure 5. Flow retrenchment during stressed periods suggests incomplete stabilizing effects

Retrenchment does not fully offset severity of stops during stressed periods

Capital flows during periods of common stress

(Normalized resident flow in Z-score)



Source: IMF database; IMF staff calculations
Note: Capital flows are measured during episodes in which the VIX index is larger than +1 standard deviation, based on average daily observations for each quarter from 2005:Q1 to 2025:Q4.

Annex

Definitions and terminologies

1. Capital flows and international investment position terms are defined as follows:

- **Gross capital inflows =** Nonresidents' net inflows = Nonresidents' purchase less sales of domestic assets.
- **Gross capital outflows =** Residents' net outflows = Residents' purchase less sales of foreign assets. Resident outflows exclude official purchases and sales of foreign assets for official reserves accumulation.
- **Net capital inflows:** Gross inflows minus gross outflows.
- **Gross external assets:** Outstanding financial claims of residents on nonresidents, including official reserves.
- **Gross external liabilities:** Outstanding financial claims of nonresidents on residents.
- **Net international investment position (NIIP):** Gross external assets minus gross external liabilities, representing the economy's net external financial position.

Note: All variables are expressed as percentage of GDP, at annualized rates. Definitions follow the IMF's Balance of Payments and International Investment Position Manual. Capital flows and international investment positions cover major functional categories, including direct investment, portfolio investment (equity and debt securities), other investment (including loans, deposits, and trade credit), and for NIIP, also reserve assets.

2. Capital flow episodes are defined as follows:

Investor Group (flow)	Large Increase (+)	Large Decrease (-)
Non-residents (gross inflows)	Surge	Stop
Residents (gross outflows)	Flight	Retrenchment

Note: "Large Increase" = year-over-year change in 4-quarter moving sum of the variable exceeds the rolling mean plus 1 rolling standard deviation for a contiguous sequence of at least 2 quarters, as long as it exceeds mean + 2 standard deviation for at least one of those quarters (Forbes and Warnock, 2012). The 4-quarter moving sums are backward looking and include the current quarter, as do the 20-quarter rolling means and standard deviations. "Large decreases" are analogously defined, with mean minus 1 or 2 standard deviations.

Data and methodology

The analysis covers 14 major emerging markets over 2005–2025. The sample consists of relatively large and financially integrated EMs with comparatively open capital accounts and sovereign debt markets accessible to international investors. Data are drawn primarily from IMF databases, together with market indicators and sovereign spread measures.

The empirical exercise examines whether resident foreign assets provide a buffer during periods of global stress. Using a panel probit framework, the analysis tests whether countries with larger resident foreign asset positions are more likely to experience retrenchment episodes during periods of elevated global risk aversion. The exercise considers both aggregate foreign assets and their major balance-of-payments components.

To examine whether resident external assets mitigate vulnerabilities associated with reliance on nonresident financing during episodes of global financial stress, we address the following question:

- During periods of elevated global risk aversion, by how much does the probability of resident portfolio asset retrenchment increase when residents' foreign assets rise by 1 percentage point of GDP?

To do so, we estimate a panel probit model to examine the onset of retrenchment episodes[3], *R* observed in the 14 major EMs from 2005:Q1 to 2025:Q4:

$$P(R_{it} = 1) = \Phi[\alpha_i + \beta_1 IIP_{ijt-1} + \beta_2 HighVIX_t + \beta_3\left(HighVIX_t \times IIP_{ijt-1}\right) + \gamma X_{it-1+} + \mu_i + \varepsilon_{it}] \quad (1)$$

The key explanatory variables are total residents' external assets, IIP_{ijt-1} expressed as a share of GDP for country *i* and IIP subcomponent, *j*. The CBOE Volatility index (VIX) is used as the global shock variable, with VIX above 1 standard deviation as the threshold for $HighVIX_t$ variable (1 or 0). To examine whether resident external assets mitigate vulnerabilities associated with nonresident outflows, the specification includes an interaction term between resident external assets and risk aversion episodes.

The regression also includes country fixed effects, μ_i, and a set of macroeconomic controls, X_{it-1}, including GDP growth, inflation, current account balance, Debt/GDP, and capital account openness index (proxied by the Chinn-Ito index). All these variables are lagged by one period to mitigate concerns regarding reverse causality and simultaneity.

The coefficients of primary interest $\boldsymbol{\beta_1}$ and $\boldsymbol{\beta_3}$, and the marginal effect of the combined impact of $\boldsymbol{\beta_1}$ and $\boldsymbol{\beta_3}$, which capture the interaction between global risk aversion and resident external asset positions. It assesses whether economies with larger stocks of residents' external assets are more likely to experience resident capital retrenchment during episodes of elevated global financial stress, providing a stabilizing source of financing during periods of global risk aversion.

References

Adrian, T., Kramer, J., and Malik, S. Forthcoming Operationalization of a cross country, high-frequency VFCI framework. IMF Note. International Monetary Fund, Washington, D.C.

Forbes, K., and F. Warnock. 2012. Capital Flow Waves: Surges, Stops, Flight, and Retrenchment. Journal of International Economics 88(2012) 235-251.

[3] The definition of retrenchment episodes follows Forbes and Warnock (2012), which is when gross outflows increase one standard deviation above its mean, providing it reaches two standard deviations above at some point.