

For release on delivery
Expected at 9:00 A.M. EDT
SEPTEMBER 23, 1981

STATEMENT

BY

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE

SENATE COMMITTEE ON SMALL BUSINESS

SEPTEMBER 23, 1981

I appreciate the opportunity to participate in this hearing on the impact of high interest rates on small business. Driven principally by rapid and persistent inflation, interest rates have been at extraordinarily high levels through much of the past several years, causing serious problems for many sectors of the economy.

Because small businesses account for the vast majority of the firms in this country today, and operate in all areas of the economy--in both a geographic and business sense--it is not surprising that they are feeling the effects of the high rates. Moreover, there are some reasons to believe that small businesses may be more vulnerable to the adverse consequences of credit stringency than are larger firms. Recently, Chairman Volcker sent a report on the impact of high interest rates on small business as well as on the auto, housing, and agricultural sectors to the Senate Committee on Banking. I have submitted that report with my statement and, as a basis for discussion at this hearing, I would like to highlight and elaborate on some of the major points made in it concerning small businesses.

1. Small businesses typically depend relatively more on debt financing than larger firms since their sources of equity capital are more limited. As a result, small businesses tend to have higher ratios of debt to equity, and the interest on the debt of small firms likely absorbs a relatively larger portion of cash flow than for similarly situated larger firms. The squeeze on cash flows of smaller firms can be especially intense if competitive pressures and sluggish demand prevent them from passing along the full cost of higher interest rates to their customers.

2. Small businesses tend to rely on commercial banks to meet their credit needs. This suggests that the impact of high interest rates on this sector depends to a great extent on the cost and availability of loans at banks and on the relationships between small businesses and their banks.

3. Direct information on the terms of bank loans made to different size businesses is not available, but data from the Federal Reserve Board's Survey of Terms of Bank Lending show that rates on small loans have risen less than those on large loans over the past several years. Moreover, in recent surveys, the average levels of rates on small loans at small banks, the type usually going to small businesses, have been generally about the same or even lower than the rates charged on larger loans at large banks. Of course, these data do not reflect the ability of large businesses to reduce borrowing costs by accessing other markets, where rates at times may be more attractive.

4. Problems of credit availability do not appear to have worsened markedly for small business this year. This is in contrast to earlier periods of high interest rates, when lending at banks--especially small banks--was severely constrained by difficulties they faced in attracting funds because of limitations on interest rates they could pay on deposits. In these circumstances many small businesses encountered trouble obtaining credit at any price. More recently, with restraints on the rates banks can pay somewhat more relaxed, most small businesses have access to credit, if they are willing to pay the price. In addition, a number of banks throughout the country reportedly have been making special efforts to be more flexible in meeting the needs of small businesses, a practice which the Federal Reserve System has consistently encouraged.

5. Although I am confident that our assessment of the current status of bank lending to small businesses is reasonably accurate in broad outline, we are aware of our lack of more detailed knowledge of this crucial relationship. In that regard, the Board, in conjunction with the interagency task force on small business finance, is currently in the process of conducting a personal interview survey with lending officers at 250 banks throughout the

country on commercial bank small-business lending practices. The interviews include questions on availability of credit to small businesses, loan characteristics, pricing and profitability, and use of government programs. The information gathered from the interviews will give us further insight into the effects of current credit conditions on small business. A report on the results will be sent to the Congress in early 1982.

6. Finally, I am encouraged by reports that many firms are learning to cope with the adverse financial and economic environment through such means as improving their product pricing strategies, cutting costs, reducing inventories, and managing cash more closely. Nonetheless, the large increase in bankruptcy filings since early 1980 is an indication of the difficulties being experienced by a number of small businesses. Of course, the bankruptcy numbers reflect not only problems related to high interest rates, but also those related directly to inflation and sluggish economic activity, as well as the liberalization in the bankruptcy code effective October 1979.

In sum, small businesses, along with larger businesses, households, and many lenders, are facing a very trying situation, the proximate cause of which seems in large measure to be high interest rates and intense competition in the credit markets for a limited supply of funds.

