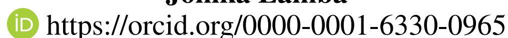
Chapter 15
Unraveling Complexity Global Capital Flow Determinants

Arshi Jamal

https://orcid.org/0000-0003-4157-8186
K.R. Mangalam University, India

Jonika Lamba

https://orcid.org/0000-0001-6330-0965
K.R. Mangalam University, India

Swati Rai
K.R. Mangalam University, India

ABSTRACT

The complexity of global financial interconnections, their role in transmitting shocks across borders, and the effectiveness of fundamental economic factors in safeguarding countries against financial instability have all garnered increased attention. In recent decades, substantial research has been devoted to understanding the importance of international capital flows in the context of financial stability. Capital flows affect people and companies on almost every scale, including national governments. Analysts frequently examine several subsets of capital flows, including changes in asset classes, venture capital, mutual fund, capital spending, and government budget movements. Capital flows can be more erratic in developing economies since the economy may go through phases of fast expansion followed by subsequent decline. Increased capital inflows may result in credit booms and asset price inflation, but they may also be countered by losses from currency depreciation based on exchange rates and drops in equity pricing.

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1.1 INTRODUCTION

The complexity of global financial interconnections has drawn increased attention in recent years. Researchers have focused on understanding the significance of international capital flows in the context of financial stability. These flows impact various entities, including national governments, and are influenced by a range of factors. Direct and portfolio foreign capital flows have a significant positive impact on a nation's economic behaviour. Several nations have taken action to promote cross-border investment flows because they believe that more capital movements will result in more efficient use of available resources worldwide (Kose et al., 2009). Over the past 20 years, this endeavour has caused a spike in foreign investment flows (Brafu-Insaidoo & Biekpe, 2014). According to Kaminsky and Schmukler, (2003), countries can enhance their ability to draw in more foreign capital by liberalizing their equity markets and capital account transactions, as well as by deregulating activities in their domestic financial markets. They go on to say that by lowering transaction costs, imposing quantitative ownership and investment limits, and raising asset yields, these measures may result in a rise in foreign capital inflows. However, Baldwin (1997) suggested that nations who actively participate in regional alliances or have ratified regional free trade and investment agreements typically draw greater levels of foreign investment. They contend further that by generating advantages such as increased trade connections, the ability to take use of large-scale economies, and improved financial growth within the participating regions, this regional initiative can draw in additional international investments. Considering their justifications, we may thus conclude that countries that liberalize their capital account and equity markets will experience a rise in the flow of foreign money. Another theory is that regionalism boosts the influx of foreign money. However, the best direct determinants of capital flows have not been established, notwithstanding these assertions.

Financial interconnectivity has increased in tandem with the past three decades' rapid financial globalization, as seen by the more than six-fold growth in a country's external assets and liabilities as a percentage of GDP. The asset and liability management (ALM) strategies of enterprises, financial institutions, and sovereigns have become increasingly global since the mid-1990s, and as a result, countries have become more interconnected (IMF, 2010).

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