

# Globalisation and Policy Effects in Africa

*Arne Bigsten and Dick Durevall*

## 1. INTRODUCTION

 GLOBALISATION has several meanings in the public debate, but economists' usage tends to refer to the international integration of economies with regard to markets for goods, factors of production, and technology. As far as the recent era of globalisation is concerned, it is clear that the speed of this economic integration has generally increased. Goods flow more easily across the globe than they used to, due to a combination of technological progress, which has lowered transport costs plus improvements in trade-related service sectors, and trade-liberalisation measures.<sup>1</sup>

During this process of globalisation, most parts of the Third World have seen considerable economic improvement, while Africa stands out as having been left behind.<sup>2</sup> Although global inequality as measured by the Gini coefficient in purchasing power terms and with country weights has decreased since 1968, the bottom ten per cent of the distribution – which largely comprises Africa – has seen its share of global GDP decline (Melchior, 2002). So why has Africa not done better?

Globalisation in Sub-Saharan Africa is closely linked to the structural adjustment programmes, where implementation creates opportunities for rapid growth, but also increases the risk of low or negative growth. The latter possibility is probably more important in African countries than elsewhere, because most of them have weak governments that for various reasons are less likely to pursue

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<sup>1</sup> Subramanian and Tamirisa (2001) show that the elasticity of trade flows with respect to distance fell by 30 per cent between 1980 and 1997.

<sup>2</sup> In Bigsten (2002) it is argued that during the last twenty years African nations have liberalised their inward-oriented trade regimes, but that the African economies have been marginalised from the international economy in several ways.

growth-oriented policies. In addition, they are regularly exposed to serious external shocks, such as terms-of-trade changes and droughts, which require policy actions that are unpopular among the general public.

In this paper we focus on structural adjustment programmes and their dependence for success on politics and institutional characteristics of the countries concerned. Before structural adjustment the scope for domestic policymakers was wider, since the existence of controls made prices, and hence production and consumption, react slowly to changes in policy. However, since liberalisation prices react quickly to policy changes. Good policymaking is thus more important in a liberalised environment than in one with many controls, because bad policies have stronger and more immediate negative effects on economic growth. Hence, we argue that one important explanation for the dismal performance of many African countries, in spite of all the measures taken towards market liberalisation, is the combination of this magnification of the effects of economic policy with a lack of willingness or ability on the part of politicians to respect the restrictions imposed on their behaviour and policy choices by the liberalised markets.

Section 2 discusses economic growth and its determinants in Africa in general, while Section 3 reviews the process of international economic integration in Africa, and Section 4 analyses the political economy of adjustment in Africa. In Section 5 the prerequisites for successful integration into the world market are outlined. It is noted that increased exposure to international prices and returns on assets make the economic equilibrium relations – the law of one price (LOP) and uncovered interest parity (UIP) – relevant guidelines for economic policy. Section 6 illustrates the arguments with the case of Zimbabwe, where lack of respect for the restrictions imposed by international markets has led to an economic crisis with negative growth rates and a departure from globalisation. Section 7 draws some conclusions.

## 2. AFRICA'S GROWTH TRAGEDY<sup>3</sup>

During the last few decades Africa has seen economic stagnation, for which a range of explanations have been proposed. Among the main candidates are misdirected economic policy, poor education, poor infrastructure, political instability, and rent seeking. Acemoglu, Johnson and Robinson (2001) argue that poor institutions are the root cause of the poor growth. Economic life in Africa is risky, and the effect of this on growth is compounded by poor contract-enforcement mechanisms, as well as uncertainty about the macroeconomic environment. Sachs and Warner (1997) emphasise poor ecology, while Sachs and Warner

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<sup>3</sup> The characterisation is due to Easterly and Levine (1997).

(2001) point out that dependence on natural resources has been associated with poor growth in many countries. Most of these factors are directly or indirectly related to economic policy, and the question then is why poor policies are pursued, or good policies are badly implemented. Easterly and Levine (1997) propose social polarisation and ethnic fragmentation as reasons.

Lack of openness has also been identified as a major constraint on investment in Africa (Collier and Gunning, 1999). Foreign-exchange controls made some investments hard to undertake and, earlier at least, overvalued exchange rates often made a mockery of calculations of economic returns on investment. Some investments in highly distorted settings, such as Tanzania, turned out to have no economic value at all once the economy was liberalised and world market prices arrived.

Trade reforms, aiming to reduce the gap between domestic and international prices, have always been part of structural-adjustment programmes under the tutelage of the IMF and the World Bank. Trade liberalisation has implied increased competition, which many firms have complained about. The change to the new competitive has not been painless. In Zambia, for example, many of the old manufacturing industries, not viable in the new open environment, went bankrupt. Now, however, the survivors are expanding and some non-traditional producers have actually become successful in export markets. So far these markets have mainly been found elsewhere within the region. However, exports to the North, which is the real challenge, are still stagnant (Bigsten and Mkenda, 2002).

### 3. IS AFRICA INTEGRATING WITH THE GLOBAL ECONOMY?

Africa's share in world exports fell from 3.5 per cent in 1970 to 1.5 per cent in 1997, and its share in world imports fell from 4.5 per cent to 1.5 per cent during the same period. There are basically two interpretations of this lack of international economic integration. One argues that Africa has not benefited from globalisation because it has not globalised, not attempted to integrate its economies with world markets. The declining African share in world trade is then taken as the result of the policy stance chosen. Subramanian and Tamirisa (2001) show that Africa has under-performed relative to other developing countries. This view suggests that it is crucial to Africa's economic recovery that it pursues export-promotion policies and opens up further (World Bank, 2000; and Sachs, 2000).

