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Economic Overview for Business Owners

September 2018

Space must be created for SMMEs to grow

In June this year I alluded to the under-performance of the JSE Small Capitalisation Stock Index relative to the JSE All Share Index, which followed a positive bounce in early 2018. This under-performance has continued in recent months. Excluding the brief rally early this year, the decline in small caps relative to the overall market has been ongoing since 2017 and is reminiscent of the Great Recession period.

Small, micro and medium business enterprises (SMMEs) are especially vulnerable to adverse domestic demand conditions. Disappointingly, the promising increase in domestic purchasing power and consumer spending recorded in 2017, stemming from an increase in South African commodity export prices, has not been followed by stronger domestic fixed investment spending and employment creation in 2018.

Small Cap Index relative to JSE All Share Index

Source: I RESS

Rather, the first two quarters of the year have both recorded negative real GDP growth, which economists often call a technical recession. In part, this reflects falling terms of trade and domestic purchasing power due to the jump in oil prices over the past year.

At the same time, tightening global financial conditions in response to the persistent interest rate hiking cycle of the US Federal Reserve, in addition to the shift towards greater US trade protectionism, have culminated in rising global risk aversion.

Emerging market (EM) countries running macroeconomic imbalances are under closer scrutiny – especially those with weak government financial positions, including South Africa. This, has limited the Reserve Bank to a shallow interest rate cutting cycle.

The relatively free-floating Rand is a useful shock absorber. But the risk is building of an interest rate hike should the Reserve Bank believe currency weakness is filtering through into higher inflation expectations. If so, this would be a severe blow, given the already palpably weak advance in private sector credit extension.

The consensus expectation is that the economy should perform better in the latter half of the year. Recent high frequency data releases, including the weak August 2018 domestic manufacturing purchasing managers index (PMI) print, suggests this view is being tested. But it still seems reasonable to argue that an end to the drought in the Western Cape, continued global growth (albeit less-synchronised) and, hopefully, more economic policy certainty should lift growth into 2019.

By the same token it is clear that the economy is in no shape to deliver a meaningful dent in South Africa's elevated unemployment rate. Ultimately, in order to establish a sustainable revival in growth, which lifts the living standards of all South Africans, policymakers must avoid crowding out private sector economic activity – notably in the SMME sector.

The high level of government borrowing is absorbing a large share of available savings. The savings pool is limited. The more government spends the more the domestic private sector and foreign investors must save to make up the difference. In the end, deterioration in government finance has resulted in a consistent increase in the tax burden in recent years, as reflected in the historically high level of individuals' tax on income and wealth relative to household income, while increasing real interest rates (in part due to sovereign debt rating downgrades).

A growth strategy must therefore include a meaningful fiscal consolidation, which does not only aim to stabilise the government's debt level, but also seeks to improve the state's net worth. The latter includes a much needed shift towards efficient capital expenditure (to meet human capital and infrastructure needs), while cutting consumption (including government's wage bill).

But it also needs a renewed focus on deregulation, de-concentration of the economy and the establishment of effective channels through which the ideas of South Africa's entrepreneurs can be commercialised.

Finally, a substantial improvement is required in the business environment generally. South Africa is ranked 82nd on the World Bank's Ease of Doing Business Index, where 1 represents the world's most business-friendly country. This implies we are a long way from where we should be. In the interim, growth prospects remain modest.

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