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DETERMINANTS OF CAPITAL FLOWS IN THE EMERGING ECONOMIES

Dr. Anuj Aggarwal*
Anika Jain**
Anirudh Mittal***

ABSTRACT

The two forces that has reshaped the global economic landscape are: Globalization and Technological revolution. There has been significant degree of financial liberalization i.e. easing controls on FDI & FII flows especially among emerging economies that has paved the way for massive flows of capital from the developed economies, but at the same time the rigid structures, lack of accountability, unorganized markets, outdated technology etc. have also led to flight of capital flows. A meta study has been undertaken to identify the major factors that influence the capital flows across economies and their policy implications in the short and long term. The results of the study have validated many theories as well as thrown quite a few surprises in terms of firm-specific and institutional factors that play a role in the investment decision-making.

Keywords: *Global Economic Landscape, Globalization, Technological Revolution, FDI & FII.*

Introduction

The flow of capital is driven by multitude of factors that determines its magnitude and direction in the contemporary global economy. The developed economies operate on a different scale due to organized financial markets and sophisticated institutional structures that distinguishes developed world from new, emerging economies that are challenging the present status-quo. The international investors are pretty excited about investing in emerging markets as they offer enormous scope to generate long-term returns and unlock greater value. In today's world, its possible to trade in financial assets across classes, from anywhere at the click of a button. This phenomenon has unleashed huge possibilities in terms of movement of capital across time and geography. In the wake of this new economic order, the countries are initiating series of trade and investment reforms to make themselves more compatible with the rest of the world.

The International management theory analyzes factors that drive firms to go global and what are the strategies to achieve global competitiveness. The Vernon's Product Life Cycle theory states the evolution of a product "from the stage of manufacturing in a developed country like the USA to being produced in developing countries." Dunning (1993) introduced a model in which he described the broad internationalization motives - Market seeking, resource seeking, efficiency seeking and strategic resource seeking motives. There is a fifth category which has been added - Network seeking motive which places emphasis on the role of networks as a conduit for internationalization. Dunning (2000) shows that closer relations with customers and durable relations with suppliers are important motives.

Market Seekers

This category of motive depends upon whether decision makers within a company acknowledge the importance of reaching specific target markets abroad and believe that a direct presence internationally is essential. Firms that invest in a particular country or region with the intention to supply goods and services are called market seekers.

* Assistant Professor, VIPS, Delhi, India.
** Undergraduate Student, Business Administration, VIPS, Delhi, India.
*** Undergraduate Student, Business Administration, VIPS, Delhi, India.

One of the most important factor to foray into foreign markets is to promote or exploit new markets, it may be because of the sheer size of the market, less regulation or an expected growth in profits etc. They may invest directly into the international markets through FDI or enter into JV's with local partners because firms' home market is limited or saturated or hyper competitive or having low customer base etc.

Resource Seekers

Sometimes the primary reason for companies to invest abroad is to obtain resources. For instance, if critical raw materials or components can be acquired at a lower comparative cost, or simply does not exist at all in the home country. It may include the search for physical resources, such as minerals (copper, oil, zinc, steel, aluminum etc.) or agricultural products (sugar, rubber etc.). These resources are sometimes central to the survival of a company, particularly if the material constitutes an important part of the production. Another resource can be cheap and unskilled (or semi-skilled) labor to minimize costs and maximize profits.

Efficiency Seekers

When firms lack competitive advantages in terms of product, technology or marketing, they seek to rationalize structures in order to gain from common governance. The underlying idea is gaining from the differences of factor endowments, cultures, institutional arrangements, and economic systems. These benefits are as a result of economies of scale and scope, and risk diversification. It is meant for experienced, large and diversified multinational enterprises that have a great spread of businesses.

Strategic Resource Seekers

Strategic resources include intangible resources dealing with the technology and human resource of the company like Patents, knowledge and skills of the employees, raw materials necessary for developing comparative advantages etc. It is important for the companies to develop strategic resources to achieve its long term strategic objectives. It can be done by acquiring the assets of domestic/foreign corporations.

Network Seekers

Networking has been described as "a dimension of international entrepreneurial culture" (Dimitratos & Plakoyiannaki, 2003). It reflects the extent to which firms would participate in strategic alliances, cooperative ventures and other forms of business connections.

