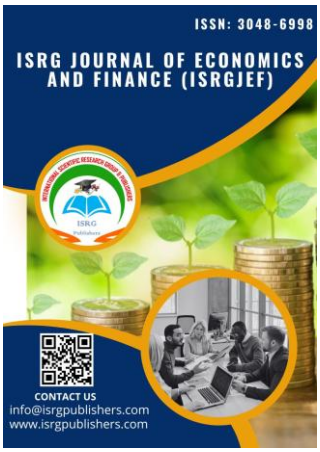
ISRG JOURNAL OF ECONOMICS AND FINANCE (ISRGJEF)

ISRG PUBLISHERS
Abbreviated Key Title: ISRG J Econ Fin.
ISSN: 3048-6998 (Online)
Journal homepage: https://isrgpublishers.com/isrgjef-2/
Volume – III Issue - VI (November-December) 2026
Frequency: Bimonthly



Political Stability, Governance, and Global Financial Conditions as Determinants of Capital Flight in Developing Countries

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| **Received:** 24.10.2026 | **Accepted:** 31.10.2026 | **Published:** 12.11.2026

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Abstract

This study explores the factors determining capital flight in emerging economies where focus is laid on political stability, government effectiveness, foreign debt, the US Federal Funds rate, and exchange-rate instability. Using the dynamic panel model, the research brings into focus the connection between domestic institutions and macrofinance variables along with capital flight. The research shows that political stability and foreign debt have negative and significant correlations with capital flight while government effectiveness, the US Federal Funds rate and exchange-rate volatility display positive and significant correlations. It is also evident from the findings that there exists persistence in capital flight as past capital flows influence current capital flows. The inclusion of both institutional and macrofinancial factors in a dynamic framework adds to the existing literature. The findings highlight the significance of political stability, credible governance, sustainable foreign debt, and shock absorption in international finance. It should however be noted that the relationships explained above are only conditional and not causal in nature as more studies need to be conducted using different indicators.

Keywords: Capital Flight; Political Stability; Government Effectiveness; External Debt; Exchange-Rate Volatility.

JEL Classifications: F21, F32, O16.

1. Introduction

The challenge of capital flight is an ongoing one for economic development in developing countries since it tends to hinder the process of capital formation and also restricts investment finance as well as the availability of resources for growth in the long run (Istikomah et al., 2020; Asongu & Nnanna, 2020). In cases where there is a need for a lot of infrastructure in an economy coupled with low domestic savings and limited availability of external finance, retaining domestic resources is of utmost importance (Egbulonu & Bhattarai, 2020; Suhendra et al., 2020). Although foreign capital can contribute to supplementing domestic savings to aid investment, it can become difficult to do so when resources tend to flow out of the country due to political, institutional, and macroeconomic risks (Anwar et al., 2022). Therefore, capital flight not only is a financial issue, but it is also a developmental one

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DOI: 10.5281/zenodo.24151594

since it can have impacts on investment, fiscal capacity, external vulnerability, and macroeconomic stability (Tariq et al., 2026; Udo et al., 2026).

The importance of capital flight in economic terms becomes especially clear during periods of high global uncertainty (Abbas et al., 2025; Reinsberg & Kern, 2025). The occurrence of financial crises in the international arena might change risk perceptions, affect the relative attractiveness of domestic and foreign assets, and bring about changes in international portfolio allocations (Zhang & Chen, 2025). The example of the global financial crisis of 2008, originating in the sub-prime mortgages market of the U.S. and affecting international financial markets, reveals how shocks coming from outside developing nations can impact their capital access and international financial flows (Glebocki & Saha, 2024). More recent instances of global financial volatility have highlighted the sensitivity of developing nations to changes in international financial conditions. However, global shocks alone cannot explain why capital flight differs among nations that are exposed to similar international environment conditions (Kassouri, 2026). Differences in the stability of domestic politics, institutional quality, external debts, and exchange rates might impact the way in which investors react to international shocks (Grellmann et al., 2025; Otieno et al. 2022).

