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Building Economic Dynamism in South Africa

The Imperative of Attracting Foreign Direct Investment to South Africa

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The release of South Africa's negative GDP growth data earlier this year and news of a technical recession was a shock. This requires an urgent taking stock of the strategic priorities of our government to put in place and implement the correct policies needed to drive economic growth.

In South Africa, building economic dynamism is urgently needed. If nothing else, the economy has to generate more jobs for the vast numbers of the unemployed and under-employed, especially among the youth. Over the longer term, it is equally necessary to raise productivity and increase the country's global competitiveness. And the key to building economic dynamism at this juncture in South Africa lies in investment and the intellectual property that comes with it.

The South African Government has appointed four highly capable individuals to spearhead this crucial task namely Mcebisi Jonas, Phumzile Langeni, Trevor Manuel and Jacko Maree. But structural reform carried out by a functional and agile state is required before their efforts will have measurable impact.

Fundamentally, investment is the prime mover of economic growth. An increase in investment translates immediately into higher GDP growth. And if investment-induced economic activities also turn out to be labour-intensive, then the impact on employment creation could be very significant. Should investment be made in the right areas where it can generate sustainably high returns, then longer-term gains in productivity would follow as well. The result is economic dynamism.

South Africa's investment level is simply too low for what the country needs. Over the period from 2010 and 2017, the average annual investment as a percentage of GDP in South Africa was 19.9%. It is the second lowest among the BRICS countries (South Africa is marginally higher than Brazil's 19.5%). It lags significantly behind China's 46.3% and India's 34.6%; as well as lower than Russia's 23.1% (based on IMF data).

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The experience of successful economic takeoff in East Asia suggests that investment needs to rise to at least 30% of GDP – and preferably higher – over a sustained period of two decades or more in order to really move the needle in economic growth and decent social development.

More investment is needed so that workers can be equipped with better tools, machinery, and infrastructure; thereby raising their productivity. The demand for more and better tools, machinery and infrastructure in turn increases the need for more workers. This then leads to an increase in capital stock per capita. High-income developed countries typically have high capital stock per capita, which also explains their workers' high productivity.

For example, the capital stock per capita in the US and Germany are estimated to be US$68,700 and US$68,100 respectively in 2015, compared with India's at a mere US$6,100. For South Africa, it is around US$11,000 in 2015 which is lower than other BRICS countries except India (utilising IMF and UNDP data). With a fast growing population, South Africa has to dramatically increase its capital stock in order to have a rising capital stock per capita. Much higher investment will be needed.

Increasing the quantity of capital is only one side of the coin, however. The quality of capital has to improve as well. This is captured by the so-called incremental capital output ratio (ICOR), which estimates how much investment is needed to raise GDP growth by one percent. The higher the ICOR, therefore, the less productive the capital. Over the 2010 and 2017 period, South Africa's ICOR is estimated at 10; which means that it takes an increase of investment equivalent to 10% of GDP to raise South Africa's GDP growth by 1%. This compares very poorly with China's 5.8 and India's 4.8. South Africa has the second highest ICOR among BRICS countries. Only Brazil's ICOR, estimated at 14.3, is higher than South Africa (as per the IMF). Should South Africa be able to bring its ICOR down to the levels of China and India, its capital can become twice as productive.

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The fundamental task of building economic dynamism in South Africa therefore requires a simultaneous increase in both the quantity and quality of investment. In this context, what should be President Ramaphosa's strategic priorities?

In formulating public policies to encourage higher investment, the priorities are: (i) preference of private sector investment over public sector investment, (ii) and in so doing, focus on attracting foreign direct investment (FDI), and (iii) achieving a better mix in investment in terms of the different sectors in the economy as well as its geographic distribution.

