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***Small Business Funding
and the Economic Recovery***

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President & Chief Executive Officer
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*Connecticut Business & Industry Association
and MetroHartford Alliance
“Economic Summit & Outlook 2012”*

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I appreciate the invitation to speak today at the Connecticut Business and Industry Association. It strikes me that the timing of this gathering is particularly appropriate, in that discussions of the economy – at least over the last few years – have not fueled any holiday cheer, but have been relevant to hopeful New Year’s resolutions.

When I joined you at this event two years ago, I reviewed some of the patterns we see in labor markets, and in particular industries, during early stages of recoveries. I noted the forces making it likely that gains in employment would be slow in this

recovery. I wish I could say I was too pessimistic that day, but as we all know the recovery has been painfully slow.

Today, after a brief overview of some recent *economic* trends I would like to focus on some key *financial* data. In particular, I want to highlight a distinctive feature of the recent recession and the anemic recovery – the fact that financial-market problems had a disproportionate effect on the length and severity of the recession and have been a complicating factor in the lack of strength in the recovery.

I would like to walk you through a number of charts that lay out the situation – particularly as it relates to small business financing. My “punch line” is that as challenging as the financial headwinds to recovery have been, there are still policy options to consider and explore that could make a difference, and I will mention a few possibilities.

Of course I would add that the views I express today are my own, not necessarily those of my colleagues on the Board of Governors or the Federal Open Market Committee (the FOMC).

First, I’ll touch on the economic trends. I would say the economic data have been improving somewhat, relative to what we were seeing in the summer. Various supply shocks that buffeted the world economy in the first half of 2011 are receding, as are the increases in a variety of commodity prices. In part, these reversals reflect expected economic weakness in other parts of the world.

As **Figure 1** shows, a number of prices that were increasing in the first half of 2011 (in blue) have moderated more recently (in red) – particularly energy prices and others closely tied to energy, like airline fares, and also food and beverage prices. In

addition to these data, I see no evidence of significant acceleration in labor costs – as a result of weakness in labor markets – and also see reversals in a number of important commodity price increases. As a result, I personally expect that inflation is likely to be below 2 percent not only in 2012 but also over the next several years.

While the difficult conditions in labor markets are a reason inflation has been well contained, the very weak job growth the country has experienced is of course itself a critical problem. **Figure 2** highlights the fact that many people are working part-time but would prefer to work full time. The percent rose quickly during the recession (the shaded portion of the chart) and has stayed high. While these workers are currently employed, this chart suggests that demand in the economy is not sufficiently strong for firms to employ more workers full time. Labor demand simply remains too weak.

With inflation expected to remain below 2 percent, and unemployment and underemployment so high, I believe it is important for the Federal Reserve to continue considering ways to promote stronger growth and hasten what is a painfully long, slow recovery and adjustment time in the economy.

As a case in point, **Figure 3** shows that households are now spending a lower percentage of their disposable income on debt-service payments, compared to just before the onset of the recession when the ratio peaked at about 14 percent. While some of this decline reflects unfortunate trends, such as defaults on mortgages, it also reflects the very low interest-rate environment – which gives households an opportunity to improve their relative financial condition¹ (the net of their assets and liabilities) as less money is spent on interest payments for mortgages and credit cards.

As an aside, I have emphasized in other talks that I think more can be done to facilitate this process of adjustment – including tweaks to Government Sponsored Enterprise (GSE) mortgage programs and, potentially, expanding the purchase of mortgages by the Federal Reserve to keep mortgage rates low during a time of great difficulty in housing markets.

In sum, I would say that the monetary policy actions already taken by the Federal Reserve are allowing firms and households to speed up the adjustment process, and as such are laying the foundation for a stronger economy.

Employment Patterns

Now I'd like to share some additional perspectives, informed by data. **Figure 4** shows the path of employment from its peak prior to the last four recessions. You see that in the most recent recession and recovery, the decline from peak employment was more severe and more lasting than in the previous three. Although we have experienced some modest improvement in employment recently, we are nowhere near a return to the peak level of employment, which had occurred in the prior three recoveries by this point in time. The current recovery's slow employment growth is, it goes without saying, worth examining in more detail.

Figure 5 shows the net change in private sector employment, in thousands of jobs, taking into account the size of the firm where the job gains or losses occurred. A close look makes apparent that there are some significant differences over time. In the 2001 recession the biggest employment declines were at the largest firms (shown in the green sections of each bar). During the recovery from the 2001 recession, firms with less

than 50 employees bounced back relatively quickly (the blue sections of each bar). But the 2001 experience contrasts sharply with the recent recession, when the net decline was much more severe across all three firm-size categories.

Particularly striking, however, is how much of a decline occurred for the smallest firms employing less than 50 employees. Not only was the recession particularly severe for small-firm employment, but employment growth during the recovery been slow at small firms.

In short, the experience of small firms is an important factor in the decline in overall employment during the most recent recession – and in the tepid employment growth in the recovery.

Figure 6 highlights that in any dynamic recovery an economy experiences large flows of job gains and losses – but in this recovery the smallest and largest firms (on the extreme left and right of the chart) account for the most significant net job decline. The only significant net gain (those slivers of green above the zero bound) is found in the mid-sized firm categories – those with more than 50 but less than 1,000 employees.

This pattern is quite different from the recovery that occurred after the 2001 recession, as shown in **Figure 7** (the red bars). During that recovery, small firms (on the left side of the chart) were an important source of net job gains, while larger firms (in the center and to the right) continued to be major sources of net job losses – consistent with the overall slow improvement in employment during that recovery. In contrast, during this recovery (the blue bars) the smallest firms have produced net job losses. The largest firms have also accounted for job losses, but to a lesser degree compared to the prior recovery.

One of the distinctive features of this recession has been the substantial decline in household net worth, particularly resulting from the decline in real estate values. During recessions that include sizable job losses, some people use difficult labor markets as their impetus to start a small business. Such efforts have often been financed through home equity loans, which tend to be the lowest-cost type of financing available, especially compared to the much more expensive use of credit cards.

However, the ability to start a small business in this way has been severely hampered by the decline in house values and the tightening of credit standards. These factors have made the traditional sources of entrepreneurial financing much less readily available.

In addition, some of the states that saw the most dramatic declines in real estate values have also seen particularly high unemployment rates. As **Figure 8** shows, the so-called “sand states” such as California, Nevada, and Florida have unemployment rates much higher than the U.S. average, and have also experienced sharp declines in residential real estate values – declines much larger than the U.S. average. As a result, unemployed workers in these states are unlikely to have home equity available for financing a startup small business that could provide alternate employment.

In sum, these data suggest a very concerning dynamic. My sense is that in areas where high levels of unemployment might otherwise lead individuals to use home-equity financing or credit cards to start a business, today many find access to such forms of credit impeded by impaired credit scores and the disappearance of home equity, given depressed home values.

Patterns in Bank Financing

Figure 9 shows how the composition of business loans (at commercial and savings banks) has changed over the past decade. There has been a significant increase in large commercial real estate loans, while small commercial and industrial (C&I) loans and small commercial real estate loans are now accounting for a lower share of the total. Relative to ten years ago, small-business loans account for a smaller percentage of overall business loans.

Over the past year we have seen only moderate growth in gross domestic product (GDP), and some hiring from the larger mid-sized firms. **Figure 10** shows that *lending* data are consistent with this pattern. Large C&I loans have recently been increasing, and large commercial real estate loans have remained relatively flat, but small C&I and small commercial real estate loans have declined.