Furthermore, political risk continues to be an important factor in the choice to hold domestic assets, as these choices are shaped by considerations other than financial gain expectations (Apergis & Bouras, 2023). This refers to the reliability of political institutions, reliability of governmental policies, rights to private property, as well as capability to enforce economic regulations. Political uncertainty leads to greater uncertainty about the course future policy will take and about the safety of one's investments; hence, causing locals and other owners of wealth to move their funds abroad (Montes & Nogueira, 2022). Similarly, inefficiency of the government can result in doubts about the functioning of governmental institutions, enforcement of regulations, and provision of stable institutional environment (Handoyo, 2024). Political and institutional factors influence the behavior of individuals with respect to capital outflow through changes in the risk of domestic assets versus foreign ones (Lensink et al., 2000; Le and Zak 2006).

It is important the difference between political stability and government effectiveness. Political stability refers to how susceptible a nation is to political instability and violence driven by politics, whereas government effectiveness refers to how the quality of the services provided by the government is perceived (Watabaji & Shumetie, 2022). A nation can be politically stable but have weak administrative capacity or be endowed with effective public institutions but face considerable political risks (Cohen, 2023). Thus, the consideration of political risk as a single factor may lead to an overlook of two different ways through which political factors influence international investment decisions. This dichotomy also has implications for how existing empirical literature should be interpreted. While Ndikumana and Sarr (2019) find a positive correlation between political stability and capital flight, Diaz and Collin (2025) find a positive correlation between political instability and capital flight. It is important to note that the two studies do not necessarily contradict each other, as the two studies may differ in terms of how they measure political stability, the characteristics of their samples, their estimation methods, and their control for other variables that determine capital flight. Specifically, it is critical to interpret political stability indices carefully considering their coding schemes. The Worldwide Governance Indicators (WGI) code political stability and government effectiveness from −2.5 to 2.5, where higher values correspond to better governance results. Hence, a positive coefficient on an index coded in such a way that higher values mean more political stability will be interpreted differently than a positive coefficient on an index coded in a way that higher values mean more political instability. It is important to address these problems of measurement and interpretation in order to find out whether political stability and government effectiveness correlate with lower capital flight and whether their correlations differ by institutional dimension.

The relationship between political risk and capital flight in developing countries needs to be investigated in an institutional and macroeconomic context. External debt might be driving capital flight due to debt sustainability reasons or decreasing it since borrowing is used for productive investments in accordance with mixed results of Mazadu et al. (2022), Shem (2021), and Nasreen et al. (2022). At the same time, the US monetary tightening affects portfolio investments internationally (Avdjiev & Hale, 2018), and exchange rate volatility increases investment uncertainty and encourages capital flight (David & Ampah, 2018). Although there is a vast literature on governance and capital flight, the specific effects of political stability and government effectiveness on capital flight are understudied especially in light of the persistence of capital flight and the impact of external macrofinancial factors on it. This paper seeks to contribute to the existing body of literature by investigating the political stability and government effectiveness in combination with external debt, US Federal Funds rate, and exchange rate volatility in a dynamic panel setting for a selected group of developing countries.

The current study makes the following three contributions to the existing literature on capital flight in developing countries. Firstly, it distinguishes between political stability and government effectiveness in order to examine if political environment and government administrative efficiency have different associations with the movement of capital across borders. Secondly, it takes into account the dynamic character of capital flight by including the lagged dependent variable to control for persistence of capital flight in time depending on the validity of the estimator and its identification. Thirdly, it includes the institutional variables together with external debt, U.S. Federal Funds Rate, and exchange-rate fluctuations to capture the link between domestic institutional conditions and external financial and currency risks. Thus, by considering all these variables simultaneously, the paper presents a more comprehensive view on the determinants of capital flight and examines if political stability and government effectiveness are still associated with capital flight.

The results obtained in this study may have implications for development policy. In case it turns out that political stability and effective government are associated with capital flight, then this would bring into focus the importance of political institutions, effective administration, and proper implementation of policy as factors which can assist in preserving domestic financial resources. At the same time, taking into consideration external debt, interest rates on the international market and exchange rate risk can assist in separating the effects of institutions from those of the external financial environment. This is an important aspect because good

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domestic policy cannot replace external debt policy and macroeconomic stability; both can work hand-in-hand.

