

Capital Inflows and Macroeconomic Policy  
in Sub-Saharan Africa<sup>1</sup>

by

Louis Kasekende\*  
Damoni Kitabire\*\*  
Matthew Martin\*\*\*

Working Paper No. 158

May 1996

Presented at a Symposium on "Global Capital Flows in Economic Development" sponsored by The Jerome Levy Economics Institute of Bard College, United Nations Conference on Trade and Development Global Interdependence Division and Intergovernmental Group of Twenty-Four on International Monetary Affairs, March 8-9, 1996.

Research was sponsored by the G-24 Trust Fund administered by UNCTAD. Working Papers 157, 158, 162 and 163 were published in UNCTAD, *International Monetary and Financial Issues for the 1990s*, Volumes VII and VIII (UNCTAD 1996 and 1997). These papers will also appear in a forthcoming volume edited by G.K. Helleiner for Macmillan entitled, *Capital Account Regimes and the Developing Countries*.

\*Executive Director, Policy and Research, Bank of Uganda, Kampala

\*\*Commissioner, Macro-Economic Policy Department, Ministry of Finance and Economic Planning, Kampala

\*\*\*Director, External Finance for Africa, London

---

<sup>1</sup>The views expressed in this paper are of the authors and do not reflect the views of the Bank of Uganda or the Ministry of Finance and Economic Planning in any way.

## INTRODUCTION<sup>2</sup>

During the last three years, there has been an increasing amount of literature on private capital inflows to developing countries. In 1992-93, attention focused on the rise in such inflows, their causes and nature. Gradually, it moved to their potential macroeconomic impact and the policy implications. In 1994-95, following events in Mexico, it has concentrated on the sustainability of the inflows, and the policy implications of potential reversal.

Virtually all of the studies have focused on Latin America, though some authors have also examined East Asian experiences. Analysis of Eastern Europe is extremely rare (Calvo, Sahay and Vegh 1995; Griffith-Jones 1995), and that of Africa is virtually non-existent (with the notable exception of the excellent study by Asea and Reinhart 1995). Even the most comprehensive recent analysis and survey of the literature (Fernandez-Arias and Montiel 1995) has concluded that there is only impressionistic evidence of private capital inflows to Sub-Saharan Africa, where "capital inflows have not materialized". Africa has continued to be analysed from the view that most of its capital inflows causing a "Dutch Disease" effect are aid inflows (Collier 1994; Younger 1992). Figures quoted in an UNCTAD<sup>3</sup> document indicate that Africa's relative share in inflows to developing countries has declined considerably from about 14 per cent in 1982-86 to about 5 per cent in 1992-94.

The key areas examined in the literature have been the scale and composition of capital inflows; their causes and sustainability; their effects on macroeconomic stability; and their responsiveness to policy measures. This paper analyses the characteristics of capital inflows to Sub-Saharan Africa in each of these areas, showing the similarities and differences with other regions of the developing world. A debate is also developing as to the nature of capital Africa should attract. Scholars have warned that short term capital inflows subject to abrupt reversal will be very disruptive to the domestic financial sector characterised by weaknesses (refer to Lipumba (1994) and Calvo et al (1995)). Some argue for FDI which is less susceptible to transient financial shocks. But counter arguments have also been made that FDI is equally volatile as dividends and retained earnings will be quickly repatriated during a financial crisis.

---

<sup>2</sup> The authors are grateful to Andrew Bvumbe, Ibrahim Elbadawi, Stephany Griffith-Jones, Richard Ketley, Mohsin Khan, Polycarp Musinguzi, Stuart Kufeni, Benno Ndulu, Carmen Reinhart, Charles Ojwiya, Jonathan Leape, Allister Moon, Tim Lamont, Daudi Sajjabi for supplying their valuable time, opinions, data and materials during the preparation of this paper; and to the Swedish and Danish governments for funding earlier work on capital flows to Africa. However, we remain responsible for any errors and misinterpretations in the current paper.

<sup>3</sup>UNCTAD document TD/8/TTNC

However, it is important at the outset to emphasise that data on capital inflows to Africa are extremely unreliable. Data issues in other regions have centred on distinguishing private from official inflows; gross and net inflows; short- from long-term; bank from non-bank; and debt from non-debt. It has been necessary to rely fairly extensively on either IMF (IFS), OECD (Financial Inflows) or World Bank (WDT) data (see Fernandez-Arias and Montiel 1995). The data for many SSA nations are more fundamental: i.e. poor recording systems for virtually all capital inflow data, and recording of many capital inflows in the current account or under errors/omissions<sup>4</sup>. Consequently, both national and international data sets on capital inflows are highly unreliable. In addition, even superficial comparison of global and country data indicates huge underestimates and unreliable categorisations of inflows in global data and particularly for the SSA region.

Additionally, we need to recognise that there are diverse experiences in Africa in general. The speed and sequencing of policy reforms has varied across countries (refer Kasekende and Martin (1995)). Notwithstanding, the policy regime in a number of countries in the region is currently more conducive to both domestic and foreign investment. Foreign exchange markets have been extensively liberalised to a point where even the capital account has been highly decontrolled. Some countries are currently receiving inflows which are quite significant relative to GDP and the less desirable effects of such inflows are emerging. In the recent past, Kenya, Uganda and Zambia have experienced disruptive effects originating from capital inflows. The reform of the policy regime has been frequently credited for the resurgence in capital inflows to selected countries in Africa especially by the IMF and World Bank<sup>5</sup>. While domestic policy reforms have, without doubt, contributed to the marked improvement of capital inflow to Africa, they cannot fully account for the varied country experiences. It would be quite interesting to assess the factors that have played an important role in stimulating private inflows to Africa.

The data problems will soon be addressed in a forth-coming project funded by the Swedish and Danish governments on Capital Inflows and Macroeconomic Policy which will seek to clarify many of these issues. Owing to data and other limitations, the current paper is limited in its scope. It focuses on six countries which have reasonably reliable data (Kenya, South Africa, Tanzania, Uganda, Zambia and Zimbabwe), and with particular emphasis on the experiences of Uganda, Zambia and Tanzania which witnessed one of the largest surge in capital inflows over the period with dramatic macroeconomic effects.

---

<sup>4</sup> Refer to Kasekende, Katarikawe and Rweikiza (1995) for a full discussion of problems relating to compiling balance of payments statistics in Uganda.

<sup>5</sup> Refer to 'Private Market Financing for Developing Countries' prepared by a staff team in the Policy Development and Review Department.

## SCALE AND COMPOSITION OF PRIVATE CAPITAL INFLOWS

In absolute terms, the scale of private capital inflows to other developing regions dwarfs inflows to Sub-Saharan Africa. The latest estimates from the World Bank, based on capital account and equity/debt inflows, indicate that during 1990-94, inflows averaged more than US\$ 180 billion a year, peaking at about US\$ 240 billion in 1993. Of these amounts, as shown in Table 1 below, about US\$16 billion a year went to SSA countries, peaking at about US\$ 18 billion in 1990.<sup>6</sup> Even in relation to macroeconomic variables such as GDP or exports, inflows to SSA were much lower than those to Latin America, East or South Asia.

---

<sup>6</sup> Source: World Bank IECIF databases

Table 1: CAPITAL FLOWS TO LDCs AND SSA (US\$ billions)

	1990	1991	1992	1993	1994
<b>ALL DEVELOPING COUNTRIES</b>					
FDI	24.10	34.40	45.20	68.50	78.20
PORTFOLIO	2.80	7.10	13.90	45.80	34.50
LT PRIVATE	5.80	10.30	19.10	23.10	20.40
MIN PRIVATE FLOWS	32.70	51.80	78.20	137.40	133.10
ST	17.00	20.90	39.30	33.60	23.70
PNG (TO PRIVATE SECTOR)	9.30	8.40	20.70	19.80	27.40
MAX PRIVATE FLOWS	59.00	81.10	138.20	190.80	184.20
LT OFFICIAL FLOWS	28.40	27.60	23.20	23.40	16.80
GRANTS	25.10	32.50	27.10	23.60	22.80
IMF	0.05	3.20	1.20	0.70	1.60
TOTAL ALL FLOWS	112.55	144.40	189.70	238.50	225.40
PROFITS ON FDI	-17.70	-18.50	-21.20	-23.10	-25.10
INTEREST ON LT PRIVATE	-32.50	-30.40	-26.90	-23.80	-28.00
MIN PRIVATE TRANSFERS	-17.50	2.90	30.10	90.50	80.00
INTEREST ON PNG	-4.90	-5.60	-5.90	-6.40	-7.60
INTEREST ON ST	-15.40	-17.60	-15.30	-16.70	-18.10
MAX PRIVATE TRANSFERS	-11.50	9.00	68.90	120.80	105.40
INTEREST ON LT OFFICIAL	-20.40	-22.10	-22.10	-24.20	-26.20
IMF CHARGES	-2.50	-2.50	-2.40	-2.30	-1.80
TOTAL NET TRANSFERS	19.15	47.70	95.90	142.00	118.60
<b>SUB-SAHARAN AFRICA</b>					
FDI	0.90	1.90	1.80	1.90	2.30
PORTFOLIO	0.00	0.00	0.00	0.20	0.90
LT PRIVATE	-0.03	0.04	-1.40	0.30	-0.40
MIN PRIVATE FLOWS	0.87	1.94	0.40	2.40	2.80
ST	2.30	-0.50	1.20	0.80	-1.90
PNG (TO PRIVATE SECTOR)	0.20	0.04	0.10	0.02	-0.20
MAX PRIVATE FLOWS	3.37	1.48	1.70	3.22	0.70
LT OFFICIAL FLOWS	4.70	4.00	4.90	4.10	4.00
GRANTS	10.40	9.60	9.60	8.50	8.50
IMF	-0.30	-0.03	0.00	-0.20	0.45
TOTAL ALL FLOWS	18.17	15.05	16.20	15.62	13.65
PROFITS ON FDI	-1.70	-1.60	-1.70	-1.70	-1.80
INTEREST ON LT PRIVATE	-1.30	-1.40	-1.50	-0.60	-0.80
MIN PRIVATE TRANSFERS	-2.13	-1.06	-2.80	0.10	0.20
INTEREST ON ST	-0.70	-0.60	-0.60	-0.50	-0.50
INTEREST ON LT OFFICIAL	-2.40	-2.90	-1.80	-2.10	-2.40
MAX PRIVATE TRANSFERS	-2.73	-5.02	-3.90	-1.68	-4.80
INTEREST ON PNG	-0.30	-0.30	-0.30	-0.30	-0.20
IMF CHARGES	-0.20	-0.20	-0.20	-0.10	-0.10
TOTAL NET TRANSFERS	11.57	8.05	10.10	10.32	7.85
NOTE: A large portion - but not all - of ST/PNG inflows are private inflows. The private inflows/transfers are shown excluding (minimum)/including (maximum) ST & PNG					
SOURCE: World Bank IECIF Database, January 1995.					

The fundamental reason for the underestimates of inflows to SSA in published global databases (apart from the fact that they do not show the most recent trends) is the composition of the inflows to many SSA countries, which makes them much harder to measure, and the absence of recording systems for the main types of inflows.<sup>7</sup> Table 2 compares the composition of inflows for SSA and other regions.

	1978-82			1990-93		
	Latin America	Asia	SSA	Latin America	Asia	SSA
FDI	15.1	15.0	9.8	33.0	37.5	140.3
Portfolio	4.9	3.6	0.0	68.1	14.2	10.9
Long-Term Bank loans	63.6	53.9	53.9	-32.1	21.7	-143.5
Short-Term loans	16.4	27.5	36.3	30.5	27.0	92.3

First the more easily measurable inflows to SSA fell since the early 1990s, from around US\$5 billion a year to under US\$1.2 billion. The composition of these inflows has evolved somewhat differently from other regions.

