

## **Remarks by Governor Lawrence B. Lindsey**

**At the Small Business Development Conference, Richmond, Virginia**  
**October 2, 1996**

### Small Business Is Big Business

It is my pleasure to be here today at the Federal Reserve Bank of Richmond's Small Business Development Conference.

A fair question might be, what is the nation's central bank doing sponsoring a conference on small business? Well, let me be clear about one thing, neither I nor my colleagues from the Fed are going to say to the small business people of America -- I'm from the government and I'm here to help. If I even attempted such a claim you would all rightly laugh at me.

But that does not mean that small business is not an important area of concern for us; nor does it mean that we have no appropriate role to play. Small business is vital to the U.S. economy in ways that go far beyond mere quantitative measures. The small business sector is the market's laboratory of new products and new ideas. Less than a century ago, Ford Motor Company was a small business -- little more than a backyard operation. Forty-one years ago, McDonald's was a single hamburger outlet in Des Plaines, Ill. Twenty years ago, Microsoft had a similarly humble origin. We do not know, nor can we ever tell which of the small businesses being formed today will become multi-billion dollar operations in the 21st century. But, we do know that some will and they will be part of the driving force which remakes the American economy.

But, even those businesses which do not become industrial behemoths still have a vital role to play. Small businesses build our homes and unclog the drains when they get full, they monitor our health and repair our cars. They provide these goods and service because in a market economy driven by consumer sovereignty, they have a better and more personal knowledge of the needs of the consumer than would a much larger enterprise. I would add that 34.1 percent of the nation's roughly 10,000 banks employ fewer than 20 workers, and the combined assets of those that meet the widely used SBA definition of small business -- fewer than 500 employees -- have 26.1 percent of the nation's banking assets.

It goes without saying that a sector which employs half of the private work force is vital to our nation's economy. But, when one considers what that sector does, it is clear that the other half of the economy could not function without it. So, as a central bank we must monitor the health of the nation's small businesses because it is a central focus of the health of the American economy.

But we, the central bank, also have a responsibility to play the role of honest broker and information provider. We are not here to make a loan, tell you who to hire, or tell you what a profitable line of business might be. We are here to facilitate the flow of information in

that regard.

### **Small Business and the Economy**

Let me begin by considering a unique characteristic about the U.S. economy that comes from its having one of the most robust small business sectors in the world. If one visits Europe and talks to economic and political leaders there, talk invariably turns to the American Job Creation Miracle. This is not a new phenomenon. During both the 1970s and 1980s the economy added jobs at the rate of 19 million per decade. So far in the 1990s we have come close to keeping up this pace, having so far added about 10 million jobs to the private economy.

The keys to this success are two closely related phenomenon. First, we have a flexible and largely unregulated labor market. To date government by and large has not imposed overly burdensome mandates on employers and made the process of hiring and firing overly difficult. Of course, the political temptation to do so is always there, as it is in Europe, but to date we have not adopted the very rigid labor market structure that characterizes so much of Europe. Of course, the price the Europeans are now paying for imposing high taxes, mandates, and regulations on their labor markets is double digit unemployment. While our private sector has been increasing employment by 1.9 million per year for a quarter of a century, the European private sector has seen barely any net job creation over the same period.

The second, and related key, is that we have a vibrant small business sector in which entry and exit occurs at an almost breathtaking pace. This involves a truly staggering rate of labor market turnover. I mentioned earlier that the country has enjoyed private sector job creation of about 1.9 million per year. But, research suggests that for every job created on net, roughly 10 new jobs were created and 9 jobs were lost. For example, in one period studied by the SBA, 1988-1990, a period in which the U.S. economy was moving from a business cycle peak into the start of a recession, they estimate that 23.2 million jobs were created and over 20.5 million were lost, for a net change of 2.7 million jobs. If one applies the 10 for 1 rule of thumb to get a measure of economic change, we find that nearly one job in six in America is "new" in any given year. Any economy which can remake itself roughly every six years is a truly dynamic engine of opportunity and change.

Of course, this environment is both conducive to and in part results from the small business sector. In a world in which employees are not tied to a single large employer throughout their working lives, economic opportunities and vibrancy naturally result. New sectors, including trade, finance, business services and high tech areas such as software and electronics, can more easily emerge. Last year, 1.7 million net new jobs were added in the United States, 75 percent of them in sectors that have a high share of small businesses. The five fastest growing sectors were health care providers, engineering and accounting research firms, amusement and recreation services, advertising services, and equipment rental and leasing. All of these have a high small business component.

### **Financing of Small Business**

In addition to a vibrant labor market, small business needs access to capital in order to survive and prosper. The Federal Reserve monitors the health of this sector on a regular basis through our bank Call Reports. But, as we all know, a good deal of the capital which small businesses use originates outside the banking sector. So, two years ago the Federal Reserve conducted our second extensive survey of small business access to and use of the financial sector. This survey, combined with other data, indicates that the links between the

small business and financial services industries continue to evolve in ways which are mutually beneficial.