2. Literature Review

Capital flight refers to the movement of funds to other countries due to risks and unfavorable domestic economic conditions. According to Cuddington (1986), capital flight refers to the movement of short-term capital based on the following factors: political instability, financial crisis, high taxes, expected capital controls, devaluation of currency, and inflation. According to Reyad et al., (2022) and Kossele and Mbai-Akem, (2019), capital owners may move their funds abroad when they see a worsening situation in the domestic economy or a decrease in the safety and profitability of their investments. Capital flight poses problems for developing economies in terms of domestic investments, capital accumulation, and dependency on foreign sources of financing. Therefore, studying its causes is important in order to understand what makes domestic owners of capital hold their funds in the domestic economy.

Portfolio theory provides explaination the theory of capital flight whereby individuals distribute their wealth based on the relative risk-adjusted attractiveness of various investments (Keskes et al., 2026; Mwangi et al. 2019). In circumstances where political, institutional, or macroeconomic uncertainties increase the risk attached to domestic investments, individuals move their wealth abroad despite the higher return possibilities of these assets. Rational expectations theory helps explain further how economic agents use available information to forecast future developments (Muth, 1961; Lucas, 1975). This means that capital flight can occur not only due to deteriorated economic performance but also because investors' expectations about future political instability, poor governance, increased debt or unfavorable international financial environment can arise. Hence, all these theories prove that capital flight occurs based on risk-return distribution and expectations about future development of domestic and international economies.

There have been previous studies on the importance of political and institutional factors but they cannot show any uniform relationship. According to Lensink et al. (2000) and Le and Zak (2006), political risk is studied concerning capital flight. On the other hand, according to Ndikumana and Sarr (2019), there is a positive correlation between the political stability indicator and capital flight and a significant negative correlation between government effectiveness and capital flight. Conversely, according to Diaz and Collin (2025), there is a positive correlation between political instability and capital flight. Overall, these results indicate the significance of taking into account the distinction between political stability and political instability when interpreting the estimated coefficients. They also encourage further investigation into the possibility of different relationships between political stability and government effectiveness with respect to capital flight.

Capital outflows can also be influenced by external indebtedness and international financial conditions. Consistent with the debt overhang approach, high indebtedness reduces expected returns on investments when future economic gains are expected to be used for servicing the debt (Krugman, 1988). External indebtedness thus increases apprehensions about future taxes, currency devaluation, and economic adjustments, leading to the transfer of assets out of the country. Studies that conform to this theory find a positive relationship between external debt and capital outflows in Mazadu et al. (2022), Shem (2021), but find a negative relationship in Nasreen et al. (2022). The differences in these results indicate that the relationship might be influenced by debt sustainability and economic conditions in which external borrowing is undertaken.

International monetary environment may affect capital flow due to changes in the differential returns and financing costs of foreign versus domestic assets. Interest rate parity helps understand how differences in interest rates at home and abroad can be combined with expectations of exchange rate moves in the process of making investment decisions in international markets (Liu & Lee, 2022). The rise in the US Federal Funds rate might make US securities more lucrative and put pressure on financing in developing countries, leading to outflow of investments. Avdjiev and Hale (2018) examine how US monetary conditions are relevant for cross-border flows of banks in emerging countries. Currency exchange rate instability can increase the risk of investment in domestic currency, particularly in case the investors are uncertain about devaluation of national currency in the future. The exchange rate overshooting model proposed by Dornbusch (1976) explains how monetary disturbances can trigger significant exchange rate moves, and the association between exchange rate instability and capital flight is established by David and Ampah (2018). However, international interest rates and exchange rate volatility might have different effects depending on other variables.