- medium- and long-term commercial lending to both the public or private sectors collapsed after the debt crisis, similar to that in Latin America; but to an even more dramatic degree. In 1978-82, such lending accounted for around half of total inflows, but by 1990-93 outflows virtually offset all non-debt inflows.
- short-term bank loans have always accounted for a larger proportion of inflows than in other regions and have become even more pronounced in 1990-93; even though they were only around 20% of inflows in 1978-82.
- foreign direct investment rose sharply as a proportion of total inflows over the period 1990-93, but has remained relatively small (at around US\$1.6 billion a year and lower in real terms than in the early 1980s) and confined largely to 6 SSA countries;

<sup>7</sup> Of course, factors noted for other developing countries may also be partly responsible, particularly: discrepancies between source and recipient country data due to on-lending through intermediary countries; and inadequate data coverage in source countries. On the latter, see also Ffrench-Davis and Griffith-Jones, 1995.

- portfolio investment has grown recently, with booms in most regional stock markets and the launching of several new regional portfolio funds, which (with the exception of South Africa) remains relatively small, reaching no more than US\$120 million a year in 1990-93.

Secondly the main inflows to SSA have been difficult to record or classify for the following reasons:

- with the loosening of borrowing restrictions on the private sector, short-term bank loans to the private sector for trade financing have grown considerably. At the same time, because it has not historically been an important inflow, virtually no country in SSA has adequate recording systems for monitoring private sector debt, especially short-term debt. Most countries do not even attempt to record inflows, believing that such intrusion may prove counter-productive to the spirit and intent of liberalisation;
- large amounts of capital inflows by residents and non-residents are mis-recorded in the current account under a residual item, "private transfers".<sup>8</sup>

These transfers have risen dramatically since SSA countries liberalised their foreign exchange systems, by firstly introducing "own-funds" imports where no questions were asked about the source of the funds; and later, foreign exchange bureaux, where all current account transactions may be conducted. Originally, it was assumed that the source of funds for the bureau system were unrecorded exports and workers' remittances. However, more recently it has become clear that, due to inadequate monitoring and supervision of bureaux transactions, virtually any capital account transaction can also be conducted through the bureaux.<sup>9</sup> In other words, the current account is entirely porous and the capital account has effectively been liberalised. In some countries, large amounts of flight capital have returned (or left) through the bureaux; and non-residents are thought to conduct frequent, albeit small capital account transactions. However, due to inadequate recording procedures, it remains impossible to separate out the proportion of bureaux inflows which are capital-related, let alone to distinguish among types of capital-related inflows. In short, the current account-related inflows produces "capital inflows" whose scale in relation to the economy exceeds other regions.

Aggregate net private capital inflows to the six countries in our sample were greatly influenced by the experience of South Africa. South Africa was a net exporter of capital in the period 1986-89. However, the direction was reversed in the period 1990-93. The huge outflow of private capital from South Africa resulted in the

---

<sup>8</sup> Similar recording of capital flows as current account transactions has been noted in El Salvador by S. Calvo and Reinhart 1995.

<sup>9</sup> It is also likely that there is substantial under-recording of the scale of the bureaux transactions.

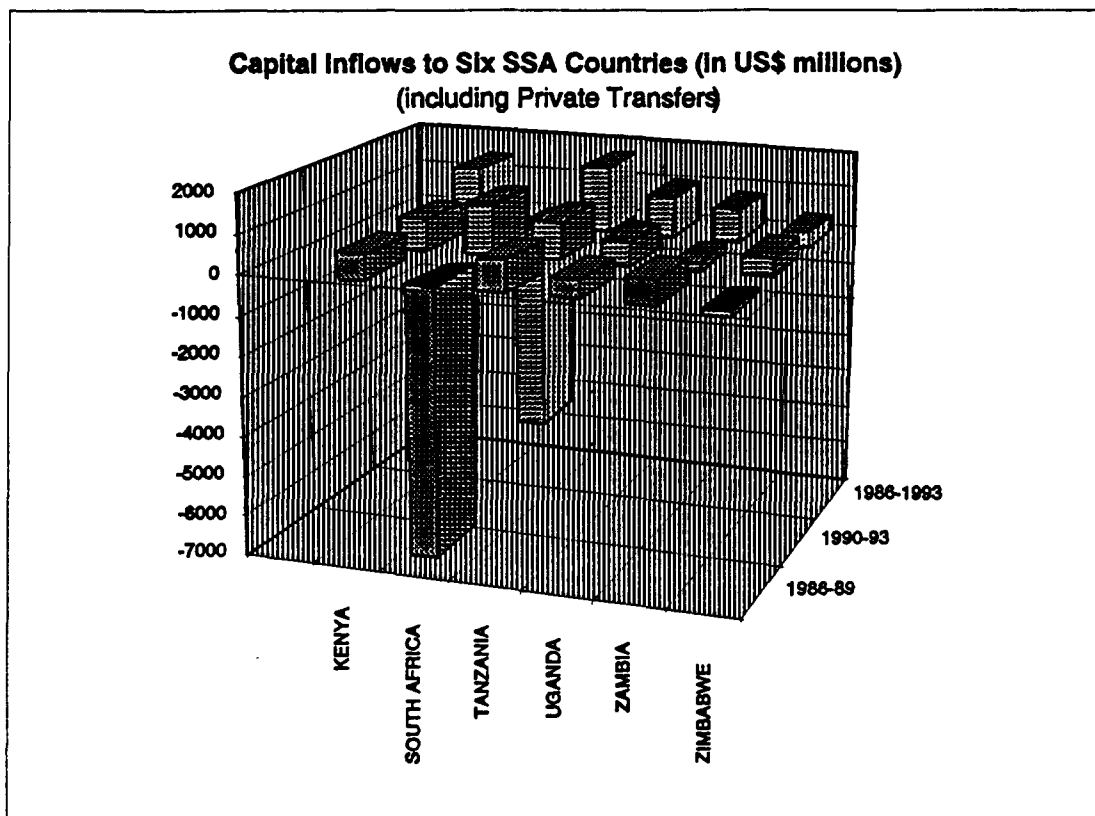
sample countries recording a net export of private capital amounting to US\$ 6,195.6 million in the period 1986-9. This was reversed to a net inflow of private capital amounting to US\$ 2,072.6 million. Excluding South Africa, the five remaining countries received private capital inflows amounting to US\$ 851.4 million in 1986-9 increasing slightly to US\$ 868.6 million in 1990-93.

The experience of Zambia also presents some interesting trends in private capital inflows. The net private capital inflows amounted to US\$ 714 million in the period 1986-89. But this significantly declined to US\$ 240 million in 1991-93. On the other hand, the remaining countries in the sample experienced sizable growth in inflows during 1990-93 compared to the period 1986-89

The following table and graph shows the magnitudes of the inflows to the region in US\$ millions.

Table 3:	Capital Inflows to Six SSA Countries					
	Including Private Transfers (US\$ Million)			Excluding Private Transfers (US\$ million)		
	1986-89	1990-93	1986-1993	1986-89	1990-93	1986-1993
KENYA	647.7	779.6	1,427.3	327.0	252.0	579.0
S. AFRICA	-6,655.0	1,243.0	-5,412.0	-7,047.0	1,204.0	-5,843.0
TANZANIA	765.2	943.9	1,709.1	-214.0	-8.0	-222.0
UGANDA	450.0	586.7	1,036.7	31.0	-20.0	11.0
ZAMBIA	597.0	200.0	797.0	714.0	240.0	954.0
ZIMBABWE	-97.7	471.2	373.5	-6.6	404.6	398.0
TOTAL	-4,292.8	4,224.4	-68.4	-6,195.6	2,072.6	-4,123.0





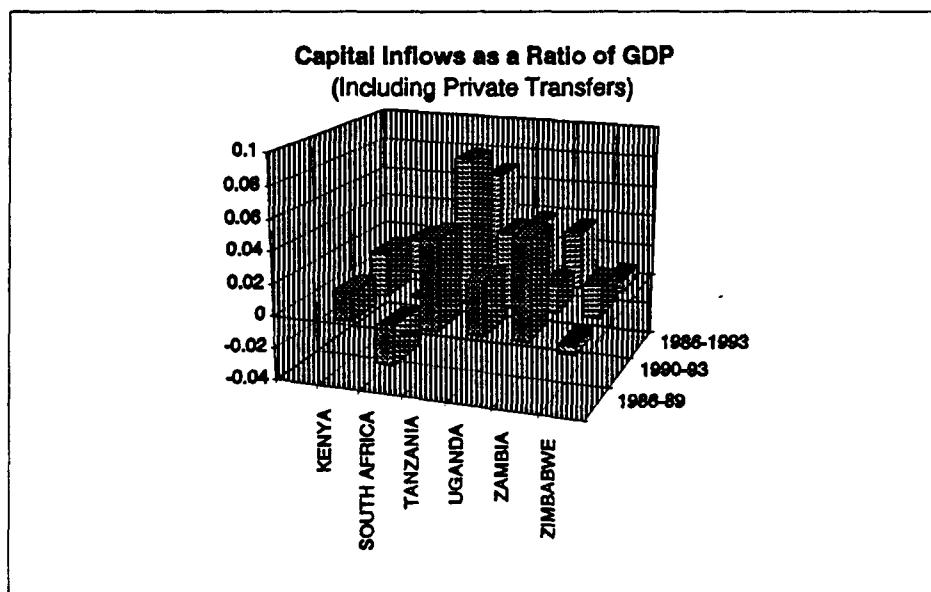
Excluding official inflows, it is estimated that private capital inflows to the six countries as a ratio to GDP increased to an inflow of 0.8 percent in 1990-93 from a net outflow of 1.2 percent in 1986-89. Zimbabwe and Uganda recorded an increase in net private capital inflows from -0.4 and 3.2 percent in 1986-89 to 2.0 and 4.7 percent in 1990-93 respectively. Similarly, Kenya and Tanzania experienced an increase in net private capital inflows from 1.7 percent and 5.5 percent to 2.8 percent and 9.1 percent of GDP in the two reference periods respectively.

On the contrary, private capital inflows as a ratio to GDP fell markedly in Zambia from 6.0 percent in 1986-89 to about 1.7 percent in 1990-93. One distinguishing factor between Zambia and the other five countries in our sample is that macroeconomic instability was much higher in the 1990-93 period compared to 1986-89. In particular, inflation increased from an average of about 50 percent in 1986/9 to an average of 149 percent in 1990/3. In the case of Kenya and Zimbabwe, the moderate increase in inflation between the two periods did not discourage private capital inflows. The following table shows the capital inflows to the region as a percentage of GDP.

Table 4 Private Capital as a ratio of GDP

Table 4:	Capital inflows % GDP Including Private Transfers			Capital inflows % GDP Excluding Private Transfers		
	1986-89	1990-93	1986-1993	1986-89	1990-93	1986-1993
KENYA	1.71%	2.75%	2.15%	0.86%	0.89%	0.87%
SOUTH AFRICA	-2.44%	0.29%	-0.77%	-2.59%	0.28%	-0.83%
TANZANIA	5.50%	9.05%	7.02%	-1.54%	-0.08%	-0.91%
UGANDA	3.21%	4.69%	3.91%	0.22%	-0.16%	0.04%
ZAMBIA	6.00%	1.69%	3.66%	7.18%	2.03%	4.38%
ZIMBABWE	-0.44%	2.01%	0.82%	-0.03%	1.72%	0.87%
TOTAL	-1.16%	0.81%	-0.01%	-1.67%	0.40%	-0.46%

Graph Private Capital as a ratio of GDP



Overall, trends in inflows to SSA are similar to those for other small countries, relying predominantly on short-term bank loans and FDI rather than MLT loans or portfolio inflows (S. Calvo and Reinhart 1995). In terms of their sustainability, it is significant that the less volatile MLT bank loans and FDI virtually cancel each other out, leaving SSA economies excessively dependent on short-term bank inflows, which could be unsustainable.

As indicated above, South Africa dwarfs the other five countries as it accounts for about 58 per cent of total net private capital inflows to the six countries in the sample in the period 1990-93. Apart from the size of inflows, nature of inflows to South Africa are quite different from those of the remaining countries in the sample. The surprising finding is that even for countries that have had stock exchange markets for long e.g. Zimbabwe and Kenya, investors are yet

to be significantly attracted to take share holding in domestic investment. This is probably due to the slow progress in liberalising the capital account.

