

# Small Business Economic Outlook: Assessing Current Conditions and Challenges to Growth

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Committee on Small Business

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## Introduction

The current economic downturn is rooted in the financial crisis, which has undermined consumer confidence and greatly constricted the flow of capital. The crisis, which was caused by a sharp rise in subprime mortgage lending and a subsequent decline in housing prices, has spread throughout the banking and investment industry. In September, it culminated in the bankruptcy and failure of several large financial institutions. The crisis is now contributing to negative economic trends in nearly all sectors of the U.S. economy.

The result of this systemic shock has been a rapid decline in economic activity and confidence, one marked by reduced consumer spending, business investment, and inter-bank lending. The Reuters/University of Michigan preliminary index of consumer sentiment fell from 70.3 to 57.5 in September, marking the biggest drop-off since records began in 1978. Meanwhile, the Institute for Supply Management's index-- a key measure for manufacturing-- dropped to 43.5 in September. In addition, retail sales plunged 1.2% last month, indicating continued declines in consumer spending.

With the entire economy now gripped by the downturn, a psychology of fear has succeeded in driving increased market volatility. Despite government intervention, it appears that this downward spiral will restrict economic growth for the near future. An economic turnaround will require renewed business investment, improved economic confidence, and overall job creation. In the past, small businesses have helped stem the effects of this kind of crisis. Following the recession of the early 1990's, for example, startups helped usher in an era of tremendous prosperity. They did this by creating 3.8 million jobs, a figure that surpassed big business expansion by nearly 500,000.

As the nation looks to stem the effects of the financial crisis, entrepreneurs are likely to play a critical role in the recovery process. This is largely because small firms employ half of the nation's workforce and comprise 99.7% of American enterprise. Small businesses account for almost all of the nation's employer firms and generate half of non-farm private output. In this report, the House Committee on Small Business examines the effects of the financial crisis on entrepreneurs. Furthermore, it explores the far-reaching impact of the current downturn on key small businesses industries, with particular emphasis on manufacturing, construction, housing and retail.

## **Highlights of the Report**

### **Weakness in the Overall Economy**

- Unemployment is currently at 6.1%, its highest mark since September 2003.
- The economy has now lost 760,000 jobs since January and has averaged 43,000 losses each month.
- A particular drag on the economy is the housing market: median prices are falling, sales of new homes continue to decline, and residential investment has fallen by 18% since the fourth quarter of 2007.

### **Small Businesses Are Hurting in All Sectors**

- Almost every sector of the economy-- including manufacturing, construction, and retail sales-- is struggling. The downturn is widespread across industries and across the country.
- The manufacturing industry has lost nearly 442,000 jobs in the past 12 months, and new orders were down 4% in August 2008, as compared to July 2008.
- The housing industry continues weigh down the economy. Making up roughly 10% of GDP, the housing industry is largely comprised of small business home builders, realtors, contractors, etc.
- Small businesses make up nearly 90% of the retail and restaurant trade. Retail has lost over 250,000 jobs in the past year. A combination of rising prices for essential goods and slowed consumer spending (which accounts for roughly 2/3 of our nation's GDP), could mean the worst is yet to come.
- Overall small business optimism is down. Fewer and fewer entrepreneurs see themselves hiring workers and expanding. Many cite inflation and poor sales as the reason behind this.

### **Crisis in the Financial Markets Has Crippled Small Business Expansion**

- Led by the downturn in the housing market, lending standards have tightened across commercial and industrial (C&I) sectors, as well as others.
- Over 65% of respondents to the Federal Reserve's Senior Loan Officer Survey reported tighter credit lending standards on C&I loans to small firms.
- Much of the report reflects an environment where credit for small firms is the lowest it has been in the history of the Fed survey.
- The volume of SBA small business loans has decreased 38% since last year. FY 2008 has reflected the largest decline in total loans in program history-- some 30,000 less than last year.

### **Economic Conditions Need to Improve for Small Businesses to Generate Economic Recovery**

- Small businesses have the ability to create jobs in those sectors of the economy that drive our economy—manufacturing, construction, and retail.
- Following the recession of the early 1990's, for example, startups helped usher in an era of tremendous prosperity. They did this by creating 3.8 million jobs, a figure that surpassed big business expansion by nearly 500,000.
- Small businesses are seeking improved credit conditions as well as improved overall business and consumer confidence.

