# THE EFFECT OF ENTREPRENEURS ON THE U.S. ECONOMY AND VICE VERSA

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**Annual Meeting of the Association of Private Enterprise Education**
**Atlanta, Georgia**
**April 10, 1995**

It is a pleasure to be addressing this group on the occasion of your 20th anniversary. I note that, thanks to the pioneering work of fellow Georgians Mike Mescon and Craig Aronoff, the formation of this association predates even that of *Inc.* magazine. That magazine was first published in 1979 to serve entrepreneurs and small business owners because, said the founder, Bernie Goldhirsh, he could not find anything in the usual business publications to help him to solve the problems of his own small business.

Also spurring interest in small business in the 1970s was some economic research by David Birch of MIT. He came out with his now-famous study that concluded that small businesses created more jobs than large firms like the Fortune 500, although subsequent research has cast doubts on these claims. While small businesses may create the lion's share of jobs in recessionary periods, they are also more apt to go out of business than large businesses are--or they turn into large businesses. Thus, we now know that net job creation by small business over time is not as significant as once claimed. On the whole, however, it must be acknowledged that small businesses are a notable source of jobs, innovation, and flexibility in the U.S. economy.

As I see it, the 1970s was really the dawning of an era of appreciation for entrepreneurs. It is not that entrepreneurs had not existed until that time. They have always existed, for every big business started with the idea of one person--or just a few. But up until then, the IBMs and the GMs were hailed as the true stars of the U.S. economy. It was not until the 1970s that the Apple Computers of this world--the proverbial started-in-the-garage-by-one-or-two-geniuses kind of company--began to be appreciated for their innovation and their contributions to the economy. In a sense, it came time for small companies to get the respect they had been lacking in earlier generations.

This morning, I have taken as my topic the importance of entrepreneurs to the U.S. economy and vice versa--the importance of the U.S. economy to entrepreneurs. As economists, you are all familiar with the concept of comparative advantage. I think we have a clear case of that today in that, as private enterprise educators, you probably know much more about small business than I do, and as a central banker who deals with monetary policy, I may know a little bit more about the economy than you do. With that in mind, I intend to spend a small amount of time speaking about the importance of entrepreneurs and a larger amount of my time speaking about two other subjects: policy considerations of a few problems that small businesses must deal with and the U.S. economic outlook for 1995.

**The Importance of Small Business**

In my capacity as president of a Federal Reserve Bank, I sometimes am invited to other countries to talk about our banking system. You may be interested to know that when I was invited to Shanghai, China, last year to speak about how China should go about setting up financial markets, I emphasized the importance of small business to the Chinese economy. In reviewing my notes from that speech, I realized that the ideas were relevant to this group. And since all of us here agree that small business is important to the United States, I thought it might be interesting to hear how this argument could be made for a country that is coming from a political and economic history far different from ours.

In essence, I said that China must create dynamic growth in the economy and an environment of trust in the system that will enable financial institutions and markets to function efficiently. In the U.S. experience, dynamic growth comes from innovators and entrepreneurs, and these small, new businesses typically turn to banks and not securities markets for their financing needs.

The best way to move toward a market-based economy, I told the Chinese economists gathered for the meeting, is to encourage the growth of small businesses and the entrepreneurs who run them. This in turn, means a move toward banks since they are the essential link between the credit markets and entrepreneurs. A sound banking system is critical as a first step toward liquid and healthy financial markets in a market-based economy. Essentially, when a nation decides to transform its economy from one that depends on central planning to one that allows markets to determine prices, it is not enough to privatize existing public industries and then to finance their investment needs by issuing securities or other claims on their assets. These are typically very large organizations and, by their very nature, not likely to meet the diverse needs of a large population, nor will they be flexible enough to change as quickly as needed in response to external shocks or shifts in consumer preferences. To sustain a market-based economy, it is necessary to let small businesses contribute to the growth and dynamism of the economy.

If there is any secret to the overall vibrancy of the U.S. economy, I said, it is that small businesses innovatively find ways to discover new demands in the system and, perhaps more importantly, also find more efficient ways to produce. In order to support this critical element of any market economy, there must be commercial banks, because banks provide the financing that allows small businesses to expand. That is because small businesses are generally too small to issue securities efficiently and therefore have little hope of attracting the attention of securities markets.

