

KEYNOTE ADDRESS: CHANGES IN SMALL BUSINESS FINANCE

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Introduction

I am pleased that this conference has been able to draw together such a knowledgeable group of Federal Reserve System economists and experts from outside the System to address issues of great significance to our business and banking communities. There are, no doubt, many different views on the potential effects that developments such as credit scoring, loan securitization, and bank consolidation, among others, are having on credit availability for U.S. businesses. But I think we would all agree that sound analysis and open discussion in meetings like this are essential to furthering our understanding of financial markets.

It is also important to place recent developments in business finance in the context of the fundamental forces that have shaped our economy during the 1990s. I will focus my remarks today on what I view as key elements in this process and the implications for small businesses.

The U.S. Economy and Technological Change

The United States is currently in its ninth year of economic expansion, an exemplary accomplishment by any standard. Growth of output has remained vigorous, unemployment is lower than it has been in nearly thirty years, and yet, despite the tautness in labor markets, there have been no obvious signs of emerging inflation pressures.

From the perspective of small businesses, the 1990s have provided a challenging and positive environment for developing and marketing new ideas. Even the most reclusive among us cannot help but be aware of the surging growth of young high-tech firms and the flashy presence of new Internet businesses. But times seem to have been good for expanding traditional lines of business as well. Our regional Federal Reserve Banks consult regularly with representatives from their small business communities. The feedback that we have received from these groups and information from surveys of small businesses—such as those taken by the National Federation of Independent Business—have revealed high levels of business optimism in recent years. The most common complaints—other than dissatisfaction with

the tax structure—have centered on the difficulty of filling jobs with qualified workers in the midst of strong competing demands for labor. While troublesome, such concerns are also indicative of an expanding economy that is productively competing for scarce resources. For the vast majority of small businesses, access to credit has not been a top concern in this expansion, but many business owners are quite anxious about the future as the familiar ways of financing business undergo sometimes dramatic changes.

A remarkable element in our recent prosperity has been the rapid acceleration in the application of computer and telecommunications technologies, which have engendered a significant increase in productivity in this expansion. Although difficult to pin down empirically, some calculations suggest that the rate of return on capital facilities put in place during recent years has moved up markedly. Meanwhile, the process of recognizing this greater value has produced capital gains in asset markets that have lowered the cost of investment in new plant and equipment. Dramatically declining inflation expectations have helped to lower risk premiums on debt and have contributed importantly to the favorable investment environment.

In addition to improvements in the efficiency of the capital stock, we likely are witnessing payoffs from improved organizational and managerial efficiencies of U.S. businesses and from the greater education—in school and on the job—that U.S. workers have acquired to keep pace with the new technology. All these factors have been reflected in an acceleration of labor productivity growth. While the pace of technological change has been breathtaking, the process of innovation is not itself a new phenomenon. Capital equipment, production processes, and financial and labor market infrastructures are always in a state of flux. I believe the words that best characterize this phenomenon are those used several decades ago by Joseph Schumpeter who described the process of “creative destruction.” Competition and innovation breed the continuous churning of our capital stock in ways that, on balance, result in more efficient production of goods and services and enhance our standard of living. New businesses are formed and existing businesses fail or contract, new products and processes replace old ones, new jobs are created and old jobs are lost. I never cease to be amazed at the ability of our flexible and innovative economic system to take advantage of emerging technologies in ways that raise our productive capacity and generate higher asset values.

In this country, technological advance is a process that combines the best creative thinking of entrepreneurs and research scientists in business and academia. It is a process that thrives in a competitive market environment in which risk-taking is valued and in which

prices and asset values signal how ideas and resources can be applied most productively.

Clearly, small businesses are crucial players in this process. Nowhere in the world are the synergies of small and large businesses operating side by side in a dynamic market economy more apparent than in this country. The list of innovations by small businesses is enormous, in fields such as computer technologies, software, aerospace, pharmaceuticals, and satellite communications. And while we would be foolish to ignore the significant contributions of corporate giants, it is important to note that many of today's corporate giants were small businesses not all that long ago. America's innovative energy draws from the interaction of both large and small businesses, and will continue to do so.

Changes in Financial Markets

An important key to the success of small and large businesses is having access to capital and credit. First and foremost, I would emphasize that credit alone is not the answer. Businesses must have equity capital before they are considered viable candidates for debt financing. Equity acts as a buffer against the vagaries of the marketplace and is a sign of the creditworthiness of a business enterprise. The more opaque the business operations, or the newer the firm, the greater the importance of the equity base.

The United States has been a leader in the development of public and private markets for equity capital. Venture capital investments in rapidly growing small businesses totaled more than \$14 billion in 1998, with much of the funds provided by private partnerships. Probably an even larger amount was invested privately by high net-worth individuals—so-called 'angel' investors. These sources are an essential part of the financial foundation for the dynamic young enterprises that are so central to our wealth-creating process. Still, more than two-thirds of equity financing for small businesses comes from the owner or family and friends.

