Moving from 'anti-development' microcredit to a 'developmental' local financial system in South Africa

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1. Introduction

It increasingly recognized around the world that an effective local financial system is a pivotal prerequisite for sustainable bottom-up local economic and industrial SME development (World Bank 2001; Guiso, Sapienza and Zingales 2004). Put very simply, a local economy requires a local financial system capable of intermediating scarce financial and other resources into the highest productivity uses. This means an ability to deliberately and efficiently channel financial resources into manufacturing-led SMEs that are capable of upgrading and generating a range of important local economic and social outcomes, including sustainable high skill jobs, technology transfer, increased product and process innovation, quality subcontracting capacity, import substitution and exports. Such a local financial system would in due course be classed as a 'developmental' local financial system (Bateman 2013a).

However, it is also widely recognized that such a 'developmental' local financial system largely does not exist in South Africa today. In fact, what has emerged instead in the post-apartheid years is almost the complete opposite: South Africa today has what has been called an 'anti-developmental' local financial system, notably characterized by the astonishing spread throughout the country of the market-driven model of microcredit. When not supporting wholly unproductive and dangerously unsustainable consumption lending (see below), the local financial system in South Africa today absorbs South Africa's scarce financial resources and intermediates this largesse into very short-term high interest rate loans suitable only for the very lowest productivity 'no-growth' informal microenterprises and self-employment ventures. As elsewhere, such as in post-Communist Eastern Europe (Hardy and Rainnie 1996: Bateman 2011), in Latin America from the 1980s onwards (IDB 2010; Bateman 2013b), in the 'non-miracle' countries of South East Asia (Bateman 2014a), and in Africa as a whole (Chang 2010: 157-167), the result in South Africa has been a calamity: an enterprise structure that imparts no long-term 'bottom-up' sustainable development impetus whatsoever, while simultaneously destroying the most important social, cultural and solidaristic pillars of South African society (Bateman 2012a)

The purpose of this paper is to begin to respond to the urgent need to reform, restructure and reconfigure the local financial system in South Africa in the direction of it becoming far more 'developmental' than at present. If substantive manufacturing-led SME development is to be anything more than a mere slogan in South Africa, then the South African government must take concrete and urgent steps to help establish a radically new pro-active local financial system. Such a local financial system would be far more capable of efficiently promoting a sustainable manufacturing-led SME development trajectory that confers benefit across the entire community, *but particularly upon its poorest constituents*, than the present local financial system in South Africa, which is primarily geared up to maximising the financial rewards attributable to a narrow stratum of CEOs and other senior managers, individual and institutional shareholders, and local and international investors.

The paper starts in Section 2 with a brief summary of the decisive role of the state in promoting sustainable development, particularly at the local level. In Section 3, I show why it is that the local financial system is so important to the development of a sustainable manufacturing-led SME sector. Section 4 briefly touches upon the post-apartheid environment in South Africa, before Section 5 goes on to highlight what I believe to be the principal obstacle to sustainable development today: the dramatic rise of the for-profit microcredit sector in South Africa since the mid-1990s. Section 6 outlines key elements in the Fashion and Textile Industry (FTI) that are receptive to the right type of policy intervention, especially financial intervention. Section 7 briefly introduces a number of important international examples where the FTI sector was amenable to policy intervention and what this might mean in the South African context. Section 8 outlines some key policy recommendations for South Africa. I conclude that it is only by actively learning from, and adapting for local use, a number of key non-neoliberal examples will South Africa's policymakers be able to create a local financial system geared up to sustainable manufacturing-led SME growth and development.

2. Background

2.1. The rediscovery of industrial policy

After more than twenty years in which the neoliberal policy agenda was imposed on governments virtually everywhere around the world, the global financial crisis that erupted in 2008 has effectively, though certainly not completely and not without resistance from those directly benefitting from it (see Mirowski 2013), brought this period of market fundamentalism to an end. Thanks to the huge amount of state intervention required after 2008 to 'save capitalism', when great swathes of the industrial and financial sector were hastily nationalized and showered with staggering amounts of emergency public funds to ward off the threat of bankruptcy, there has inevitably been a revalidation of state activism.

But much more importantly, industrial policy has reappeared as government policy this last decade or so because there is now overwhelming evidence to hand that over the longer term it actually works (Stiglitz, Lin and Monga 2013). Pioneering work by Chalmers Johnson (1980) first pointed out just how much of Japan's stunning post-war economic recovery was a result of state coordination and targeted investment, rather than the unleashing of market forces as many free market economists reflexively believed. Weiss (1988; 1998) then went on to show that similar forms of state coordination and targeted investment were responsible for the spectacular post-war recoveries in (northern) Italy and in the former West Germany, though here too many were very reluctant to openly admit what was going on.[1] And in the USA, as Block (2008) recounts, the developmental state and a very active industrial policy actually played a very central role after World War Two in elevating the country's industrial sector into a world-leading position in many technology sectors. This was also a fact that the US political establishment and business elites simply could not recognize for fear of undermining the centrality of free markets and private ownership to the ideological model that they supported.[2]

From the 1960s onwards, the enormous development success of South Korea, Taiwan, Indonesia, Malaysia, Thailand, and later China and Vietnam, confirmed in abundance the important role of the state. Even though some very high-profile free market

[1] Weiss (1998) points out that neoliberal politicians and free market economists in the former West Germany were very reluctant indeed to publicise the very significant role of the regional and local state in bringing about their "*Wirtschaftswunder*" (economic miracle). This was because of the fear that such an admission would give succour to the planned economies of the East (including the former GDR) during the long years of the Cold War, and to their ideological opponents in the western economies. Most willingly went along with the manifest falsehood that West Germany's economic success was 'all about the free market'.

[2] As Block (2008: 2) points out, 'In the United States (.) the developmental state is hidden; its existence is not recognized in political debate or in the media. Congress, under the rubric of "competitiveness policy," periodically passes legislation that bolsters and expands the developmental capacities of the U.S. state, but this happens with little public debate or discussion'.

economists initially, and yet again quite wrongly, claimed that the East Asia's successes were down to the free market,[3] more detailed analyses confirmed that the East Asian economic 'miracle' could only really be explained by reference to the deployment of a sophisticated, well-funded, multi-faceted and carefully monitored raft of state coordinated industrial policies operating under a developmental state apparatus (Amsden 1989; Wade 1990; Chang 1994; Evans 1995).

Importantly, Chang (2002) then demonstrated what he called the 'hidden history' of state pro-activity and that an efficient 'developmental state' actually stood out as the key reason why virtually all of today's rich developed economies prospered.[4] Indeed, Chang exposed the two historically most aggressive free market-oriented industrialised countries, the USA and UK, as the leading historical proponents of state pro-activity and industrial policy deployment. In these countries, strategic policy choices were deliberately, if quietly, undertaken in order to first establish, and then very aggressively maintain, global dominance in many industrial sectors and key manufacturing operations, especially those intended for export. Most recently, Mazzucato (2013) demonstrated that virtually of today's technological giants, notably the Apple Corporation, were also built on the back of technological breakthroughs financed by huge amounts of strategic public investment risked on developing 'blue skies' technologies and product and process innovations.[5] Pointedly, so as not to encourage

[3] Notably Milton Friedman famously misunderstood, or else perhaps sought to deliberately misrepresent, the origins of East Asian success, arguing quite wrongly that it was all down to textbook market dynamics and individual private entrepreneurs (Friedman and Friedman 1980). Responding to pressure from the Japanese government to register the success of the 'developmental state' model, including in Japan, the World Bank (1993) went on to willfully misrepresent and distort the evidence from East Asia's success as part of a carefully coordinated attempt to suggest, like Milton Friedman, that, after all, it was actually a success attributable to free markets and market-friendly policies (on this episode, see Wade 1996). Although the World Bank's high-profile 'Miracle Report (World Bank 1993) was immediately attacked and ultimately discredited, notably by Amsden (2004a), for some considerable time - presumably as intended - it served to stiffen the spine of many developing country policymakers and their western advisors who were beginning to lose confidence in neoliberal free market policies.

[4] Alongside, of course, colonisation, slavery, military/imperialist adventures, and other wholly unacceptable development methods.

[5] Mazzucato's book achieved significant media attention on its release because it coincided with a stream of media revelations showing that almost all of the technology giants she highlighted carefully avoided paying tax on their global operations, mainly by using offshore entities in ultra-low tax regimes as the pretend centre of operations, notably Ireland. Apple is often seen as one of the main offenders. See 'Senators accuse Apple of 'highly questionable' billion-dollar tax avoidance scheme' *The Guardian*, 21st May, 2013. http://www.theguardian.com/technology/2013/may/20/apple-accused-tax-avoidance-billions-scheme (last accessed on February 10th, 2014). This strongly suggested that the huge public subsidies that underpinned the rise of such high-profile companies, as well as the risks taken by government, actually reaped very little return for the public. See 'Google joins Apple avoiding taxes with stateless income', *Bloomberg*

industry-based competition to those countries that had successfully industrialized, Chang also shows that governments in developing countries were deliberately warned off from deploying similar state-driven industrial development policies. The two governments most involved in this effort at 'kicking away the ladder' were, inevitably, the US and UK governments.

This fundamentally revised explanation of the real, as opposed to ideologically-driven, origins of industrial development fired up by collectively engineered technological progress and state-driven and financed innovation finds it main expression in the concept of the '<u>developmental state</u>'. A developmental state can be defined as a state bureaucracy that is willing and able to pro-actively establish, guide and financially underwrite certain risky development trajectories, as well as decisive industrial research projects, in order to help create over the longer run the most productive industries, sectors and individual enterprises. However, although the developmental state and associated industrial policies underpinned so much of the progress in today's richest economies, as Chang noted, the concept first achieved real prominence in relation to East Asia's rapid development from the 1960s onwards, in the so-called 'East Asian 'miracle' economies.

But an even more important angle to consider here is provided once more by Chang (2003) who emphasizes that we need to understand that <u>without</u> an explicit industrial policy, it is actually impossible to establish a sustainable economic and industrial development trajectory. By saying this Chang accepts that not all developing countries were able to achieve long-run economic success by attempting to establish a developmental state and introducing associated industrial policies. But we must understand also that there are virtually no examples of sustainable economic and industrial success having been achieved <u>without</u> the construction of a developmental state and the deployment of a range of appropriate industrial policies. Going further, specifically with regard to the crucial role of new technology in development the late Alice Amsden (2004b) usefully added that, '*(M)ost investments in new technology, whether private or public, fail. (But) (i)f countries do not invest in technology, however, their economies will almost certainly fail too'*. In other words, there are no guarantees

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Personal Finance, May 22nd, 2013. http://www.bloomberg.com/news/2013-05-22/google-joins-apple-avoiding-taxes-with-stateless-income.html (last accessed on February 4th, 2014).

of success when a country chooses to design, implement and finance an industrial policy, but there is almost a complete guarantee of failure if a country chooses not to implement *any* form of industrial policy.

The manifest success of the rich western economies in the late 1800s and 1900s, and then the East Asian ‘miracle’ economies from the 1950s onwards, moreover, sharply contrasts with the abject failure of those developing countries that were unable or unwilling to accept the need to construct a developmental state or meaningfully deploy industrial policies. This is particularly the case in Africa, which was for a long time unable to construct robust developmental state-type structures. The main reasons for this were, on the one hand, weak bureaucratic capacity in the aftermath of decolonisation, as Lockwood (2006) notes, and, on the other, because the neoliberal-oriented international development community, especially the World Bank, strictly forbade African governments from attempting to build such important structures (George and Sabelli 1994; Harrison 2010).