The alternative interpretation is that Africa has taken advantage of trading opportunities as well as could be expected, given its level of development. This view is supported by studies that suggest that Africa, given its underlying characteristics and trade determinants such as size, income and geography, is not

trading 'too little'. Most of these studies have used gravity models. Foroutan and Pritchett (1993) compared Africa with other Third World countries and concluded that the intra-African trade pattern is not atypical, and that distances impose similar restrictions as in other similar regions. Coe and Hoffmaister (1999) also investigated North-South trade and found that in 1970 Africa 'overtraded' with the North, while in the 1990s its trade flows were not different from those of comparable non-African countries. And Rodrik (1999), looking at aggregate trade and, after controlling for income, size and distance to world markets, found that Africa's total trade is not atypical. This view suggests that the causality runs from growth and productivity to trade, and that the policy focus needs to be on the broader range of issues determining productivity.

Whichever way one looks at the debate on the causal relationship between trade and growth, most would agree that rapid growth in Africa must involve trade expansion. Opening up is essential for such trade expansion to take place, and we would thus argue that it is a necessary condition for rapid growth, though it is also clear that it is not sufficient. The rest of the paper discusses the problems of pursuing a growth policy in a more open and internationally integrated setting, and the reasons why things might go wrong.

#### 4. THE POLITICAL ECONOMY OF STRUCTURAL ADJUSTMENT IN AFRICA

Successful market economies must have an underpinning of sound institutions. They require secure property rights; agencies that regulate the conduct in goods, services, labour, asset and financial markets; fiscal and monetary institutions to maintain macroeconomic stability; institutions for social insurance; and institutions for conflict management.

So what can we say about these institutions in the context of Africa? One fundamental part of the institutional structure is the state, a 'meta-institution' that determines or influences the ways in which a whole range of institutions in the economy works. Africa's peculiar history and its specific conditions may help explain why African states work as they do and what determines their policy choices. It is therefore important to understand how the state works and how globalisation impulses are transmitted through it.

Africa has the highest concentration of states where the process of state creation was exogenous to their society and where the leadership or elite has inherited the state rather than shaping it. Citizens came to view the African state not so much as an outcome of a social contract, based on common ideological convictions, as an instrument of collective action or for reduction of transaction costs, but as an alien institution; they did not agree about the rules of the political game or that it should be played at all. The new rulers thus had to deal with groups with competing loyalties, while opposition focused not so much on policies as on

the government itself. Because of this, African politics displays high instability, with frequent constitutional deadlocks and military coups, secession attempts and civil wars.

Power is fragile for the ruling elite, and this limits the number of policy options available, because successful implementation of policies requires a certain level of societal loyalty. When bureaucrats are not loyal to the state and private agents distrust the public institutions, politicians find it hard to implement policies effectively. Instead they tend to resort to personal rule and neo-patrimonial policies. They

substitute patron-client links for the lack of moral right to rule, to replace the state with an informal web of *ad hoc* political alliances, and thereby provide the regime with a semblance of social foundations (Engelbert, 2000, p. 1824).

This type of rule relies on the creation and maintenance of rents such as those derived from trade restrictions, and implies a preference for distributive over long-term investments.<sup>4</sup> Neo-patrimonial policies lead to widespread distortions in market mechanisms, since resources are allocated according to political rather than economic criteria.

The relative payoffs of developmental versus neo-patrimonial policies depend on state legitimacy. With low legitimacy, neo-patrimonial policies yield the greatest relative short-term payoffs to elites in terms of consolidation of their power. They bolster domestic support by directing public resources to private actors through unofficial channels and networks. This analysis suggests that underlying the problems of Africa is a crisis of governance. African leaders in general do not choose bad policies because they don't know any better. Rather historical circumstances determine the relative returns in terms of power of different strategies.

But why are there no effective forces that can guarantee good governance? There is a lack of effective democratic control even in the countries that have been (partially) democratised. The government in power often tends to look to the interests of its core supporters, rather than to the welfare of the country as a whole.

External pressure for democratic change has also been weak until recently, but it is possible that the economic-reform programmes have contributed to greater political openness. What is lacking is agents of restraint that can force governments to behave responsibly, to introduce sensible economic policies and then to stay on track.

Integration into the world market could serve as a disciplining device, forcing policymakers to exercise caution so that policies do not depart far from the new market economy path. This could push countries towards increased macroeconomic stability, and thus towards better growth performance. On the other hand, if

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<sup>4</sup> See Bigsten and Moene (1996) for an analysis of the case of Kenya.

policymakers stray from the narrow path, punishment from the market would be more severe than under the old control regime.

However, one can question the effectiveness of this disciplining device in the case of African governments.<sup>5</sup> As discussed above, the way the competition for power is structured has a major impact on what policies are actually implemented, and on *how* they are implemented.

Some countries, like Uganda, have observed the constraints put on their choices, and they have done well. However, leaders of other countries, such as Zimbabwe, still act as if they are unaware of the constraints or, which may be more likely, act in accordance with more fundamental incentives.

