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Capital Flight in Developing Countries

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Abstract: This research delves into the patterns of capital flight in emerging nations by examining how instability and political uncertainties as well as financial crises influence short-term capital outflows in these regions. Challenges such as income levels and restricted investments coupled with increasing foreign debts exacerbate the difficulties experienced by these countries. The study employs statistical approaches to shed light on occurrences such as the 2008 global economic downturn and the recent COVID-9 pandemic, which instigated instances of capital flight. The data shows that there is a distribution to the right with a standard deviation and significant variations in capital flows due to extreme values present in the data set. The research highlights the role of monetary policies in controlling capital outflows and maintaining financial stability. The results stress the necessity for developing countries to address weaknesses in order to reduce capital flight and bolster their infrastructure.

Keywords: Capital Flight, Residual Model, Developing Countries

1. INTRODUCTION

Capital is one of the most important factors in every country, whether developing or not. With abundant capital availability, a country can improve the welfare of its population (Istikomah, 2020). However, capital limitations become a significant constraint, particularly in developing countries. Low income affects the state treasury and also leads to low investment (Anwar et al., 2024). Low income also leads to a minimal inflow of foreign capital into the country, a negative impact on

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the capital account, and an increase in foreign debt due to the deficit. (Suhendra et al., 2022).

Given the significance of capital flows, particularly in developing nations, it is crucial to utilize these inflows as efficiently as possible to avert capital flight. Istikomah (2020) argue that the term 'capital flight' is generally associated with short-term outflows caused by economic or political uncertainty in the home country. Uguru et al. (2014). In 2008, we witnessed the phenomenon of capital flight. From the start of the subprime mortgage crisis in 2005 until June 2006, the Fed implemented a contractionary policy by raising the Fed rate target 14 times to 5.25%. Then, from July 2006 to August 2007, the Fed kept the Fed rate target constant at 5.25%. In September 2007, the Fed changed its policy direction to an expansionary stance, marked by lowering the Fed rate target to 4.75%.

The decrease in the Fed rate target caused a crisis in the US money market. As a result, a highly influential global crisis emerged, posing a significant challenge to developing countries. According to Anwar et al. (2023), the subprime mortgage phenomenon in the United States caused the global crisis, significantly impacting global economic growth, eroding investor confidence, and leading to the withdrawal of capital by foreign investors. The incident triggered a capital flight as investors sought safer places to store or allocate their capital (Kholishoh, 2024).

The trade war between the United States and China in 2018 also impacted the decline in global economic growth, especially in developing countries, and caused uncertainty in the global financial market, which later prompted investors to withdraw their funds. This situation also poses a threat to external stability. Trade wars can also trigger a crisis of confidence in the global financial system and in a country's ability to resolve conflicts peacefully. Such a crisis of confidence can exacerbate capital flight as investors lose faith in the country's ability to maintain economic stability.

Following the trade war between the US and China, the COVID-19 outbreak in 2020 led to a decline in global economic growth in the third quarter of 2021, while also affecting capital mobility restrictions and supply disruptions. When supply faced obstacles and resulted in increased commodity prices, the COVID-19 phenomenon also affected the rise in global inflation rates. The COVID-19 pandemic can lead to a decrease in foreign investment due to business and economic uncertainties, where if foreign investors withdraw their investments from a country, it can cause capital flight and increase pressure on the country's currency.

These phenomena result in economic uncertainty in developing countries and also impact one of the external factors that lead to high capital flight. The development of capital flight. Capital flight has become a significant issue, particularly for developing countries, as the continuous outflow of capital impacts financial stability and slows down the country's economic growth. The central bank primarily regulates the course of the economic system and ensures its stability through a policy known as monetary policy. The implementation of a country's monetary policy depends on the conditions and issues specific to that country. Monetary policy is the most important instrument for achieving economic stability, including maintaining stable prices and the financial system (Blot et al., 2015).