3. Data dan Methodology

3.1 Data

The study focuses on analyzing the factors influencing capital flight in 34 developing countries for the period 2011Q1-2021Q4 using quantitative analysis based on secondary data from the World Bank, Worldwide Governance Indicators (WGI), International Monetary Fund (IMF), and the Federal Reserve Board. Capital flight is considered the dependent variable, whereas political stability, government effectiveness, external debt, the US Federal Funds rate, and exchange-rate volatility are used as independent variables. The choice of these variables is justified using the principles of portfolio theory, rational expectations, debt overhang theory, interest rate parity, and exchange rate overshooting theory as means of explaining how institutional factors and foreign macrofinancial events affect incentives for transferring assets abroad.

Capital flight is estimated with the residual approach; political stability and government effectiveness are taken from the WGI database, with higher values indicating better governance performance. External debt estimates the risk from debt, the US Federal Funds rate estimates the international monetary situation, and exchange-rate volatility is calculated with the help of GARCH. The quarterly panel allows dealing with differences among the observations and time dynamics. However, as the WGI indicators are mainly annual, the technique used to quarterly split them should be described. Moreover, the frequency of the capital flight and external debt estimates' data should be checked.

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Table 1. Descriptive Statistic

Variable	Abbreviation	Mean	Std Dev.	Min.	Max.
Capital Flight	CF	14.7115	30.2006	-42.0210	206.5007
Political Stability	PS	-0.3837	0.7889	-2.8100	1.2338
Government Effectiveness	GE	-0.2183	0.5517	-2.1870	1.1609
External Debt	ED	98.4470	156.5149	0.1580	612.8659
US Federal Funds Rate	Fed Rate	0.5793	0.7395	0.0700	2.4100
Exchange Rate Volatility	VNT	0.0029	0.0051	0.0000	0.0456

3.2 Econometrics Methodology

The measurement of exchange rate volatility is based on the use of the Generalized Autoregressive Conditional Heteroskedasticity (GARCH) model. First, the exchange rate return for each developing country is calculated as the percentage change from the previous period. Afterward, the return series is modeled using the GARCH model to calculate volatility in exchange rates. According to Anwar et al. (2021), in this study, the GARCH(1,1) specification is used because of the relatively easy implementation and ability to capture dynamics of the conditional variance using information from past periods. Similarly, David and Ampah (2018) highlight the ease of implementation of the model and its use in robustness check. The GARCH(1,1) specification used to estimate exchange rate volatility is as follows (Oseni, 2016).

The analysis in this paper uses a dynamic panel data approach and Generalized Method of Moments (Arellano & Bover, 1995) for the study on the determinants of capital flight. Because of the dynamic nature of economic variables (lagged values of the dependent variable may be used as explanatory variables) and endogeneity, the estimation of conventional static panel models might produce bias results (Ginanjar et al., 2020). Estimation will be done using Stata with the System GMM estimator that was introduced by Blundell and Bond (1998). This estimation technique combines equations in first differences and equations in levels which allows using more moment conditions to increase estimation efficiency based on certain assumptions. The general formulation of the System GMM model is as follows (Blundell & Bond, 1998).

Based on the general equation form of the SYS Generalized Method of Moments (GMM) model above, in this study, the research model used is as follows.

$$CF_{it} - CF_{it-1} = \alpha(CF_{it-1} - CF_{it-2}) + \beta_1(PS_{it} - PS_{it-1}) + \beta_2(GE_{it} - GE_{it-1}) + \beta_3(ED_{it} - ED_{it-1}) + \beta_4(Fedrate_{it} - Fedrate_{it-1}) + \beta_5(VNT_{it} - VNT_{it-1}) + (\nu_{it} - \nu_{it-1}) \quad (1)$$

where CF denotes capital flight, PS represents political stability, GE denotes government effectiveness, ED refers to external debt, Fedrate represents the US Federal Funds rate, and VNT denotes exchange-rate volatility. The model captures the dynamic persistence of capital flight while assessing the relationships between institutional, domestic macroeconomic, and external financial factors and capital flight.