**Policy Considerations for Small Business**

If the opportunity to speak in Shanghai helped me to crystallize my thoughts on the importance of small business to any economy--not just the U.S. economy--preparing for this speech today has helped me to clarify my thoughts about policy considerations for small business. Of three issues I would like to discuss, one stems directly from my point about the difficulties small businesses have in getting the attention of securities markets.

Many small business owners that I talk with would say that it is just as hard for them to get the attention of banks. The truth is that most entrepreneurs start their businesses by using their own funds--and very often that of family and friends. Only at a later stage of development does venture capital or a bank loan even become a possibility. I am not really certain whether that means there is a market failure here. I know that the Community Reinvestment Act was adopted to be a partial remedy for this problem. We also need to take into consideration, though, that entrepreneurs have a high rate of failure and that they may not be well versed in how to prepare a proper business plan, both of which make it difficult for traditional lenders to give them credit. In fairness to bankers, too, it is more difficult to collateralize loans against businesses that specialize in services, as do many small businesses. That is because, typically, the capital used to start a service business is intellectual capital, and no one can take possession of that sort of capital. In view of these problems, we may need to consider policies that might gain entrepreneurs and small business owners readier access to capital, particularly since these businesses help to create jobs and wealth for the economy. Let me explain what I mean.

Historically in the United States, small business has been a major pathway of upward mobility for immigrants, and that avenue remains the chosen course for many immigrants today. But even as many have succeeded, there are still people living in pockets of poverty in the nation who seem immune to this kind of economic boot-strapping. As a policymaker, I am interested in the question of whether small business can serve as a vehicle to help solve the poverty problem in the United States. If banks are not able to help potential entrepreneurs in certain sectors of our society--because of the need for collateral, for instance--perhaps we should be turning toward programs that have worked in other countries, such as group lending or microlending, on a larger scale. A study by one of our Atlanta Fed economists has shown that conventional financial institutions and development banks created by governments in other countries have been plagued by insolvency and liquidity problems, whereas alternative lending arrangements have been more successful at providing credit to targeted groups. On the other hand, these nontraditional programs typically incur high costs and operate on a small scale, contributing to market segmentation. I believe this area would be worth more research on the part of enterprise educators such as yourselves. With your help, we may be able to decide whether more would-be entrepreneurs who need loans to start businesses here in the United States would benefit from a greater emphasis placed on community development loan funds and microenterprise loan funds.

A second area that concerns me as a policymaker is the effect of too many regulations. I hear about this problem directly from the small business owners on our Small Business, Agriculture, and Labor Advisory Council who meet with me regularly to discuss their views of the economy. They never hesitate to let me know when they think they are being affected unfairly by rules and regulations that may be good for society, such as environmental laws, but are relatively difficult for small businesses to absorb financially. Although I think the current Administration and Congress are making strides in cutting down the amount of paperwork, rules, and regulations that companies--both big and small--must follow, I do not think we can ever expect there to be a net loss in regulation. Perhaps the recent direction in CRA discussions of allowing smaller banks to be exempt from some of the regulations is the way to go for rules and regulations on most firms.

A third policy consideration for small businesses has to do with the economic statistics that are intended to capture the true status of our economy. Since many small businesses fall into the services category rather than manufacturing, it may be that the government's traditional methods of data collection, which emphasize manufacturing over services, do not accurately reflect the contribution of small business and the overall contribution of services to economic output. That at least is the conventional argument. But we may be overlooking an even more obvious imbalance. According to Office of Management and Budget (OMB) figures, roughly 15 percent of the funding for economic statistics is used for agriculture, and another 10 percent is being used to track energy and mining. Earlier in this century, when farming and mining were proportionately more important sources of income to the nation, it may have been useful to spend 25 percent of all statistical funding on following them. Nowadays, however, agriculture and mining each represent only 2 percent of real gross domestic product (GDP), and it would seem that the funding is grossly out of proportion. Perhaps a reallocation toward studying the service economy is in order.

