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Investment in South Africa: Opening the Economy to Transform the Society

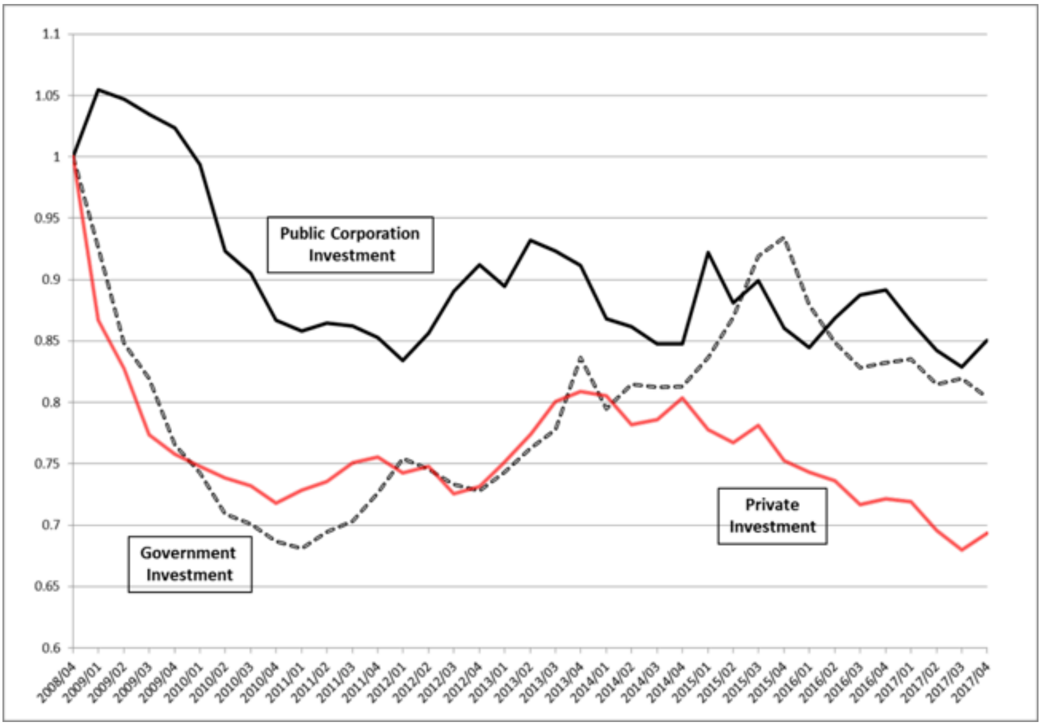
In the last ten years South Africa economic stagnation has been reflected in a dearth of private sector investment. The level of private sector investment today is still around 20 per cent lower than the level reached before the Global Financial Crisis in 2008 (Figure 1). This observation, together with an apparent increase of cash hoarding by private corporations, has suggested many commentators that the private business sector was on an "investment strike", driven mainly by political concerns during the Zumapresidency. [1]

The change in administration at the beginning of the year has certainly positively altered the business climate. There is an expectation that the business sector will respond positively to the government charm offensive by rapidly increasing investment in the country. For this purpose, President Ramaphosa announced an investment conference and an international investment drive targeted at foreign investors.

Can we expect these efforts to be successful? The optimism of this time of policy change should be tempered by recognising that private investment has been weak for a long time. Some of the investment trends are linked to a worldwide dearth of private investment after the global financial crisis, which is now hopefully behind us; some of the trends are linked to the political uncertainty in the Zuma's years, which has been partly overcome; but a large part of the trend has a strong structural origin which requires a strong reform effort.

