

François Groepe: The role of small business in the economy

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at the AHI conference on “The role of business in local government and local economic development”, organised by the George Business Chamber, George, 9 October 2015.

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Introduction

It is an honour and a great pleasure for me to speak at the AHI conference, not least since I firmly believe that small business plays a critical role in a thriving economy. When viewed through an evolutionary lens, small business can make two indispensable contributions to an economy. Firstly, it is an integral part in the renewal process that pervades and defines a market economy as it plays a crucial role in innovation that supports technological change and productivity growth. In the second instance, small business is an essential conduit whereby millions of people enter the economic and social mainstream of a society, and is particularly adept at creating opportunities for women, immigrants and minority groups.¹

The domestic and global economy

Current economic conditions and trends to a large extent shape the environment within which business has to function. Allow me therefore to highlight a number of key developments that have a bearing on our business environment.

Ever since the onset of the global financial crisis and the failure of Lehman Brothers in September 2008, the world economy has been struggling to regain robust growth momentum. Advanced economies have generally recorded subdued performance, with activity in the euro area and Japan particularly sluggish. This disappointing state of affairs has continued notwithstanding expansionary monetary and fiscal policies. Ultra-stimulatory monetary policies, with policy interest rates close to zero, have been sustained in the United States, the United Kingdom, the euro area and Japan for more than half a decade. Financial markets are awaiting the first upward movement in the US policy rate with bated breath and which is likely to be within the next six months.

Growth in developing economies has been stronger than in advanced economies, as may be expected. China in particular has played an important role to ameliorate the slowdown in the advanced economies' growth rate in the aftermath of the global financial crisis, and with its high propensity to invest in commodity-intensive capital projects has lent strong support to commodity markets. Recently, however, economic growth in China has started to decelerate while at the same time the composition of domestic expenditure has begun to shift from commodity-intensive investment to less commodity-intensive consumption. This structural shift has acted as a drag on commodity prices. The South African Reserve Bank estimates that the price of a basket of South African export commodities like gold, platinum and coal has declined by 20 per cent in US dollar terms over the past 12 months to September 2015.

South Africa's economic growth has disappointed in recent years. In 2014, real gross domestic product (or GDP) growth registered 1,5 per cent and the latest projections estimate that real GDP growth in 2015 will also be around 1,5 per cent. This falls short of the estimated population growth of 1,6 per cent. The slow growth outcomes have been registered despite expansionary monetary and fiscal policies, and mainly relate to a number of structural impediments in the

¹ Zoltan, J. (ed.) 1999. “Chapter 1: The new American revolution”. In *Are small firms important? Their role and impact*. New York: Springer Science + Business Media.

South African economy, such as the electricity constraints; the small pool of skilled labour and certain infrastructure bottlenecks.

Several sectors experienced contractions in output volumes in the second quarter of 2015. In the case of agriculture, this was the result of drought which reduced the size of the maize crop by about 30 per cent from that of the previous year. The electricity sector suffered from a lack of capacity as unplanned maintenance disrupted supply, resulting in numerous instances of load-shedding. This in turn contributed to a reduction in manufacturing and mining output, exacerbating the impact of already lustreless domestic and global demand.

As could be expected in an environment of slow growth, employment creation has also been weak recently. For instance, underlying employment in the formal sectors of the economy has declined by 0,3 per cent over the year to the second quarter of 2015, taking out the distortion arising from the election-related 130 000 temporary government employees added to the second-quarter 2014 base level of employment. Employment declines have been concentrated in the goods-producing part of the economy while services employment has been more stable. Overall, unemployment remains elevated at around 25 per cent of the workforce.

The international price of oil have more than halved since mid-2014 causing inflation outcomes in South Africa to have been favourably affected, with the most recent reading of the consumer price inflation rate, at 4,6 per cent, quite close to the midpoint of the 3–6 per cent inflation target range. However, due to base effects, 12-month inflation is expected to pick up notably in the coming months and to exceed 6 per cent in 2016. This does not leave much room for complacency in monetary policy as prices are known to be sticky and inflation expectations remain stubbornly entrenched around the upper end of the inflation target range. The South African Reserve Bank continues to be in a tightening cycle and has raised the repurchase rate by a cumulative one percentage point since early 2014 to its current level of 6 per cent. Despite this tightening, monetary policy remains broadly accommodating, with the real repurchase rate remaining close to 0 per cent.

The public sector has, over the past six years, stepped up its capital expenditure to alleviate the bottlenecks in the economy – a welcome development. South African households have simultaneously raised their consumption expenditure. Both capital and consumption spending have a high import content, directly or indirectly, with the result that imports have been elevated. At the same time, exports were held back by certain structural impediments, as well as by deteriorating export prices. Accordingly, the deficit on the current account of the balance of payments has exceeded 5 per cent of GDP since 2012. These large deficits reflected a considerable depreciation in the real (i.e. inflation-adjusted) effective exchange rate of the rand since mid-2011, when the rand traded at less than R8 to the US dollar. However, the deficits have continued to be financed by savings from abroad as non-residents continue to invest in South African assets.

