MINISTRY OF FINANCE

REPUBLIC OF SOUTH AFRICA

The role of banks in infrastructure development

Speech by the Honourable Deputy Minister of Finance: Nhlanhla Nene Banking Summit – Banking Association

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Ladies gentlemen, it is an honour to address you this morning on behalf of the Deputy President.

As you know, the country is going through a difficult period after the tragedy in Marikana. The President has called on the country to observe a week of mourning. We trust that this matter will be resolved and South Africa will rise above it.

Last Wednesday, the National Planning Commission handed over its final report to President Jacob Zuma in Parliament. The document summarises a long process of introspection.

It sets out a vision of South Africa in 2030. It eloquently speaks to the desire for all South Africans to have a country with world class schooling, health care, and public infrastructure to support development.

The National Development Plan makes some very important observations about the path between now and 2030. The most important are perhaps the opportunities and challenges of our changing demography. In particular, the plan notes that we have arrived at a “sweet spot” in the demographic transition. The population has a proportionally high number of working-age people, and a proportionally low number of young and old.

In contrast to Europe and other developed countries, South Africa is young and vibrant - a “perfect window” for growth.

This presents an enormous opportunity, but is an enormous challenge. Many of these young South Africans are without work.

The National Development Plan warns that: *“If not managed, the ‘perfect window’ could become ‘a perfect storm’. South Africans between the ages of 15 and 29 will make up more than a quarter of the total population until 2030. This could be potentially dangerous if this cohort is alienated. The challenge is putting this working-age population to work. There is a real opportunity to build a stronger economy, eliminate poverty and reduce inequality.”*

So what should we do? Again, the NDP proposes some concrete steps. At the heart of the future we dream of is infrastructure – schools, roads, hospitals, trains.

On infrastructure, the Plan states: *“The country needs to make large investments to propel economic activity. These investments need to be made in a structured, considered manner to prevent inappropriate initiatives, protect South Africa's resources and ensure that prioritised investments are efficiently implemented.”*

Infrastructure development is a crucial part of raising South Africa's potential growth rate. A one percentage point increase in infrastructure investment will, by some estimates, raise long-run GDP by about 1.3 per cent and employment by about 0.7 per cent[1]. Conversely, inadequate investment in infrastructure creates bottlenecks and slows development.

The pivotal role of infrastructure in economic growth is also borne out by international experience. One of the defining features of China's rapid transformation into an industrial powerhouse has been investment-led growth. The post-war reconstruction of Germany and its ongoing success are due in part to substantial investment into ports, high-speed railways, autobahns, schools and universities.

If we want the same rapid transformation of our country into an economic powerhouse, we must begin building that future now.

South Africa can also play a leading role in the region in this regard – strengthening regional ties to other African countries. Infrastructure almost quite literally creates a bridge between South Africa and the rest of the world; and particularly South Africa and the rest of the region.

The African Development Bank estimates that a shortage of roads, housing, water, sanitation and electricity reduces sub-Saharan Africa's output by about 40 per cent. Africa represents a huge future market, and we are its Gateway.

So can we do it?

Perhaps you have forgotten the successful World Cup after our spectacular success in the Olympics! But during the World Cup and now

[1] Based on National Treasury econometric research. Additional research is in the National Development Plan, while Perkins, Fedderke, Luiz (2005) and summarise research in this area.

in the Olympics, we saw that as one nation we can do anything. Even beat Michael Phelps.

It is appropriate that the Banking Association has chosen Rosebank as the venue for our discussion on infrastructure today. Rosebank has been transformed significantly in recent years and that is thanks to the construction associated with the Gautrain project. The Gautrain was barely 15 years ago just a vision. Today it is a reality. The Gautrain is a world-class piece of infrastructure that ferries individuals backwards and forward at 160km/h. It boasts one of the best punctuality figures in the world.

The Gautrain represents a glimpse of our future as a country – black and white, rich and poor, travelling from Alexandra to Sandton; Park station to Pretoria; and via OR Tambo airport to anywhere in the world. A unified country working together, proving that together we can do more.

In other parts of Rosebank, glittering new office blocks are being built, plush new apartment complexes are springing up; and there is a sense of a prosperous vibrant future.

But Rosebank is also a world away from the rest of our country, a country that bankers perhaps only rarely visit.

The majority of our people do not live in Rosebank. They do not travel by high speed rail or in air-conditioned cars on the M1.

They do not live near the very best hospitals, or great educational institutions, nearby excellent art galleries, or large and leafy parks to play in.

Since 1994, we have made great strides as a country in meeting the many challenges we inherited. But more needs to be done.

We need to continue to build, to grow, to develop. We need to keep on building.

Infrastructure – the spending projections

As bankers, you are probably most interested in the numbers. Government has identified potential projects worth about R3.2 trillion[2] between now and 2020. Over half of these projects, about R1.9 trillion worth, are in electricity, transport, education and health.

The projects range from those already under construction, such as the R121 billion Kusile power station, those at a feasibility stage such as the Sishen-Saldanha iron ore railway line, to those that are still at a conceptual stage.

Many of these projects reflect our vision of where we want to be in 2030 – new universities, new hospitals, new railway lines, new houses.

The President has established what is called the Presidential Infrastructure Coordinating Commission (PICC) whose task is to oversee the implementation of infrastructure and to ensure that there is proper coordination between government departments. In order for us to succeed in this mammoth task, we need the cooperation of all stakeholders not only financial institutions.

