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Promoting Recovery through Cheap Credit for Small Businesses

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The single most important reason for the failure of the recovery to take hold thus far is that private credit markets are locked up, especially for small businesses. Private business borrowing and lending is at a standstill, while private banks are holding an unprecedented $1.1 trillion in cash reserves in their Federal Reserve accounts. In 2007, before the recession began, the banks held only $20 billion in reserves. The 2007 figure was itself dangerously low. But a nearly $1 trillion turnaround in bank reserve holdings is a new form of Wall Street excess.

The solution is for the federal government to create strong incentives on both the borrowing and lending sides of the market to push affordable credit back into the market—again, especially for small businesses—where these funds will start financing business investments and job creation. The federal government already has the power to accomplish this with minimal impact on the federal budget. It will entail working with existing policy tools and agencies, in particular the loan guarantee program now operating at the Small Business Administration (SBA).

The economic policy debate is now dominated by issues around the federal budget deficit. The deficit hawks are wrong to claim that we are heading toward a fiscal train wreck unless we undertake austerity measures now. At the same time, federal deficits over the past two years, at about 10 percent of GDP, have been unprecedented in the post World War II era. We need to maintain large deficits now to prevent the economy’s floor from collapsing, in particular through avoiding severe cuts in state and local government spending on education, health care and public safety. But, even more important, we need to push the private credit markets to begin supporting a viable recovery.

In recognition of this situation, Federal Reserve Chairman Ben Bernanke proposed in late August that the Fed should start purchasing securities as a means of lowering long-term interest rates and to also stop paying interest on the private banks’ $1.1 trillion in reserves held with the Fed. These are both steps in the right direction, but they are half-measures at a time when bold initiatives are needed.

My proposal includes just two main features, one carrot and one stick. The carrot is an expansion of existing federal loan guarantees by $300 billion, which would roughly double the amount total annual guarantees. Small businesses would be the primarily recipients of the guarantees. The stick is a 1-2 percent tax on the excess reserves held by banks.
This program could generate about 3 million new jobs, if it succeeds in channeling about $300 billion into new productive investments. The job creation levels would be significantly higher still if a high proportion of the new business spending were for green activities, where the levels of job creation per dollar of expenditure are about 50 percent greater than the economy-wide average. The impact of the program on the federal budget would be modest, most likely accounting for no more than additional 0.3 – 0.5 percent increase in federal spending.

How the Program Would Work

Significantly Expand Existing Federal Loan Guarantees for Small Business. In 2009, the total level of loans guaranteed by the Federal government was about $340 billion. The two largest categories were subsidized mortgage and student loans. About $50 billion went to business loans, through the Small Business Administration and Export-Import Bank. Under this proposal, the federal government would roughly double its overall loan guarantee program—that is, inject another $300 billion in guaranteed loans into the credit market, and shift the focus of the new guarantee programs to the smaller half of businesses operating in the US. Roughly, this would include businesses with either less than 5,000 employees or $70 million in annual receipts.

Terms of Guarantees Should Be Generous. Existing guarantee programs offer a range of terms, with respect to: a) the level of guarantee; b) the fees for lending institutions; and c) interest rates for borrowers. For this initiative to be effective at reducing risk and encouraging new investment, the terms will have to be generous around all three dimensions—large guarantees, low or no fees, and low interest rate requirements for borrowers. At present, SBA loans offer a guarantee of 85 percent for the first $150,000 of loans and 75 percent above that. Given current conditions, guarantees should be kept at 85 percent for the full amount of the loans. The interest rate on the majority of guaranteed small business loans is currently about 3 percentage points above the prime bank lending rate. To encourage the needed accelerated rate of borrowing, the interest rate on guaranteed loans should be set lower, at 2 percent above the prime rate.

Tax Excess Bank Reserves. An excess reserve tax should create a strong disincentive for banks to continue holding excess reserves. It is difficult to know in advance what the appropriate tax rate should be for this purpose. My judgment is that Congress should set the tax rate initially at between 1-2 percent. But the law should also allow Congress, operating in conjunction with the Federal Reserve, to adjust the rate as needed for channeling excess reserves into job-generating investments. In undertaking this measure, the Fed would also stop paying positive interest rates on bank reserves, as Chairman Bernanke has already proposed.

Impact on Federal Budget Would Be Modest. Expanding the existing level of guarantees would entail a modest increase in administrative costs. Beyond this, the government would incur costs only as a result of defaults on the guaranteed loans. If we assume the default rate remained at roughly the 2007 level for the expanded program, this would add about $10 billion, or about 0.3 percent of the federal budget. Even if, implausibly, the default rate on the new loans doubled relative to the 2007 levels, this would still increase the federal budget by only 0.6 percent. The revenues generated by the excess reserve tax should be directed toward covering the costs of loan guarantee program. These revenues should cover a significant share of the total budgetary expense of the loan guarantee program.

Overall, this should be a program that everyone can support. By dramatically lowering the risks for banks of lending money, it benefits the banks themselves, but then also their borrowers, the small businesses, who will receive greatly reduced lending terms. The new wave of small business investments will, in turn, be a major engine of job creation. Finally, all of this can be accomplished with relatively modest costs for the federal government.