#### 5. WHAT IS REQUIRED FOR SUCCESSFUL INTEGRATION?

The implementation of structural-adjustment programmes has been the most important step taken by African economies towards integration into the world economy. The standard package has included trade liberalisation and the creation of a foreign-exchange market; de-regulation of domestic markets, including the financial sector; privatisation of public enterprises; reduced budget imbalances; tax reforms; and public sector reform. These measures have been intended to make the countries' allocation of resources more economically rational. But at the same time as the reforms have 'got the prices right', they have also implied that the countries have become more sensitive to the actions of economic agents, both domestic and foreign. This feature of globalisation has been important for the subsequent growth performance of many Sub-Saharan countries.

A consequence of opening up an economy and integrating it with the world market is increased exposure to both international prices and to returns on assets. A simple way to capture this exposure empirically is to study two economic equilibrium relations that are expected to hold in well-integrated markets: the law of one price (LOP), and uncovered interest parity (UIP). LOP implies that similar goods should have similar prices, even if they are produced and sold in different countries, because in an integrated market, divergences make it profitable to move goods from the low-price to the high-price country. When economic agents engage in such arbitrage, prices will go up in the low-price country and go down in the high-price country, so that the prices will converge. When LOP holds for every good, or on average for all goods, then purchasing-power parity (PPP) holds.

Similarly, UIP states that the expected return on a financial asset should be approximately the same across borders. The mechanism is the same as for LOP:

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<sup>5</sup> In their review of the political economy of African growth Bates and Devarajan (2000, p. 40) note that 'rather than being the primary purpose of politics, policy choice is often better viewed as a by-product'.

People will move their assets to the place with the highest expected return, and this will lead to convergence of the returns.

The two relations can be written as:

$$P_k \approx EP_k^* \quad (1)$$

$$i \approx i^* + \frac{\Delta E^{exp}}{E}, \quad (2)$$

where  $P_k$  is the price of the good  $k$ ,  $i$  is the return on a financial asset,  $E$  is the exchange rate,  $\Delta E^{exp}$  is the expected change in the exchange rate, and an asterisk indicates foreign prices or interest rates.

In practice, LOP and UIP do not hold exactly even when markets are well integrated. There are a number of reasons for this: transportation costs, limited information, difference in risks, etc. Moreover, all goods are not traded internationally. Yet the two relations do restrict movements of prices, interest rates and exchange rates, because there are limits on how far away they can be from their equilibrium values without having strong negative effects on economic growth.

Before structural adjustment, there were very weak or no forces maintaining LOP and UIP in most Sub-Saharan countries. Domestic prices could differ considerably from international prices of similar goods because of restrictions on international trade, in the form of import quotas and tariffs, bans on exports and limited access to foreign currency. It was simply much harder to make a profit by exploiting price differences in such an environment than in a country with free trade. Interest rates could differ across borders because domestic interest rates were set administratively at low levels, the domestic currency was not convertible, and the authorities controlled capital flows in and out of the country.

The efficiency of controls on international transactions varied across countries. Smuggling was common in many countries, with thriving parallel markets for foreign exchange and goods. Companies also used transfer pricing to keep foreign exchange outside the home country. Nevertheless, substantial deviations from LOP and UIP were common, and had negative effects on economic performance. But in controlled economies the effects were often not obvious to policymakers or to people in general, because they appeared slowly over time. Hence, policymakers did not bother much about LOP and UIP.

Structural adjustment has increased the potential for international arbitrage considerably, through the removal of many restrictions on international transactions. Evidence for the success is seen in the decrease in importance, or disappearance, of parallel markets for foreign exchange and the creation of official foreign exchange markets, and increases in capital flows. There are thus reasons to believe that in many Sub-Saharan countries LOP and UIP have become important equilibrium relations to which the authorities should pay attention, because LOP and UIP restrict their policy choices considerably. Moreover, external shocks,

such as drought or changes in export prices, now have a stronger effect on the parities, since domestic prices, interest rates, and to some extent the exchange rate, are all now allowed to adjust to market forces. Since these adjustments can generate large short-run deviations from equilibrium, there is a greater need for government action after shocks to facilitate adjustment.

Policymaking in a country that is becoming more integrated in the global economy is thus very different from that in a controlled economy. For example, an expected decline of exports, or careless statements by leading politicians, can generate large capital outflows and a drop in the value of the local currency. The increase in the exchange rate can then rapidly be transmitted into higher domestic prices of basic commodities. Hence, to benefit from globalisation, policymakers have to accept the discipline imposed by the LOP and UIP restrictions. If they do not, the negative consequences are far more serious than they were before structural adjustment.

#### 6. THE CASE OF ZIMBABWE

Zimbabwe's structural-adjustment programme was initiated late in 1990 and was planned to last until 1995. In general the programme was implemented according to plan, and in some respects even faster than that. However, there were repeated failures to meet the budget-deficit targets. The budget deficit remained at about the same level as previously but, due to deregulation of the financial sector, real interest rates became positive, and interest payments on the public debt increased progressively. Together with a combination of policy mistakes and external shocks, the accumulation of public debt set off a current-account crisis in late 1997. Without this development, it is likely that the popularity of the government would have been much better today and that many of the disastrous events that have taken place during recent years could have been avoided. What follows is a brief but fuller account of the developments that led to the current crisis, illustrating why care must be exercised by the authorities because of the constraints imposed by the LOP and UIP, and showing that adequate policy responses to external shocks are important for the maintenance of high economic growth.

