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Statement of

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before the

House Select Committee on Small Business

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## SMALL BUSINESS FINANCING

The Federal Reserve System, with its interest in a financial organization and climate favorable to orderly economic growth and a stable dollar and with its particular responsibility for bank credit, necessarily has a concern about the availability of financing for business--both small and large business, new as well as established business.

This continuing interest in credit availability for business as a whole prompted us to initiate a comprehensive study of financing facilities for, and of the financing problems of, smaller business.

It is important to understand the nature of the Federal Reserve System's role and responsibility with respect to credit expansion, interest rates, and inflationary pressures. The Federal Reserve's responsibility is primarily for relating the availability of bank credit to the needs of sustainable growth of the economy. The aim of the Federal Reserve is to see that banks have, or can readily obtain, reserves that are adequate for these needs but not in excess of them.

Demands of borrowers and the credit standards of lenders determine through what channels credit is made available. Because banks have a responsibility to their depositors to repay deposits at face value on demand or on short notice, individual banks must maintain a high proportion of liquid, that is, short-term, assets. As a general practice, long-term loans and investments come from savings and not from commercial bank credit.

When demands for credit and capital are heavy and inflationary pressures exist, if the Federal Reserve were to attempt to supply credit directly to meet demands of a particular sector or type of business, without cutting down credit for other purposes, it would run the risk of supplying reserves to the banking system in larger amounts than would be

appropriate for healthy and sustainable economic growth. It should be remembered that funds initially supplied for a specific purpose continue in the total credit stream after they are once spent and become available for other purposes.

The Federal Reserve does have a concern with the financial needs of particular sectors of the economy, including small businesses. However, the System's main concern in this respect relates to the question of whether the institutional arrangements of our credit structure are such as to produce an economic and equitable distribution of the available supply of savings and bank credit.

The Federal Reserve program of inquiry into this subject has been developed after extended discussion within the System and also with interested individuals and organizations in and outside of Government. The program divides into three parts.

In part one, we are taking stock of existing knowledge and information to see what light all of this material, when brought together systematically, throws on the small business financing problem. Our probing will deal with such subjects as the characteristics and role of small business in a dynamic economy; trends in the relative importance of such business; typical ways in which small business obtains its financing; risks and returns to lenders in small business financing; and Federal Government and regional programs for aiding such financing. Staff members of the Board of Governors and of the Federal Reserve Banks are making some of these studies. Others are being undertaken by university scholars. The National Bureau of Economic Research--a private, nonprofit research organization of national reputation--has agreed to cooperate with us in making the study of risks and returns in small business financing. The

Arthur D. Little Company of Boston, Massachusetts, one of the nation's leading industrial research firms, is examining management aspects of small business operations and their relation to success in obtaining outside financing.

The second part of the System's inquiry is an inventory of the financing facilities presently available in our economy for meeting small business credit and capital demands. Thus, it is involving an intensive survey of the financing techniques and credit terms of a variety of providers of funds to small business. These include the commercial banks, finance companies and factors, life insurance companies, investment bankers, and trade creditors. Questionnaires and field interviews are being relied on to develop pertinent information. The staffs of the Federal Reserve Banks are assuming the main responsibility for conducting this field survey study.

A special segment of this part of the research program is a national survey of business loans of commercial banks outstanding at mid-October, 1957. The System made a similar national survey in October 1955. Thus, a comparative picture of the lending activities of commercial banks for a recent period of strongly expanding credit demands will be provided. These surveys cover information on a number of characteristics of the loan and the borrower, including size and maturity of loan, size and industry of borrower, and the interest rate charged. In each survey, in the neighborhood of 2,000 commercial banks have provided data on roughly 200,000 individual loans.

The business loan survey is of special interest to this Committee and to the Small Business Administration and its planning has involved the cooperative participation of the staffs of your Committee and

other committees of the Congress as well as that of the staffs of the Small Business Administration and other interested agencies of the Executive Department.

It is hoped that the major portion of the first two parts of our inquiry will be completed by early next spring. It is our plan to supply the research findings to your Committee as well as to other interested Congressional committees as soon as they become available.

Part three of this program of inquiry is a pioneering venture. It contemplates a national survey of the financing structure and needs of small business and would be done on a sample basis. The planning and conduct of such a direct survey involves many difficult sampling and reporting problems and feasibility of the survey hinges on their successful solution. The Board's staff is currently working on these problems with the help of the technical staffs of the Bureau of the Census, the Federal Trade Commission and the Securities and Exchange Commission, as well as the Bureau of the Budget. It is too early to say just when plans for the survey will be completed but the best judgment of our staff at this time is that planning and testing work will require at least a year. Nevertheless, this approach of going directly to the small businessman himself appears potentially so promising that the Board feels that work should go ahead on it even though it will take considerable time to plan and execute.