As a rule of thumb, private sector investment is qualitatively superior than public sector investment. In a market economy, private sector investment typically faces competitive pressure that is not always present in public sector

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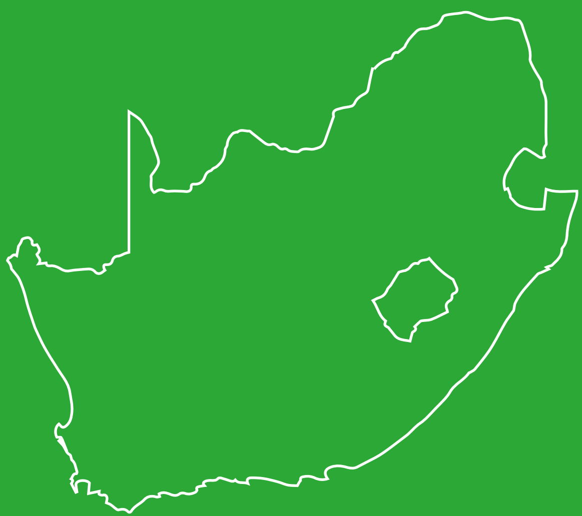

investment. Thus private sector investment has to be sufficiently productive to survive. The bottom line is that with any given amount of investment, the higher the proportion coming from the private sector, the more productive it is likely to be.

In this connection, FDI is particularly impactful because it usually comes with a lot of inbound transfer of knowhow and skills. As demonstrated powerfully by the experience of East Asia, global companies are instrumental in introducing state-of-the-art technical and management techniques as well as in upgrading the skills of local workers that they employ in countries in which they invest. This is true whether it is with respect to the capital and knowledge-intensive sectors like banking and finance, biotechnology, electronics, and aerospace (as in Singapore and Malaysia) or labour-intensive industries like light manufacturing, construction, and transportation (as in Thailand, Indonesia, and most spectacularly, China).

Unfortunately, South Africa has not been exactly successful in attracting FDI. In the period from 2005 to 2016, FDI in South Africa on average amounted to just 7.4% of total investment (World Bank data). As mentioned earlier, the average annual investment in South Africa in recent years is estimated at around 19.9% of GDP; and at 7.4% of total investment, average annual FDI therefore comes to a minuscule 1.5% of GDP. Attracting more FDI must be a top strategic priority for President Ramaphosa.

In spite of persistent volatility and elevated levels of uncertainty in the global economy, conditions continue to be favourable for attracting FDI to South Africa. Global FDI flows did indeed contract between 2016 and 2017. However, it is in the developed countries that FDI contracted, from US$1.2trn in 2016 to US$0.72trn in 2017. For developing countries, FDI flow was basically unchanged at US$0.63trn in 2016 and US$0.62trn in 2017 (UNCTAD data). Clearly global companies are still very interested in seeking opportunities in developing countries. South Africa must pull out all the stops to position itself as a preferred FDI destination.

With any given amount of FDI inflow, the more it is directed to low-income regions of the country with high concentration of the unemployed, the better. The current pattern of FDI inflow in South Africa appears to be the opposite of what should happen. Close to half of FDI has flowed to financial services, real estate developments and other businesses services which are highly concentrated in urban areas (South Africa Reserve Bank).

Effectively FDI has gone into expanding business operations to serve the urban middle class which constitutes a minority of households in the South African society. However, an increase in FDI in infrastructure across the whole country, including more efficient and affordable transportation, would do wonders in creating jobs and raising productivity economy-wide.

To the extent that investment flow, FDI or otherwise, can be channeled to target business start-ups and small entrepreneurs, the impact on building economic dynamism would be even more pronounced. For example, it is estimated that 21% of private equity investment in China has gone to start-ups and early-stage business development; whereas in Japan the estimate is just 4%. Instead, some 82% of private equity investment in Japan is in buying out established and profitable businesses (AVCJ Private Equity Research). No surprise that the Chinese economy is far more dynamic than the Japanese economy however it is measured.

These are the strategic priorities that President Ramaphosa should focus on in building economic dynamism in South Africa. The stakes cannot be higher and the need more urgent. The time to act is now.

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