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South Africa’s Country Investment Strategy: A case for manufacturing investment for improved regional integration and industrial capacity

CCRED-IDTT Policy Brief

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1. Introduction

Despite several efforts by policymakers, South Africa continuously faces the triple challenges of unemployment, poverty, and inequality and remains trapped in a low growth–low investment economic environment. These challenges have further been exacerbated by the Covid-19 pandemic. As a result, South Africa is at a crossroads where radical change is urgently needed if the current trajectory is to be reversed. There is broad recognition for radical policies and strategies to stem the tide of persistent economic and social structural stagnation.

South Africa's inaugural Country Investment Strategy (CIS) is a vital step in charting a new economic pathway for the economy. The CIS recognises the critical role of investment in economic development and achieving the targets set out in the National Development Plan (NDP). It aims to position South Africa as an attractive investment destination in a well-coordinated manner, anchored by quality institutions and robust economic infrastructure.

However, the proposed interventions lack crucial detail on ensuring that inward investments are channelled towards sectors and industries with high potential for driving sustained growth, quality employment, and enhancing industrial capabilities. From a structural transformation perspective, the crucial questions about the kind of investment needed and where and how this investment should be directed remain largely untouched. The CIS also fails to contextualise the current investment climate and the political economy of investment in South Africa.

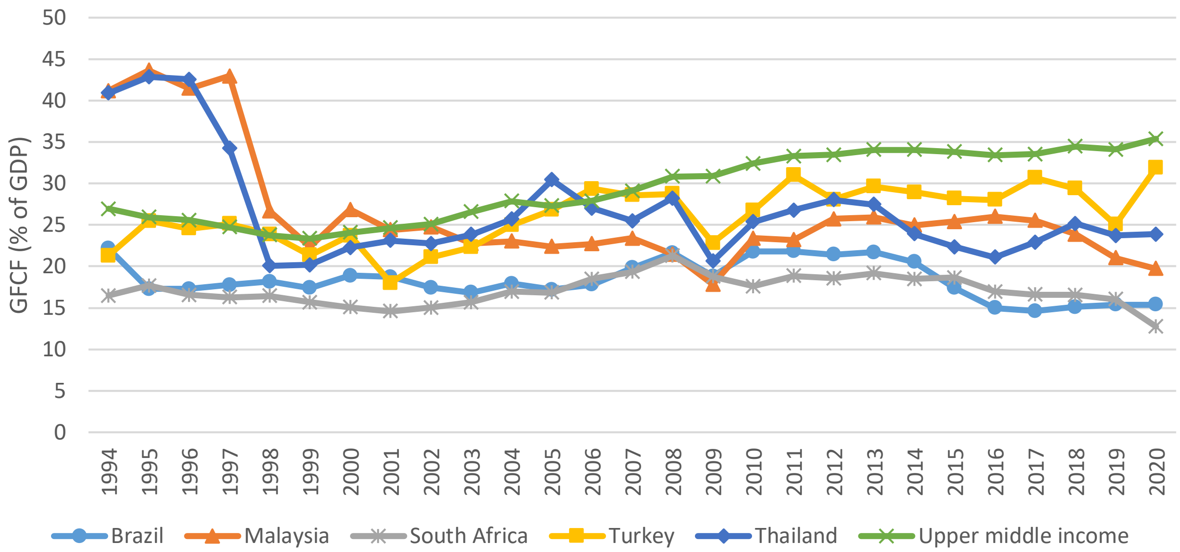
In response, this brief aims to contribute to the refinement of the CIS by highlighting the relative neglect of manufacturing as a driving force of structural transformation and economic development and makes the case that South Africa's investment dilemma is a manufacturing problem. It also provides evidence on how existing patterns of investment have not been adequately channelled into sectors supportive of structural transformation and how the nexus between corporate profits and investment has become increasingly dysfunctional.

In conclusion, we offer some propositions on how South Africa's economic investment strategy must focus on reindustrialisation by emphasising the need for investment in productive, value-adding industries and sectors. We argue that this is essential in alleviating structural challenges in the South African economy.