Only more recently, in the second quarter of 2015, has the deficit on the current account narrowed to 3,1 per cent of GDP – an improvement due to a number of factors, which include a reduction in industrial action, additional exports met by drawing down inventories, the lower oil price, and the impact of the sustained lower exchange value of the rand.

In the banking sector, conditions have remained stable, with the banks adequately capitalised. Overall credit extension growth in the banking sector remains slow, consistent with the state of the economy. Loans to businesses are growing at a moderate double-digit rate, with brisk increases in lending to firms engaged in green energy projects. Loans to the household sector are also growing, albeit at a low single-digit pace, with microlending activity particularly weak. Following a long period of negligible growth, the pace of increase in mortgage credit has started to firm in recent months.

With global interest rates still relatively low, share prices continued to rally. On the JSE, share prices reached record highs in the second quarter of 2015 but have subsequently receded as growth projections for China weakened which in turn contributed to the Chinese share market correcting from the exuberant levels previously reached. Further contributing factors included

softer commodity prices and expectations of an imminent increase in US interest rates. Despite the downward correction, South African price-earnings ratios still seem to be on the demanding side when compared to historical trends. South African house prices have continued to rise over the past year, but at a subdued single-digit rate.

Ever since the onset of the global financial crisis, South Africa's public finances have been growth-supportive. Caution about the upward trend in government debt has prompted authorities to adopt a programme of gradual reduction in the deficit, both through capping expenditure and through raising additional revenue. This has been somewhat complicated by the weakening in international commodity prices and the subdued domestic and global economy, resulting in downward pressure on tax collections and the extension of the original fiscal consolidation timeframe.

Small business in the economy

"Small business" is difficult to define. In South Africa's National Small Business Act, passed in 1996, the definitions provide for "micro enterprises" to have fewer than 5 employees, "very small businesses" to have 6 to 20, "small businesses" to have 21 to 50, and "medium businesses" to have fewer than 200 employees.²

Government has recently raised the status of its small business initiatives with the creation, in 2014, of a department dedicated to this cause: the Department of Small Business Development, under the political leadership of Minister Lindiwe Zulu, with an annual budget of approximately R1 billion. Previously, programmes dealing with small business development fell under the Department of Trade and Industry and the Economic Development Department.

Estimates of the contribution of small, medium and micro enterprises (SMMEs) to the economy vary. In terms of contribution to GDP, an estimate of 52 to 57 per cent has been quoted by the Deputy Minister of Trade and Industry, Elizabeth Thabethe, who put the number of SMMEs in South Africa at 2,8 million and their contribution to employment at 60 per cent. Moreover, looking ahead, the National Development Plan projects that, by 2030, no less than 90 per cent of new jobs will be created in small and expanding firms.

Small business, furthermore forms part of the backbone of a thriving society. In order to survive, it has little choice but to be versatile, innovative and entrepreneurial as SMMEs seldom have a monopoly. Hence, SMMEs are often subjected to fierce competition with scant opportunities to extract rents. This, by necessity brings out the best in them.

Innovation

Innovation is not the exclusive domain of small business as many forms and kinds of innovation require economies of scale, large investments in research and development, and the ability to bear out long periods to gestation and regulatory approval. But there are numerous examples of small businesses that have sufficient talent to produce significant and bankable innovations. Being nimble, lean and hungry supports executional excellence, as is borne out by the garage innovators of Silicon Valley and the swimming-pool equipment innovators of South Africa.

South Africa, however does have some way to go on the innovation front. The IMD³ World Competitiveness Yearbook 2015, for instance, shows that South Africans register very few patents. With the 2 211 patent applications filed by South Africans in 2013, the country comes out at number 49 out of 61 countries in the "patent applications per capita" category of competitiveness measurement. Total expenditure on research and development at 0,73 per

² This is a rough approximation because the National Small Business Act in fact provides for different numbers depending on the industry, and also introduces turnover and total asset value criteria.

³ Institute for Management Development.

cent of GDP puts South Africa at number 46 out of the 61 countries ranked by the IMD, with Israel topping the list with 4,2 per cent of GDP. South Africa also lags on the number of computers per capita criterion – at 195 computers per 1 000 people, it occupies place number 53 out of 61, with the US leading the way at a ratio of 1 111 per 1 000 people.

