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Accelerating investment – three thoughts

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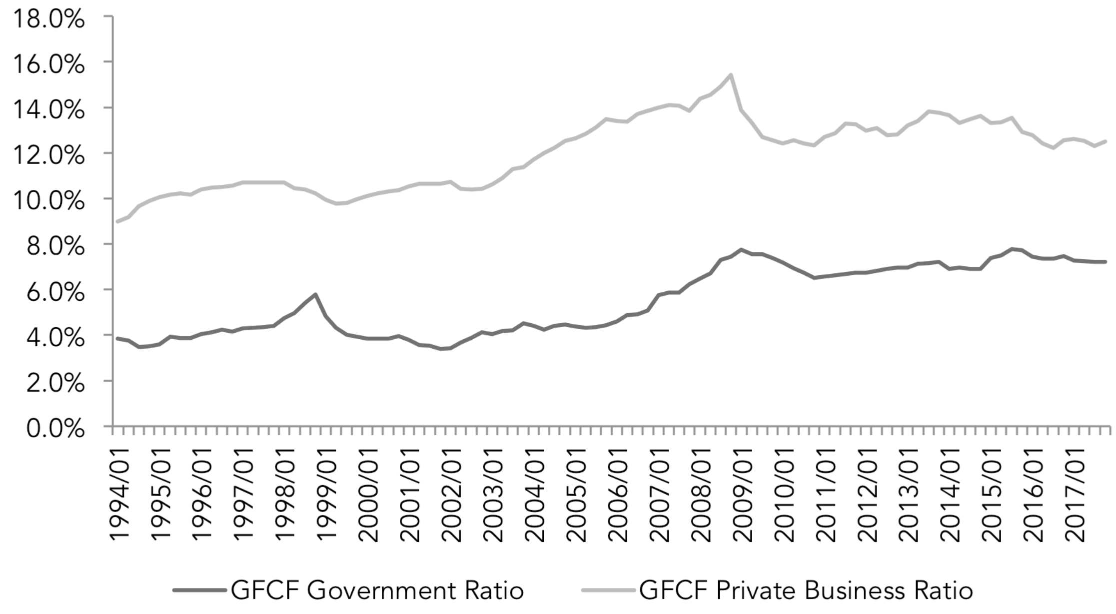
Pres Ramaphosa has announced an initiative to secure investment worth R1,200 billion[1]. I assume that the focus is on new investment, which does not replace or 'repackage' existing capital expenditure. This note offers three thoughts on accelerated investment in South Africa related to the role of government investment, the cost of capital, and the changing nature of investment.

Government-driven investment

As part of the investment drive, Pres Ramaphosa plans R480 billion worth of new investment by public corporations. Contrary to popular perception, investment by public corporations – and indeed general government – is relatively high, when expressed a proportion of GDP. After the financial crisis, government-related investment *rose* in real terms, whereas private-sector investment declined, leaving government-related investment[2] more or less at 7% of GDP over the past few years, as shown in the figure below. Even so, it is common knowledge that the finances of our public corporations are in dire straits. Distributing the R480 billion new investment over five years would add (very roughly) R100 billion in new investment per year. Given public corporation investment of R123 billion in 2017[3], this implies an 80% increase, which is optimistic given current financial problems. The only feasible way to generate increases would be to seek out the private sector or, perhaps, China and other large countries for partnerships.