2. South Africa's investment trajectory in perspective

Since 1994, South Africa's Gross Fixed Capital Formation (GFCF) has become increasingly delinked from its middle-income country peers (Figure 1). Although the economy experienced a period of increasing growth and investment during 2000-2010– mainly on the back of the global commodity boom during the first half of that decade and massive infrastructure investments in the second half leading up to the 2010 soccer world cup tournament – levels of investments (gross fixed capital formation) have declined for most of the subsequent decade up to 2020.

Figure 1: Gross Fixed Capital Formation to Gross Domestic Product



Source: World Bank Development Indicators

The decline of private-sector GFCF in the past decade is in stark contrast to the significant growth of the asset base and market value of JSE-listed firms.[1] Market value in the JSE appears to be delinked from real private sector investment, despite JSE companies possessing enormous financial resources that could potentially be productively reinvested into the economy. Analysis of revenue and profitability, two critical drivers of investment, among a sample of the top 100 JSE-listed firms, presented in Figure 2, provides a number of aggregate and sector-level insights into low levels of investment (Robb et al., 2022).

First, revenue growth has been muted at 1.8% over the full 2011-2021 period, with slightly more robust growth of 3.5% in the latter 2017-2021 period (Figure 2a). Second, profitability (measured by ROE and ROA) fell rapidly for the top 100 firms from 2016 (Figure 2b). Third, data on capital expenditure indicate that firms' investment fell in step with declining profitability from 2016, with the key difference that capital expenditure did not recover alongside profitability in 2021 (Figure 2c). Lastly, stocks of plant, property and equipment (PPE) for core industrial sectors such as manufacturing and mining have stagnated over the last decade (Figure 2d), with the result that PPE growth for the top 100 sample was just 0.5% per annum from 2011-2021. In short, weak revenue growth, profitability and investment have led to stagnation in South Africa's stock of productive assets.

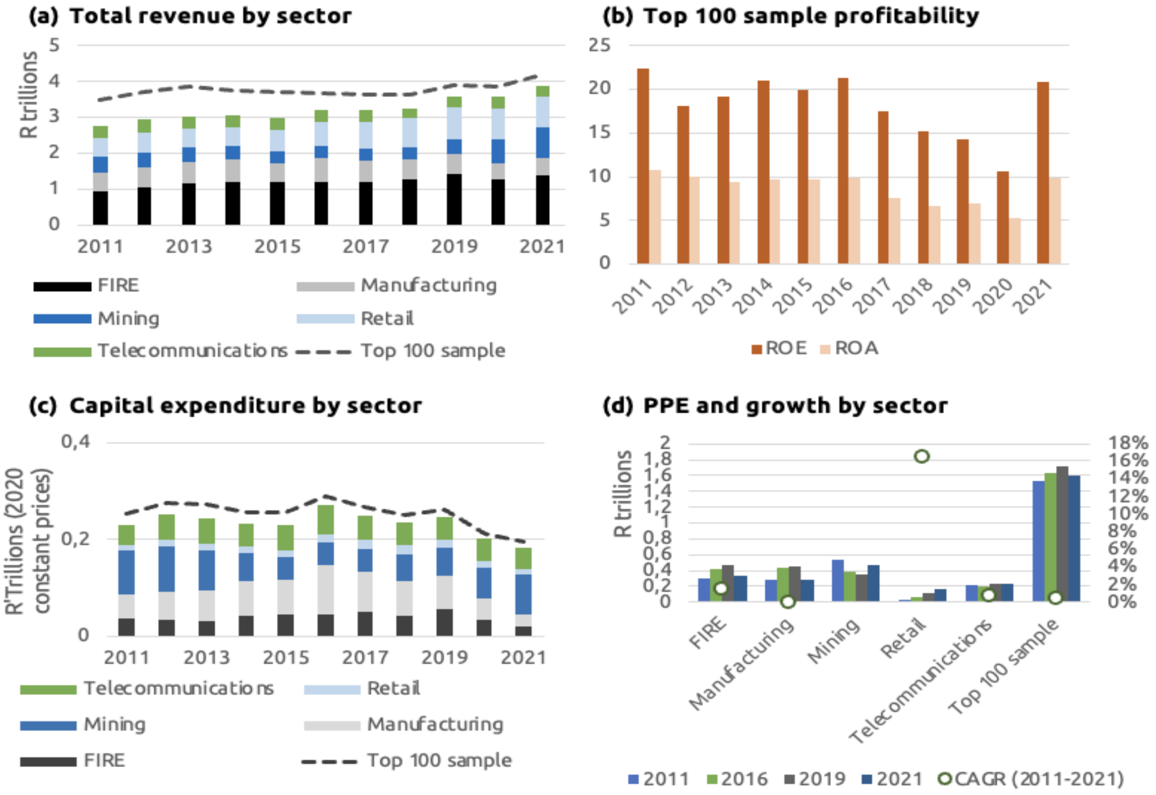
The finding on profitability is critical. Where Bosiu et al's (2017) analysis of JSE firms from 2011-2016 described a prolonged period of high profitability but low investment, the updated analysis of JSE firms suggests that low investment (among other factors) has started to erode firms' underlying profitability. Low profitability then further exacerbates