To me, the pattern is even more striking when you break up the composition of loans by the size of the bank, as shown in **Figure 11**. While small-business lending (in blue) has decreased across all bank sizes, the decline has been particularly striking at the larger banks, shown on the left, where you see a substantial decline in small business loans. Banks of all sizes have increased their lending for large business loans (in red), with the biggest percentage increase occurring at the smallest banks. In part this reflects the fact that many of the smaller banks remain very well capitalized, and some mid-sized firms have decided to shift their banking relationships from large banks to more community-based banks (as more community-based banks compete for that business).

Figure 12 shows the creation of new establishments. Given what I have described so far, it is unfortunate but not surprising that the “birth rate” of new

establishments declined sharply and remains below historical levels. Starting businesses with financing from home equity or credit cards has become more difficult, and getting small business loans without some form of collateral remains quite challenging. While demand for small business credit from qualified seekers surely plays a role, my sense is that at least one reason for slow job creation in this tepid recovery may be that obtaining financing for new firms has become more difficult. And this suggests one reason why recoveries after financial crises are particularly slow.

Impact on the Outlook and Policymaking

Recently the economic data has been somewhat more positive concerning the fourth quarter, but most forecasters do not, unfortunately, expect that momentum to carry through 2012. Most forecasters expect that economic growth in 2012 will be between 2 to 3 percent, with the outlook gradually improving over the course of the year. Unfortunately, my own forecast is quite similar, which is consistent with only a very gradual improvement in labor markets.

Allow me to briefly summarize my thinking.

Recessions accompanied by significant financial problems tend to be more severe downturns, followed by relatively slow recoveries. One reason for a slow recovery is that the financial condition of households and firms – their “balance sheets,” given their liabilities and assets – take time to recover, and credit for borrowers with financial impairments becomes more difficult to obtain. This is currently reflected in both lingering problems with residential real estate and with the difficulties related to small business creation that I’ve described today.

Let me touch briefly on residential real estate. It continues to be impacted by high foreclosures, falling housing prices in some areas, and tightened credit standards. I have noted in prior talks that residential real estate tends to grow rapidly in the early stages of a recovery, but not this time. Policymakers have pursued a variety of fiscal and monetary approaches to help with a housing recovery, and there have been recent suggestions around what more can be done.²

In terms of monetary policy, actions the Fed has taken to reduce long-term interest rates are supportive of housing, and the Fed's purchases of mortgage-backed securities provided an even more targeted approach to stimulating housing. Further purchases of mortgage-backed securities would in my view help provide a more rapid recovery in housing, by reducing the costs of refinancing or purchasing new homes. Of course, these Fed actions would be even more effective if accompanied by fiscal policies designed to speed the recovery in housing.

As I have highlighted today, some of the slow employment growth we see is associated with a less robust small business sector. The charts I shared show that loan originations to small businesses have been quite weak, and that smaller firms have not pushed the improvement in employment that we saw after the last recession. (I would note that these points are amplified and more formally addressed in a Federal Reserve Bank of Boston working paper by Duygan-Bump, Levkov, and Montoriol-Garriga.³).

This is a very serious challenge to the recovery and to the economy. As such, policymakers must in my opinion explore all possible remedies, and weigh the costs and benefits of each.

While many of the problems in this sector reflect impaired financials for many small businesses, and inadequate demand for products, I would add that credit availability for creating or expanding small businesses can be quite a challenge. Again, monetary policies that push down longer-term rates can be helpful, and that would be particularly true if there could be a targeted approach to improve small business financing. As with housing, such monetary policies would be most effective if pursued in conjunction with fiscal policies targeted to improving conditions for small business.

Actions taken to date highlight that these problems are not easy to resolve. This, to my thinking, only underlines the need to look for creative policy solutions targeted to both housing and small business.

In addition to these tangible problems, there remain of course significant downside risks that are likely to make households and businesses cautious. Problems with a slowing European economy, and sovereign and banking issues in Europe, remain downside risks. Excessive fiscal austerity here or abroad also has the potential for near term downside risk. Finally, recent uncertainty in the Middle East highlights the ever-present risk of potential oil shocks. Of course monetary policy has no direct influence on any of these risks. But they highlight the importance of finding ways to hasten the pace of economic growth and job creation at this point in time.

Concluding Observations

In summary and conclusion, I know I don't need to tell you that we continue to have a slow recovery. We all know, as well, that issues of some concern exist in Europe

and elsewhere. I would reiterate that one reason for the tepid pace of recovery is that financial problems and restraints continue to have lingering effects on the economy.

Today I have focused on one of those lingering problems, the impairment of household financial condition that has made new business formation particularly difficult. Given the low inflation rate and weak labor markets that are both likely to persist this year, I believe the Federal Reserve should continue to explore ways to promote more rapid recovery through stronger growth.

The Federal Reserve has a variety of tools to consider as we try to promote faster economic growth – including communicating in different ways the likely future path of the economy and the implications for interest-rate policy (as was mentioned in FOMC minutes released this week), and considering additional large-scale asset purchases.

In addition, I believe that policymakers can and should continue to look at ways to better target fiscal and monetary policy to address the housing and small business financing problems we are seeing in this recovery. I believe that the continuing difficulties compel us to think creatively and proactively about ways to return the economy to full employment. I hope today I have stimulated some thinking about the possible policy remedies.

Thank you for having me join you today, and despite these challenging economic times let me extend my best wishes for the coming year to each of you and to every New Englander.

Thank you.

NOTES:

¹ i.e., the household “balance sheet.”

² For example, see the following:

- the Federal Reserve white paper on housing of January 4, 2012 (<http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>);
- September 2011 remarks by Federal Reserve Governor Elizabeth Duke on rebalancing the housing market (<http://www.federalreserve.gov/newsevents/speech/duke20110901a.htm>); and
- my September 2011 remarks on housing and the recovery (<http://www.bostonfed.org/news/speeches/rosengren/2011/092811/index.htm>).

³ In a Federal Reserve Bank of Boston working paper (“Financing Constraints and Unemployment: Evidence from the Great Recession”), Duygan-Bump, Levkov and Montoriol-Garriga provide a more formal analysis of the impact of financing constraints on unemployment. They find that financing constraints for small business are important in explaining the employment dynamics of the Great Recession.

