SMALL AND MEDIUM SIZED BUSINESSES KEY TO U.S. ECONOMIC RECOVERY

HIGHLIGHTS

- Small and medium sized businesses (SMBs) are a pivotal component of the U.S. economy, making up over 99.7% of the total firms in the country and over 50% of total employment.
- The Great Recession hit SMBs particularly hard. Job losses amongst small business were even greater than for larger firms.
- Many of the hardest hit sectors during the recession were those dominated by small- and medium-sized businesses.
- Access to credit was also a major issue for SMBs during the recession. The credit crunch exacerbated lay-offs amongst the smallest firms at the height of the recession.
- The economy is on the mend. Economic growth turned positive in the second half of 2009 and the recovery has become more entrenched in early 2010. Payrolls have expanded for the past four months.
- Small and medium-sized businesses will be an important contributor the continuing economic recovery. As private demand rebounds, so too will sales and revenues. For small and medium-sized businesses, the next several years should be growth years.

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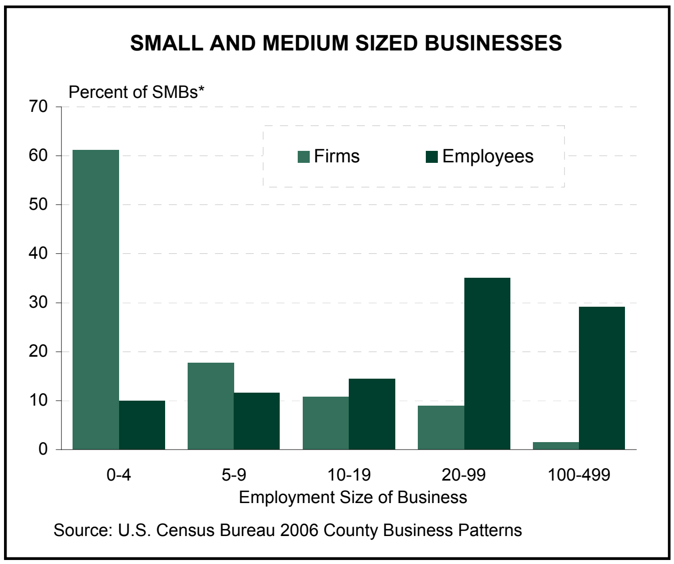
It is difficult of overstate the importance of entrepreneurs to the success of the U.S. economy. While economists spend a lot of time analyzing near-term trends and developments in aggregate data, economic growth over the longer-term is driven primarily by individuals taking risks and making sacrifices in order to bring innovative ideas to market.

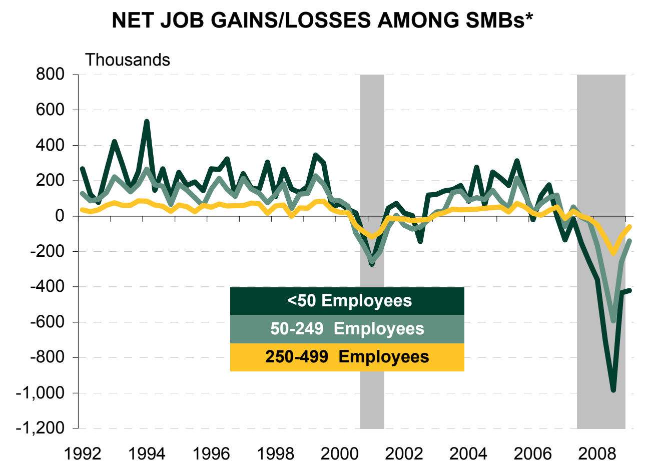
At the forefront of this creative process are small and medium-sized businesses (SMBs). SMBs, typically characterized as companies with fewer than 500 employees, make up 99.7% of the firms in the United States and represent over 50% of total employment in the country. In addition to their majority share in total employment, small businesses are also profoundly important to generating new employment. New businesses (formed within the last five years) have been responsible for the vast majority of net job growth in the United States over the past two decades.[1]