The other interesting finding revealed by the data is that investor confidence has greatly improved in South Africa. In the period 1990-92, South Africa received substantial resources under the category of short term inflows (net) amounting to US\$ 2,181 million with a peak in 1991. But since 1992 the shift is in favour of portfolio investment and private long term debt.

Short term capital inflows have exhibited a very high level of volatility. In a number of instances countries have recorded high inflows in a year followed by an net outflow in the subsequent recording period. For example in 1987, Kenya received net inflows under this account amounting to 2.6 per cent of GDP but this was followed by an outflow equivalent to -0.8 per cent of GDP. The phenomenon was repeated in 1990-91 when Kenya allowed holders of foreign exchange certificates to negotiate premiums in secondary market trading. As a result, Kenya received net short term inflows amounting to about US\$300 million (equivalent to 3.2 per cent of GDP) in 1990 but following the reversal of the policy, Kenya experienced an outflow amounting to US\$ 273 million (equivalent to 3.6 per cent of GDP) in 1991. Similarly, Zambia has recorded wide swings in net short term capital inflows. Net inflows equivalent to 4.2 per cent of GDP were recorded in 1988 but were followed by outflows in 1989 and 1990 equivalent to 2.4 and 3.3 per cent of GDP. For most of the countries in the region, short term capital inflows are accounted for by short term trade credits.

Foreign direct investment has been mainly directed to Zambia in the period 1986-93 equivalent to 3.62 per cent and 2.9 per cent of GDP in 1986-9 and 1990-3 respectively. This could be reflecting investments in the mining industries. Kenya, Tanzania and Zimbabwe have also benefitted from FDI but the inflows as a percentage of GDP are between 0.16 and 0.4 per cent. For the six countries aggregated, FDI amounted to US\$ 279.8 million in 1986-89 increasing to US\$ 475.2 million in 1990-93. This represents an increase from 0.08 per cent of GDP to 0.09 per cent of GDP.

The other development which distinguishes South Africa and Zambia from the remaining four countries is that the latter countries receive substantial resources recorded as private transfers. Including the inflows in the broad assessment of private capital inflows reflected that the six countries exported just over US\$4,292.8 million in 1986-89 but received over US\$ 4,224.4 million in 1990-93. In the period 1990-93 private transfers accounted for over 50 per cent of the total private capital inflows equivalent to about 0.4 per cent of GDP. Most of the private transfers were accounted for by Kenya, Uganda and Tanzania. The three countries recorded receipts of private transfer equivalent to about 2.0, 4.9 and 9.1 per cent of GDP. Apart from the above three, Zimbabwe also recorded a marked increase in private transfers during the 1990's, especially in 1992 when it recorded receipts equivalent to 0.6 per cent of GDP.

Finally, it has not been possible to collect data on costs or maturity of inflows - particularly of bonds; or on the sources of inflows (especially the division between domestic and foreign investors, or the sources of inflows). These variables would be expected to have major implications for the sustainability/volatility of inflows and the resulting policy response (see International Capital Markets 1995 and French-Davis and Griffith-Jones 1994).

#### Composition of Capital Inflows to SSA Countries.

Table 5	COMPOSITION AND RELATIVE SHARE OF CAPITAL INFLOWS TO SSA					
	1986-89	1990-93	1986-93	1986-89	1990-93	1986-93
	US\$ millions			As a % of the total.		
FDI	279.8	475.2	755.0	-0.1	0.1	-11.0
NET FLOW OF ST DEBT	-3,061.0	1,379.0	-1,682.0	0.7	0.3	24.6
NET FLOW OF LT DEBT	-2,235.0	-1,502.0	-3,737.0	0.5	-0.4	54.6
PORTFOLIO EQUITY	-1,179.4	1,720.4	541.0	0.3	0.4	-7.9
PRIVATE TRANSFERS	1,902.8	2,151.8	4,054.6	-0.4	0.5	-59.3
Total	-4,292.8	4,224.4	-68.4	1.0	1.0	1.0

#### CAUSES

One of the central issues in the debate on the recent private capital inflows is what has caused them? The factors underlying capital inflows to developing countries tend to be divided them into external or "push" factors; and domestic or "pull" factors.

"Pull" factors include:

- political and economic (stabilisation/structural) reforms boosting confidence in the economy;
- debt restructuring to reduce the debt overhang and enhance the sustainability of foreign exchange inflows;
- liberalisation of foreign exchange markets and the current or capital accounts of the balance of payments;
- proliferation of specific incentives and simplification of procedures for direct and portfolio investment, (Gooptu 1994);
- liberalisation of restrictions on private sector foreign borrowing.

The major "push" factors have been identified as:

- the decline in international interest rates;
- the cyclical downturn in developed countries, which reduced economic activity and demand for investment funds;
- the trend towards diversification of assets by portfolio investors, limited by a maximum stock of investments in emerging markets which such investors wish to hold;
- changes in regulations in developed countries which made investment in emerging markets easier and more profitable.

Overall, the literature has concluded that both were involved, with some stressing "push", especially interest rate differentials (Calvo et al 1992 and 1994; Asea and Reinhart (1995) Chuhan et al 1993; Fernandez-Arias 1994) and others stressing "pull" (Edwards 1991; Hernandez and Rudolph; Niehans).

One of the problems with much of the literature on causes of capital inflows, is that it tends to rely on econometric analysis of relative prices (notably interest rate differentials), which takes too little account of structural factors in individual countries, influencing inflows, or of the subjective "sentiment" factors influencing international capital markets (see Fernandez-Arias and Montiel 1995). As a result, some of the literature has attempted to judge the influence of different "pull" factors by trends in the stock markets of the recipient countries, or in their secondary market debt prices, as if these trends were objective measures of the credibility of the recipient country. This is a particularly dubious method to use for SSA countries, where there are large subjective "risk premia" in all such prices, and where individual distorted trades patterns based on speculative information can determine prices.

There has been virtually no econometric analysis of the causes of capital inflows to SSA countries with the exception of Asea and Reinhart 1995, due partly to lack of data. Given the less "formal" nature of the inflows, "push" factors, especially US short-term interest rates, have had much less of an impact than in other regions (Asea and Reinhart), indicating that inflows might be more sustainable.

As a result of the poor sequencing of adjustment reforms, it seems likely that several transitory "pull" factors were even more important in SSA countries, notably:

- extremely high real domestic interest rates on Treasury bills, and Central Bank bills were a major factor in capital inflows to Zambia and Zimbabwe during the initial stages of financial sector liberalisation (see also Asea and Reinhart). These reflected the inefficiency of financial intermediation in SSA and the ineffectiveness of monetary control instruments in the absence of structural reforms of the financial sector which caused a self-sustaining cycle; through exchange rate appreciation and even higher interest rates attracting capital inflows due to sterilisation efforts (see also Galbis 1993; Montiel 1994; and Roe and Sowa 1995). In addition, the high domestic interest rates pushed private sector borrowers to seek foreign loans in order to avoid high domestic interest rates.
- temporary booms in export prices which have (as in earlier periods - see Hadjimichael et al) attracted large export prefinancing loans and speculative capital inflows. This was particularly the case in Kenya and Uganda in 1994-95.

One other factor explored has been the “spillover” effects from the crisis in Mexico on inflows to all developing countries, and of inflows to/from large countries on smaller countries (S. Calvo and Reinhart 1995). While the spillover effects from Mexico on SSA are not thought to have been great, being overruled by regional factors, with the exception of South Africa. A review of South Africa’s international borrowing reveals that delayed entry of South Africa into the international capital markets was to a great extent due to the Mexican crisis. There was a Global bond issue by South Africa in December 1994 but this did not perform well as investors shifted to higher quality bonds at the time. Interest in South African bonds was only regained in the second half of 1995. This has been in part influenced by high yield on South African bonds and stable exchange rate. Trends in capital inflows to Kenya and Uganda have also varied sharply with perceptions of relative economic prospects and arbitrage opportunities from relative trends in interest rate and exchange rates. Similarly, there is growing evidence that capital inflows to South Africa have influenced the entire Southern African region, partly because South African companies are borrowing for investment in neighbouring countries.

A deeper analysis of the numbers in the sample countries in the study reveals that most of the short term debt are trade credits. Following the liberalization of the foreign exchange markets in these countries, exporters found it cheaper to access short term finance especially from buyers of the exports as foreign interest rates were far lower than interest rates prevailing in these countries (refer to table 7). This is explained by a combination of pull and push factors. From the point of view of the creditors, the export creditors have an advantage as it is common for foreign governments to guarantee such lines of credit. This substantially reduces the risk borne by the creditor agency. The ECGD of UK and COFACE of France have actively participated in the guaranteeing credit to SSA. Since such inflows are normally for very short periods and are highly volatile, there is need for a rapid restructuring of the financial sector in these countries to reduce intermediation margins. There is evidence in the numbers presented in table 6 to suggest that countries in the sample received external capital on account of the very high interest rate differential. In the case of Kenya, this is evidenced by the receipt of short term debt which increased from an outflow of about US\$70 million in 1988 to an inflow of about US\$350 million in 1989-90. Similarly, the inflow of short term debt to Zimbabwe increased from a net outflow of US\$8 million in 1986-88 to an inflow of US\$290 million in 1989-90.

The temporary high interest rates on treasury bills in Zambia and Kenya in the early 1990’s reflected the inefficiency of intermediation in SSA financial systems and ineffectiveness of monetary control instruments in the absence of structural reforms of the financial sectors. It caused a self sustaining cycle attracting capital inflows through exchange rate appreciation and higher interest rates due to sterilization efforts (see Galbis 1993; Montiel 1994; and Roe and Sowa 1995).

Table 6: Composition of Capital Inflows to Six SSA Countries

	FDI		NET FLOW OF ST DEBT		NET FLOW OF LT DEBT		PORTFOLIO EQUITY		PRIVATE TRANSFERS	
	1986-89	1990-93	1986-89	1990-93	1986-89	1990-93	1986-89	1990-93	1986-89	1990-93
KENYA	138.0	84.0	87.0	115.0	102.0	53.0	0.0	0.0	320.7	527.0
S.AFRICA	-171.0	-26.0	-3416.0	1241.0	-2376.0	-1760.0	-1084.0	1749.0	392.0	39.0
TANZANIA	1.0	31.0	-215.0	-39.0	39.0	205.0	0.0	0.0	979.2	951.0
UGANDA	3.0	7.0	28.0	-27.0			0.0	0.0	419.0	606.0
ZAMBIA	360.0	342.0	354.0	-102.0			0.0	0.0	-117.0	-40.0
ZIMBABWE	-51.2	37.2	101.0	191.0			-95.4	-28.6	-91.1	66.0
TOTAL	279.8	475.2	-3061.0	1379.0	-2235.0	-1502.0	-1179.4	1720.4	1902.8	2151.0
<b>% OF GDP</b>										
KENYA	0.36%	0.30%	0.23%	0.40%	0.27%	0.19%	0.00%	0.00%	0.85%	1.80%
S.AFRICA	-0.06%	-0.01%	-1.25%	0.29%	-0.87%	-0.40%	-0.40%	0.40%	0.14%	0.00%
TANZANIA	0.01%	0.30%	-1.54%	-0.37%	0.00%	0.00%	0.00%	0.00%	7.04%	9.10%
UGANDA	0.02%	0.06%	0.20%	-0.22%	0.00%	0.00%	0.00%	0.00%	2.99%	4.80%
ZAMBIA	3.62%	2.90%	3.56%	-0.86%	0.00%	0.00%	0.00%	0.00%	-1.18%	-0.30%
ZIMBABWE	-0.23%	0.16%	0.46%	0.81%	0.18%	0.87%	-0.43%	-0.12%	-0.41%	0.20%
TOTAL	0.08%	0.09%	-0.83%	0.26%	-0.60%	-0.29%	-0.32%	0.33%	0.51%	0.40%
<b>RELATIVE SHARE</b>										
KENYA	21.31%	10.77%	13.43%	14.75%	15.75%	6.80%	0.00%	0.00%	49.51%	67.60%
S.AFRICA	2.57%	-2.09%	51.33%	99.84%	35.70%	-141.59%	16.29%	140.71%	-5.89%	3.10%
TANZANIA	0.13%	3.28%	-28.10%	-4.13%	0.00%	0.00%	0.00%	0.00%	127.97%	100.80%
UGANDA	0.67%	1.19%	6.22%	-4.60%	0.00%	0.00%	0.00%	0.00%	93.11%	103.40%
ZAMBIA	60.30%	171.00%	59.30%	-51.00%	0.00%	0.00%	0.00%	0.00%	-19.60%	-20.00%
ZIMBABWE	52.41%	7.89%	-103.38%	40.53%	-39.92%	43.51%	97.65%	-6.07%	93.24%	14.10%
TOTAL	-6.52%	11.25%	71.31%	32.64%	52.06%	-35.56%	27.47%	40.73%	-44.33%	50.90%

