



Exporting and importing by small and medium firms in South Africa

SME Growth Index Thematic Paper

Prepared for the Employment Promotion Programme

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The National Development Plan envisages small and medium firms participating in the export market, and by so doing, will be a driving mechanism of job creation in South Africa. Exporting is, however, a rare and specialised activity, and much of it is concentrated among a relatively small number of companies. There are potentially significant gains to be made if a greater export orientation can be achieved. But if this is to happen, and more specifically, if some sort of policy intervention can be harnessed to encourage this to happen, it is important to understand the existing dynamics concerning SMEs engaging in import and export trade.

At present, South Africa's economy is not demonstrating widespread export potential. Rather, its export markets are dominated by a small group of firms, and South African exporting is relatively more concentrated than it is among its peers. Research by the World Bank (Cebeci, et al., 2012) shows that the top one percent of South African exporters account for almost 80% of exports by value. For developing countries the average is 54%. This concentration is partially explained by the high share of primary products, including minerals, in the country's export basket but is exacerbated by a number of policies and inefficiencies which disadvantage smaller firms in particular.

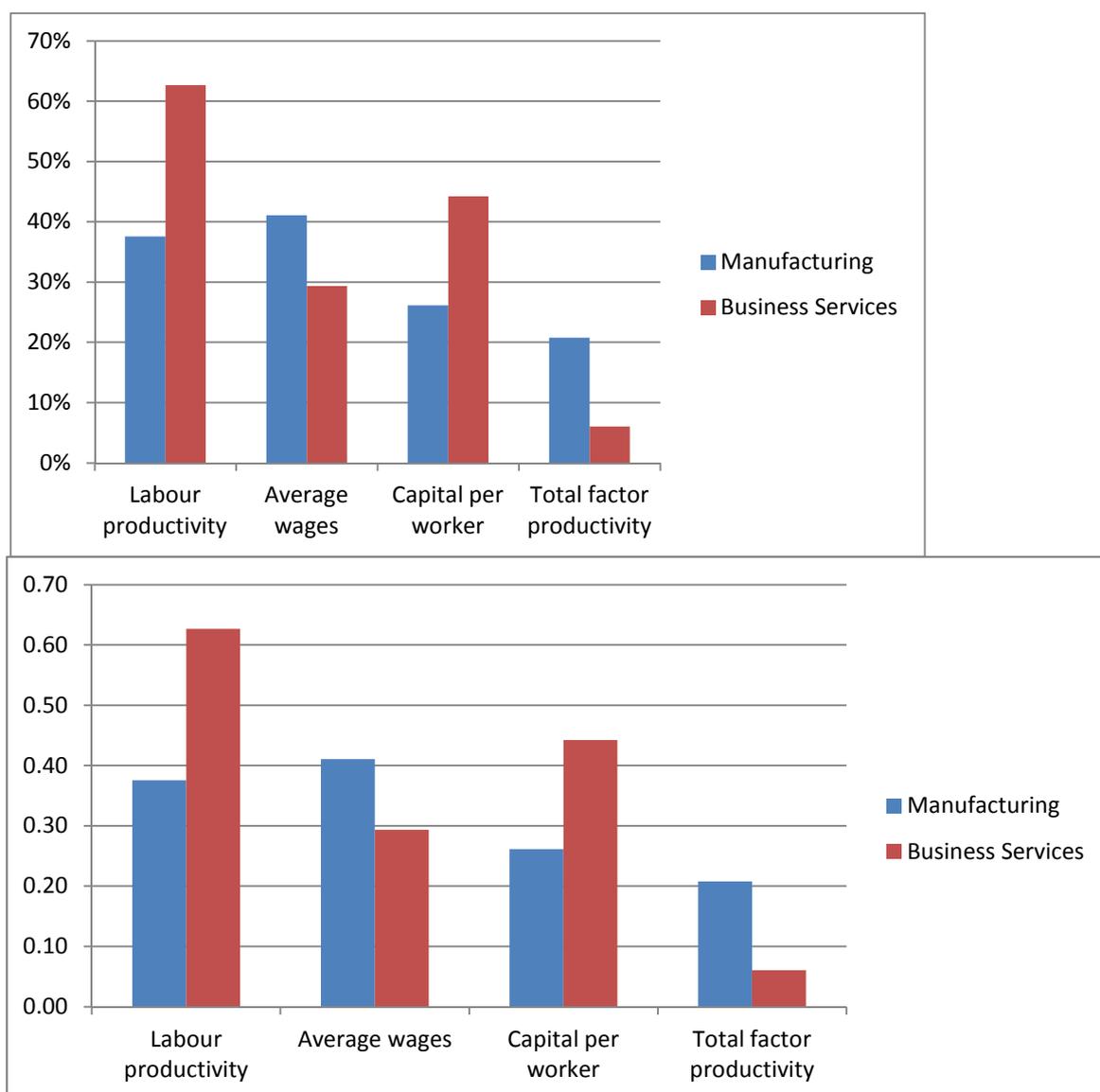
What makes exporters different from non-exporters?

In many senses exporters share particular characteristics - they tend to be larger, more productive and pay higher wages. In order for South Africa to create jobs through exports the country needs to move away from the concentration of exports among a few firms and create more firms who are able to export and increase the amount exported by those firms which already participate in the export market. South Africa needs to create an environment where more firms have the characteristics of exporter, especially higher levels of productivity. This is particularly the case for smaller firms since there is a natural bias which favours bigger companies in the export market. Larger companies already have many of the characteristics that make successful exporters. They may have grown larger since they were more productive than their competitors. Larger firms have the administrative structures in place which make it easier to track exports. They also are better able to bear the risk of non-payment, exchange rate variability and other uncertainties which come with exporting. They have existing relationships with financial institutions which allow them to finance exports. The SME Growth Index provides a unique data set to track how small and medium companies are faring in the global market and to identify the challenges which these firms face.