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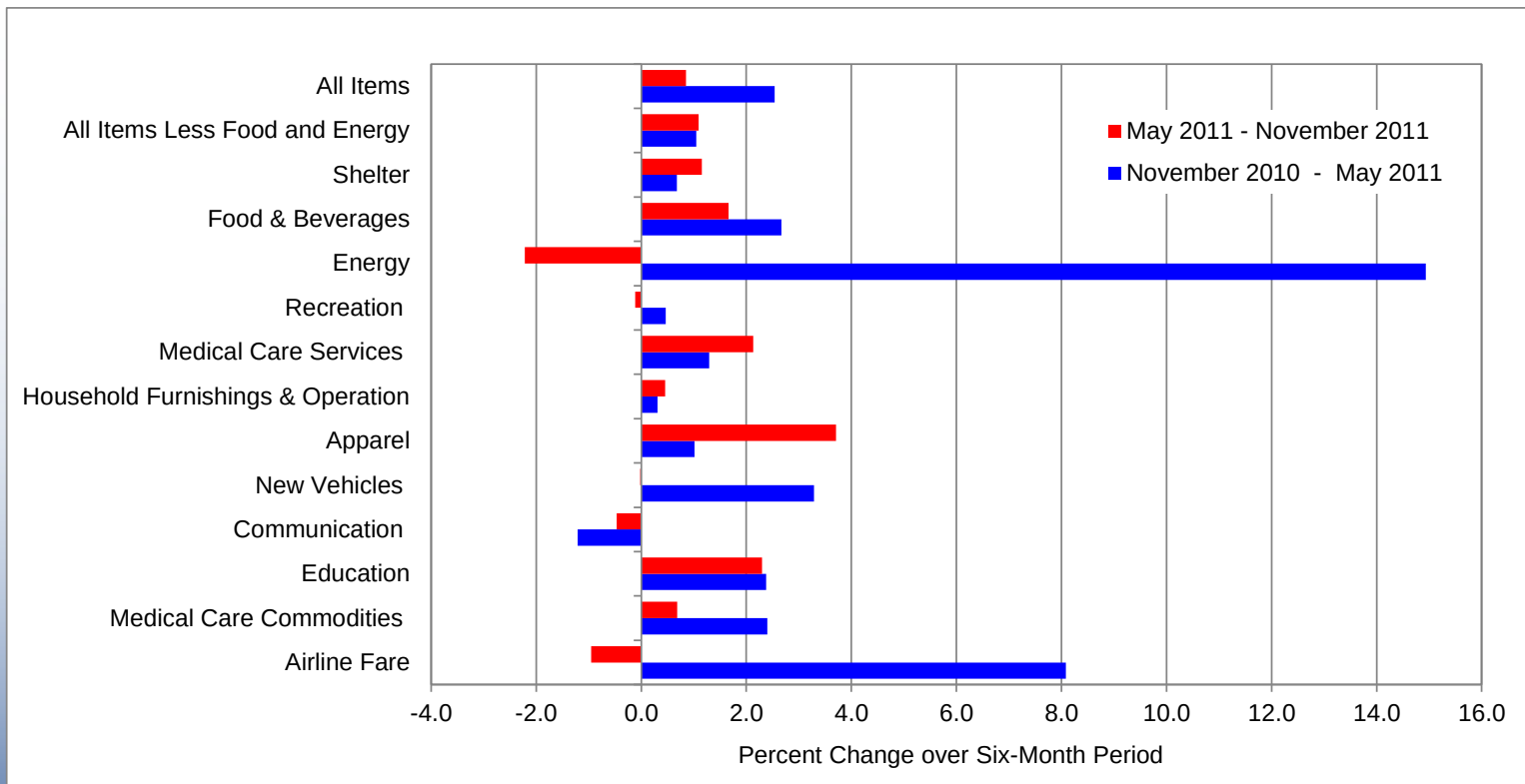
January 6, 2012



Figure 1

Inflation Components: Growth over Most Recent Six Months versus Previous Six Months