The connection between economic policy and economic performance in Zimbabwe has been very clear; hence it serves our purposes well. Nevertheless, the relevance of the case of Zimbabwe can be questioned, for at least two reasons. First, Zimbabwe might be an exception, and thus of limited interest in this context, if policies are mainly determined by President Mugabe's personal preferences. Second, one could argue that economic difficulties are due to structural problems inherited at independence, such as the unequal distribution of land, which has caused the political tension and public disorder which in turn might

be seen as the main cause of the country's dismal economic performance. In our view, neither of these objections is relevant. Mugabe is not a special case in Sub-Saharan Africa, even though his policies have generated a lot of public attention. In fact, a fundamental problem is that governments often take measures to keep themselves in power, but which are in conflict with good economic policy, as described in Section 4. Although the second objection has some validity, in particular for the years 2001 and 2002, the increase in violence and insecurity has not been the major cause of the economic crisis: as argued below, the economic crisis is mainly due to economic imbalances. There is also ample evidence of the devastating economic effects in other countries with similar macroeconomic imbalances (e.g., Argentina in 2002).

At the beginning of 1997, the prospects for the Zimbabwean economy looked quite good in spite of the large domestic debt. Although the IMF had declared Zimbabwe off-track at the end of 1995 and several donors had then withheld disbursements of foreign aid, the economy grew by 7.3 per cent per capita in 1996. Moreover, public-enterprise losses had been reduced significantly and the budget deficit as a ratio to GDP was declining. The improvements in fiscal policies, and the budget presented for 1997/98, persuaded the World Bank that the economy was on track again, and it decided to release the second tranche of the second structural adjustment credit in mid-1997. However, just before the agreement was to be signed, President Mugabe announced that more than Z\$4 billion (3 per cent of GDP) had been promised to war veterans in compensation and pensions.

The action taken by President Mugabe illustrates one of the fundamental problems in African politics: an interest group succeeds in obtaining a large share of a country's income. Exactly how powerful the war veterans really were at the time is hard to know, but the issue of their compensation could certainly have been handled in a much better way. Now the result was an unplanned, unbudgeted increase in public expenditures that made it impossible for the World Bank to release its money. Hence the President lost the chance of significantly increasing government revenue and thereby avoiding the debt trap that was widely expected.<sup>6</sup>

In conjunction with this failure to reach an agreement with the World Bank, three other important events took place. First, during late 1996 and early 1997 there were adverse developments in export volumes and prices, and a rapid increase in imports, which led to a large trade deficit and a downward pressure on the exchange rate. Defending the value of the currency, the authorities reduced foreign reserves sharply. Second, because of *el Niño*, fears were created of a serious drought in 1998, which would raise food prices and reduce export income. Third, and most important, in an attempt to boost its popularity among

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<sup>6</sup> Mugabe was aware of the debt problem but did not seem to understand its consequences, as is evident from the following statement he made soon after giving in to the war veterans: 'Have you ever heard of a country that collapsed because of borrowing?' (Meredith, 2002, p. 138).

the public after the agreement over compensation to the war veterans, the President announced that close to 1,500, out of 4,000, mainly white-owned commercial farms would be nationalised during 1998. The announcement was made without clarifying how the nationalisation would be financed, or to what extent farmers would receive compensation for their property. In fact, the project seemed badly planned, and there was a lack of administrative capacity to carry it out in such a short period (Moyo, 1998).

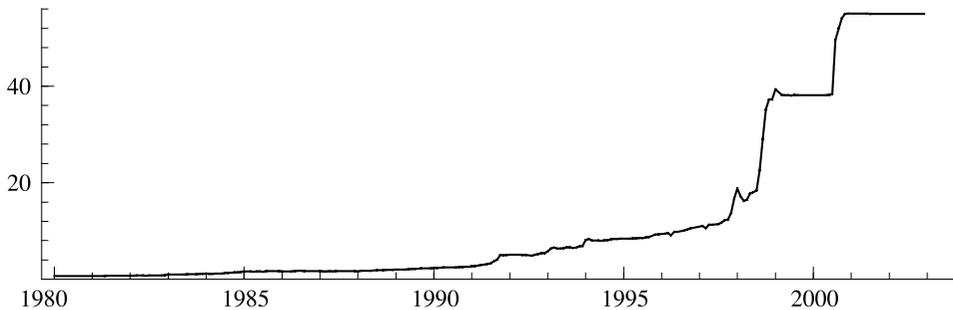
The decision to carry out the reform so hastily is an indication that the government desperately needed to buy loyalty, since it is hard to believe that public pressure for land reform was particularly strong at that time. The land issue had been on the agenda since independence in 1980, but apart from redistributing 3.6 million hectares of land and resettling 70,000 families during the first half of the 1980s, not much had been done. Moreover, a new land acquisition Act had been enacted in 1992, so the authorities could have revitalised the land-reform process already in 1993 (Moyo, 1998).