Accordingly, the real policy debate this last two decades, accelerating after the events on Wall Street in 2008, has not been about whether or not industrial polices are needed in the first place, including in Africa, but how best to design, implement, monitor and continually evolve a developmental state and a sound industrial policy platform. As a result, many governments once seen as standard bearers for the neoliberal agenda are now relatively freely experimenting with a variety of new state capacities and associated industrial policies, such as in Mexico, Venezuela, Colombia, Ecuador, India and across Africa. Importantly, the neoliberal-oriented international development agencies are now coming around to the position that such interventions were, after all, important - perhaps *hugely* important - in securing development and ‘catch-up’. Notable among the recent ‘turn-abouts’ is the Inter-American Development Bank (IDB), which in a high-profile publication (IDB 2010) now advocates what it calls ‘Productive Development Policies’ (PDPs). For its part, the World Bank has also begun to allow notable heterodox economists to put forward their ideas at major gatherings specifically designed to address industrial policy issues.[6]

[6] One example would be a major conference organised in Washington DC in late 2013 attended by many of the most important heterodox economists, notably Ha-Joon Chang, Mushtaq Khan and Marianna

2.2. The important role of local industrial policy

For a long time, the developmental state concept was very much viewed through the lens of central government macro-activity and national institutions and policy interventions. However, it is often overlooked that a major part of developmental state activity, and ultimate industrial policy success, actually took place at the sub-national level, involving a range of pro-active city, municipality and regional bureaucracies and associated sub-national institutional capacities. This type of sub-national state-coordinated activity constitutes a 'local developmental state' (LDS) model (Bateman 2000). The LDS approach is particularly appropriate to the construction of a sustainable manufacturing-led SME sector. Developing countries can learn much from the developed countries' experience of promoting industrial development at the local level through the LDS approach, not least the fact that it is easier to promote and upgrade the important manufacturing-led SME sector when actually physically much closer to, or 'embedded' within, the local community. Several examples of this will suffice to illustrate the concept.

Northern Italy's stunning post-war economic success is widely attributed to locally-driven measures undertaken by both pro-active municipalities in the early post-war stages and then very pro-active regional governments from the 1970s onwards (Weiss 1988; Pyke, Becattini and Sengenberger 1990). Northern Italy was very much the pioneer in terms of enterprise development bodies operating within, and financed by, the public sector, but with extensive links into the non-state community and business sector. In particular, its 'real service' (*servizi reali*) centres were a major institutional innovation, and subsequently widely copied around the world. Probably the most famous of the Italian 'servizi reali' was ERVET. Located in Bologna, the capital city of the region of Emilia-Romagna (see below), ERVET provided critical support to the region's clusters of innovative microenterprises and SMEs, including those operating within its famous 'industrial districts'. With the 'red' government in Emilia-Romagna providing secure financial support for its operations, ERVET achieved its goal of

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Mazzucato. See '*Making Growth Happen: Implementing Policies for Competitive Industries*', October 16-17, 2013, World Bank Headquarters, Washington DC. http://www.worldbank.org/en/events/2013/10/04/conversation-with-joseph-stiglitz-and-head-of-president-obamas-council-on-jobs-and-competitiveness (last accessed on February 3rd 2014).

building a flourishing innovation-driven, growth-oriented industrial microenterprise and SME sector. Importantly, the social development impact of such policies was very positive indeed. In subsequent years, the very high levels of solidarity, equality and dignity at work generated thanks to the heavy emphasis upon the cooperative enterprise model and mutual support, meant that the region of Emilia Romagna began to regularly top European ‘Quality of Life’ surveys (Bateman 2007: 41-2).

In the Basque region of Northern Spain, a similar process of efficient local and regional government pro-activity has been documented (Cooke and Morgan 1998). Importantly, at least part of the inspiration behind the construction of this capacity was the manifest success of the famous Mondragon cooperative complex, which amply demonstrated the huge benefits of providing an integrated set of pro-active support institutions in generating and sustaining (cooperative) businesses at the technological frontier (Bateman, Girard and McIntyre 2006). Thanks to the gradual extension of the Mondragon model throughout the Basque region, similarly very high levels of equality, solidarity, dignity at work, and mutuality as in Emilia Romagna became the norm (Bateman, 2007).

Post-war West Germany also stands out as an important example of local and regional governments actively and successful promoting local industrial development. As Meyer-Stamer and Wältring (2000) have highlighted, the *Lander* (regional) and local state played a decisive role as local development catalysts that helped the country recover from its enormous war damage. In particular, this dense local institutional structure was critical to the re-emergence of the *Mittelstand* (medium enterprise sector) which, in many important respects (Simon 1996), actually lies at the heart of West Germany’s post-war economic miracle. In post-war Japan, too, David Friedman (1988) shows that the local government played a quite crucial role in pro-actively supporting an efficient technologically competent industry-based microenterprise and SME sector. These enterprises were then linked into efficient sub-contracting chains headed up by the largest Japanese industrial companies, notably in shipbuilding, electronics and automobiles. Importantly, the risk and rewards involved in these subcontracting chains were pretty equitably shared, unlike in many other countries where top-down exploitation ruled (Nishiguchi 1994).

In developing countries, the LDS model has also made a significant, though also not generally recognised, contribution to economic development. For sure, this is the case in post-Allende Chile from the 1970s onwards, where one might best arguably describe the widely trumpeted neoliberal policy-driven ‘miracle’ as a myth. This is because we can actually trace Chile’s economic success back to its core institutional and industrial policy roots at the local and regional government level. Especially important in Chile was a raft of powerful regional enterprise and technology support institutions, notably Fundación Chile and CORFO (Corporación de Fomento de la Producción de Chile), which were funded by continued state ownership of CODELCO, probably the world’s largest and most profitable copper facility (Schrank and Kurtz 2005). Elsewhere in Latin America of late, there has been a definite rise in the strategic role of local government and, broadly speaking, the importance of the LDS model (Bateman 2014b). In Asia, too, and although over-shadowed by the role of national governments in most accounts of the developmental state in action, the LDS model has actually played a crucial role in the success of many of the East Asian ‘miracle’ economies (Bateman 2000).

More recently, China’s stunning rise to economic power stands as a very strong endorsement of the LDS model (Blecher 1991). Beginning in the early 1980s in the south of the country, China’s economic success stems from the role played by local governments in promoting a completely new enterprise structure – the Township and Village Enterprise (TVE). TVEs were largely local-government-owned enterprises that were profit-seeking, operated under hard budget constraints and had to accord to strict performance targets. The TVEs began to proliferate very rapidly right from the start, and by the mid-1990s there were nearly 7.6 million industrial TVEs operating right across China (O’Connor 1998). The success of China’s LDS model is such that it is being suggested in China today that, in recognition of the importance of local (city, municipality and regional) level economic development activity, especially in the dynamic city of Shanghai, the declining ‘Washington consensus’ (neoliberalism) label might usefully be replaced by a new ‘Shanghai consensus’ label.

3. The crucial role of the local financial system in underpinning local industrial development

During the period in which the neoliberal policy agenda was globally dominant (approximately 1980-2000), developing countries were firmly instructed to leave the allocation of scarce capital resources as much as possible to markets and the private sector, which, working together, would efficiently allocate capital on the basis of maximizing private returns. In the neoliberal-oriented international development agencies, this narrow intermediation mechanism has always been seen as optimal by definition (for example, see World Bank 2002). By the same token, there was no need for any non-market or 'artificial' (i.e., state coordinated at any level) diversion of financial resources into certain types of enterprises, clusters of enterprises or sectors.

However, a pivotal aspect of the LDS model was the establishment and continual upgrading of a <u>local financial system amenable to the programmed pursuit of key local industrial policy objectives</u>. The origins of such a local financial system often differ. Some highly effective local financial systems were historically rooted in a wide variety of state initiatives and generally leftist social and political movements, notably the cooperative movement and trade unionism, such as in Germany, Italy, France, Spain and the Scandinavian countries. Elsewhere, equally effective local financial systems emerged out of a state-building and political legitimacy-seeking context, and to specifically play a role within an emerging industrial policy. Examples of this typology would include post-war Japan, South Korea, Taiwan, many parts of Latin America, Thailand, Malaysia, Indonesia, China and Vietnam.

Either way, economic history overwhelmingly points to the fact that it is possible to construct and maintain a local financial system that is able to efficiently establish, guide, encourage and cajole public and private financial resources *into* key growth-oriented industrial sectors, including the crucial manufacturing-led SME sector, and *away* from far less productive uses, such as informal microenterprises and self-employment ventures, consumption spending, speculative uses and 'capitalist consumption'. Put simply, the financial system can be designed not just to directly underpin key growth-oriented industries, sectors and enterprise clusters, but also to indirectly support the local enterprise sector by financing a wide variety of technologies and product and process innovations that, if successful, can be taken up and incorporated into marketable local outputs.

What, then, are the constituent parts of a 'developmental' local financial system? In mainstream economics, as much as in the narrower field of the study of institutions, it is always difficult to isolate cause and effect. Notwithstanding, it is possible to outline a set of core institutions and operating principles that economic history shows are generally most conducive to successfully implementing a local industrial policy.

The core function of the local financial system is to efficiently mobilize capital (e.g., through savings, taxes, government investments, etc) and channel this capital into the best possible investments. In turn, the 'right' type of enterprise to offer support to would be small, medium or large enterprises that have the following characteristics:

- formally registered and operating according to all legal requirements
- operating at or well above minimum efficient scale
- as much as possible operating on the technology frontier
- innovation and skills-driven rather than (just) low labour cost-driven
- horizontally – clusters, networks – and vertically – sub-contracting, supply chains, public procurement – productively inter-connected with other organisations
- able to continually facilitate the creation of new organisational routines and capabilities

The developmental state analysis has also helped to define the 'wrong' type of enterprises to avoid supporting, among other things in order not to waste scarce financial resources. A 'wrong' enterprise is loosely the mirror image of the 'right' enterprise, and is defined by a number of obvious characteristics,

- it is typically a simple microenterprise or one-person self-employment venture,
- it is informal
- it has no functional links to other local enterprises (subcontracting, clustering) or to the community (e.g., taxation, adherence to health and safety legislation)
- it operates below minimum efficient scale,
- it is low/no technology-based,
- it is driven more by low wages rather than innovation or skills upgrading,

- it has almost no concern for the environment,
- it is very often petty trade-based.

An optimum financial system is therefore increasingly widely seen as one that can most efficiently channel sufficient capital through to the ‘right’ enterprises while avoiding support for the ‘wrong’ enterprises (on this, see also King and Levine 1993; Levine 2005). And, indeed, many localities have evolved an approximation to just such an efficient local financial system.

It is widely accepted that in many parts of Europe, notably in post-war West Germany, France, Italy, Switzerland, and the Scandinavian states, as well in the USA and as post-war Japan, that local community-owned and controlled financial institutions have played an absolutely pivotal role in local economic and industrial success. By ‘community-owned and controlled’ we mean here a dense local network of cooperative banks, savings banks, credit unions and other financial institutions that actually constituted the mainstay of many local financial systems in what we might call pre-neoliberal times. Some of these local financial institutions were constituted as not-for-profit, such as credit unions, but probably more of these institutions were structured as for-profit. The crucial point here is that the operating modality in these historic examples always reflected an overall aim of promoting long-term local development above all short-term profit considerations. Financial self-sufficiency and profitability (or surplus) was often important in order to ensure the institution’s survival and gradual growth via reinvestment, but profit was the means to a greater end, not the end itself (as in so many financial institutions operating during the neoliberal period).

The actual institutions that are of much importance here are, first, well-functioning financial cooperatives and cooperative banks. From the mid-1800s onwards, such financial institutions were typically established by individual social reformers, but then accorded legitimacy within the community once it was seen that it would operate to the benefit of that community. Examples include the cooperative banks of northern Italy, which, once recapitalised and restructured after 1945, went on to play a very decisive role in rebuilding Northern Italy’s SME-based industrial sector (Goglio and Alexopoulos, 2011). In particular, important lessons can be learned from the northern

Italian region of Emilia Romagna. This was a once poor region that began to flourish in the post-war era largely thanks to patient cooperative bank support for a manufacturing-led SME development trajectory that built upon the region's largely destroyed military-industrial complex (Capecchi, 1990). Serving the SME sector at the local level are the German savings banks (*sparkasse*), which have been very successful in promoting a bottom-up industrial development trajectory (Hakenes *et al*. 2014).

Spain provides two important examples here: one famous, and the other much less so. The first is located in the Basque region of northern Spain. The *Caja Laboral Popular* (CLP) attached to the famous Mondragon Cooperative Complex has proved over 50 or more years to be a very successful promoter of manufacturing-based cooperative enterprises (Bateman, Girard and MacIntyre 2006). Such is its diligence, as well as the quality of technical support, worker training and business planning, that the CLP has only ever had to deal with a handful of failed cooperative enterprises in its entire existence. As Ellerman (1982) concludes, the CLP's long-term loans and other financial support measures effectively laid the basis for an entire regional economy based on local manufacturing and innovation.