## **I. Economic Data Shows Slowing Economy and Increasing Job Loss**

Declines in business investment, consumer spending, and the housing market have caused nearly every sector of the economy to struggle. According to the Federal Reserve, consumer spending decreased across most of the country, with drop-offs reported in retailing, auto sales and tourism.<sup>1</sup> Manufacturing and commercial real estate activity slowed in most communities, while residential real estate markets remained weak.<sup>2</sup> A main contributor to this broad slowdown is the financial crisis, which has severely tightened credit conditions across the nation. As a result, the capital availability for businesses – both large and small – has been substantially curtailed.

As a result of these economic declines, the country has seen a substantial increase in unemployment. In September, U.S. employers reported the highest amount of job loss in more than five years. The U.S. Department of Labor reported that this decline was led by a reduction in service sector jobs, as well as mounting losses in the construction, manufacturing and retail sectors. The unemployment rate is now at 6.1%, its highest point since September 2003. Since January, the economy has lost 760,000 jobs and averaged a monthly decline of 43,000 in the last year. That figure fails to keep pace with workforce growth.

There are clear signs that the economy is slowing. After two strong quarters, economic growth fell by 0.2 % in the fourth quarter of 2007. Meanwhile, it only increased by 0.9 % in the first quarter of 2008. However, revised figures show a 2.8 % growth in the second quarter of 2008. Given reports on consumer spending and business investment, it is likely that the recent crisis in the financial markets will cause growth to be at or below zero for the third quarter of 2008.

After the protracted appreciation of home values, median housing prices fell by 1.8 % in 2007, marking what may be the first year of falling prices since the Great Depression.<sup>3</sup> And the decline appears to be worsening over time: prices fell 6.5 % between December 2006 and December 2007.<sup>4</sup> Other housing data fell even further; existing home sales plunged 22% in the twelve months through December 2007. Residential (home building) investment fell by 18 % in the four quarters ending in the fourth quarter of 2007.<sup>5</sup> While other components of the GDP have grown at reasonably healthy rates, the decline in residential investment has acted as a significant drag on overall GDP growth. Many economists argue that the housing boom was not fully caused by improvements in economic fundamentals (such as rising incomes and lower mortgage rates), and instead represented a housing bubble -- a situation where prices were being pushed up by unreasonable expectations.

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<sup>1</sup> *The Beige Book*, October 15, 2008. Prepared by the Federal Reserve Bank of Chicago.

<sup>2</sup> *Ibid.*

<sup>3</sup> Michael Grynbaum, "Home Prices Sank in 2007, and Buyers Hid," *New York Times*, January 25, 2008. Prices are compiled by the National Association of Realtors.

<sup>4</sup> Congressional Research Service.

<sup>5</sup> *Ibid.*

The combination of negative job creation and slowing or declining GDP growth creates sizeable economic risks for the economy. During past economic downturns, the economy has exhibited resilience and strength. Unfortunately, the financial markets crisis was a systemic shock that will prove challenging to overcome. If history is any indication, it will be several years before the economy restores job losses. Following the recession that ended in 1991, it took the economy it took 33 months to regain all its lost jobs.

Along with this broad analysis of the general economic environment, the Committee has examined specific challenges now facing a number of small business-driven industries. The Committee also reviewed the overall business confidence among firms – a key indicator of the short-term economic outlook.

## **II. Broad Array of Small Business Industries Hit by Economic Downturn**

Given the fact that small businesses represent 99.7% of all employer firms and employ nearly half of all private sector employees, small businesses span all aspects of our economy. Small businesses make up a large portion of firms in key sectors like manufacturing, construction, restaurants, home building and retail. At the same time, they also comprise a significant segment of businesses operating in fields like health care and financial services. The Committee examined how these various segments of the economy are faring, with a particular focus on how small businesses have been impacted.

