TRADE & INDUSTRIAL POLICY STRATEGIES

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COVID-19 and small business finance: Lessons from the 2008 global financial crisis

INTRODUCTION

The small and medium enterprise (SME) sector is critical for the South African economy and job creation – but it is highly vulnerable to external shocks. In responding to the COVID-19 crisis there is much to learn from the experience of the 2008 global financial crisis (GFC) and the impact that the credit contraction after the GFC had on the South African economy and the SME sector. This policy brief looks at the effect of the GFC, particularly the extent of credit contraction and its impact on small businesses and job creation; and makes some recommendations on how to avoid a repeat of the same the cycle.

GLOBAL FINANCIAL CRISIS

The 2008 GFC was at its heart a banking crisis that had a knock-on impact across the globe. It resulted in a broad economic crisis, which in South Africa led to one million jobs being lost, mainly in small enterprises. The COVID-19 pandemic has different roots but is resulting in an economic and social crisis with far-reaching impact across the globe and severe implications for business survival and job losses.

The lessons from the GFC are relevant and of value in managing the current crisis, and provide insights as the country plots a way forward in a situation of extreme uncertainty.

The first observation is that the 2008 financial crisis (beyond the initial financial shock) had a huge impact on bank behaviour, particularly on credit flows, which in turn impacted on the real economy. The accepted narrative in South Africa is that we have to thank the regulatory framework, as well as the foresight of the domestic banking sector, in protecting South Africa from the worst of the impact of the GFC.

The statistics, however, tell a more complex story of the extent to which the impact of the GFC on the South African economy was magnified by the reaction of the banking sector to the crisis, with a resulting credit contraction, and the impact that this had both on consumer demand and on the business sector for many years after 2008.

The second important lesson is that specific measures and interventions are required to avoid a collapse of the small business sector and the negative impact that this will have, particularly on jobs and income flows into poor communities. Effective small business support does not relate only to credit but also to procurement, infrastructure provision, business incubators and to microenterprise support schemes. All of these require some level of attention.

The GFC saw a decline in the number of small business, the number of people employed by small business and the availability of credit to small business. The lessons from the GFC are valuable in formulating the response to the economic impact of the current COVID-19 crisis. If we do not learn from these past experiences, the same cycle may be repeated, and potentially at a much larger scale.

Apart from the direct impact of the virus, and the impact of lockdowns on incomes and consumer demand, the country has also been affected by the loss in exports, the decline in tourism, and the disruption of regional trade.

A domestic credit contraction and a collapse of the small business sector would both aggravate and prolong the direct impact of the pandemic.

Trade & Industrial Policy Strategies (TIPS) is a research organisation that facilitates policy development and dialogue across three focus areas: trade and industrial policy, inequality and economic inclusion, and sustainable growth

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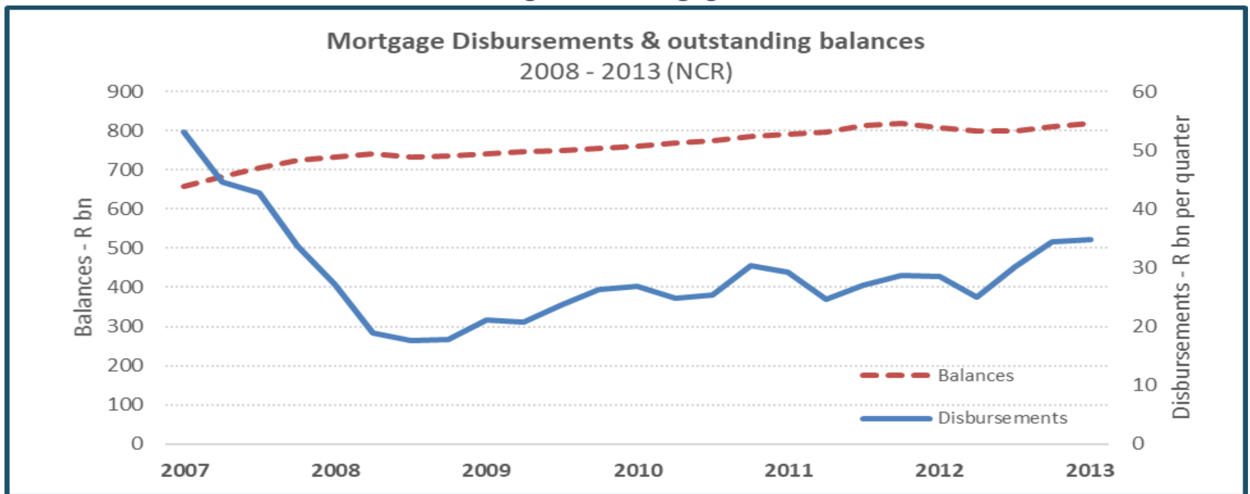
Figure 1. Mortgages