There is abundant evidence from both South Africa and more broadly that exporting firms are different from non-exporters. These differences are present in the SME Growth Index too. Exporters have higher levels of labour productivity (63% higher for business services and 38% for manufacturing), they pay, on average, higher wages (41% higher for manufacturing and 29% for business services) and are more capital intensive (26% for manufacturing and 44% for business services). In terms of total factor productivity (TFP), a measure of overall competitiveness, exporters perform better than non-exporters, particularly in manufacturing. Exporters in the manufacturing sector have TFP levels which are more than 20% higher than non-exporters.

Figure 1. Percentage differences between exporters and non-exporters



Note: Total factor productivity is measured as the coefficient estimate of the export variable in a Cobb-Douglas production function which imposes constant returns to scale. It is measured in revenue terms.



These observed differences show the important role competitiveness plays in the export market. Firms with higher levels of productivity are more likely to enter and be successful in the export market. There is also some evidence that participation in the export market makes firms even more productive through interactions with clients and exposure to more competition.

Export expansion

Developing the country's export sector, is, as has already been indicated, a part of official thinking for economic and employment growth. Indeed, rhetorically at least, South African businesses are encouraged to find markets in Africa, and the prospects of gaining greater (and possibly privileged) access to large developing markets is a factor in official enthusiasm for the BRICS.

The SME community's views are compatible. Expanding into new markets through exporting is a strategy which many SMEs plan to follow; in fact it is more common than servicing new markets through establishing new businesses in these locations. In the next year a third of manufacturing firms intend to look for new markets within Africa and 15% intend to look outside Africa. For business services 23% will look for new markets in Africa and 9% outside of Africa. The proportions intending to open new locations are small compared to this. Only 5% of manufacturing firms intend to open a plant in another African country and 10% of business services intend to open a branch. Intended expansion outside of Africa is even smaller – 2% of business service firms and 1% of manufacturers intend setting up in a new location outside of Africa.

It is apparent therefore that there is a strong aspiration to seek new markets rather than new physical locations for business operations. The expectation is that these will be found within South Africa, but a notable plurality sees a need to see them outside the country's borders, with Africa viewed as the most promising export destination. The graphs below illustrate these trends.

Figure 2. Proportion of firms looking for new markets

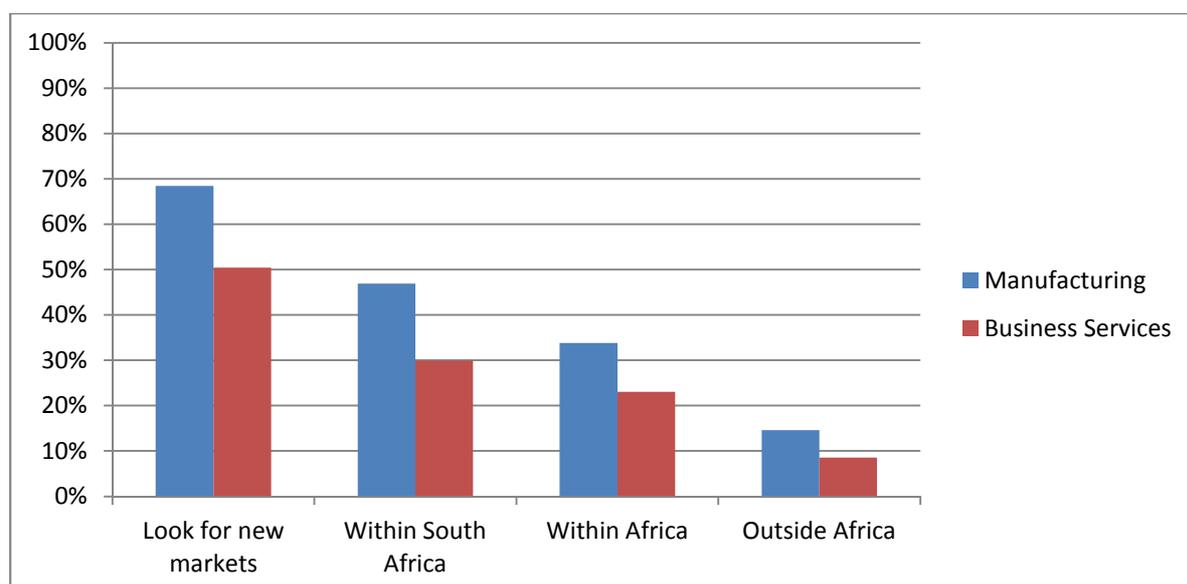
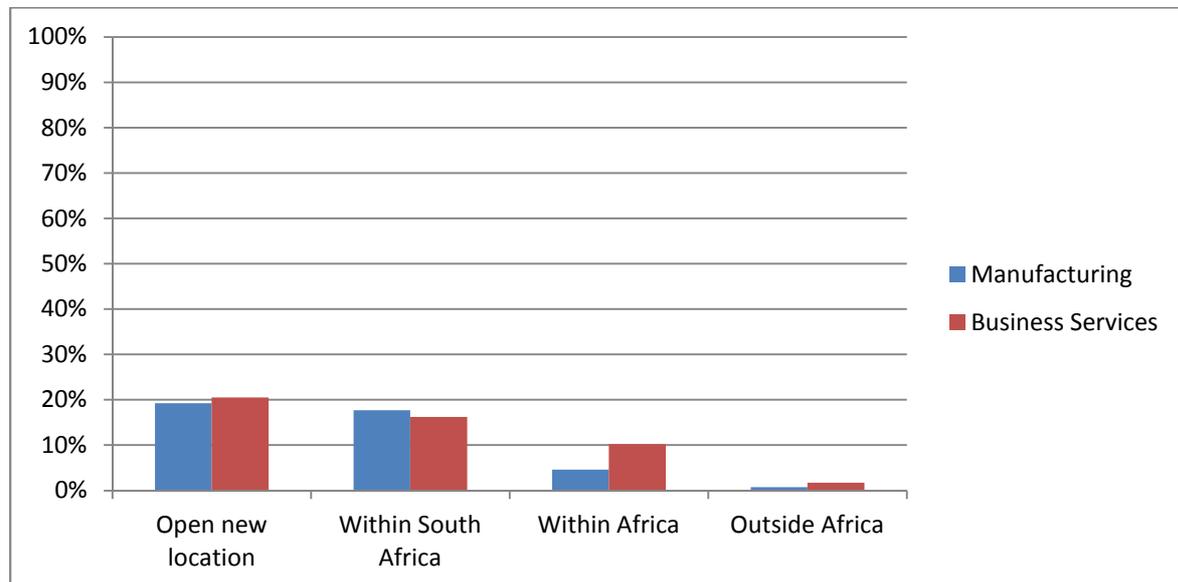