### **1. Manufacturing**

A key area of small business entrepreneurship and development exists in the manufacturing sector. Small businesses are involved in nearly all aspects of manufacturing, whether related to the production of durable and non-durable goods or technology driven products. What is clear is that the manufacturing sector is not faring well. Job losses continue to mount in almost every portion of the manufacturing sector. The motor vehicle and parts industry has lost over 140,000 jobs in the past 12 months. Meanwhile, durable goods manufacturers have witnessed 17,000 job losses in the past month alone. All told, the manufacturing industry has lost nearly 442,000 jobs in the past 12 months.<sup>6</sup> At the same time, new orders for manufactured goods decreased by \$18 billion dollars, or 4%, in August 2008. This represented the largest decrease in new orders since September 2006.

Due to the decreased demand for their products, many small manufacturers have been forced to either close their doors or downsize. Small business manufacturing jobs are generally high-paying positions performed by highly skilled workers. Over 80 % of the country's nearly 290,000 manufacturing firms have fewer than 20 employees, and over 98% have fewer than 500 employees.<sup>7</sup> Therefore, if the goal is to get the economy moving again, there must be a renewed focus on providing opportunities to small business manufacturers.

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<sup>6</sup> Source: Bureau of Labor Statistics, The Employment Situation: September 2008. Released Oct. 3, 2008.

<sup>7</sup> Source: 2005 SBA Office of Advocacy – Employers by NAICS Code.

## **2. Housing Market and Construction**

The housing market and the construction industry in general are leading indicators of the overall economic health of the country. In 2008, there continues to be a decline in construction work. In the past month alone, the industry has lost over 35,000 jobs, and over 500,000 since the beginning of 2007, according to the U.S. Department of Labor's Bureau of Labor Statistics. Most of those job losses have been in the residential components, where countless small businesses are involved in the brick laying, carpentering, and construction of residential and commercial buildings.

By some estimates, residential investment, and construction alone accounts for roughly 5-6% of the Gross Domestic Product (GDP), while all other ancillary services that support the housing industry comprise another 5%. While some industries are struggling, the housing industry is facing a crisis not seen since the Great Depression. The inventory of unsold new homes remains elevated at 10 months, well above the long-term average of 6 months. Meanwhile, home prices continue to fall, just as mortgage delinquency and foreclosure rates continue to climb.<sup>8</sup> Even more troubling is recent data released by the U.S. Commerce Department, which reveals that housing starts nationally declined by 6.3% to an adjusted rate of 817,000 units. That marks the slowest building pace since 1991. Housing starts are a critical indicator for the housing industry, as they not only reflect current conditions, but also give a glimpse into our economic future. Considering that the home building trades have lost 567,000 jobs since February 2006, the worse may be yet to come.<sup>9</sup>

The downturn in the housing market has impacted small businesses whose livelihoods are built on the housing industry. Over 80% of all home builders are entrepreneurs, and most of them are now struggling to make ends meet. Some have had to tap into home equity, borrow from their 401(k), or max out credit cards just to keep their business running. Furthermore, there are millions of additional small businesses that rely on the housing market, such as realtors, mortgage lenders, real estate appraisers, plumbers, and contractors. As a myriad of economists, political leaders, and government officials--including Treasury Secretary Henry Paulson, and Federal Reserve Chairman Ben Bernanke-- have commented, our economy is unlikely to see positive growth until the housing market corrects itself.

## **3. Retail Trades**

Small businesses have long dominated the retail trade, a sector in which they are now experiencing significant challenges. The retail trades include a variety of different outlets, including department stores, discount chains, restaurants, gasoline stations, drug stores and businesses that sell goods online or through catalogues. In September 2008, the U.S. Department of Commerce reported that retail trade sales were down 1.2% from August of 2008, and a full 1.4% below last year's levels. This has impacted the industry greatly. The retail trade lost 40,000 jobs in September 2008 alone, and over 250,000 in the last 12 months.

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<sup>8</sup> Source: Data released from the Joint Economic Committee, Sept. 9, 2008.

<sup>9</sup> Source: Data gathered by the National Association of Home Builders.

Like the housing sector, retail sales and consumer spending are key indicators of the state of our economy. In fact, consumer spending is responsible for almost two-thirds of our nation's GDP. Given that small businesses make up roughly 90% of the retail industry, it is unlikely that the U.S. can reach and sustain recovery-- *and* provide relief to millions of small businesses-- without first improving consumer confidence and spending.