All this contributed to a severe currency crisis in November 1997, when the value of the Zimbabwe dollar plummeted. To curb the crisis, the Reserve Bank tightened up monetary policy and ordered all companies to liquidate their foreign currency accounts. Shortly after, the government announced tax increases to finance the war veterans' compensation, but the ruling-party conference held a few days later unanimously rejected this measure. Moreover, a wave of strikes hit the country. Over the following year the crisis deepened, as basic food prices rose rapidly, and yet another currency crisis followed, reducing the value of the Zimbabwe dollar by 50 per cent against the US dollar. On top of this, Zimbabwe entered the war in the Democratic Republic of Congo.

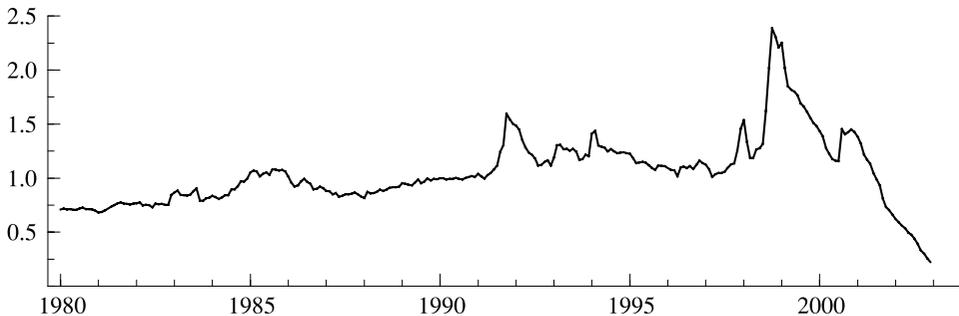
These events highlight the increased interaction between politics and the economy. Liberalisation had created a situation where government policies were evaluated by the market in a way that made costs and benefits much more visible to the public than in the old regime. Earlier, an event like the announcement of badly planned land-redistribution would not have led to any visible reaction at the macro-level, at least not in the short run. However, in a liberalised environment where international trade is free and there are markets for foreign exchange and agricultural commodities, the response is immediate.

One illustration of this is the rapid rise in prices of basic commodities at the beginning of 1998, which resulted in violent demonstrations. One of the responses of the government was to fix the exchange rate, the purpose being to reduce inflation in general, and to stabilise food prices in particular. This was an important policy change that disrupted the arbitrage conditions, and led to very damaging effects on the economy. As no progress was made in reducing the budget deficit and stabilising the growth of domestic debt, which were the fundamental driving forces behind the price increases, domestic inflation continued. As a consequence, the real exchange rate appreciated. Since the real exchange rate is

FIGURE 1  
The Zimbabwe–US Dollar Exchange Rate



The Real Exchange Rate Defined as the Zimbabwe–US Dollar Exchange Rate Times the US Wholesale Price-index, Divided by Zimbabwe’s Consumer Price Index (1990:1 = 1)



the ratio between foreign prices – measured in domestic currency – and domestic prices, this affected LOP and PPP relations. One result was that foreign-exchange shortages started to appear at the end of 1999.

Reviewing the course of the nominal exchange rate (defined as Zimbabwe dollars per US dollar) as depicted in the upper panel of Figure 1, there is evidence of macroeconomic instability during the whole of the 1990s, as indicated by the increase in the exchange rate compared to the 1980s. However, it was in the latter half of the 1990s that the value of the Zimbabwe dollar dropped rapidly; the US-dollar exchange rate went from Z\$10 at the beginning of 1997 to Z\$55 at the end of 2000. Yet the equilibrium market rate was much higher, as indicated by re-birth of the parallel foreign-exchange market at the end of the 1990s. By mid-2002 the parallel exchange rate was Z\$750, and at the beginning of 2003 it had risen to about Z\$1,500, while the official exchange rate continued at Z\$55 (*Daily News*, 15 August, 2002; and *Financial Gazette*, 23 January, 2003).

A major factor behind the large spread between the parallel and official exchange rates is exchange-rate policy. Since 1998 there have been two prolonged periods

with stable official exchange rates, the first followed by a large devaluation in August 2000, the second by a decrease in the price of the Zimbabwe dollar to 824 per US dollar for those selling foreign exchange in February 2003; the buying price was kept at Z\$55. Since the Reserve Bank does not have foreign reserves to defend the official exchange rate, it is maintained by decree. Hence, more and more trade has moved to the parallel market as the currency has become more and more overvalued.

The evolution of the real exchange rate is shown in the lower panel of Figure 1.<sup>7</sup> It is clear that PPP does not hold over the period 1980–2002 since that would have implied a stable level. Nevertheless, comparing the real exchange rate with the nominal one in the upper panel reveals that relative prices account for most of the variation in the latter. Moreover, trade liberalisation at the beginning of the 1990s seems to have generated a real depreciation, as expected. Hence, there appear to be forces that move the nominal exchange rate towards the PPP level, although structural changes can alter its value.

The development of the real exchange rate during recent years shows how a policy of fixing the exchange rate, in combination with high inflation, leads to dramatic changes in the relative prices of domestic and foreign (US) goods, measured in Zimbabwe dollars. This policy has led to overvaluation of the exchange rate and negative effects on the economy, with the period after January 2001 particularly alarming because of the rapid appreciation of the real exchange rate. Yet the degree of overvaluation, measured as deviation from PPP, is even larger than indicated by Figure 1, since there are shortages of most basic commodities, and prices in parallel markets are far higher than the official ones. For instance in August 2002, bread cost between 75 and 100 Zimbabwe dollars, while the official price was 60, and at the beginning of 2003 the price of maize meal was ten times higher in the informal market than in the supermarkets. This means that the official price index underestimates the price level, and that the actual real exchange rate is lower than the recorded one.