Table 7: Lending Rates

	1986	1987	1988	1989	1990	1991	1992	1993	1994
Kenya	14	14	15	17	18	20	20	55	27
S. Africa	10	15	18	18	18	17	14	13	13
Tanzania	12	19	28	30	31	31	31	39	39
Uganda	40	30	40	50	45	41	33	20	22
Zambia	27	21	18	18	35	na	55	113	70
Zimbabwe	13	13	13	13	12	16	35	36	35

All figures are presented as percent per annum

For South Africa, the numbers represent the bank rate

Further analysis of the data on private capital inflows reveals that recent developments, especially in the policy environment, are key in accounting for the inflows to the six countries in our sample. In the case of South Africa, political factors influenced the inflow of capital to the extent of reversing the outflows that occurred in the 1980s to inflows in the 1990s. In particular, the reforms initiated by De Klerk in 1989 and the release of Nelson Mandela in 1990 improved the credit rating of South Africa resulting in resurgence of short term trade finance. Further, investor risk assessment improved following successful abolition of the Financial Rand in March 1995<sup>10</sup>. The liberalisation of the foreign exchange markets including permitting residents to hold foreign exchange in domestic banking system has also played a catalytic role in the return of flight capital and increasing remittances by nationals working abroad in countries in our sample excluding South Africa. The countries have mainly attracted private transfers representing mainly return of flight capital, workers remittances and mis-reported capital account transactions, and short term inflows mainly on account of financing trade. The presence of sizable private transfers in the overall private capital inflows complicates judgement on volatility of inflows. If these are transformed into holding of real assets, the private transfers will be less susceptible to high volatility. Chances are that private transfers will be sustained as long as attractive policies are maintained such as allowing residents/non residents to open foreign exchange denominated accounts in the domestic banking system.

As countries reduce their debt burden, improve on imports cover and maintain a track record of private sector inflows such as private transfers, their credit rating in international capital markets will improve and is likely to trigger international short-term capital inflows. One interesting observation from the numbers is that FDI and private short term debt can be quite sensitive to the macro-economic environment. Zambia was unable to sustain private capital

<sup>10</sup> Refer to the Quarterly Review October 1995 Pg 2-10 of the Centre for Research into Economics and Finance in South Africa.



inflows at levels experienced in 1986-89 as the macroeconomic environment worsened during 1990-93.

All the indications are that it is pretty difficult to fully assess whether inflows to the region are of temporary nature. This makes it difficult to design appropriate policy response. To the extent that the private capital inflows are subject to misjudgment, countries in the region should design corrective measures well aware that the inflows are temporary. Given that the financial sectors of countries in the region are inefficient and that effectiveness of monetary policy remains weak, the countries are faced with a big challenge of absorbing such inflows without excessive appreciation in the domestic currency.

### SUSTAINABILITY

The balance of international opinion on the sustainability of private capital inflows has undergone a virtual U-turn in the last two years. Though some authors (Devlin, Ffrench-Davis and Griffith-Jones 1994; UNCTAD 1994) have been warning of problems for two years, opinion in the International Financial Institutions (IFI) and the financial community was that - because capital inflows reflected a fundamental revival of confidence in emerging markets and sustainable "push" factors - they were sustainable, though their magnitude might decline over time. Even at the end of 1994, Washington sources were suggesting that a "soft landing" (i.e. a gradual decline in net inflows) was possible, unless there was a sharp rise in international interest rates or collapse in recipient country economies (Fernandez-Arias 1994; World Debt Tables 1994).

In 1995, opinion moved more towards the "hard landing" (large fall in net inflows) and "crash" (large net outflows) scenarios (see Fernandez-Arias and Montiel 1995: 28), with organisations such as the IMF (ICM 1995) and BIS (Annual Report 1995) suggesting that, with the benefit of hindsight, the inflows were unsustainable.

Opinions in some African countries have undergone a similar evolution largely responding to actual trends in inflows. Overall, the causes of inflows to Africa identified above would appear to indicate that the stabilising influence of the lower weight of "push" factors might be offset by the higher weight of temporary/volatile "pull" factors and regional influences. It might be expected, therefore that inflows would be unsustainable.

The composition of inflows to SSA makes them a priori less sustainable. It is generally accepted that short-term and portfolio inflows are highly volatile (Griffith-Jones 1995; International Capital Markets; Reisen 1993). It has been shown that FDI exhibit some measure of volatility, (Claessens et al 1995). If we add private transfers - which have been the most volatile type of inflows in SSA nations to the volatility ranking of Turner (1991), Capital inflows to Africa have been highly volatile.

Nevertheless, until inflows actually declined sharply, opinion in some quarters was euphoric about the prospects for continued inflows, on the (untested) assumption that permanent "pull" factors were at work. Without a doubt, as in the Mexican case, there will soon be many sources telling African governments that the inflows were "obviously" unsustainable, and identifying previously-ignored economic "fundamentals" which should have indicated to anyone with reasonable intelligence that the inflows could not continue.

The key issue for African governments is to avoid the euphoria and the retrospective judgements, and to focus on objective measures of the sustainability of inflows. The most convincing suggestion so far has been by Dadush, Dhareshwar and Johannes (1994), that net liabilities ought not to be more than 200% of exports or, in dynamic form, that the change in net liabilities (measured as the ratio of the current account deficit to exports) ought not to be more than twice the change in exports (averaged over a period of 4 years). This measure has been criticised for its assumption of equal weighing for all types of inflows, ignoring the higher volatility of short-term and portfolio inflows. In addition, it would be inaccurate for many SSA countries, because it would include the current account private transfer inflows. A more accurate measurement for SSA countries would be the change in net liabilities (measured as the current account deficit excluding private transfers) compared to the change in exports. In addition, to take account of different levels of volatility, it would be desirable to check short-term/portfolio inflows as a proportion of total inflows and in relation to GDP/exports. Sustainability ought also to be judged against the fact that domestic investors can nowadays far more easily denominate their holdings into foreign exchange, making vulnerability to outflows much greater.

Finally, SSA governments should be mindful of the large volume of literature indicating that inflows to developing countries (and financial inflows in general) are intrinsically volatile, having produced 6 crises in Latin America in the last 150 years (see Griffith-Jones 1995). Perhaps the most prudent guideline has been provided by Williamson (1994): and that is to regard all positive shocks as temporary and all negative shocks as permanent. As Griffith-Jones has pointed out, if a country bases policy action on assuming that inflows are permanent, they are more likely to become temporary as in the case of Mexico, while, if it more prudently assumes they are temporary, they are more likely to be permanent as with Chile.

## MACROECONOMIC IMPACT OF CAPITAL INFLOWS ON THE DOMESTIC ECONOMIES

The economies in the Sub-Saharan Africa have over the past decade or so implemented wide ranging policies intended to promote efficiency and growth as mentioned above. It then becomes difficult to assess whether capital inflows are a cause or effect of macroeconomic stabilization. In particular, ODA inflows have played a critical role in the reform process of a number of countries in the region. Because of such inflows, with the associated domestic financing of the budget, member countries have been able to widen both the current account and budget deficit to GDP ratios without threatening macroeconomic stability. A related issue is the mis-recording of capital account transactions in the current account as private transfers. To the extent that private transfers are large, the current account deficit to GDP will be underestimated.

As indicated earlier all countries in the sample received much higher private capital inflows in 1990-93 than in the period 1986-89 with the exception of Zambia. Private capital inflows have until recently often been seen as having largely positive effects; namely overcoming foreign exchange and import constraints; supplementing domestic savings and investment; smoothing national expenditure by compensating for negative terms of trade shocks; raising the microeconomic efficiency of production, especially by reducing financial intermediation spreads and by supplying technology and skills through FDI projects. However, more recently, developing countries have come to realise that private capital inflows can also have negative effects, especially on macroeconomic stability, linked closely to the above positive effects. For example:

- in attempting to overcome foreign exchange constraints, capital inflows could lead to sharp exchange rate appreciation;
- if capital inflows are spent on imports, overcoming the import constraint can lead to rising current account deficits;
- if spent on consumption, capital inflows can discourage domestic savings and have no effect on the amount or productivity of investment;
- if developing countries financial markets are underdeveloped and performing poorly, large external inflows can reduce their intermediation efficiency still further, causing loss of monetary control and greater volatility in financial markets;
- overall, if capital inflows are procyclical, they exaggerate all the destabilising effects of terms of trade changes.

This section focuses on each of these effects in turn.

The single most important effect of capital inflows has been seen as on the exchange rate, because they have led to sharp appreciation in some instances and undermined efforts to improve export competitiveness - and because changes in inflows have undermined exchange rate stability, with negative effects on long-

term growth (eg Ghura and Grennes). Their effects are hard to disaggregate from those of other stabilisation measures, terms of trade changes and official capital inflows. However, Elbadawi and Soto have found that all types of inflows can have large short-term destabilising effects on the exchange rate, even though short-term and portfolio inflows have no long-term effect on the exchange rate<sup>11</sup>; and longer-term direct investment inflows have effects largely consistent with macroeconomic equilibrium.

The private capital inflows, though predominantly short term, have led to short term exchange rate appreciations in almost all countries in our sample as shown in the table below. Kenya and Uganda experienced very sharp appreciation in their exchange rate in 1993/94 and 1994/95 at time when private transfers and access to short term trade credits markedly increased. The appreciation in real effective terms in both Uganda and Kenya was well over 20% in 1994. Zambia experienced a depreciation in real effective terms in 1991 which was followed by an appreciation in 1992 and 1993 and a depreciation in 1994. Similarly, South Africa has experienced movements in either direction in its real effective exchange rate. In the period 1986 - 89, when South Africa was a net exporter of capital, the real effective exchange rate depreciated but appreciated in the period 1990-92 as the country became a net recipient of capital. Unlike other countries in the sample, Zimbabwe has experienced a depreciation in the real effective exchange rate throughout the period 1990-94.

Table 8: Nominal and Real Exchange | Rates 1985 = 100

		1986	1987	1988	1989	1990	1991	1992	1993	1994
Kenya	N	98.8	100.6	107.9	125.6	139.6	167.7	196.3	353.7	342.1
	R					103.5	108.1	100.7	128.0	100.0
South Africa	N		92.8	103.0	119.5	118.0	126.0	130.0	149.0	na
	R		96.1	102.0	101.3	98.4	95.0	91.3	93.4	92.6
Tanzania	N	186.9	367.4	567.4	819.4	1114.9	1252.6	1701.0	2316.0	2912.0
	R					396.0	382.0	438.0	497.0	497.0
Uganda	N	209.0	639.0	1584.0	3330.0	6401.0	10955.0	16922.0	17835.0	14717.0
	R					155.8	217.0	227.0	23.0	179.0
Zambia	N	251.6	283.9	264.0	416.0	932.0	1990.0	5042.0	14026.0	24813.0
	R					70.0	81.0	75.0	70.0	79.0
Zimbabwe	N	106.2	106.2	113.0	137.0	150.0	212.0	319.0	406.0	506.0
	R					100.7	126.0	128.0	132.0	139.0

R - denotes real exchange rates

N - denotes nominal exchange rates

Source: Economic and Social Statistics on Africa ECA and;  
IFS IMF Publication.

<sup>11</sup> These tend to be magnified by weaknesses in the financial sector. Uganda for example, experienced turbulence in the foreign exchange market in August 1994 partly due to panic in the foreign exchange market caused by the inability of most dealers to hold wide foreign exchange exposure levels.