November 2010 - November 2011

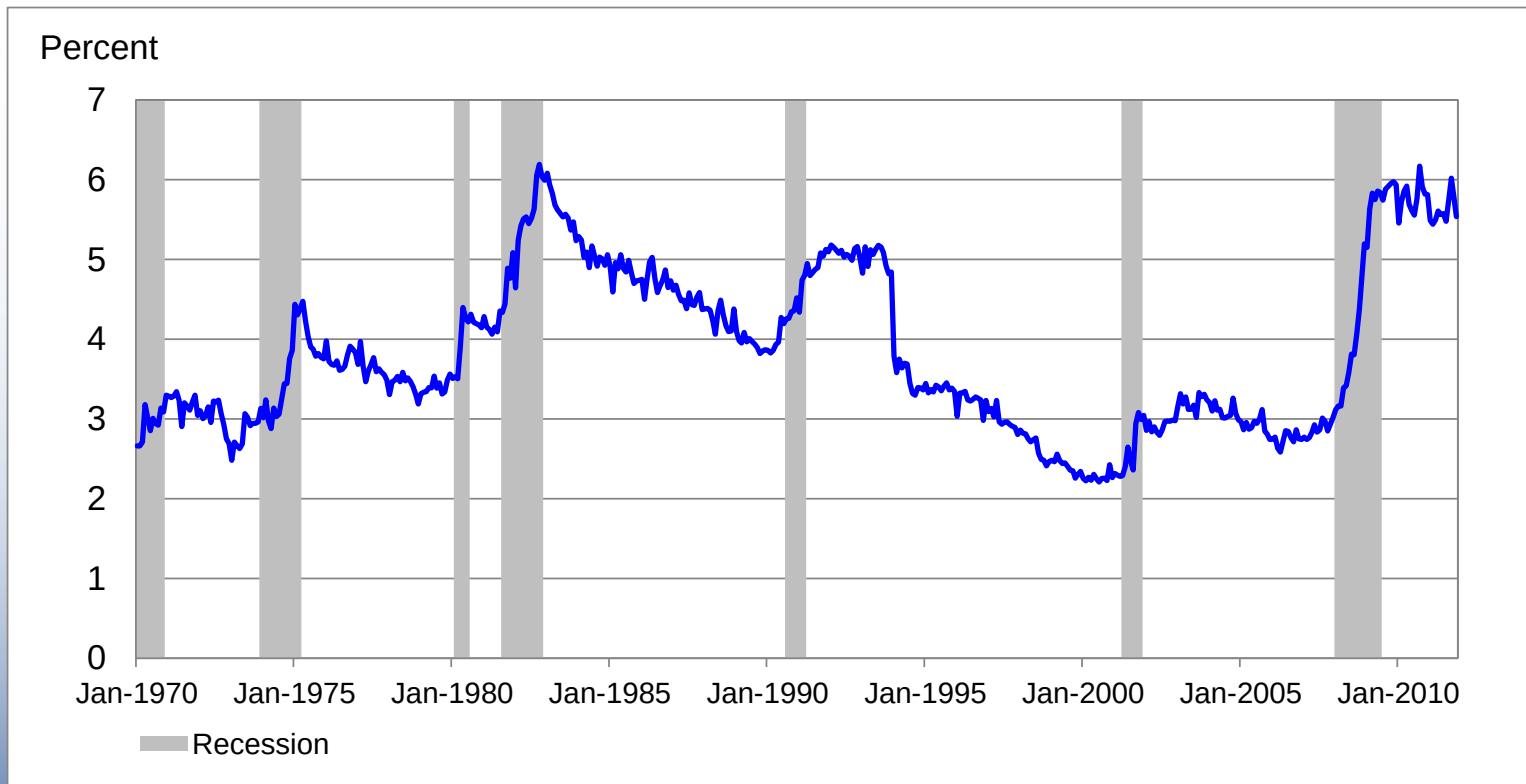


Source: BLS / Haver Analytics

Figure 2

Percent of Labor Force Part Time for Economic Reasons

January 1970 - November 2011

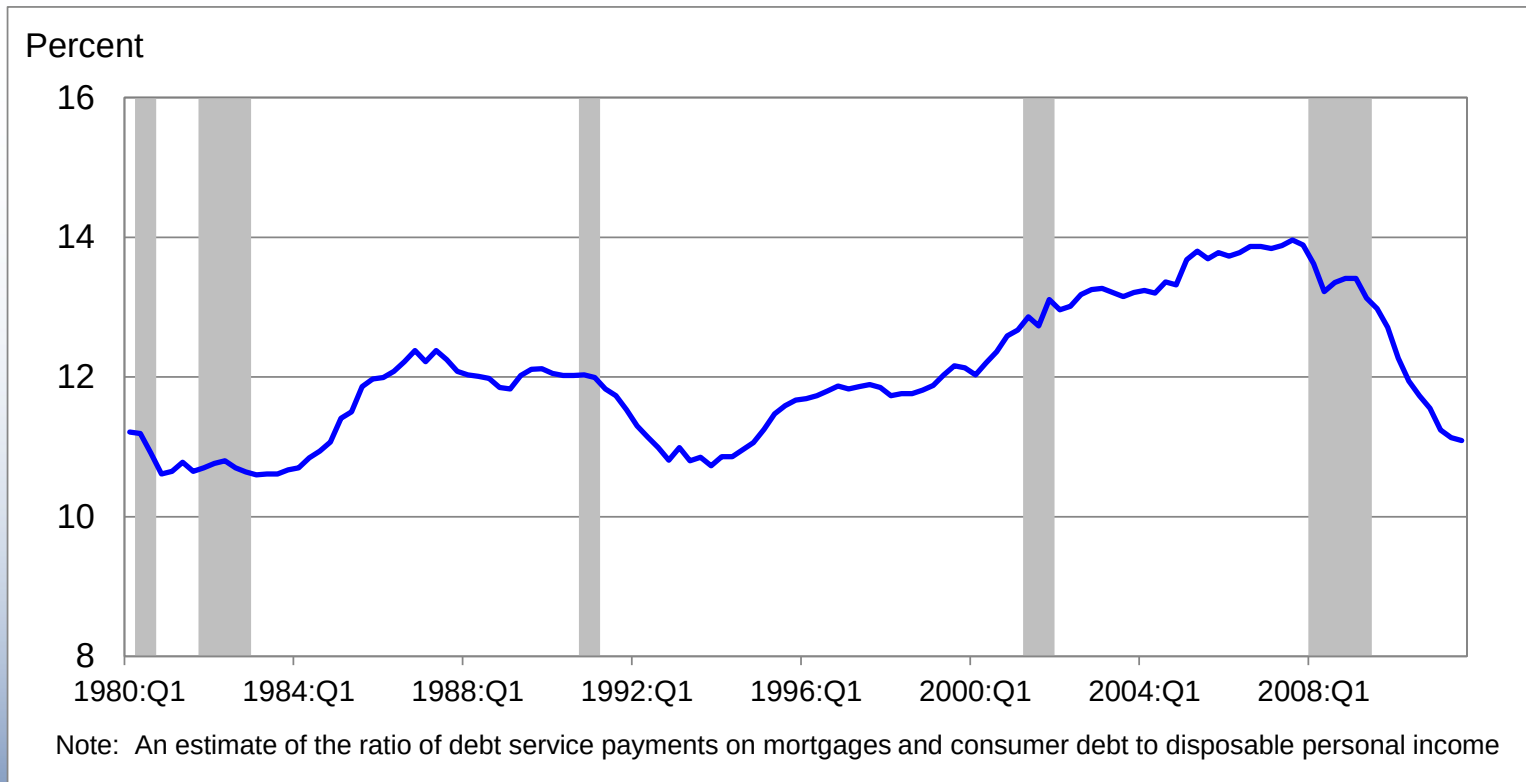


Source: BLS, NBER / Haver Analytics

Figure 3

Household Debt Service Ratio

1980:Q1 - 2011:Q3

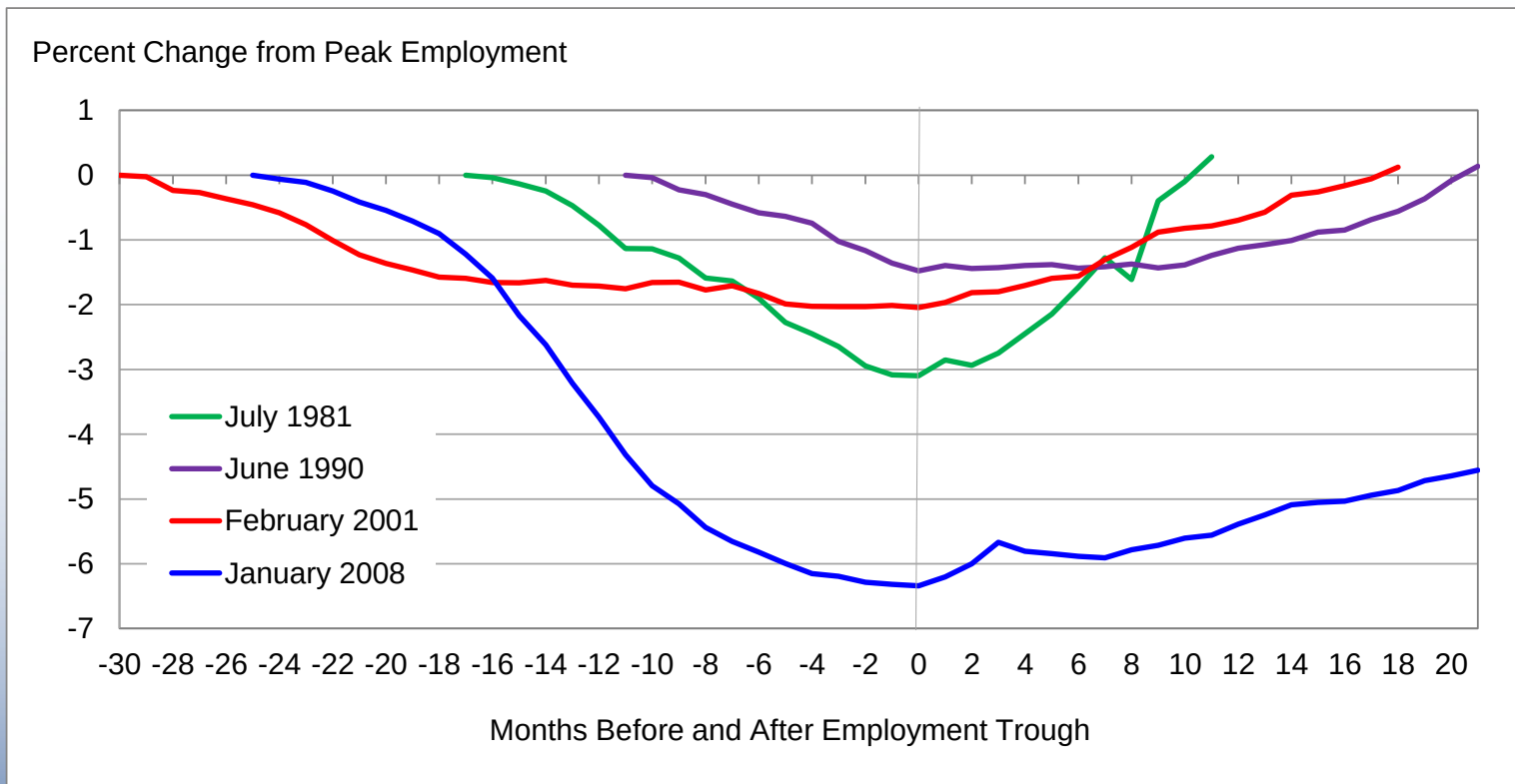