THE CREDIT CONTRACTION

Over the course of the 2008 GFC, events in the United States and Europe caused fear in the banking sector through concerns about the likely level of contagion, for instance through the impact of these external events on domestic liquidity and the risk of defaults by private and business clients affected by these external events. These fears led to a contraction in the flow of credit to the domestic economy as banks tried to shore up liquidity and reduce their exposure to the expected increased credit risk. The reduced credit flows to consumers caused a dramatic decline in domestic consumer demand, while the contraction in business credit simultaneously reduced the business sector's access to working capital and other forms of credit or finance.

The concurrent challenges faced by firms of having to deal both with sharply reduced consumer demand and the simultaneous contraction in availability of business credit had a devastating impact on the SME sector. It reduced the operational capacity of businesses (e.g. the capacity to stock up for seasonal demand or meet large orders) and undermined the capacity of business to respond to the crisis.

Due to a lack of bank finance, the normal cycle of business restructuring, with stronger businesses taking over weaker competitors or of businesses diversifying into new areas of business, could not take place. Rather, the combination of declining demand and a credit contraction exacerbated business failure and resulted in permanent job losses. The impact of these developments was still being felt between five and 10 years after 2008.

A contraction in credit access in an extended down-cycle is clearly a cause for concern. It justifies strong government action to stabilise financial flows (and consumer demand) and to protect the economy from the impact of further job losses on already vulnerable communities. These are issues that John Maynard Keynes was writing about almost a century ago against the background of two world wars and the Great Depression. South African unemployment is already at a level that competes with these extreme times, and we cannot afford policy choices that could make the position even worse.

Figure 1 and Figure 2 reflect the dramatic decline in loan disbursements after the 2008 financial crisis for mortgages and for secured credit (e.g. motor vehicle and furniture finance). In both cases, loan disbursements by banks declined dramatically and immediately, causing a general contraction in