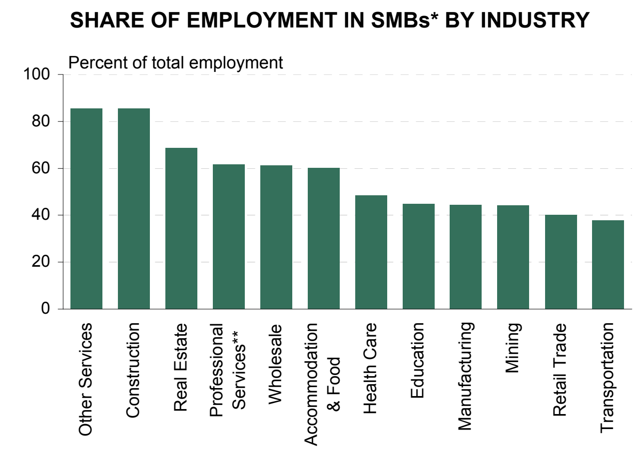
So it's easy to see that as the U.S. economy continues on the road to recovery, the success of small businesses will be of paramount importance. The Great Recession was not kind to small businesses in America. SMBs suffered a disproportionate share of the job losses and many still have difficulty accessing credit from some lenders. Fortunately, things are beginning to look up. Job growth turned positive in each of the last four months, household spending has begun to rebound. And, after tightening dramatically over the course of the recession, credit standards for small business are now moving in the right direction. Nonetheless, there is a long way to go. Looking ahead, the strength of the U.S. rebound will depend importantly on the performance of SMBs.

Greater Recession for SMBs

The U.S. economy is currently in the early stages of recovery from one of the worst economic downturns in modern-history. Whether gauged in terms of the peak-to-trough decline in real GDP (-3.8%) or employment (-6.1%), the Great Recession was one for the record books. SMBs were particularly hard hit by the recession. According to the Bureau of Labor Statistics, over 60% of the more than 8 million net jobs lost over the course of the recession took place in firms with



*Firms with fewer than 500 employees.
Source: Bureau of Labor Statistics Business Employment Dynamics



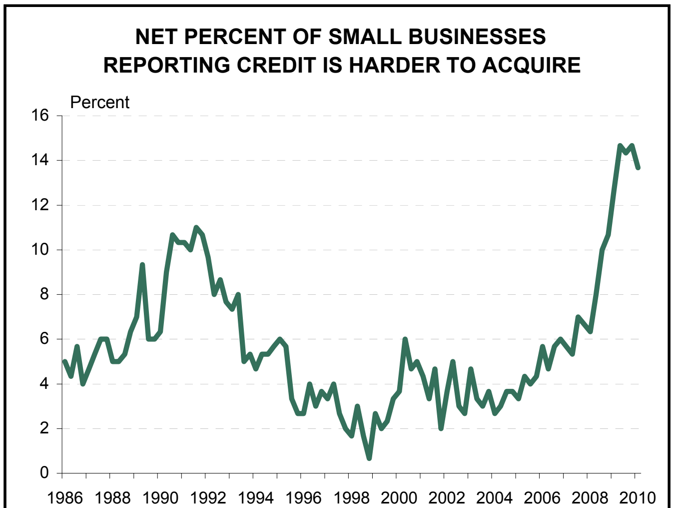
*Businesses with fewer than 500 employees.
**Professional, Scientific & Technical Services.
Source: U.S. Census Bureau 2006 County Business Statistics

fewer than 500 employees. Moreover, job destruction was even greater among the smallest firms (fewer than 50 employees). During the depth of the recession in late 2008 and early 2009, firms with fewer than 50 employees accounted for over 50% of total jobs lost. While the vulnerability of small-businesses to the economic downturn is not a new phenomenon, several characteristics of this recession have been particularly hard on SMBs.

