DETERMINANTS OF PRIVATE INVESTMENT:
A REVIEW

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1. INTRODUCTION

The relevance of private domestic investment to economic growth in developing countries has received particular emphasis among researchers and policy makers in the 1990's. This swing in growth strategy towards accepting the private sector a leading role while allowing the government to concentrate on improving social overhead capital, and poverty alleviating goals is based on two major reasons. First, there has been a growing empirical evidence on the relative efficiency of private over public investment in the productive sectors. Second, there is physical complementarity between private investment and public infrastructural investment (see for example, World Development Report, 1991).

Given these propositions and the available evidence favouring them, promoting private investment becomes the agenda of the day. Nevertheless, promoting private investment is a complex task because the factors affecting it are intricate and delicate. The major factors which have an important bearing on private investment in developing countries are the quality and quantity of public infrastructural investment, differential rates of return to investment in the economy, level of entrepreneurial skill, exchange rate policy, fiscal and monetary policies, incentive structures, factor market conditions, credibility, uncertainty and irreversibility of investment decisions. The literature on private investment generally points to the significance of these variables in encouraging private investment while leaving room for country specific problems.

2. THE THEORY OF INVESTMENT BEHAVIOUR

Investment theory has remained one of the unsettled issues in Economics. Keynes (1936), for example, underscored that investment depends on the future marginal return to capital relative to the cost of invested funds. However, he also pointed out the importance of human instincts in investment decision making, owing to the intractable problem surrounding the computation of future returns to investment in a world of uncertainty.

In the 1950’s and 1960’s, the accelerator theory of investment which postulated a linear relationship between investment and output became popular. According to this theory, the investment requirement for a certain desired target of output growth is computed from a given incremental capital output ratio. However, this model disregards the importance of expectation, profitability and cost of capital; in stark contrast to the forward-looking nature of investment. Jorgenson (1967); and Hall and Jorgenson (1971), criticised the accelerator model pointing
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to its static assumptions and developed another model that puts investment as a function of output and the user cost of capital (which in turn depend on prices and interest rates). This model is also devoid of dynamic expectation as regards future prices, interest rates and demand.

Tobin (1969) pointed that investment decision is a function of the ratio of the addition to the value of the firm due to an extra unit of capital installed to its replacement cost. If this ratio, called Tobin’s q is greater (less) than unity, firms would want to increase (decrease) their capital stock. In a disequilibrium context investment is viewed as dependent on both profitability and demand for output (Malinvaud: 1980, 1982), and (Snejersens: 1987). In the context of developing countries a recent study on the Pakistan Economy shows that private investment is a function of output growth, public investment and the availability of credit to the private sector. Further, when public investment is broken into infrastructural and non-infrastructural investments the latter is inversely related to private investment (Sakr: 1993).

In the following section of the paper, a discussion of the major factors affecting private investment will be presented.

3. PRIVATE AND PUBLIC INVESTMENTS

Empirical studies on the relationship between private and public investment in developing countries other than Pakistan show that while public investment in non-infrastructure discourages private investment the latter is strongly induced by investment in infrastructure. Moreover, private investment in the productive sectors is more efficient than public investment in the same (Blejer and Khan 1984; Shafik 1990).

Public investment in infrastructure unifies fragmented markets, decreases production and information costs thereby raising the return to private investment. Further, a climate in which enterprise promotion is based on market signals leads to a higher productivity of capital than the case in a distortionary market situation.

According to the World Bank, when market incentives are inappropriate and complementary investments and institutions absent, private sector projects tend to be inefficient (World Development Report 1991). Thus, looking at the overall economy private investment tends to follow the supply of infrastructural facilities.

Ethiopia’s position as regards infrastructure is highly restrictive for private investment at large. Roads are not in sufficient supply and the existing ones are of poor quality. On top of that those in the northern part of the country have been seriously damaged during the war, some of which need major reconstruction before they can be put to use. Similar conditions also exist in eastern Ethiopia. Power supply is another factor constraining private investment in Ethiopia. Electric power failure is common in many parts of the country and the total supply in the country is

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insufficient. Lack of power would thus inevitably constrain investment in some regions of the country.