Figure 2. Secured credit

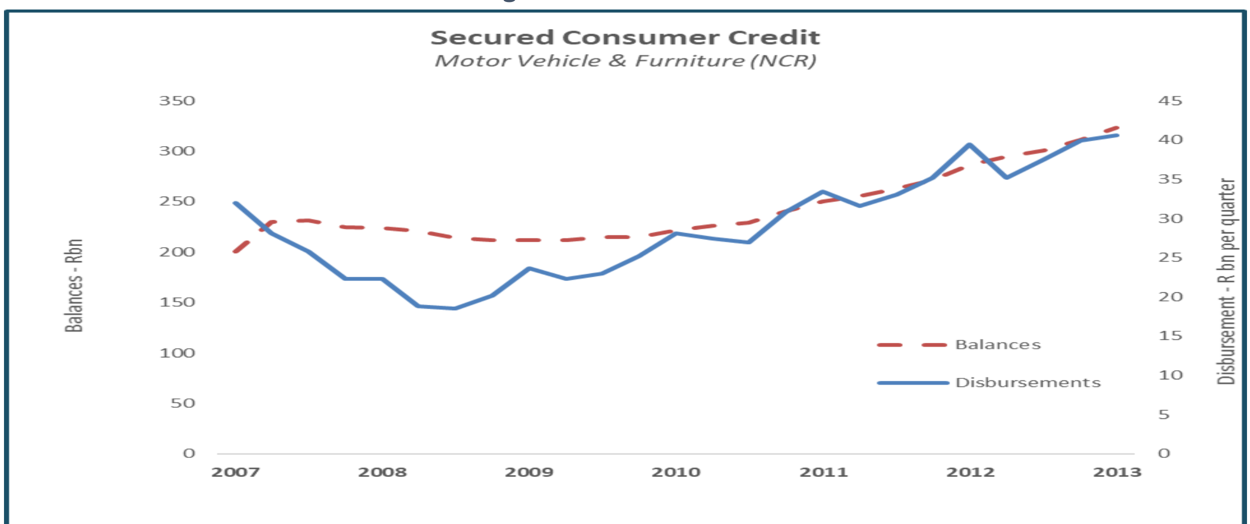
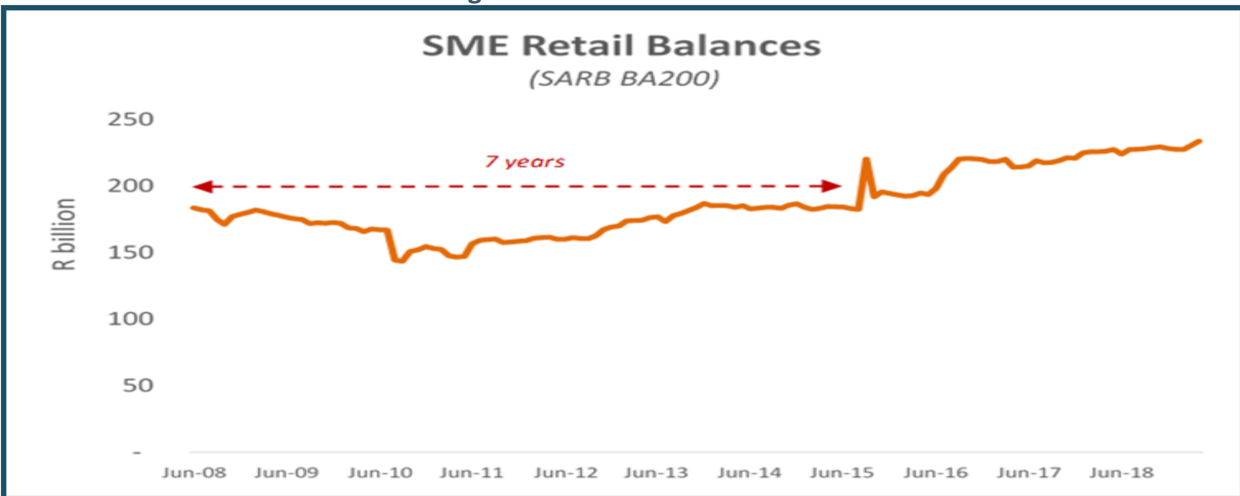


Figure 3. SME Retail balances



in demand, which became a major contributor to a reduced level of domestic economic activity. Mortgage disbursements declined by more than 60% from the pre-crisis levels to the bottom of the cycle two years later, while secured consumer credit reduced by 42%. It took four years for loan disbursements to secured credit to recover to the pre-crisis level, and much longer for mortgages. Across all categories of consumer credit the reduced flow of credit into the economy was R93 billion for 2009 and R24 billion for 2010 (compared to 2008 levels, based on National Credit Regulator published data). This implied dramatically reduced sales revenues for a broad range of businesses.

As shown in the figures, contraction in consumer credit resulted in reduced aggregate consumer demand and therefore on business sales volumes. But what about the availability of business credit?

Data on credit to the business sector are available from statistics published by the South African Reserve Bank (SARB). This data[1] paints an alarming picture.

Figure 3 illustrates the extent to which gross credit exposures to SMEs declined in the aftermath of the 2008 GFC. It took seven years before credit exposure in the SME Retail[2] segment started growing beyond the 2007 levels.

Figure 4 illustrates just how deep the contraction in SME Retail credit was, in comparison to other categories of credit. From the peak (before the 2008 GFC) until the trough at the end of 2010, SME Retail credit exposures had contracted by 20%, much more than any other category of credit. By the end of 2013, by which time SME Retail credit exposures (SME loans < R12.5 million) had only just recovered to the 2008 level, SME Corporate loans (SME loans > R12.5 million) were already up by 32% while loans to

[1] SARB publishes data on credit exposures (outstanding balances) and does not publish separate data for loan disbursements. Consequently, outstanding balances ("gross credit exposures") is used as a proxy. Credit flow data would be better and more relevant, and would also better illustrate the level of volatility and the impact on consumer demand, given that credit flows (disbursements) translates directly into consumer spending and illustrate the level of volatility much better that changes in credit stocks (outstanding balances).