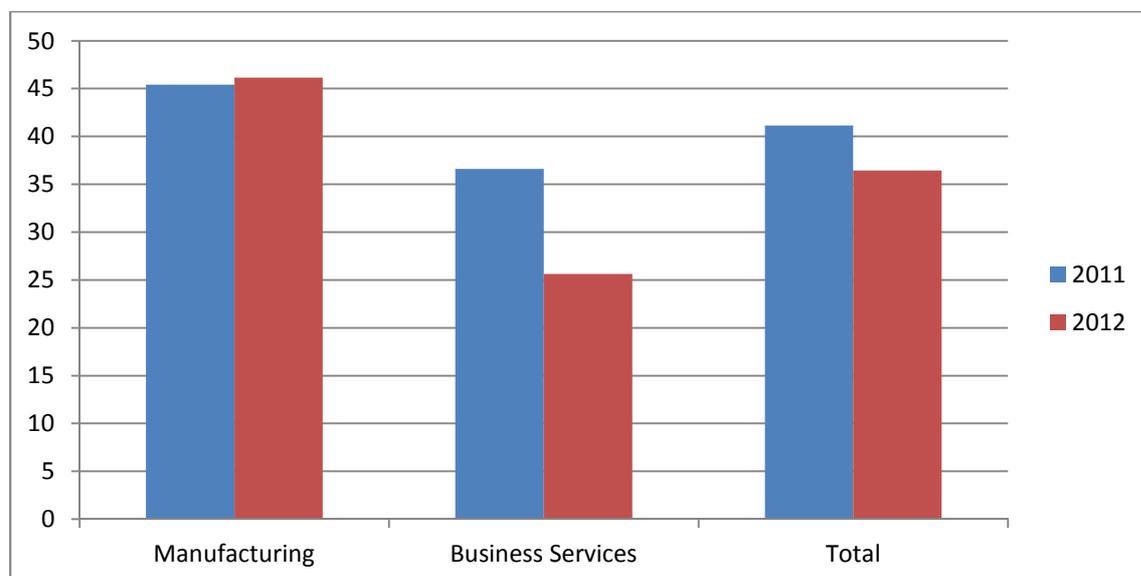


Figure 3. Proportion of firms looking to open new locations



It therefore seems correct to conclude that SMEs are looking to expand through exporting as envisaged by the NDP but what does current export participation look like? Export participation differs between the manufacturing and business services sectors. In both 2011 and 2012, almost half of the firms in the manufacturing sample reported exporting; among business services panellists, the equivalent proportions were 37% in 2011 and 26% in 2012. Across the two years of the survey export participation has fallen for business services, but remained constant for manufacturing.

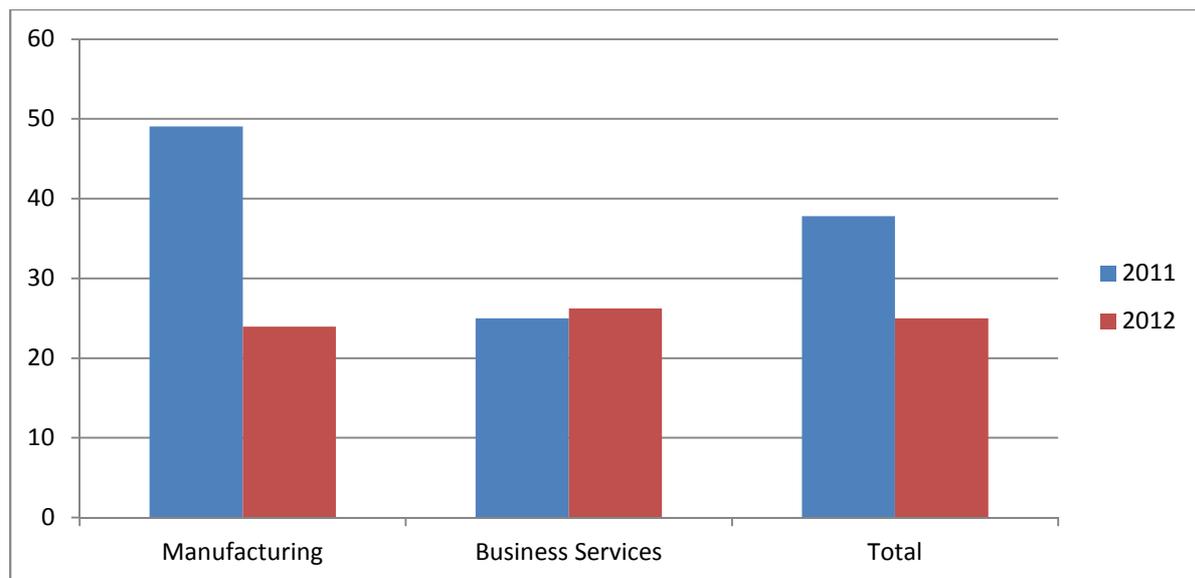
Figure 4. Proportion of firms exporting by year and sector





Exporting is one aspect of participation in the international market. The other is importing. In general firms in the sample are less likely to import than export. A quarter of the firms in the sample imported goods and services in 2012 compared to 36% in 2011. As with exporting, manufacturing firms are much more likely to participate than business services firms. These measures are likely to undercount the true importance of foreign goods and services to South African firms though as they refer to direct imports rather than foreign products and services bought through an intermediary.