It is important for companies to forge networks, relations and collaborations with partners outside the organization. The companies that are network seekers nurse, develop and expand their existing networks while cultivate new ones.

Chen, Chen and Ku (2004) directed our attention towards relational capital and its importance i.e relations between a firm and its suppliers, customers, partners, government agencies and research institutions is part of relational capital which represents goodwill and trust. The investment in relational capital and linkages enables the firm to create a competitive advantage, foster innovation, knowledge-sharing and value creation.

Research Problem

To understand the whole array of factors that influence the movement of capital flows to and from emerging market economies.

Objectives of the Study

The following are the objectives of the study:

- To identify the factors for attracting foreign portfolio investments (FPI's) among different sets of countries.
- To assess the firm-level and institutional factors for flight of capital in the emerging economies.
- To undertake a meta analysis of the existing literature on the determinants of inflows and outflows of capital from the emerging markets perspective.

Research Methodology

A comprehensive analysis of the existing literature has been undertaken to analyze the host of factors responsible for attracting or flight of capital flows in the emerging economies. The study has derived meaningful insights from a variety of sources including research papers, articles in business press, external agencies, independent think-tanks, industry associations, analysts' presentations etc. The paper is a sincere attempt to draw the linkages between inbound and outbound investors in terms of their motivations to invest, and strategies pursued to meet their organizational objectives.

The exhaustive internet search was made to collect 38 major research studies done in the associated areas of study over a period of time. Some of the key words used were Foreign Direct Investment, Foreign Portfolio Investment, Capital Flows, Capital flight etc. The list of references given in the papers was also thoroughly reviewed. Within the search results obtained, the theoretical papers or those based on case studies were eliminated.

Literature Review and Research Gap

In order to meet the research objectives, the comprehensive meta analysis has been conducted with respect to the driving forces and motivations for flow of capital from one part of the world to another. Following are the studies that analyzed the policies, structural reforms and business climate required to attract investment flows:

- **Aggarwal (1997) Foreign Portfolio Investment in Some Developing Countries: A Study of Determinants and Macroeconomic Impact**

It was found out (as a result of regression) that real exchange rate, inflation rate, index of economic activity and the share of domestic capital in the world stock market capitalization significantly influence FPI.

- **Montiel (1999) Do capital controls and macroeconomic policies influence the volume and composition of capital flows? Evidence from the 1990s**

The study stated that domestic forces such as structural reforms and external forces such as international interest rates are the main reasons behind the increase in capital flows to emerging economies.

- **Chakrabarti (2001) FII Flows to India: Nature and Causes**

It was concluded that factors like US and world equity returns, changes in interest rates, stock market volatility, measure of the country risk and the exchange rate play an important role in bringing capital flows to India.

- **Rai and Bhanumurthy (2004) Determinants Of Foreign Institutional Investment In India: The Role Of Return, Risk And Inflation**

It was studied that determinants such as stock market returns, inflation rates and ex-ante risks attract FII inflows to india.

- **Portes and Rey (2005) The Determinants of Cross Border Equity Flows**

The results of the study showed that market size, openness, efficiency of transactions and distance are the most prominent factors of transaction flows.

- **Vita and Kyaw (2008) Determinants of capital flows to developing countries: a structural VAR analysis**

The study stated that the most important factors of capital flows in developing countries are foreign output and domestic productivity.

- **Powell (2002) Capital inflows and capital outflows: measurement, determinants, consequences**

It was stated that determinants influencing capital inflows to developing countries are fiscal surplus and competitive exchange rate.

- **Lin (2009) Structural changes in foreign investors' trading behavior and the corresponding impact on Taiwan's stock market**

This study investigates the impact of the expected and unexpected trading behaviour of foreign investors on return volatilities during structural change periods.

The empirical results reveal that the impact of the expected trading of foreign investors on Taiwan's stock return volatility increases in accordance with a gradual relaxation of the foreign trading limits and gives rise to a negative effect; political shocks influence Taiwan's stock market.

- **Byrne (2011) International Capital Flows to Emerging and Developing Countries: National and Global Determinants**

The study found out that the US long run real interest rate influenced the flows of global capital more than the real commodity prices.

- **Fratzscher (2012) Capital Flows, Push Versus Pull Factors and the Global Financial Crisis**

The study stated that domestic factors like capital account openness, external financing need and exchange rate regime and global factors like US interest rates and investor risk aversion surges the capital flows.