[2] The SME segment consists of two sub-segments, SME Retail and SME Corporate. SME Retail are loans of up to R12.5 million, while SME Corporate are loans above this level, when the business turnover is less than R300 million. Most central banks apply a similar segmentation.

Figure 4. Contraction in credit exposures

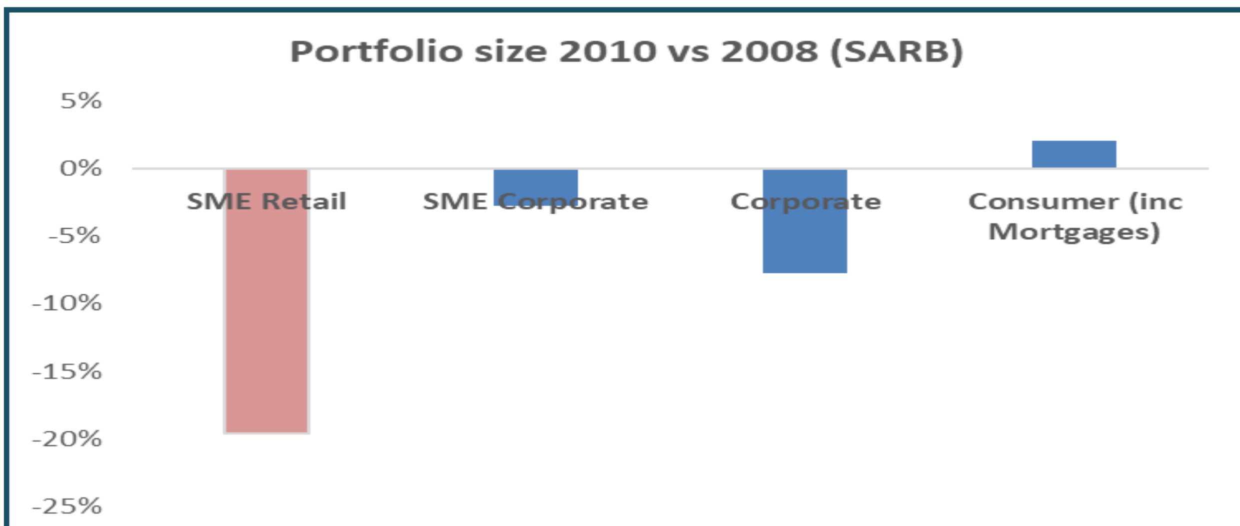
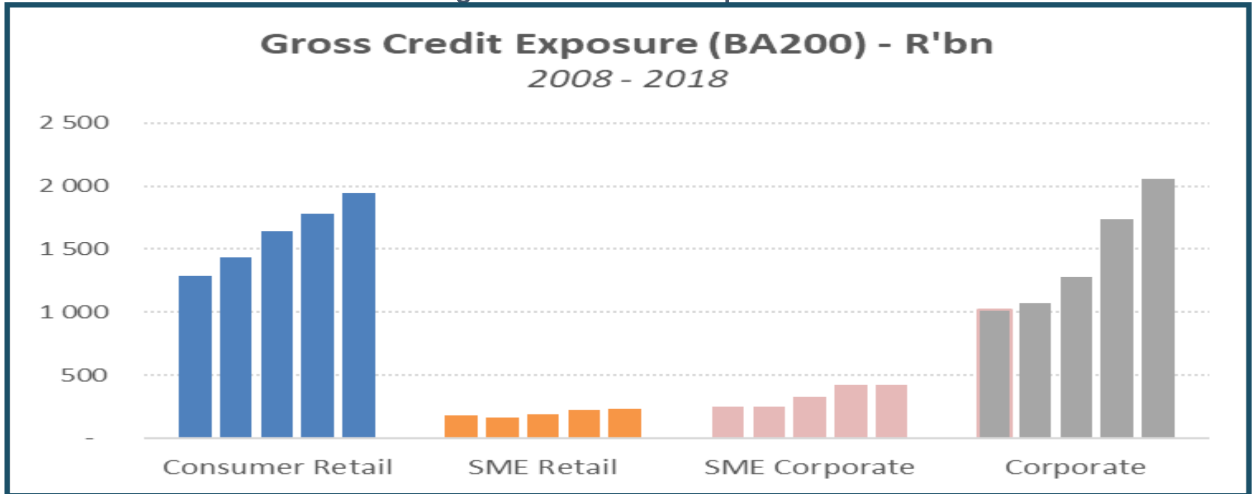


Figure 5 Gross Credit exposures



corporates were up by 21% and consumer credit exposures (including mortgages) were up by 27%.