The other less recognized example from Spain is *Cajamar*. Located in Almeria Province in the south of Spain, *Cajamar*, is today the largest cooperative bank in Spain. Its importance is that it served as the core driving force behind a local economic development success story that, very much like in the Basque country, turned a once-dirt poor backwater and Spain's poorest region into one of Spain's (and Europe's) richest and most productive regions. The 'Almeria Model' that has been carefully distilled from this experience (Giagnocavo, Fernandez-Revuelta Pérez and Uclés Aguilera. 2012) is based around Cajamar's self-appointed active role in local economic and community development (felt necessary since most local government capacity was destroyed by the civil war) and, in particular, its patient support for clusters of agro-industrial SMEs serving an increasingly intensive agricultural sector. In addition, as Cajamar's own capacity developed, it was able to become a constant source of further social innovation, technology acquisition and transfer, and other forms of social and economic development. Giagnocavo, Fernandez-Revuelta Pérez and Uclés Aguilera (2012: 107) conclude their summary of Cajamar's contribution as one where, 'a cooperative bank, in concert with the cooperative movement, (.) was able to con-construct an economically stable community through sustainable innovation'.

Alongside cooperative banks formed by civil society, many state-directed local financial institutions can play an important role within a 'developmental' local financial system. Once again after 1945 in Europe, many countries attempted to reconstruct through a variety of local state-coordinated financial institutions. These were established with the specific intention that they would underpin newly formulated local industrial policies that were being pushed through by newly elected local and regional governments. In post-war West Germany, this meant the *Landesbanken*, or regional state-owned banks, which were established to provide low cost funds to the famous *Mittelstand* (medium sized industrial enterprises). In Northern Italy, this meant the state-owned but locally operated Special Credit Institutes (SCIs) that, as Weiss (1988) carefully documents, very successfully provided large quantities of affordable financial support (10 year loans at low interest rates) for machinery purchase and workshop modernisation. In post-war Japan, Friedman (1988) shows that the local state was heavily involved in establishing networks of municipal banks and special funds attached to local governments.

East Asia's rise to dominance from the 1960s onwards is very much attributable to a range of sophisticated financial intermediation policies, especially involving state development banks (Chang 2006). Newly 'de-landlordised' farmer-owned credit cooperatives were important in South Korea in facilitating successful rural agricultural sector reconstruction in the immediate post civil war period. Later on, eight government funds and a credit guarantee scheme, among other financial interventions, combined to establish a very effective industrial SME development trend (Leipziger and Petri 1993), one that turned out to be especially decisive in building quality subcontracting capacity that could serve the large family-owned enterprises (*chaebols*). Elsewhere in Taiwan, Thailand, Malaysia and Indonesia, local branches of state-owned development banks successfully facilitated rural industrialisation and also, later on, industrial SME development through manufacturing-led SMEs (Wade 1990: Meyanathan 1994).

Learning much from these earlier successful examples, China supported its important TVE sector through newly established rafts of urban and rural credit cooperatives

(UCCs and RCCs) set up and largely controlled by local governments (Girardin and Ping 1997). Importantly, the RCCs and UCCs were incorporated into local development plans, and so both could receive additional core funding and other forms of support from local government. Local government ownership also gave local savers the confidence necessary to mobilize sufficient local savings (for example, local people knew their savings would not be wasted supporting heavy ‘rustbelt’ industries in the north of China). A little later, Vietnam closely followed China’s model and established a similar very sophisticated set of local financial institutions under local government control and oversight, which also proved capable of successfully supporting rural industrialisation and industrial SME development (Bateman 2010a: 191-198).

In Latin America from the 1950s onwards, and in spite of some obvious limitations, state bureaucracies nevertheless proved vital in providing financial support to numerous industries and smaller suppliers through its Import Substitution Industrialisation (ISI) policies (Amsden 2004b). Brazil’s state development bank, BNEDES, has almost uniquely provided the driving force behind that country’s recent economic miracle. It did this by judiciously supporting key large enterprises (famously such as the aircraft maker Embraer), but also the SME sector, both directly with affordable loans and indirectly through the very extensive use of local content agreements attached to its large company investments.

A third constituent part of a ‘developmental’ local financial system is the private banking sector. Here we generally mean private, often family owned, banks that are embedded within a mix of dense regulations and societal/community obligations. Unlike the majority of profit-maximising banks, the banks we are talking about here have often provided an impetus and incentive structure to efficiently support local economic development for reasons other than just pure profit-maximisation. Once again in northern Italy, the big pre-war commercial banks had little interest directly assisting the post-war reconstruction process, preferring instead to use what resources they had to underpin the hugely profitable post-war business in importing consumer goods for middle and upper class Italian consumers. However, smaller private banks in communities to which they felt an obligation were much more willing to support the reconstruction of the local industrial and agricultural sectors, offering low cost loans, grace periods and other benefits to ensure that projects supported had the best chance of success.

This very positive process of embedded local obligation and horizontal mutual support structures has been described by Becattini (1990) as the ‘theory of the local bank’. This insight was useful in helping to explain why the local financial system in northern Italy was such a positive factor in local economic development compared to its counterpart in southern Italy, where the local financial system was embedded within vertical patronage (and often criminal) networks which engendered very little trust, reciprocity and mutual support structures (on this, see also Putnam 1993).

Overall, therefore, a ‘developmental’ local financial system generally involves an evolving mixture of cooperative, local state-owned/controlled and community-oriented (rather than [just] profit maximizing) private financial institutions that develop a way of working together in order to promote key local industrial development goals through the programmed expansion of the SME sector. The precise arrangements governing the operation and coordination of these local financial institutions will be dependent upon an individual locality’s and country’s own history, economic structure, balance of class forces, international relations, and other idiosyncratic factors. But the general recipe here is to mobilise funds and socialise the risk involved in providing long-term affordable financial support to the ‘right’ industrial and agro-industrial SME enterprises and, it must be emphasised, which the market on its own would not otherwise provide.

4. The post-apartheid era of development in South Africa

4.1. The legacy of apartheid

Growing global antipathy to the apartheid regime meant that from the early 1960s onwards the South African economy was increasingly isolated and unable to freely import particular goods, inputs and technologies. This was especially the case if the end use of these goods was military-related. In order to preserve white minority rule against both internal and external threats, the South African government was thus forced into adopting a number of heterodox economic policy steps to ensure self-sufficiency in a number of areas, such as armaments, food, engineering, and so on.

The armaments sector received the most attention of policymakers. At the centre of this strategy was a large, state-owned defense industry centred on a large state-owned procurement and production company, Armscor. Built up around Armscor was a support structure for SME development that combined international technology acquisition and transfer, support for local innovation, willingness to establish state-owned SMEs in cutting edge technologies, advanced training and education, support for the provision of world-leading industrial R&D facilities, and extensive networking among the SME sector and between SMEs and large industries that was coordinated and facilitated by state bodies. Crucially, the financial sector was carefully coordinated to provide sufficient financial support to key SMEs on very affordable terms and maturities and to ensure that it was used in the manner to which it was intended. In effect, South Africa’s peculiar history under apartheid effectively meant that it had to adopt a quasi-developmental state approach towards the manufacturing-led SME sector. The result was that the South African government succeeded in building up one of the most advanced armaments sectors in the developing world (Dunne 2006).

Operating alongside the military-industrial complex was a network of large industrial plants under both state and private ownership associated with the production of a range of core consumer goods, such as food, motor vehicles, white goods and construction materials, as well as important infrastructure, such as electricity, roads and highways, ports, and so on. Here also the South African state took an active role in ensuring that a relatively advanced manufacturing-based SME sector would emerge to productively subcontract to such industries and to substitute for imports that were increasingly denied to the South African economy.

In terms of the majority black population, the situation was, of course, radically different. The initial approach after the establishment of apartheid in 1948 was to brutally suppress all forms of independent entrepreneurial activity in the black communities. Anything other than simple informal microenterprises was generally not tolerated, and certainly not financed with the help of state or other resources. For much of the apartheid era the black community was prohibited from ownership of formal SMEs (Department of Trade and Industry 2008:26). This strict stance changed in the late apartheid period, however, when the apartheid government was persuaded that there was a better and more subtle strategic option. Accelerated development of the informal microenterprise sector would never present a threat to white-owned businesses, but enhanced entrepreneurial opportunities just might convince a section of the black population to forget about trying to overthrow the white regime and bring about the end of apartheid (Smith 1992). The hope was that enough of the black population, including intelligent and charismatic individuals who might otherwise become future leaders of the anti-apartheid struggle, would chose to seek economic salvation *individually* through micro-entrepreneurship, and not *collectively* through social mobilization, revolutionary organizing and bringing about the end of the apartheid system.[7]

Precisely to serve those in the black community wishing to engage in petty entrepreneurial activities, greater freedom was thus given to a wider range of local financial institutions to operate alongside the traditional burial societies, ROSCAs[8] and *mashionisas*. This included a number of proto-microfinance institutions, including some operated by white-run NGOs, which effectively served as the foundations upon which South Africa's current microcredit sector was built. The result under late apartheid was thus a growth in the informal sector involving the black community.

4.2. The turn to neoliberalism

South Africa's post-apartheid era happened to coincide with the continuing rise of global neoliberalism as a political and economic policy program. It was inevitable, therefore, that South Africa's newly elected ANC government under President Nelson Mandela would come under intense pressure to abandon its earlier long-standing pledge to adopt a radical plan-driven approach to post-apartheid reconstruction and development. And, indeed, this is exactly what came to pass. After initially vowing to retain public ownership and a major role for the state, the new ANC government signed up to a World Bank-drafted package of neoliberal reforms that, among other things, envisaged a sharply reduced role for the state (Bond 2004).

[7] The inspiration, if not advice, behind this move came from the US government's violent suppression of labour and church-based based movements in Latin America, especially the 'liberation theology' movement associated with the local Catholic Church. When this proved unsuccessful, a new 'soft power' strategy was adopted that hoped to co-opt certain sections of the poor through microcredit-supported informal microenterprise activity (Bateman 2014a).
[8] Rotating Savings and Credit Associations.

In the military-industrial complex, the role of Armscor (renamed Denel) was fundamentally changed as the South African government adopted a strategy of sourcing (once again) from the largest military suppliers based in the USA and UK. Denel was forced to cast-off much of its manufacturing activity in favour of building links as a sub-contractor and supplier to the major military suppliers. Offset agreements were used to try to guarantee Denel subcontracting work on any major purchase agreed by the South African government with an international military supplier. But any plan to use Denel as the core of a major arms conversion program that might give rise to a major technology-intensive SME sector, such as in the famous regional example of Emilia-Romagna in Italy after 1945 (Capecchi 1990), was largely off the table.

Elsewhere in the economy, and in spite of its obvious success in promoting a particular narrow aim (white minority control), the state in the post-apartheid era was now reflexively described as 'inefficient' and powerless in the face of market forces, and certainly incapable of piloting the post-apartheid economy along a sustainable development trajectory. The result was that the accelerated market-driven expansion of the informal economy became the South African government's de facto strategy in order to create employment for the poor black majority (Jordhus-Lier 2010).

4.3. The rediscovery of local industrial policy in South Africa

The importance of pro-active local industrial policies that can identify, establish and upgrade key manufacturing-led SMEs was immediately recognized in South African policy circles in the aftermath of the apartheid era. For the most part this is because the manufacturing-led SME sector can play a pivotal role in creating sustainable forms of employment that raise the average level of enterprise productivity and technology intensity, which were issues that South African policymakers urgently needed to deal with at the time (Department of Trade and Industry 2002).

Others have pointed to the fact that manufacturing-led SME development can also address the very high levels of unemployment, as well as inequality, poverty and exclusion that persisted into the post-apartheid era (Pollin, Epstein, Heintz and Ndikumana 2007). Rising unemployment since the end of apartheid is widely identified as one of the most damaging features of the post-apartheid neoliberal policy. Between 1995 and 2004, the number of individuals unemployed rose from 4.2 million to 8.1 million on the widest definition of unemployment, or 2 million to 4.1 million on the narrow definition. Only the former communist countries of Eastern Europe come close to matching such stark figures.[9]

Almost since the end of apartheid, therefore, the international development community has financed major programs on local economic development and associated job creation programs in South Africa. The EU and the UK government's aid arm, DFID, have been particularly active in establishing and promoting local business institutions and policy-making capacities in local and regional government. However, although some progress has been registered here, it is in the area of the local financial system where the South African economy is perhaps least suitable for supporting such important local industrial development initiatives, as the next section will outline.