The policy of fixing the nominal exchange rate and letting the real one appreciate has led to the re-emergence of serious foreign-exchange shortages in the official currency market, starting in November 1999. Moreover, it has generated a sharp contraction in international trade and negative GDP-growth. The basic mechanism at work is straightforward. When the currency is overvalued it is not profitable to export because foreign prices, measured in domestic currency, are low. This reduces the supply of foreign exchange. To some extent foreign aid, loans and private capital inflows could generate the foreign currency needed, but all these sources have to a large extent dried up, with the exception of remittances, which have grown due to emigration (Hawkins, 2003). As a result, it is

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<sup>7</sup> The real exchange rate was measured as the number of Zimbabwe dollars per US dollar times the US wholesale price-index, divided by the Zimbabwe consumer price index.

hard to obtain foreign currency at the official exchange rate. Since firms in general require imported inputs to produce, most of them have to either source their foreign exchange in unofficial (parallel or black) markets, try to get locally produced inputs, or simply reduce production. Moreover, firms' export proceeds are supposed to be sold in the official market at Z\$55 per US dollar, though some are sold in the unofficial markets, and some can be kept for future imports. This situation has led to a decline in domestic production, as indicated by the downward spiral of GDP since 1998: it dropped by 0.7 per cent in 1999, 5.1 per cent in 2000, 8.5 per cent in 2001, and is estimated to have declined by 10.6 per cent in 2002 (World Market Analysis, 2003). Furthermore, exports and imports have contracted by almost 30 per cent since 1997. The government's response to the foreign exchange crisis has been to re-introduce controls, gradually reversing the exchange rate liberalisation implemented at the beginning of the 1990s, while introducing special exchange rates for some vital export sectors that risk collapsing, e.g. gold and tobacco. Although the authorities have considered returning to a regime of strict exchange-rate controls like the 1980s, they have not done that yet (*Financial Gazette*, 1 August, 2002; and Hawkins, 2003).

In addition to the attempt to keep the exchange rate fixed to stabilise prices, the government has also re-introduced price controls on several basic commodities. Initially, this was in response to food riots that took place after the devaluation in 1997 resulted in higher import prices. Although price controls can have beneficial effects in the short run, i.e., for a couple of months, they are not a good strategy when used for a long period, particularly in a de-regulated economy. With low controlled prices, exports of some goods become profitable for some economic agents, but not for Zimbabwe as a whole. For example, the government-run Grain Marketing Board appears to have exported maize grain to make profits during 1998 (see Muchero, 1998), creating shortages and pressure for price increases in the domestic market for maize meal. Moreover, large amounts of maize meal were exported illegally to neighbouring countries; there is anecdotal evidence that tons of maize meal were carried across the Victoria Bridge to Zambia before the authorities stopped the trade.

After that, people switched to trading in bread. The potential for the Grain Marketing Board and others to make profits from exporting during 1998 was very good, since the producer price was about one third of the actual export price (Durevall and Mabugu, 2000). Legal and illegal exports of price-controlled goods have probably expanded since 1998 as price differences have increased. A highly visible example are the day-shoppers arriving from neighbouring countries to buy food and clothes, whose numbers probably have increased by about 200,000 since 1999 (Hawkins, 2003).

Another problem with the price controls is that they are selective; for instance, the producer price of maize is controlled, but not prices on inputs used in maize production, such as fertilisers, pesticides and seeds. Since these are influenced

by world prices, profits from maize production decline as world prices rise, in particular after large devaluations. Although it is possible for the authorities to adjust controlled prices in line with costs, they often do not do it for political reasons. As a result, production of goods exposed to price-control declines. Hence, the shortages of maize during the 1990s are partly due to farmers having shifted to other crops, though the badly planned land reform and unfavourable weather explain the poor harvests in 2001 and 2002 (Durevall and Mabugu, 2000).

One commodity that has come to play a particularly important role in the Zimbabwean economy recently is fuel. During implementation of the structural-adjustment programme, the government never relinquished control over its price. The policy goal was to maintain a low price, making fuel widely available and keeping production costs down. Indeed, in 1998 the only Sub-Saharan countries that had lower pump prices than Zimbabwe were Nigeria and Angola (Bryceson and Mbara, 2002).