Source: Federal Reserve Board, NBER / Haver Analytics

Figure 4

Employment Change from Peak Employment

Most Recent and Three Previous Peaks



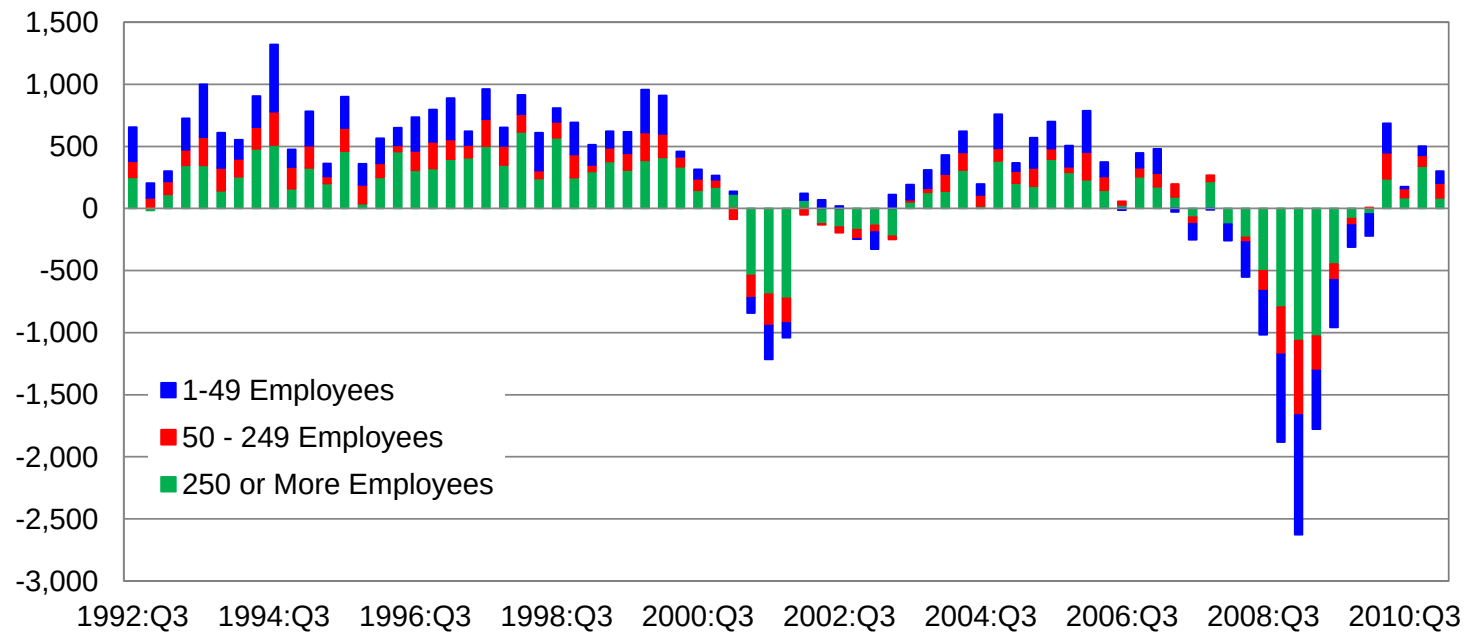
Source: BLS / Haver Analytics

Figure 5

Net Change in Private Sector Employment by Firm Size

1992:Q3 - 2011:Q1

Thousands of Jobs

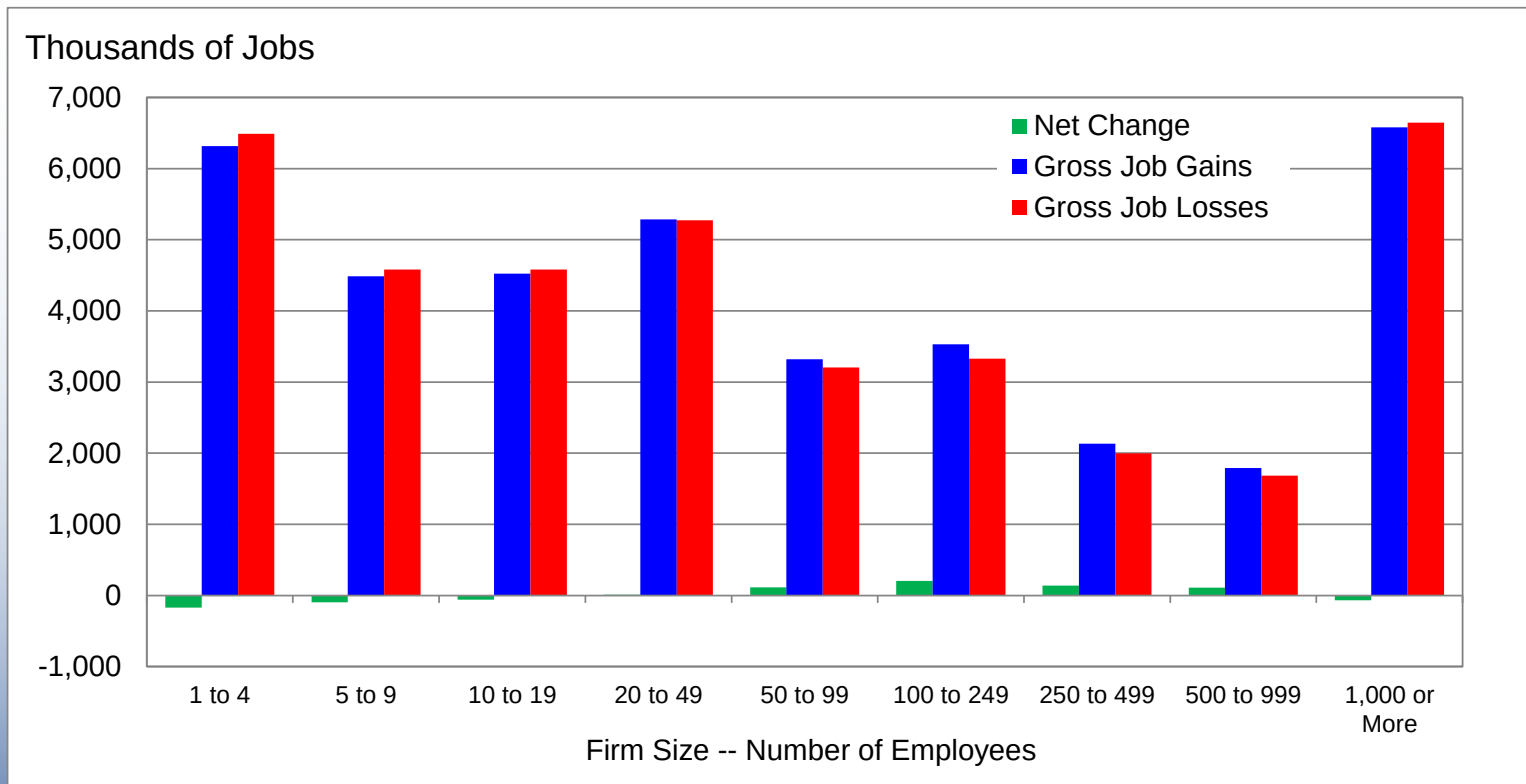


Source: BLS (Business Employment Dynamics) / Haver Analytics