The efficiency and supply of telecommunication service in the country as a whole is neither encouraging. Nevertheless, the importance of this service to business promotion cannot simply be overemphasized. The situation in health and education facilities which indirectly if not directly encourage private business is considered not to improve in the near future. Given these conditions the relevance of increasing the supply of infrastructural facilities to the promotion of private investment is clear. Further, while low and poor infrastructural supply retards private investment in the economy as a whole, the distribution of such facilities across sectors and areas creates imbalance and distortion. Other things being equal, a straight forward result would be the flow of capital towards sectors and/or areas where concentration of infrastructure is the highest (see, for example, table 1). The concentration of new industries in Addis Ababa, among other things, is basically attributable to infrastructure supply and demand. Differences in infrastructure supply generate differences in rates of return to capital through the variation in information cost, production cost and period of realization of the return to capital. The lower these variables the more attractive these sectors/regions to investment. In Ethiopia, as long as return to capital in trade is higher than that in agriculture and industry, capital will continue to cling to the trade sector. Even if the system in the trade sector is dismantled which is the case in most structural adjustment programmes, lack of entrepreneurial skill, among other things, would continue to constrain capital flow from trade to agriculture or industry.

Hence, the flow of investment to the different sectors depends, inter alia, on the structure of the rates of return to investment across sectors in the economy. The structure of these rates and the extent of rigidity in the economy have also significant bearing on the efficiency of macroeconomic policy instruments destined to promote private investment.

4. DEVALUATION AND PRIVATE INVESTMENT

Over the last several years many empirical studies have been carried out on the effect of macroeconomic policies on investment decisions. One of the macroeconomic variables having a significant bearing on private investment is the exchange rate. An exchange rate action involving a real devaluation and aiming at correcting external imbalances affects investment. In the non-tradable sector investment is depressed because a real devaluation increases the cost of new capital relative to domestic goods. In the tradable sector however, investment rises owing to the decline in the cost of new capital compared to the price of output. The result on aggregate investment is therefore not clear (Serven & Salimano 1991; Cardias 1991; and Larine & Vergara 1991).

In a country where capital goods producing sector is nonexistent and the import component of investment is a large proportion of aggregate investment, a real devaluation could bring an
adverse supply shock to the economy. Imported machinery and equipment become expensive because devaluation increases the domestic currency counterpart and widens the tax base. In these contexts, availability of credit to importers of investment goods becomes critical. In addition, revision of the import tax structure and the provisions for importers of machinery and equipment would be necessary to mitigate this problem. The Investment Code of Ethiopia has a leeway for investors; nevertheless, the procedure involved in gaining investment benefits is cumbersome. First, there is the length of time needed for securing an Investment Certificate. Second, any one with an IC who imports a capital good is required to pre-deposit money equivalent to the duty payable if the good were imported by one with no IC. Third, it takes quite a long period of time to get the pre-deposited money back forcing the investor to lose the alternative return of such money.

In addition, a real devaluation raises the debt burden of firms by directly increasing the real value of foreign currency debt. With weak credit markets such firms are likely to face credit constraints since creditors may raise the cost of credit owing to risk of default. Investment is therefore likely to fall as financing becomes scant and meagre (Serven and Salimano 1992).

5. AVAILABILITY OF FINANCE

In developing countries firms fail to generate adequate self-financing. The amount of resources available for investment financing in these countries are also very limited because of low income and low savings. Finance is therefore an important constraint to promoting investment in developing countries. This is further exacerbated by the absence and/or inefficiency of capital markets in developing countries. Capital markets mobilize savings and direct them into productive investment. Moreover, they improve efficiency and raise competitiveness.

Empirical evidence on the relationship between real interest rates and investment is mixed. McKinnon (1973) and Shaw (1973), for instance, suggest that there is a positive relationship between these variables. This however holds as long as the impact of real interest rates on savings remains higher than that on unit cost. Be that as it may, in developing countries, investment tends to be more sensitive to the availability of bank credit than to real interest rates, owing to financial repression. The role of bank credit becomes all the more significant when the import share of investment is large as import pre-deposits will be necessary to carry out importation of investment goods.

In Ethiopia, manufacturing firms are faced with shortage of liquidity. For instance, participating in the auction for foreign exchange is not simply within the reach of many firms of this type. The collateral requirements set by the Commercial Bank of Ethiopia and administrative biases against small firms are also highly restrictive for investment in small manufacturing firms. These and other factors have therefore exposed small manufacturing enterprises in Ethiopia to
informal credit at interest rates as high as 8 to 10 percent per month. This is 96 to 120 percent per annum. Private business in Ethiopia is therefore carried out under extremely harsh financial conditions and easing such constraints is expected to promote private sector development in the country.