Figure 5. Proportion of firms importing by year and sector



The most noticeable change in import behaviour between the two years is the substantial fall in imports by manufacturing firms. In 2011 almost half of the manufacturing firms participated in the import market. This dropped to 24% in 2012. What changed between 2011 and 2012 which affected manufacturing importers by disproportionately more than those in business services? An obvious candidate is the exchange rate. In July 2012, 1 US Dollar cost about R8.20 compared to R6.70 a year earlier. This substantial depreciation made it more expensive for South African businesses to import. Over this period 57% of only-importers (firms that import but do not export) in manufacturing were likely to exit importing in 2012. Of those firms doing both importing and exporting in 2011, 66% of firms exited importing in 2012, only 21% remained doing both and 14% exited the international market totally. The depreciation had a much less marked effect on exporting in manufacturing though, increasing export participation by 4 percentage points. Furthermore, even with this depreciation exports from the business service sector fell.

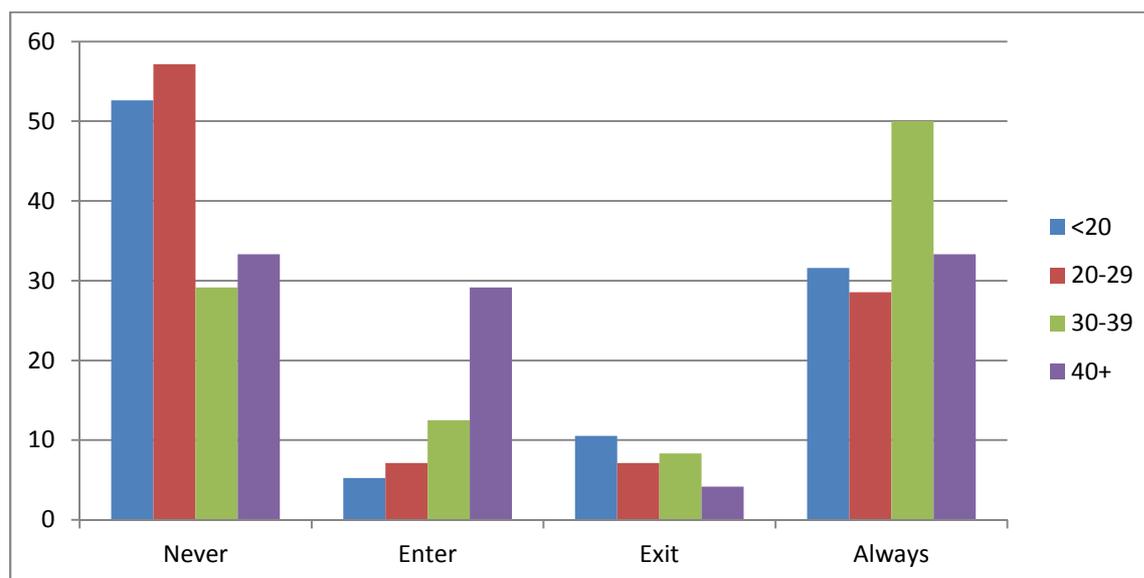
One panellist alluded to the complexities of depreciation. Simultaneous changes to input prices and imports can shift business choices towards imports: "Input costs versus importing goods makes it more viable to import. This would solve a number of problems i.e. I would not have any more drama from unions, labour, electricity etc." To this might be added the fact that building productive



capacity in the first place often involves importing, whether capital goods or intermediate inputs. These may not always viably be obtained locally, and sharply increased prices as a result of currency changes may be detrimental. In other words, there is simply no guarantee that depreciation will boost domestic production and make exports viable.

Between 2011 and 2012, the dynamics of exporting and importing in the manufacturing sector varied by firm size. Larger firms in the sample were much more likely to start exporting and less likely to stop compared to smaller firms. This pattern is not present for importing. This suggests that changes in exchange rates can have different effects across the size spectrum of firms. A depreciation may enable firms which are on the threshold of export participation, which are generally the larger firms, to enter the export market but have little effect on the export behaviour of smaller firms. The impact on imports is much more equally felt across size categories. Although the drop in imports by the manufacturing firms may be interpreted positively since it indicates that these companies may have switched to local suppliers, the long term effects are less certain. Imports in the manufacturing sector are generally intermediate costs, forming part of the overall cost of firms' end products. A switch to local suppliers – invariably at higher costs than were being paid to foreign suppliers prior to the depreciation – would have increased input costs. Given that most of these firms derive a majority of their revenue from the domestic market, they are likely to pass on these cost increases (or at least a part of them), and prices will rise for consumers. A depreciation also increases domestic inflationary pressures, and with them wage demands. For a depreciation to be an effective tool to encourage exporting, it is thus apparent that it needs to be a real depreciation, where input costs increase by less than output prices.