#### **4. Small Business Optimism**

The economic indicators above paint a bleak picture of the current state of our economy. This is also seen in the pessimism expressed by many small business owners when asked to reflect on the near future. The National Federation of Independent Business' monthly Index of Small Business Optimism fell one point to 88.2 in July 2008, continuing one of the longest strings of recession-level readings in the 22-year history of the survey. Decreased profits have forced many small businesses to lay off workers and abandon expansion plans. That same index indicated that small businesses are less optimistic when considering not only the current economic situation, but also their financial future. In fact, few entrepreneurs expect to expand their business or take on new employees in the next 3 months.<sup>10</sup>

When asked about their top concerns, one third of small business owners report the uncertain economy as the biggest challenge to business growth. That is the largest percentage in the seven-year history of the American Express OPEN(R) Small Business Monitor, a semi-annual survey of business owners.<sup>11</sup> And until small businesses feel more optimistic about their businesses in the near and long term, this economy will continue to drag.

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<sup>10</sup> Source: SBA Office of Advocacy, Second Quarter 2008: The Economy and Small Business.

<sup>11</sup> Source: American Express OPEN Small Business Monitor, released each spring and fall, is based on a nationally representative sample of 768 small business owners/managers of companies with fewer than 100 employees. The survey was conducted via telephone by Echo Research from August 12 - August 25, 2008. The poll has a margin of error of 3.5%.

### **III. Credit Crunch Affecting Small Businesses**

While much of the focus on the financial crisis has been the impact on banks and major financial institutions, the problem of a “credit crunch” has also hit small firms. Because small businesses rarely issue equity or debt securities, lending has historically been their primary source of capital. Businesses rely upon this financing to make necessary purchases, execute expansion plans, and hire new employees. Consequently, the availability of affordable financing is a critical factor in fueling the small business economy.

Most small businesses use traditional types of credit, including fixed-term loans, fixed-rate lines of credit, mortgages, equipment loans, or motor vehicle loans.<sup>12</sup> Small businesses also make prodigious use of alternative credit products-- particularly credit cards to finance business expenses.<sup>13</sup> Recent economic conditions--however, have led to several troubling patterns in credit availability and credit costs for small firms.

As outlined below, small businesses have seen that it has become more difficult to secure capital. At the same time, the terms of loans are higher than in previous cycles. These factors have contributed to a precipitous decline in small business lending – a problem which could impact the ability of small businesses to grow and expand.

#### ***Recent Economic Conditions Have Tightened Credit for Small Firms***

Lending standards for small businesses have tightened considerably across commercial and industrial (“C&I”) as well as alternative credit sectors. The Federal Reserve’s Senior Loan Officer Survey for the third quarter of 2008 showed a dramatic tightening of lending standards, one that far exceeded any previous level in the history of the survey. Over 65 % of respondents reported tighter credit standards on C&I loans to small firms, compared to just 50 % in the previous survey, and 7% at the same time one year earlier. (Figure 1) The Survey reflected a similar increase in credit standards for credit card loans, with over 66 % of bank officers reporting tighter credit standards on credit cards, compared to just 32 % in the previous survey – an increase of over 100% . No respondent reported an easing in credit standards and most respondents expected further deterioration in credit quality throughout the remainder of 2008, and continuing into the next year. These statistics reflect an environment where the supply of credit for small firms is lower than it has ever been in the history of the Fed survey.