The evolution of world fuel prices in Zimbabwe dollars and domestic fuel prices are depicted in Figure 2. Both price series are set to unity in 1990, revealing the slow adjustment of domestic prices from 1995 to 2000. At the end of the 1990s shortages of foreign exchange created shortages of fuel, and as a result consumption of petrol and diesel decreased by 40 per cent from 1999 to 2000. This crisis forced the government to adjust prices in 2000, as indicated by the rapid

FIGURE 2  
Indexes for the World Price of Petrol Measured in Zimbabwe Dollars (—) and the Domestic Gasoline Price (+++++) (1990:1 = 1)

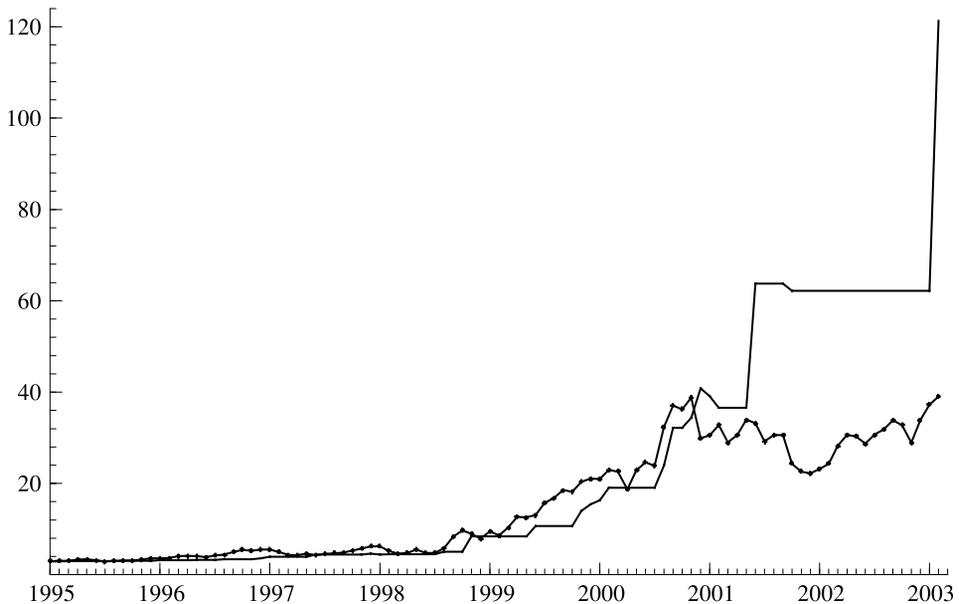
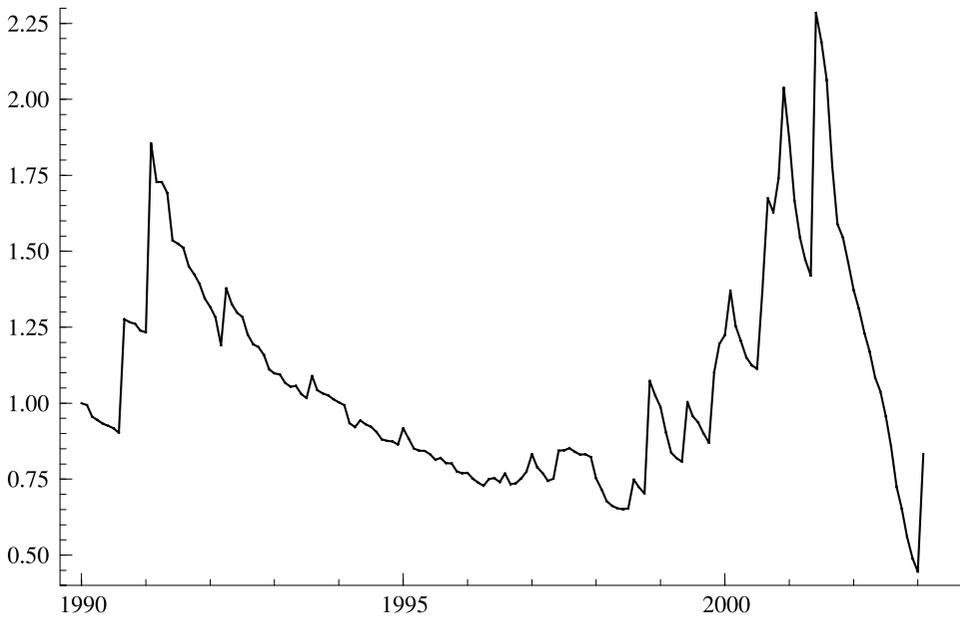


FIGURE 3  
Index of the Real Price of Petrol (1990:1 = 1)