Continued efforts to develop the markets for private equity investments will be rewarded by an innovative and productive business community. This is especially true in lower-income communities, where the weight of expansive debt obligations on small firms can severely impede growth prospects, or more readily lead to business failures.

On the credit side, the same forces that have been reshaping the broader economy have also been transforming the financial services industry. The advent of computer and telecommunications technology has lowered the cost and broadened the scope of financial services. These developments have made it increasingly possible for borrowers and lenders to transact directly, and we have seen a

proliferation of specialized lenders and new financial products that are tailored to meet very specific market needs. At the same time, the development of credit scoring models and securitization of pools of loans hold the potential for opening the door to national credit markets for a broad spectrum of businesses operating in local and regional markets. As a result, competitive pressures in the financial services industry are probably greater than ever before. This competition has been heightened by deregulation and the removal of barriers to interstate banking. Evidence that this process is well under way can be found in the new CRA data on small business lending. These data show, for example, that institutions located outside the local community are an important source of credit for many businesses.

Changes in financial markets are perhaps most apparent in the realignment taking place among our commercial banks. Most projections of the future U.S. banking structure call for a substantial reduction in the number of American banks. Recent mergers have already resulted in the creation of nationwide banks and large financial service companies. More are sure to come. However, we should not expect that all institutions will become financial supermarkets. Indeed, I have no doubt that thousands of smaller banks will survive the consolidation trend, reflecting both their individual efficiencies and competitive skills, on the one hand, and the preferences of the marketplace for personalized service on the other.

The demand for traditional services by smaller businesses and by households should continue to flourish. And the information revolution, while it has deprived banks of some of the traditional lending business with their best customers, has also benefited banks by making it less costly for them to assess the credit and other risks of customers they would previously have shunned. Thus, banks of all types will likely continue to engage in a substantial amount of traditional banking.

Indeed, an often-expressed concern with the ongoing consolidation of the U.S. banking systems is a feared reduction in the supply of credit to small businesses. However, studies of the dynamic effects of bank mergers and acquisitions suggest that while mergers are apt to reduce small business lending by the participants, this decline appears to be offset in part, or even in whole, by an increase in lending by other institutions in the same local market. With the benefits of improving technology, well-managed regional institutions will seize the opportunity to increase their customer base in markets where large institutions have acquired local competitors. I think it is safe to say that, whatever their cost advantages, large automated systems can never fully displace the value of personal contact and familiarity with local economic circumstances, which are the keystone of community banking.

Potential Impediments to Efficient Resource Utilization

Overall, our evolving financial system has been highly successful in promoting growth and higher standards of living. However, much work remains to be done to improve the process. Barriers still prevent the free flow of capital and people to their most productive employment. In the small business sector, potential impediments include: lack of market information, difficulties in assessing risk, high transactions costs for small loans, and, in rural areas, special challenges associated with geographic distance from lenders and potential markets. One particular barrier—apparent disparities in the access to credit for minority-owned businesses—is the focus of several papers being presented at this conference.

In some cases, these studies have found discrepancies in the turn-down rates for minority-owned small business applicants responding to our small business survey. Not all of these differences are readily explained by income, balance sheet factors, or credit histories, although considerably more work needs to be done to take account of possible explanatory factors not included in the studies to date. But, if after such examination the gap persists, it raises disturbing questions.

To the extent that market participants discriminate—consciously or, more likely, unconsciously—credit does not flow to its most profitable uses and the distribution of output is distorted. In the end, costs are higher, less real output is produced, and national wealth accumulation is slowed. By removing the non-economic distortions that arise as a result of discrimination, we can generate higher returns to human capital and other productive resources. It is important for lenders to understand that failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, it harms the lending institutions and, ultimately, robs the broader economy of growth potential. In this regard, we need to make further progress in establishing business relationships between the financial services sector and the rapidly growing number of minority- and women-owned businesses.

This conference highlights several developments that hold the promise of improving such links. As large banks and finance companies try mass-market approaches to small business lending, the potential for inappropriate discrimination is diminished. In addition, new intermediaries—such as community development corporations, micro-business loan funds, or multi-bank and investor loan pools—are beginning to build expertise in specific areas of the small and minority business marketplace. These innovators are working with traditional lenders to develop new approaches to managing costs and evaluating the risks associated with providing financing for very small and young firms.

Conclusion

Let me conclude my remarks by thanking the participants at this conference for helping us to better understand the forces at play in financing small businesses. Several of the papers presented have drawn on data reported by banks as part of their CRA requirements and several others have used data from the Federal Reserve's 1993 National Survey of Small Business Finances. The Fed currently is working on its third survey of 6,000 small businesses—to be known as the 1998 Survey of Small Business Finances. We expect this new information, coupled with annual CRA reports, to add greatly to our knowledge of changes taking place in small business finance. I want to thank in advance any small business that is selected to be part of the Fed's new survey and to encourage them to participate. It takes a lot of time and effort for survey respondents to answer our detailed questions, but as evidenced by the presentations here, the information is very valuable to us. More broadly, it is the type of information that provides the basis for sound analytical research on many important issues.