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Table of contents

Capital Flow Surges and Reversals

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Abstract: Today, capital is able to move rapidly from country to country for higher profits and safer portfolios. While capital flows bring benefits, they can also incur costs, especially in emerging markets. Excess capital flow surges can overheat economies and also result in large capital flow reversals for some countries. Most previous studies do not explicitly link surges and reversals. This dissertation therefore examines the determinants of reversals, focusing on surges, using various measurement methods with relevant variables. This study finds that, depending on the method between 60-75% of surges are found to be followed within one year by reversals. However, 28-70% of reversals are not preceded by surges.
Unlike previous studies, this one uses various methodologies to measure reversals and surges from a sample of 46 emerging markets between 1980-2010. This dissertation shows that both reversal and surges have occurred frequently in recent decades and are not specific to certain regions. The surges have happened more frequently in recent decades.
The empirical analyses in this study examines the determinants reversals using several empirical models, This study also utilizes three methods of identifying reversals, six measurements of surges, three ways of calculating current account deficits and the share of the composition of capital flows. Up to 162 combinations of these methods are used to develop the models and, as a result, coefficients of each independent variable are shown in the form of distributions, which capture the whole picture of each coefficient in terms of size and frequency and thus reduce any measurement and specification errors.
From more than a thousand regressions, capital flow surges are estimated to be a highly significant determinant of capital flow reversals across the different types of methodologies. Current account deficits are also significant in a substantial portion of the regressions. Reserves are found to reduce the probability of reversals that are not preceded by surges. This dissertation confirms that FDI is a less vulnerable component of capital flow than bank loans, equity, and bond investments. It also finds that, if the economy is in distress, foreign investors reverse capital flow more actively than domestic investors.

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