5. The destructive rise of microcredit in post-apartheid South Africa

5.1. Background

The redesign of the local financial system in post-apartheid South Africa was undertaken with the aim to establish a flourishing manufacturing-based SME sector. In turn, this was expected to create a broad-based inclusive recovery built around sustainable new industrial jobs, increased average incomes, greater use of new technologies and (so) rising productivity, and progress towards greater social inclusion and equality (World Bank 2011). In particular, it was recognised that South Africa cannot develop upon a foundation of informal microenterprises and self-employment ventures. Not only does economic history show quite clearly that the vast bulk of productive formal SMEs do <u>not</u> have their origins in the informal microenterprise sector (La Porta and Schliefer 2008), but also, for a number of reasons, an expanding informal microenterprise and self-employment venture sector actually frustrates and blocks the

[9] For example, Bosnia today has an official unemployment rate of nearly 44%, a depressing statistic that is being held up today as the principal reason for the recent outbreak of violence right across the country. See 'Street violence flares in Bosnian protests', *Financial Times*, February 7th, 2014. http://www.ft.com/intl/cms/s/0/2a70d05a-902e-11e3-a776-00144feab7de.html#axzz2tZrLw1IE

upgrading and expansion of the crucial manufacturing-led SME sector (Bateman 2010a, 2013a, 2013b: IDB 2010; Bateman and Chang 2012; Chang 2010: 157-167).

However, with the neoliberal project in its ascendance in the 1990s, the guiding operational and strategic principles that underpinned the redesign of all local institutions in South Africa were very much drawn from the standard neoliberal financial model (McDonald and Smith 2004). This involved a very important, if not primary, capital allocation role for the private commercial banking system. This created a major problem, however, because for-profit private financial institutions are free to pursue their own strategic profit-maximising goals, even if this means channelling South Africa's scarce financial resources into largely unproductive informal microenterprises and self-employment ventures. Given the limited impact of such enterprises in comparison to manufacturing-led SME sector, as just noted, this clearly amounts to an adverse 'anti-development' trajectory.

Perhaps the most dramatic manifestation of this adverse 'anti-development' trajectory in South Africa involves the meteoric rise of the microcredit sector. Even though the African continent has a long history of community-based and for-profit finance (Shipton 2010), the commercialised microcredit model that was brought to South Africa in the late 1990s was a radically new way of doing things. Numerous international development community microcredit programs began to arrive in post-apartheid South Africa, while the South African government itself was encouraged to support a number of microcredit programs of its own. Local and international commercial banks and dedicated microcredit banks also began to provide massive volumes of microcredit to the poorest. The supply of microcredit thus began to rise very fast.

Initially, this mere outreach factor was cause for huge celebration, and the international development community was praised for its contribution. Many analysts, some with quite stunning naivety (the defining example of this is Moyo 2009),[10] began to present

[10] Apart from misunderstanding the microcredit model and its history (Bateman 2010: 96-99), Moyo's (2009: 129) specific account of the supposed development impact of microcredit is riddled with logical flaws and naïve suppositions. Her rendition of the development impetus given by microcredit, for example, starts from an example from her native Zambia, where she invites the reader to, "Think of a woman selling tomatoes on a side street. …[T]his group – the real entrepreneurs, *the backbone of Zambia's economic future* – need capital just as much as the mining company" (my italics). There is no

microcredit as the perfect solution to South Africa's post-apartheid problems, and also as the answer to the wider issue of under-development and unemployment across the entire African continent. The South African government was also lauded for its apparent determination to ensure that black South Africans now had very easy access to microcredit.

However, it soon became clear that the introduction of microcredit in South Africa was a very serious misstep. First, no evidence transpired to confirm any sustained progress in terms of poverty reduction and NET job creation in the black communities and rural areas. Second, the massive profits soon being generated by so many microcredit institutions (hereafter MCIs), commercial banks and other financial intermediaries began to increase inequality and destroy the social fabric. Third, such fantastic rewards stood in stark contrast to the mass over-indebtedness that gradually became a part of everyday life in the black communities from 1994 onwards. One of the main problems here - recognized early on by many microcredit advocates but largely ignored – was the fact that most of the microcredit was supplied to already employed individuals to meet consumption spending needs (Meagher 2002), not to those with an idea for an income-generating project.

Recognizing that it had better do something to seriously regulate the microcredit sector before it entirely exploded, in 2007 the South African government passed the National Credit ACT (NCA). A National Credit Register (NCR) was also set up. Both acts brought a little more transparency, discipline, accountability and fairness into what was an increasingly usurious and out-of-control microcredit market. Nonetheless, any gains from the NCA were short-lived. Profit-hungry MCIs, notably Capitec (see below), had entered the market seeing a major profit-making opportunity in the form of unsecured microcredit, which by the end of the 2000s they were supplying in massive volumes. A major new cycle of expansion in the microcredit market in South Africa thus began. Once again, this latest expansion was hailed as the solution to South Africa's problems;

apparent understanding of the importance of job displacement and enterprise exit, both of which are very high in Africa (Bateman 2010: 63-73; Page and Söderbom 2012 – see also below), and which together result in there being no NET job creation in to the medium to longer term. More fundamentally, Moyo is completely unable to specificy an actual mechanism by which more and more tomoto sellers will aggregate into a development trajectory. Nor is there any reference to the fact that there is simply no economic history to confirm from anywhere that expanding the scope and scale of such simple economic activities might be a suitable foundation for sustainable economic development.

this time, though, the argument was couched not in terms of the now somewhat out-moded and wholly inaccurate notion of 'promoting poverty reduction', but in terms of resolving what is being described as the new and even more pressing problem facing poor communities - 'financial inclusion'.[11]

By 2010, however, thanks to this latest dramatic growth spurt, South Africa's microcredit sector was plunged into deep crisis. Nearly half of the 19 million credit active consumers in South Africa were described as having 'impaired' credit records (meaning they are three or more months in arrears), while a further 15% were described as 'debt-stressed' (meaning they are one or two months in arrears). This translated into more than 11 million (more than 60%) of all credit active consumers in South Africa being defined as over-indebted.[12] South African household debt now amounts to around 75% of disposable income.[13] As one investor finally conceded after reluctantly ending his company's support for highly profitable microcredit investments in South Africa, [14]

> 'The industry seems to be pumping debt down peoples' throats. It is no longer socially responsible and does not belong in developmental funds (.) The fundamentals are blown and the business model is unsustainable; 70% to 80% of 'new business' is to existing clients. So the trick is to keep them on an indefinite treadmill, always reoffering them a new loan, or reschedule but by lengthening the term to reduce the instalment'

Bombarded with microcredit in such a way that they simply cannot repay even a fraction of what they owe, with some estimates that up to 40% of the South African workforce's income is spent on repaying debt.[15] South Africa's poor are today caught in a microdebt-trap of quite unimaginable proportions.

5.2. The microcredit model proves to be an 'anti-development' trap

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[11] Financial inclusion has been defined as, 'A state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers. "Effective access" involves convenient and responsible service delivery, at a cost affordable to the customer and sustainable for the provider, with the result that financially excluded customers use formal financial services rather than existing informal options'. (CGAP, 2011: 1).

[12] See Mandy de Waal, 'Debt traps, the silent killers of the SA's vulnerable', *Daily Maverick*, 7th August, 2012. (last accessed on October 14th 2012).

[13] See http://www.fin24.com/Money/Drowing-in-debt-20120323 (last accessed on November 20th, 2013).

[14] See 'New blow for micro-lenders', BD Live, October 6th, 2013. http://www.bdlive.co.za/business/financial/2013/10/06/new-blow-for-microlenders (last accessed on November 4th, 2013).

[15]See http://www.moneyweb.co.za/moneyweb-financial/garnishees-exploit-all-south-africans--webber-went (last accessed on November 20th, 2013).

The legitimacy of the microcredit model is facing an unprecedented challenge almost everywhere around the world (Bateman 2010a), no more so than in South Africa (Stewart *et al*. 2011: Bond 2013). There are at least four key generic problems that emerged in post-apartheid South Africa.

First, while the microcredit model exists on paper to support income-generating activities, in South African practice it has emerged since 1994 as very much more about supporting simple consumption spending needs. A large number of MCIs emerged that could deal with the obvious risks of consumption lending activity and make considerable sums of money. This new raft of institutions was made up of many private commercial banks 'downscaling' into microcredit, plus a surprisingly large number of white government officials eased out of their positions after apartheid ended in 1994 and setting up as micro-lenders (James 2012). The initial client group was mainly composed of the upwardly mobile, ambitious and already employed black middle classes. After 2007 and the passing of the National Credit Act, however, the client group changed to include those in the much poorer black communities already in debt and coping with grinding poverty. Nonetheless, it was still possible to make a lot of money from virtually any individual client thanks to such techniques as obtaining a garnishee order on a client's salary. By 2012, as little as 6% of the total volume of microcredit advanced in that year was actually used for business purposes.[16]

Second, the very small percentage of microcredit that actually does go into supporting income-generating microenterprises, as per the original model, has almost zero development impact. The income-generating activities that emerged thanks to the increasing supply of microcredit are *not* the drivers of sustainable development and poverty reduction. In fact, the main impact here was a negative one: the microcredit–induced entry of new informal microenterprises and self-employment ventures after 1994, and the obvious increase in competition and 'double whammy' of a softening in prices and a reduction in the average turnover per unit, imparted very significant downward pressure on the average financial returns per business unit in many sectors.

[16] See 'South Africa: Microfinance And Poverty Alleviation In South Africa'. *Mondaq*, 11th November 2013. http://www.mondaq.com/x/274240/Microfinance+And+Poverty+Alleviation+In+South+Africa (last accessed on November 16th, 2013.

Partly as a result, between 1997 and 2003 self-employment incomes fell by an astounding 11% per annum in real terms (Kingdon and Knight 2005). As elsewhere across Africa (Page and Söderbom 2012), and in the US and western European countries as well (Bateman 2012b; Nightingale and Coad 2014), high microenterprise entry rates are almost entirely cancelled out by equally high rates of local job displacement and microenterprise exit, resulting in nothing more than a local 'job churn' effect and so – crucially - *no NET local employment creation*. Going further in this vein, Cohen (2012) reported on the difficulties caused by larger numbers of petty retailers competing with each other for a stable or declining level of business, with few able to make any real inroads in terms of increasing income or employment. Even worse, given the already tense inter-ethnic and community relations in South Africa, is the fact that social tensions have been greatly exacerbated thanks to the hyper-competition that now prevails in the poorest communities. Ethnically motivated business turf wars are one of the inevitable results.[17]

Third, the dramatic rise of the microcredit sector in South Africa is very much related to the opportunities afforded by the extensive commercialisation introduced into the global microcredit industry in the 1990s. This measure was taken in order to make the microcredit industry financially self-sustaining, and less dependent upon donor and government subsidies to function (Bateman 2010a). As elsewhere, however, far too many high-profile microcredit supporters and policymakers in South Africa naively bought into the myth of the free market, including its particular aversion towards robust regulation. The belief inevitably emerged that the newly commercialized MFIs would dutifully stick to their mission statement and responsibly lend to the poor. This ideologically-driven assumption proved to be spectacularly wrong. In fact the real aim of the private banks and MFIs was not so much to help their poor clients, as to extract as much value from them in the shortest time possible before exiting the sector and moving on to other fields of business. Apart from making a large number of the poor poorer through over-indebtedness and collateral losses, one of the most destructive results of the commercialisation drive and inevitable profiteering was that already low levels of trust and social cohesion in the immediate post-apartheid period were blown

[17] See 'Analysis: The ugly truth behind SA's xenophobic violence'. *The Daily Maverick*, 28th May, 2013. http://www.dailymaverick.co.za/article/2013-05-28-analysis-the-ugly-truth-behind-sas-xenophobic-violence/#.UnAFdyVwa1s (last accessed on November 10th, 2013).

apart even further. Many previously dedicated social investors now openly admit that the microcredit sector in South Africa has entirely lost sight of its original poverty reduction and 'bottom-up' development goals.[18]

The fourth, and perhaps most serious, problem with microcredit in South Africa relates to its deleterious effect on the longer-run chances of there being a sustainable local economic and social development trajectory. As I pointed out above, it is well established in both theory and practice that formal SMEs are a far more powerful force behind productivity growth and sustainable poverty-reducing development than informal microenterprises and self-employment ventures (Baumol 1990; Chang 2007; IDB 2010). Moreover, the microcredit-induced expansion of the informal sector all too often serves to undermine the sustainable development of the formal SME sector, because it can divert valuable demand (albeit just temporarily) away from more productive businesses that would otherwise be able to operate at a more efficient scale of operations (Vargas 2012). The informal sector can do this not because it is more competitive in the positive ('high-road') sense, but because it is able to pay subsistence wages, avoid any tax responsibilities, demonstrate no concern for safe working conditions, and so on (the 'low road').

