

Small



When the Small Stuff Is Anything But Small

You're all probably familiar with the famous quote "don't sweat the small stuff—and it's all small stuff." Some days, that's very good advice to follow.

But in the world of economics, I have found that sweating the small stuff is often exactly the right thing to do--because paying attention to the small stuff can help you understand the big stuff.

So, with apologies to Dr. Richard Carlson, who wrote the wonderful book on not sweating the small stuff, I want to spend some time today talking about a specific sector of our economy--small business. So much of the public's attention in the wake of the financial crisis has been focused on big business--the turmoil at the big banks, the headlines about companies such as GM or AIG, layoffs at big firms, and so forth--that it's easy to forget the crucial role that small business plays in economic growth. I know it comes as no surprise to you that many small businesses are under stress right now. The Federal Reserve has been actively monitoring this situation, and we have been stepping up efforts to make sure the economic recovery doesn't leave small businesses behind--because, in truth, we can't have a full recovery without a healthy small business sector.

In my comments today, I'll first sketch the overall picture of where I see the national economy heading and why the economic recovery that is underway doesn't feel like one. Second, I will explain how these general economic conditions are affecting the small business sector. Finally, I will comment on the role the Federal Reserve is playing to help the economy recover from this economic crisis.

Of course, the views I express today are my own and not necessarily those of any of my colleagues in the Federal Reserve System.

I. A Recovery that Doesn't Feel Like One

Let me begin, then, with the national economy. You know we have been through one of the most severe and longest recessions in our nation's history. The recovery from the recession may also end up being one of the longest in our history. In fact, it may take years just to get back to the level of output we enjoyed in 2007, just before the economic crisis began.

Some of you may think I am being too pessimistic. After all, we saw a strong GDP growth estimate for the fourth quarter of last year--nearly 6 percent at an annual rate. But I think that figure overstates the underlying strength of our economy right now.

This is a case where paying attention to the small stuff--the details beneath that impressive number--reveals a more complicated story of

Additional Information

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**Dayton Chamber of Commerce
Governmental Affairs Breakfast**

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what is shaping up to be a gradual recovery. Most of the thrust behind that impressive fourth-quarter GDP growth figure owes to a rebuilding of inventory stocks, which had been cut to the bone and could no longer support even a mild economic recovery. Over the course of this year, I expect overall growth in employment and output to be on the weak side for the early stages of an economic recovery.

For many American households and businesses, this is a recovery that just does not feel much like a recovery. Let me point to two reasons why this is so. The first is due to the large amount of excess capacity that has accumulated. As spending declined in the recession, firms of all sizes cut back, drastically in many cases.

Paring down generally follows a pattern in business. You cut expenses, you trim your orders from vendors, you let inventories wind down, and if you must, you reduce employees' hours or lay people off. But at the same time you need to leave enough capacity so that your business can accommodate new orders when they start rolling in. Hunkering down isn't the same as shutting down.

This time feels different, however, due to the degree of paring back. Nationally, the manufacturing capacity utilization rate now stands at only 69 percent--its lowest level since 1982. And in some specific manufacturing industries, capacity has actually been shrinking, as some firms have passed the tipping point of maintaining idle capacity and have shut down plants and closed offices.

Excess capacity is a dilemma for businesses of all sizes. They can maintain capacity for only so long without an uptick in sales, and they're confronting a market where demand is only gradually recovering after having fallen off a cliff. In fact, according to the most recent survey of the National Federation of Independent Business, or NFIB (January 2010), members cited poor sales as their single most important problem. The latest American Express Open Pulse Survey also expresses a similar perspective. A very slow recovery in demand, which translates into low sales for most firms, makes it far tougher to maintain idle capacity over time. In the surveys, poor sales topped taxes and government red tape as the number-one concern, so you know this is a serious problem.

One of the forces holding back demand is the continuing high level of unemployment. Indeed, poor labor market conditions pose another large challenge to the recovery. Throughout our economy, unemployment persists as a huge and broad-based problem. The current official unemployment rate is 9.7 percent--and right here in Dayton, it is 11.8 percent. Other national calculations that take into account discouraged and underemployed workers--those who have stopped looking for work and those who are working part-time because of poor job-market conditions--run as high as 17 percent.

The duration of unemployment is also a big concern. According to the Bureau of Labor Statistics, the share of workers who have been without jobs for 27 weeks or longer now stands at 41 percent--the highest number since this series began in 1948.

Clearly, massive layoffs contributed to these large unemployment numbers, and fortunately, layoffs slowed months ago. Our current problem is a lack of job openings. In fact, the job-finding rate now stands at a historic low. Businesses are not creating new jobs very quickly, and where labor utilization is picking up, employers are simply restoring hours that had been previously cut.

Labor market conditions are adversely affecting all job seekers. As you might expect, less-educated people are more likely than college graduates to be unemployed, but surprisingly, the numbers show that

once a person becomes unemployed, the likelihood of having a long unemployment spell is virtually the same for both groups.

Without a pickup in hiring, it will be hard to sustain greater consumer spending in the economy more broadly, and without more spending, hiring will in turn remain subdued. The gravitational pull of the severe recession we have experienced is still rather strong, and I think it will just take somewhat longer than usual before we see a more robust pace of job creation.

