

## STATEMENT OF WILLIAM DUNKELBERG, CHIEF ECONOMIST, NFIB

In the United States, small business owners did not report a sudden “freezing up” of capital flows as was often reported in the media. Monthly surveys of a sample of NFIB’s members (about 500,000) reveal that credit tightened as the expansion peaked and the economy faded, but the experience was no different than that observed in the 1980s expansion or the 1990s expansion (see charts). There was no “freezing” of credit markets. Borrowing activity is also historically low because loan demand is weak. SMEs are postponing inventory investment and capital spending at 35 year record high rates. The reduction in lending due to weak demand will be erroneously attributed to the “credit crunch”. Fewer than 1% of SMEs have government sponsored loans. SBA loans are down because (1) loans are made primarily by large banks because of the “red tape” and large banks are short on capital, (2) banks typically securitize the guaranteed part of the loans but that market has dried up, (3) loan demand is down. The link between reports of “50 money center banks” in the Fed survey regarding changes in lending standards for SMEs is only weakly related to reports of credit difficulties among SME owners (see chart). Bank customers likely had given more accurate reports of “conditions on the ground” than the CFOs of large banks in New York.

The experience of SMEs in the U.S. is different because there are 8000 or so independent commercial banks (plus other financial institutions including credit unions). In simple terms, these banks are SMEs, competing for the business of other SMEs (there are 6 million employers in the U.S., 90% have fewer than 20 employees and another 10 million “one person enterprises). This is not the case in most other countries. In the U.S., the largest banks have experienced (caused?) the most severe financial problems. However, on “main street”, banks were not engaged in financial engineering, but were doing simple basic banking, collecting savings in their markets and lending to consumers and businesses in their market. Their capital was not impaired by the credit market collapse, although it has been impaired by reductions on the yield on their assets imposed by the Federal Reserve rate cuts and by increased insurance premiums charged by the FDIC to cover the losses incurred by the largest banks.

In simple terms, if a country has one bank with 1000 branches, all branches suffer the fate of the large bank and SME finance is affected. In the U.S., large banks abandoned programs to finance new fast food franchises for example. But if there is one large bank with 500 branches and 500 independent small banks, the entire banking system is not fully impacted by troubles at the large bank. In the U.S. small banks refer to the large bank problems as the “goose that keeps laying golden eggs” as good large bank customers shift their business to them.

As further evidence of the benefits of competition, decades ago states had differing rules about branch banking, ranging from unit banking states (only 1 branch is allowed) to state wide branching. NFIB studies showed that SMEs always reported (1) the highest degree of customer satisfaction, (2) the best loan terms and (3) the lowest refusal rates in states with unit banking laws where the number of competing independent banks was larger.

Much discussion will revolve around what the government could do to alleviate the credit issues currently experienced (regardless of the cause). One good answer is to develop a competitive banking system (diversify the risk of a large bank failure). But the discussion will probably focus primarily on the usual requests from government – provide subsidies, guarantees, below market rate loans, loans to firms that don't qualify for a loan from banks etc. These may reduce the pain today, but are not the kind of policies needed to foster the long term growth of the SME sector (in the U.S., half of private GDP and well over half of private sector jobs). SME finance will still suffer from the lack of competition among banks and will remain vulnerable to the next big financial market problem.