It is therefore of considerable importance to South Africa that its microcredit-dominated local financial system increasingly channels the country's scarce financial resources *towards* the most unproductive informal microenterprise and self-employment ventures, and so *away* from the most productive and sustainable activities pertaining to formal manufacturing-led SMEs. This gradual diversion of scarce funds has taken place in South Africa even though, one the one hand, it has long been recognised that formal manufacturing-led SMEs find it very difficult to access financial support,[19] and, on the other hand (as noted above), a large volume of capital has been used simply to over-indebt large numbers of vulnerable black individuals. The South Africa government now realises that this dichotomy is probably the pivotal issue

[18] See 'New blow for micro-lenders', BD Live, October 6th, 2013. http://www.bdlive.co.za/business/financial/2013/10/06/new-blow-for-microlenders (last accessed on November 4th, 2013).

[19] For example, the IFC's Enterprise Survey in South Africa (IFC, 2007) found in its survey of mainly formal manufacturing-led businesses that 'access to finance' was the third most important business environment constraint, topped only by 'crime, theft and disorder' in first place and 'electricity' in second place.

inhibiting sustainable development, as Minister of Trade and Industry, Rob Davies, usefully summed up,[20]

> 'The (South African) economy is characterised by extensive financialisation, but only a small percentage of investment is channelled towards the productive sectors.'

The arrival of the microcredit sector in South Africa was initially greeted by celebration in the international donor community and in the South African government too. The experience since the mid-1990s has shown unfortunately, that it has been a major policy dead-end. Put simply, the microcredit sector has absorbed a substantial volume of South Africa's scarce financial resources that would have been far more productively invested in sustainable businesses, including manufacturing-led SMEs.

6. Saving South Africa's Fashion and Textile Industry (FTI)

6.1 Background

To help illustrate some of the practical operational and strategic development problems in South Africa's industrial SME sector, it is useful to focus on one sector. Given its historical importance to South Africa's development, and its current difficulties, the Fashion and Textile Industry (FTI) sector is an appropriate example to choose. Moreover, it is also possible to compare developments in South Africa with the history of comparable FTI sectors elsewhere, which I do in Section7, thereby to get a fuller picture of the barriers to industrial SME development as well as some of the local financials system solutions hit upon in these other countries that might have some relevance to South Africa.

South Africa's FTI sector has its origins in the manufacture of blankets in the early part of the last century. Already the major industrial centre in South Africa in the early 1900s, the city of Johannesburg initially became the core of the FTI sector as well, with some supplementary development in the Western Cape province in the main city of Cape Town. During the apartheid era, however, restrictions on the use of African labour

[20] Speaking Notes of The Minister of Trade and Industry, Dr Rob Davies at the Launch of the Industrial Policy Action Plan (IPAP) 2013/14-15/16 held at IDC Sandton on 4 April 2013.

in urban areas began to push the FTI sector out towards Durban and Cape Town where there was a large pool of low-cost Indian and Coloured labour. Cape Town gradually became the leading city for the FTI sector producing for the main retail chains, many of which were headquartered in Cape Town and which exerted significant influence over the supply chain. Meanwhile, Durban evolved to become the centre for the much lower priced segments of the FTI market.

The FTI sector evolved into one of post-apartheid South Africa’s most important industrial sectors, accounting for important shares of output and exports. However, the fall of apartheid in South Africa coincided with the arrival on the global stage of ultra-low cost Asian competition in the FTI sector, especially from China (including Hong Kong). As in most countries at the time, this development put South Africa’s FTI sector under enormous pressure. In spite of substantial growth in demand for textile products in recent years in South Africa, its domestic enterprises were unable to service this demand at the prices/quality expected, and it was met instead by increased imports from Asia. With South Africa’s FTI sector running into serious difficulty, over 2007-8 the South African government imposed a series of quotas on Chinese FTI-related goods.

However, this measure failed to halt the decline in the FTI sector, suggesting instead that the structure of the FTI sector was problematic and could no longer compete on the domestic market. In addition, a wide variety of inputs required by the FTI sector were also increasingly met by imports. Imports from China (including Hong Kong) thus went from just under 17% of total rand value 1995 to nearly 80% by 2005 (Morris and Reed 2008: 18). In addition, FTI prices also dropped as a result of the global glut of textile products produced by Asian nations, further undermining local South African FTI producers. A similar problem was registered on the exports side. The FTI sector was initially able to rapidly increase its exports in the post-apartheid era until around 2002, but then an equally sharp decline began to take hold as Asian competition around the world began to make itself felt.

The FTI sector today is largely based in the regions of the Western Cape and KwaZulu-Natal, with some minor FTI activities undertaken in Gauteng province. The KwaZulu-Natal FTI cluster of enterprises has evolved into the primary location for mass market FTI production, while the Western Cape has evolved in the opposite direction into the location for higher value added design-intensive and niche market products mainly situated in medium to large enterprises. Cape Town has retained its importance as the site of most of South Africa's higher-end FTI work as well as being the location for the top five retailers who account for around 70% of the formal clothing market in South Africa (Morris and Reed 2008). In short, South Africa's FTI sector has effectively fallen between two stools; on the one hand, the Cape Town cluster of FTI enterprises has not been able to forge a place for itself in the global economy (yet) on the basis of high-value added 'just-in-time' fashion outputs using the latest technologies backed up by significant capital investment; on the other hand, KwaZulu-Natal cluster of FTI enterprises has had little success in locating for itself a place in the global economy as a mass-market producer based on low cost labour and scale economies (*ibid* 36).

One of the main strategies to date to try to ensure the survival of South Africa's FTI sector has been a 'low road' squeeze on the labour side, with minimal wages and poor working conditions increasingly the norm. This trajectory has involved a move to more Cut-Make-and-Trim (CMT)-focused mode of operating which involves less capital costs, coupled with the growing informalisation of the FTI sector as inputs are increasingly sourced from formal and informal microenterprises and home-workers. While this has cut costs in the FTI sector operations, it has also and inevitably lowered the FTI sector's ability to compete globally into the long-term. The alternative to this 'low road' strategy - a 'high road' strategy based on accelerated capital investment, machinery upgrading and worker training – had to be rejected because of the shortage of capital on affordable terms and maturities.

Thanks to the growing FTI-related imports, and particularly because of the decline in value chain capacity in South Africa, the South African Government through the Department of Trade and Industry (DTI) and its deployment arm, the Industrial Development Corporation (IDC), embarked on an extensive incentive programme. Foremost of the incentives on offer were the Clothing and Textile Competitiveness Improvement Program (CTCIP) and the Production Incentive (PI) which assisted firms in competitiveness and capital upgrading respectively. The most recent (Aug 2012) information released by the DTI indicates that to date these incentives have been broadly successful and, among other things, the decline in employment has been halted. In addition, the South African government's 2010 Industrial Policy Action Plan was introduced to support the country leverage more local procurement in order to assist local production by overhauling the Preferential Policy Framework Act and assigning points in the tender process to those firms that procure locally.

Overall, however, South Africa's FTI sector remains in serious difficulty. According to knowledgeable industry sources,[21] while not all of the problems are finance-related, <u>many of the most important barriers to success are.</u> In particular, formal financing in the FTI sector (including South African government funding through the IDC) generally requires a minimum of R1 million or more. This means that FTI sector SMEs that wish to expand are simply unable to access formal financing either because they simply cannot afford to service such a large loan, or else because they are not 'bargaining council compliant' and are therefore ineligible for any government linked low interest loans. In general, too, the commercial banks and South African government programs resist supporting operating costs in the FTI sector. There is simply too much risk involved in financing product development, raw material purchases, logistics costs, and so on, and where there is little chance of any return on any investment in less than 4 to 6 months.

As a result of such financial sector issues, the future for the FTI sector in South Africa remains problematic. Unless changes are made to sustain existing FTI enterprises and promote new innovative ones, there is little future for South Africa's FTI manufacturing sector. As the former executive director of the Johannesburg-based Textile Federation of South Africa, Brian Brink, warned with regard to the threats to the FTI industry and other South African industries, 'Deindustrialization is a real threat. We have to decide whether we go down that slippery path. What happens then? We all become a bunch of traders.'[22] But how have other FTI sector reacted to the very same global pressures currently being vectored against South Africa's FTI sector? For further important policy insights it is useful to briefly analyse a number of other high-profile

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[21] Personal communication with Anita Stanbury, Executive Director of the newly formed South African National Fashion Council (SANFC).
[22] See 'South Africa faces threat of de-industrialization (Update 2)', *Bloomberg*, 8th September 2009. http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aKBl6AE9alNc (last accessed on March 12th, 2014).

FTI sectors to gauge the reaction of policy-makers to globalisation pressures and whether or not these insights hold any lessons for the South African context.

7. Learning the financial lessons from 'best case' FTI development episodes

The FTI sector has historically played a major role in many countries that sought to escape their origins of under-development, low productivity informal employment and generalised poverty. Even more important, in many of these cases the FTI sector proved especially responsive to a variety of state interventions and industrial policy measures that combined were able to ensure the deployment of efficient organisational structures, technological upgrading, and high quality yet affordable final products (Amsden 2001). In particular, we almost always find that appropriate financial sector institutions and financial policy measures helped to underpin the development of the FTI sector where conventional market-driven private financial institutions refused to go. In this section I provide thumbnail sketches of three important FTI sectors that have responded to the pressures of globalisation and the rise of Chinese competition in different ways and have deployed various financial measures to retain a meaningful FTI sector.

7.1. Denmark

Denmark's FTI sector has survived and, in fact, prospered in spite of a very high cost base, a factor often seen as a major barrier to long-term success thanks to the entry of ultra-low-labour cost China into the global FTI sector. In 2012 the Danish FTI sector registered turnover of nearly \$10 billion, of which around more than a half was exported. The FTI sector is the 4th largest export sector in Denmark spread across 600 enterprises operating under the 4 largest enterprises – Bestseller, BTX, DK Company and IC Company (Dansk Fashion and Textile 2013).

In common with many SME sectors in the 1980s and 1990s, a process of consolidation took place in the FTI sector as a response to lower cost producers emerging around the world, especially in the case of China. The Danish government could either allow the FTI sector to contract, or else take positive steps to restructure the industry: it chose the latter option. As part of its wider industrial policy in the late 1990s of rebranding Danish products in order to compete on fashion, innovation and ‘Danishness’, rather than (just) low cost, the Danish FTI sector underwent a radical transformation. Effectively piloting the change was the Danish government, which wanted to maximise its strengths in knowledge/creativity-based industries. As one fashion industry researcher remarked,

> ‘As I see it, the Danish government found an interest in the fashion industry, because it demonstrated a successful transformation from being a production based industry to a knowledge (design and sale) based industry.’
>
> (quoted in Salonoja 2013: 53).

In the early 2000s, the Danish government embarked on a project to establish Copenhagen as the fifth global fashion centre, after the four cities recognised as the leading centres - Paris, London, New York and Milan. This was the key to ensuring that the FTI sector was reborn, and ultimately would expand. The Danish Fashion Institute (DAFI) was established in 2005 to promote a Danish fashion identity. DAFI was started with, and is today mainly financially supported by, the Danish government, though some membership fees later came on stream to support additional activities.

Financial support issues were crucial especially given the systemic reluctance of conventional private sector financial institutions to support start-up enterprises. Since 1914, when the first cooperative bank was established, Denmark’s cooperative banking sector has provided sustained support for growth-oriented SMEs, especially in key agro-industries (Chlupkova, Svendsen and Tingaard 2003). Notably, the cooperative banking system was quite decisive in facilitating the supply of long-term low cost capital that allowed Denmark’s famous dairy and pork sectors, both of which sectors were almost entirely organised along cooperative lines as well, to become globally important industries.

In more recent (neoliberal) times, new go-go private financing mechanisms have appeared, such as venture capital funds, business angels and, most recently, ‘crowd-funding’. But it is generally accepted that, while highly visible and suitably ‘cool’, in practise such initiatives cannot hope to fund anything more than a very small percentage of potentially viable industry-based start-ups. Moreover, given their roots in traditionally conservative agricultural communities, Denmark's cooperative banks have been reluctant to respond to the much riskier types of industrial SME project that require financial support.

