For Release on Delivery
Expected at 1:00 p.m. EST

Statement by

Frederick H. Schultz

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Access to Equity Capital and Business Opportunities

House Committee on Small Business

April 2, 1980

I am pleased to appear before you once again to discuss the impact on small business of the Federal Reserve's efforts to fight inflation. I welcome, in particular, the opportunity to discuss the program of credit restraint announced on March 14.

When I last appeared before this committee in October, the Federal Reserve had just undertaken a number of actions designed to slow the growth in money and credit. The October 6 policy changes were adopted in response to continued rapid expansion of money and credit, and an apparent worsening of inflation and inflationary expectations. These conditions had made themselves felt most prominently in the markets for gold and for some other commodities, where speculative activity was reaching alarming proportions.

As I indicated at that time, it was essential that the Federal Reserve take strong action to restrain money and credit growth in order to prevent a further serious acceleration of inflation and make a start on winding it down. Only in this way could we work toward a more stable financial environment for economic activity over the long run. The lesson of recent years is quite clear: namely, that the long-run consequences of allowing inflationary pressures to get out of hand are likely to be far worse than the short-run costs of actions to contain these pressures.

The policy procedures adopted in October, and the accompanying rise in market interest rates, led to a marked slowing in the growth of money and credit in the fourth quarter of last year. Since the beginning of this year, however, there has been a resurgence in credit demands, especially on the part of business firms. Bank loans and commercial paper have expanded very rapidly. Moreover, it has become clear that the financial markets, and the general public, remain concerned about the ability and commitment of the government and the monetary authorities to contain inflation.

No doubt inflationary expectations have been reinforced by the recent surge in the major price indexes--even though these increases were in large part the predictable result of the spurt in OPEC prices in the latter months of 1979 and of higher mortgage rates that are an unavoidable consequence of anti-inflationary monetary policy. Expectations also have been heightened by the continuation of strength in economic activity--in particular by the failure of the long-expected recession to materialize--and by the possibility that an acceleration in our defense expenditures would enlarge the Federal deficit.

The most dramatic manifestation of the reinforcement of expectations has been the unprecedented run-up in yields on long-term bonds--a movement that has erased hundreds of billions of dollars of market values. Spending patterns also have been affected. The household savings rate in the fourth quarter reached its lowest point since the Korean war, and retail sales were strong early this year suggesting that the "buy in advance" psychology was still in operation.

It was against this background that the monetary and credit program was announced on March 14 as part of a government-wide effort to stem inflation. The program is intended to strengthen the effectiveness of the October measures and to reaffirm our commitment to bring inflation under control. The thrust of the program, as it pertains to businesses, has several aspects. First we are seeking to slow the overall growth in credit. A key element in this regard is the imposition of restraint on certain types of consumer credit, including credit cards and check overdraft plans. In addition, several specific actions have been taken that apply directly to bank credit growth. These actions include a tightening of the marginal reserve requirement on managed liabilities of large member banks that was initiated on October 6 and a special deposit requirement on increases in the managed liabilities of large nonmember banks, as well as the establishment of a surcharge on repeated borrowings by large banks at the discount window.

The March 14 actions also initiated a Special Credit Restraint Program. Under this program, banks are expected to limit loan growth this year to 6-9 percent, a range consistent with announced targets for growth in money and credit reported to Congress on February 19. Through the Special Credit Restraint Program, guidelines have been set forth for borrowers and lenders to assure that funds are available to meet certain priority needs. These guidelines are designed to moderate the uneven impacts that reduced credit availability may impose on particular sectors of the economy, such as small businesses and agriculture. The program also covers business borrowing from finance companies and in the commercial paper market.

The increased marginal reserve requirements on managed liabilities and the surcharge on discount borrowing further increase the cost of additional acquisitions of borrowed funds by the banks. Banks thus will be faced with the task of allocating a more costly and slower growing volume of credit among alternative uses. Businesses--both large and small--will find that bank loans are more costly and less readily available. Some borrowers will determine they cannot afford to pay higher rates charged on loans, and a greater portion of credit demands will not be met.

A reduction in the availability of bank loans is, of course, a more serious matter for some borrowers than for others. Limited access to alternative sources of funds makes small enterprises very dependent on commercial banks for credit. This dependency may be even greater during a period such as now, when cash flows may be weakening, and suppliers are probably less willing or able to expand trade credit.

Following the Federal Reserve's actions in October, Chairman Volcker sent a letter to member banks urging them to give particular care to accommodating the needs of small businesses and other borrowers that rely primarily on banks for credit. The Special Credit Restraint Program incorporates explicitly our concerns in this area. The program states that a primary responsibility of banks during the coming adjustment period will be to "meet the basic needs of established customers for normal operations, particularly smaller businesses, farmers, thrift institution bank customers, and agriculturally-oriented correspondent banks and homebuyers with limited alternative sources of funds." Moreover, the Board expects that in setting interest rates and other lending terms banks will, where possible, take account of the special needs of these borrowers. At the same time, institutions are asked to avoid extensions of credit for speculative or nonproductive purposes, or for purposes that may be financed from other sources. Thus, within the overall range of the 6 to 9 percent loan growth target, banks are encouraged to channel funds to groups likely to use them for productive purposes and to those that have limited alternative sources.

The Fed has not attempted as part of this program to specify the portion of credit that banks should allocate to specific borrowing groups nor to establish numerical guidelines for the relative terms of lending. We feel that individual institutions are much better able to assess the needs of particular customers and their own ability to service those needs. I have little doubt that most lending institutions will make a concerted effort to meet, as best they can, the legitimate needs of their regular customers.

The Federal Reserve plans to follow closely developments in all sectors of the credit market, seeking to spot distortions in credit flows that may emerge. As part of this monitoring, we are requiring monthly or quarterly reports from selected banks that detail, among other things, the nature of their lending programs and the volume of credit flows to particular groups, especially small businesses. We are asking what steps have been taken to implement the guidelines and for explanations when lending patterns appear to violate them. Similar information will be sought from finance companies. Large businesses are on notice that they should not turn to the commercial paper market to replace other credit, as such a shift would reduce the residual credit available for other borrowers.

Let me reiterate, however, that these measures can not prevent small, and indeed all, businesses from encountering strains in coming months. As I stated in October, the process of breaking the inflationary grip in our economy will not be a painless one. But only by obtaining some degree of price stability can we create an environment in which small business can prosper. Once the inflationary spiral is broken we may expect to see interest rates move down, with particular benefit to small businesses. Indeed, the procedures adopted by the Fed in October promise a more prompt decline in rates once demands for money and credit ease than in the past. Without a reduction in inflationary expectations, however, we have no hope of lowering interest rates over the longer-term. Such a reduction can only occur when businessmen and consumers become convinced that all branches of government have truly recognized inflation as our "number one problem" and have taken the necessary--often painful--steps to deal with it. I believe that, with time, successful implementation of the March 14 program by the Fed, along with fiscal restraint exercised by Congress and the Administration will have this effect. We will emerge on the other side of these troubles a stronger nation, with heightened dedication to the provision of a stable economic environment in which all sectors of our economy have the opportunity to flourish.