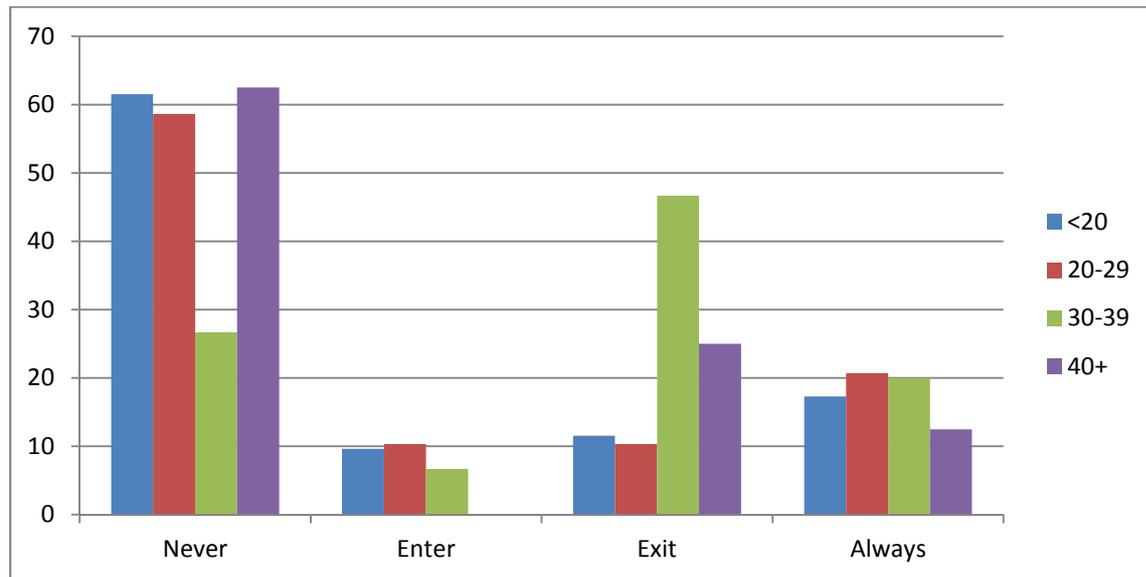
Figure 6. Export dynamics by firm size, manufacturing firms only.



Notes: 'Never' are firms that did not export in either year, 'enter' are firms that did not export in 2011 but did export in 2012, 'exit' are firms that exported in 2011 but did not export in 2012, and 'always' are firms that exported in both 2011 and 2012.



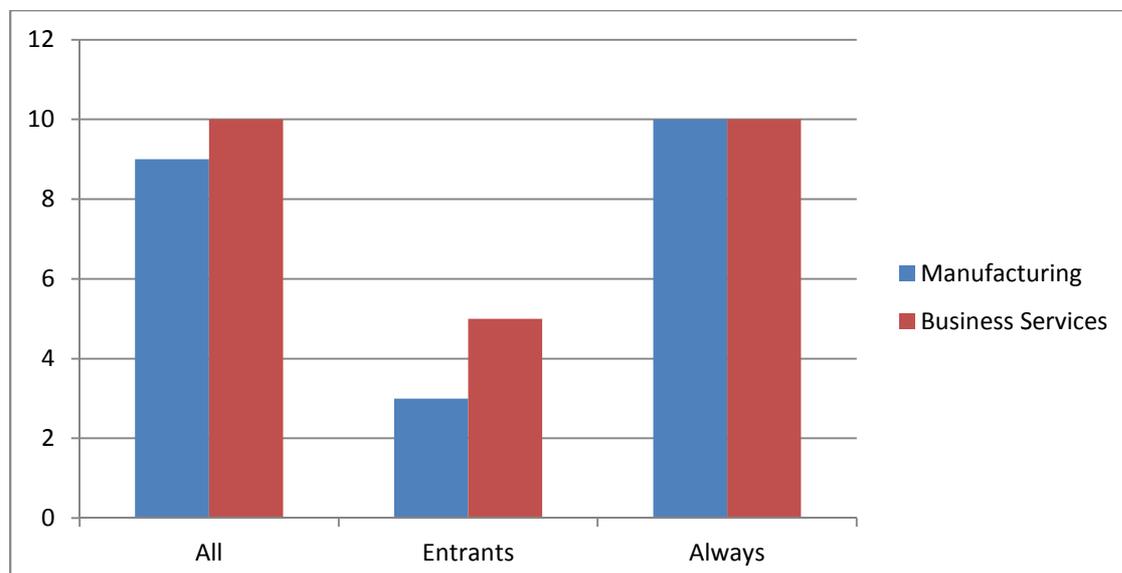
Figure 7. Import dynamics by firm size, manufacturing firms only.



Notes: 'Never' are firms that did not export in either year, 'enter' are firms that did not export in 2011 but did export in 2012, 'exit' are firms that exported in 2011 but did not export in 2012, and 'always' are firms that exported in both 2011 and 2012.

Most of the firms in the sample do not see the international market as their primary focus or biggest source of revenue. Overall, exports make up less than 10% of revenues for more than half the exporting firms, and for 80% of exporting firms, exporting accounted for 20% of revenues or less. However, there are a group of firms which are specialised exporters. About 7% of the exporters export all their output.

Figure 8. The median proportion of turnover exported for companies which export, all firms (all), new entrants to the export market (entrants) and companies which exported in both years (always)





The relative magnitudes of export participation and the amount exported suggest that the most successful strategies for increasing exports among these sized firms are twofold. First, to create the conditions which are conducive to firms entering export markets. For manufacturers this means an environment in which they can grow to be big enough successfully to export and for all firms this means policies which reduce costs and increase productivity to make these firms internationally competitive. This in turn implies that the domestic conditions for firm growth and profitability (reasonable input costs, efficient governance and so on) can be critically important for developing strong, export-ready firms. Second, it makes more sense for policies to encourage existing exporters to increase the amount they export rather than focus on getting new firms into exporting (although obviously policies which can do both would also be beneficial). A firm which is already exporting has demonstrated that it can compete in at least one foreign market and has overcome the initial hurdles of entry into exporting. Entry into other markets or the expansion in the markets it already operates in, are likely to be less risky and lower cost than those associated with establishing exports initially. The typical firm also has a relatively large scope to increase the amount exported since this is typically below 10%.