Figure 6

Private Sector Gross Job Gains, Gross Job Losses and Net Change by Firm Size

Current Recovery – 2009:Q3 - 2011:Q1

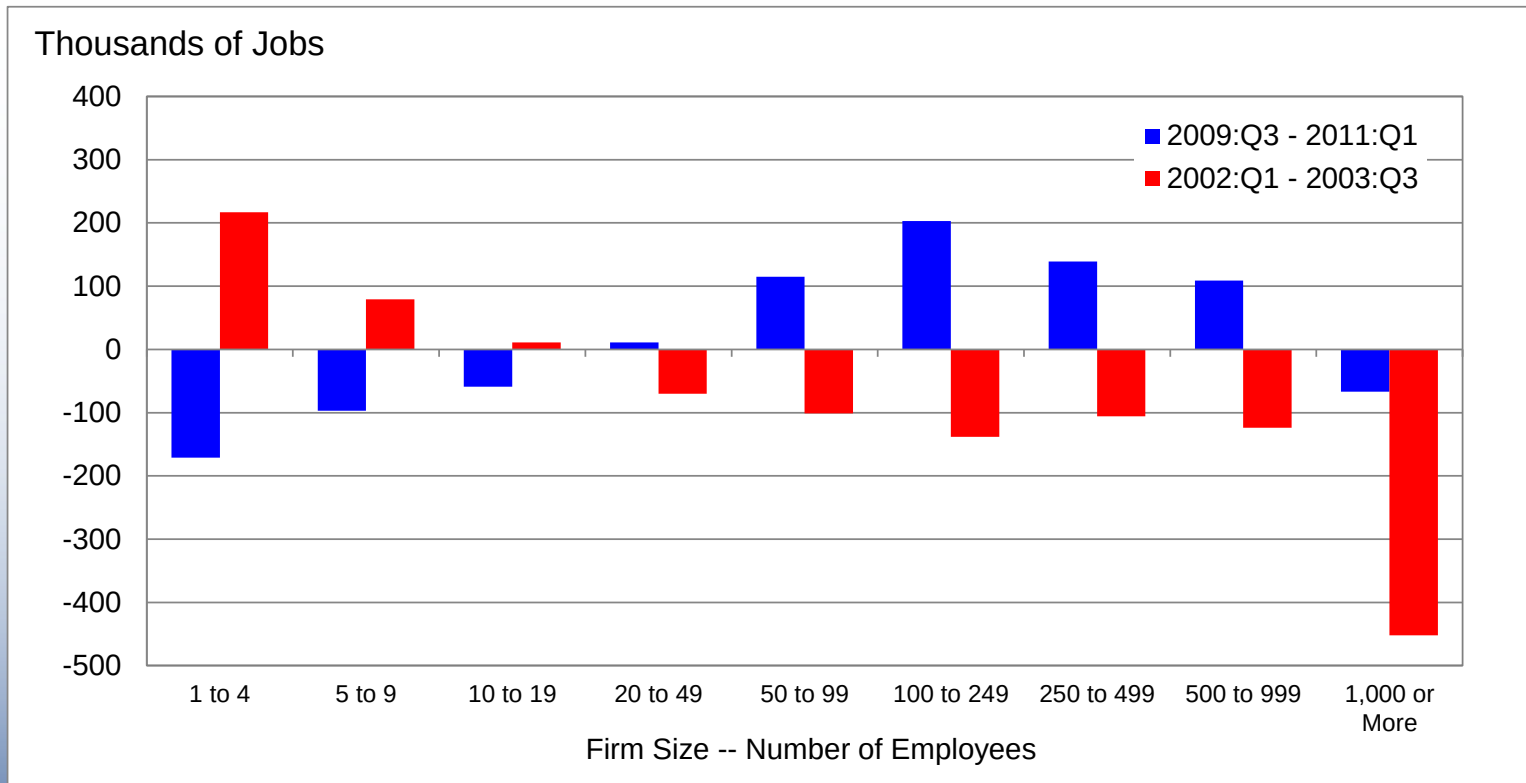


Source: BLS (Business Employment Dynamics), NBER / Haver Analytics

Figure 7

Net Change in Private Sector Employment by Firm Size

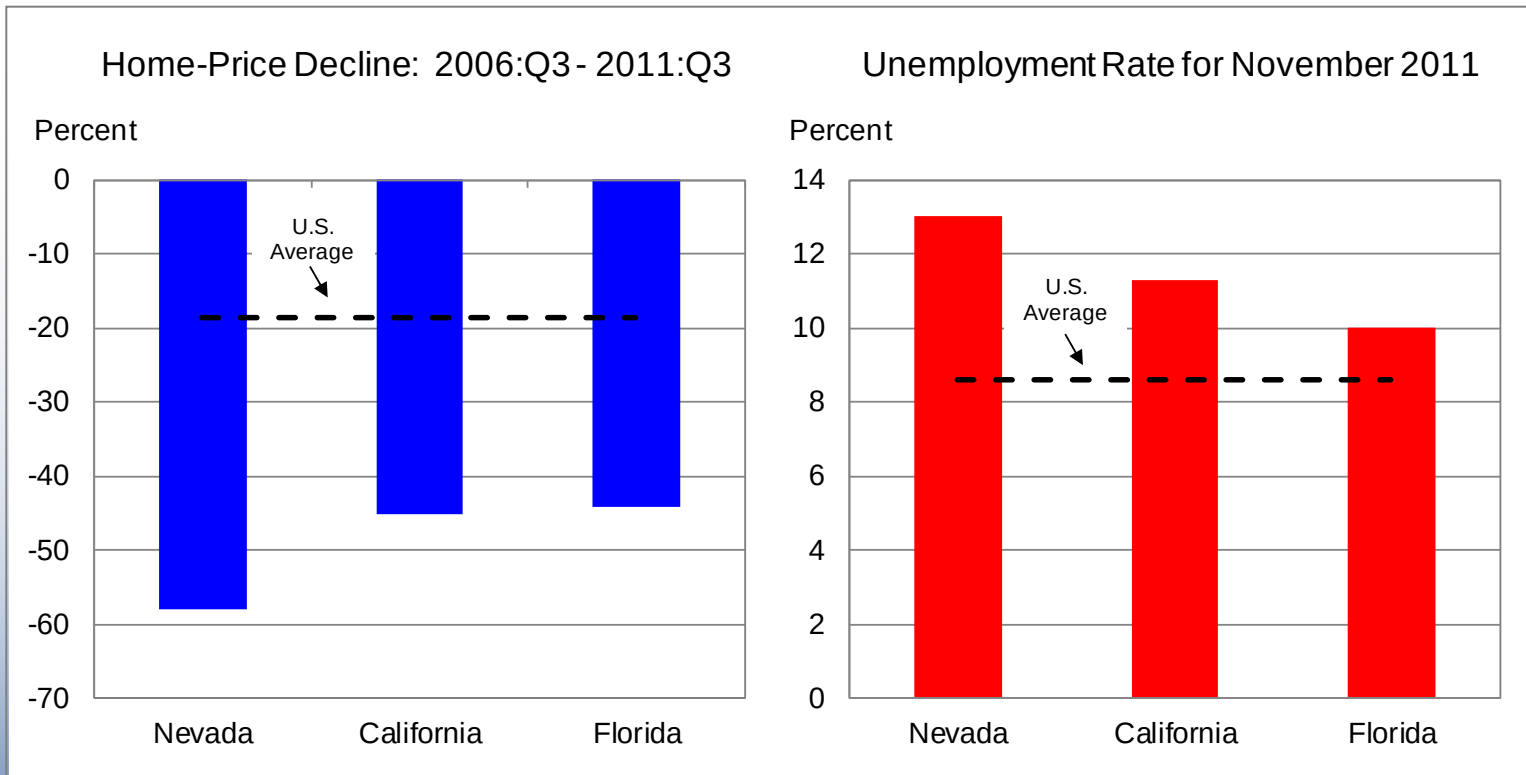
First Seven Quarters of Current and Previous Recoveries