This should not surprise us. The National Federation of Independent Businesses conducts a regular survey of small businesses to ascertain the greatest problem they face. In the latest survey only 4 percent of respondents cited a lack of access to or the cost of credit as their primary problem, to give it a rank of seventh on the list of small business concerns. By contrast, 29 percent cited high taxes, 19 percent cited regulation and red tape and 12 percent cited the low quality of labor, a reflection of the problems which our public schools are having in meeting the needs of a growing economy. You can see why I did not even try to claim that I'm from the government and here to help you.

Credit cost and availability has not always been of such minor concern. As we came out of the high inflation period in the late 1970s and early 1980s, credit cost and availability was cited by more than one third of respondents as their biggest problem. Similarly, in late 1989 and early 1990 as concerns about bank credit problems in the commercial real estate area caused a re-evaluation of regulation and banking behavior in this area, the cost and ease of access to credit was cited by 10 percent of respondents.

The diminished problem of credit access and its cost is also borne out by banking loan statistics. Consider, for example, data from the June 30th Call Reports, which show a hefty rebound in small business lending by banks whose business loans are small. The 1996 report showed a 12.9 percent increase over the previous year. This followed a 13.2 percent increase in 1995 over 1994 and a 10.9 percent increase in 1994 over 1993. Even if one looks at all domestic commercial banks, small business lending has maintained a 6.5 percent annual rate of growth for the past two years. Regardless how one measures it, the access to bank credit by the U.S. small business sector has been growing much faster than the economy of late.

Our small business survey indicated that just over half of all firms reported outstanding credit in the form of a credit line, a loan, or a capital lease. Lines of credit and motor vehicle loans were the two most commonly cited types of credit obtained. In addition, the survey showed that borrowing against real estate was an important method of funding small business.

### **Prospective Developments**

There are a number of ongoing developments which are likely to continue and even further develop the relationship between the financial services industry and small businesses in our economy. On the financial services side, we have witnessed many large institutions that previously had left the small business market to community banks, rushing to develop a wide array of loan products and services specific to small business needs. Sweep accounts, tailored investment programs, affinity credit cards, smaller revolving credit lines, and improved lock box services are just some of the business services being offered in the new, more competitive small business market.

At the same time, new technologies and information flows are providing opportunities for banks and other lenders to more efficiently evaluate loan risks and lower the costs of small business lending. One technique that is gaining broader acceptance is credit scoring. Credit scoring is a statistical procedure that evaluates default risk based on the relationship between observed loan performance and specific characteristics of the loan and the borrower. The development of score cards for businesses requires that lenders have a large amount of historical information on the performance of loans with similar characteristics. Given the

huge diversity among business borrowers, it will take awhile to develop these databases. To facilitate this process, lenders usually adopt more standardized loan terms and application forms. Many large banks already have begun to probe the possibilities of credit scoring techniques for small business markets.

Once developed, credit scoring and loan standardization may offer significant cost advantages for evaluating the risks associated with lending. And as credit scoring and loan standardization become more commonplace, the ability of banks to "securitize" small business loans likely will be greatly enhanced. A key benefit of securitization is that it potentially increases the liquidity of small business lending and provides banks and other lenders with additional sources of funding. One would expect the cost savings generated through lower origination costs, better risk assessment, and greater liquidity to be passed on, at least in part, to small business customers. Clearly not all small business loans are going to be appropriate candidates for securitization, and not all banks will wish to adopt complex statistical models for managing risks. There will continue to be a market for nonstandard small business lending and a role for regional and community banks.

In addition to bank financing, equity market developments have also produced a very favorable environment for small businesses. The initial public offering market has seen enormous development. More than \$50 billion has been raised through IPOs in 1995 and 1996. In particular there has been an explosive growth in the private equity markets. This has become an important source of capital for start up firms, private middle market firms, and public firms seeking buy-out financing. Between 1980 and 1995, venture capital outstanding increased ten fold, from \$3 billion to more than \$30 billion. Non-venture private equity increased even more over this period -- from \$2 billion to \$70 billion. In addition, the development of the limited partnership form of organization, which began to really take hold in the 1980s, has spurred the development of a much more efficient delivery system for capital.

In sum, the reasons to be optimistic about the American small business sector can be found in the organization and structure of our capital and labor markets. A comparatively lightly regulated set of markets, full of potential for innovation and exploration of market niches, has made the American small business sector a world leader. In turn, the dynamism which is an inherent part of this sector has created the American job creation miracle. The importance of continued innovation and the creation of opportunity cannot be underestimated. So, on behalf of all of my colleagues at the Fed, I am delighted that we can play a role in fostering this innovation through the sponsorship of conferences like this one.

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