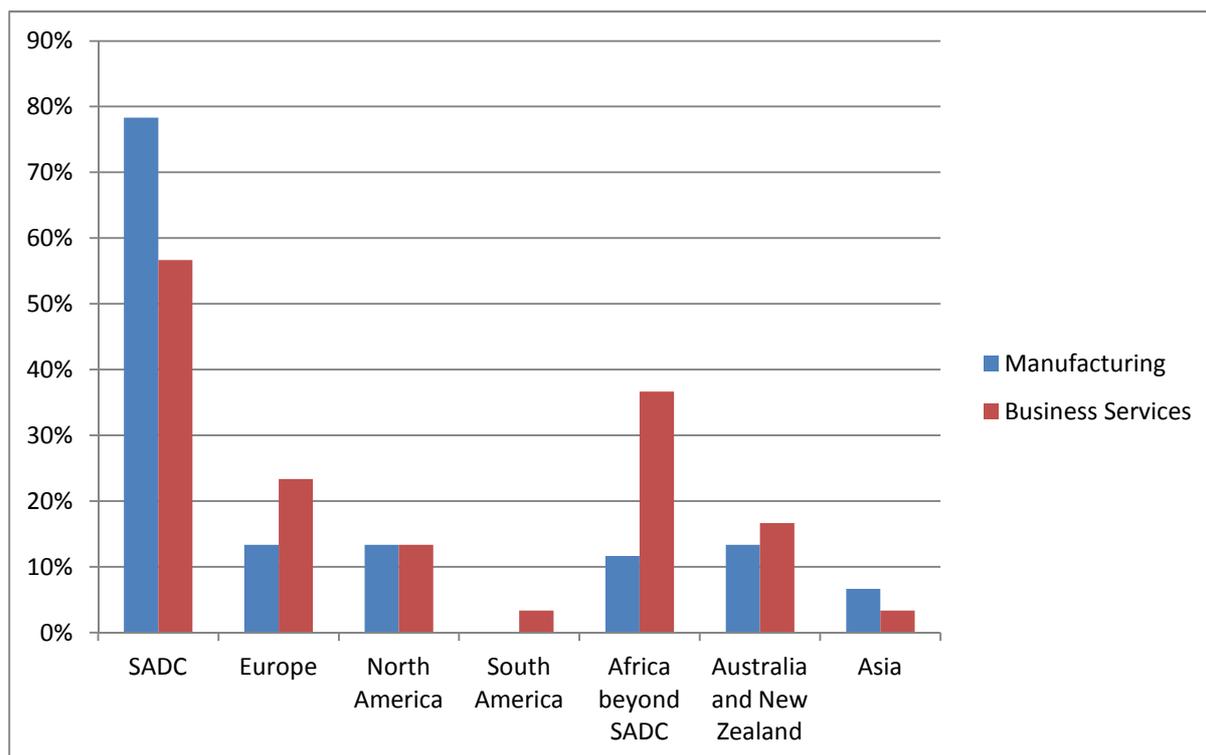
A separate but related matter to raise at this point concerns the impact of imports on SMEs. Asked about the chief factor hindering market expansion, some 10% of the Panel identified competition and imports. Among manufacturers this was more pronounced, at 15%. Although this was less of a concern than a lack of finance and demand, the potential loss of business to cheaper foreign imports was clearly a significant challenge. It was further raised in various guises by several panellists when open-ended comment was requested, typically and most strongly by manufacturers, although some business services firms also expressed concerns. There was a clear sense that imports, and specifically Chinese imports, were undercutting local suppliers. The following comment is representative: "No import regulations, the Chinese and Indian market (sic) are coming in with cheaper product in direct competition to us, but the quality is inferior". In the same vein, another remarked: "Decrease in market due to foreign imports impeding business".



Where do exports go?

The Southern African Development Community (SADC) is the most common destination for exporters. Close to 80% of manufacturers and more than half of business service firms that export do so into the region. For business services, the next most common destination is Africa beyond SADC.

Figure 9. Proportion of exporters by export destination



If exporters export to multiple regions then some regions pair commonly with others. The table below shows the most overall patterns of pairing. Exporting to SADC tends to be associated with exporting to the continent beyond the SADC region. Regions beyond Africa tend to be paired with one another. Intuitively, it appears that this may be related not just to geographical location but to the sophistication and competitiveness of South Africa's SMEs in their sectors vis-à-vis the export destinations. Thus, while Asian manufactured goods have captured an extensive market share in South Africa, those manufacturing firms that export to Asia are also associated with exports to Europe. This suggests they are fulfilling a particular, probably high-value added, "developed world" niche. These firms are most likely not struggling to mass produce white goods that countries such as China, India and Vietnam can produce more cheaply. On the other hand, business services pair their exports to SADC and Africa beyond SADC to Asia and South America. South Africa's business services sector is a sophisticated one, and in some respects is a trend setter. The services it provides may be in short supply in emerging markets, and attractive to clients there. In both cases, it is likely that



competitiveness based on quality and comparative advantage – largely ruling out economies of scale – has been key to export success.

Table 1. Most likely combination of regions to export to.