Source: BLS (Business Employment Dynamics), NBER / Haver Analytics

Figure 8

Home-Price Declines and Unemployment Rates for Selected States

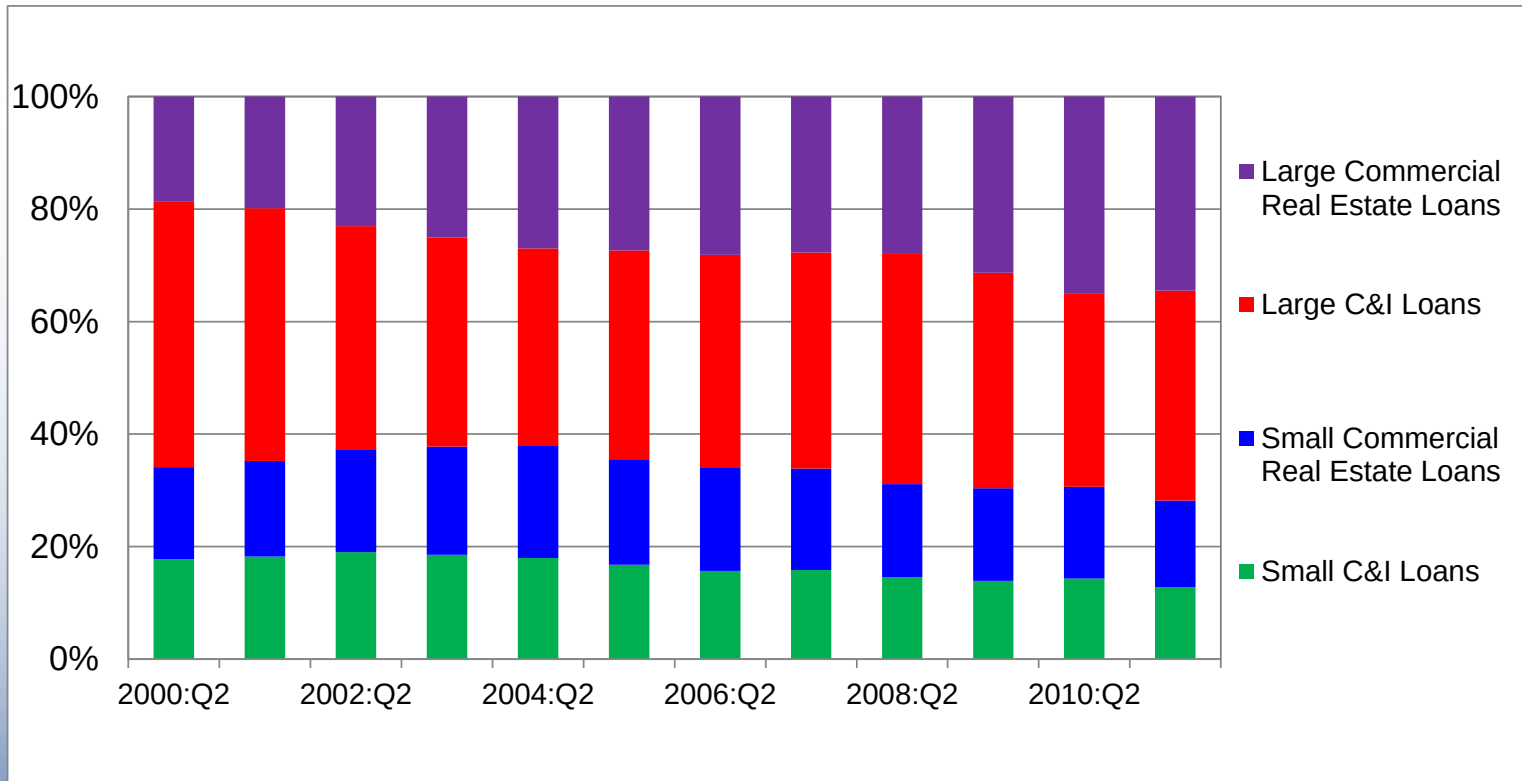


Source: FHFA, BLS

Figure 9

Business Loan Composition at Commercial and Savings Banks

2000:Q2 - 2011:Q2



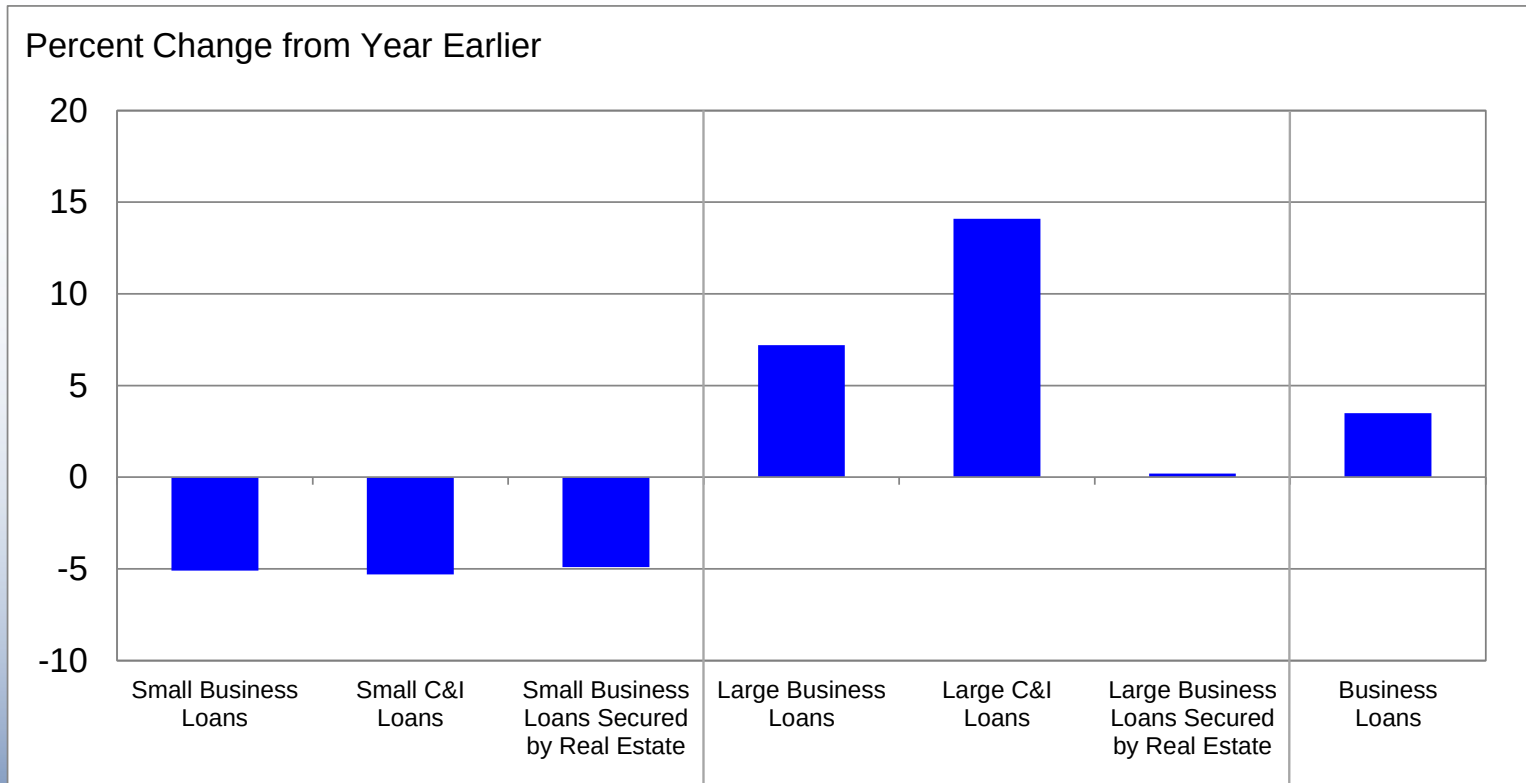
Note: Small business loans are defined by the size of the loan – business loans of \$1 million or less at origination.