4. Results and Discussion

4.1 Dynamic Panel Data Estimation

Table 6. Panel GMM Estimation Results

Variable	Dependent Variable: *Capital Flight*
CF (-1)	0.5196*** (0.0014)
PS	-0.4409*** (0.1610)
GE	3.7655*** (0.2845)
ED	-0.0068*** (0.0004)
Fed Rate	0.4112*** (0.0171)
VNT	21.6451*** (7.1743)
AR (1) (p-value)	0.0338
AR (2) (p-value)	0.6280
Sargan Test (p-value)	1.0000
No. of Cross-section	34
No. of Observation	1326

As per the results obtained from System GMM model, it has been found that capital flight is a persistent variable, which can be seen by using the positively signified and statistically significant coefficient of the capital flight lagged variable (0.5196, $p < 0.01$). This is indicative of the fact that capital flight in the prior period has a positive association with capital flight in the contemporary period. Political stability has a negatively signed coefficient that is statistically significant, (-0.4409, $p < 0.01$), which means that an increase in political stability leads to decrease in capital flight, thereby supporting the hypothesis that increased political stability leads to decreased uncertainties and makes domestic assets more attractive. Contrary to the expected negative result, the coefficient of government effectiveness comes out to be positively signed and statistically significant.

This suggests that higher levels of government effectiveness are associated with higher levels of capital flight. This unexpected result could be due to differences in financial development, ability to transfer assets internationally or specification and endogeneity problems, which require further investigation. External debt also shows a negative and statistically significant coefficient (−0.0068,

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$p < 0.01$). This goes against the debt-overhang hypothesis. The explanation for this result could be that external borrowing could aid domestic economic activities or access to foreign finance although the result should be interpreted with caution. In addition, the US Federal Funds rate shows a positive and statistically significant coefficient (0.4112, $p < 0.01$). This means that tighter monetary policy in the US is associated with higher levels of capital flight from developing countries due to changes in relative returns and international portfolio allocation. Exchange rate volatility also shows a positive and statistically significant relationship with capital flight (21.6451, $p < 0.01$) in line with the hypothesis that higher exchange rate uncertainty increases the incentives to invest in foreign assets.

4.2 Discussion

Empirical findings support the significance of domestic institutions' characteristics and macrofinance's global dimensions in explaining the phenomenon of capital flight in developing countries. As regards the impact of political stability on capital flight, there was shown to exist a negative significant relation. Namely, a more politically stable situation is accompanied by less incentives to transfer wealth from a certain country. The findings support the portfolio theory, according to which an investor considers not only expected returns, but also risks of holding assets. An increase in political stability can decrease uncertainty about the future political situations and the safety of investments, thus increasing investors' confidence in domestic assets. In addition, empirical findings confirm the study of Diaz and Collin (2025), where authors state the presence of a positive correlation between political instability and capital flight. From the standpoint of rational expectations theory (Muth, 1961; Lucas, 1975), information about the political situation plays a crucial role in the forecast of future economic risks. Thus, maintaining political predictability and policy stability will help developing countries avoid capital flight.

However, contrary to expectation, government effectiveness is found to have a statistically significant positive relation with capital flight. This observation is contrary to the findings by Ndikumana and Sarr (2019) on the negative effect of government effectiveness on capital flight but in agreement with the positive relationship between a broad index of governance and capital flight as identified by Nasreen et al. (2022). The first explanation may involve the possibility that the improvement in government effectiveness is correlated with financial globalization and international capital movements. Second, government effectiveness may not be able to incorporate some institutional factors that may affect capital flight, including property rights, economic predictability of policies and regulations, and credibility of economic policies. This list is not exhaustive as the empirical model does not test any mechanism. Therefore, this finding suggests that government effectiveness by itself may not be able to explain capital flight. For developing nations, improvement in public services and policy implementation should be accompanied by clear regulations, consistent enforcement, and credible investment protection.

