Senate Democratic Policy Committee
"Removing Barriers to Job Creation:
Are Banks Lending to Small Businesses That Are Ready to Hire?"

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Thank you Chairman Dorgan and the other distinguished members of this committee for the opportunity to testify today. I am the Chief Economist and Co-Founder of Moody's Economy.com. I started the firm that became Economy.com with my brother and another colleague nearly twenty years ago. We sold it to the Moody's Corporation four years ago after we had grown into a business employing close to 125 employees. I am therefore both an economist and a former small business owner. My remarks today reflect my views and not those of the Moody's Corporation.

I will make four points in my remarks. First, the Great Recession is over. The solid gain in real GDP during the third quarter and a likely similar gain in the current quarter prove that the longest, broadest and most severe economic downturn since the 1930s has finally given way to an economic recovery.

It is no accident that the recession ended just as the fiscal stimulus program began providing its maximum impetus to the economy. If the financial crisis had been allowed to continue unchecked by aggressive government action, the economy would not yet have reached a turning point.

My second point is that despite rising GDP, for most Americans it still feels like a recession as the GDP growth has not been sufficient to stem the loss of jobs—now more than 8 million and counting—or the rising unemployment rate that now sits firmly in double digits. The job market is arguably as bad as it has been since the Great Depression, with nearly every industry, occupation, and region of the country suffering from weak labor demand.

The struggling job market is the most serious threat to the fledgling economic recovery. In a typical business cycle, recession occurs when consumer and business demand is undermined by a shock such as a surge in oil prices, a stock market crash, or—as in the current cycle—the bursting of a house price bubble. Businesses respond by slashing investment and payrolls to cut costs and stabilize profits. As they do, investors, who had driven down stock prices leading up to the recession, now bid prices up. With better profit margins and higher stock prices, businesses stop cutting, and recession gives way to recovery. A self-sustaining expansion takes hold when businesses feel comfortable enough to invest and hire. In the current business cycle, profits and stock prices have risen, businesses have stopped cutting, and recovery has begun. But because employers have yet to resume hiring, expansion remains elusive. Indeed, the odds that the economy will backtrack into recession remain uncomfortably high.

This leads me to my third point, that small businesses are especially vital to job growth. Establishments with fewer than 100 employees account for about one-half the net job loss in our economy since the Great Recession began in late 2007. Layoffs at these businesses

remain high, but even more worrisome is the sharp decline and now extraordinarily low rate of job creation. As you have heard already this morning, this is particularly true at start-up companies; the companies that ultimately power the economy's long-term growth.

Small firms are now struggling mightily to obtain credit; their principal lenders, small banks, are under intense pressure, and hundreds more are set to be taken over by the Federal Deposit Insurance Corporation. Commercial and industrial loans outstanding are declining at a rapid pace. Credit card lenders, another key source of loans to small business, have aggressively raised their underwriting standards. The number of bank credit cards has fallen by nearly 100 million or 25% since peaking earlier this year. The collapse in house prices and commercial real estate values is also weighing on small business lending as business owners often use the property they own as collateral in obtaining a loan.

My final point is that policymakers could take a number of steps to help quickly alleviate the credit crunch faced by small businesses. Most importantly, policymakers could empower the Small Business Administration to provide more credit. Banks aren’t making as many SBA backed small business loans as they could because the loan’s interest rates are currently capped at less than 6 percent — not enough to compensate for their risks at a time when business bankruptcies are high and rising. Creditworthy small firms would gladly pay somewhat higher rates to obtain credit. Increasing the maximum size of a S.B.A. 7a loan to $5 million from its current $2 million limit would also

significantly boost lending. A wide range of small business expansion plans are being impaired but the current loan limit. Temporarily raising the percentage of the loan guarantees to as high as 97.5 percent, from their current 90 percent, would also prompt much more lending.

To free up credit for small businesses, policymakers should also take steps to facilitate activity in the secondary market for small business loans. Efforts to revive issuance of securitized small business loans by the Federal Reserve through its TALF program and the provision of $15 billion in TARP monies for this purpose have not been successful. A more aggressive use of these funds to revive this market and to develop the loan syndication market for small business loans would help restart small business lending.

Small businesses would also benefit from the adoption of a job tax credit. The credit would apply to jobs that expand payrolls and could equal the payroll tax costs for these new hires for at least one year and perhaps two. While small businesses are more focused on the demand for what they produce and the availability of credit when making hiring decisions, the cost of labor, which this credit targets, is also important. The credit could be made more effective by allocating a set amount of funds for those businesses that hire first. This would encourage firms to act quickly and accelerate the benefit of the credit.

The government could also help minimize the number of new job losses at small businesses by promoting work-share programs. Nothing damages morale at a company more than layoffs; the experience not only is crushing for those who lose their jobs, but

also weighs on those who remain, including managers. Layoffs are also costly, given severance expenses and the costs of rehiring or training new employees when business picks up again. Seventeen states offer effective work-share programs. Under these arrangements, employers cut workers' hours — not their jobs — and states make up a portion of workers' lost wages with unemployment insurance payments. Congress should provide financing to expand such programs nationwide.

While these policy steps would not be free, they could be surprisingly economical. Moreover, the costs to taxpayers would be measurably greater if the economy does not turn the corner into expansion but instead retreats back into recession.

The nation has made significant strides in the last year; 12 months ago, major financial firms were disappearing and the economy was in free fall. Yet the proverbial coast is not clear. The Great Recession has given way to recovery, but with firms still unwilling to add to their payrolls, it will take more policy help, particularly to small businesses to ensure a self-sustaining economic expansion takes root.

Thank you again for the opportunity to offer you my views on this very significant issue.