In 1996, the South African Government faced a growing current account deficit, a depreciating currency, and persistent inflation. Economic policymakers developed a macroeconomic policy entitled Growth, Employment, and Redistribution (GEAR) which rejected the existing policy of reliance on fiscal expansion for growth. GEAR focused instead on both fiscal and monetary discipline in hopes of obtaining reduced inflation, stabilization of the currency and increased investment. The policy was not successful.

Background: The South African Economy Prior to 1996

The Apartheid government’s high investment during the 1970s resulted in an unusually well developed infrastructure, but this infrastructure served only South Africa’s white population. South Africa had extremely modern financial markets (the Johannesburg stock exchange is the twelfth largest in the world). Its business sector, consisting of mining, agriculture, forestry, citrus, wines, refining, manufacturing of metals, and electrical engineering, was high cost, labor intensive, and highly concentrated after years of protectionism. This would all change in the early 1990’s.

In 1990, amid violence, mass protest and international sanctions, South Africa’s Apartheid government was forced to lift bans on political organizations and repeal racist laws. In 1994, Nelson Mandela led the African National Congress in electoral victory over the National Party in South Africa’s first free and open elections. The new South Africa faced severe social challenges including soaring crime rates, high HIV/AIDS infection rates, large migratory movements, the need for infrastructure expansion, an inadequate education system and high unemployment.

Before the election in 1994, the ANC was actively involved in developing the new economic policy framework through involvement in the National Economic Forum. Debate on macro- and micro- economic models was both intellectually broad and pragmatic in nature, and expertise was drawn in from all over the world, including the IMF, World Bank and International Labor Organization. To address the glaring inequities in the economy and revive growth prospects, the South African Government established the Reconstruction and Development Program (RDP) in 1994. Funding was to come from re-prioritizing government expenditure towards redistributive social spending, supplemented by foreign aid and joint-financing deals between the government and the private sector. The RDP was progressive in nature, envisioning a Keynesian economic framework of fiscal expansion-led growth, but was relatively silent on how sustainable economic growth would be achieved. Furthermore, the specially set-up RDP ministry lacked political and operational authority to co-ordinate government departments and was ultimately closed down.
Growth, Employment and Redistribution (GEAR): Fiscal and Monetary Discipline

In 1996, GDP was growing at 3% and inflation had declined to 8.5%, but the there were still stark income inequalities, low investment and savings, and high unemployment. The ANC government still faced some major structural problems – deficit spending was running at 5.6% of GDP, there was a growing current account deficit, a depreciating currency, and persistent inflation. Absent an economic strategy, South Africa faced continued slow growth and rising unemployment. In June of 1996, the ANC government refocused its efforts on a new conservative ‘integrated’ macroeconomic framework called the Growth, Employment, and Redistribution (GEAR) policy. “It rejected the introduction of a national minimum wage and an expansionary fiscal policy to achieve these goals, and saw the real depreciation of the Rand as growth-enhancing, if sustained by a firm anti-inflationary monetary policy.”

With GEAR the South African government stressed fiscal and monetary discipline, acknowledging the limitations of government policy in stimulating growth and recognizing that the market would have to play a major role in rebuilding the economy. The ANC focused on the private investment, state expenditure, and net export components of aggregate demand. Thus the GEAR strategy was aimed at stimulating growth by accelerating private sector investment and infrastructure development. The ANC government based its GEAR strategy and policy mechanisms for achieving these goals on a number of assumptions.

GEAR Assumptions and Fiscal Policy Mechanisms

At the center of the GEAR strategy was deficit reduction. The ANC government believed that the government’s fiscal deficit necessitated too much additional borrowing, driving up the real interest rate in the domestic money market and crowding out private investment. GEAR envisioned government expenditure to be limited to 19% of projected GDP over the period from 1996-2000. This policy was based on the following assumptions:

- Crowding out was an important phenomenon in South Africa.
- Deficit reduction would result in a fall in the interest rate.
- A lower interest rate would stimulate higher private investment.
- A lower interest rate and higher investment would cause an appreciation of the currency and a slight deterioration of net exports.

