

## **The Response of Capital Flows to Interest Rate Differentials: The Case of South Africa**

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**ABSTRACT** Global economic shocks affect different economies at different times, and the policy responses are often different, taking into account each economy's endowments fundamentals. The latest global financial crisis, provide a unique opportunity for testing this assertion empirically. In a Vector Error Correction Modelling (VECM) framework, this study econometrically tests the response of capital flows to interest rates differentials in South Africa over the period 1990-2013, controlling for the effects of financial crisis. The study found that, even though South Africa had positive interest rate differential, this did not translate to proportionately higher capital inflows which can be explained by externalities in human capital formation and risk premium in favour of developed economies. On the other hand, different capital flows respond differently to interest rate differentials.