A second key issue is the balance of payments effect: price-induced increase in expenditure on imports (increasing the current account deficit) or reserves accumulation. This is important for sustainability because, to the degree that capital inflows increase the current account deficit through higher imports, they will automatically decline as this macroeconomic indicator deteriorates (though they will also increase fiscal revenue from tariffs); on the other hand, accumulation of reserves should increase inflows by boosting confidence. Spending on imports has also been found to lag well behind the receipt of capital inflows. Calvo and Reinhart 1995 suggest that small countries in Latin America have seen more reserves accumulation and less import expenditure.

The experience with the reserve build up in the countries in our sample has been mixed making it difficult to identify a single factor accounting for observed changes therein. From the table below some countries have consistently built reserves over the period. However, some of them lost reserves due to a decrease in the medium term loans especially following a scale down in donor financial support. Zimbabwe lost reserves due the prolonged drought period in 1992. The loss of reserves in Kenya and South Africa was due to a decline in official transfers, while in Zambia and Tanzania this was accounted for by the decline in the medium term capital inflows. In Uganda and Zambia the drop in medium and term loans was more than offset by the increase in grants. In addition, some of these countries lost reserves because of the increase in the level of imports. One key factor which has to be recognised is that the private transfers have substantially increased in Kenya, Uganda and Tanzania to a point that donor disbursement for balance of payment support is used for reserve build up.

Table 9: External Reserves expressed in months of imports

	1986-89	1990	1991	1992	1993
months of imports					
Kenya	1.6	0.9	0.6	0.4	2.2
South Africa	7.2	5.6	6.7	8.1	5.8
Tanzania	0.5	2.8	2.8	4.5	2.7
Uganda	0.6	0.7	1.0	1.5	2.1
Zambia	0.8	1.4	1.4	na	na
Zimbabwe	1.5	1.3	1.3	3.3	

The third main group of effects is on investment/savings and consumption, and thereby on GDP growth. In this context, it is important to note that greater expenditure on consumption will cause the real exchange rate to appreciate more rapidly, whereas investment will slow appreciation by importing capital goods for investment (Calvo 1994; Khan and Reinhart). This is particularly true of investment expenditures related to FDI transactions: because these are not intermediated through the domestic financial system, they will have less effect on the real exchange rate or financial markets. Beyond the initial division into investment/consumption, the key variables determining the GDP-effect are the type and productivity of investment, and the proportion allocated to the production of

tradables.

Unfortunately, reliable savings and investment data are extremely rare in Sub-Saharan countries; those which exist are usually derived as residuals in national accounts. Equally, data on import composition which might be used as a proxy are usually somewhat out-of date; and data on the current account which might indicate a savings-investment gap are also misleading because they include some capital account inflows<sup>12</sup>. Preliminary calculations based on 1986-93 data indicated ambiguous results on savings and investments behaviour in the six countries.

Zambia managed to increase the rate of Gross Domestic Investment to GDP. This was mainly financed by ODA (refer to Table 10). Similarly, Zimbabwe was able to marginally increase the ratio of GDI to GDP. For the remaining countries, GDI to GDP fell between the two periods.

Table 10: Macro-Economic Indicators

	GDS/GDP		FISCAL /GDP		GDI /GDP		INFLATION		DEBT SERVICE	
	1986-89	1990-93	1986-89	1990-93	1986-89	1990-93	1986-89	1990-93	1986-89	1990-93
KENYA	19.9	19.5	(5.7)	(5.8)	24.0	18.0	7.0	28.0	39.0	36.0
SOUTH AFRICA	2.7	2.2	(2.4)	(4.7)	20.0	16.0	15.6	14.5		
TANZANIA	(1.4)	4.0	(5.3)	(3.9)	21.6	21.4	31.0	22.0	47.0	105.3
UGANDA	3.8	0.2	(2.3)	(4.1)	16.8	14.8	170.0	30.1	55.0	77.0
ZAMBIA	16	14.3	(8.0)	(5.0)	16.9	24.3	50.0	149.0	33.0	69.0
ZIMBABWE	23.2	11.1	(6.2)	(6.0)	21.0	22.0	11.8	27.6	29.0	29.0

The savings as a ratio to GDP have generally decreased in the countries within our sample with the exception of Tanzania. Zimbabwe suffered the biggest decline of close to 12 per cent. The trends in Gross Domestic Savings to GDP indicates that growth in these countries is mainly financed by foreign savings. To the extent that private capital inflows are volatile, growth is not sustainable. There is an urgent need to mobilize domestic savings to support the growth process especially in Tanzania and Uganda.

The numbers presented in Table 10 also reveal that import demand as a ratio to GDP increased in the countries in the sample with exception of South Africa. Trade liberalization combined with increased capital inflows to the six countries has increased import dependence. This is especially so in Kenya, Zambia and Zimbabwe.

More detailed breakdowns of types and productivity of investment and the

<sup>12</sup> In a number of countries in the region, bureau transactions are not properly categorised. Certain capital account transactions are misreported as current account transactions under the line "private transfers".

proportion allocated to tradeable are for the time being impossible, as is any systematic attempt to isolate the effects of private capital inflows from those of other variables (notably aid inflows). Much more comprehensive work on the uses of inflows is needed and may produce dramatically different results. This remains to be tested and proven through surveys of capital transactions for a wider range of countries in the Capital inflows project.

Monetary and financial effects are the fourth main group. A potential risk of attempts to prevent exchange rate appreciation through accumulation of reserves is the loss of monetary control, leading to acceleration in inflation. The appropriate policy response to sterilise the liquidity injection through open market operations. Depending on the magnitude of the liquidity injection and depth of the financial sector, there is a great likelihood that successful sterilisation will be attained at very high interest rates. Further, the appreciation of the domestic currency, in both nominal and real terms, may not be avoided.

Increased volatility in financial markets has certainly occurred in SSA countries, but less in the stock markets than in markets for Treasury bills/central bank bills which have been attracting private capital inflows, causing speculative bubbles and high interest rates, with knock-on negative consequences for the performance of bank lending portfolios (Asea and Reinhart; Calvo, Sahay and Vegh 1995; Griffith-Jones 1995; International Capital Markets 1995). These can be magnified by the imbalances in the structure of assets and liabilities produced by capital inflows. The financial system acquires liquid liabilities in foreign exchange, integrated into a volatile international capital market (to add to its volatile domestic liabilities which may be made more volatile by foreign capital inflows), while its assets are neither externally protected nor liquid (Rojas-Suarez and Weisbrod 1995).

It is difficult to separate the capital inflow effects from those of the wider distortions and underdevelopment of the financial sector: capital inflows only exacerbate the moral hazard and adverse risk selection already prevalent by adding to the volume of funds requiring intermediation (Calvo, Leiderman and Reinhart 1993). However, it is reasonable to assume that the negative effects of capital inflows on the financial system will be more pronounced in countries where the financial sector is in poor health.

Overall, there is strong evidence that private capital inflows to some SSA countries have been procyclical rather than countercyclical, following terms of trade booms (Kenya/Uganda) and exaggerating all of their destabilising effects: "Dutch Disease" effects (in contrast to Latin America, where they have offsetting terms of trade movements - Ffrench-Davis and Griffith-Jones 1994).

The effects of such trends may be even worse in SSA nations than in other regions, because of their high degree of aid dependence: private capital inflows can reduce the capacity of SSA countries to mobilise aid inflows, especially for

balance of payment support. In the context of liberalised foreign exchange markets, private inflows have reduced private sector demand for donor-funded import support, leading donors to cut new pledges ( Zambia and Zimbabwe). Similarly, accumulation of reserves and the apparently more healthy balance of payments position leads donors to question the whole rationale of fast-disbursing balance of payments support and lead them to move funds to much slower-disbursing project support. This may not be appropriate, given the low absorptive capacity of the project implementing agencies and the continuing budget constraints which would be better resolved by programme aid. The negative implications may become clear if private capital inflows reverse themselves, leading to a fall in international reserves precipitating a foreign exchange crisis as the currency depreciates rapidly. The alternative to programme financing is direct budget support. The local currency equivalent of a disbursement is used to support the budget as the foreign exchange boosts reserves. Apart from name, direct budget support has effects similar to those of import support. Further, it is equally difficult to sustain budget support if macro-economic impact of such inflows adversely affects economic growth.

It is for these reasons that we prefer to call recent events in Uganda a "Uganda Disease", rather than a "Dutch Disease" (see Kasekende and Martin 1995 for more details of this argument).

### POLICY MEASURES

The potential negative economic effects of capital inflows discussed in the previous section show the need for policy measures to influence their scale and composition. The literature has concluded that no single policy measure can influence them decisively. Not surprisingly, the effectiveness of individual measures depends on the scale, nature and purpose of the capital inflows and the characteristics of the recipient economy. It is relatively easy to specify theoretical policy rules: for example, short-term volatile portfolio inflows might require some offsetting policy intervention to smooth any destabilising effects, even though their long-term effects on equilibrium might be minimal; while long-term direct investment might be entirely consistent with long-term macroeconomic equilibrium and therefore require no corrective measures (Corbo 1994; Elbadawi and Soto). However, given the problems with data and monitoring, many SSA governments have had extreme difficulty in identifying capital inflows (especially their scale, composition and permanence) and therefore in deciding appropriate policy responses.

Three types of policy measures have been used by countries receiving large capital inflows:

- measures to increase foreign exchange demand, including central bank intervention in foreign exchange markets; liberalisation of the current account; and liberalisation of the capital account;
- measures to reduce aggregate demand and offset the inflationary effects of



- the capital inflows or of intervening in the foreign exchange market; measures to reduce the scale of capital inflows or to influence their composition in favour of investment

The crucial question for African countries has been whether to resist exchange rate appreciation and, if so, how. The scope for exchange rate policy change has been made much more limited by the extreme degree of liberalisation (to a free float) implemented in most non-CFA countries, compared to the "basket pegs", administered devaluations or band mechanisms used in other developing countries (mentioned earlier in this paper). This makes many of the conventional recommendations irrelevant: such as those for moves towards more exchange rate flexibility, administered appreciations or depreciations, or deliberate introduction of exchange rate uncertainty/noise to deter speculators. Some Washington-based authors have even suggested that exchange rate policy is no longer relevant or feasible in SSA circumstances. However, given the central role of exchange rate depreciation in the few successful adjustment programmes in SSA - notably in promoting export competitiveness - most African governments have preferred to treat any exchange rate appreciation as a major problem and to take measures to reverse or reduce it.<sup>13</sup>

Furthermore, policy response to the large capital inflows has been complicated by the current fiscal stance. With the exceptions of South Africa, the countries have faced varying degree of budgetary problems. The budget deficits expressed as a percentage of GDP have varied from between 1.0 and 13.0 percent. In case of Kenya and Zimbabwe, these have remained high throughout the first half 1990s. Uganda and Zambia have since 1992 achieved significant success in controlling the budget. In the case of Uganda the Government has made substantial repayments to the banking system since 1992. This has been achieved through strict control of Government expenditure combined with efforts to boost revenue mobilisation. The countries in the sample mostly rely on the sale of financial instruments (mainly treasury bills) to sterilise liquidity injections. In cases where fiscal policy is expansionary, open market operations are used to promote macro-economic stability. Similarly, liquidity injection arising from mopping up of excess foreign exchange from the market would be sterilised mainly by sale of financial instruments. As pointed out earlier, the instrument suffers from limitation arising from the lack of depth in the financial sector.

#### MEASURES TO INCREASE FOREIGN EXCHANGE DEMAND

Unsterilised intervention in the foreign exchange market, leading to reserves accumulation, will increase the money supply. This can have secondary positive effects by reducing interest rates and making inflows less likely - but (in the absence of an accommodating increase in money demand) it may also increase inflation and thereby increase the real appreciation of the exchange rate further.

---

<sup>13</sup> For a powerful argument of the case for making the exchange rate a key element of development policy, see Williamson 1995.

Nevertheless, in the absence of monetary tools which can sterilise such large inflows, this has often been the first line of defence for low-income SSA countries.

