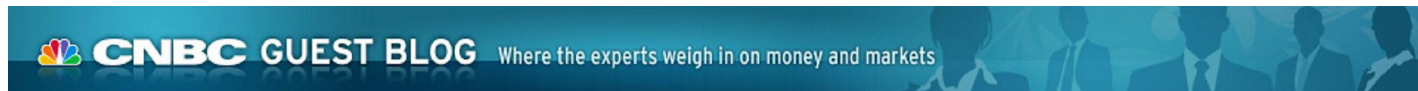
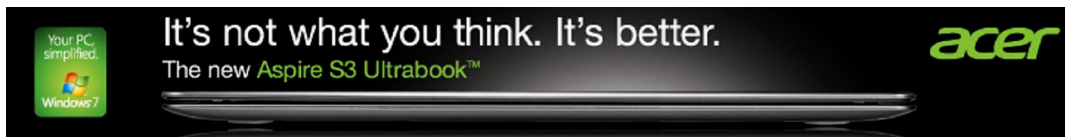


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Dunkelberg: Small Business, Small Banks & Credit—Two Views

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If you listen to Washington and New Yorkers working for bailed out institutions or in offices 100 floors above Wall Street, the recovery is weak because banks, and now small banks in particular, won't lend money to small businesses. There has been plenty of evidence to the contrary (demand is weak rather than banks are hoarding money), but facts don't play well in Washington.

First of all, we should stop "benchmarking" to 2006 and 2007, a period of credit excesses enabled by an apparent "weakening" of credit standards in many parts of the economy. This is not a period we should aspire to return to. Of course credit is "harder" to get than it was prior to the recession. And of course the press can find someone who thinks they deserve credit but can't get it.

These "Man Who" statistics ("I know a man who.....") quoted in the press and in hearings are not helpful and highly misleading. Nobody did the investigatory work to see if any of these alleged cases of unfair credit rationing were really bankable. In the best of times, 5% of small business owners say their credit needs weren't met – it was 8% in May (NFIB). Banks aren't venture capitalists; they have no ability to recognize the next "great idea" and don't make loans to fund such projects.

Lending is about capacity to repay – tomorrow, not yesterday.



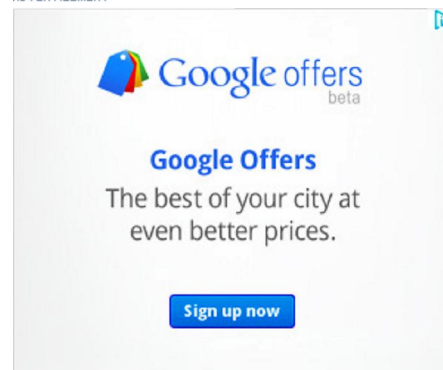
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The "message" from Washington and some New York pundits is that the banks "owe it" to the U.S. to make more loans (it's "unpatriotic" not to!) because they were "bailed out".

Well, most small banks were not bailed out, but they sure are paying through the nose to cover the "bad actors" with FDIC premiums 700% higher.

The implication is that banks are not making good loans when the opportunity arises, an unlikely situation. Large banks lost a ton of bucks, and did restrict their lending. But the "small banks" for the most part did not engage in risk-taking like the larger institutions and have money to lend. Surely the administration is not suggesting that banks go back to making

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bad loans to create jobs.

NFIB (which surveys a sample of its 300,000 or so members each month) finds that only 3% of its members report financing as their top business problem (as high as 37% pre-1983). A third cites "weak sales" as their top problem. 92% report all of their credit needs met (or having no desire to borrow). Thirteen percent of regular borrows report credit "harder to get" than their last attempt which now dates into the post crash period – of course it is harder!! (But not as high as pre-1983 survey readings).

Loans to small business are down primarily because huge amounts of private credit demand are on the sidelines:

- A. Housing starts are 1,000,000 below normal needs, normally built by thousands of small construction firms financed by thousands of community banks. At, say, \$200,000 per construction loan, that's a huge gap in private credit demand. In the first year after the more modest 1991 recession, 100,000 new construction jobs were credit by a housing recovery. Missing today.
- B. Auto purchases are 5 million units below normal
- C. For 6 million employer firms, actual capital outlays are at 35-year low levels, purchases that are normally financed at banks.
- D. For two years, firms have been liquidating inventory, not adding, an activity usually supported by bank loans.
- E. Consumers have been actively paying down their indebtedness.

In short, there are far fewer firms looking for credit these days, there is money to be lent, but a shortage of eligible borrowers. A special NFIB study of D&B firms with fewer than 100 employees in December 2009 indicated that the purpose of most borrowers (over 70%) was to supplement cash flow, not expanding their businesses or hiring. In addition to too many houses, we also built too many strip malls, retail outlets and restaurants and accumulated too much inventory to keep up with a non-saving consumer.

Now, all these firms must share a reduced level of consumer spending to support them. Not all will succeed unless, of course, consumers return to their old spending ways. In the meantime, the Treasury found it a lot easier to finance our trillion-dollar deficit. But when the private sector begins to expand and private credit demands explode, "crowding out" will provide a strong headwind to private sector growth.

Assets, whether human capital or physical assets must "earn their keep". Workers don't get hired unless they have high odds of generating enough sales to pay for the cost of hiring them. Equipment isn't purchased unless it can be productively used to pay for itself. You can give owners interest free loans and they will not spend the money because they have to repay the loan and in this environment the assets are unable to earn their keep.

Business tax cuts won't be spent on endeavors that have a low probability of paying off. Anyway, \$30 billion isn't much to throw at the problem if the Administration really believes that small bank reticence to lend is the problem. One firm with a handful of employees got twice that amount (and will not pay that back to taxpayers with all likelihood because it was a loan that rational private sector lenders wouldn't make for that reason).

So, lending to small business is down primarily because credit demands are down, and, of course, firm balance sheets and income statements are in poor shape. In this recovery, inventory rebuilding (manufacturing) and exporting have led, not housing and the consumer. This has favored large firms (and the stock market), not small businesses that are usually the first to see the turnaround in

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the economy. Yes, credit standards are higher than they used to be, using 2007 as a benchmark!

But making bad loans is not the key to stimulating the economy.

Government has done this, sadly, but the private sector is more careful with the funds entrusted to its lending institutions by savers, especially small banks. Small business produces half of private sector GDP in normal times. Perhaps the reason GDP growth is rather anemic (and inventory driven) is that the small business sector of the economy is not participating. Certainly developments in Washington offer little encouragement for small business owners and the consumer is less than exuberant. But all of this is not a result of unwillingness on the part of small banks to lend and make good loans.

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