Source: Commercial and Savings Bank Quarterly Call Reports

Figure 10

Growth in Bank Business Lending by Loan Size and Type

2010:Q3 - 2011:Q3



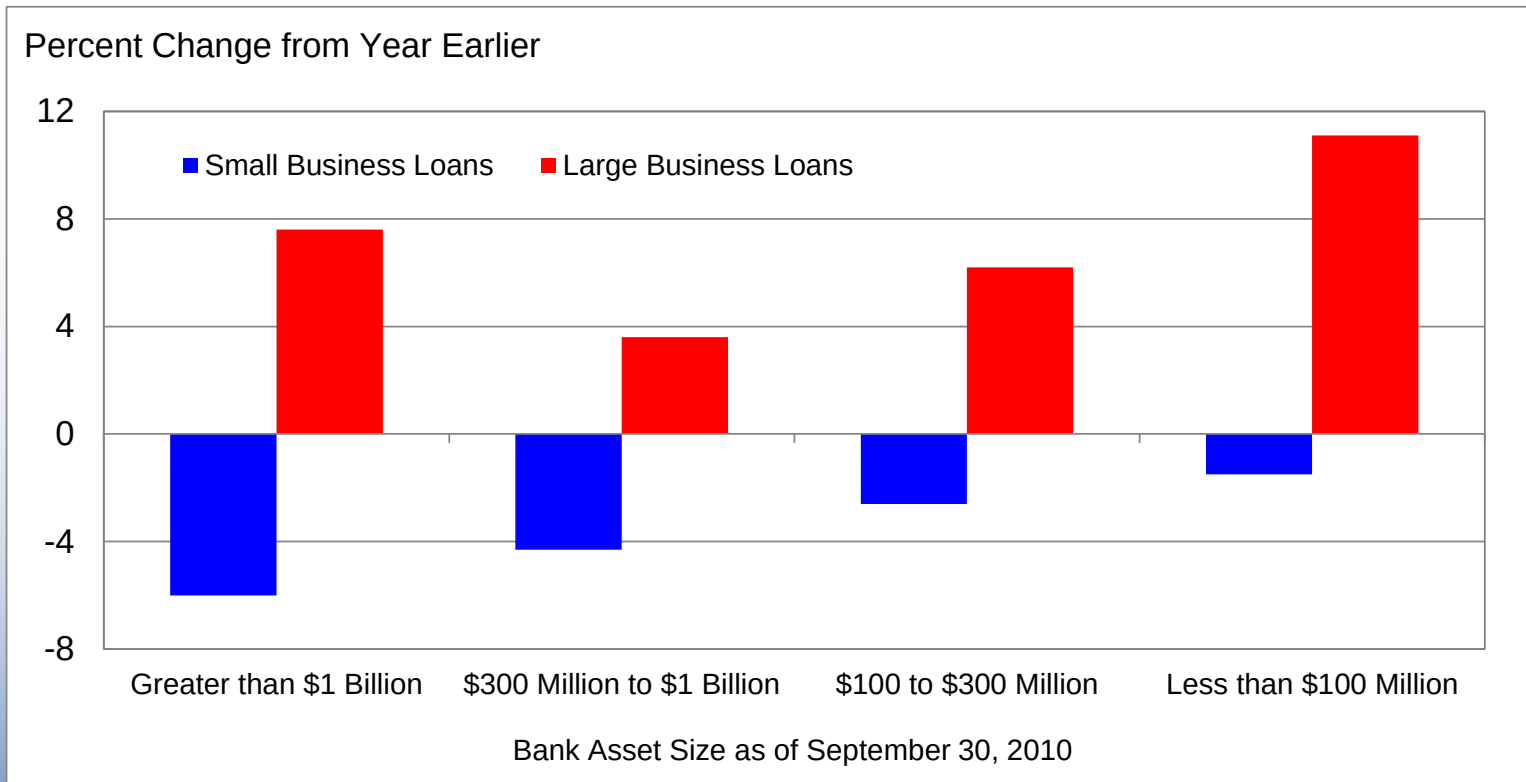
Note: Includes only banks reporting in both time periods, adjusts for merger activity, and excludes de novos. Small business loans are defined by the size of the loan – business loans of \$1 million or less at origination.

Source: Commercial and Savings Bank Quarterly Call Reports

Figure 11

Growth in Bank Business Lending by Loan Size and Bank Asset Size

2010:Q3 - 2011:Q3



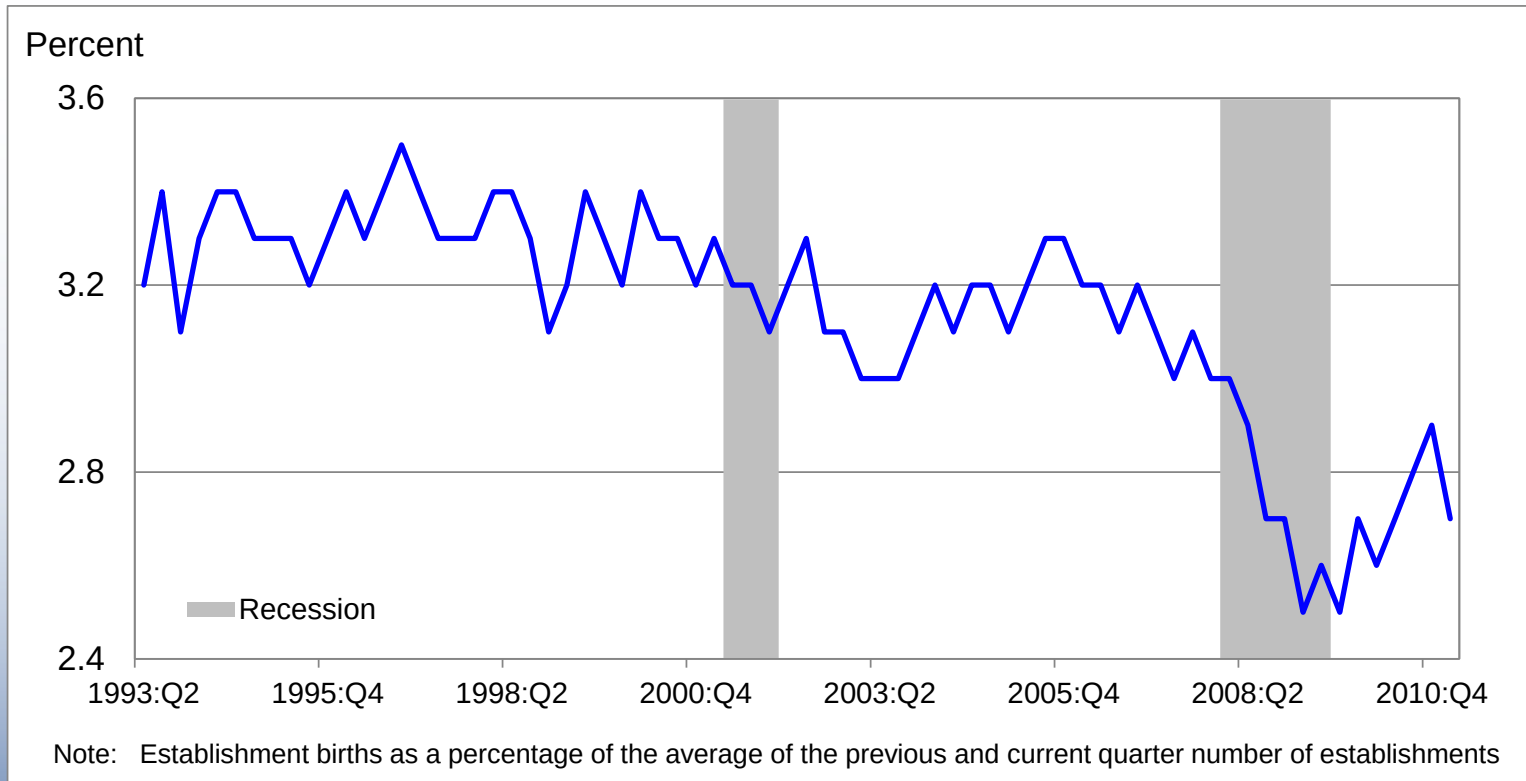
Note: Includes only banks reporting in both time periods, adjusts for merger activity, and excludes de novos. Small business loans are defined by the size of the loan – business loans of \$1 million or less at origination.

Source: Commercial and Savings Bank Quarterly Call Reports

Figure 12

Private Sector Establishment Birth Rate

1993:Q2 - 2011:Q1



Source: BLS (Business Employment Dynamics), NBER / Haver Analytics