2. LITERATURE REVIEW

Cuddington (1986) defines the term "capital flight" as speculative, short-term capital outflows that involve hot money to tackle political or financial crises, high taxes, the tightening of promising capital controls, or a significant devaluation of the domestic currency leading to hyperinflation. Capital flight is defined as the transfer of foreign assets to a country, resulting from efforts to identify the sources and uses of international funds. This process involves an increase in recorded gross foreign debt and net foreign direct investment, which the country then uses to finance current transactions and boost its foreign exchange reserves. This equates capital flight with all unofficial capital outflows (Schineller, 1997).

The research titled "Capital Flight and External Debt Nexus: Fresh Evidence From Nigeria" using the ARDL method shows that the variables of external debt, macroeconomic instability, budget deficit, and foreign reserve have a positive and significant impact on capital flight (Mazadu & Abubakar, 2022). The research titled "Exchange Rate and Capital Flight: An Empirical Analysis" using panel data analysis methods shows that the variables external debt, economic growth, interest rate, and corruption index have a positive and significant impact on capital flight, while the exchange rate variable shows no significant impact on capital flight. (S. Otieno, Mose, & Thomi., 2022)

Research titled "Fighting Capital Flight in Nigeria: Have We Considered Global Uncertainties and Exchange Rate Volatilities?" Fresh insights via the quantile ARDL model and using the ARDL method show that the variables uncertainty index, exchange rate volatility, and GDP have a positive and significant impact on capital

flight (Uche & Effiom., 2021). Penelitian yang berjudul Kidnapping Rate and Capital Flight: Empirical Evidence from Developing Countries dan dengan menggunakan metode analisis GMM menunjukkan bahwa variabel kidnapping rate, gdp growth rate volatility, trade openness, foreign aid, real exchange rate memiliki pengaruh positif dan signifikan terhadap capital flight namun variabel inflation, natural resources (oil rents) memiliki pengaruh negatif dan tidak signifikan terhadap capital flight sementara itu variabel saving rate menunjukkan hubungan negatif dan signifikan terhadap capital flight. (Okafor & Ede.,2021).

The research titled "Determinants of Capital Flight in the East African Community" and using panel data methods shows that the variables corruption index, external debt, and exchange rate have a positive and significant impact on capital flight, while the variable interest rate differential has a positive but not significant relationship with capital flight. The variable real GDP has a negative and significant relationship with capital flight. (S. J. Otieno et al., 2021).

3. METHODOLOGY

We use the residual approach to calculate capital flight. We estimate this approach by comparing the total change in foreign debt with net direct investment, the inflow of capital, the surplus or deficit in the current account, and the change in foreign exchange reserves over a specific period. The equation for the residual approach is as follows (Istikomah, 2003):

$$CF = (H + B) - (A + F) \quad (1)$$

$$CF = (\Delta ED + \Delta FDI) - (CA + \Delta OR) \quad (2)$$

Dimana :

CF	: Capital Flight
H / ΔED	: Change in Foreign Debt
B / ΔFDI	: Net Foreign Debt
A / CA	: Surplus/Deficit Current Account
F / ΔOR	: Change in Foreign Reserve

4. RESULTS

4.1. Basic POLS Estimation

Table 1: Descriptive Statistics

	CF
Mean	5.242357
Median	1.754320
Maximum	58.02013
Minimum	-12.10828
Std. Dev	9.656039
Skewness	2.426991
Kurtosis	10.57244
Jarque-Bera	3883.345
Probability	0.000000
Sum	6039.195
Sum Sq. Dev	107318.2
Observations	1152

Descriptive statistics results show that this data has an average of 5.242, with a median of 1.754. The average being higher than the median indicates a right-skewed data distribution, where most values are below the average but there are some very high values that push the average up. The maximum value reached 58,020, while the minimum value was -12,108, indicating a fairly wide data range from negative to positive. A standard deviation of 9.656 reflects a relatively high level of variation in the data, indicating that the values in this dataset are widely spread from the average.