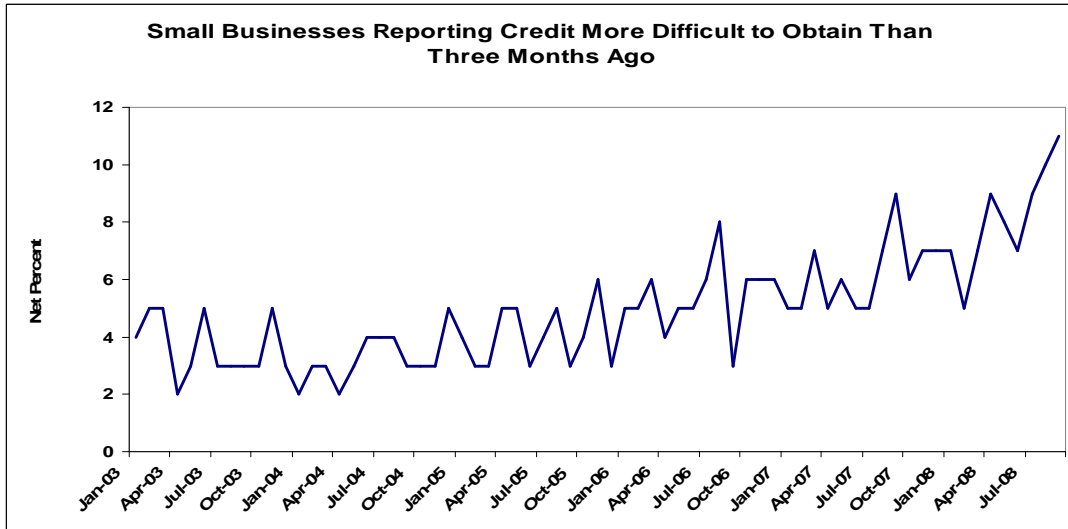
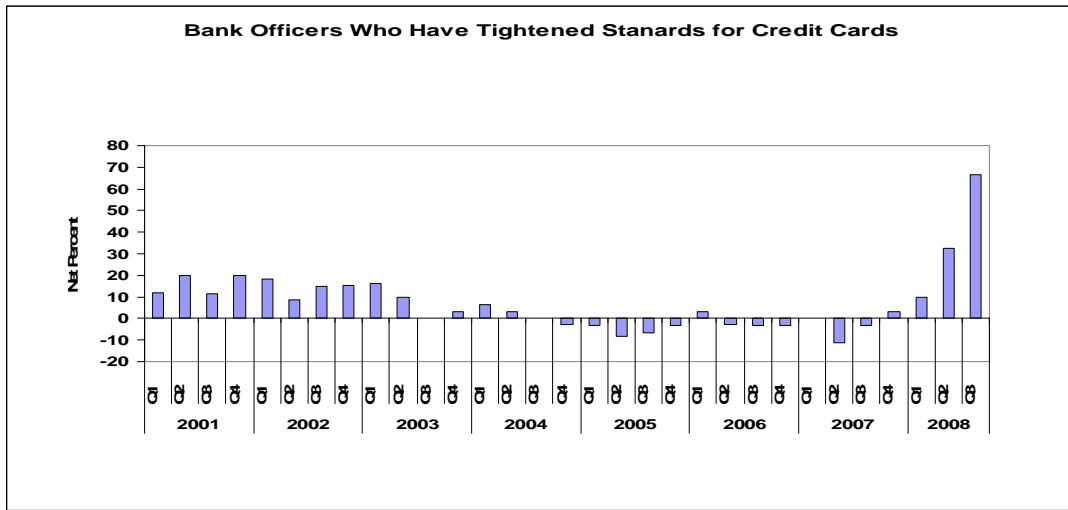
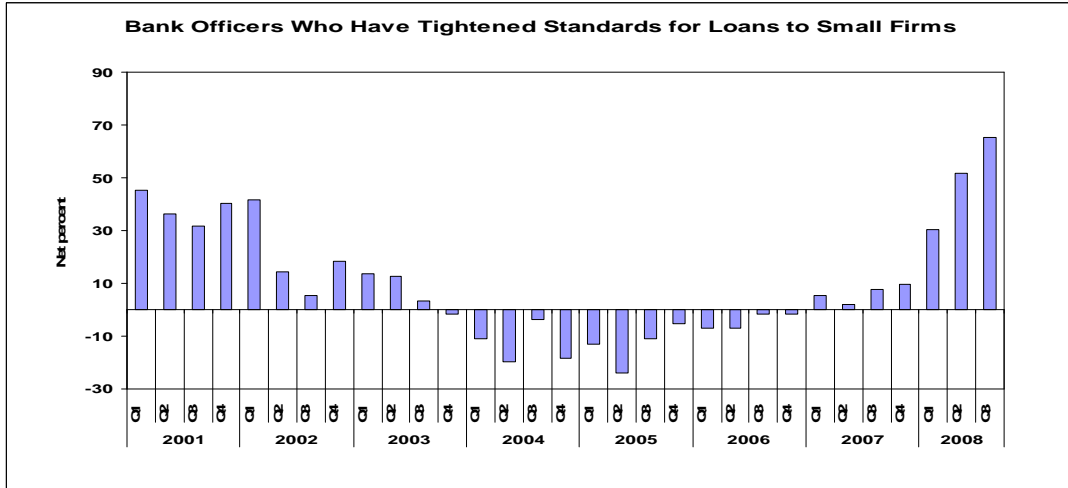
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<sup>12</sup> In the most recent Federal Reserve Study of Small Business Finance (SSBF), 60.4% of small businesses used one of these traditional forms of credit.