So, to sum up, while we are likely now in a period of recovery, it doesn't really feel much like one. All types of businesses are continuing to see weak levels of demand - in other words, they don't expect to see a bounce-back in sales for quite a while yet. This in turn creates excess capacity, which leaves businesses having to decide whether to maintain or shut idle plants and offices. In such an environment, firms are being cautious about new hiring and so unemployment persists at a high level, which in turn restrains spending. From any perspective this is not a pretty picture, but it is especially challenging for small business, so let's look at that sector in a bit more detail.

II. The Small Business Sector

The importance of small businesses to our economy--especially in the early stages of a recovery--cannot be overstated. They have generated 64 percent of net new jobs over the past 15 years. During the initial years following each of the prior two recessions, those in 1990 and 2001, the strongest expansion in employment came from very small firms--those with less than 20 employees. Collectively, these statistics tell us that small business is in fact *big* business, and its impact is even greater because it remains one of the most innovative and flexible parts of the economy.

It is misleading to lump all small businesses into the same bucket. Even though they make up nearly 99 percent of all firms and account for just over half of all private-sector employees, there is really no such thing as a typical small business. Depending on whether it employs five people, or 50, or 500, the way a small business finances itself is likely to be different. Those on the larger end of the scale tend to rely most heavily on bank credit, for example. Those on the small end frequently turn to personal credit cards, and they often put up their own homes and vehicles as collateral.

But if I can make one general statement, I would say that small businesses are unique in other ways that make them particularly vulnerable during harsh economic times like these. It is fair to say that most small businesses are unable to go to the commercial paper, bond, or stock markets for financing. Also, small businesses are far more likely to be exposed to problems in the real estate markets than are large businesses. This is because of the direct nature of their business, such as construction, or because their buildings figure more prominently in their share of business assets, or because their personal property is often used to secure lines of credit. And don't forget that most community banks, which generally lend to small businesses, are actually small businesses themselves. For all of these reasons, the deterioration of residential and commercial property values has hit many small businesses hard, and many are finding access to credit to be especially challenging these days.

Now, let me say up front that I have worked at the Federal Reserve long enough to have heard bankers and business executives disagree about access to credit many times before. And, as usual, this is one of those situations where both sides are correct--up to a point. But this time the amount of passion each side is bringing to the table is unprecedented in my experience.

To get a closer look at why access to credit remains such a challenge for small business, the Federal Reserve Bank of Cleveland has been conducting an extensive outreach program to hear the views of small business owners, community bankers, and other stakeholders. One complaint we are hearing from small businesses is their difficulty in obtaining or maintaining credit on acceptable terms. From the perspective of many small businesses, credit is extremely tight.

Some businesses are seeking to restructure existing loans because these firms are now finding it difficult to make payments on these loans. Beyond that challenge, some small businesses are finding their bank may want to change lending terms because the borrower's collateral is no longer worth what it was before the financial crisis. From the banker's perspective, the struggles to make payments and declines in the value of collateral raise alarm bells, and the bank sees more risk than it likes.

Here is one example. A small business owner in Cincinnati recently told us that his lender was reappraising the equipment he purchased only three years ago, lowering its value by 30 percent. With such a drop in collateral value, the firm's ability to secure a revolving loan to carry it through to the high summer season was severely hampered. Now, the company can't get the money it needs to make as much product as necessary, which leads to lower sales, which leads to potential layoffs, and which might lead to violations of credit terms due to lower revenue growth. And on it goes.

Now let me tell you what bankers are saying. Bankers tell us loan demand is way down, and many companies aren't fully drawing on existing lines of credit. This actually confirms what the NFIB survey reports, namely, that only 5 percent of their respondents cite financing as their most important business problem. In fact, 89 percent of their respondents indicated that they could obtain all of the financing they needed, or they were not interested in borrowing.

Bankers also tell us that in cases where their small business customers do want to borrow, the businesses are simply not in as good shape as they once were they are either losing money, overextended, or don't have adequate collateral. With their own capital positions weakened coming out of the financial crisis, some bankers admit they are having to "button down" on lending standards. From the bankers' perspective, there is often more risk than reward out there. It will come as no surprise to you, then, to hear that the question I get asked more than any other these days is, "How can we turn this situation around?"

III. The Role of the Federal Reserve

I have no cure-all solution, but I do want to describe a few of the actions that policymakers either have been taking or are considering to cope with this economic crisis and to promote a recovery. First, let me tell you about the actions the Federal Reserve has taken. I think it is clear by now that we acted aggressively to forestall a total shutdown of credit channels and a devastating economic collapse.

Historically, the Federal Reserve's main tool for conducting monetary policy to support economic growth and price stability has been adjusting the federal funds rate--that is, the rate that banks charge one another for short-term loans. In response to the worst financial crisis in decades, we lowered the federal funds rate from 5-1/4 percent in mid-2007 all the way down to effectively zero in December 2008, where the rate still stands today.