Since the 1990s, therefore, a large number of new state-supported programs have been introduced to promote industry-based SME development in sector deemed to represent future innovation and growth opportunities for Denmark (OECD 2008). The FTI sector was included. These financial institutions include state-backed Innovation Incubators founded after 1998s and which capitalise R&D-driven start-ups emerging from Denmark's University sector and its raft of Science Parks. There is also the *Vaekstfonden,* which is a state-sponsored investment fund that was established in 1992 with around €300 million. Although initially intended to fund high-technology start-ups and expansions using leading edge technologies, more recently the *Vaekstfonden* has become an almost purely commercial venture capital fund.

After 2007, however, especially when a new government reform was passed, the provision of basic business advice and financial support for start-ups became more the responsibility of local government. Many innovative new programs have been introduced, with much focus on new starts being able to export as soon as possible, not least because after 2008 domestic demand in Denmark slumped as a result of the global financial crisis. For existing SMEs with growth potential, regional 'Centres for Growth' now exist to provide financial and technical support. In the FTI sector, one of the programs launched was the 'Fashion Accelerator' a program targeting SMEs in the FTI sector in Copenhagen and Central Denmark. SMEs linked to the program receive a package of support measures, including access to generous low cost financial support.

Recent trends shows that the Danish FTI sector is not just managing to survive in the face of Chinese competition, but to grow. Support from state institutions has been vitally important in previous years, along with support from Denmark's many non-state financial institutions, including its cooperate banks. More recently, the commercialisation of the financial sector that took place in the heady go-go atmosphere that prevailed in the run-up to the collapse on Wall Street in 2008, made life somewhat more difficult for low profit FTI sector enterprises.

7.2. The region of Emilia-Romagna, Italy.

Originally a region based on making straw hats, after 1945 the FTI sector in Emilia-Romagna rose to become a regional export success and in the 1970s accounted for as much as 18% of employment in the region. The FTI sector is organised into clusters operating in different parts of Emilia-Romagna, with each cluster capable of completing all the requirements to produce the final product. The initial FTI cluster was located around the city of Carpi, but FTI activities later emerged in the provinces of Modena, Reggio Emilia and Ferrara.

The key to Emilia-Romagna's post-war success was a series of major investments undertaken, first, identify potential new FTI products that would aid in the urgently required diversification process, and then, second, to actually begin producing a range of new FTI products. Because financial support for such 'blue skies' activities was (and is) highly risky it is largely shunned by the private sector; it was, instead, mainly the preserve of the public sector, or local non-public financial institutions with a major interest in the long-term health of the local community. Above all, the Emilia-Romagna experience is instructive with regard to the importance of patient institutional support to the enterprise sector.

A key institutional milestone behind FTI sector success in Emilia-Romagna was the founding in 1974 of ERVET – the regional development agency. In turn, ERVET was charged with establishing a number of sectoral and inter-sectoral bodies that could provide high-level support services to enterprises in the region. One of the first such bodies founded by ERVET was CITER (Emilia-Romagna Textile Information Centre), which was founded in 1980 the district of Carpi and with a specific mission to promote the FTI sector. Membership of CITER centrally included ERVET, but also other key stakeholders, including the Chambers of Commerce, business associations and more than 400 SMEs involved in the FTI sector (Sölvell, Lindqvist and Ketels 2003). The early success of CITER led to many more such centres across Emilia-Romagna, and across northern Italy. One of the most important innovations introduce perfected by Carpi's FTI sector was a form of 'just-in-time' production termed 'Pronta Moda'.[23]

[23] The academic term for this technique, coined by Piore and Sabel (1984), is 'flexible specialisation'.

This involved the production of small batches of the most up-to-date fashion items at low costs using state-of-the-art machinery and technology, which were then released on to the market at precisely the most appropriate sales period (e.g. Christmas, summer holidays).

From the 1990s onwards, however, the FTI sector in Emilia Romagna and especially in Carpi, came under a major threat. This threat was the massively increased competition coming from low labour cost Asian countries, especially from China. The immediate result was that from the mid-1990s onwards, a growing number of FTI sector small enterprises began to exit the market. It also did not help that neoliberal ideas began to dominate European governments in the 1980s, and especially in Italy from the mid-1990s onwards under the various governments of Prime Minister Silvio Berlusconi. One immediate result of the new ideology was that central government funding for all regional governments was cut back, particularly to leftist governments such as in Emilia Romagna. In addition, thanks to a series of upheavals in the Italian political system in the 1980s, the post-war dominance of leftist parties in Emilia-Romagna began to come to an end, and the old big business elite began to reassert its pre-war power once more (Restakis 2010). Public financial sources were increasingly diverted away from public/state institutional capacity-building and directed towards individual businesses instead, a process sometimes known as 'corporate welfare'.

As a result of these developments, inevitably ERVET and CITER came under intense scrutiny. Both were increasingly forced to refocus and commercialise their activities in order to make do with less state support and generate their own funding in order to keep going. For example, CITER was initially 100% funded by the public authorities, but ten years later this figure was down to only 30%, with the other 70% financed through a combination of membership fees and the winning and undertaking of consulting projects (Humphrey and Schmitz 1995). However, this neoliberal-inspired 'earning ones keep on the market' mode of operation gradually pushed CITER into supporting FTI projects that had a short-term commercial pay-off, thereby allowing CITER to generate lucrative consulting fees, while increasingly ignoring FTI projects that generated a much larger and/or longer-term development and economic growth pay-off, but which would not generate sufficient funds in the short term to cover CITER's required consulting fees. Thus, right when the FTI sector actually needed an even *more* robust, patient and focused institutional response than ever before, the almost exact opposite trajectory began to emerge.

The FTI sector only finally began to stabilise in the mid-2000s. CITER itself was able to restructure itself and, crucially, it was largely able to revert back to its former pro-active public agency role, rather serve than serve as one of a number of consultancy outfits seeking contracts. Accordingly, CITER redoubled its efforts on the promotion of innovation and knowledge transfer, creating networks involving local Universities, research centres and individual enterprises, and disseminating information on new market opportunities to its members. In addition, professional training in the FTI sector was significantly improved with the founding of Carpiformazione, a public agency dedicated to professional training. Carpiformazione specialised in providing courses in all aspects of the FTI sector, including within small enterprises in the supply chain (Mariotti and Zirulia 2008).

One of the historically most important aspects that accounts for the great success of the FTI sector in the region, and an innovation that still helps out enormously even today, was the willingness of FTI firms, often with regional government advice and support, to organise themselves into consortia (*consorzi*) in order to obtain better access to affordable capital. By forming into a sort of credit cooperative, the consortia can obtain a large loan from a local cooperative bank at very low interest rates and long maturity, which was then divided up to members according to their needs. Importantly, all of the members of the consorzi collectively guaranteed the loan from the cooperative bank. Restakis (2010: 81) remarks that,

> 'So successful are these consortia, and the default rates so low, that the large national banks have been trying to break into this market for years, with little success. The smaller regional banks provide for almost all of the region's capital needs'

The most recent indications are that the FTI sector is just about standing up to competition from lower cost Asian countries, largely thanks to a variety of collective interventions that to an extent have been able to disperse the famous clusters in order to assure their survival. One method her has been outsourcing some parts of the production chain to lower costs countries in Europe, such as Romania. While many predicted the FTI sector in Emilia-Romagna would significantly contract under globalisation pressures, this has not been the case. While some employment has been lost compared to the booming 1980s, the FTI sector in Carpi, and in Emilia-Romagna overall, has succeeded in remaining a major driver behind regional growth.

7.3. Turkey

The FTI is a major sector in the Turkish economy. In 2009, Turkey was the world's seventh largest exporter of textile products and the fourth largest exporter of finished clothing (WTO 2009). In 2009, the FTI sector accounted for $22.3 billion, or one fifth of Turkish exports (Lau, Suvankulov and Karabag 2012). The bulk of formal employment (up to 85%) in the FTI sector is located in micro and small enterprises (up to 10 employees), but when informal employment is included, this more than doubles the amount of employment involved to around 2 million (Ministry of Industry and Trade 2010). Key aspects of competitiveness are the ability to diversify very quickly in order to meet changing demand patterns abroad. Importantly, Lau, Suvankulov and Karabag (2012) emphasise that managers employed in the FTI sector highly value the support provided by the Turkish government and its regional units. This support has taken numerous forms, including support for R&D and innovation. One of the major barriers to sustained growth in the FTI sector identified by the Turkish government, however, is widespread informality (Ministry of Industry and Trade 2010: 129). Among other things, informality debars an FTI company from participating in important state support programs and obtaining bank finance.

Growing global competition, especially from China, has inevitably put at risk the important contribution of the FTI sector in Turkey to employment and exports. The Turkish government has responded with a twin-track strategy of financially encouraging the most labour-intensive activities (e.g., basic production of cloth) to relocate to less-developed eastern cities, while expanding the crucial design, fashion and finance arms into clusters operating in the more sophisticated and fashion conscious cities of Istanbul and Izmir (Ministry of Industry and Trade 2010: 131).

After a long history supporting Turkey's export and import trade, in recent years Turkey's banks have begun to much more actively engage with the manufacturing sector, including Turkeys SMEs working in the FTI sector. Overall, the share of bank credit directed to SMEs has risen markedly since 2001 (Ministry of Trade and Industry 2010: 85). However, in spite of this recent progress, it is also recognised that the banking sector remains comparatively unsupportive of the SME sector, and it lags most other European countries in this respect. One central issue is the much higher profitability/lower transactions costs involved in working with consumer loans, the supply of which has massively expanded in Turkey in recent years. The result, as the Turkish government was forced to conclude in 2010 (Ministry of Trade and Industry 2010: 86), is that, '*While a more rapid growth in consumer loans and credit cards continues, loans to companies, and especially to SMEs, are limited*'. The result is that the shortage of financial support for the SME sector is today seen as a very serious handicap in terms of promoting the sustainable development of the SME sector across all activities, especially including FTI.[24]

The seriousness of this financial problem eventually forced the Turkish government to step in and begin to provide special support to encourage the banks to finance SMEs and for loan guarantees to be provided. In the booming years of the 2000s, sufficient financial resources were available to underpin these programs, and so the SME sector was able to access more financial support than hitherto. But since 2008 the situation has changed markedly, and the Turkish government has less ability and resources to prod private sector banks into supporting the SME sector.

In short, Turkey's FTI sector has expanded since the 1990s to become one of the country's major export and employment sectors. This growth initially took place against a background of limited financial support, one of the results of which was to directly and firmly embed the FTI sector in the informal sector, where it very much remains today.

7.4 Core lessons pertaining to the financial sector?

[24] Moreover, the recent financial sector problems experienced in Turkey, and its dramatically declining currency in particular, are seen as the inevitable outcome of a banking sector that effectively allowed itself to become dangerously over-concentrated on serving the consumer sector at the expense of the SME sector.

The examples above help to illustrate several points of relevance to the South African FTI sector as it seeks to restructure and survive in an increasingly competitive world market.

First, long-term financial support provided at appropriate terms and maturities is clearly critical to building a strong FTI sector. In the case of Denmark and Italy, the socially-oriented cooperative banking sector was the mainstay in terms of providing long-term working capital finance for the FTI sector, allowing for major episodes of equipment upgrading, new product development, and other initiatives. In both countries, a number of new jazzy financing mechanisms emerged in the later (neoliberal) years – business angels, venture capital, etc – but while these financing structures garnered lots of media publicity, they generally contributed very little in terms of underpinning the FTI sector in any real sense. In Turkey, on the other hand, the market-driven private commercial banks provided little *favourable* support to the FTI sector over the years, preferring to fund their activities on regular terms, while few other forms of financing were forthcoming from anywhere else. The key issue was that the private banks could generate more profit working in other areas, such as trade financing, construction and consumer loans, and so had little reason to venture into the already risky FTI sector with special discounted interest rate programs in search of business. With few other sources of finance, and in spite of its labour cost advantage, it was almost inevitable that Turkey's FTI sector would increasingly move into the informal sector.

Second, alongside external sources of financial support, state support is generally required for the important start-up phase. Comprehensive programs in Denmark emerged out of a major state effort to retain as much of the FTI sector as possible, if not expand its influence, and this led to a major bottom-up impetus via new entrants. Similarly in northern Italy, the regional and local state's sophisticated advisory and support structures, notably CITER, turned out to be world-leading structures when linked to equally sophisticated sources of finance, such as the famous *consorzi*. Once again, Turkey's experience was different, eschewing all forms of dedicated support for start-ups.

