(For release 12:30 p.m.,
Central Standard Time,
May 16, 1958)

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Member of the Board of Governors

of the

Federal Reserve System

before the

Seventy-first Annual Convention

of the

Kansas Bankers Association

Kansas City, Kansas

May 16, 1958

"A Challenge to Our Financial Community"

When one is asked to speak on a topic related to monetary policy, the door is opened for a talk on almost any aspect of our economy. Monetary policy operates through our money and credit mechanism, but its impact extends far beyond interest rates and bank reserve positions. It can contribute to, and therefore must be deeply concerned with, the solution of a wide range of national problems. Some of these problems are broader than others. Some appear more urgent than others. But attention paid to seemingly smaller, perennial problems will frequently help to solve broader, urgent ones.

We who have long lauded "competition" as one of the most potent of all driving forces are now in the middle of the most portentous competition of all time. If the launching of Sputnik the first, last October, did nothing else, it demonstrated that we can no longer rest on past laurels and reassure ourselves with mere talk. It made us wonder whether too many of us had become lazy - content to watch the game rather than play it. It made us cognizant of the need for action, for "tooling-up" for the space age, and for determining what other steps we must take if we are to be successful in meeting the challenge of Communist Russia.

What we in America are faced with today is a complex problem that involves not only our military power and scientific achievement but also our economic strength - a problem, in short, of effectively demonstrating the many superior accomplishments of which a democratic, free enterprise economy is capable.

In their effort to make our system of government, our economy, and our way of life distasteful and unacceptable to the peoples of captive nations and "uncommitted" nations, those unfriendly to the United States usually describe us as a country dominated by a small number of gigantic financial and industrial corporations, which in turn are controlled by a handful of powerful financiers and tycoons - the top-hatted bloated capitalists of communist cartoons.

Perhaps we should publicize with more vigor the major part played in our economy by relatively small, independent businesses - exemplified, for instance, by the 600 one-office banking institutions of the State of Kansas, more than one-fourth of them with total resources under a million dollars, and over 95 per cent of the remainder between one million and fifteen million. How many people, even in our own country, are aware that well over 90 per cent of all American business concerns would be classed as "small" by any reasonable definition, and that they number in the millions? Millions of our citizens, in other words, are exercising the right to be their own boss, to try out their own ideas, to risk failure in the hope of great success.

But small business is more than a way of life for millions of independence-loving entrepreneurs. It has contributed a great deal to our material strength. A large portion of our inventions, scientific discoveries, and industrial innovations has come out of small companies - from electronic gadgets that make possible the compact machinery needed in our rockets and missiles, to the household gimmicks that make the housewife's chores easier or more pleasant.

We cannot afford to let small business operate under any serious permanent handicap, in part because there are so many of them, in part because they play such an important part in our way of life, and in part because they can contribute so much to the technological progress we need. It is to our national interest to foster small business and to strengthen its position through providing the appropriate economic climate, technical assistance, and financial facilities it needs in order to grow and prosper.

Considerable attention has been focused recently on this last one - the provision of appropriate facilities for financing small business. Many people talk about the financing problem of small business; most people even agree as to the nature of the problem; but there is almost no agreement as to just what to do about it.

The first two volumes of a sizable study of small business being made for Congress under the direction of the Federal Reserve System <u>suggest</u> that the unfilled financing needs of small business are for long-term credit or capital. They also suggest that the kinds of business most in need of such funds are those that are just starting up, or those that are desirous of expanding the size of their operations, especially if their activities require a relatively high proportion of fixed assets.

I use the word "suggest" advisedly, because the evidence we have on the "gap" in the financing of small business is far from complete. In fact, our information on small business - how it operates, how it finances itself, what its financing and other problems are - remains very spotty, even after an enormous research effort. This is a field in which it can be truly said, there are no experts. The little bits and pieces we have assembled do not as yet give us the whole picture. We find ourselves, as Dickens said, with "a smattering of everything and a knowledge of nothing".

I am sure you as bankers would be among the first to recognize this. Those of you in smaller institutions know a lot about your small business borrowers - including the fact that there is no such thing as a "typical" small business; each one is unique in its structure and problems. Likewise, those of you in the larger banks know a lot about the small concerns that are regular customers of your business loan department, although much less about the financial characteristics of the businesses that obtain credit through your consumer loan department. However, none of you knows very much about the businesses that never try to obtain bank credit.

This last group - which appears to include a large proportion of all small businesses - is the very group we should know more about. Why are there so many small businessmen who do not regularly use bank credit - or even apply for it? Are their financing needs adequately met by the sales credit advanced by suppliers, by money borrowed from friends and relatives, by their own savings and the profits of the business? How many businessmen do not try to get bank credit because they are not interested in expanding their operations beyond the limits permitted by the funds they have? How many would like to have, and could profitably use, additional funds but are convinced that they could not get them?