**Current Account Liberalisation.** One recommendation in the literature is for greater current account liberalisation in order to increase demand for foreign exchange. As already discussed, current account transactions have been fully liberalised in the Anglophone SSA countries which have been experiencing capital inflows. The only additional liberalisation which could occur is reduction of import tariffs. It is unlikely that this would have much effect on increasing import demand, given the existing high level of import dependence of low-income SSA countries and the low level of enforcement of tariff collection. In addition, a reduction in tariffs would be undesirable given the dependence of the budget on tariff revenue; and an increase in import demand would be undesirable, given the already high import dependence of SSA countries and the failure of adjustment programmes to effect any rationalisation of import demand.<sup>14</sup> Thus further current account liberalisation would not be a priority tool for most SSA countries.

**Capital Account Liberalisation.** This is seen as a second method of increasing demand for foreign exchange. Suggestions include full capital account liberalisation to allow capital outflows which would offset inflows; to reducing/eliminating subsidies on any inflows (eg incentives for foreign investment, deposit insurance or subsidised forward cover on foreign exchange transactions); targeting gradual liberalisation designed to encourage certain types of inflows/outflows (see Fischer and Reisen 1992).

In some SSA countries, such measures might well be ineffective at this time, given the relative unimportance of inflows subject to capital account controls or subsidies/incentives, and the predominance of inflows coming through the porous current account and the bureaux. However, Kenya in October 1994 announced far reaching measures intended to offset capital inflows. Residents were permitted to invest abroad and to hold overseas account. South Africa and Zimbabwe are currently having active debates about capital account liberalisation. The recent trend call for critical analysis (see Ffrench-Davis and Griffith-Jones 1994) due to risks that:

- liberalisation may well increase inflows (Hanson 1992; Laban and Larrain 1993; Mathieson and Rojas-Suarez 1993; Williamson 1992);
- it may also undermine the effectiveness of sterilised intervention by making domestic and foreign bonds fully substitutable;
- correct sequencing of capital account liberalisation with other measures (especially stabilisation and internal financial sector strengthening and liberalisation) is crucial. Almost the only consistent sequencing recommendation of adjustment literature is that capital account liberalisation should be one of the last steps in adjustment policy (see

---

<sup>14</sup> For more on these issues, see Martin and Mistry 1995.

Kasekende and Martin 1995): thus it should not be undertaken prematurely in countries with weak domestic financial systems, merely in order to influence private capital inflows.

#### MEASURES TO REDUCE AGGREGATE DEMAND

As in other regions, sterilisation through open market operations has been the most popular policy in SSA countries. Sterilisation has 2 main risks, which has provoked debate over whether it is "easy" (Reisen) or "hard" (Calvo et al 1993/1994):

- that it will perpetuate interest rate differentials and accelerate capital inflows. Frankel concludes that sterilisation will increase interest rates, but to a much larger degree if the source of the problem is higher export receipts or higher money demand rather than capital inflows. The degree of increase will depend on the substitutability of government paper and other assets, on the behaviour of the demand for money (especially its sensitivity to interest rates), and on the interest elasticity of aggregate demand. However, Fernandez-Arias and Montiel indicate that the higher interest rate effect should be only temporary.
- that it will increase fiscal/quasi-fiscal burdens of government or central bank paper, both through larger issues of such paper, and through higher interest rates than the central bank can obtain on its reserves (Calvo et al 1994; Corbo 1994).

For these reasons, some have suggested that a more realistic target than complete sterilisation is to maintain the pre-inflow growth rate of real balances, as has been achieved by Chile.

As a result of the over-reliance on the treasury bill instrument to sterilise both large capital inflows and finance wide budget deficits, interest rate have increased sharply in some countries. Tanzania, Kenya and Zambia have suffered from this problem at different times during the early 1990s with discount rates increasing to well over 50 percent per annum. To avoid the problem, fiscal policy should be tight to ease the burden of mopping up. Uganda offers a good example of the latter. The discount rate on treasury bills in Uganda have fallen from 40 percent in 1990 to the current levels of between 9 and 15 percent. The recent experience of Zambia also supports the need for fiscal restraint. Zambia has managed to reduce the discount rate of the treasury bills from over 70 percent in 1993 to about 20 percent in 1994 through fiscal discipline.

Other Methods of Sterilisation can be used, including:

- increasing the reserve ratio on bank deposits (or particular types of deposits). Though this represents a tax on the banking system (because reserve requirements are not remunerated), it can be a highly effective

prudential measure in reducing intermediation spreads and the money multiplier and credit to the private sector (Reinhart and Reinhart). It can work particularly effectively on individual types of inflow (eg offshore borrowing or uncovered foreign exchange exposure) and if used counter-cyclically to target the source of a boom. However, over the medium term, it risks decreasing the efficiency of the financial system by pushing borrowers towards less efficient lenders in order to avoid the effects of reserve requirements. In addition, it requires a balanced judgement about the possible negative effects on key elements of finance such as trade finance - which was excluded from the Chilean reserve requirements increases.

Kenya and Tanzania have both used the policy of varying reserves requirements in management of liquidity requirements. However, given the current weakness in the financial sector, the policy tends to further widen the intermediation costs. For that reason, Uganda has avoided increasing the reserves requirements. Efforts have been made to reduce costs to commercial banks by treating a portion of vaults cash as reserves eligible in addition to reducing the reserves requirement to the current level of 8.0 percent. The difference in policy of reserves requirement may offer a partial explanation for the far higher lending rates in Kenya and Tanzania compared to Uganda.

- moving government deposits (or postal savings/social security/public enterprise funds) from commercial banks to the central bank or into government paper (see Fischer and Reisen 1992; Reisen 1993; Khan and Reinhart 1995). This has also proved to be a highly effective means of sterilisation. However, depending on the interest rates paid by the central bank, this could have the effect of reducing the rates paid to savers or of increasing interest rate costs to the central bank.

Fiscal Measures. Many Washington-based authors see this as the only long-term policy tool (Corbo 1994; Schadler et al 1993). Similarly, the main recommendation in SSA adjustment programmes has been to tighten fiscal policy, for three reasons:

- to guard against the inflationary impact of possible eventual reversal of capital inflows.
- to offset the effects of sterilisation by reducing interest rates due to lower government borrowing, thereby discouraging capital inflows;
- It has also been suggested that expenditure cuts are more effective than tax rises in reducing aggregate demand (Calvo, Leiderman and Reinhart 1993).

However, many authors have cautioned against the distortion of long-term fiscal plans in order to offset potentially temporary capital inflows. This could be especially important in those SSA countries where expenditure is already at

critically low levels and the potential to increase revenue is limited.

They have also indicated that fiscal measures may increase capital inflows by reducing prospects of government liquidity problems and freeing funds for domestic borrowing linked to some types of capital inflows.

Nonetheless, the policy of fiscal restraint has been used with measurable success in Uganda. The recent positive experience in Zambia and the difficulties in promoting macro-economic stability in Kenya, Tanzania and Zimbabwe lend further support to fiscal restraint. Uganda has managed to absorb the large inflows without losing control over inflation and interest rates.

Measures to Increase Domestic Savings/Reduce Consumption. These are sometimes seen as measures to reduce aggregate demand, and sometimes as measures to influence the expenditure of capital inflows. Similarly, targeted sterilisation measures (reserve requirements on particular types of capital inflows or borrowing) may be used to reduce aggregate demand and to influence the composition of inflows.

Most SSA adjustment programmes have recently begun to include dramatic measures to boost private savings by reform of the financial sector. However, the principal mechanisms proposed have been greater competition in the financial sector by more open entry of new financial institutions, and liberalisation of interest rates. There is little evidence from Africa or elsewhere that such measures have had a dramatic positive effect on private savings, and there is a high risk that other measures in financial sector reform programmes may undermine prospects for higher private financial savings rates (especially the disappearance of rural bank branches and savings networks). Finally, some of the key factors in mobilising private sector savings in other countries, such as postal savings banks, more productive social security funds, or private pensions, have barely been considered.<sup>15</sup> Given this design of financial sector reform, it seems unlikely that measures to increase domestic financial savings will have effects large enough to counteract the effects of private capital inflows.

## MEASURES TO INFLUENCE THE SCALE / COMPOSITION OF INFLOWS

Capital Controls and Taxes. There has been heated debate over the desirability and feasibility of capital controls and taxes, with some (Dornbusch, Griffith-Jones, Williamson) believing they are an essential part of the policy arsenal; and others (Corbo 1994, Schadler et al 1993; Mathieson 1993) seeing them as a temporary and largely ineffectual measure, which are quickly dodged through over- and under-invoicing of trade or through parallel financial and foreign exchange markets. However, recently even conservative sources (BIS 1995; IMF

---

<sup>15</sup> For more on a typical financial sector reform programme in Africa, see Martin 1995.

International Capital Markets 1995) have acknowledged the positive role played in the Latin American and Asian cases by such measures as:

- extra reserve requirements on particular inflows, especially on foreign borrowing by companies or banks or open foreign exchange positions of the banks
- quantitative restrictions on inflows, for example on foreigners buying Treasury bills (in Malaysia) or domestic bonds (Colombia)
- taxes on short-term inflows aiming to reduce the dollar returns of investments (in Brazil, Chile and Colombia).
- minimum stay periods on FDI (Colombia)

Some have tried to distinguish among measures which are good for short periods (taxes and bans) and those which are desirable for longer periods (prudential regulations such as reserve requirements), but the consensus appears to be growing that many forms of controls on capital *inflows* are an essential weapon in the policy makers' arsenal, provided that they are accompanied by measures on foreign exchange demand and domestic demand above, and pursuit of "sound macroeconomic fundamentals".

Given the current absence of data on capital inflows in many SSA countries, it is hard to see how governments could design appropriate capital inflows controls or taxes. Any measures designed in the current low-information context would be more likely to risk exacerbating current distortions or speculative bubbles. In addition, the arguments used about evasion in middle-income countries with better recording systems would apply more strongly in SSA countries, making effective implementation doubtful. The same would apply to any SSA participation in a global tax. However, once more information is available, it should be possible to design carefully targeted controls and taxes.

## CONCLUSION

Where does the above analysis leave African policy makers in deciding which policy measures to use to react to capital inflows? As in every other country, the need for policy intervention depends on the size and composition of inflows, their causes, and the perception and objective analysis of their sustainability. We have shown that the key first step for all Sub-Saharan countries must be to improve recording and monitoring of inflows. For some, this means starting virtually from scratch with Disaggregating inflows through the bureaux and monitoring private sector borrowing; for others, it is a more sophisticated process of improving the coverage of existing monitoring, especially of uses of inflows. However, for those countries which have abandoned all monitoring, there is concern that any attempt to record inflows would be perceived by the markets as an attempt to control, and would undermine the credibility of liberalisation, driving the capital inflows away or back into the parallel markets.

In order to facilitate proper analysis of capital inflows and their macroeconomic effects and in attempting to influence these through appropriate policy measures, authorities must seek to improve the recording and the monitoring systems both in their own countries and in international organisations. The intractable problem though is firstly, how to introduce recording and monitoring systems without driving capital inflows back to the parallel market; and secondly how best to monitor and improve international data sources.

Nevertheless, pending improvements in the data, it is possible to see that:

- contrary to the message of global databases, several Sub-Saharan countries have experienced sizable private capital inflows which are larger compared to their economies than those of Latin American and Asian countries;
- the composition of those inflows (insofar as it is known), indicates that large elements (private transfers and short-term bank inflows) could be volatile. However, the prospects of maintaining private transfers given an attractive macro-economic environment are high.
- the causes of the inflows have been predominantly “push” factors and transitory “pull” factors, and regional spillover effects in Southern African countries, rather than permanent “pull” factors, again indicating their likely unsustainability;
- perceptions and objective analyses of sustainability both indicate that the inflows could be temporary but as indicated, lack of information on the nature of investment may render them permanent.

The potential volatility of the inflows makes a strong case for action to monitor them and to minimise their destabilising macroeconomic effects.

The type of action to be taken depends on the macroeconomic effects of the inflows, compared to the current situation and objectives of the government. As for the effects:

- flows to Sub-Saharan countries have consistently caused real exchange rate appreciation, either through nominal appreciation (where stabilisation policies have been tightly pursued) or through inflation where they have not.
- they have sustained high import levels and permitted reserves build-up in the countries analysed;
- they have caused protracted financial instability and undermined financial sector reform programmes;
- they have been procyclical and complicated aid mobilisation efforts.