Third, both business and financial support to the FTI sector cannot generally be constructed to a for-profit business itself. This is to say that the popular neoliberal imperative of transforming all enterprise support programs into profitable activities in their own right, has been proved quite wrong. Enterprise development is an investment in the local economy, not a profitable business opportunity. Failure to understand this important point led both Denmark and Italy into watering down their once sophisticated non-financial and financial support structures, though in later post-neoliberal years this degradation was reversed. In Turkey, where free market (neoliberal) policies have long prevailed, both financial and non-financial support structures were always implored to generate their own revenues – 'earn their keep on the market' – and so offered little real long-term support to the FTI sector.

8. Local financial system restructuring implications for South Africa

> The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.
>
> Franklin Delano Roosevelt (1933)[25]

> '[R]ecognising institutional diversity should not be confused with the argument that therefore there are no lessons to be learnt […] It is both possible and instructive to identify some major principles that underlie […] successful experience, and to try to adapt the policy tools and institutional vehicles that were used to realise those principles in order to fit local conditions elsewhere, and if necessary devise new policy tools and institutions. Indeed, if East Asian governments had themselves believed in the impossibility of such institutional adaptation and innovation and had ignored earlier success stories, it is doubtful whether we would have an East Asian Miracle to discuss.'
>
> Akyuz, Chang and Kožul-Wright (1999)

The above discussion, and especially the financial issues raised in the finer-grained look at the FTI sector in South Africa and in three important FTI sectors elsewhere, raises a number of basic policy issues for the South African government to consider not just in relation the FTI sector, but more generally.

First, there can be no doubt that for-profit local commercial financial institutions have seriously under-performed on behalf of local communities in South Africa in the period since the collapse of apartheid. Ideology notwithstanding, spectacular profitability and

[25] Quote from his first Inaugural address.

dividend payment opportunities that are appropriated by a narrow elite are simply not consonant with the efficient provision of financial services, particularly to manufacturing-led SMEs. Instead, South Africa's poor have simply been plunged into a form of microdebt peonage thanks to an adverse process that social geographer, David Harvey (2006), has termed 'accumulation by dispossession'. Thus, while the private commercial banking sector has its role to play locally, it should not be expected that this role will include extensive provision of dedicated long-term financial support to manufacturing-led SMEs.

Second, the range of local financial institutions involved in the successful promotion of the SME sector around the world strongly suggest that, first, diversity is important, but also, second, that some form of community ownership and control of a financial institution is absolutely paramount. The brief examples of the FTI sector success described in Section 6, as well as much data from elsewhere around the world, shows that there is no 'one size fits all' local financial system. Instead, adaptability and innovation seem to be the key issues, as well as control by the community of a financial institution in a way that embeds longer-term development goals as much as, if not more than, mere financial self-sustainability.

Third, there remains much scope to ensure that a robust manufacturing-led SME sector in South Africa can still compete, but this will require – at a minimum - the construction of a suitably effective local financial system. Economic history shows that, if the local financial system is specifically geared up to this important task, <u>there is much scope to significantly improve the chances of retaining a meaningful manufacturing-led SME sector</u>. This means, however, that the conventional orthodox (neoliberal) specification for what is an 'efficient' financial system in South Africa – that it must primarily aim to maximise its own profitability which it does by supplying capital to those activities that are best able to repay a loan at as high an interest rate as it is possible to levy – must be rejected. Such a financial system has not addressed the many and varied issues involved in successfully promoting manufacturing-led SME development in South Africa.

Instead, we need to establish a local financial system that is able to assist in the promotion of a manufacturing-led SME sector rather than restrain it as at present. It is clear that, even though it generates massive financial rewards for its CEOs and local and international shareholders, the South African financial system has nevertheless evolved into a patently inadequate structure with regards to development, and specifically as regards to manufacturing-led SME development. Economic history shows that this divergence is actually a quite common occurrence, as 1993 Nobel Economics prize winner, Douglass North, pointed out in his path-breaking book on the role of institutions in development (North 1990)

> ‘The organizations that develop in this institutional framework will become more efficient – but more efficient at making the society even more unproductive and the basic institutional structure even less conducive to productive activity.’ Douglass C. North (1990:9)

The following is a set of policy interventions that experience and analysis of the local situation suggest might constitute a suitable package for South Africa in its drive to establish and sustainably expand a manufacturing-led SME sector.

8.1. Establish a local/municipality SME development bank

After many years of being unjustifiably criticised, the state development banking concept is now returning to the mainstream. Important examples from economic history are now receiving far more attention as possible role models for other developing countries to follow (Amsden 2007) and even more so in the aftermath of the global financial crisis (Marois 2013). Moreover, many developing country officials, including from South Africa (Timm 2011), are heading to Brazil to evaluate the adaptability to their own circumstances of Brazil’s extremely successful state development bank, BNEDES. This rediscovery process also very much includes local and municipality development banks that are specifically designed to work with the SME sector. Post-war West Germany’s ‘*Landesbanken*’ (regional state-owned banks) were crucial support structures as much in the former industrial heartlands (all destroyed by mid-1945) as was as in the rural areas seeking to industrialise in small environmentally-friendly units. Northern Italy’s experience with Special Credit Institutes also stands out. It should also be remembered that much of good work undertaken by Brazil’s BNEDES is through its local branches, which are embedded within the local community and understand its needs and potentials.

And even in the USA, one of the most successful regional development banks of all is a state-owned bank - the Bank of North Dakota. Formed in 1919 to free the local population from the clutches of the big private banks in New York and Chicago that were charging high interest rates on farm loans, the Bank of North Dakota has since then been a major supporter of local businesses and farms. In addition, it not only prospered without the need for Wall Street-style salaries and bonuses, and it survived the global financial crisis without the need for any state bail-out, it also continued in its role as a major *contributor* into the state's budget.[26]

The key outcome of the state-led SME development bank approach is that it can promote cutting edge new enterprises that are inherently risky, long-term focused and grow by 'learning by doing', the type of enterprises which virtually all other financial institutions will not touch as potential clients.

A similar local state-led SME banking institution is possible in South Africa. Indeed, there has already been much experimentation in South Africa with national state banks. Here, however, the emphasis would be on creating a local development banking structure with longer-term perspectives and an industrial developmental focus. The bulk of the lending and other support would be targeted at manufacturing-based SMEs with growth prospects either through exports or inclusion within local supply chains. The core idea is that a more secure and affordable financial service will help suppliers operating within large enterprise supply chains to invest more willingly in key technologies and quality control, thereby to provide a 'better' input (higher quality, lower cost, just-in-time, etc) to the large enterprise. And rather than expecting that its activities will be able to 'pay their own way', there must be a realisation that development is NOT a costless activity, and that public investment will be needed upfront to capitalise such an institution before any real development returns are generated. Having said that, over the longer-term it is perfectly possible for such a development bank to take equity stakes in any enterprises supported and which, when

[26] See 'How the Nation's Only State-Owned Bank Became the Envy of Wall Street', *Mother Jones*, March 27th, 2009. http://www.motherjones.com/mojo/2009/03/how-nation%E2%80%99s-only-state-owned-bank-became-envy-wall-street

eventually cashed in if the assisted enterprise is a success, can cover a proportion – often a very high proportion - of the running costs of the bank.

Support for such a community development banking model, and its ability to avoid the most destabilising aspects of the contemporary orthodox financial system, also comes from one of the most astute critics of financialised capitalism, Hyman Minsky. It is now accepted that Minsky's theories on financial instability under capitalism constitute the most accurate prediction of the 2008 global financial crash and its precise mechanism (Minsky 1986). Less well-known was that Minsky's rejection of orthodox financial institutions led him to propose (Minsky 1993) a bottom-up alternative in the shape of a network of for-profit community development banks, operating under the umbrella of a national state-owned banking body that would provide guidance, support, regulatory oversight, bulk funding, and so on. The rationale he gave (in the US context) was that '*the vitality of the (..) economy and democracy depends on the continual creation of new, small, and novel enterprises* (*ibid*: p 34). Minsky believed that only community development banks could marry social responsibility to the need to develop new and expand existing manufacturing and other innovative enterprises in the community, thereby avoiding the short-sighted and casino-speculative mentality increasingly ingrained in the orthodox private commercial banking system.

Further underlining the importance and feasibility of a dedicated local bank serving SMEs and, in particular, SME suppliers to large enterprises, we can refer to Europe's experience with specialised SME development banks formed by large and often state-owned companies in order to better finance their crucial supplier networks. Even in countries where the local financial structure is famously deep, such as in Germany,[27] such dedicated SME development banks are vitally important to improve the chances of local manufacturing-led SME development, particularly through supply chain development. For example, both largely family-owned BMW and partly state-owned Volkswagen (20% of its shares are owned by the Lower Saxony regional government) have long had their own SME banks that efficiently finance their local supplier

[27] Germany's famous regional banking system was deservedly praised for its ability to provide low cost loans to the famous medium-sized enterprise sector (*mittelstand*). However, in the 1990s, at the behest of the UK in particular, the EU was forced to push Germany's state banks to become more commercial, or even to privatise, precisely because such banks gave German SMEs a major advantage over British SMEs! Thus we have another example of an efficient institution being destroyed simply because of ideology.

networks, and in so doing provide an important comparative advantage to the parent company and – crucially - to the locality.

Most recently, in view of the growing unwillingness of Europe's private banks to fund industrial SMEs in the aftermath of the global financial crisis (banks increasingly prefer to rebuild their depleted capital base by working with higher profit/lower risk consumer loans, housing mortgages and trade financing), many large industrial enterprises are effectively being forced into resolving the problem more directly through their own SME development bank. One notably example is that of state-owned Airbus, the world's largest aircraft company, which announced in February 2014 that it was acquiring a small German private bank, Salzburg Munchen Bank, in order to provide capital for its crucial SME supplier base at much lower rates and longer maturities than are currently on offer. Crucially, in view of the problems that the Boeing Corporation have had with their Dreamliner 787 aircraft thanks to poor suppliers, it was hoped this new SME bank would allow Airbus's suppliers to patiently reinvest in the technologies and equipment required to ensure the very highest quality outputs.[28]

In South Africa, thanks to the self-sufficiency necessities forced on the apartheid government, there exists a broadly positive history of state banking linking to SME development. Many of the country's most important industrial SMEs locate their origin in affordable loans granted to them by state banks. However, while today the *aims* of such state banks – to preserve white minority rule – are naturally invalid, there is nevertheless something to learn from the *operating methodologies* used in this period. In particular, it appears that many of the industrial SMEs supported were indeed able to use the financial support, allied to other business support services, to successfully integrate into local supply chains and, eventually, to export too (mainly to other African states). There would seem to be no reason why such valuable experience could not today be turned into ensuring the successful establishment of a municipality-driven SME development bank today.

Several important issues would need to be resolved, however. First, capitalisation of the bank would likely have to be ensured through government sources outside of the

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[28] See 'To help its suppliers, Airbus will buy a bank', *International New York Times*, February 15-16, 2014.

municipality in question, which would inevitably mean having to deal with national political pressures of one sort or another. Second, corruption and nepotism would need to be minimised at the local level by ensuring transparency and openness in its running. Given that this presents a major problem today in South Africa, real thought will have to go into resolving the issue of how to ensure that a municipality-led SME bank can genuinely locate and support those SME projects with the highest potential from a development point of view. Third, and partly a way of dealing with the issues just raised and partly because of the inevitability of there being limited funds, a very clear operating mandate would have to be developed to ensure that the new bank used its limited funds to focus on key interventions, rather than disburse funds to minimal impact unconnected projects. Fourth, another issue to consider relates to scale issues, which are present whenever a small local bank extends credit to local SMEs, especially if mainly in the same sector. The inevitable potential of mass default if industry-wide conditions change adversely, can be dealt with by assuring that all local banking units are linked into an apex development banking unit, or serve as units of the state development bank, so as to spread risk and information around the system.

8.2. Financial cooperatives and cooperative banks

The municipality-based development banks noted in the section above are important in supporting risky investments in SMEs if the potential upside benefit to the local economy is sufficient. Financial cooperatives/cooperative banks, on the other hand, are generally more risk-averse and opt to prioritise the preservation of the value of the savings of members above more risky enterprise development strategies. Nonetheless, by adopting a long-term ‘patient’ approach to finance, most financial cooperatives and cooperative banks have historically been very effective in meeting the important working capital needs of local industrial SMEs. Indeed, in terms of providing large quantities of finance on appropriate terms and maturities, robustly regulated financial cooperative and cooperative banking structures have very much to recommend them. The history of cooperative banking shows that local communities determined to promote a bottom-up process of local economic development can begin to mobilise their own financial resources, on the one hand, and channel those resources into the best possible growth-oriented SME projects, on the other.

