

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 according 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

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

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.

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.

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 formidably 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.

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Table 2
Licensed Industries, Capital & Employment

Type of Industry	1983			1984			1985 *(nine months)		
	Number	Capital (Millions of Birr)	Employment	Number	Capital (Millions of Birr)	Employment	Number	Capital (Millions of Birr)	Employment
Food	139	12.3	1135	249	23.0	1605	192	14.1	1319
Beverages	1	0.75	15	1	0.52	34	-	-	-
Textile	137	14.8	3935	190	17.1	2196	50	5.7	553
Leather	28	6.1	353	55	9.4	587	30	5.6	481
Wood Work	2	0.05	18	9	1.2	-90	4	0.3	47
Printing	11	2.0	150	13	6.4	273	1	0.2	10
Chemical	6	2.2	81	19	13.3	265	9	9.2	151
Non-metallic Mineral	20	2.0	302	43	5.7	597	26	3.6	343
Total	344	40.2	5989	579	76.62	5647	312	38.7	2904

Source: Ministry of Industry.

Table 3
Percentage Distribution of Industries by Sector

	Food	Textile	Leather	Non-metallic Mineral	Chemical	Printing	Wood Works	Beverages
1983	40.4	39.8	8.1	5.8	1.7	3.2	0.6	0.3
1984	43.0	32.8	9.5	7.4	3.3	2.2	1.6	0.3
1985*	61.5	16.0	9.6	8.3	2.9	0.3	1.3	0

* nine months data

Source: *Ministry of Industry*

Table 6

Distribution of Domestic Credit
(millions of Birr)

	1989/90	1990/91	1991/92
Government	5027.4	6045.3	7033.6
Non government	2944.6	2885.0	3072.3
Total	7972.0	8930.3	10105.9

Source: *National Bank of Ethiopia*

Table 7

Foreign Exchange Used for Capital Goods
Imports by the Private Sector
(millions of dollars)

1992	1993
25.2	39.7

Source: *National Bank of Ethiopia*

* Excludes Foreign Exchange distributed through auction.

Note: Over 95 percent of the foreign exchange indicated above went to small and medium size industries. Moreover, leather industry took the major part of the foreign exchange allocated during the two years.