[1] Total JSE market capitalisation has grown in real terms from around R8 trillion in 2010 to R12 trillion in 2020, whilst the value of assets has grown from R15 trillion to R23 trillion over the same period (INETBFA data).

low investment, suggesting that South Africa has entered a dangerous negative feedback loop between the two.

These findings make a case for manufacturing as the most critical target sector for increased investment in South Africa.

Figure 2: Key trends in revenue, profitability and investment, 2011-2021[2]



Source: Robb et al. (2022)

3. South Africa's investment dilemma is a manufacturing problem

The importance of the manufacturing sector as a driver of structural transformation is well established.[3] However, the importance of the manufacturing sector in the SA economy has been diminishing over time, with recent evidence showing continued deindustrialisation. Premature deindustrialisation has taken shape through stagnating investment, declining

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[2] All data is presented in 2020 constant prices, having been adjusted for inflation using Stats SA's producer price index (December 2020=100). PPE stands for property, plant and equipment – i.e. firms' physical assets. The PPE data presented here represents net stocks of PPE – i.e. gross stocks of PPE less depreciation, depletion and amortisation.

[3] McMillan, M. & Headey, D., 2014. Understanding Structural Transformation in Africa. World Development, Volume 63, pp. 1-10.; Lall, S., 2004. Reinventing Industrial Strategy: The Role of Government Policy in Building Industrial Competitiveness. G-24 Discussion Paper Series.; Khan, M. & Blankenburg, S., 2009. The Political Economy of Industrial Policy in Asia and Latin America. In: G. Dosi & M. Cimoli, eds. Industrial Policy and Development. Oxford: Oxford University Press, pp. 336-377.; Hausmann, R., Cunningham, B., Matovu, J., Osire, R., & Wyett, K., 2014. How should Uganda grow? ESID Working Paper No. 30.

value addition, and inadequate diversification[4], leading South Africa to fall into the middle-income trap[5].

Research has emphasised the importance of investment for industrial development, economic growth, and employment creation.[6] Despite this, investment in manufacturing sector in South Africa has not grown significantly since 1994, with GFCF remaining concentrated in the tertiary and primary sectors (averaging more significant than 75% of total GFCF combined, see Figure 3). The continued concentration of investment in these sectors means that the South African economy will remain undynamic, undiversified and stuck in a cycle of low-value adding and low-productivity production and services.

At a sub-sectoral level, in the last 10 years, sub-sectoral investment has been dominated by business services, general government, mining and quarrying, and transport and storage which account for more than 50% of GFCF on average over the period.[7] Manufacturing, on the other hand, has not experienced significant growth in its investment levels since 1994. Moreover, the sub-sectors that have managed to maintain – and in some case grow – their investment levels, such as Food; Coke & refined petroleum products; Basic chemicals, and Basic iron and steel, while accounting for ever-larger shares of total manufacturing GFCF (see Figure 4), are still operating at investment levels well below these GFCF-dominant sub-sectors of the economy. Evidence on South Africa shows that investments in these manufacturing sub-sectors generate different outcomes.[8]

These low investment levels in manufacturing are surprising considering the potential for value addition in many of these manufacturing sub-sectors. Unfortunately, South Africa's manufacturing value addition is currently also dominated by upstream resource-based sectors.[9] Similarly to the investment story, the concentration of value-addition in upstream sectors has come at the expense of wider diversification and sophistication in many downstream sectors.[10] Despite this large-scale regression away from diversified manufacturing, there have been some success stories of sub-sectoral growth and development in automotives, food products, and machinery and equipment. Yet, this success came with serious weaknesses in terms of broad-based capabilities and capacity development that have significantly weakened the competitiveness and inclusiveness of these sub-sectors.[11]