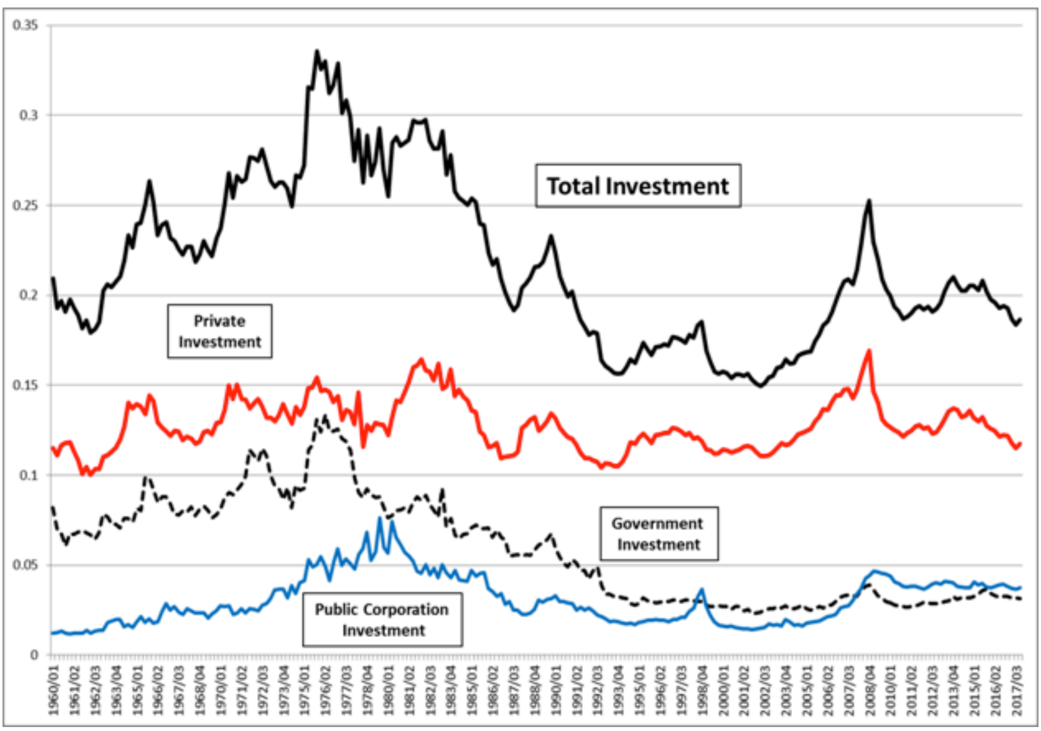
Looking back at the history of private investment in South Africa (figure 2) it is clear that the increase in private sector investment above 15 percent observed before the financial crisis was the historical exception. Even the growth in capital accumulation of the 60's and 70's was strongly driven by Government investment and investment of public corporations. Private sector investment remained between 10and 15 per cent of GDP for almost the whole period.

Figure 1 – Private and Public Investment in South Africa 2008-2017



(Source: SARB Quarterly Bulletin Dataset)

Figure 2 – Investment In South Africa - 1960-2017



(Source: SARB Quarterly Bulletin Dataset)

After 1994, investment has been considerably lower than comparable emerging countries, as shown in Table 1. The increase of investment in the last ten years is being driven by large public infrastructure investment which has not yet generated a positive response of private sector investment.

Table 1 – Total Investment over GDP in selected countries

Countries	1994-2000	2000-2008	2008-2017	1994-2017
South Africa	17.945	18.511	20.132	18.977
Brazil	18.793	18.480	20.124	19.175
Colombia	22.645	19.493	24.496	22.157
Chile	26.502	21.956	23.408	23.637
Turkey	22.715	25.012	28.286	25.665
Australia	25.454	26.693	26.801	26.424
Malaysia	39.138	24.061	24.299	27.919
India	25.016	30.626	34.748	30.769
China	37.531	39.621	46.267	41.591

(Source – IMF World Economic Outlook Database)

The structural nature of this low investment dynamic is reflected also in the low level of Foreign Direct Investment, which after 94' has never reached much more than two per cent of GDP.

In fact, South African firms are more often venturing abroad with the stock of foreign assets held by South African firms significantly higher than the stock of South African assets held by foreign companies.

Given that achieving the growth objectives of the National Development Plan requires aninvestment rate of Chinese proportion, the change needed is much more structural than a simple change in policy attitude.

South Africa is a small economy (roughly the size of Honk Kong and Israel with five to six times the population) and the size of the market can increase only by integrating into the global economy.

A significant, but never sufficient, body of research gives us some idea of the main determinants of investment in South Africa. [2] This research was carried out mainly in the 1990s and early 2000s, with some more recent work confirming and reinforcing the early results.[3] This research allows us to say a few clear things about the determinants of investment

The first thing we can say is that the most important determinant of long term investment is the expected size of the market.