Most of these questions are still unanswered. In the parts of our study that have been completed and published, systematic efforts were made (1) to examine and correlate existing information on small business and its problems and (2) to obtain new information directly from those who finance it. These two approaches are now being supplemented by a third one - a questionnaire survey of small businesses themselves, covering their financing practices and difficulties.

The task of obtaining reliable information of this type is a formidable one that for years has discouraged students of small business problems. Consider, for example, the difficulty of selecting a representative sample of concerns from this enormous and varied area, or of obtaining detailed and consistent financial records from very small enterprises. But we are going ahead, on an experimental basis, to do the best job we can, realizing that we are exploring uncharted seas with no ready-made map to guide us.

Twenty years from now, the fruits of this effort undoubtedly will seem meager in contrast to the complete and accurate data that will then flow smoothly and instantaneously from electronic computers. But it is comforting to recollect that the huge printing machines and linotypes of today would not be turning out millions of newspapers and books every hour if Gutenberg had not built his primitive screw press and carved his wooden types five centuries ago.

When this third part of our work is completed, we hope we will be a little closer to understanding the financial needs of small business. In the meantime, we are faced with the alternative of either ignoring the apparent existence of a financing problem, or of making the best judgment we can, in the absence of complete information, and acting accordingly. In my opinion, there is no real choice here. This is no time for delay or for trying to make progress by standing still.

The best guess we can make on the basis of the information now available is that there _is_ a small business financing problem, that it lies largely in the long-term area, and that it cannot be solved with existing financing arrangements. The problem may turn out to be more serious - or less serious - than we now think it is, but we can find out only if we are willing to make some pioneering effort - pioneering effort of the kind and quality that took place nearly a century ago in that portion of the middle west typified by my home town of Broken Bow, Nebraska, and thousands of other places like it; pioneering of the kind that changed the "western frontier" into the breadbasket of the nation.

The financing of business, agriculture, and individuals has always involved pioneering and experimentation and, as you are thoroughly aware, over the years we have made a great deal of progress in developing new methods tailored both to the needs of the borrower and the safety and liquidity requirements of the lender.

While long-term financing of small business is largely outside the present range of commercial bank lending, the problem of filling this gap must concern bankers. For one thing, your _short-term_ small business borrowers are better credit risks if their capital and long-term financing are adequate for the nature, size, and volatility of their operations. At many a loan officer's desk, frustrated borrowers have learned the truth of Ben Franklin's maxim that "A light purse is a heavy curse."

A frequent reason for turning down otherwise worthy applicants is inadequate capital protection. In our recent interviews with commercial banks, we inquired why loan applications from small businesses were rejected. The reason cited most frequently - by over 90 per cent of the banks interviewed - was "insufficient owner's equity". "Requested maturity too long" was cited by 70 per cent. If a way could be found to enable small businesses to obtain adequate capital and long-term credit, more businesses would be more creditworthy, to the benefit of the size and quality of the loan portfolios of commercial banks.

Also, bankers should be concerned that the financing gap appears to be particularly serious - as might be expected - in the case of new enterprises and expanding ones, because these represent the most dynamic elements in our small business universe. They are the small businesses with the greatest potential for contributing to raising our standard of living, and to strengthening our economic and military position as the free world's leader. Their health and growth is very important to the health and growth of our economy - a matter of great significance to us all, bankers and nonbankers alike, including our friends and allies abroad.

Another reason why bankers should be interested in this long-term financing problem is that a way may be found for them to participate in filling the gap. Their knowledge of local businesses should be very valuable in helping to select those which need assistance. In addition, a method <u>may</u> be developed that will enable them to finance the long-term needs of small businesses.

Today most banks do not advance long-term credit to small businesses because the risks are too great, the maturities too long, and the costs too high to provide the safety, the liquidity and the return which responsibility to their depositors requires. You will remember, however, that an equally strong case could once be made against other types of loans that are now an important and accepted part of commercial bank lending activities. I am thinking particularly of the extension of intermediate-term credit to businesses and long-term mortgage credit to individuals. What happened, as you know, was that <u>new</u> ways of lending were developed that provided adequate safeguards and made term loans and real estate loans acceptable and appropriate outlets for bank funds. It could happen again!

A single commercial bank, or a single savings institution, cannot conduct a major lending experiment with funds that have been entrusted to its care. It can, however, often participate in an experiment undertaken on a nationwide basis, when there is a coordinating organization to do the pioneering work of ferreting out the specifics of the problem, helping set up a program to meet it, providing safeguards to reduce the risks and help cover the operating losses, especially in the early stages of the program.