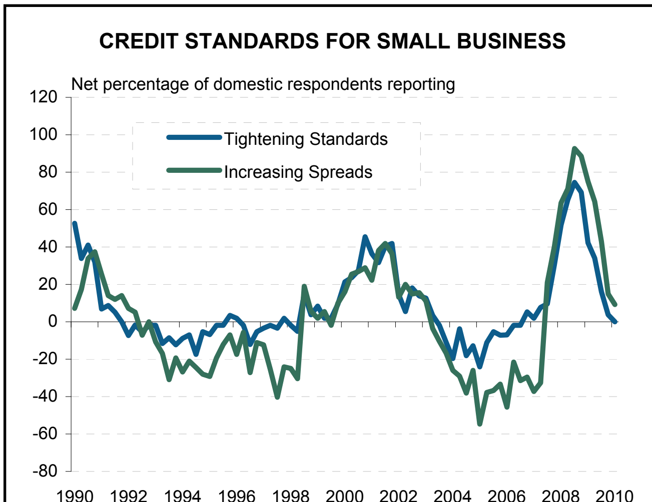
Credit crunch has put the squeeze on SMBs

A major factor that has made this recession worse than past downturns for SMBs is the amount by which credit has tightened. While firms of all shapes and sizes had a difficult time accessing credit over the worst of the financial crisis, the ability of major corporations to raise funds directly in financial markets lessened the credit crunch for these companies. Corporate bond spreads rose to unprecedented heights during the financial crisis in late 2008, but came down just as quickly as the crisis subsided. For small businesses, dependent on bank lending, the situation has been slower to improve. This is evident by looking at credit growth of the non-financial non-corporate business sector. As of the final quarter of 2009, the total value of corporate bond liabilities of non-financial non-corporate businesses was up over 10% from a year-ago, while bank loans were down over 18%.

The National Federation of Independent Business has been gauging the outlook of small businesses since the mid 1980s. According to their survey, the net-percent of businesses reporting a harder time acquiring credit rose to its highest level at 16% of firms in mid-2009. As of April, the net-percent of firms reporting a harder time acquiring credit improved slightly but remains elevated at 14%. This echoes



Source: National Federation of Independent Business



Source: Federal Reserve Senior Loan Officer Survey the results of the Federal Reserve's Senior Loan Officer Survey (SLOS), which at its height in the final quarter of 2008, showed the net-percentage of respondents reporting tighter standards for small businesses at a whopping 92.7%. Similarly, the net-percentage of respondents reporting higher credit spreads reached a record-high 74.5%. These measures have since plunged. As of the second quarter of 2010, the net percentage of respondents reporting tightening credit fell to 0.0% and the net percentage reporting higher spreads reached 9.3%.

Source of downturn has stung

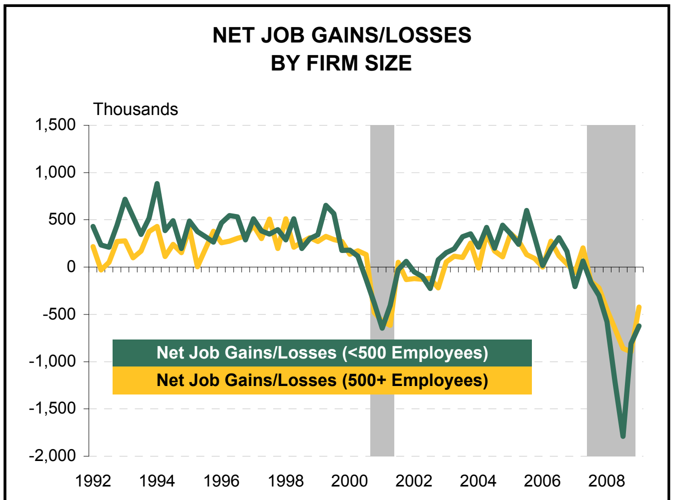
Another factor that has been particularly hard on small businesses is the source of the economic correction. Small businesses exist in all sectors of the U.S. economy but are particularly important to construction, real estate services, professional, scientific and technical services, and other services (a category which spans a number of diverse elements from motor vehicle repair and maintenance to personal and laundry services).