South Africa is a small economy (roughly the size of Honk Kong and Israel with five to six times the population) and the size of the market can increase only by integrating into the global economy. In fact, investment is not only promoted by an increase in exports but also by an increase in imports. This is because a general increase in openness increases technological transfers, influences management practices and more importantly determines the level of competitive pressure on the firm to innovate and be more productive.

Unfortunately most of economic sectors in the country are protected from external competition by explicit or implicit barriers to entry. High mark-ups in monopolistic sectors are partly distributed to workers through the bargaining process, producing a dynamic of wages largely disconnected from the dynamic of productivity. This induces a peculiar alliance between national capital and labour that always requires more protection and subsidies to withstand competition and increase rent extraction.

In this situation, investment and diversification of the economy is mainly driven by expectations of the level of internal demand, which is limited by the long term productivity growth of the economy. This is a catch-22 situation of investment being constrained by the lack of demand which is constrained by lack of investment.

While, in the past, mining provided revenues to sustain internal demand and finance heavily subsidized import substitution policies, mining now is constrained by regulatory uncertainty, increasing costs and uncertain market prices. The economy than has to find other sources of return to investment if it has to grow at the desired level.

South African firms do not have a problem of financing investment: they just don't want to invest at home.

Reducing the user cost of capital can certainly promote investment. This can be achieved by increasing the supply of savings, which would then reduce the risk free rate in the economy. The East Asian economic miracle received significant support by policies of forced savings and credit policies to reduce the firm cost of capital. But the marginal effect of these policies is likely to be small in a moment when the world is experiencing an excessive supply of saving. South African firms do not have a problem of financing investment: they just don't want to invest at home.

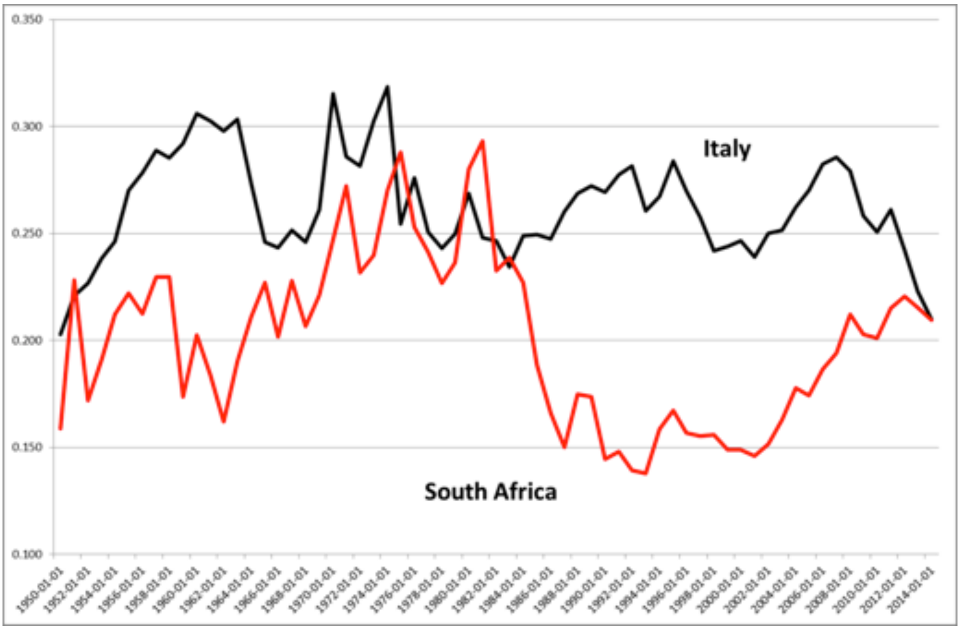
One of the possible reasons is that the economic and political environment in South Africa is "uncertain" and unpredictable. Uncertainty is certainly important: modern dynamic investment theory emphasizes the inter-temporal nature of economic decisions. If investors cannot predict the regulatory or political environment they will face, they will wait for more information to come before committing to an investment plan. The same can be said for price uncertainty in the mining sector, exchange rate uncertainty for the export sector and so forth. A particular role in the debate is played by "political uncertainty". This refers to a wide spectrum of regulatory and political events: uncertainty about the protection of property rights; levels of political corruption; legislative uncertainty and policy conflicts; general inefficiency of the state. In the most recent literature, the power of big data has been used to capture political uncertainty by just measuring the amount of times the word is used in the news, a technological twist of the old adage "I know it when I see it".[4]

While all these factors are important, their quantitative effect is not as large as we often assume. Its marginal effect is comparable to the effect of increase of the cost of capital. It is instructive to consider Figure 3 which shows the level of capital accumulation from the 1950's to the present in South Africa and in Italy, the country that defines political uncertainty and inefficiency of the state. For the whole period, investment in Italy has been higher than twenty per cent of real GDP. Political uncertainty matters in Italy as much as it matters in South Africa. Like in South Africa, political uncertainty explains a good part of the short run changes in investment. But the long run level of investment is strongly linked to the structural characteristics of the economy and the expected return of investment.