That said, the headline numbers also hide the complexities of such a large and ambitious plan. Not only do we need to build infrastructure, we need to plan for it, finance and operate it, and then maintain it.

[2] For an overview of the projects under consideration, see Chapter 7 of the *2012 Budget Review,* available online at http://www.treasury.gov.za

How do we choose?

We cannot build everything – resources are, after all, limited. The real value of infrastructure lies in the economic and social activities it supports, rather than the limited benefits that are generated during the construction phase.

Therefore, it is important that only the infrastructure that will generate the highest welfare impacts be undertaken. In addition, we should prioritise projects whose costs can be covered equitably, and those that are implementable.

To help government sift through a myriad of potential projects, here are the four hurdles that every proposed project must clear:

1. Is the infrastructure aligned with our socio-economic context?
2. Can evidence of current or future demand for the service be demonstrated?
3. How will the cost of the infrastructure be covered equitably?
4. Is there sufficient implementation capacity?

Sustained, high demand indicates that a project should be prioritised. For social infrastructure, this would mean prioritising backlogs, e.g. housing, basic services, over-crowded classrooms, etc.

For economic infrastructure, it means unblocking the largest supply constraints, of which the symptoms include traffic congestion, rising property prices, increasing input prices, and inability to fulfil export orders.

Moreover, an assessment of whether the benefits of proceeding with a project rather than postponing must be made. For instance, laying down a pipeline with capacity that exceeds today's needs can in the long run be cheaper than building a small pipeline now and then expanding its capacity later.

Next, how do we finance it?

Many infrastructure projects have both a "social" and a "commercial" component, and therefore require a hybrid financing approach. Therefore, the optimal financing structure needs to be tailored on a case by case basis to fit the specific nature of the infrastructure project. The same applies to the repayment model.

Government expenditure is limited by two things: First, how much tax revenue government can collect without hurting economic growth, and, secondly, how much debt we can borrow. Our revenue collection and our ability to borrow are constrained by the weak global economic conditions. This means there is limited capacity for Government to pay for everything.

Thus, while infrastructure projects will always rely heavily on public funding, there is a role for the private sector. In the words of our National Development Plan: *"Greater use of public-private financing is likely to bring about better decision-making and improved spending discipline, resulting in more rigorous assessment, shareholder accountability and reporting. These factors will, in turn, ensure easier access to capital."*

So, we need to think out of the box – the potential exists for equity finance, mezzanine finance, "build-operate-transfer" – the bankers in the room can surely provide all the many innovative alternatives.

Also, from Government's side, we need to think about the costs and benefits of using (1) direct funding from the fiscus, or (2) using our state-owned entities or (3) utilising development finance institutions such as the Development Bank. In each of these cases, how we leverage private sector financing is very important.

While private sector investment is vital, we must always ensure the risks and benefits are shared fairly between private and public sector. Infrastructure development should not be seen as an easy way to make money out of Government.

There are also other factors at work. The investment climate is changing and investors are increasing seeking less risky projects. Investment in infrastructure assets can provide portfolio diversification and stable, inflation-protected cash flows. Moreover, institutional investors can better match their existing long-term liabilities with long-term assets and reduce portfolio volatility.

While infrastructure projects require substantial funding during construction, they thereafter yield steady returns over an extended period. The investment aids in revenue diversification, delivering stable revenues during all stages of the business cycles – becoming a natural hedge against the market – and reducing the cyclicality of investment returns.

South Africa has a well-developed financial market, and has strong access to funding from global sources, both of which will prove vital during the building of infrastructure.

What is the role for banks?

Our infrastructure plan creates huge opportunities for banks to contribute to the building of our nation.

Long-term profitability requires a long-term vision, and banks need to lend long-term. Lending for consumption might be profitable in the short-term, but it is not sustainable. Just as our National Development Plan thinks ahead – banks must also think forward to 2030.

South Africa has a skills shortage in managing large infrastructure projects. Managing the project from the initial concept to the final deliverable requires many skills – you need “creatives”, “financial gurus” and “engineering nerds”. Many of these skills exist in the banking sector. We should not let these skills go to waste. We must think how best we can work together so that these skills can be used to improve our country. A growing, successful South Africa is in the long-term interests of all.

Also, as banks you have developed deep and complex links into Africa. Government stands behind your efforts to expand into Africa. By expanding into Africa we can uplift the continent, while creating new opportunities for us all.

Later this month, the Minister of Finance is meeting with the Bank Chairmen and CEOs, and again the topic will inevitably arise as to what banks are doing to help build South Africa.

Finally, banks are part of the fabric of society, and should not stand apart. At the moment, Standard Bank is hosting an exhibition of 20th Century masters in its art gallery in downtown Johannesburg, bringing great art to all. Banks have a long history of contributing to their communities. The great banker Lorenzo de Medici commissioned works of art from Michelangelo, da Vinci and Botticelli. Have you endowed universities in rural areas, as John Harvard did in 1636? Or built halls for the arts like Andrew Carnegie? As all countries have developed and grown, philanthropy has been at the centre of building a vibrant, intelligent society.

Conclusion

And so let me conclude with the message that we should start a conversation between banks and Government.

The rebuilding of South Africa is an opportunity we should not allow to go to waste. We should talk constructively and openly about the challenges of growth and what we should do to build the kind of South Africa that is envisioned in the National Development Plan.

Thank you