The current situations and objectives of the governments are remarkably similar. All of the countries studied share objectives of competitiveness and reducing inflation: yet, with the possible exception of South Africa, none of them would wish to use a stable exchange rate as an inflation anchor. All have relatively recently embarked on financial sector reform programmes, and are anxious to raise domestic savings from current low levels (again South Africa is the exception with much higher savings levels).

Given the need to balance the objectives of competitiveness and stability, the desirable policy mix for SSA countries would be a pragmatic one drawing on the maximum number of policy levers, as in Chile, rather than relying exclusively on sterilised intervention or fiscal compression (Fernandez-Arias and Montiel 1995; Williamson 1995). However, as with small nations in other continents, fewer policy options are currently open to SSA governments (S. Calvo and Reinhart 1995), because of the following factors:

- their complete exchange rate flexibility, and highly open current account openness and (through a porous current account) capital account;
- their slow progress with structural reforms, notably development of the domestic financial sector, which make sterilisation methods less effective and formal capital account opening less desirable, for fear of exacerbating the poor health of most domestic banks;
- (in some countries) the poor fiscal position, which makes sterilisation costs unsustainable; (in others) the prior fiscal adjustment, which makes further fiscal adjustment to temporary capital inflows undesirable and politically problematic;
- the poor quality of data and of enforcement mechanisms for taxes and controls of any kind, and the unconventional nature of much of the capital (in the form of private transfers) which will make capital taxes and controls (whether national or global) less effective.

Given these factors, the priority policy measures would appear to be:

- sterilised intervention in order to minimise inflation and to accumulate reserves to guard against reversal of capital inflows;
- application of selective reserve requirements, especially on offshore borrowing and foreign borrowing by the private sector;
- fiscal tightening, despite shortcoming, is consistent with promoting macro-economic stability in countries faced with high capital inflows given relative ineffectiveness of monetary policy;
- transfer of government/other deposits from commercial to central banks should be considered but may undermine stability in the financial sector given current weaknesses in the sector;
- measures to limit foreign purchases of Treasury bills and domestic bonds;
- removal of incentives for capital inflows and selective gradual opening of the capital account (where justified based on analysis of motives for inflows/outflows and on adjustment sequencing considerations).
- convincing donors to maintain levels of balance of payments and/or fiscal support in order to increase reserves and guard against future outflows.

Even this seemingly specific and limited list looks long for a typical Sub-Saharan policy-maker faced with many other demands on their scarce human



resources for monitoring, research and policy design/implementation. Yet, as strikingly put by Sara Calvo and Carmen Reinhart (1995, p.35),

“While sound macroeconomic policies are advisable, policy-makers in *small* countries are advised to be extra cautious in protecting the domestic financial system against the vagaries of international capital inflows”.

Most Sub-Saharan countries are very small: thus the problem of large unsustainable capital inflows is one they should take very seriously, devoting resources to urgent further analysis of its scale and causes, and the policy measures they can take to minimise its negative effects.

## Appendix One

### **A BRIEF SUMMARY OF LIBERALIZATION PROCESS IN SELECTED COUNTRIES IN SOUTHERN AFRICA.**

Zimbabwe The experience of Zimbabwe in liberalizing its economy is fully described in Ncube et al (1995). The first phase of the liberalization process was started in 1990 with the objective of moving the economy from a highly regulated status to a market oriented one. Imports were substantially liberalized, while surrender requirements remained in force. The current account deficit deteriorated from US\$147 million in 1990 to US\$ 500 million in 1991. In the following year, Zimbabwe devalued its currency to eliminate overvaluation. Unfortunately, the economy was hit by a drought in 1992 which further widened the current account deficit. The deficit was financed by external borrowing, enabling government to maintain a high level of reserves. The cover of imports increased from 4.1 months in 1993 to 5.5 months by end December 1994 and 7 months by June 1995. The controls in foreign exchange dealing were gradually eased in the period 1992-94, and the Government allowed foreign investors to freely invest in the Zimbabwe Stock exchange and remit both capital and dividends, beginning July 1993. Foreign exchange surrender requirements were also gradually eased.

Between January-July 1994, exporters were required to surrender 40 per cent of their earnings at the official rate while 60 per cent could either be sold in the interbank market or held on a foreign currency account (FCA). The surrender requirement was abolished 1st July 1994. The exchange rate was gradually depreciated from Zim. \$2.8 in 1990 to Zim. \$8.2 per US\$ in 1994. An interbank foreign exchange market (IFEM) was set up January 1994, though the Reserve Bank of Zimbabwe (R.B.Z) remained an active participant in the market especially during the first six months of its operation. The RBZ initially retained an official window rate but the two tier exchange rate was finally abolished 1st July 1994. In order to increase competition in the interbank, Government permitted the setting up of foreign exchange bureaux. Zimbabwe became an Article VIII member of the IMF in February 1995.

A key outcome of financial reform in Zimbabwe is the surge in domestic interest rates, both nominal and real, from about 10 per cent in 1990 to 30 per cent by 1994. As a result some private sector borrowers resorted to cheaper credit lines from external sources precipitating a real appreciation of the Zimbabwean dollar.

Zambia. Zambia gradually moved its foreign exchange regime from a controlled to a market based system over the period 1992 to 1995. As a first step, Zambia established a foreign exchange bureaux system in October 1992, which operated simultaneously with the official window managed by Bank of Zambia. The dual system was eliminated in December 1993, with the setting up

of the interbank system. Since then, the foreign exchange system has been fully market-based.

In January 1994, all forms of exchange controls on both capital and current account transactions were eliminated. The nominal exchange rate depreciated by over 80 per cent from Kwacha 177 per US\$ in 1992 to about K942 in September 1995. However, with the very high rate of inflation experienced during the period the real exchange rate actually appreciated. Zambia's import cover rose from 1 month in 1991 to 2.5 months by 1994.

Interest rates were liberalized in September 1992 at a time when the requirements for fiscal accommodation were still high. As a result, the nominal discount rate on short term government paper increased sharply from 182 per cent in 1993 to 591 per cent in July 1993. The rates have since dropped to around 40 per cent. Such high interest rates undoubtedly attracted short term capital inflows. Beginning 1994, non-residents were allowed to participate in Treasury Bills and Government bond markets without restriction.

Tanzania Similar to developments in Zimbabwe and Zambia, significant progress has been achieved in decontrolling prices in Tanzania. The exchange and trade regime have been extensively liberalized. Import licensing has been eliminated and exporters are currently permitted to 100 per cent retention of their foreign exchange receipts. In order to promote dealings in foreign exchange, Tanzania established an interbank foreign exchange market in June 1994 and the bureaux which were set up in 1992, are permitted to participate in the interbank foreign exchange market. This was intended to promote competition in the foreign exchange market since only two banks were registered by then. The participation by bureaux in the interbank foreign exchange market is to be reviewed with a view to limiting their operations to cover only over the counter transactions.

Tanzania has made significant progress in its privatization programme. By end 1994, a total of about 95 out of 371 parastatals had been divested and 50 had been targeted for restructuring or divestiture in 1995. In a further effort to provide financial support to the economic development process, Tanzania is preparing the ground-work for the establishment of capital markets. However, foreign investors are not yet permitted to participate in the capital market. Capital transfers to all countries are still subject to approval by the authorities.

Kenya Kenya made substantial progress in liberalizing its trade regime during the late 1980's. However, insufficient adjustment of the exchange rate made the liberalization process unsustainable. Whenever import demand outpaced supply of foreign exchange, import licensing would be tightened as a means of matching demand and supply of foreign exchange.

The failure to sustain the reform process continued to characterize macroeconomic management in the first 3 years of the 1990's. In the foreign

exchange market, holders of foreign exchange certificates were permitted to negotiate premiums in secondary market trading which created a dual system. This was followed by a revaluation and foreign exchange rationing system which caused substantial losses to holders. Additionally, the economy was characterized by rising inflation, from 13 per cent in 1989 to a peak of 46 per cent in 1993. Furthermore efforts to finance the widening budget deficit through sale of Government paper pushed interest rates to very high levels.

Since mid 1993, Kenya has moved very fast in stabilizing the macroeconomic environment and liberalizing the economy. Inflation was brought down to single digit levels. An interbank foreign exchange system was started in October 1993. By end of 1993, all restrictions on remittances of dividends and expatriate earnings had been lifted residents were permitted to borrow abroad up to \$ 1m. In February 1994, further efforts to eliminate controls on the capital account were announced. Exporters were allowed 100 per cent retention of export proceeds, limit on resident borrowing from abroad was removed, foreigners were allowed to open foreign currency accounts in domestic banks and the restrictions on domestic borrowing by foreign controlled companies was removed. By June 1994, Kenya accepted obligations of Article VIII of Articles of Agreements of the IMF.

In the financial year 1994/95, Kenya made further progress in reforming the foreign exchange market and liberalizing the capital account. The Central Bank of Kenya started licensing foreign exchange bureaux in October 1994. In addition, residents were permitted to invest funds abroad including retaining funds in overseas accounts. Additionally foreign investors were allowed to participate in the Nairobi Stock Exchange. In 1994, offshore borrowings by residents were allowed without limit provided that interest does not exceed LIBOR plus 2 percentage points and such borrowing is not guaranteed by Government.

Uganda The liberalization of the foreign exchange and trade regime in Uganda is extensively discussed in Kasekende et al (1994)<sup>16</sup>. The new government that came into power in January 1986 took almost 1½ years in search of an appropriate policy package to address the numerous economic problems that affected Uganda. During that time, the policy regime was characterized by a high degree of uncertainty, an overvalued exchange rate and very high inflation.

Following the launch of the Economic Recovery Programme in May 1987, insufficient exchange rate adjustment and inefficient budget management undermined the reform programme. However, since June 1990, Uganda has moved reasonably quickly to correct macroeconomic distortions. Government

---

<sup>16</sup> Section II of the Uganda Final report as part of a wider study covering five other African Countries under External Finance for Africa Project managed by Oxford International.

implemented very tight monetary and fiscal measures; sanctioned the establishment of foreign exchange bureaux in July 1990, launched a foreign exchange auction system in January 1993 and replaced it with an interbank system in November 1993. Under the interbank system, all surrender requirements on exports or any other foreign exchange inflows were removed. In addition, residents are permitted to operate foreign currency accounts. During the period since 1990, government pursued an aggressive policy of attracting foreign investment. As part of this process, Uganda enacted a new Investment Code with highly liberal provisions on repatriation of capital and dividends. Since early 1993, both nominal and real exchange rates have appreciated markedly in part reflecting higher private capital inflows and terms of trade. The capital account is not yet fully liberalised. In 1994, Uganda acceded to Article VIII Sections 2,3 and 4 status of the Fund's Articles of Agreement.

South Africa According to Mlambo and Nell (1995), South Africa has experienced structural disruptions since 1970 that have had a profound impact on investment and the overall economic performance of the country. The Angolan war, oil price shocks in the 1970's, the worldwide recession by the end of the 1970's, sanctions and political instability have all combined disrupted the long-run growth performance of the country.

In 1980 there was a sharp upsurge in gold price which restored investors' confidence and paved the way for major policy transformations. By then, the political situation in South Africa had deteriorated to such an extent that foreign creditors were reluctant to extend further credit to domestic enterprises and other financial institutions. Disinvestment campaigns emanating mainly from Western nations, accompanied by stricter trade and financial sanctions, forced the government to declare a debt moratorium on foreign debt in 1985. According to Van der Walt and De Wet, 1993 disinvestment together with the repayment of foreign debt contributed to net capital outflows of around R5 billion per annum from 1985 onward.

In addition, before 1985, the balance of payments (BOP) was characterized by cyclical patterns, during an upswing in the business cycle, increased demand for imports caused the current account to move into a deficit, which in turn was financed by direct and indirect capital inflows. During a downswing, imports declined, and the current account moved into a surplus that enabled the repayment of loans. The cyclical pattern of the BOP was however disrupted by net capital outflows which occurred after 1985. Whereas in the past current account deficits were financed by capital inflows, net outflows that have taken place since 1985 implied that the current account had to be transformed into a surplus.