Looking at job growth in the expansionary period prior to the recession, several of these industries were growth leaders. Of particular note, professional and technical services, while accounting for only 5% of total non-farm employment, represented over 15% of the jobs created between 2002 and 2007. Similarly, the construction sector with only 5% of employment, accounted for 10% of the net-new jobs in this period.

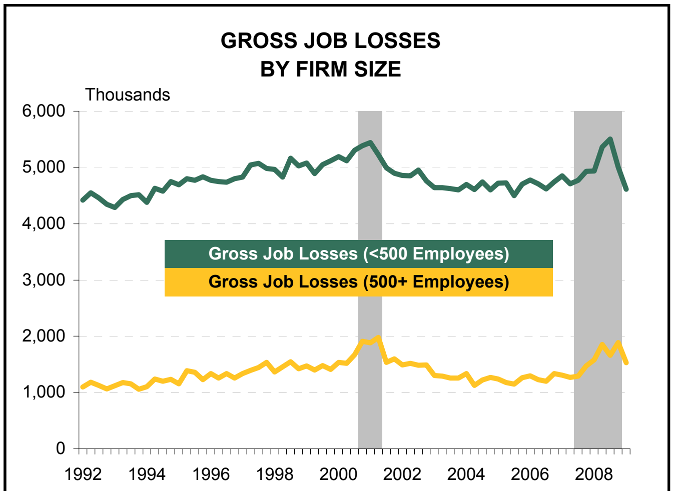
By far the hardest hit sector in the economy over the course of the recession was the construction sector, an industry where small businesses make up over 85% of employment and over 80% of output.[2] From its peak in 2006, real investment in construction (residential and non-residential) has fallen by close to 40%. In terms of employment, the construction sector shed over 2 million jobs, or just under 30% of its workforce.

SMBs do the hiring and the firing

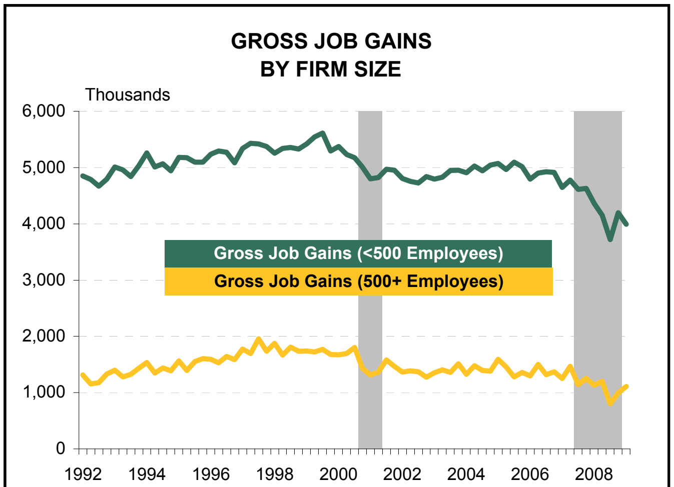
The importance of small business to the growth of the U.S. economy is most evident by breaking down the net changes in employment into the gross number of new jobs created and the gross number of jobs destroyed. As the charts on the right show, new hiring takes place predominantly within SMBs, as do the majority of job losses. This turnover (or reallocation) of jobs is an important element of economic growth, as the churn often represents new, more productive firms replacing less productive ones. It also is an integral component of the net-job creation process. Business start-ups are especially important to generating new jobs.



Source: U.S. Bureau of Labor Statistics: Business Employment Dynamics



Source: U.S. Bureau of Labor Statistics: Business Employment Dynamics



Source: U.S. Bureau of Labor Statistics: Business Employment Dynamics

Over the 25 year period between 1980 and 2005, without the contribution of start-up firms, net-job creation would have been negative.[3]