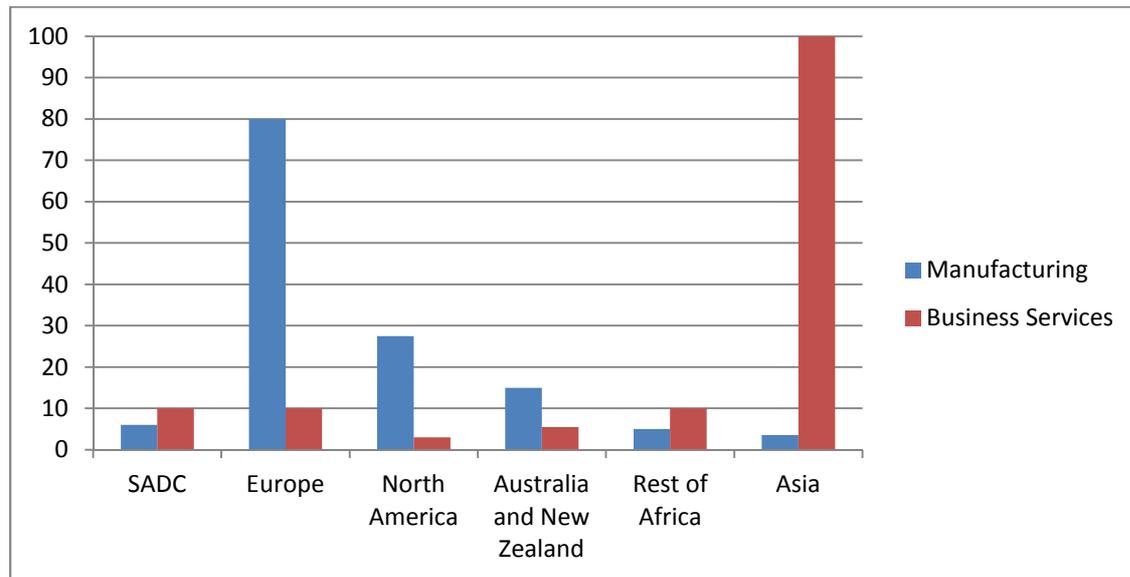
Manufacturing		Business Services	
Europe	Asia	North America	Australia/New Zealand
North America	Australia/New Zealand	Europe	North America
Europe	North America	Europe	Australia/New Zealand
SADC	Africa beyond SADC	South America	Africa beyond SADC
Asia	Australia/New Zealand	SADC	Asia
		SADC	Africa beyond SADC

Africa forms a natural expansion path for small and medium firms. The costs associated with entry into the export markets are low and many products do not require modification. These countries are increasingly familiar, as Africa has opened up to foreign business over the past 20 years. Business contacts with South African firms already operating in such countries, as well as expanding entrepreneurship and growing moneyed middle classes make these attractive markets. As one manufacturing panellist commented when discussing strategies for expansion: “People have a huge demand in Africa. Their economies are doing well. Investment into Africa is huge.”

In policy terms, these are the types of SME exporters who will create jobs. To do this requires policies which make trading within the sub-region and continent easier. The much hyped SADC free trade area (FTA) which aims for common external tariffs, simplification of rules and reductions in non-tariff barriers by 2015 should do this for Southern Africa. Better market integration and lower market fragmentation means that expanding the amount exported is easier since firms face lower costs of entry into each market. This is particularly important for SADC and the region where the median amount exported by firms in these markets is below 10%.



Figure 10. Median proportion exported by export destination



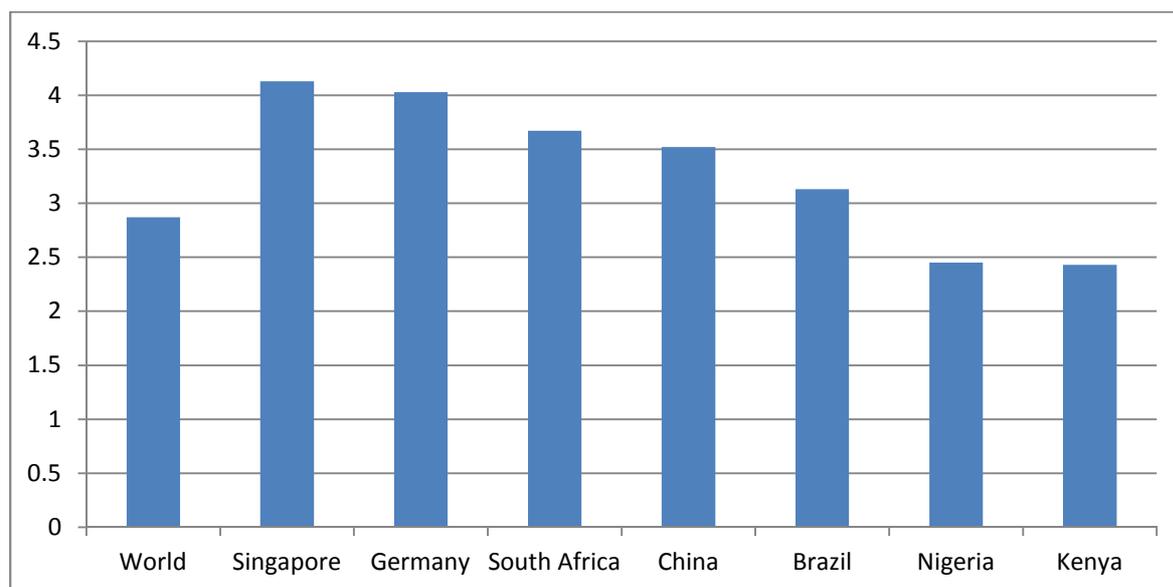
Note: the proportions here refer to the median proportion of output exported to the listed destinations by the firms exporting to them.

Improving the ability of South African based firms to engage with the outside world is a key strategic matter. Over the past decade this has received considerable attention in South Africa, both direct and oblique. Central to this has been the state of the country’s infrastructure, notably its transport network (and crucially, the efficacy of its ports), and its ICT systems – both of which were considered expensive and inadequate to underwrite a sophisticated economy like South Africa’s.

However, by International standards, South Africa’s international trade infrastructure is fairly well regarded. The Logistics Performance Index (LPI), a composite measure of various aspects of this infrastructure (ranging from 1, poorest, to 5, the best), places South Africa comfortably above the global average, as well as above that of the “BRICs”, and other African comparators.



Figure 11. Logistics Performance Index, selected countries, 2012



Note: Logistics Performance Index overall score reflects perceptions of a country's logistics based on efficiency of customs clearance process, quality of trade- and transport-related infrastructure, ease of arranging competitively priced shipments, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time. The index ranges from 1 to 5, with a higher score representing better performance.