Broadly speaking, in contrast to the period before 1985, the period thereafter saw a sharp increase in the user cost of capital for public enterprises that subsequently led to a sharp decrease in public investment.

Furthermore, it is noteworthy that because the level of savings was not enough to finance capital outflows, the significant decline in the GDFI/GDP ratio since 1985, eased the pressure on the current account of the BOP.

Developments in the BOP constraint have had important implications for investment in South Africa since 1985. Subsequently, real growth declined to a mere 0.6 percent per annum between 1985 and 1993. Furthermore, GDFI as a percentage of GDP (gross domestic product) declined sharply from an average annual rate of 28.6 percent in the period 1970-1984, to 21.2 percent in the period 1985-1993. In the same sub-periods, private investment as a percentage of GDP decreased from 15.3 to 13.6 percent, while public investment showed a significant decline from 13.3 to 7.6 percent. Surprisingly, the BOP constraint appears to have had a marginal impact on private investment inflows.

With the breakdown of the Bretton Wood system in 1971, South Africa experimented with various exchange rate systems to accommodate floating exchange rates. Following the recommendations of the 1978 Interim Report of the Commission of Inquiry into the Monetary System and Monetary Policy, South Africa opted for a dual managed floating exchange rate system in 1979, with substantial intervention by the South African Reserve Bank. The high gold price during the 1970's and early 1980's contributed to the exchange rate being overvalued.

In 1983 the Reserve Bank allowed the exchange rate to be more market-determined. A direct attempt was made to drain the economy of excess liquidity with the liberalization of exchange control with the abolition of the financial rand mechanism in February 1983. This, coupled with declining gold prices since 1981; political unrest and disinvestment contributed to a sharp depreciation of the exchange rate. Capital outflows since 1983, however, necessitated the reinstatement of the financial rand in 1985. The depreciation of the exchange rate effectively increased the cost of imported capital and subsequently suppressed investment.

Political uncertainty and the concomitant macroeconomic instability that prevailed during the 1970's, and particularly after 1985, increased the risk for potential investors and consequently reduced investment.

South Africa formally accepted the obligations of Article VIII, section 2, 3 and 4 of the IMF's Articles of Agreement in September 1973.

## REFERENCES

- Agosin, M., "Saving and Investment in Latin America", UNCTAD Discussion Paper 90, October 1994, Geneva.
- Asea, P.K. and Reinhart, C.M., "Real Interest Rate Differentials and the Real Exchange Rate: Evidence from Four African Countries", paper to AERC workshop, June 1995, Nairobi, mimeo.
- Bank for International Settlements,  
--Annual Report, 1994-95 editions.  
--International Banking and Financial Market Developments, 1994-95 editions.
- Calvo, G.A., "The Management of Capital flows: Domestic Policy and International Cooperation", International Monetary and Financial Issues for the 1990s, UNCTAD/GID/G24/4, 1994.
- Calvo, G.A., Leiderman, L. and Reinhart, C.M.,  
--"Inflows of Capital to Developing Countries in the 1990s: Causes and Effects", Economic Perspectives, September 1994.  
--"The Capital Flows Problem: Concepts and Issues", IMF PPAA/93/10.  
--Capital flows and Real Exchange Rate Appreciation in Latin America: the Role of External Factors, mimeo, June 1992.  
--"The Perils of Sterilisation", IMF Staff Papers 38 (1991): 151-74.
- Calvo, G.A., Sahay, R. and Vegh, C.A., "Capital inflows in Central and Eastern Europe: Evidence and Policy Options", IMF Working Paper 95/57, May 1995.
- Calvo, S. and Reinhart, C.M., "Capital Flows to Latin America: Is There Evidence of Contagion Effects?", mimeo, April 1995.
- Cardenas, M.S. and Barrera, F.O., Efectos macroeconomicos de los capitales extranjeros: El caso colombiano. IDB Working Paper 147, June 1993.
- Chuhan, P., Claessens, S. and Mamingi, N., Equity and Bond Flows to Latin America and Asia: the Role of Global and Country Factors. World Bank IECIF Policy Research Working Paper 1160, July 1993.
- Claessens, S., Dooley, M. and Warner, A., "Portfolio Capital Flows: Hot or Cold?", World Bank Economic Review 9,1, January 1995.
- Collier, P., EC REPORT ON UGANDA.
- Commonwealth Secretariat, International Capital Markets, 1994-95 editions.
- Corbo, V. and Hernandez, L., Macroeconomic Adjustment to Capital Inflows:

Latin American Style versus East Asian Style, World Bank IECIF Policy Research Working Paper 1377, November 1994.

Dadush, U., Dhareshwar, A. and Johannes, R., Are Private Capital Flows to Developing Countries Sustainable ?, World Bank WPS 1160, 1994.

Dehesa, Guillermo dela (1994),  
"The Recent Surge in Private Capital Flows to Developing Countries." Is it sustainable?" Per Jacobsson Lecture

Dooley, M.P., Fernandez-Arias, E. and Kletzer, K.M., Recent Private Capital Inflows to Developing Countries: is the Debt Crisis History ?, NBER Working Paper 4792, Cambridge, Mass, July 1994.

Dornbusch, R., "Cross-Border Payments Taxes and Alternative Capital Account Regimes", report to the Group of 24, September 1995.

Elbadawi, I.A. and Soto, R., Capital Flows and Long-term Equilibrium Exchange Rates in Chile, World Bank PRD Working Paper 1306, June 1994.

Fernandez-Arias, E., The New Wave of Private Capital Inflows: Push or Pull ?, World Bank IECIF Policy Research Working Paper 1312, June 1994.

Fernandez-Arias, E. and Montiel, P.J., "The Surge in Capital Inflows to Developing Countries: Prospects and Policy Response", mimeo, March 1995.

Ffrench-Davis, R. and Griffith-Jones, S., Coping with Capital Surges. Lynne Rienner, New York.

Fischer, B. and Reisen, H., Towards Capital Account Convertibility, OECD Policy Brief No. 4, Paris, 1992.

Fitzgerald, E.V.K, "External Finance and Economic Adjustment", paper to ISS Policy Workshop on International Capital Flows and Economic Adjustment in Developing Countries, The Hague, December 1993.

Frankel, J.A., Sterilisation of Money Inflows: Difficult (Calvo) or Easy (Reisen) ?, IMF Working Paper 94/159, December 1994.

Galbis, V., High Real Interest Rates Under Financial Liberalisation: Is There a Problem ?. IMF Working Paper 93/7, January 1993.

Ghura, D. and Grennes, T.J., "The Real Exchange Rate and Macroeconomic Performance in Sub-Saharan Africa", Journal of Development Economics 42 (1993): 155-74.



Goldstein, M., Coping with Too Much of a Good Thing: Policy Responses for Large Capital Inflows in Developing Countries, World Bank WPS 1507, September 1995.

Gooptu, S., Are Portfolio Flows to Emerging Markets Complementary or Competitive ?, World Bank IECIF Policy Research Working Paper 1360, September 1994.

Griffith-Jones, S., "Capital Flows to Latin America and Asia: Lessons for Eastern Europe", mimeo, IDS, Sussex, June 1995.

Hadjimichael, M.T., et al, Sub-Saharan Africa: Growth, Savings and Investment 1986-93, IMF Occasional Paper 118, 1995.

Hanson, J.A., Opening the Capital Account: a Survey of Issues and Results, World Bank FPS Working Paper 101, May 1992.

Hernandez, L. and Rudolph, H., Sustainability of Capital Flows to Developing Countries: Is a Generalised Reversal Likely ?. World Bank WPS 1518, October 1995.

International Finance Corporation, Quarterly Review of Emerging Markets, 1994-95 editions.

International Monetary Fund,

--"Conditionality Review: Distilling the Main Messages and Directions for Future Work". Document EBS/94/164. August 1994.

--International Capital Markets: Developments, Prospects and Policy Issues.

Washington, 1995. + Background Papers.

--World Economic Outlook. 1994 and 1995 editions.

Kasekende, L, M. Katarikawe and R Rweikiza (1994),  
The Impact of Imports on Development in Low Income African  
Uganda Final Report

External Finance for Africa Project Managed by Oxford International Associates.

Kasekende, L. and Martin, M., "Macroeconomic Policy Research Issues: the Sequencing, Credibility and Consistency of Adjustment in Africa", paper to AERC Senior Policy Seminar, Nairobi, April 1995.

Khan, M.S. and Reinhart, C.M., Capital Flows in the APEC Region, IMF Occasional Paper 122, March 1995.

Leape Jonathan "A Review of South Africa's International Borrowing." Quarterly Review, Centre For Research into Economics and Finance in Southern Africa,

London School of Economic, October 1995, Pg 2-10.

Lipumba, Nguyuru (1994), "Africa Beyond Adjustment" Overseas Development Council, Washington DC

Martin, M., et al Financing Investment and Production in Mozambique. Report to European Commission by IDS, Sussex, June 1995, mimeo.

Martin, M. and Mistry, P.S., Financing Imports for Development in Low-Income Africa (report to Sida/Danish Foreign Ministry, November 1995, mimeo).

Mathieson, D.J. and Rojas-Suarez, L., Liberalisation of the Capital Account: Experiences and Issues. IMF Occasional Paper 103, March 1993.

McKinnon, R., The Order of Economic Liberalisation: Financial Control in the Transition to a Market Economy. Johns Hopkins University Press, Baltimore, 1991.

Mlambo K and Nell K., "Public Policy and Private Investment in South Africa: An empirical Investigation, 1995.

Montiel, P., "The New Wave of Capital Inflows: Country Policy Chronologies", mimeo, World Bank, April 1995.

Ncube, Paul Collier, Jan Gunning and Kapukile Mbalmbo (1995), "Trade Liberalisation and Regional Integration in Zimbabwe" AERC Collaborative project on Regional Trade and Trade Liberalisation in Sub-Saharan African.

Niehans, J., "Elusive Capital Flows: Recent Literature in Perspective", Journal of International and Comparative Economics 3, 1994: 21-43.

Organisation for Economic Cooperation and Development,  
 --Financing and External Debt of Developing Countries, 1994-95 editions.  
 --Financial Market Trends, 1994-95 editions.  
 --Geographical Distribution of Financial Flows to Developing Countries, 1994-95 editions.

Reinhart, C. and Dunaway, S., "Dealing with Capital Inflows: Are There Any Lessons ?", mimeo, April 1995.

Reinhart, C. and Reinhart, V., "On the Use of Reserve Requirements in Dealing with Capital Flow Problems", mimeo, October 1995.

Reisen, H.,  
 --"The Case for Sterilised Intervention in Latin America", mimeo, 1993.

--"Capital Flows and their Effect on the Monetary Base", CEPAL Review 51, 1993.

Reisen, H., and Fischer, B., eds., Financial Opening, OECD, 1993.

Roe, A., and Sowa, N.K., "From Direct to Indirect Monetary Control in Sub-Saharan Africa", plenary paper for AERC, Nairobi, December 1994, mimeo.

Schadler, S., Carkovic, M., Bennett, A. and Khan, R., Recent Experiences with Surges in Capital Inflows. IMF Occasional Paper 108, 1993.

Turner, P., "Capital Flows in Latin America: a New Phase", BIS Economic Paper 44, May 1995.

UNCTAD, Trade and Development Report (1994 and 1995 editions). Geneva.

Williamson, J.,

--"Exchange Rate Policy and Development Strategy", paper to AERC plenary session, Johannesburg, December 1995, mimeo.

--"A New Facility for the IMF ?", report to the Group of 24, March 1995.

--"The Management of Capital Inflows", paper for IFC for Government of India, mimeo, December 1994.

World Bank.

--Financial Flows to Developing Countries (quarterly, 1993-95 editions).

--Global Economic Prospects (quarterly, 1994-95 editions).

--World Debt Tables (1993-94 and 1994-95 editions).

Younger, S., "Aid and the Dutch Disease" Macroeconomic Management When Everybody Loves You", World Development 20,11 (1992): 1587-1597.