Preliminary assessments were made on whether or not excess liquidity exists in Ethiopia. The difference between the rate of growth of nominal money supply and nominal GDP has been found to be positive for the last 15 years, which to some extent could be used as an indicator of the existence of a monetary over-hang in the economy. An alternative indicator of monetary over-hang in the economy is the existence of a positive elasticity coefficient between the rate of growth of the price level and money supply growth less GDP growth, assuming that hoarding is at least less than the amount of excess liquidity in the economy. However, the interest here is in assessing the existence of excess liquidity in the economy whether hoarded or not and we would not be bothered with the estimation of the elasticity coefficient. In Ethiopia given the restrictive policy of the past regime as regards private participation in industry and agriculture, private business was biased towards trade and with the high rates of return a large amount of liquidity started to accumulate in this sector for lack of outlet in other sectors of the economy. However, real sector investors in Ethiopia are suffering from liquidity constraint due to lack of efficient and sufficient intermediation in the economy.

People in the trade sector though highly liquid refrain from moving into real sector investment, the reason being that such people are new comers to the trade sector let alone the real sector and hence have very little experience of competitive business. The past system made them rich overnight and having been used to "quick money" they definitely would not go for investment of long gestation period. Thus, entrepreneurial skills such as risk taking, vision and prestige are lacking in this community. Direct industrializing or agriculturalizing "trade money" would therefore be a very difficult exercise. However, one can financialize such liquidity by allowing private investment in the banking sector. This sector would more easily attract liquidity in the trade sector than industry or agriculture for two main reasons. First, gestation period is shorter in the banking sector than in agriculture or industry. Secondly, given the exorbitant interest rates in the informal financial sector the return to investment in banking would be attractive if collateralization is reduced and administrative efficiency is enhanced with no discrimination against small investors. Hence, with the necessary components of financial reform put in place, the excess liquidity in the economy would be led into the financial sector and eventually finance industry and/or agriculture. Thus, this study argues that direct industrialization or agriculturalization of the excess liquidity in the economy is not feasible given the structure of the economy and the nature of the business community in which the liquidity is located. However indirect industrialization or agriculturalization is possible through the introduction of appropriate financial reform which opens the way for the development of full fledged capital markets in the economy.
A financial reform aimed at developing a competitive financial system that provides efficient services to the economy requires the establishment of legal framework for conducting transactions, adopting laws suitable for a market economy and setting limits on market freedom.

Private participation in the financial sector in Ethiopia, to a very large extent, depends on whether or not the reform addresses the following three interrelated issues:

i) Laying a general legal framework relating to contracts, property rights, business, civil procedures, taxation, bankruptcy, competition, insurance, labour and consumer protection;

ii) Laws on Financial Institutions: this centers on the definition of financial institutions among other things and their activities, licensing requirements and procedures, and modes of supervision and instruments of control for the monetary authority; and

iii) The Central Banking Law: this concentrates on defining the objectives of the Central Bank, its competence and decision making procedures.

6. FOREIGN DIRECT INVESTMENT

The impact of foreign inflows on investment has been and is still debatable. One strand of thought argues that, foreign inflows do not only ease the domestic financing constraint but also can generate crowding in effects through linkages and externalities, such as new technology, competition and economic dynamism. Another strand argues that large multinationals are in a better position to displace infant domestic firms and hence the crowding out effect may be stronger than the crowding in effect. Gaining benefits from foreign inflows is therefore not an easy task. However, given the low level of savings in the rest of the world and the competition among countries to attract them Ethiopia should do all its best to attract as much foreign direct investment as possible. Current policy stance seems to favour foreign direct investment compared to the past. Nevertheless the question of land, property rights and adverse attitudes of regional governments seem to be lingering problems related to foreign direct investment in Ethiopia.

7. UNCERTAINTY, IRREVERSIBILITY AND CREDIBILITY

Investment is a decision made today to be justified by the outcomes of tomorrow. However, future outcomes are not fully predictable. Investment decision in an uncertain climate entails the option of waiting for additional information. To the extent that incentives lag behind the risk premium of uncertainty the decision to invest is likely to be postponed. In this situation fluctuations in demand, interest rate and exchange rate volatility paralyse investment decisions (Pondyck 1988 and Bartola 1989).
The problems of irreversibility and uncertain demand force firms to go for lower capacity investment. This is so because investment once committed cannot be undone without costs. The implication of this is that policy measures aiming to attract capital should take into account uncertainty and the irreversible nature of investment which happen to be important to investor decision. Moreover, the problems of uncertainty and irreversibility become compounded when policy reform packages are incomplete and half-hearted. For example, the restriction of private operators from the banking system and the absence of a clear land policy in Ethiopia are cases in point. While the Economy is known to possess excess liquidity, most of it concentrated in the trade sector, real sector investors are currently suffering from liquidity constraint because of lack of efficient and sufficient intermediation. The absence of a sound land policy and ambivalence in authority demarcations between the centre and regions is also a constraint to the mobilisation and utilisation of excess liquidity in the surplus sectors and regions. Capital seems to continue to cling to the trade sector because the structure of the economy is such that the rate of return to investment in trade is much higher than that of the return to investment in the real sector. Moreover, as argued earlier in this paper, owing to lack of entrepreneurial skills in this community, industrializing or agriculturalizing capital located in the trade sector is likely to be a remote possibility unless measures to financialize it are introduced.