The information currently available on business financing is generally of an over-all character. We know, for example, that in recent years our economy has been characterized by high-level business activity and vigorous demands for credit and capital by business concerns. These demands plus those of individuals and governments have

pressed hard against the supply of savings, and have resulted in higher interest rates. The funds made available by savings and bank credit have supplemented demands for goods and services made effective by high and rising incomes and by the use of previously accumulated cash balances. In this way, they have been a root cause of inflationary pressures.

Recently a table showing the changes in the volume of outstanding debt of the various types crossed my desk and I was struck by the very large growth in debt shown by most major categories. A copy of this table is attached.

The table shows that in the business field, concerns other than farms and financial enterprises increased their debt from \$98 billion in mid-1951 to \$119 billion in mid-1954, and to \$156 billion in the middle of 1957. This translates into a 31 per cent increase from mid-1954 to mid-1957 and to a 59 per cent increase from mid-1951 to mid-1957. These changes compare with increases in total debt other than that of the Federal Government of 36 per cent since mid-1954 and 81 per cent since mid-1951.

Unfortunately, these figures are not available by size of business, but the Board's staff has made a rough breakdown of the data by corporate and noncorporate status. This breakdown shows quite similar percentage increases in debt for the corporate and noncorporate sectors over both periods. Since unincorporated businesses are typically small in size, the breakdown suggests that in recent years businesses of all size have been willing and able to expand their debt positions.

I was also impressed by other figures in this table, notably by the very sharp increase in home mortgage debt in recent years. The outstanding volume of this debt in mid-1957 totaled \$94 billion. Home

mortgage debt more than doubled from mid-1951 to mid-1957. Consumer credit has also increased rapidly over these years.

Reflection about the figures of debt increase shown by this table prompted me to request the Board's staff to prepare another which would show participation by commercial banks in the large private debt expansion of recent years. This table, also attached, covers changes in total assets, total deposits, total capital accounts and total loans of various classes of member banks from the end of 1951 and 1954 to mid-1957.

This second table shows that in the case of total assets, total deposits, and total capital accounts, the country banks, which individually are much smaller on average than the city banks, experienced since 1951 a greater relative growth than city banks. Also, the banks in reserve cities other than New York and Chicago experienced a greater relative growth for these items than did the very large banks in these big centers, which are known as central reserve cities. In the case of total loans, relative growth for the whole period from 1951 to mid-1957 was greater at country banks than at city banks, but for the period from 1954 to mid-1957 the reverse was the case. In both periods, however, the differences in loan growth by class of banks were rather small.

In general, city banks individually are large and country banks are small. While city banks make small as well as large loans, country banks, both because of their limited size and the legal limitations generally restricting the amount of individual loans to a per cent of capital and surplus, can make only relatively small loans. Many of these small loans of country banks go to consumers, home owners, and farmers, but many also go to small retail, service, construction, and manufacturing concerns in the local communities which the banks serve.

The slightly greater relative loan growth at the larger city banks since 1954 has undoubtedly been associated with more intensive demands for bank credit by larger companies. The economy has been undergoing a "capital goods boom," and capital goods industries as well as the industries requiring heavy capital investment are generally characterized by large-scale enterprises. It is to be expected, in such circumstances, that requirements for outside financing of large-scale enterprises should mount more rapidly than those of smaller scale enterprises.

Before leaving these banking data, you may wish to note the increase in bank capital during recent years. This increase in bank capital plus a favorable earnings position has provided a healthy strengthening of the equity base of our banks. A strong equity base for a private banking system is a prime requisite to the maintenance of effective bank credit services to growing communities. It is gratifying to observe that the banks are continuing to add to their capital strength.

The study which the System is making will, we trust, shed sufficient light on all aspects of the problems of small business financing to help all of us resolve many of the questions to which we do not now have adequate answers.