<sup>13</sup> The most recent SSBF found 77 % of small businesses used either a business or a personal credit card to pay for business expenses.



**Figure 1: Credit Availability to Small Businesses<sup>14</sup>**

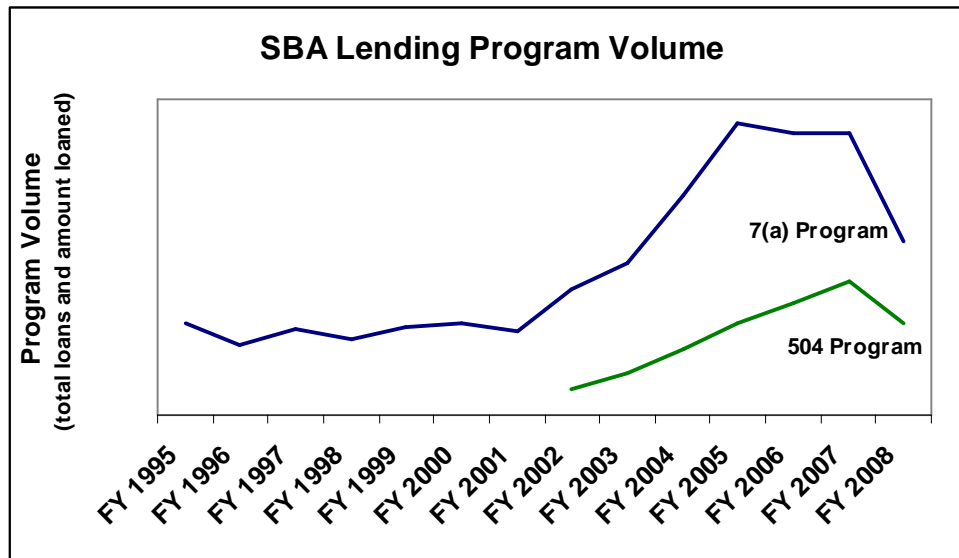


<sup>14</sup> Source. Top and middle panels are from the Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices. Bottom panel is from the National Federation of Independent Business Small Business Economic Trends.

## *Declining Availability of SBA Loans*

Periods of tightening credit availability are precisely when government guaranteed lending, such as the Small Business Administration's 7(a) loans, should increase. However, this has not been the case during the current credit contraction. The Small Business Administration's 7(a) and 504 loan programs have not expanded to fill the gap for credit. For the end of FY 2008, volume in the SBA's flagship lending program, the 7(a) program, declined 38 % compared to the previous year. The total number of 7(a) loans the agency provided in FY 2008 reflected the largest decline in the history of the program, falling by over 30,000 as compared to the previous year. Total funds loaned through the program also experienced the largest decline in the history of the program. In fact, the agency made \$1.64 billion less loans than in the previous year – a decline of over 11%. Similar drop-offs were experienced in the 504 loan program, with both total number of 504 project financings and total dollars of 504 loans falling by over 16% compared to FY 2007. (Figure 2)

**Figure 2: Declines In SBA Lending<sup>15</sup>**



It should be noted that, prior to the current Administration's implementation of a zero-subsidy policy in 2002, lending in the 7(a) program actually increased during economic downturns. During each of the last four recognized recessions (1973, 1980, 1990, and 2000), lending in the 7(a) program increased from the prior year, in some cases by as much as 27% in the number of loans made and 41% in the gross dollar amount of loans. This was consistent with the original purpose of the SBA's lending programs, which was intended to serve as a countercyclical source of credit when lending tightened in the conventional markets.

