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Statement by

Frederick H. Schultz

Vice Chairman

Board of Governors of the Federal Reserve System

before the

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I am pleased to have the opportunity this afternoon to participate in these hearings on the effects of monetary policy on small business. At the outset, I want to emphasize that the financing problems of small business are a subject very much on our minds at the Federal Reserve. We recognize that in many key respects small businesses form the backbone of the American economic system, providing much of the employment, investment, technological innovation, and competitive vigor that are so important to the continued vitality of our economy. At the same time, we are aware of the problems small businesses are encountering in the current financial and economic environment. These are the problems that your Committee grappled with last year, and in my testimony I will be commenting on the issues raised in the report you published last fall on the subject "Federal Monetary Policy and Its Effect on Small Business."

Although I am glad to participate in your deliberations on these issues, none of us can be pleased that conditions have made it necessary to hold hearings again on the same subject that was of such concern over a year ago. The reason we are back is, I believe, the result of the continuation and virulence of inflation over the intervening period. Small businesses themselves most frequently list inflation as their number one problem, even ahead of high interest rates, government regulation and taxation.

It is easy to see why this is so. Businesses--whose survival depends on their ability to earn a reasonable rate of return on their investments--must be able to anticipate changes in product sales and future income flows. The persistence of generally rising prices greatly alters established patterns of spending and saving, and creates an environment in which it is particularly difficult to discern underlying demand and supply relationships. In particular, price adjustments that are frequent and variable undermine the

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ability of business managers to plan; profit flows are much less predictable; and the risks of undertaking new investments are greatly increased. Small businesses are especially vulnerable to the problems associated with inflation. Unexpected shifts in product demand are likely to be much more devastating to a small firm whose activities typically are concentrated in a narrow range of product lines or in a small geographic area. In addition, the sluggish pace of economic activity that has accompanied recent inflation has made it more difficult to pass through cost increases to their customers.

Only by returning to a path of price stability and lower inflationary expectations can this country hope to obtain sound economic growth and the kind of economic environment in which businesses, small and large, can thrive. An essential element in the effort to restore price stability is the Federal Reserve's commitment to a responsible and disciplined monetary policy. Experience over long periods and in many different countries has shown that inflation cannot persist in the absence of rapid monetary growth to support it; it seems only sensible, therefore, that the Federal Reserve work to bring down the pace of money expansion over the long run to noninflationary levels. This is the approach that has governed monetary policy for well over two years now.

Last year, as the Federal Reserve refused to accommodate inflation-fed demands for money and credit, interest rates rose substantially. These rate advances also were given impetus by concerns about inflation, the unexpected resilience of the economy, and the growing Federal deficit, factors whose importance cannot be overemphasized. Under circumstances like those prevailing last year, the Federal Reserve could not have attempted to hold down interest rates without abdicating its commitment to achieving targeted growth

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rates in the monetary aggregates and thus its commitment to a policy that would ultimately result in breaking the inflation spiral.

Unfortunately, experience has shown that when monetary policy carries a disproportionate responsibility for restraining inflationary pressures, the greatest burden falls on those sectors of the economy that are heavily dependent on financial intermediaries for credit--including housing, farmers, and small businesses. There is no question that small businesses have been particularly hard hit by the high level of interest rates. Because they typically have fewer alternative sources of funds, small firms rely heavily on commercial banks for credit, and therefore much of their borrowing is short- or intermediate-term. As interest rates rise, small firms, which in general already borrow at rates above those extended to larger companies, experience substantial increases in financing costs that are not readily passed on. Inflation, moreover, has greatly enlarged their financing needs, thus increasing their exposure to changes in credit market conditions and perhaps increasing the risk premiums they must pay for borrowed funds.

On balance, 1980 was not a good year for the economy in general and for small business in particular. Not only did interest rates move to unprecedented levels last year, but they also behaved in an extraordinarily irregular and volatile fashion. Such abrupt swings in the level of activity and financial conditions obviously create serious planning and adjustment problems for businesses; small businesses probably find it particularly difficult in the short run to alter operating or financing practices in response to such rapid changes in the environment. A number of factors contributed to the unusually sharp fluctuations in rates last year, not the least of which was the imposition of credit controls last March, which had a profound impact on developments in

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the spring and summer. And, demands for money and credit fluctuated widely in response to exceptional movements in real activity--including one of the sharpest declines in output on record in the second quarter followed by a surprisingly strong rebound in the third.

Although 1981 should have less violent ups and downs, I certainly cannot assure you that the months just ahead will offer a substantial improvement in overall economic conditions. We at the Federal Reserve believe we have embarked on a course that will eventually reduce inflation and interest rates. But this will take time and we recognize that, in the interim, there could be considerable discomfort for many as we move to a noninflationary environment. Inflation has become deeply embedded in our economic system, and there is no painless way out of our predicament. In these circumstances, as we ponder specific efforts that might smooth the transition, it is unfortunately easier to state what we ought not to do than it is to suggest what should be done.

The question of interest rate volatility, for example, is very troublesome, but the small amount of additional short-run interest volatility that may be resulting from the Federal Reserve's monetary control techniques must be weighed against the advantages of better control over the monetary aggregates. To seek to stabilize interest rates by accommodating shifts in money and credit demands can produce dangerous deviations from targeted growth rates of the money supply and make it more difficult to achieve noninflationary growth of money and credit over time. And in the process it can increase the cyclical movements in rates that are far more significant in their effects on the economy.