Nevertheless, concerns about the inadequacy of South Africa's infrastructure have been recognised. Plans to spend some R1 trillion on upgrading the country's infrastructure are, in principle, to be welcomed, provided this is carried out effectively, and adequate provision is made for future maintenance and upgrading, as may be required in future. The need to address the country's infrastructural deficiencies and the costs they impose was underlined by a recent report by the Ports Regulator of South Africa. It pointed out, among other things, that National Ports Authority tariffs in Durban (South Africa's busiest port) on cargo owners was between 721% and 874% above the global average. (The difference in the percentage arises from whether rebates are considered or not, though even the lower number denotes an extraordinary cost differential.) A senior official at the Department of Trade and Industry remarked correctly that port charges "represent a very significant constraint to exports of value-added, labour intensive, tradable manufactured goods".

Aligned to the infrastructural issues are those linked to issues within the country's internal market. For example, labour unrest and the associated disruption of production can damage relationships with foreign purchasers. One panellist said: "Transport Strike directly threatened our exports, where we lost a number of clients that we cannot re-open".

Furthermore, the administration of systems (a large part of which is the regulatory environment) needs to be effective. In general, it is common cause that there is significant room for improvement in the operation of the South African state. This point has been made in the National Development



Plan, while the SME Growth Index draws attention to intense concerns about governance, and the functioning of government agencies. While problems in the administration of the state in general will likely have knock-on effects on international trade, a small number of Panellists drew attention to administrative issues specific to trade matters. These included limited hours to clear goods at customs points; corruption on the part of officials responsible for managing aspects of the import and export of goods (manifested in part in the failure to levy duties on some imports); a lack of knowledge or understanding of their tasks or the business environment; the abuse of such initiatives as BEE – there were suggestions that preferred candidates were favoured over productive entrepreneurs. Initiatives to assist businesses were not viewed favourably by those who commented on them. A business services panellist commented about the lack of government assistance in establishing links with SADC markets: “New Markets is (sic) not SA, into countries Africa where you got to have solid networks into those markets to benefit. Access to the information around those markets is a barrier. We have tried to get support from DTI but find them incredibly unhelpful, they don’t have a clue about SADC”. Another said: “Export incentive - it is a nightmare! You spend, then you fill in millions of forms to get a refund, then it stagnates and nothing happens.”

Improving infrastructure and reducing costs in trade is likely to benefit other traders too. Better infrastructure within the region also means lower transport and trading costs for imports from outside the region. South African companies, particularly in manufacturing, are thus likely to face more competition from low cost producers including China. Thus policies which facilitate trade also need to be accompanied by policies which improve competitiveness.

Where to from here?

South Africa has a great deal to gain from expanding its exports, particularly among its SMEs. The current state of play is profoundly discomfiting, since only a small part of the community is at present engaged in it. To address will require action on multiple fronts.

Firstly, those who are at present engaged in exporting should be nurtured. Access to existing markets needs to be maintained, even as new ones might open up. It must be accepted that import capable firms tend to be in the upper-size reaches of the SME community. Trying to encourage smaller firms will probably yield indifferent returns.

Secondly, the ability of firms to reach a point at which exporting becomes a real possibility will depend on their ability to build up their own competitiveness, in all likelihood, through operating in the domestic market. The state of the domestic market is therefore crucial to help firms find their feet. It remains crucial for sourcing inputs and creating products that can competitively be exported. Both the 2011 and 2012 headline reports of the SME Growth Index show the depth of concern for domestic market conditions (red tape, governance deficiencies, input costs). These cannot be



divorced from export competitiveness, and any interventions designed to encourage firms to export – no matter how well-meaning – are likely to have a limited impact if domestic conditions are dysfunctional.

In the latter respect, it should be noted that it is a reasonable assumption – taking concerns about domestic conditions and the intention to export, along with some of the comments made by the Panel, into account – that the growing interest in exporting is seen as an escape route from the South African market as well as a gateway to greater business opportunities. In other words, the difficulties of operating in South Africa are forcing some entrepreneurs to look elsewhere. It is difficult to say what the outcome of this is likely to be. There may be advantages – certainly in the short term – as exports grow. However, firms engaging in what might be termed a “necessity-based” export strategy would still probably face eroding competitiveness over the long term as their products were still exposed to problems within South Africa value chains, and came to face competition in their export markets from suppliers operating from better function home markets. Moreover, these circumstances would likely leave in place an environment which disincentivises employment in South Africa, thereby cancelling one of the key social outcomes that export competitiveness would hope for.

An opinion that emerges from the Panel – and particularly from manufacturers – is a plea for some form of protection. This appears not to be a priority, even among manufacturers: when asked to suggest what government could do to assist them, a little under 4% of the Panel suggested that government protection from import competition would be the key intervention required. However, it is an understandable request. However, even if trade protection successfully reduces imports, which is not always the case, this is a short-term solution and one that discourages companies adjusting to the competitive environment of the world economy. What might more profitably be done is for South Africa to campaign for greater market access and more equitable terms of trade. For example, while the South African government takes pride in its relationship with China, the undervaluation of the latter country’s currency places South African producers at a disadvantage. This is not a matter that South Africa appears to have taken up with any vigour.

It is crucial not to lose sight of the fact that exports are a function of the economy that produces them. There is in fact relatively little that can be done to manage recipient markets, and measures to cloister domestic industry from foreign competition are essentially palliatives, may not prove effective or desirable in the long term. Rather, it is much better to address those issues which make these South African companies less able to compete. A business environment which increases the costs of production with little benefit to companies is one key constraint. Cutting red tape, reducing input costs and encouraging companies to become more productive are all important for South African firms to become more competitive. The key conclusion from this is that if South Africa wants to increase exports and exporting thereby creating jobs then it needs to focus on policies which increase the competitiveness of firms.