South Africa faces two obstacles that reduce the expected return on investment, one historical and one natural.

The natural obstacle is the limit to international integration imposed by the distance of the country from the main markets. The way to overcome this barrier is by productivity

Figure 3 – Share of Gross Capital Formation at Current Purchasing Power Parities 1950-2014



(Source Penn World Tables)

growth that increases the ability of national firms to compete internationally and overcome distance barriers.

> *The threat of job losses in an economy with extraordinary levels of unemployment is a effective way to protect incumbent firms against external competition.*

Instead South Africa has seen an increase of the productivity gap relative to the frontier, particularly in those sectors that have the most potential to absorb the excess supply of labour in the economy. This takes us to the second obstacle faced by the South African economy: an historical tendency towards being inward looking both in the economy and the politics. Efforts to open the economy and increase its competitiveness are always limited by the need to protect the incumbents firms and workers. The threat of job losses in an economy with extraordinary levels of unemployment is a effective way to protect incumbent firms against external competition. The politics on the other hand is constrained by a prominence of the distributional consideration, which in a static economic situation becomes a complicit distribution of rents or a dangerous zero-sum game The net result is lack of economic dynamism, stagnation in job creation, increasing economic and political uncertainty and poor investment and growth.

While experiencing low productivity growth in manufacturing and mining, South Africa has experienced growing productivity in some service sectors, especially ones with high skill intensity. In a reverse of traditional development models, it is the non-trade sector that is driving economic growth in the country with the increase in productivity in the service sector inducing an increase in wages across all sectors.

Firms in the manufacturing sectors respond to the increase in labour costs either by contracting their labour force or by demanding higher level of protection against competition from more productive external competitors. The negative spiral of low productivity and low competitiveness is thus self-reinforcing, with an increasing monopolistic nature of the traded goods reducing productivity and limiting access to international markets.

The process is reinforced when considering sectorial skill intensity. The services that have experience greater productivity growth are also the most skill intensive. Skills are therefore rewarded both by an increase in productivity and by an increase in skill premium. Low skill workers in the high productivity service sectors will benefit as well with an increase in wages. The manufacturing sector will instead shrink and become more inward oriented.

To reverse this vicious circle we need to start by recognizing the dimension of the task ahead. Growing at 5%-7% per year for a considerable period of time requires a truly revolutionary transformation of the South African economy and its society. At that rate of growth the economy doubles in size in ten years: double the number of firms; double the number of skills; double the number of roads, ports and houses. Can South Africa relying on the willingness of the incumbents to sacrifice their position of rent for the common good? It is unlikely. This means that any corporative solution of the present stagnation will probably suffer for a status quo bias, where the interest on the incumbents dominates the policy discussion.

The first step for this transformation of the society is thus to open the economy to contestation by integrating into the global economy and exploring the opportunities on the continent. No single policy will be the catalyst of this transformation but the research indicates some fundamental criteria all policies should adhere to.

First, all policies should have a bias for openness: although it might be necessary to manage transitions, in openness there is more opportunities of innovation and growth.

Second, all policies should have a bias for change, by favouring new entrants against the established position of rent: the incumbent cannot be the driving force of future economic growth.

Third, all policies should have a future generation bias, by favouring the interests of the young. This means moving resources from subsidizing present consumption and rent extraction to accumulation of skills, technological upgrading and future consumption.

NOTES

1 For a discussion of the "investment strike" hypothesis, see Keeton (2018).
2 The main reference is Fedderke (2004) and Fielding (1999)
3 The stability of the results while using very different data samples shows how little the economy has changed in the last twenty years.
4 See for example Hlatshwayo and Saxegaard, (2016)

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Figure 1
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(SARB Quarterly Bulletin)
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