Additionally, the data distribution exhibits a positive skewness of 2.427, indicating a rightward skewed distribution. Additionally, the high kurtosis, which is 10.572, indicates that the data distribution is highly leptokurtic, with a sharp peak and long tails. This indicates the presence of many extreme values or outliers, both on the low and high sides. The Jarque-Bera test result of 3883.345, with a probability close to zero (0.0000), confirms the non-normal distribution of this data, likely due to high skewness and kurtosis.

According to Cuddington (1986), the term capital flight refers to short-term capital outflows that are speculative in nature and involve "hot money." People often use this capital in response to political or financial crises, high taxes, anticipated tightening of capital controls, or significant devaluation of the domestic currency, all of which have the potential to cause hyperinflation.

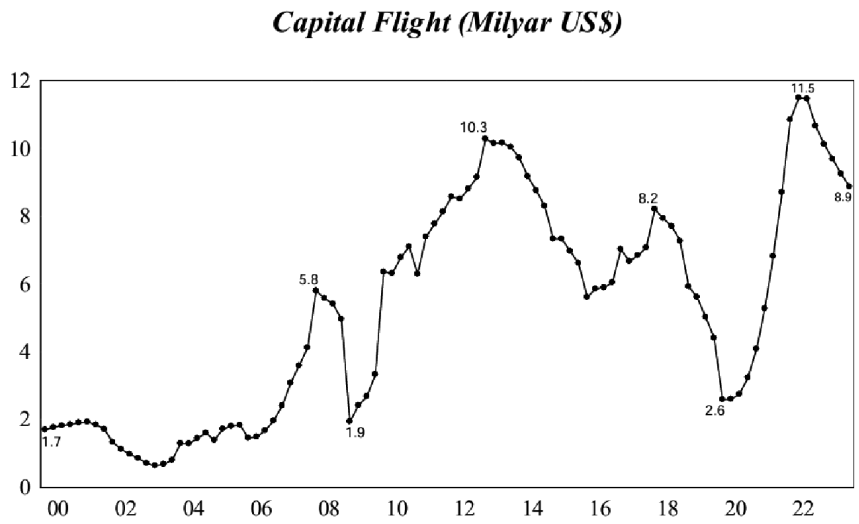

Figure 1: Capital Flight in Developing Countries

Figure 1 shows the development of the average capital flight value in developing countries during the period 2000Q1–2023Q4. The value of capital flight increased every year, reaching 5.8 billion USD in 2008 Q1, then decreased by -0.67% or 1.9 billion USD in 2009 Q1. The increase in capital flight during this period was caused by the widespread global crisis of 2008, particularly affecting developing countries. This crisis has caused economic uncertainty and currency fluctuations, which have driven capital flight. In 2013Q1, there was a significant increase in capital flight, reaching 10.3 billion USD. 2018 Q1 saw a repeat of this increase, reaching a value of 8.2 billion USD. However, in 2020Q1, capital flight decreased to 2.6 billion USD due to the COVID-19 pandemic. After the pandemic subsided, capital flight drastically increased again in 2022Q1, reaching 11.5 billion USD, the highest value in the last 22 years. The image above suggests that global economic conditions significantly impact the occurrence of capital flight in developing countries.

5. CONCLUSION

The analysis of the capital flight data reveals significant fluctuations influenced by global economic events. The right-skewed distribution, with a high standard deviation and positive skewness, highlights the wide variation and presence of extreme values in the data. The high kurtosis and Jarque-Bera test results confirm that the distribution is far from normal, largely due to the outliers and sharp

changes in capital flows during times of crisis. The trends observed in capital flight, particularly the surges in 2008, 2013, and 2022, underscore the strong relationship between capital flight and economic instability, such as financial crises and political uncertainty. These insights emphasize the need for developing countries to address the underlying causes of capital flight, implement effective economic policies, and improve financial stability to reduce vulnerability to such drastic financial movements.

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