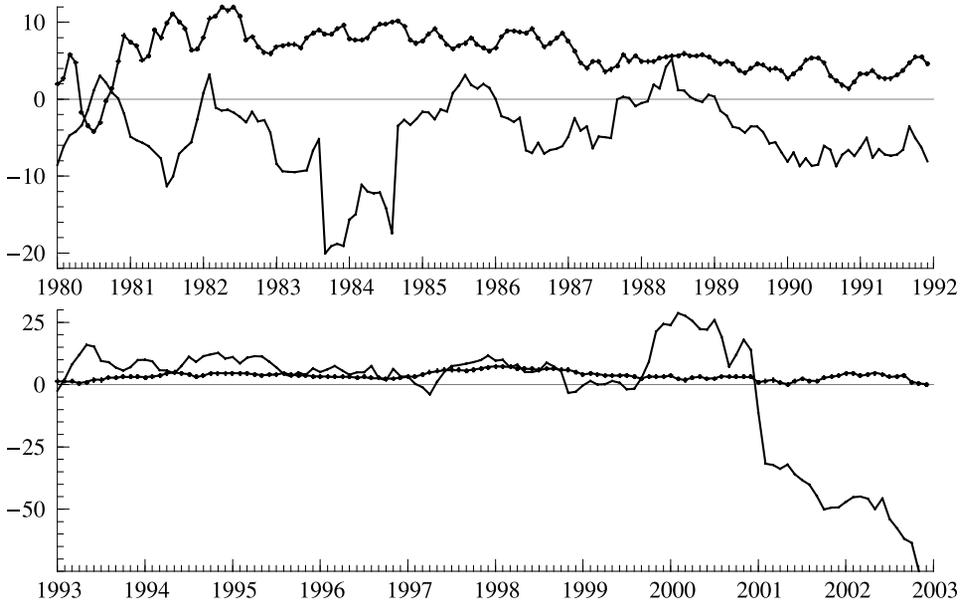


increase in domestic prices. In real terms the price of petrol went up by 80 per cent between July 1998 and December 2001 (see Figure 3). However, the low-price policy was not abandoned and the next change took place in February 2003, when the nominal price was raised by 95 per cent, but remained low in real terms.

One consequence of keeping an artificially low price is higher consumption of energy than otherwise would have been the case. This was of course one of the reasons for the price policy, but it contributed to the shortage of foreign exchange, and there were other side effects. Since the government kept domestic prices lower than the world price, the government-owned National Oil Company of Zimbabwe (NOCZIM), which had a monopoly on importing fuel until 2000, made large operating losses and incurred a huge debt, which led to cancellation of its credit lines and even worse shortages of fuel. Another side effect was that large re-exports of fuel took place. It is hard to quantify its importance, but it is well known that South African trailers were equipped with extra tanks so they could go to Zimbabwe to buy cheap gasoline. A comparison of petrol prices in the region indicates the gains to be made: in 1998 the price of one litre was 26 US cents in Zimbabwe, 43 in South Africa, 53 in Zambia, 55 in Mozambique and 31 in Botswana (Bryceson and Mbara, 2002). Hence, the case of fuel illustrates well the consequences of large policy-induced deviations from LOP in an open economy.

The government has also influenced UIP through its exchange rate and monetary policies. To show this, Figure 4 compares the real Treasury bill rate in

FIGURE 4  
The Real Treasury Bill Rate in Zimbabwe (—) and the Real Three-month Euro-dollar Rate (+++++)



Zimbabwe and the real three-month Euro-dollar rate. This provides information similar to UIP but is easier to construct, since we do not have information on the expected rate of change of the exchange rate, and the current one is fixed.<sup>8</sup> As the upper panel shows, during the 1980s there was little relation between the two variables because of controls on capital flows and interest rates. The lower panel depicts the interest rates for the period 1993:1–2002:12. After liberalisation Zimbabwean interest rates rose sharply in both nominal and real terms, so that from 1993 to 1995 returns to investment in Zimbabwe were high, leading to large inflows of capital. As the crisis of the late 1990s unfolded, however, there was first a period of very low real interest rates and large capital outflows, then nominal and real interest rates shot up, as the ballooning government domestic debt and large interest rate payments increased demand for credit. Since interest rate payments reached almost 30 per cent of GDP, the government decided to try to reduce these by issuing long-term bonds instead of Treasury bills. As a result interest rates on Treasury bills dropped to less than 10 per cent and real interest rates declined to less than –30 per cent. However, the long-term bonds are not

<sup>8</sup> Real interest-rates were calculated as nominal interest-rates minus inflation. We used the yearly rate-of-change of the consumer price-index for the Zimbabwean interest rate, and the US wholesale price-index for the Euro-dollar interest-rate. This formulation can be interpreted as giving the *ex post* real interest-rates since we used actual instead of expected inflation.

attractive enough for lenders, so the government has been forced to finance its deficit with money-printing, that is, by monetising its domestic debt.

We thus conclude that the Zimbabwean government has paid little attention to the restrictions imposed on policymaking by the markets, and the result has been devastating. Although political instability, the occupations of commercial farms and resulting violence have also contributed to economic problems, their origin and basic driving-force have been bad economic policy. In the 1980s, similar policies would not have had such immediate negative effects but now they have made GDP decline for four years in a row, resulting in a contraction of GDP per capita between 1998 and 2002 of about 30 per cent. Moreover, hyperinflation is around the corner as the domestic debt is being monetised: inflation was 57 per cent at the start of monetisation in January 2001, 122 per cent in May 2002, and 208 per cent in January 2003. Hence, whatever policies are implemented, the coming years will be very difficult for the people of Zimbabwe.

## 7. CONCLUSIONS

So what is the way forward? Globalisation is not a panacea for development. It can help, but if the effects of opening-up in terms of economic growth are to be substantial, other aspects of the economy also have to be in order. Macroeconomic policies must be right, as well as the various institutions supporting the economy. Corruption, poor policies or poorly-implemented policies negate the effect of attempts to open up and integrate in the world economy.

Will opening-up help the system to reform itself domestically? This is hard to prove one way or the other, but it seems reasonable to believe that a more open environment will make it harder to be corrupt and to pursue counter-productive policies. Nevertheless, the process of change towards a policy environment that exploits the possibilities of globalisation has been neither rapid nor smooth in most Sub-Saharan countries.

The recent experience of Zimbabwe provides a good example of the devastating effects of carrying out policies that ignore market mechanisms. Such policies could be implemented with less immediate and obvious negative effects before structural adjustment, that is, when domestic markets were much less integrated into the world economy. However, economic success in a globalised world is dependent on policies that respect the constraints imposed by markets.

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