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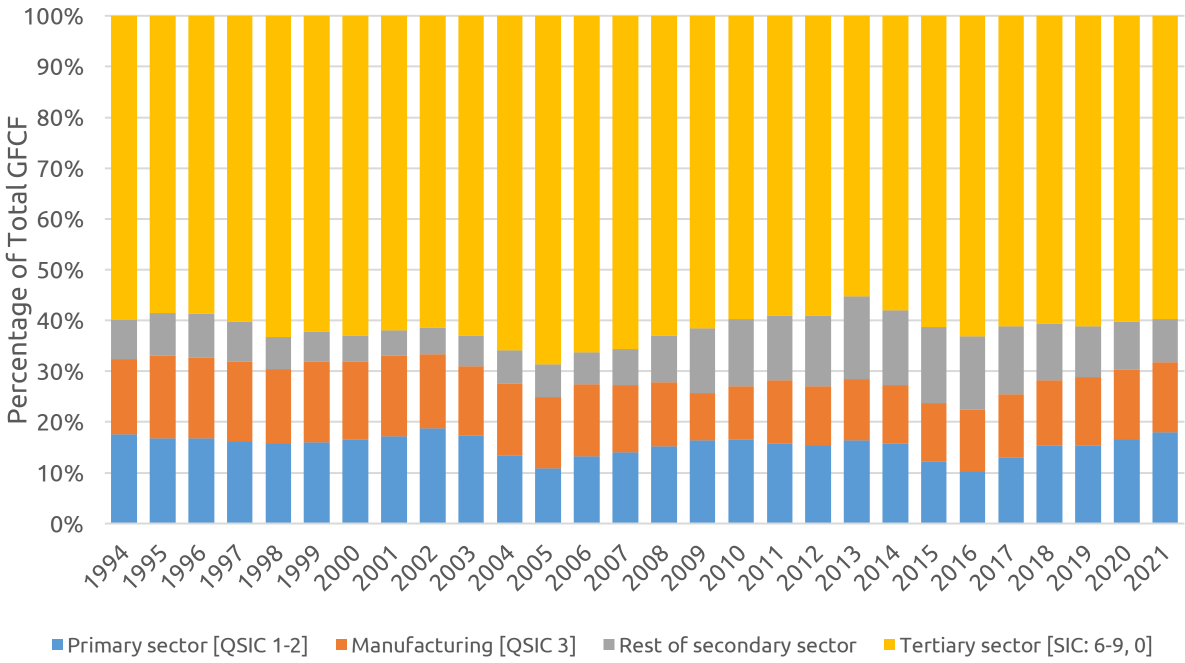
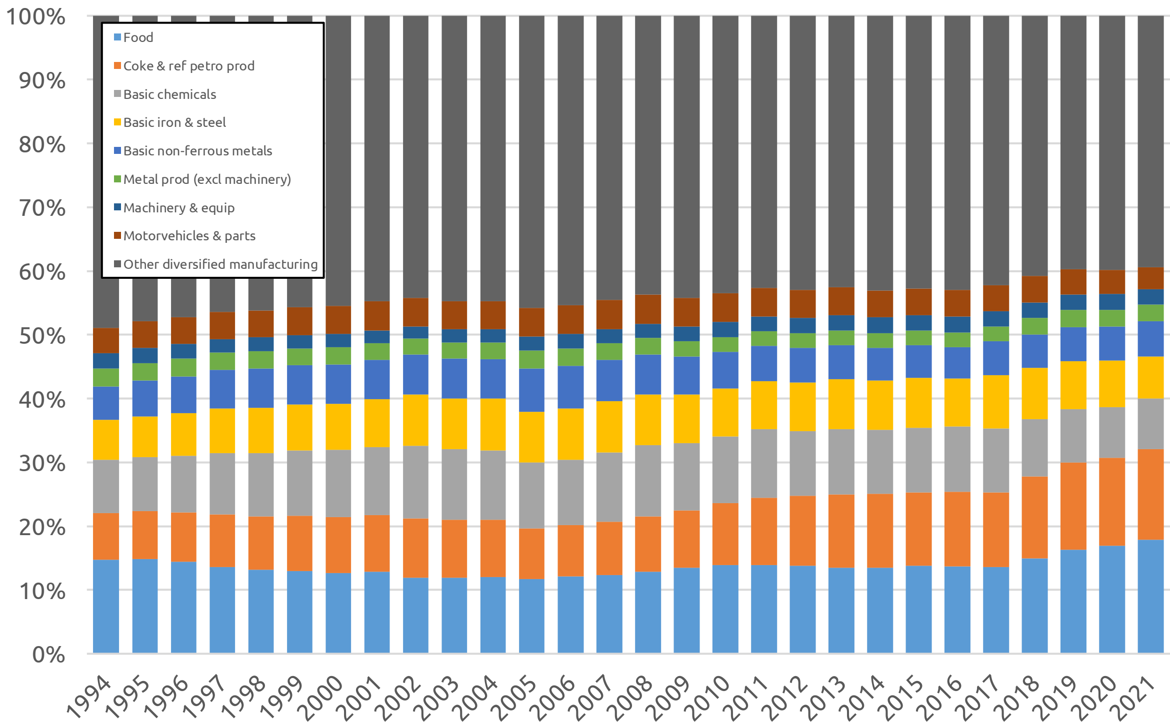
[4] Rodrik, D., 2016. Premature deindustrialization. Journal of economic growth, 21(1), pp.1-33.
[5] Andreoni, A. and Tregenna, F. (2018). Stuck in the Middle: Premature Deindustrialisation and Industrial Policy. CCRED Working Paper Series.
[6] Temple, J., 1999. The New Growth Evidence. Journal of Economic Literature, 37(1), pp. 112-156.; Team, E. G. F. S., 2005. High Growth of Investment, Macro-cost and the Sustainability of Economic Growth. Economic Research Journal, Volume 10, pp. 12-23.; Beil, R. O., Ford, G. S. & Jackson, J. D., 2005. On the relationship between telecommunications investment and economic growth in the United States. International Economic Journal, 19(1), pp. 3-9.; Gylfason, T. & Zoega, G., 2006. Natural Resources and Economic Growth: The Role of Investment. The World Economy, 29(8), pp. 1091-1115.
[7] Using data from Quantec (https://www.easydata.co.za/)
[8] Monaco, L., Bell, J.F. and Nyamwena, J. (2019). Understanding Technological Competitiveness and Supply Chain Deepening in Plastic Auto Components in Thailand: Possible Lessons for South Africa. CCRED Working Paper Series.
[9] Bell, J.F., Goga, S., Mondliwa, P. and Roberts, S. (2018). Structural transformation in South Africa: Moving towards a smart, open economy for all.
[10] Bell, et al. (2018).
[11] Bell, et al. (2018).

