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Statement by

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before the

House Committee on Small Business

Subcommittee on Access to Equity Capital and Business Oportunities

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I am pleased to appear before you today to discuss the impact on small business of the Federal Reserve actions announced on October 6.

These actions, as you know, included: an increase of 1 percentage point in the discount rate; a marginal reserve requirement of 8 percent on so-called "managed liabilities" of larger banks; and a change in operating procedures to give more emphasis, in implementing our money supply targets, to the supply of bank reserves and less to the level of interest rates. Together they should enable us to exercise firmer control over the growth of money and credit and thus assure that monetary policy plays its appropriate role in dampening inflationary pressures.

At the time of the October 6 actions, the monetary aggregates and bank credit had been growing at rates well in excess of our announced targets, inflation and inflationary expectations were showing no signs of abating, and speculative activity had unsettled a number of commodity markets. These developments were not unrelated, nor self-correcting. Failure to deal with them carried long-term risks that in our judgment outweighed the short-run risks of taking forceful steps to contain inflation. Reinforcing our determination to keep the growth of money and credit within our earlier target ranges seemed essential under the circumstances.

These ranges had been reaffirmed in the Board's July oversight hearings before the Congressional banking committees, and were endorsed by those bodies. The long-run targets adopted for 1979--that is, for the period from the fourth quarter of 1978 to the fourth quarter of 1979--still seem appropriate for orderly growth of the economy. We have not changed them. We have simply increased our ability to achieve them. Growth in money and bank credit had not only been rapid but threatened to become excessive. If this happened, we would be unable to meet our objective of supplying sufficient credit to finance orderly economic growth while slowing the pace of inflation. The steps we have taken provide better assurance that we can meet that objective.

Opinions differ as to how long it will take for our message to be widely understood. We think the time will be relatively short. Once the public recognizes that we are serious and that we intend to stay the course, inflationary expectations should begin to recede and the base will be laid for a return to the stable and productive economy we all want.

It almost goes without saying that a healthy economy provides the kind of environment in which small business can prosper, and conversely that the soundness and prosperity of this very important sector is essential to the stability and productiveness of the overall economy. Success in our efforts to take the steam out of inflation and out of self-fulfilling inflationary expectations will be of particular benefit to small business.

But the process of getting firmer control of the money supply, as a first step toward unwinding inflation, will not be easy or painless. The next few months could prove difficult for some businesses--large and small. Those that have borrowed to finance speculative transactions can be expected to bear the brunt of the program we have adopted, and appropriately so. Risky and over-extended businesses also may find it difficult to roll over or fund maturing short-term debt. Even some well-managed firms needing funds for productive purposes may, for a while, find credit somewhat less readily available and more expensive than it was before.

Since small businesses are of necessity so dependent on commercial banks for the credit their suppliers do not provide, and since the actions the

Federal Reserve has taken are designed to restrain the growth of bank credit, I would like to suggest what seems to me the most likely response of these lenders to the new conditions under which they must operate.

I have no doubt but that banks will make every effort, as they always do, to meet the legitimate needs of their best customers, and for most banks the bulk of their best business customers is small. We have urged our member banks to make special efforts to do so in these difficult times. In a letter of October 23 to member banks, Chairman Volcker said that "lending institutions need to be alert to the continuing need for credit on reasonable terms to finance the basic needs of the economy. In accommodating these needs, we believe banks should take particular care that small businesses, consumers, home buyers, and farmers continue to receive a reasonable share of available funds."

However, banks themselves are likely to be under considerable financial pressure over the near term, as demand for bank credit remains heavy while growth in lendable funds moderates.

The reserve requirement placed on further additions to the managed liabilities of larger banks will make such funds more expensive and thus less attractive; managed liabilities have financed a significant share of the recent expansion in bank credit. And the increase in the discount rate is intended to discourage excessive borrowing from the Federal Reserve Banks as an alternative source of financing. In addition, banks have been attracting considerable funds from issuance of money market certificates, but banks in general (including nonmembers) and small banks in particular may be more cautious in promoting this source of lendable funds while it is so expensive.

At the same time, slowing in customer demands for credit may be delayed, in part by lack of acceptable financing from alternative sources.

For example, recent increases in the cost of funds in long-term securities markets have caused the postponement of a number of new issues. Unless the planned use is also postponed, these borrowers are likely to seek temporary financing from their banks. Also, there is as yet little evidence of the expected recession-associated slowdown in business loan demand.

Under these circumstances, it seems likely that an increased proportion of credit demands will not be met. We have asked our member banks to avoid lending for speculative purposes and to channel their available funds into loans for productive purposes. While it is sometimes difficult to distinguish between a nonproductive use and a productive one, I would expect to see a sharp cutback in financing of obviously speculative transactions, even before a turnaround in the outlook for inflation dims the profits potential of such transactions.

Banks are also likely to firm their lending standards, not only as a result of Federal Reserve actions but also because--as is usually the case--anticipation of a slowdown in the economy is causing lenders and investors to become more quality-conscious. In addition, banks can be expected to encourage even high-quality borrowers to postpone or scale back their financing demands, if they can and have not done so themselves. But I honestly do not believe that banks will need to, or will, deny credit to sound, established customers with financing needs that cannot be postponed.

In fact, the most serious financing problem for such customers over the near term, as I see it, will be not lack of credit but its cost, which in turn will likely reduce some spending plans and financing demands. In his October 23 letter, Chairman Volcker said, "In adjusting loan rates, the Board would also call your attention to the desirability of considering the special problems of smaller customers who have limited financing alternatives." Individual bankers have told us that they will be making particular efforts to hold down the rates charged on loans to small business. Banks that have a dual prime arrangement have indicated that they do not intend to abandon it, and some of them apparently have decided to widen the spread between the prime and the lower small-business base rate.

What we all most want to see, of course, is a reduction in inflationary expectations and this should bring with it a decline in interest rates. The unprecedented present cost of borrowed funds appears to be unfortunately unavoidable, given the inflation premium which has been imbedded in interest rates for some time. There is no chance that interest rates will come down significantly until inflationary expectations are damped. We are convinced that our recent actions, especially when combined with disciplined fiscal policy, represent the best and fastest way to bring that about.

It is clear, from what one hears and what one reads in the newspapers, that small businesses are worried, and if I were a small businessman I might be worried too. There is reason to be concerned. The next few months could be very difficult for some businesses. But one has to keep in mind that continuation of the inflationary and increasingly speculative environment that had been developing would ultimately have had far worse consequences, for the economy as a whole and for most small businesses. The long-run dangers of failure of the Federal Reserve to make a determined effort to curb inflation outweigh the short-term risks inherent in the actions we have taken.