This is where government has in the past played a vital role. The primary purpose of many of its assistance programs was to relieve an emergency situation such as the mortgage foreclosures and business loan defaults of the early thirties. In most cases, however, these emergency programs - generally developed in cooperation with private lenders - introduced and established the feasibility of new financing methods that were gradually adopted as permanent additions to our private lending tools after the emergency was over and the government partially or wholly out of the picture. This role of innovator - or catalyst, if you will - is an appropriate and desirable function for the government to perform.

A large dollar amount of government loans to small business is not the desired goal. In fact, I would be reluctant to see the government increase its activity as a lender of taxpayers' money to selected groups. I would dislike to see extension of undesirable government subsidies - even to small businesses. I am not in favor of any program that would serve only to prolong the life of uneconomic business units. I would not favor any program which would impose obligations on the Federal Reserve System to lend or allocate funds in this field because its ability to perform its basic central banking function might be impaired thereby. But I am in favor of the government initiating new, needed, sound programs, that are designed to encourage private funds to come in at the start and in time to take over completely.

This is the role envisaged for the government in a number of bills now pending before the Congress that deal with the problem of providing long-term credit and equity capital to small business. These bills vary considerably as to the way the programs they propose would be organized and administered, but most of them are aimed at a limited financial contribution by the government and maximum participation by private enterprise.

This should be an essential feature of any program to provide long-term credit or equity capital to small businesses. Except possibly in the early, experimental stages of the program, the government should not be involved in deciding which specific business units are to receive assistance. Nor should it make a practice of using public funds to acquire a direct ownership interest in private businesses. Decisions like these should be made by private investors operating with private funds.

I have no idea, of course, what kind of program will be adopted by the Congress - or when - but I am sure that some action to alleviate the problem will be taken. I also have no idea what new long-term financing arrangements may come out of such a program. This looks to me like a hard nut to crack. But we have cracked others, with what must have seemed - after they were developed - like very simple and obvious tools.

Before the days of the regularly amortized real estate loan, the problem of finding a way to assure that farmers and home owners would be able to pay off their mortgages, when they finally fell due, must have seemed impossible of solution. But a solution was found, and with the introduction and refinement of the amortized mortgage, by government and private lenders, lending that had been too risky for commercial banks to undertake in large volume became an acceptable and substantial part of bank loan portfolios. The term loan that was developed under the Reconstruction Finance Corporation loan program and refined by commercial banks is another example. Government agricultural loan programs have been effective in demonstrating how loans to farmers can be tailored to fit particular needs.

Long-term financing of small business is, as we know, costly and risky under present lending techniques. In order to discover the best way to bring down the costs and reduce the risks, we need a program that would be frankly experimental in the beginning. After a period of experiment and experience, a financing method might well emerge that not only would expand our inventory of lending techniques and provide a sound and profitable outlet for the funds of banks and savings institutions, but - perhaps most important of all - would help greatly to correct a persistent weakness in our economy.

I feel sure that - if they are willing to think hard enough about the problem - bankers and other lending and investing groups can help to develop some way of facilitating the flow of long-term investment funds to creditworthy small enterprises. A basic characteristic of our competitive, free-enterprise, capitalistic economy is the extent to which enlightened self-interest encourages all of us to tackle common problems - either together or, frequently, in active, productive competition with each other. When we become satisfied to sit back and let the other fellow, or the government, work out solutions for our problems, we are doomed - not just as individuals, but as a nation.

As has nearly always been the case, today we have many problems to solve. This problem of strengthening the position and maximizing the contribution of our dynamic small businesses is just one of them. A very serious current problem that disturbs us all is that we, the greatest economic power in the world, have been unable to avoid a recession that hurts many of our people, has unfortunate repercussions on other parts of the world, and provides amusement - or more likely, great satisfaction - to the nation that is determined, so her present leader says, to bury us.

Faced with these problems, we must remember that Communist Russia has challenged us on our own ground - industrial production, agricultural output, and applied scientific achievement. This is no challenge to a chess match, or to a gentlemanly debate on political systems. This is a contest for survival, not just for ourselves but for our way of life and that of the whole free world. Consequently, we cannot afford to be smug or self-righteous about the superiority of our way of life, or complacent about temporary setbacks.

However, I hasten to add that this is no time for panic, either - for plunging headlong into programs that are ill-conceived or in conflict with our democratic principles.

And above all, this is no time for discouragement, for giving up the race simply because the road ahead is long - and has some rough, tough stretches.

This is the time to buckle down and find solutions for our problems - economic, financial, political, and social. We must work together with determination and with minds that are open to new ideas, to demonstrate that a nation that believes in democratic principles of government, a nation that encourages private initiative and respects the worth and dignity of the individual, can at the same time continue to be the strongest nation in the world and out-distance any totalitarian state in providing the good life for all its citizens.