Figure 3: GFCF Sectoral Breakdown, 1994-2021



Source: Quantec

Figure 4: Manufacturing GFCF sub-sectoral breakdown, 2011-2021



Source: Quantec

Additionally, much of the growth over the democratic era has continued to be driven by sub-sectors linked to the Minerals-Energy Complex that has perpetuated the high levels of systemic concentration, high profits, and low investment among many of these sub-sectors.[12] More worryingly, in the sub-sectors where investments have been taking place, these investments have not been centred on expansion with investment in productive capital assets largely absent. Rather, the large firms that often dominate these industries have been able to exert their economic power, while also taking advantage of political uncertainty and barriers to entry (BTE) to engage in unproductive investments like mergers and acquisitions, working to consolidate markets at the expense of inclusive and meaningful competition, structural transformation, and dynamism.[13] To date, the proliferation of this perverse concentration of key sectors deprived the economy of dynamic rivalry, innovation, competitive pricing, improved production processes and capabilities, and learning-by-doing. Furthermore, research into development finance institutions[14], black industrialists[15], and BTE[16] have detailed how investments in South Africa have favoured established firms to the detriment of new, small- and medium-sized entrants into many key markets.

The development of a robust and dynamic manufacturing sector is possible through channelling investments into sub-sectors that possess opportunities for vertical and horizontal linkage development, digital modernisation and sophistication for firms operating in high-value adding industries. However, given the unique historical, economic, and political structures of South Africa, in its current version, the South Africa's inaugural CIS raises several questions. Key among these is: how can the CIS change the existing failed investment model and redefine the relationship between investment and industrialisation in the context of the political economy and history of South Africa? The next section provides some high-level recommendations in line with the structural transformation and development targets set out in the various growth and development documents.

4. Leveraging AMNCs to improve regional industrial capacity

This section explores some high-level recommendations intended to strengthen the CIS report based on the work of the Industrial Development Think Tank (IDTT)[17].

- ***There is the need to recognise that the nexus between profit and investment is broken in South Africa.*** A new investment model that takes into consideration the political and industrial structures of South Africa is needed. Government and the

[12] Bell and Goga (2020). Key competition challenges in the South African economy: Large firms, concentration and lack of dynamism. In Opening the South African Economy. Vilakazi, T., Goga, S. and Roberts, S. HSRC Press. pp. 11-23.
[13] Bell and Goga (2020); Nyamwena, J. and Bell, J.F. (2021). South Africa's economic recovery plans: What are the missing pieces for a sustainable and inclusive drive towards industrialisation?. CCRED-IDTT Policy Brief.
[14] Goga, S., Bosiu, T. and Bell, J., 2019. Linking IDC finance to structural transformation and inclusivity in post-apartheid South Africa. Development Southern Africa, 36(6), pp.821-838.
[15] Bosiu, T., Nsomba, G. and Vilakazi, T. (2019). Black Industrialists, Barriers to Entry, and Appropriate Interventions. CCRED Working Paper Series; Bosiu, T., Nsomba, G. and Vilakazi, T. (2020). South Africa's Black Industrialists Scheme: Evaluating programme design, performance and outcomes. CCRED Working Paper Series.
[16] https://www.competition.org.za/competition-and-barriers-to-entry
[17] See https://www.competition.org.za/

various government departments have a crucial role in bringing together stakeholders and forming new coalitions of interest, from both the public and private sectors, to work together to realise a new investment model and economic future for the South African economy.

- ***Manufacturing is essential for translating investments into growth and development.*** Industrial policy is critical in directing investment into value-creating manufacturing sectors. Evidence by the Industrial Development Think Tank shows that there is a need for crucial investment in vulnerable root industries such as petroleum products, chemicals, rubber and plastic, metals, metal products, machinery and equipment, and food, beverages and tobacco to spur economic recovery and reindustrialisation. These sub-sectors must be prioritised for intervention by policymakers as they are well-entrenched within South Africa's current industrial structure.
- ***South Africa's re-industrialisation and inclusive growth agenda must focus on productive investment and widening economic participation in the manufacturing sector.*** Along with this, there needs to be a coherent vision for long-term investment in productive capacity and prioritising innovation. This means engaging boldly and critically with big and large businesses in addressing the broader political economy issues stemming from the country's history.
- ***Targeted investment is needed in advanced digital technologies to take advantage of its prospects for improved productivity, competitiveness, and digital industrialisation.*** Specifically, the government needs investment to curtail bottlenecks and constraints limiting the adoption of digital technologies such as upfront capital costs, skills gap, digital infrastructure, and limited R&D investment that inhibit the drive towards digital transformation in South African manufacturing.
- ***A strong and supportive institutional and policy landscape is necessary to develop an inclusive, prosperous and sustainable society while actively targeting entrenched market positions.*** Adopting an investment strategy ultimately requires a robust, entrepreneurial and capable state to take the lead in building a developmental coalition both domestically and regionally in the context of the AfCFTA. This entails eradicating fragmentation in the government and its various economic and social *departments that have thus far significantly weakened the implementation of industrial policy.*
- ***Development finance institutions need to reorientate from the overwhelming provision of finance for capital-intensive upstream sectors of the economy toward facilitating the meaningful entry of SMEs into high-value and labour-absorptive downstream industries.*** There is a need for a purposefully integrated model which directs investments by development finance institutions that unlock fixed long-term investment from large incumbent players to smaller and newer players to set the country on a path towards structural transformation and inclusive economic growth.