Net Domestic Debt

|                                       | Outstanding--midyear<br>(In billions of dollars) |            |            | Percentage Change     |                       |
|---------------------------------------|--|------------|------------|-----------------------|-----------------------|
|                                       | 1951   | 1954       | 1957       | mid-1951-<br>mid-1957 | mid-1954-<br>mid-1957 |
| Domestic debt--government and private | <u>427</u>                                       | <u>505</u> | <u>601</u> | 41                    | 19                    |
| Government debt                       |  |            |            |                       |                       |
| Federal Government (net)              | 216  | 224        | 220        | 2                     | -2                    |
| State and local governments (net)     | 26   | 36         | 46         | 77                    | 28                    |
| Private domestic debt                 |  |            |            |                       |                       |
| Business (net)                        |  |            |            |                       |                       |
| Nonfinancial business                 |  |            |            |                       |                       |
| Nonfarm                               | 98   | 119        | 156        | 59                    | 31                    |
| Farm                                  | 10   | 13         | 15         | 50                    | 15                    |
| Financial business                    | 9  | 14         | 19         | 111                   | 36                    |
| Individuals                           |  |            |            |                       |                       |
| Mortgage debt                         | 42   | 63         | 94         | 124                   | 49                    |
| Consumer credit--total                | <u>21</u>  | <u>30</u>  | <u>42</u>  | 100                   | 40                    |
| Instalment                            | 14   | 23         | 32         | 129                   | 39                    |
| Noninstalment                         | 7  | 8          | 10         | 43                    | 25                    |
| Other debt of individuals             | 6  | 7          | 10         | 67                    | 43                    |

Note. Data may not add to totals because of rounding. The figures on total domestic debt represent, within the limits of statistical availability, all loans and debt securities. They exclude deposit liabilities of all kinds, currency liabilities, trade payables in the form of extensions of book credit to business firms, internal accruals such as tax liabilities, and insurance reserves. Figures on Federal debt exclude holdings of such debt by Federal Government corporations, agencies, or trust funds. Figures on State and local government debt exclude holdings of such debt by any State and local government agency. Financial business includes mainly banks, insurance companies, savings and loan associations, finance companies of various kinds, mortgage companies, security brokers and dealers, and investment companies.

Source. Board of Governors of the Federal Reserve System.

Selected Assets and Liabilities of All Member Banks,  
by Class of Bank, 1951, 1954 and mid-1957

| Class of Bank              | Dollar Amount (in millions) |                  |                 | Change (in per cent) |                   |
|----------------------------|-----------------------------|------------------|-----------------|----------------------|-------------------|
|                            | Dec. 31,<br>1951            | Dec. 31,<br>1954 | June 6,<br>1957 | 1951-<br>1957        | 1954-<br>mid-1957 |
|                            | Total Assets                |                  |                 |                      |                   |
| All member banks           | <u>153,439</u>              | <u>172,242</u>   | <u>176,507</u>  | +15.0                | + 2.5             |
| All reserve city banks     | <u>97,090</u>               | <u>107,878</u>   | <u>108,105</u>  | +11.3                | + 0.2             |
| Central reserve city banks | 38,436                      | 40,713           | 39,140          | + 1.8                | - 3.9             |
| Other reserve city banks   | 58,654                      | 67,165           | 68,965          | +17.6                | + 2.7             |
| Country banks              | 56,349                      | 64,364           | 68,404          | +21.4                | + 6.3             |
|                            | Total Deposits              |                  |                 |                      |                   |
| All member banks           | <u>141,015</u>              | <u>157,252</u>   | <u>157,593</u>  | +11.8                | + 0.2             |
| All reserve city banks     | <u>88,727</u>               | <u>97,893</u>    | <u>95,402</u>   | + 7.5                | - 2.5             |
| Central reserve city banks | 34,261                      | 36,097           | 33,606          | - 1.9                | - 6.9             |
| Other reserve city banks   | 54,466                      | 61,796           | 61,796          | +13.5                | 0.0               |
| Country banks              | 52,288                      | 59,360           | 62,192          | +18.9                | + 4.8             |
|                            | Total Capital Accounts      |                  |                 |                      |                   |
| All member banks           | <u>10,218</u>               | <u>12,210</u>    | <u>14,058</u>   | +37.6                | +15.1             |
| All reserve city banks     | <u>6,459</u>                | <u>7,703</u>     | <u>8,754</u>    | +35.5                | +13.6             |
| Central reserve city banks | 2,938                       | 3,403            | 3,572           | +21.6                | + 5.0             |
| Other reserve city banks   | 3,521                       | 4,300            | 5,182           | +47.2                | +20.5             |
| Country banks              | 3,760                       | 4,506            | 5,304           | +41.1                | +17.7             |
|                            | Total Loans, Net            |                  |                 |                      |                   |
| All member banks           | <u>49,561</u>               | <u>60,250</u>    | <u>78,448</u>   | +58.3                | +30.2             |
| All reserve city banks     | <u>33,265</u>               | <u>38,809</u>    | <u>51,119</u>   | +53.7                | +31.7             |
| Central reserve city banks | 13,614                      | 14,823           | 19,684          | +44.6                | +32.8             |
| Other reserve city banks   | 19,651                      | 23,986           | 31,435          | +60.0                | +31.1             |
| Country banks              | 16,296                      | 21,442           | 27,330          | +67.7                | +27.5             |

Source. Board of Governors of the Federal Reserve System.