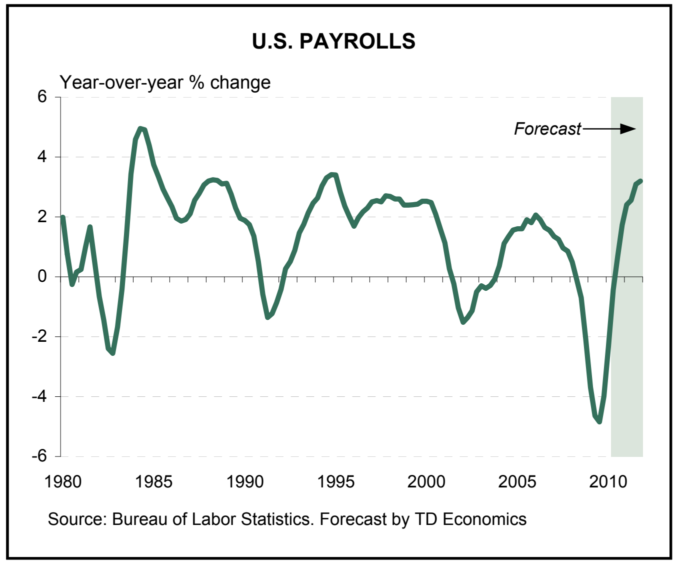
In addition to this structural story, peering into the hiring and firing data also gives an extra level of insight into what happened at the firm level during the Great Recession. New business formation tends to be pro-cyclical (declining relatively more precipitously in economic downturns and rising relatively faster in expansions). The fall in economic activity during the recession is evident in both a retreat in new hires and an increase in lay-offs, but the data also reveal a recession that had several stages to it. In the first stage, the net change in jobs was driven by a decline in new hiring, especially among SMBs. In the second phase, the pace of new hiring descended further and the pace of layoffs increased dramatically (for both SMBs and large businesses). However, in the third phase, while job firing has fallen, especially among SMBs, new hiring has yet to gain momentum. Clearly, an improvement in hiring by SMBs is fundamental to repairing the jobs lost over the recession.

On the horizon

The prospects for economic recovery depend importantly on the prospects for small businesses. Fortunately, there have been signs of improvement. In terms of credit standards, Senior Loan officers are no longer reporting to be tightening standards for small business and only a small fraction are reporting higher spreads on lending products to small business. Research that relates credit standards to changes in economic activity shows that momentum is important, and the downward movement in the net-percentage of respondents tightening should soon turn into a balance swinging in the favour of SMBs.

More importantly, a broader economic recovery appears to be taking shape. Rising private-sector demand will be the tide that lifts all boats, leading to increased sales for existing small businesses and creating opportunities for new businesses to enter the fray.

While we do not have data yet on gross hiring and firing, the overall job story also appears to be turning around.



Non-farm payrolls have expanded in every month so far this year. The U.S. economy added 230,000 jobs in March and 290,000 in April. Eighty percent of these were private sector jobs and many of them in the sectors that are important to SMBs such as construction, professional services, accommodation and food, and other services. By the end of 2011 we expect to see a U.S. economy with over 6 million more people employed than there are today. Like past economic recoveries, small and medium sized businesses will play an important role in creating and sustaining these jobs.

In terms of the sectoral composition of the recovery, after shedding jobs in every single month since July 2007, the construction sector finally added jobs in March and April of this year. Employment in “other services” (with over 85% of employment in SMBs) also rose in both March and April. While conditions in the housing sector will likely remain volatile over the next several months, opportunities in construction will strengthen as the year progresses. By 2011, we expect residential construction to grow by close to 20% and add close to half a million new jobs. The vast majority of these jobs will take place among small and medium size businesses. In short, it has been a tough couple of years, but the tide has turned for the better.

Endnotes

1 Stangler Dane and Robert E. Titan. "Where Will the Jobs Come From?" Kaufman Foundation Research Series: Firm Formation and Economic Growth. November 2009. http://www.kauffman.org/uploadedFiles/where_will_the_jobs_come_from.pdf

2 Kobe, Katherine. "The Small Business Share of GDP 1998-2004" Economic Consulting Services, LLC for the Small Business Administration Office of Advocacy. April 2007. http://www.sba.gov/advo/research/rs299tot.pdf

3 U.S. Census Bureau. "Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States." Last Modified Date: April 24, 2009. http://www.ces.census.gov/docs/bds/BDS_Jobs_Created_ces.pdf