<sup>15</sup> Source. Small Business Administration

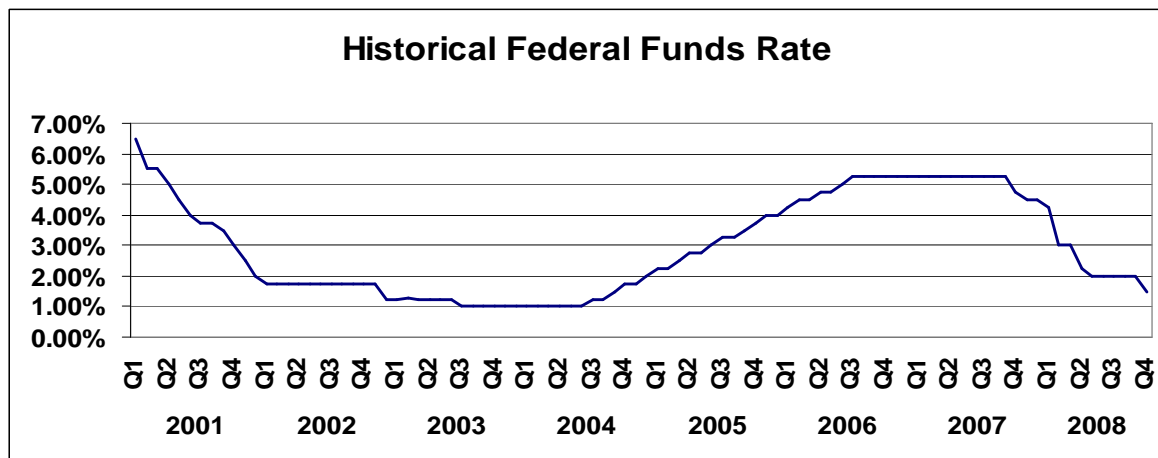
With the shift to a zero-subsidy policy, however, this goal would be impossible to achieve. The SBA is no longer in a position to mitigate the increased risks that are inherent to small business lending. Instead, risks flow through to the programs' small business borrowers and lenders, who must then allay that risk through increased fees. As a result, the gap in the conventional markets that hinders the free flow of capital to small businesses will not be bridged, and lending in the program will ebb and flow in accordance with the prevailing market forces. This is precisely what has happened, as recent economic conditions have tightened the supply of credit for small firms, and the SBA has followed suit.

***Borrowers See Higher Costs for Capital***

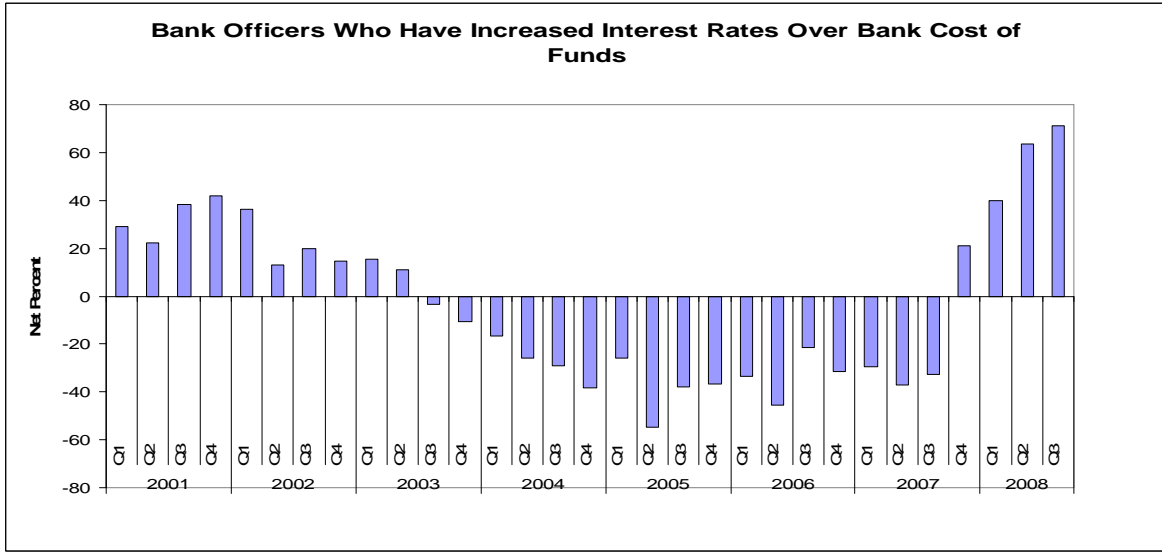
In late 2007, the Federal Open Market Committee (FOMC) instituted a series of cuts to the Federal Funds Rate, reversing its previous efforts to increase the rate in response to inflationary pressures. (Figure 3) As conditions in the housing sector began to spill over into other parts of the economy and global credit markets ground to a halt, the Fed brought the Federal Funds Rate to its current level--1.5 %- in an effort to forestall the effects of a severe credit freeze.