There are a number of core issues to consider here. First, there is the extent to which local individuals and enterprises will support the project. A sufficient level of community support is required to ensure that a cooperative bank will succeed, not just through the deposit-taking function, but through its ability to reliably interact with the local business community in order to identify the best SME projects to support. A wide multi-stakeholder group might be involved in the *establishment* of such a cooperative bank, but ideally its long-term management will be chosen by individual saver-members. In both the northern Italian and Basque region of Spain examples of cooperative banking, one of the principal initial attractions for member-depositors and many other groups, such as the church, was the fact that the cooperative bank would explicitly focus on long term job creation in the locality (Bateman 2007). Local people and institutions were very concerned to get involved and to see that the new cooperative bank would become a success. But once established the banks became subject to overall democratic management by the member-savers alone.

Second, there is the related issue of the initial capitalisation. Rather than wait for savings deposits to rise to acceptable amounts, it is often the case that such cooperatives are 'seeded' by outside bodies, especially the state. In Finland, as MacIntyre (2003) reports, after 1945 the government used state funds to immediately recapitalise the main cooperative bank after the war in order to promote trust and to achieve scale as quickly as possible. The resulting lending programs, especially involving cooperative enterprises, quickly began to transform a quasi-Soviet satellite economy into one of Europe's most successful industrial economies. Similar initial funding may be required in some of South Africa's poorest communities if their initial poverty is not to become a permanent barrier to an escape from that poverty through SME development.

Third, there is the issue of locating and hiring the right skilled individuals to work in the cooperative bank on promoting local enterprise development. In many previous experiences, notably in Mondragon in Spain and in northern Italy, it was a passion to develop one's own ethnic/political community that drove forward highly-skilled yet lowly paid individuals to excel in their job. It might be useful in the South African context, therefore, to develop various subsidy schemes that can attract and retain a number of skilled enterprise development professionals, even if only for mentoring purposes, alongside the regular account managers.

Overall, the cooperative banking structure represents for South African communities not just a potential source of local capital mobilisation for working capital needs in local enterprises and a way of efficiently intermediating these valuable savings into the very best SME projects, but also a way of promoting and underpinning the important social values associated with cooperation – solidarity, equality, trust, reciprocity, social justice and mutual support.

8.3 Hybrid local financial institutions

An important variant on the above cooperative bank/financial cooperative arrangement is a financial institution jointly owned by the large company and the collective of suppliers. This type of arrangement is historically quite popular in agricultural communities, where a large processor takes the initiative with a view to helping its farmer suppliers.

A surprisingly large number of examples of such financial structures already exist in South Africa (though many were carried over from the apartheid era and were mechanisms to ensure white domination). One good recent example is that Akwanzi Agricultural Finance (AAF) which is located in Mpumalanga Province. AAF is a joint venture between TSB, a sugar processing company in Mpumalanga Province, and 900 farmers who provide the raw material to TSB and who organised themselves into a cooperative. The rationale for AAF derived from the fact that small-scale farmers producing sugar cane simply could not usefully use the financial support offered by local commercial banks and microcredit institutions. Both of these sets of financial institutions were far more interested in providing highly profitable unsecured consumer loans. An alternative was therefore sought. AAF was founded on an initial capital base provided by each of the local sugar cane farmers putting a little cash into the project, cash which was then matched with an interest free loan from TSB. Along with subsequent injections of cash to match the growing numbers of successful farmers, this initiative created a farmer-controlled cooperative that could provide needed low interest long-term loans to its farmer-members secured on the output of their farm.

As of mid-2010 AAF had nearly 900 members and was growing. TSB reported that it greatly benefitted from the security of its supplier base, as well as from the higher specific investments made by its supplier farmers, who are all able to operate using the latest production and harvesting equipment and so could meet important quality controls. The farmer-members of AAF benefit from the supply of low cost finance that allows them to realise a greater return from farming, and also to invest in sustainably expanding and diversifying their operations to meet new demands and market opportunities provided by TSB and other customers (Bateman 2010b)

In South Africa, there is much scope to promote these hybrid local financial institutions in the agricultural sector, as will as in other industry-based supply chains involving larger numbers of small subcontractors, such as motor vehicles and the FTI industry noted earlier. The security provided by the contract is an important aspect is minimising risk and transactions costs (screening, etc) while the in-house knowledge of all parties to the program ensures that the financial package can be designed to 'fit' with the end user's requirements as much as possible.

8.4. Dedicated local funds to finance local content agreements and public contracts

In the EU countries and in the USA, the use of loan-fund backed public procurement policies to stimulate manufacturing-led SME sector is a well established intervention. Partly it is designed to support the small business sector in preference to larger companies, which are seen as less efficient job-generators and less conducive to the formation of sustainable local business communities. There is also a more nuanced 'developmental' approach to public procurement, which is to preferentially help a small business in the difficult first few years of its life by awarding government contracts awarded on preferential terms and conditions. Because the start up period is a difficult one for most small businesses, the idea is to offer some guaranteed demand to help the business as it attempts to perfect its product, builds scale, trains its workforce, and so on. After the small business reaches a satisfactory level of maturity, the idea then is to disengage from providing preferential contracts and to encourage the business to compete on normal market terms.

Perhaps the best example here is that of Japan's national and local governments, which have been extremely successful in carefully using state loan funds attached to public contracts to help potentially high-growth and innovative technology-based SMEs get established and sustainably expand. One of the most notable successes was in the case of industrial robotics, a global market which the Japanese small business sector effectively came to dominate (Porter 1990).

In South Africa, public purchasing contracts have also been used to support a new raft of businesses, many black-owned as part of the BEE initiative. However, it is widely accepted that many of these small businesses have been supported purely because of political motives and actually have very little potential to reach viability outside of the flow of government financial support. The rise of businesses unable to survive outside of government tender support has given rise to the phenomenon adversely referred to as the 'tender-ocracy' and 'tender-preneurs'. This has naturally discredited the entire concept of public procurement support being used as an economic development instrument. All told, the use of public procurement policy to leverage developmental impacts is an accepted policy in most developed countries. However, in the South African and Mpumalanga context, this policy intervention has unfortunately become mixed up with crude political patronage and simple corruption.

A more efficient system of financial support for public procurement-led SME development programs in South Africa would require highly qualified and politically-independent management. In addition, equity stakes in the business would be desirable in order to recoup for the public at least some of the immense value represented by a stable public contract.

8.5. Encouraging loan consortia among suitable SMEs

The Italian example shows the long-term benefit of groups of SMEs forming consortia to bid for lower cost funding that would be applicable to individual SMEs. The concept has been immensely attractive in the past because it has reduced risk on the part of the financial institutions as well as monitoring costs, thanks to joint liability between the SMEs, while also reducing opportunistic behaviour on the part of participating SMEs. It is no surprise that in Italy's FTI sector, the use of consortia was extensive, providing members within each consortia of a valuable supply of long-term, low cost capital for machinery purchase and working capital costs.

In South Africa, forming groups of industrial SMEs with a view to them collectively obtaining capital on better terms largely depends on the commercial banking system's willingness to participate. Elsewhere, above all in Italy, it was the local commercial banks' willingness to help develop the local economy that encouraged them to work with groups of SMEs in this way. Such an ambience is perhaps somewhat less developed in today's South Africa, though it cannot be ruled out with regard to the more socially-oriented banks in the country. This suggests that such consortia might work best alongside municipality or cooperative banks, as a further way of ensuring that these institutions are able to positively impact in the local community.

8.6. Build-operative-transfer (BOT) enterprise financing programs

One of the most important barriers to pro-poor SME development is the problem of 'initial conditions'. This problem emerges because the poor by definition cannot afford to invest into the most profitable parts of the supply chain, which means they are forever condemned to operating in the least valuable parts, and so must allow richer members of the community – individuals and companies – to exploit the most valuable parts of the supply chain. This effectively cements in place local inequality and exclusion through unequal supply chains based on capital input.

One way around this problem is for public bodies to provide the poorest members of the community with sufficient grant or loan finance to integrate into the most valuable parts of any supply chain, the returns from which they can use to develop the community. For example, in agricultural supply chains, it is well-known that the most valuable/profitable section of the chain are in processing and retailing, which the poor generally do not enter because of simple capital constraints. If, however, these most valuable sections of the supply chain are purchased by an external body and later on sold back to the poorest participants, a major SME development breakthrough is possible: the poorest participants will end up controlling the most valuable sections and can ensure that value is passed down the chain to those most in need for personal and investment purposes.

In Ecuador, for instance, regional governments have provided significant resources to traditionally poor farming communities in order for them to integrate into the most valuable/profitable parts of the agricultural supply chain – the processing and retailing parts. Rather than consigning the poor to the mere production phase and allowing wealthier Ecuadorian individuals and private businesses (including foreign multinationals) to monopolise the higher value added sections of the supply chain, which is often the direct motive of many international development community programs aiming at 'strengthening the supply chain',[29] the idea behind these interventions is to encourage the poor to collectively own the most valuable/profitable parts of the supply chain with a view to the value being channelled downwards into the poorest communities. With regional government providing up to $1 million to successfully establish a functioning processing plant, which was then sold off to the cooperative owned by the farmers, the regional government established an equitable and developmental supply chain as never before in the past (Bateman 2012c).

In terms of promoting equitable and sustainable enterprise development, this is one of the best ways possible. An initial lack of capital on the part of poor communities need not 'lock in' the poor to a permanently disadvantaged position but can, instead, be overcome thanks to capital investment by the wider community. Important capital assets can be built up using loan funding and then transferred over to 'collectivities' of the poor (cooperatives, associations, municipalities, etc) and used by the poor to generate wealth. This is a direct way of supporting SME development, but an important one since it overcomes the typical barriers associated with poverty and exclusion.

8.7. Renewed emphasis upon credit unions as support for consumption loans.

Finally, we come to the 'elephant in the room' question in South Africa, which is What to do about the massive consumer debt overhang that exists today. South Africa's massive individual debt overhang is largely as result of the actions of for-profit microcredit institutions. While for many years, the local informal moneylender

[29] The US government's USAID arm is probably the worst offender here, routinely promoting 'more efficient supply chains' that are actually all about helping large US companies and corporations to build a more efficient supplier network in order to maximise their own profits, rather than maximise development opportunities in the poorest communities.

(*mashonisa*) would ply his trade in South Africa, the social legitimisation of the microcredit model encouraged formal financial institutions to engage with the very poorest communities in pursuit of profit. However, maximising profits involved, among other things, the need to bring in as many clients as possible in order to cut unit costs. This emphasised rapid growth no matter if this was, or was not, in the best interests of the community itself. The worst case of expansion involved the deliberate over-indebting of the mining communities around Rustenburg, the end result of which was to exacerbate the conditions under which the miners lived to the extent that they felt forced to go on strike, with horrendous results at the Marikana mine on August 16th 2012 when 34 unarmed miners were shot dead by local police (Bateman 2013).

Credit unions, on the other hand, have no internal profit-maximisation incentive to stimulate such lending. As saver-member organisations, a credit union exists to provide services for current members, which include microloans but also other servicers, and where there is no in-built profit-driven impetus to expand as much as possible. Like their informal cousins, ROSCAs (Rotating Savings and Credit Associations), formal credit unions tend to attract much more support in the community *because they are owned by that community*. Robust regulations will be required, however, in order to ensure that there is a minimum of mismanagement and corruption.

9. Conclusion

This paper has centrally argued that the local financial systems that have evolved in recent times under neoliberal policy regimes, very much including in South Africa, have proven to be entirely unsuitable to a manufacturing-led SME development trajectory. Importantly, historical experience, also including from South Africa itself, provides a wealth of examples of highly effective <u>non-neoliberal</u> local financial systems that are intimately associated with sustainable industry and agro-industry-based SME development progress. These insights were then set against the understanding that the local financial system typical of most communities in South Africa today represents one of the most important barriers to the success of a manufacturing-led SME sector. Change is therefore urgent.

Using insights from the FTI sector in South Africa, the conclusion of this paper is that urgent steps must be taken in South Africa to reconfigure the local financial system in a non-neoliberal direction. A number of alternative non-neoliberal financial institutions were therefore outlined. In particular, I emphasised that economic history time and again shows the developmental power of community-based (owned and controlled) financial institutions. While not without problems, community-based financial institutions provide a far better chance of establishing an effective local financial system in post-apartheid/post-neoliberal/post-global financial crisis South Africa.

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