Where did all the capital go?

After an uneven 2011, the economy is showing some encouraging signs as we begin 2012. But the economy is still pretty weak, and the prospect of a return to recession in Europe doesn’t help.

One of the factors weakening the U.S. economy is its financial sector. I don’t mean that the sector itself is weak. Its profits have recovered strongly after plummeting 80 percent from 2006 to 2008. Industry profits are near an all-time high, even though nearly one-tenth of its work force has been shed since 2006. Finance employs only 4 percent of all nonfarm workers, but it accounts for about one-third of all corporate profits.

But one has to ask the question: What is a financial sector for? If the answer is to trade for itself and generate profit, then it’s doing a bang-up job. But the traditional purpose of finance is to enhance the fiscal operations of other industries and make them more productive. In this sense, financial activities are infrastructural in nature.

A classic example involves farmers who borrow money in the spring to buy seed but won’t receive payments until the fall harvest. Without financial intermediaries connecting farmers with savers and investors, farmers will plant less and consumers will see higher prices and less produce.

This is essentially the problem currently faced by small businesses and startups. In normal times these businesses do a lot of hiring. But not now. Of course one big reason is that consumers still aren’t spending much. Another big reason is the dearth of financing.

The demand for credit is strong and rising, but bank loans to small businesses are at their lowest point in six years and 15 percent lower than before the 2008 financial crisis. A recent Wells Fargo/Gallup survey found that one-third of small businesses had difficulty securing credit.

Even when loans are made, lenders are cautious to the extreme. It’s increasingly rare for loans to be made against a purchase order, even against more solid assets like contracts and invoices. And it’s tough to find a good rate.

Many small entrepreneurs are forced to finance their businesses by taking out second mortgages and unwinding 401(k)s. Others are pursuing exotic approaches such as “crowdfunding,” in which entrepreneurs seek small amounts of money from large numbers of online funders.

And of course venture capitalists and angel investors are always out there.

If the financial sector doesn’t start lending to and investing in more small businesses, the economy’s encouraging signs may be short-lived. It’s one thing for a business to fail because it didn’t find customer demand. That’s the market at work. But failing due to a prolonged credit crunch implies a dysfunctional financial market.

Fortunately, the financing outlook for 2012 is also encouraging. For example, a new loan program by the federal Small Business Administration has the potential to make loans for working capital more widely accessible.

My interest in this issue is more than academic, because in addition to my affiliation with UNC-Greensboro, I’m a principal in a start-up business. Our company, Mattress Go Round LLC, recycles and refurbishes mattresses for institutional clients such as colleges, hotels, and long-term care facilities.

It’s a green business that saves customers money, and the response so far has been quite positive. But raising capital has been nearly impossible.

Because of that, Mattress Go Round is hustling and finding creative ways to generate cash flow even without traditional financing. We’ll be fine. But it shouldn’t be this way.

Andrew Brod is a Senior Research Fellow in UNC-G’s Center for Business and Economic Research and a member of The Business Journal’s Editorial Board of Contributors. Reach him at (336) 707-0439 or andrewbroad@uncg.edu. An archive of Brod’s columns is available at http://cer.uncg.edu.

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