The government’s medium-term expenditure framework sought to make fiscal policy more credible and predictable by mapping out the government’s spending plans on a rolling multi-year basis. Private and public sector wage increases would be kept in check; the government rejected instituting minimum wage to avoid the firms’ expectations of wages increasing that would lead to further inflation. Government spending would remain at 19% of GDP. Given the GEAR strategy’s reliance on lower interest rates and higher private investment as the main stimulus for economic growth, it was unlikely that its growth targets would be met without this projected effect.
Monetary Policy

The South African Reserve Bank (SARB) is independent from the ANC government, so its monetary policy may not be in line with the government’s fiscal policy. The main aim of monetary policy has been to curb inflation and maintain price stability by controlling the growth of M3. Additionally, the SARB relaxed exchange controls but set a goal of maintaining a constant real exchange rate for the Rand. With world inflation running only 2-3% in competing economies, Chris Stals, the governor of the Reserve Bank, felt he could waver little from his commitment to lowering inflation. The depreciation of the Rand was also putting upward pressure on real wages, increasing business costs for firms and fueling inflation. The SARB reacted to the currency depreciation by increasing interest rates through open-market operations and higher rates on discount loans. While Stals recognized that high interest rates might nullify the investment effect that the government was trying to achieve with GEAR, but he felt that high rates were necessary to bring down high inflationary expectations.

An Analysis of GEAR’s Effect on the South African Economy

IS-LM Analysis (Graphs in Appendix A)

Contractionary Fiscal Policy

The cutback on government spending in 1996 reduced the economy’s planned expenditure, leading to an inward shift of the investment-savings (IS) curve and lower interest rates. Lower deficit spending reduced the government’s influence in the money market, resulting in an exogenous downward shift in money demand (a de facto increase in the money supply), putting downward pressure on the interest rate. Initially, the conservative fiscal policy of deficit reduction decreased output. The ANC government hoped that the lower interest rates resulting from an ease in government borrowing would encourage higher investment, fueling economic expansion to meet GEAR’s ambitious growth targets. The GEAR model also anticipated further current account deterioration, but expected the increase in private investment to outweigh this loss.

Contractionary Monetary Policy

The South African Reserve Bank’s primary aim of monetary policy was to control the growth of M3, and the de facto increase in money supply (and the lower interest rates) compounded inflation. Also, the deterioration of the current account would also tend to weaken the Rand, and this depreciation trend tended to lower investor confidence in the South African economy. SARB acted to combat these inflationary pressures and currency depreciation by independently raise interest rates. The Bank’s ‘inflation bias’ and currency stabilization goals therefore prevented the higher investment predicted by GEAR. Overall, the combination of tight fiscal and monetary policy caused output to fall, dashing any hope of reaching the 6% growth target in 2000 predicted by GEAR.
The Effect on Investment

\[ I = I_0 - br \]

\( I_0 \): Low confidence due to the slow privatization of the economy and other ‘animal spirits’ reacting to forces such as the volatility of the economy.

\( r \): The interest rate continued to grow through 1998, as the Reserve Bank attempted to bring inflation down to global levels, stabilize prices, and combat the Rand depreciation. Therefore, investment (I) did not increase as hoped.

Net Exports, Investment and Depreciation (Graphs in Appendix B)

Investment in South Africa fell with the increasing interest rate. Lower investor confidence caused the Rand to depreciate and, as predicted by the trade balance model of the small open economy, the current account should improve. In South Africa, falling investment was indeed accompanied by a depreciating currency.

However, net exports fell in South Africa with a decline in capital inflows. The country did not increase its production of goods and services as it did not have the investment necessary to do so and net exports therefore did not increase as predicted by the model. The GEAR document had attempted to circumvent the increased current account deficit by predicting an increase in foreign direct investment, which never happened, yet another reason for SARB to increase the interest rate.