- **Forbes (2012) Capital Flow Waves: Surges, Stops, Flight, and Retrenchment**

The findings of the study indicated that factors like specific crisis events, changes to global liquidity and risk conditions have a considerable effect on global capital flows.

- **Bhasin and Khandelwal (2013) Foreign Institutional Investment in India: Determinants and the impact of crises**

The research stated that shocks such as exposure to the domestic exchange rate or degrees of access to liquidity influence the waves of capital flows.

- **Dua and Garg (2013) Foreign Portfolio Investment Flows to India: Determinants and Analysis**

The author found out factors such as returns on MSCI Emerging Market Index, past values of FII inflows and the growth rate of the Indian economy affect inflows of FII to India.

- **French (2013) Volatility and foreign equity flows: evidence from the Philippines**

With the help of the econometric analysis the researcher found out that forces such as domestic stock market performance, exchange rate, domestic output growth, emerging market equity performance, interest rate differential, volatility in exchange rate and foreign output growth drives both FII and ADR/GDR flows.

- **Ghosh et. al (2014) Surges**

This paper examines when and why capital sometimes surges to emerging market economies (EMEs). External financing needs, growth performance, the exchange rate regime, financial openness, and institutional quality help determine which countries experience an inflow surge.

- **Ahmed and Zlate (2014) Capital Flows to Emerging Market Economies: A Brave New World?**

It was stated that growth differentials, policy rate differentials and global risk aversion determine the net capital flows to EMEs.

- **Srinivasan and Kalaiyani (2015) Determinants of Foreign Institutional Investment in India: An Empirical Analysis**

The author stated that factors like exchange rate, domestic inflation, domestic equity market returns, returns and risk associated with US equity market influence the FII flows in India.

- **Brana and Lahet (2010) Determinants of capital inflows into Asia: The relevance of contagion effects as push factors**

It was studied that forces such as interest rate differences with Japan, the exchange rate with the dollar, growth in advanced countries and global increasing liquidity are the traditional push factors of capital flows.

- **Arora (2016) The Relation between Investment of Domestic and Foreign Institutional Investors and Stock Returns in India**

Through the study, the author analyzed the trading patterns of Domestic institutional investors (DII) and Foreign institutional investors (FII) in relation to the Indian stock market returns and equity flows. It was found that investments from DII have a positive relation with stock returns while the FII investment has a completely opposite and negative impact on the same.

- **Singhania and Saini (2017) Determinants of FPI in Developed And Developing Countries**

It was stated that in developing countries determinants like trade openness, interest rate differential, host country stock market performance, freedom index and US stock market returns while in developed countries, trade openness, interest rate differential, host country stock market performance and US stock market returns effect the inflow of FPIs.

Table 1: Summary of Inflow Studies

S.No.	Study	Major Findings
1	Aggarwal(1997)	Real exchange rate, inflation rate, index of economic activity and the share of domestic capital in the world stock market capitalization significantly influence FPI.
2	Montiel(1999)	Domestic forces such as structural reforms and external forces such as international interest rates are the main reasons behind the increase in capital flows to emerging economies.
3	Chakrabarti(2001)	Factors like US and world equity returns, changes in interest rates, stock market volatility, measure of the country risk and the exchange rate play an important role in bringing capital flows to India.
4	Powell(2002)	Determinants influencing capital inflows to developing countries are fiscal surplus and competitive exchange rate.
5	Rai and Bhanumurthy(2004)	Determinants such as stock market returns, inflation rates and ex-ante risks attract FII inflows to India.
6	Portes and Rey(2005)	Market size, openness, efficiency of transactions and distance are the most prominent factors of transaction flows.
7	Vita and Kyaw(2008)	The most important factors of capital flows in developing countries are foreign output and domestic productivity.
8	Lin(2009)	The empirical results reveal that the impact of the expected trading of foreign investors on Taiwan’s stock return volatility increases in accordance with a gradual relaxation of the foreign trading limits and gives rise to a negative effect.
9	Brana and Lahet(2010)	Forces such as interest rate differences with Japan, the exchange rate with the dollar, growth in advanced countries and global increasing liquidity are the traditional push factors of capital flows.
10	Byrne(2011)	The US long run real interest rate influenced the flows of global capital more than the real commodity prices.
11	Fratzscher(2012)	Domestic factors like capital account openness, external financing need and exchange rate regime and global factors like US interest rates and investor risk aversion surges the capital flows.
12	Forbes(2012)	Factors like specific crisis events, changes to global liquidity and risk conditions have a considerable effect on global capital flows.
13	Bhasin and Khandelwal(2013)	Shocks such as exposure to the domestic exchange rate or degrees of access to liquidity influence the wave of capital flows.
14	Dua and Garg(2013)	Factors such as returns on MSCI Emerging Market Index, past values of FII inflows and the growth rate of the Indian economy affect inflows of FII to India.
15	French(2013)	Forces such as domestic stock market performance, exchange rate, domestic output growth, emerging market equity performance, interest rate differential, volatility in exchange rate and foreign output growth drives both FII and ADR/GDR flows.
16	Ghosh et. al. (2014)	External financing needs, growth performance, the exchange rate regime, financial openness, and institutional quality help determine which countries experience an inflow surge.
17	Ahmed and Zlate(2014)	Growth differentials, policy rate differentials and global risk aversion determine the net capital flows to EMEs.
18	Srinivasan and Kalaiyani(2015)	Factors like exchange rate, domestic inflation, domestic equity market returns, returns and risk associated with US equity market influence the FII flows in India.
19	Arora(2016)	Impact of both FII investment and DII investment on future stock returns.
20	Singhania and Saini(2017)	In developing countries, determinants like trade openness, interest rate differential, host country stock market performance, freedom index and US stock market returns while in developed countries, trade openness, interest rate differential, host country stock market performance and US stock market returns effect the inflow of FPIs.