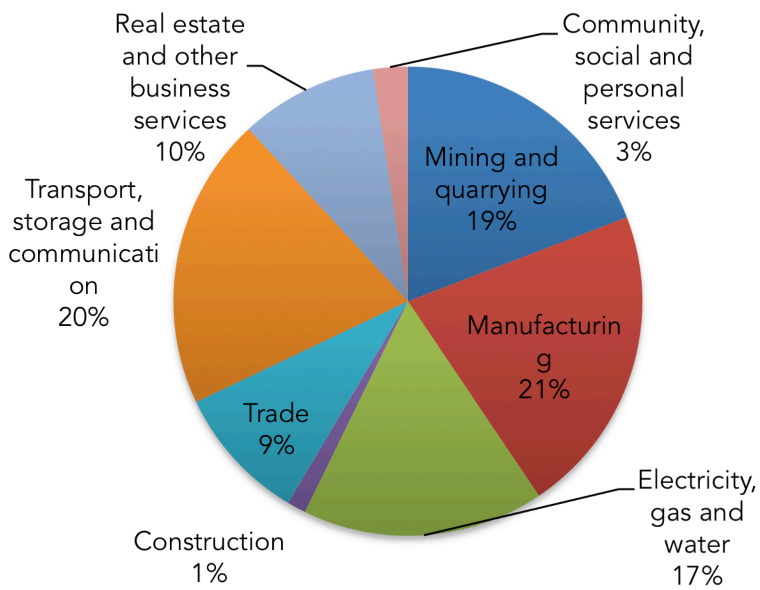
Cost of capital

Pres Ramaphosa has also emphasised the need to attract foreign capital as part of the new investment initiative. The challenge in attracting foreign investment lies with offering superior returns to those available in other countries. Currently, this may appear easier, given that the South African 'risk premium' has declined and given that interest rates are generally low. CDS spreads[4], for example, are around 155bps, and much lower than earlier spreads in 2017, which at some point exceeded 300bps. The Reserve Bank estimates our long-run risk premium at about 2%. One should therefore allow for at least some increases in the long run – the horizon relevant for investors. More important, long-term interest rates in South Africa must ultimately reflect the fact that US interest rates may soon rise by 1%-1.5%. Fixed investment, with a longer time horizon, will therefore require rates of return that are 2%+ higher than those justifying short-term portfolio investment, even before allowing for project-specific risk.

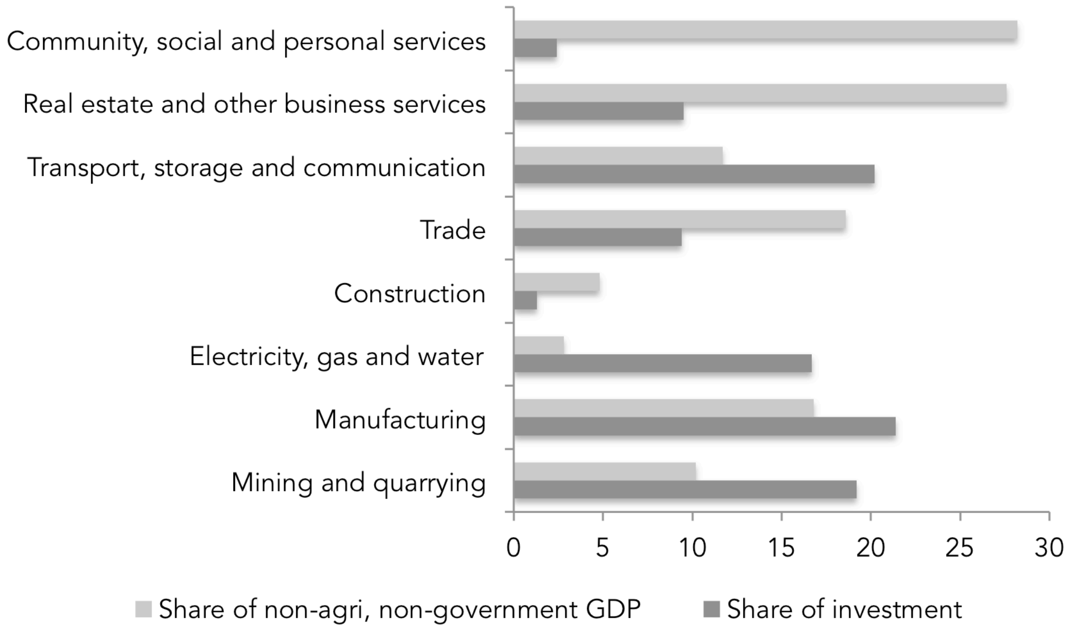
Some of the investment drive is aimed at attracting Chinese investment, which one could think of as public, rather than private, investment. Yet Chinese companies, although state-owned, will not make charitable investments. The South African government would still have to contend with long-run financial market realities, especially if it is to become involved in making investment more attractive for Chinese or other firms by, for example, offering guarantees to reduce risk.

Investment by sector

Finally, in assessing the challenges facing the new investment initiative, it useful to consider which type of firms are doing the investing in South Africa. The figure below shows that mining, manufacturing and electricity gas and water (i.e. the primary and most of the secondary sector) constitute 57% of non-agricultural private investment[5].



Compare this to the share of different sectors in GDP, as shown in the figure below[6]. Clearly, the tertiary services sector, which dominates the economy, accounts for only a small portion of capital expenditure.



Indeed, in many services industries, and especially in those associated with high tech, competitive advantage derives primarily from the ability to turn ideas and know-how into profitable services, often with very little physical capital input. An economy dominated by the tertiary sector requires accelerated human capital expenditure to complement vigorous physical capital formation.

End notes

1 $100 billion converted to Rand at R12/$
2 As measured by gross fixed capital formation
3 Gross fixed capital formation by general government and public corporations in nominal terms
4 CDS refers to credit derivative swaps, which are financial derivative instruments used to buy insurance against sovereign default.
5 Quarterly Financial Statistics, December 2017, Table F p 30, published by Statistics South Africa
6 Quarterly Bulletin, Table S-109. Proportions calculated after subtracting "Agriculture, fishing, forestry" and "General government services".

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