The South African Economy and Models of Growth (Graphs in Appendix C)

Solow Growth Model

Most economies lie below the Solow Growth Model capital stock steady state. It is thus safe to assume that South Africa’s economy lies below this threshold. Given this assumption, the Solow model holds that the investment in the capital stock outpaces capital stock depreciation. Therefore, the model predicts that both capital stock and output will grow until the economy reaches its steady state level of capital and output. There are several reasons to believe that the South African economy is not consistent with the Slow Growth model. For one, GDP per capita shrank by .2% in the 1990s. Also, by the time GEAR was implemented, the investment and savings rates had dropped to record lows. These facts suggest that, while the South African economy lies below the steady state capital stock level, depreciation outpaces investment in the capital stock. Because the rate of growth in South Africa is not consistent with the Solow Growth Model, the Endogenous Model may better represent the South African economy.

The Endogenous Growth Model

The Endogenous Growth Model predicts that a country with capital stock below the capital threshold level will continue to experience decreasing capital stock. It is likely that the investment rate (I=S) in South Africa is lower than the capital depreciation rate, resulting in falling capital stock and falling output as predicted by the model.
The fiscal authority was unable to affect output both with GEAR and with the policy preceding GEAR. Output did not rise with the pre-GEAR expansionary fiscal policy or with the post-GEAR contractionary fiscal policy. The fiscal authority was unable to affect the interest rates with GEAR program because it was coupled with the contractionary monetary policy. However, even without the contractionary monetary policy, the initial contractionary fiscal policy would not have seen significant growth in output from increased investment, which fiscal authorities hoped to see. Although the lowered interest rate could increase investment initially, the lowered interest rate would also depreciate their currency even further. Such depreciation then leads to improvement in their current account, which then shifts the lowered IS curve back up (rightward shift) to its original level and thereby raises the interest rate. Since South Africa is a small open economy under floating exchange rate, the movement of the IS curve would continue until the initial interest rate is restored. Therefore, the intended boost of the investment with lower interest rate is reversed. Additionally, since the South African government should not aggravate the current fiscal deficit problem, expansionary fiscal policy should be avoided. In sum, fiscal policy is not an effective tool for South Africa.

Our recommendation for policy action focuses on the monetary authority. The main concern for monetary authority is high inflation, which is largely influenced by people’s expectation of high level of inflation. Consequently, the South African Reserve Bank (SARB) should conduct a long-run policy to stabilize inflation by impacting the public’s expectation for future inflation. This can be done through improved policy coordination, transparency and credibility. Once the SARB announces the inflation target, they should pursue relevant policies in furtherance of their commitment.

Transparency increases monetary policy efficiency, especially in an environment of uncertainty. It encompasses communication with the markets and the public in order to be understood and to be effective. The progress towards deflation and the policy steps taken have to be communicated to all relevant parties, including the general public, so that this communication will have an appropriate influence on inflation expectations and enhance public understanding of and support for monetary policy.\textsuperscript{16}

However, being too concerned about inflation may tend to neglect other competing objectives, such as output growth, employment, interest rates and exchange rates. Moreover, the inflation rate of South Africa, compared with most other developing countries is not considered very high. Thus, the monetary authorities should be more cautious about conducting contractionary monetary policy, which has negative effect on their output. Increasing transparency of monetary policy and thereby making the SARB more accountable for their actions should be their highest goal, but at the same time, not readily resorting to contractionary monetary policy.

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\textsuperscript{1} Richard Vietor, South Africa: Getting in GEAR, Harvard Business School, June 27, 2000. pg. 2.
\textsuperscript{2} Ibid.
\textsuperscript{3} Ibid.
\textsuperscript{4} Economic Intelligence Unit, Country Profile South Africa 17 Feb 1997: <http://db.eiu.com/reports.asp>>
\textsuperscript{5} Ibid.
\textsuperscript{6} Economic Intelligence Unit, Country Profile South Africa 17 Feb 1997: <http://db.eiu.com/reports.asp>>
\textsuperscript{7} Economic Intelligence Unit, Country Profile South Africa 17 Feb 1997: <http://db.eiu.com/reports.asp>>
\textsuperscript{8} The main determinants of GDP are consumption (C), investment (I), government expenditure (G), and Net exports (NX). \text{GDP} = C + I + G + NX
\end{flushright}
10 Economic Reform has shaped ANC Policy, The Economist, Country Profile Report: South Africa
12 Weeks, pg. 801.
14 Ibid.
15 Vietor, pg. 1.
16 Economic Reform has shaped ANC Policy, The Economist, Country Profile Report: South Africa