**The U.S. Economy**

Now let me turn to what is happening in the U.S. economy. The reason for doing so is that, however the economy is doing, it affects the fate of every small business. If the economy is doing well, as it is now, it is important for small business owners to figure out how to fit in to take advantage of growth areas. Growth in output last year was 4 percent, and this year also looks like another good year, but with somewhat more moderate growth of 3 percent or possibly a bit higher on an annual average basis. I might add that, considering that the expansion has been going on for nearly four years, this rate of growth in 1995 would also be more appropriate. With growth decelerating, it is unlikely that the unemployment rate will decline much further. My best guess is that it will average between 5-1/4 percent and 5-1/2 percent. Inflation may rise to somewhat above 3 percent, since price pressures tend to increase as the economy operates at or near capacity.

As has been true the past few years, the main areas of strengths and weaknesses in the U.S. economy will not change much in 1995. Certain components of gross domestic product that have been growing strongly through 1994, such as personal consumption, capital spending, and construction, will still be growing--but at a slower rate. Healthy demand for automobiles and other durable consumer goods accounted for much of the acceleration in personal consumption last year. Sales of automobiles and other durables will be good again in 1995, but they will not provide as large a boost to the economy as they did in 1994. That deceleration is the result of increases in interest rates that have occurred. Also, pent-up demand has largely been met. Consumption of nondurable goods like clothing will continue to grow, but not enough to offset the expected slowing in demand for consumer durables to a pace that is more sustainable.

The same theme holds true in the area of investment by businesses in productive capital, such as plant and equipment. Capital spending has been growing in the double-digit range for two years now. Although this investment will be decelerating, this retreat is from a very high pace. I would like to add that this aspect of growth is quite significant. That is because it expands the capacity of the economy, a matter which is quite vital at this time when we seem to be near or at our capacity--whether measured in terms of the unemployment rate or factory use. This rapid addition to productive capacity helps to temper price pressures from strong demand and is reflected in the inflation forecast.

Another type of investment spending, construction of single-family homes, has contributed strongly to economic growth in the United States over the past few years. This boom in building activity has now peaked. Although multifamily and commercial construction should be increasing in 1995, these anticipated increases will not offset the decline in single-family construction.

Government spending is likely to be flat after shrinking somewhat last year. Even in the face of the defeat of the balanced budget amendment, the ongoing pressure to reduce the federal budget deficit should help to keep government spending down. Of course, it is hard enough to make economic forecasts. I am certainly not going to attempt a U.S. political forecast, especially this year. Still, any changes that the new Congress might enact are not likely to affect economic activity directly in 1995, although they could indirectly affect expectations as reflected in financial markets. Let me emphasize also that, although government spending will not add to GDP, any progress toward reducing the deficit will be good for the long-term prospects for economic growth.

Looking at that part of our economic growth that is affected by foreign trade, I can say that the gap between exports and imports should begin to shrink this year after several years of growing larger. However, this is not to say the deficit will go away. The United States has been growing relatively faster than its traditional trading partners. In turn, the demand for imports in the United States has increased faster than the demand abroad for U.S. exports.

Fortunately, the signs point to a narrowing of this trade gap this year, as the U.S. expansion slows and the pace of economic growth picks up in Europe. Additionally, the ratification of the General Agreement on Tariffs and Trade (GATT) will set a more positive climate for U.S. trade, although I do not expect a substantial impact in 1995. On the negative side, the Mexican peso has depreciated dramatically in recent months. This development, along with the institution of more restrictive economic policies in that country and possibly others in Latin America, will probably restrain demand for U.S. exports from those areas. In addition, with the high value of the yen, economic growth in Japan may not pick up as quickly as was thought possible earlier in the year.

So, to recap briefly, in the United States this year, GDP should grow by about 3 percent, with inflation rising to somewhat above 3 percent, and unemployment averaging between 5-1/4 percent and 5-1/2 percent. Although it is true that some areas of the U.S. economy may be slightly weaker than in the past year or two, overall the economy will be very healthy.

**Conclusion**

In conclusion, the large picture shows the economy doing relatively well and inflation being contained. Thus, small businesses should benefit. In the smaller picture, though, small businesses must always contend with problems, such as finding adequate credit and dealing with rules and regulations, that do not seem to affect big businesses so adversely. I for one recognize the importance of the dynamism that entrepreneurs and their small businesses bring to the U.S. economy, and I appreciate the work that you are doing as you prepare our next generation of entrepreneurs to deal with and contribute to our dynamic market economy.