There exists a negative and statistically significant relationship between external debt and capital flight, opposite to the prediction in the debt overhang theory (Krugman, 1988) which implies that higher levels of indebtedness discourage investment and lead to worries about future economic adjustments. Nonetheless, this finding is consistent with those of Liew et al. (2016), Lawal et al. (2017), Ampah and Kiss (2019), and Nasreen et al. (2022), which show negative relationship between external debt and capital flight. It could be assumed that external borrowings can be used for productive spending, improve infrastructure and increase economic opportunities which makes investment more attractive. It highlights the fact that the effect of external debt depends not only on their size but also on the allocation and sustainability of the same. But the negative sign does not imply that higher borrowing decreases capital flight since the effect might be due to the difference in debt composition, country-specific features or measurement of capital flight. Hence, the policy implication is that the developing nations should focus on sustainable borrowing and use the external borrowings for productive activities which increases economic potential.

United States' Federal Funds rate depicts a positive relation with capital flight. It is clear evidence that supports the statement regarding the effects of international monetary policies on the global allocation of foreign capital investments. Interest rate parity theory explains the impact of differences in interest rates and exchange rate expectations on global investment flows. In case when interest rates in the United States increase, there will be an increase in attractiveness of dollar assets and higher costs of financing the economies of developing nations. Such results support the study of Avdjiev and Hale (2018) regarding the relation between international monetary policy and cross-border bank flows in developing nations. However, the identified relationship could be explained by global financial conditions rather than just by US monetary conditions only. For that reason, developing nations should increase their resilience to financial risks associated with macroeconomics and prudent external financing and economic policies.

Exchange rate volatility has been found to have a positive relationship with capital flight, as demonstrated by the results obtained in David and Ampah (2018). The above finding further supports the proposition of the portfolio theory that increased uncertainties associated with exchange rate movements lead to high risks in holding domestic assets, especially because of possible loss from the transaction in foreign currency. The framework proposed by Dornbusch (1976), also known as the overshooting model, provides a different theoretical perspective in relation to short-run movements caused by monetary shocks to the exchange rate. In turn, exchange rate movements may cause increased uncertainty about the future value of domestic currency assets, making the investor invest money internationally. However, the above finding does not mean that exchange rate volatility always causes capital flight; it depends on the views of the investors.

Lastly, the positive and significant regression coefficient of lagged capital flight demonstrates that capital outflows display persistence over time. This implies the use of a dynamic panel approach and the correlation between present capital flows and past outflows. Persistence could be due to slow adjustment of the portfolio, accumulated worries about the domestic economy, or exposure to risks in terms of institutions and external finance. Taken together, this means that capital flight is influenced by both domestic governance and international macrofinancial factors. Nevertheless, the unexpected coefficients of government effectiveness and external debt demonstrate that there is much more complexity in the process of capital flight. Overall, the results emphasize the significance of political stability and sustainable foreign

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DOI: 10.5281/zenodo.24151594

borrowings. Yet, the results have to be treated conditionally rather than causally, while unexpected coefficient signs have to be analyzed through other estimations and robustness checks.

5. Conclusion

The present study attempts to analyze the determinants of capital flight in the developing countries, which include political stability, effectiveness of governance, external debt, US Federal Funds rate, and exchange rate volatility. Results indicate that political stability and external debt have a negative and significant influence on capital flight, while effectiveness of governance, US Federal Funds rate, and exchange rate volatility have a positive and significant influence. Persistence of capital flight suggests that there is an association between past and future movements of capital flight. Findings provide contributions to the existing literature by considering the integration of the institutional and macro financial factors in the dynamic panel data framework. It can be noted that the positive association of effectiveness of governance with capital flight and the negative one with external debt makes the relationship complicated.

These results suggest that policymakers need to increase political stability, improve regulatory transparency and institutional credibility, make sure that borrowing abroad is associated with productive investment, and increase resilience against changes in international financial market conditions and exchange rates. However, it is important to note that the results can only be viewed as indicative relationships without being considered causative ones. There are some limitations to the study in terms of measurement problems with capital flight, small sample size of countries studied, and concerns about the issue of endogeneity and model specification. Future research might explore different ways of measuring capital flight, focus on institutional factors separately, test for non-linear relationships between variables, and try other identification approaches.

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DOI: 10.5281/zenodo.24151594

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DOI: 10.5281/zenodo.24151594