Incidentally, on the overall competitiveness scoreboard, the IMD ranks South Africa 53rd out of the 61 countries ranked. Of the BRICS countries, only Brazil, at number 56, is below South Africa. The US, China and Singapore occupy the first three places.

Entrepreneurship

Significant changes in relative prices signal great entrepreneurial opportunities. An example is the sharp reduction in the relative prices of information technology as well as communication goods and services, the huge opportunities which they created, and the impressive way in which entrepreneurs – worldwide – have responded to these opportunities.

In South Africa too, our IT entrepreneurs continue to scale new heights. An opportunity which is worthwhile bearing in mind relates to the big changes in the exchange rate of the rand, i.e. the relative price of producing goods and services locally rather than elsewhere. A domestic wine exporter selling a bottle of wine for US\$5 would have pocketed R37 five years ago; today they would realise R69.

The entrepreneurial response – expanding exports and substituting imports – is probably initially muted due to what the academic literature attributes to lags in both consumers' and producers' responses and imperfect competition. Given the state of the world economy, the probability of a strong recovery in the international prices of South African export commodities in the near term seems low, which should assist the real exchange rate of the rand to remain relatively competitive. In addition, entrepreneurs can use hedging strategies to lock in the advantages of a certain set of relative prices for lengthy periods; for example, in South Africa there is an active market for forward cover in foreign exchange, with outright forward transactions against the rand fluctuating at around US\$1,7 billion and swap transactions at around US\$13 billion per day. I am therefore confident that the adjustment towards external balance will gain further momentum and it is supported by the fact that export volumes have risen more briskly than the pace of global growth in the first half of 2015.

To incubate entrepreneurship, South Africa needs bold improvements in the education and school system. Interestingly enough, South Africa's total public expenditure on education as a percentage of GDP, at 7,0 per cent, puts the country in the third-highest position among the 61 countries ranked, with only Denmark and Iceland above it. However, the amount spent per capita gives a dramatically different result, pushing South Africa down to the 42nd position on the IMD ranking. Education outcomes in South Africa do however show room for further improvements in support of enhancing the small business sector as well as in the interest of long-term economic growth and developments.

The role of the South African Reserve Bank (the “Bank”)

The Bank is responsible for monetary policy in South Africa. It has been given the task of protecting the purchasing power of our money in the interest of balanced and sustainable economic growth and development. Apart from ensuring price stability, it also plays a key role in maintaining an environment of financial stability.

Since 2000 the task of protecting the purchasing power of our money has been given clearer definition, with government adopting an inflation-targeting framework. The target has been set at 3 to 6 per cent, and the Bank has instrument independence to do what is necessary with its repurchase rate to ensure that inflation remains inside the target band. In doing so, the Bank is mindful of the lag between changes in the repurchase rate and inflation, and of the need to avoid unnecessary volatility in output.

Since 2002, when the inflation target became effective, the targeted rate of consumer price inflation has averaged 6,1 per cent to date. In the preceding two decades, consumer price inflation averaged 12,3 per cent. Furthermore, the more gradualist approach facilitated by the adoption of flexible inflation targeting can be inferred from the range within which the banks' prime lending rate fluctuated over the respective periods. Under inflation targeting, the prime rate has ranged between 8,5 and 17 per cent per annum. In the two decades prior to that, it ranged between 9,5 and 25,5 per cent.

Small businesses often lack the financial reserves and facilities of the large business sector. Accordingly, large swings in interest rates and inflation can be far more crippling to the SMME sector. It follows that keeping inflation low and stable, and therefore being in a position to prevent sharp swings in interest rates, is the contribution that the Bank can make to the financial health of the country and of SMMEs in particular. This is complemented by the role of the Bank in making sure that the financial system is safe and sound, while allowing for the orderly entry and exit of financial institutions.

Conclusion

In conclusion, let me firstly emphasise that the current environment is testing for small businesses. With agricultural output and mineral commodity prices down, the spending power arising from agriculture and mining-based communities and enterprises is under considerable downward pressure. This also triggers various multipliers and accelerators in the economy, working in reverse gear and extending the pain to other sectors, capital expenditure and the like.

Secondly, every opportunity should be grasped and, as indicated above, the depreciated external value of the rand may be one such opportunity, bringing about more attractive relative prices of exports and import-substituting goods and services. Agile businesses that can respond appropriately stand to benefit.

Thirdly, to grow the number of small businesses in the country the education system has an important role to play by raising the level of skills among the workforce and empowering potential entrepreneurs to realise that potential.

Finally, the growth and indeed the flourishing of small business is key to our future. The South African Reserve Bank is conscious of its enabling role as the provider of a stable platform for price and financial stability in this regard. With its commitment to well-contained inflation that feeds into less volatility in interest rates and maintaining an environment of stability in the financial system, the Bank hopes to provide small business with at least one less thing to worry about.

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