Beyond that, as the crisis unfolded, we also created and implemented a number of unprecedented programs to provide

liquidity to financial markets and to get credit flowing again. Collectively, these programs were crucial in helping revive the securitization markets, stabilize the housing sector, and extend credit to households and small businesses. One significant result of our actions is that our own balance sheet expanded enormously in the process--from roughly \$900 billion before the crisis to approximately \$2.2 trillion today. In other words, we have far more assets and liabilities on our books than we would in more normal times.

We took these actions to rescue the entire economy, aiding businesses both small and large. Our policies are aimed at strengthening the demand for goods and services, the very factor that so many companies regard as their top concern. Yet the economy is anything but back to business as usual--and I expect the economic recovery to progress only gradually. These conditions, in my view, warrant exceptionally low levels of the federal funds rate for an extended period.

I realize that some people are concerned that if we do not take steps soon to throttle back on the amount of monetary accommodation we have been providing to the economy, our aggressive policy actions could lead to inflation.

This is a concern to keep in mind, but I do not see warning signs of inflation pressures on the horizon. At the Federal Reserve Bank of Cleveland, we monitor and produce future inflation predictors, and these measures remain at low levels. We have also worked hard to develop measures of inflation expectations, and those measures also continue to show that financial markets expect inflation rates to remain low over the next five years.

Nonetheless, as the economy strengthens, there will eventually come a time when we will have to scale back the degree of policy accommodation. Because of the unusually large amount of excess reserves we have supplied to the banking system, the Federal Open Market Committee has been discussing the tools and strategies for removing our policy accommodation when the time is appropriate. I am confident that we have the necessary tools to adjust monetary conditions when the time comes to do so.

The Federal Reserve also has responsibilities for banking supervision. In our capacity as a bank supervisor, we have joined the nation's other bank regulatory agencies in issuing new guidance on small business and commercial real estate lending. What's really important about this new guidance, I think, is how it encourages bankers to work with their customers during periods of stress. Often, it is in the best interest of both the bank and the customer to restructure loans so they can be repaid in a reasonable period of time. I can tell you that in my Reserve Bank, our supervisors are not automatically criticizing a credit just because it has been restructured. We are trying to be prudent but reasonable in assessing bank managements' handling of troubled loans. We do not want overzealous supervision to create additional problems for bankers and their customers.

Another set of actions geared toward the small business sector is the potential role of other government and public programs. Let me turn to one of the more obvious sources of financing for small firms--loans guaranteed by the Small Business Administration. A persistent story among the businesspeople we have been talking with over the past month is that SBA loans are appealing in theory, but difficult to secure in practice. Often, the problem is just a matter of paperwork. Other times, it is a matter of borrowers not being able to find a banking partner to underwrite the loan.

As it is currently structured, the overall scope of SBA lending is just too narrowly focused on start-ups and the scale of lending is too

small to deal with the shortfalls in credit that small businesses are reporting. In total, SBA guaranteed credit accounts for only about 5 percent of outstanding credit to small business. The Administration, for its part, has taken steps to address this issue by proposing legislation to allow increases to the caps on certain kinds of SBA loans, as well as to allow for the refinancing of certain kinds of owner-occupied commercial real estate. The Administration has also proposed using \$30 billion of TARP funds for community banks to use for small business lending.

So while there is no cure-all solution, there is widespread awareness at the policy level that helping to find solutions to the challenges facing small business is vitally important to our recovery. We at the Federal Reserve Bank of Cleveland are fully committed to staying engaged in this effort.

Conclusion

Let me conclude my remarks by noting that the ability of the Federal Reserve to endure as a positive force in the economy depends in no small part on our institutional design. Having 12 Reserve Banks across the country puts us in a very good position to act quickly, thoughtfully, and decisively. We hear from our small and large business contacts about conditions on the ground. We get real-world input that we share at the Federal Open Market Committee meetings, where we set national monetary policy. To me, this is the genius of the "decentralized central bank."

At a time when our nation faces unusual economic and financial challenges, it is important to know that the Federal Reserve was set up to be independent so it can focus on longer-term policy objectives while remaining accountable to the Congress and the American people. I believe it is vital that we retain that independence if we are to maintain public confidence as we work to promote economic and financial stability.

We still have a long journey ahead of us. We are at the very beginning of what is shaping up as a shallow recovery, and its trajectory is uncertain. The small business sector has been one of the catalysts behind every economic recovery in our history, and it is the collective actions of thousands of business owners that drive our economy every day. Small business and Main Street are not "small stuff" by any means-instead, they are the real crux of our economy.

Some may think the Federal Reserve is too big or too wrapped up in national concerns to be interested in whether or not a small business in Dayton can get access to credit, but our structure ensures we take these needs into account, and I want to assure you both personally and on behalf of my Bank that we are fully committed to listening, to talking, and to ensuring these concerns are heard.

Since I began with a quote from Richard Carlson, let me finish with another one. Carlson once said "circumstances don't make a person; they reveal him or her." When I talk to business owners across my District I see tenacity, determination, and a strong commitment to rebuild and prevail. We have a long road ahead, but every time I attend an event like this I am heartened by the drive and optimism I see.