While the underlying causes of the current COVID-19 crisis are very different from the causes of the 2008 GFC, the risk is that the same cycle of credit contraction alongside a fall in demand may be repeated, potentially much more dramatically given the extent and severity of the impact of the pandemic on both consumers and businesses.

IMPACT ON SMALL BUSINESS

In the course of the GFC, lending to the SME Retail category declined more than any other category of lending and took many more years to recover than any other category of credit. At the same time as having to deal with the external effects of the 2008 GFC, such as the decline in exports and decline in consumer demand, the sector also had to contend with a sharp contraction in availability of bank credit, reducing its capacity to respond to the crisis. The outcome was large-scale business closures and job losses. Between 2008 and 2010, 80 000 formal SMEs closed, with only 60 000 new firms emerging by 2016 (TIPS 2017). The bulk of the job losses in the aftermath of the financial crisis originated in the SME sector, which saw a collapse of 14% of formal SME jobs between 2008 and 2010.[3]

This raises serious warnings for the years ahead, given that the direct impact of the COVID-19 crisis on the real economy is that much more severe than the 2008 GFC, and early indications point to the potential of far greater numbers in business closures and job losses in South Africa than during the GFC.

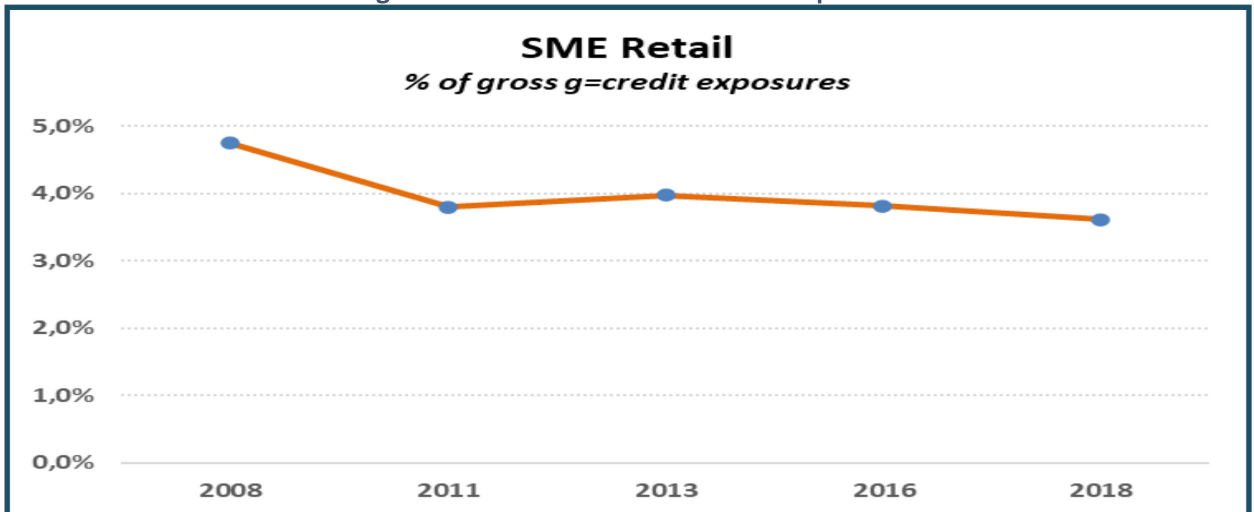
The pandemic hits at a time when small businesses were slowly starting to recover following years of stagnation (TIPS 2020). This growth took place despite the weak state of the economy and the poor track record of bank lending to small businesses. As shown in Figure 5, the portion of credit being allocated to the SME sector by South African banks has been stagnant since the 2008 GFC, placing the SME sector in a particularly weak position to deal with the impact of COVID-19.