Notwithstanding the efforts of the Fed to stimulate activity in the commercial lending markets, small businesses have continued to see higher borrowing costs for capital. The most recent Federal Reserve Survey of Senior Bank Loan Officers saw over 70% of loan officers reporting increased interest rate spreads for loans to small firms. (Figure 3) This represents the most widespread increase in rate spreads in the history of the survey, and stands in stark contrast to conditions one year earlier: In 2007, over 30% of loan officers were actually lowering spreads for loans to small firms.

**Figure 3: Cost of Funds For Lenders and Increased Rates for Businesses<sup>16</sup>**



<sup>16</sup> Source. Top panel is historical data from the Federal Open Market Committee. Bottom Panel is from the Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices.



Overall Impact of Credit Availability on Small Businesses

As the raw data reveals, the credit conditions for small firms are less than optimal for small businesses. A recent study by the National Small Business Association found that over a third of business owners expressed the most significant concern over access credit. Additionally, in an American Express OPEN Economic Pulse Report issued in October, 63% of small businesses reported being impacted by tightening credit conditions. This is up from 50% just two months earlier. Until credit conditions rebound, it will prove difficult for small businesses to start expanding and creating jobs.

## Conclusion

The financial crisis has acted as a catalyst for broader economic problems. With unemployment rising and growth declining, the U.S. economy is facing substantial challenges. Small businesses, as a key driver of job growth and economic development, will play a leading role in the nation's economic recovery. In order for them to be positioned to do so, however, it will require aggressive fiscal and monetary policies.

On many fronts, the economy is showing signs of significant weakness. Unemployment has increased to 6.1%, its highest mark since September 2003. The economy has now lost 760,000 jobs since January – an average of 43,000 losses each month. The prospects for growth remain hindered by the housing sectors and sharp reductions in consumer spending. The manufacturing sector is also reducing its activity as new orders were down 4% in August 2008 when compared to July 2008. Retail sales were down sharply in September, reflecting a downturn in consumer optimism.

In order to improve these economic trends, policies must be enacted that are quick acting and timely. There must be a focus on stimulating consumer demand, while restoring confidence in our financial markets. The economy generally-- and small businesses specifically-- will benefit from an increase in consumer spending. Consumer spending can be improved through an extension of unemployment benefits, an expansion of food stamps, and grants to states and localities for infrastructure. Much of this funding will flow through to small businesses, including retailers, contractors, and manufacturers, resulting in job creation and increased economic activity for local communities.

While these broad measures will assist small businesses, targeted measures will also be necessary to stimulate investment. This can be accomplished by targeting tax incentives to small firms and crafting a monetary policy that supports an increased flow of capital to companies of all sizes. There are also a number of government lending programs that could be tailored to address this current shortfall of capital. Maintaining strong investment in the business community is critical to spurring new endeavors which will create the new jobs our economy needs.

At a time when the economy is slowing and investor appetite for risk remains modest, policies must spur entrepreneurship. They must promote innovation, provide seed capital for those with new ideas, and retrain workers whose employment opportunities have waned. During times like these it is easy to forget that the U.S. economy has a strong foundation – a flexible workforce, deep capital markets, accessible raw materials, and high quality infrastructure. While this has served the country ably, recent events have called the structure of our market-based economy into question. To generate a recovery, there must be a renewed commitment to entrepreneurialism and the innovative spirit that is so engrained in the U.S -- doing so will yield growth and a promising economic future.