Below are the studies conducted by research scholars and analysts on the forces that influence outflow of capital investment:

- **Hermes and Lensink (1992) The magnitude and determinants of capital flight: The case for six sub-Saharan African countries**

The results of the study revealed forces such as increase of government and government-guaranteed foreign debt and the overvaluation of the real exchange rate are significant in the variations of capital flights.

- **Powell (2002) Capital inflows and capital outflows: measurement, determinants, consequences**

It was studied that determinants influencing capital outflows from developing countries are mainly the investment climate, income and integration effects and discrimination between residents and foreign capital.

- **Makino (1996) Local Knowledge Transfer and Performance: Implications for Alliance Formation in Asia**

The study was based on a sample of 558 Japanese Joint Ventures. It was found that dealing with local firms can be a primary strategy for accessing local knowledge and improving JV performance.

- **Zacharakis (1997) Entrepreneurial Entry Into Foreign Markets: A Transaction Cost Perspective**

The study states that smaller firms generally does not have as many entry strategies as do larger multinational companies as small firms have resource constraints. The paper examines the problems between the small firms and export agents and thereby suggests methods for overcoming these problems.

- **Rondinelli (2000) Do government incentives attract and retain international investment? A study of foreign-owned firms in North Carolina**

The author stated that shocks such as labor force, transportation, quality of life, and overall business climate influence the flight of capital.

- **Harrigan (2002) On The Determinants Of Capital Flight: A New Approach**

It was studied that factors like exchange rate movements, changes in external debt, real GDP growth and foreign direct investment activities influence outflows of capital.

- **Fayoumi (2011) The Determinants Of Capital Flight: Evidence From MENA Countries**

It was found that lag capital flight, external debt, foreign direct investment, real GDP growth rate and uncertainty are the main determinants of capital flows to MENA countries.

- **Alam and Quazi (2003) Determinants of Capital Flight: An econometric case study of Bangladesh**

It was stated that factors like political instability, increases in corporate taxes, higher real interest rate differentials and lower GDP growth rates majorly contribute to outflow of capital.

- **Khanindra Ch. Das Nilanjan Banik (2015) What motivates Indian firms to invest abroad?**

The paper examines the motivations behind Indian firms' outward investment, i.e. whether these firms are investing abroad in search of market, resource, technology, strategic-assets, efficiency, etc. The result shows that there is strong evidence of resource-seeking, technology-seeing and efficiency-seeking outward FDI.

However, the market-seeking motive for internationalization has not been supported in the analysis, which is contrary to some of the previous studies based on aggregate FDI outflows at bilateral level. The results are robust to use of alternative sample of outward investing firms. The results also suggest that the BITs could play a role in facilitating outward FDI. In addition, OFCs emerge as a significant destination of outward FDI by Indian firms.

