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Statement by

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before the

Subcommittee on General Oversight and Minority Enterprise

House Committee on Small Business

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I appreciate the opportunity to appear before you today to discuss the difficulties that inflation poses for our economy and, in particular, for small businesses.

There is wide agreement in this country that inflation is our most serious economic problem. It is a problem that we have lived with for more than a decade. Even so, the difficulties encountered in adjusting to an inflationary environment, and the costs associated with these adjustments, make it clear that inflation is not a phenomenon that people can learn to live with comfortably.

Inflation breeds economic instability, especially when it accelerates unexpectedly, as it has in recent years. In such an environment, it is particularly difficult to interpret current market developments and plan and forecast future events. For businesses, earning a reasonable return on investment hinges on an ability to spot emerging trends in product demand, to utilize the most efficient method of meeting that demand, and to price products appropriately. Inflation alters spending and saving patterns, requiring businesses to adapt constantly to a varying economic environment. At the same time, the general rise in prices can obscure changes in price relationships and the underlying shifts in supply and demand that they signal.

Inflation impairs the ability of businesses to plan because future income flows are particularly hard to project when prices are being adjusted upward frequently. A major plant expansion, for example, would not be undertaken without some assurance that it would earn an adequate return over its lifetime. This calculation depends on predictions about the cost of the plant as well as the labor and materials used in the production process and the price and volume of its output. In an inflation these projections have a greater

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chance of being wrong. As a result, profits tend to be more variable, increasing the risks in any capital venture, and raising the rate of return that investors will require to finance it. For this reason, some investments that might have been undertaken in a stable price environment would not be attractive in an environment of inflation.

Indeed, even the measurement of income flows from capital investment is a difficult task in an inflationary environment. Under traditional accounting techniques, corporations value the materials and physical capital used in production at historical prices, which tend to fall increasingly below current costs of production during rapid inflation. The effect of this is to enlarge the reported profits of corporations and also the tax liabilities of these firms. The increase in profits, however, reflects capital gains on inventories and fixed assets rather than income generated from the operations of the firm. These capital gains must be reinvested by the firm if it wishes to maintain its productive capacity. The increased tax burdens associated with these gains, however, tend to reduce internal funds available to corporations.

Many of the problems associated with inflation seem especially acute for small business. Subject as they are to competitive forces, small businesses have little control over many of the factors affecting their profitability. As purchasers, they may lack the influence to make their suppliers absorb a portion of cost increases; as sellers, they may be less able than large businesses to pass through to consumers cost increases as they occur. Moreover, because of their dependence on outside suppliers, small businesses may have trouble anticipating cost increases. This can be espe-

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cially troublesome when a business must sell products or services at prices contracted for several months in advance.

Dependence on a single or limited line of products increases a small firm's vulnerability to unexpected changes in product demand or production costs. Its size often precludes the flexibility to alter production or sales practices quickly in response to rapid changes in underlying supply and demand conditions. And it is less able to absorb losses that result from a bad guess or a purchase or contract that turns out to be unprofitable.

The financing needs of businesses are increased during an inflation as the dollar volume of transactions rises along with the price level. Moreover, the nominal cost of financing will rise as interest rates increase to compensate lenders for the declining value of the dollars they will be repaid. Small businesses can be especially affected by these developments. Typically, they rely heavily on short-term funds, and thus their financing costs tend to escalate rapidly as inflation boosts interest rates. Rising interest charges may be particularly difficult to pass on in the price of output if competitors are less dependent on short-term credit. Also, fluctuations in rates add an additional element of uncertainty to the planning process. We have heard from many small businesses over the last few years that inflation-enlarged interest expense has squeezed profit margins and deterred expansion. Moreover, most small businesses can not borrow directly in credit markets, and thus they are especially vulnerable to reduced credit availability at banks and other lenders on which they must rely.

I have only touched upon a few of the problems that inflation can cause for small businesses and others. They serve, however, to underscore

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the importance of a return to price stability. It is towards this goal that the Federal Reserve's recent actions have been directed. Last October, the Federal Reserve took steps to slow the growth of money and credit and to improve its ability to control future expansion of these variables. In February we announced to the Congress target ranges for the monetary aggregates in 1980 designed to produce an appreciable slowing of money growth and bank credit consistent with a move toward a noninflationary economy.

In the near term these actions, taken against a backdrop of strong credit demands, have raised the cost and reduced the availability of credit for all borrowers. Because such restraint works initially through the banking system, it may be having a disproportionate impact on small businesses and others who rely primarily on banks for funds.

Our March 14 initiatives were designed to spread the effects of credit stringency more equitably, as well as to reinforce our earlier actions. As part of the Special Credit Restraint Program, banks and finance companies are encouraged to "meet the basic needs of established customers for normal operations, particularly smaller business, farmers" and others "with limited alternative sources of funds". Moreover, the Board expects that in setting interest rates and other lending terms banks and finance companies 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. We are requiring reports from lenders so that we may monitor their efforts to meet our goals. Other parts of the March 14 program work toward assuring an adequate flow of credit to small businesses by discouraging certain types of consumer loans and by reducing the incentive

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for depositors to move funds from banks and thrifts into money market mutual funds.

There should be no illusions about this program, however. It can not be used to insulate some classes of bank customers from the impact of tight money. The program must be viewed in the context of the Board's and the nation's overriding goal of reducing inflation. I might note that a greater degree of fiscal discipline would speed the return to more stable price behavior. Moreover, a reduction in federal borrowing would relieve some of the pressures on interest rates and free credit for use in the private sector.

The process of breaking the grip of inflation on our economy will not be a painless one. Nonetheless, the effects of inflation are so serious for small business and others that we must persevere on our current course. Delay will only increase the severity of inflation and the costs of eventually bringing it under control.

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