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Similarly, many have called for the monetary authorities to lower interest rates, but we see this as a transitory short-run response that in the long run would be detrimental to our financial well-being. Although the Federal Reserve might be successful in temporarily lowering short-term rates by pouring reserves into the system and by increasing growth of the money stock, such a policy would only serve to exacerbate inflationary pressures and produce even higher interest rates down the road.

It also would be extremely unwise for the Federal Reserve to get into the business of setting guidelines or reserve allocation schemes designed to channel credit flows to specific sectors. Our experience with the credit restraint program last year reinforces our reluctance in this regard. I can assure you that administering these controls proved to be a task filled with intractable problems. The program was designed to rely as much as possible on market forces, given the basic objectives of the Administration's anti-inflation effort, yet it demonstrated all too plainly how difficult it is to implement desired credit allocation policies. Business decision-making is distorted in unanticipated and unintended ways. Inequities multiply and require an unending chain of exemptions and qualifications. In the short-run, the confusion and uncertainty are damaging to the economy; in the long-run, the market devises ways of circumventing the controls; and in the meanwhile, attention may be diverted from the fundamental policies needed to achieve economic stability.

Nor should the Federal Reserve get involved in setting terms on credit, such as requiring banks to maintain dual prime lending rates. We believe that the lending institutions are best able to determine the require-

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ments of their customers and their own abilities to service those needs. The lending rate appropriate for any particular loan will vary depending, among other things, on the bank's costs of funds, the borrower's credit-worthiness, and the purpose and terms of the loan: these factors can only be evaluated by the individual institution, and the loan terms negotiated between bank and borrower.

Many banks, of course, tie rates on their loans to small businesses to the prime lending rate. The meaning of this practice has been called into question recently by the phenomenon referred to as "below-prime lending." As you are aware, some of the large commercial banks have made a sizable share of their loans at interest rates that fall below prime. Indeed, our most recent data indicate that about 70 percent of loans extended in the first week of February at a selected sample of the nation's largest banks were at rates below prime. Thus, the prime rate no longer seems to be the lowest rate offered to prime or best business customers--as it was in the past.

In a study of below-prime lending by the Fed staff, however, it was clearly demonstrated that loans at these discounted rates are of a different nature than ordinary business loans. They tend to be very large loans that are extended for very short time periods, with rates that are tied to money market rates. In essence, they are loans designed to compete with commercial paper issuance as a source of short-term financing for very large corporations. This suggests that the prime rate may still be a relevant concept for the traditional type of business loan, and that discounting below prime need not be construed as an attempt by the banks to mislead their other business customers. Nevertheless, by grouping these different types of

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business credit under one heading, considerable confusion has arisen. I personally believe the banks would do their customers a great service by choosing different terminology to distinguish these lending rates.

Before concluding, let me suggest some ways in which the Federal Reserve is attempting to better understand and deal with the financial problems of small businesses directly. First, as a matter of continuing policy, the Board encourages commercial banks to take account of the special needs of their small customers. The vast majority of the banks in this country are themselves small, local and regional institutions, whose economic well-being is inalterably tied to the health and vitality of their local business communities. Most of these institutions, I am sure, give top priority to the needs of their small business customers. Some large banks also have developed active small business lending programs, and it is likely that such programs would be initiated on a larger scale if bank managements were better informed of demand and potential returns. Our staff and those of the Federal Reserve Banks are working in a variety of ways to learn more about the particular problems of small businesses, and about the types of programs that have been instituted.

We are also seeking ways to increase the availability of data on small business financing. As noted in this Committee's report, the lack of a substantial data base for small businesses makes it impossible to quantify the impact of changing financial and economic conditions on this sector of the economy. In part the lack of data reflects the difficulty of establishing uniform and useful definitions of "small business"; in addition, the cost of collecting statistically reliable data for this heterogeneous population has appeared prohibitive. There are several projects currently underway,

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however, that should give us a better indication of what data are needed and the cost of obtaining them. One of these projects--under the guidance of an interagency task force on small business finance--is specifically focusing on the financing needs of small businesses. An important part of the project is an interview survey of small business lending practices at a small sample of banks and other creditors. The results of this survey will be available early next year and should provide some insight into the types of data that might feasibly be collected from such lenders.

In summary, let me assure you that the Federal Reserve has very much in mind the plight of small business firms in the current inflationary environment. We believe, however, that the best course is to pursue with diligence those policies that will return us to a world of price stability. Any sign that the Fed is turning away from its commitment to monetary restraint would seriously undermine the credibility of our fight against inflation, set back the progress that has been made, and make it much more difficult to break the embedded inflationary psychology.

At the same time, it is essential that the burden of restraining inflation not rest solely on monetary policy. The Congress, along with the Administration, have at hand one of the most important means for reducing the strains on private financial markets--that means is the implementation of prudent and disciplined budgetary policies. A large volume of government borrowing associated with huge federal deficits such as we have had in recent years both raises the cost and reduces the availability of funds to private borrowers--the impact of this is most pronounced on housing and small business finance. I strongly support the Administration's efforts to reduce the growth of budget outlays and the size of the deficit, and ask that the Con-

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gress give these proposals serious consideration. I would be gravely concerned, however, if the benefits achieved in budget cuts were dissipated in excessive tax reductions so that the financing needs of the government remained large. Such a course would worsen rather than ease the financial pressures facing private businesses and all borrowers. While the process of reducing the grip of inflation will require painful adjustments by all sectors of the economy for some time to come, I feel confident that adherence to our monetary goals, accompanied by responsible fiscal policy, will lead us to the kind of stable financial and economic environment in which businesses can operate efficiently and productively.

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