- **Hamel (1991) Competition for Competence and Inter-Partner Learning Within International Strategic Alliances**

This study highlights the importance of competitive collaboration as the main determinant learning outcomes. The study said that asymmetries in learning alter the relative bargaining power of partners as not all partners are equally adapt to learning.

- **Bloodgood (1996) The Internationalization of New High-Potential U.S. Ventures: Antecedents and Outcomes**

The author analyzed the effects of internationalization in the U.S of 61 new high-potential ventures. It was found that the board of directors work experience, the use of product differentiation and size of the IPO are directly related to internationalization. Also, the increased sales growth was a result of low cost, product differentiation/innovation and the level of internationalization of the IPO.

- **Gulati, Nohria and Zaheer (2000) Strategic Networks**

The study is based on the importance of inter-firm networks and the issues in strategic research. Key areas of strategic research are industry structure, positioning with an industry, inimitable firms resources and benefits, dynamic network constraints and benefits and contracting and coordinating costs.

- **Lu and Beamish (2004) International Diversification and Firm Performance: The S-Curve Hypothesis**

It was studied how a firm's motive of expanding internationally influenced the performance consequences. It was found that firms who invest more in their firm's intangible assets like advertising and technology attracted much more Foreign Direct Investment(FDI) than other firms and hence, experienced greater profitability.

- **L Henry (1996) Capital Flight from Beautiful Places: The Case of Three Caribbean Countries**

The study was done to find out the reasons of capital flight from three Caribbean economies namely- Jamaica, Barbados and Trinidad and Tobago. Through the use of the OLS Model, real interest rate differentials, external debt and the level of social instability were found to be the most influencing factors of capital outflow.

- **Kolapo and Oke (2012) Nigerian Economic Growth and Capital Flight Determinants**

The authors studied the effects of the determinants of capital outflow on the growth of Nigerian economy. The indicator for economic growth was Gross Domestic Product (GDP) and the determinants of capital outflow were Inflation Rate, Foreign Direct Investment, Exchange Rate and Fiscal Deficit.

- **Ajayi, L.B.(2012) Capital Flight and Nigeria Economic Growth**

This paper provides evidence on the negative impact of the assessment of capital flight on economic growth of Nigeria for 40 years (1970-2009). It provides a comprehensive analysis of capital flight and its resultant impact on domestic investment and the growth rate of the economy.

Trade faking has been discovered as an important vehicle of effecting capital flight. Domestic macro economic policy distortions is the culprit in the capital flight. Further, the investment incentives offered by the economies cannot be left out.

- **Albert Makochekanwa(2007) An Empirical Investigation of Capital Flight from Zimbabwe**

This paper investigates the causes of capital flight from Zimbabwe for the period 1980 to 2005. The results show external debt, foreign direct investment inflows, and foreign reserves to be the major causes of capital flight. Economic growth is negatively correlated with capital flight.

- **Victor Murinde' Robert Lensink (1996) Comparative Aspects of the Magnitude and Determinants of Capital Flight in Six Sub-Saharan African Countries**

This paper investigates the country-specific and cross-country magnitudes and determinants of capital flight in six Sub-Saharan African countries.

Table 2: Summary of Outflow Studies

S.No.	Study	Major Findings
1	Hamel(1991)	Competitive collaboration is the main determinant of capital flight.
2	Hermes and Lensink(1992)	Forces such as increase of government and government-guaranteed foreign debt and the overvaluation of the real exchange rate are significant in the variations of capital flights.
3	Bloodgood(1996)	The board of directors work experience, the use of product differentiation and size of the IPO are directly related to internationalization. Also, the increased sales growth was a result of low cost, product differentiation/innovation and the level of internationalization of the IPO.