Moreover, many have asserted that this situation can only be worsened by the recent surge of bank lending activity associated with mergers among some very large firms. The loans and commitments involved are extremely large, and some have concluded that funds advanced for this purpose will not be available for any other use--such as for lending to smaller businesses.

In my view, any effects from this activity are easily exaggerated. First, the volume of credit involved is not that large relative to total flows; the actual amount of loans taken down for takeover purposes appears to be much less than the reported credit lines, in part because a number of the lines were related to the proposed takeover of the same company. Second, and more importantly, these loans and the transactions they finance do not in any fundamental sense use credit in such a way as to make it unavailable to other borrowers. The actual transactions involved in the mergers merely result in a transfer of financial assets; the acquiring company borrows money from the bank to pay the stockholders of the acquired company. The stockholders then likely reinvest the money or repay debt, recycling the funds through the financial markets. I recognize that in the short run these loans could have some impact on the distribution of credit, possibly affecting its cost and availability for other bank customers. But I believe that in a freely operating financial system any distortions of this sort are likely to be small and short-lived.

The problems facing small businesses are not related to takeover lending; they are not even caused in the most fundamental sense by high interest rates. Rather, the principal source of their current difficulties is the extraordinarily high and persistent level of inflation our country has experienced in recent years. Inflation has a very direct and immediate effect on the entire cost structure of industry. Increases in labor and other input costs likely have a much greater impact on the earnings of small businesses than do rising interest rates. Recognizing this fact, small businesses until very recently have identified inflation, not credit costs, as their principal problem.

Moreover, high interest rates themselves are primarily a necessary and unavoidable consequence of rapid inflation, augmented under current circumstances by anticipation of large federal deficits. Only in recent months have price increases shown significant moderation from the double-digit rates experienced in the last two years. The virulence of actual inflation and expectations that it will continue at a high rate have prompted lenders to demand interest rates high enough to compensate for the declining purchasing power of the dollars they lend. Expectations of price increases also weaken borrowers' reluctance to pay high interest rates. The impetus needed for a significant and lasting decline in interest rates is a continuing slowdown in the actual rate of inflation and a conviction by both borrowers and lenders that those making monetary and budget policy will not allow the rate of price increase to reaccelerate.

Because of the problems inflation has brought to our economy, it is imperative that the government implement policies that focus on bringing the inflation rate down--and keeping it down. For its part the Federal Reserve has been seeking a gradual moderation over the longer run in the growth of the money supply. As this policy bears fruit, we are confident that the result will be reduced pressures in the credit markets and an eventual decline in interest rates.

We realize that the adjustments required will be painful; we should not expect the reversal of a 15 year trend of accelerating inflation to be accomplished quickly and without unpleasant side effects. The process of adjustment to a noninflationary environment can be made less painful, however, if the Congress and the Administration hold down federal government spending. The tax cuts that already have been legislated need to be balanced by additional

expenditure cuts. If further spending cuts are not made, pressures in financial markets will remain very strong. Large public sector borrowing requirements resulting from a substantial federal deficit put upward pressures on interest rates for private borrowers--including small businesses. I believe it is critical, therefore, that the Congress and the Administration work to reduce the federal deficit promptly and substantially. Combined with the Federal Reserve's monetary policy, this would minimize the strains on our economy and financial markets, and reduce the length of the adjustment process needed to bring down inflation and, with it, interest rates.

We at the Federal Reserve are acutely aware of the difficulties that have beset small businesses in recent years. At the same time, we think it is noteworthy that small businesses generally have been among the strongest and most steadfast supporters of the Federal Reserve's policy of moderating expansion of money and credit. This is because they recognize that such a course--however painful in the short run--is a necessary precondition to the overriding goal of returning our economy to a path of steady noninflationary growth. We are beginning to see some indications that inflationary pressures are now beginning to abate. It is vitally important that we avoid the temptation of opening up the monetary spigot to obtain temporary relief from high interest rates--relief that could come only at the expense of our long-run progress toward reducing inflation. Turning away from a disciplined monetary policy would be unsound, unwise, and unfair since it would mean that the difficulties already endured would have gained nothing, and that greater dislocations and more intense pain would necessarily be suffered at some point in the future.