Figure 5 and Figure 6 illustrate just how badly the SME sector has been performing in access to credit. While consumer credit and corporate credit recovered strongly after 2010, credit to the SME sector remained stagnant for more than a decade.

Over the 10 years from 2008, credit to the SME Retail segment declined from 4.7% of gross credit to 3.5% by 2019. Over the period from 2008 to 2019,

[3] *Formal small businesses in 2015: 670 000, down from 707 000 in 2008 (TIPS, 2017).*

Figure 6. SME Retail % Gross Credit exposure



consumer credit (including mortgages) grew by 5.6% a year and corporate credit by a staggering 10.8% a year, compared to 2.9% a year for the SME Retail category. After adjusting for inflation, credit available to the SME sector has been declining by nearly 4% a year over the past decade. The relative lending to small businesses, as shown in Figure 6, had also been in decline. This was the position of the SME sector before even considering the impact of COVID-19 and national lockdown.

IMPLICATIONS FOR COVID-19

The implications of the COVID-19 storm are stark. As and when the country recovers to normal levels of activity, the first priority should be the immediate financial needs of the business sector – many firms simply need funds to restart their businesses. This has been the focus of the National Treasury/SARB COVID-19 Loan Guarantee Scheme, which by the end of February 2021 had unfortunately only seen R18.01 billion in business loans approved by participating banks.

But we have to consider the risk of a "COVID-19 hangover" and the reaction of the banking sector to these events. If banks' risk perceptions result in a continued diminished appetite for lending after the end of lockdowns this will inevitably deepen the eventual downturn. One of the lessons from the 2008 GFC is that contraction in credit flows to both consumers and businesses will exacerbate and prolong the impact of the crisis and impede the ability of businesses to recover, as happened after the GFC, resulting in business closures and a further round of job losses in the SME sector.

Bankers will undoubtedly and justifiably be concerned with the level of risk in the SME sector as well as having to provide for the losses that will emanate from their current loan portfolio. Banks therefore have a strong incentive to reduce credit exposures in order to minimise the risk of future losses. Unfortunately, this response can become a self-fulfilling prophecy. It will push businesses that are on the margin into bankruptcy. It also means that the stronger businesses, which may see opportunities to expand, for instance by taking over weaker competitors, will also not be able to get finance for such transactions. Even at this early stage there are ample signs of the 2008 cycle being repeated.

RECOMMENDATIONS

This analysis highlights the risk of a credit contraction in South Africa. Constrained demand due to COVID-19, along with a contraction in credit, could result in worse economic outcomes than the pandemic itself. It is recommended that:

- Every effort should be made to collect detailed disaggregated data in order to monitor credit extension and track the recovery. The greater the awareness of the trends in credit flows, preferably at the level of loan disbursements (not only outstanding balances) at a sub-sectoral level, the better the capacity to develop appropriate policy responses. Informed and proactive engagement between regulators and industry will in itself be a stabilising factor and build confidence, allowing a smoother return to normal.
- Transform the COVID-19 SME Guarantee into an effective national SME guarantee fund. As noted in a TIPS April 2020 report, a gap remains in SME support because of the lack of an SME guarantee fund. The value of guarantee funds in facilitating finance to the SME sector and in playing a counter-cyclical role in times of stress have been demonstrated by guarantee interventions across the globe. There are good international examples of how such a fund could be structured and a well-designed guarantee fund would be of huge value in future years, as well as a powerful counter-cyclical mechanism.
- The immediate response of the regulators was focused on the banking sector. Yet non-bank lenders play an important role in providing finance to small businesses, as well as to low-income consumers and the agricultural sector. In an extended recovery phase these institutions will require a greater level of attention and support to ensure that credit reaches these high priority groups. This could include special funds to provide liquidity support to the non-bank sector or to provide funding to priority market segments. It may also require support to assist non-bank lenders in the process of "digitisation" and improving their access to the national payment infrastructure.[4]
- Small businesses are at risk when they take on additional debt in such extreme environments as present. This implies that a range of different approaches has to be considered. A significantly resourced venture capital fund, which could take some of the risk from the small and medium businesses, could play an important role, but would only be viable it if has access to a level of risk bearing funding.

[4] *CGAP (2020) provides an extensive review of the role of MFIs during the crises and areas of potential support.*

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