4	Makino(1996)	Dealing with local firms can be a primary strategy for accessing local knowledge and improving JV performance.
5	Murinde and Lensink(1996)	Annual increase of domestic inflation, inflow of grants over GDP and overvaluation of the real effective exchange rate are the factors influencing capital flight.
6	Henry(1996)	Through the use of the OLS Model, real interest rate differentials, external debt and the level of social instability were found to be the most influencing factors of capital outflow.
7	Zacharakis(1997)	Export agent, licensing, joint venture or strategic alliance strategy.
8	Rondinelli(2000)	Shocks such as labor force, transportation, quality of life, and overall business climate influence the flight of capital.
9	Gulati, Nohria and Zaheer(2000)	Industry structure, positioning with an industry, inimitable firms resources and benefits and dynamic network constraints are main factors influencing capital outflow.
10	Powell(2002)	Determinants influencing capital outflows from developing countries are mainly the investment climate, income and integration effects and discrimination between residents and foreign capital.
11	Harrigan(2002)	Factors like exchange rate movements, changes in external debt, real GDP growth and foreign direct investment activities influence outflows of capital.
12	Alam and Quazi(2003)	Factors like political instability, increases in corporate taxes, higher real interest rate differentials and lower GDP growth rates majorly contribute to outflow of capital.
13	Lu and Beamish(2004)	It was found that firms who invest more in their firm's intangible assets like advertising and technology attracted much more Foreign Direct Investment(FDI) than other firms and hence, experienced greater profitability.
14	Makochekanwa(2007)	External debt, foreign direct investment inflows, and foreign reserves to be the major causes of capital flight. Economic growth is negatively correlated with capital flight.
15	Fayoumi(2011)	Lag capital flight, external debt, foreign direct investment, real GDP growth rate and uncertainty are the main determinants of capital flows to MENA countries.
16	Kolapo and Oke(2012)	The indicator for economic growth was Gross Domestic Product(GDP) and the determinants of capital outflow were Inflation Rate, Foreign Direct Investment, Exchange Rate and Fiscal Deficit.
17	Ajayi(2012)	Trade faking has been discovered as an important vehicle of effecting capital flight. Domestic macro economics policy distortion is the culprit in the capital flight episode.
18	Das and Banik(2015)	There is strong evidence of resource-seeking, technology-seeing and efficiency-seeking outward FDI.

A number of issues and research gaps were discovered during the literature review and those have been duly incorporated in the study. It has been found that while there is a good amount of research undertaken on developed economies, there is serious lack of scholarly research done for emerging economies. Hence, there is a strong case for more research to be directed towards emerging economies as they have undertaken fundamental transitions towards becoming market-based economies since the 1980's, and offer concrete grounds to test theories and develop new ones.

Further, it has been observed that strategy researchers have attempted to carry out studies drawn from the learnings of the previous studies which were based on developed country perspective. There are many reasons as to why the research of emerging markets must be done separately:

- There exists a substantial amount of capital gap exists between emerging and developed markets firms.
- The pace of institutional development and creation of robust factor markets that are required to undergo organizational transformation has been slow in emerging economies.
- The human capital in the emerging economies lack the knowledge, skills, foresight and experience necessary to compete in global markets.

- There has been a sizeable change in emerging economies in terms of managerial ability, but the differences in terms of institutional infrastructures between emerging and developed economies are so immense that it prevents managers' strategic orientation.
- The traditional managerial capabilities that were viable and successful in planned economies are no longer effective & relevant in more market-oriented economies, hence triggers the need for the acquisition of newer capabilities.

Findings of the Study

Following are the tables for the key factors that are held responsible for movement of capital investment within the global economy.

Table 3: Frequency of Factors (Inflow of Capital)

Factors	Frequency in Papers
Stock market performance	10
Exchange rates	8
Growth rate differentials	8
Interest rates	7
Global risk management	3
Capital account/trade openness	3
State of liquidity	3
Investment climate/Policy reforms	5
External financing needs	2
Aggregate output	2
Inflation rates	2
Transaction efficiency	1
Fiscal surplus	1
Market size	1

Table 4: Frequency of Factors (Outflow of Capital)

Factors	Frequency in Papers
External debt	8
Exchange rates	5
Growth rate differentials	5
Interest rates	4
Business environment/Investment climate	4
Labour force	3
Transportation	2
Political stability	2
Corporate Tax	2
Inflation rate	4
Potential for collaboration	2
Local knowledge	1
Trade relations	1
Market size	1

Discussion and Implications of the Study

The major factors that influence the decision making pertaining to attracting foreign capital into the emerging economies include stock market performance, exchange rates, growth rate differential, interest rates and investment climate prevailing in the economy.

The dominant factors that causes the flight of capital include:

- annual increase of the government-guaranteed external long-term debt over GDP.
- the overvaluation of the real effective exchange rate
- prevailing business climate, financial incentives and pace of reforms
- the growth rate differential between US and domestic financial assets
- annual increase of domestic inflation

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