The relevance of credibility to investment, particularly in the case of Ethiopia emerges from two interrelated factors. Firstly, whether or not the government, initiating policy reform programmes, continues to stay in power in the future and consistently carries out these programmes is an important input for the decision to invest. This becomes all the more important to the private investor when one thinks of the future "general election" and the ambiguity in the power relationship between the centre and regions. Secondly, even if it happens to stay in power the reliability of the degree of commitment on the part of the government to pursue the reform is crucial for the investor. Investors detect signs of weakness in commitment to carry out policy reforms when such reforms are either incomplete or half-hearted. Hence, the possibility of reversal of policy erodes investor confidence which might be one of the factors serving as a strong disincentive for investment in some sectors and regions of the country.

Thus, while determination, completeness and graduality in implementation to achieve modest objectives are necessary for building investor confidence, the distribution of adjustment costs within as well as across generations is also of utmost importance for success of adjustment programmes. It is therefore argued that uncertainty, credibility and the problem of irreversibility have particular implication on the development of the private sector in Ethiopia.
8. CONCLUSION

In the foregoing discussion it has been emphasized that private investment in developing countries is determined by structural, macroeconomic and political factors. Needless to say, such problems are relevant to Ethiopia. The structural problems mainly refer to growth of output, infrastructural facilities, the setting of prices to reflect costs so as to improve resource allocation in the economy and the enhancement of business support services to encourage the development of entrepreneurial skills among the business community.

Moreover, while public investment in roads, power and communications encourages private investment, government investment in directly productive activities discourages it because of the crowding-out effect. The rates of return to investment in trade and service as compared to the real sector also affect the decision to invest in this sector. In developing countries such differences in the rates of return to investment are rooted in the structure of the economy. Entrepreneurial characteristics such as risk taking, vision, the ability to see opportunities, prestige, political experience and decision making are lacking in the business community of such countries.

The problems on the macroeconomic front constraining private investment are credit policy, exchange rate policy, budgetary policy, and financial sector policy. Given the high import component of investment in developing countries, access to credit for the private sector would be crucial. With a real devaluation, imports of capital goods and hence production would be disrupted in the absence of credit facility to the private sector, as import pre-deposits are necessary to be able to import capital goods. Preliminary assessments show that the above factors have particular significance to the private sector in Ethiopia.

As regards budgetary policy, it is to be recalled that the need to finance fiscal deficits is at the root of crowding out the private sector from credit markets. Controlling the fiscal deficit and becoming a good borrower on the part of the government is therefore of utmost importance for creating a stable macroeconomic environment that is conducive for business. Ethiopia's experience in this front has yet to go further to attain this goal.

Real sector investment in Ethiopia is constrained, inter alia, by lack of liquidity in this sector. Nevertheless, the economy as a whole has excess liquidity. Such liquidity is located in trade. Owing to lack of experience and know-how, the community in the trade sector would not be bold enough to move to agriculture and industry. However, given appropriate policy measures in the financial sector one can financialize the excess liquidity in the trade sector and use it to finance agriculture and industry. This would require financial sector reform including private participation in this sector to develop full-fledged capital markets. In this context, the financial sector does not only make finance available for the private sector but it also promotes efficiency and competitiveness in the economy at large.
Lack of access to land is another serious constraint to private investment, particularly in today’s Ethiopia. Both expansion as well as new investments are hampered by the absence of urban and rural land policies conducive for private investment in the country.

Political and business conditions which breed the problems of uncertainty, credibility and irreversibility are intimately related to business confidence and investment decision making. When uncertainty and credibility are highly restrictive, the question of irreversibility compounds the problem of investment decision making. The significance of these problems in decision-making among investors in Ethiopia has received attention within policy makers and authorities over the last two years. The provision of incentives through the investment code and the revision of the import tax structure are cases in point. However, gaining investment benefits is a difficult exercise for investors owing to the complexity and procrastination involved in this process. Indeed, the actual practice of implementing the investment code is said to have deviated from what is written on paper so much so that it has formidable become an impasse for domestic and foreign investors alike. In view of this, the government should pay ample attention to the major problems discussed above to ease the constraints and improve the business environment in Ethiopia.

REFERENCE


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