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Statement by

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I am here to join you in discussing the economic and financial problems posed by the financial crisis of New York City.

The difficulties now facing New York stem from the erosion of its financial position over the past decade. During this period the expenditures by the City's government grew rapidly while revenues failed to keep pace. To close the gap between its revenues and expenditures, the City relied increasingly on borrowed funds. Not only capital expenditures, but also the mounting deficits on current operations, were financed in this fashion. By the end of 1974, New York City's outstanding debt amounted to over $13 billion, much of which was in the form of short-term notes -- that is, obligations maturing in a year or less.

Investors may learn slowly, but their innocence does not last forever. As poor management of New York finances persisted, at first a few but in time more and more investors became concerned about the City's financial condition. During the past winter and spring the City began to experience very serious difficulties in rolling over its debt -- to say nothing of adding to its outstanding indebtedness.

Unfortunately, the City failed to take clear-cut remedial measures, and there was some loose talk about an investor conspiracy against the City. The basic facts, of course, were quite simple. First, commercial bankers, being aware of their responsibility for other people's money, felt they may already have approached -- if not exceeded -- the limits of prudence in their holdings of New York City securities. Second, the many thousands of individuals who invest on their own account likewise focused on safety; they were no longer much tempted by promises of an exceptionally high yield. Investor confidence in the City's finances thus dwindled, while its need to pay current bills and to refinance maturing obligations became more pressing. Once this stage was reached, the possibility of default on the City's obligations became very real, and it was so advertised almost daily in our nation's newspapers.

The financial crisis confronting the nation's largest city prompted the government of New York State to offer financial and managerial assistance. Starting in April, the State put at the City's disposal substantial sums that were not scheduled for payment until some months later. Then, around mid-June, the State legislature created a new agency -- the Municipal Assistance

Corporation (MAC). This agency was empowered to sell up to $3 billion of its debt obligations, which were to be backed by certain tax revenues that otherwise would have gone to the City, and then to make the proceeds of its borrowing available to the City. Armed with such broad authority, MAC sought to wring some clarity out of the City's tangled finances and to help develop a budgetary plan that could lead the City back to a balanced budget.

These measures, however, proved insufficient to restore investor confidence in the City's financial management, and even the new securities issued by MAC soon came under a cloud. To ward off imminent default by the City of New York, the State adopted firmer measures on September 9. First of all, control of the City's finances was turned over to a State-dominated Emergency Financial Control Board. Second, the power of MAC to issue debt securities was enlarged. Third, the State sought to arrange additional financing of $2.3 billion for the City, of which $750 million in loans was to be provided by the State. This financial plan was designed to tide the City over until early December, and it was hoped that by that time the newly organized Control Board would have in being a sufficiently strong program of budgetary restraints to enable the City to resume the sale of its securities to the investing public.

But when investor confidence is once shaken, it can rarely be restored quickly or easily. The new financial plan failed to elicit enthusiasm on the part of investors. In general, the financial community remained skeptical about the City's ability to avert default and rebuild its financial strength. The concern of market participants was heightened by a judicial ruling on September 29 that brought into question a portion of the financial aid package, namely, the purchase of MAC bonds by the State pension funds. Beyond that, the recent intertwining of the State's finances with the City's finances has troubled many investors and damaged the State's credit standing. Thus, the stresses and strains that developed in the municipal securities market over the summer months have become more acute in recent days.

Since the summer, and to an increasing degree in recent weeks, the participants in the municipal market -- that is, investment bankers, securities dealers, and ultimate investors -- have been attempting to reduce their exposure to the risk of loss. This has affected not only securities bearing a New York name, but also issues of some other State and local governments. Thus, many securities dealers have sought to cut back on their inventory of municipal securities, and they have often found it necessary to offer bonds for sale at prices considerably below their purchase price. Underwriters of municipal issues have generally scaled back on their participation in new offerings, thereby protecting their capital in an uncertain and volatile market. Some underwriters have gone so far as to withdraw entirely from bidding syndicates. And investors -- the ultimate buyers of municipals -- have been tending to shift to higher-quality municipal securities or to categories of investment judged to be less hazardous.

Trading in the market for outstanding tax-exempt bonds has therefore slowed appreciably and the spread between bid and asked quotations has widened. These developments are characteristic of a period when investor confidence has been shaken, and they are indicative of a weakened market.

The recent behavior of investors and dealers has resulted in a rise of the yields on municipal securities to the highest level ever experienced in the tax-exempt market. Yields for even the highest-rated borrowers have risen over the past few months.

Some of this increase has been associated with the upward drift of open-market interest rates since mid-year. In addition, municipal yields have been under upward pressure because of the heavy volume of new tax-exempt issues flowing to market. The market for tax-exempt securities is more concentrated, and therefore smaller, than for taxable bonds. Hence, when unusually large amounts of such securities have to be placed, larger yield adjustments relative to taxable markets are likely to occur. Nevertheless, until the last two weeks, I would judge that the yields on the highest-rated municipal issues have not been out of line with those available on corporate bonds of comparable quality.

In choosing among tax-exempt securities, however, investors have become increasingly selective. The differences in yields, comparing lower-rated bonds with higher-rated issues, have increased considerably since last spring and have become unusually large. Thus, the average yield on Moody's A-rated bonds now exceeds that on Aaa-rated bonds by more than a full percentage point -- or about three times the risk differential required by investors during the preceding six years. Thus, the interest cost for lower-rated borrowers coming to market has risen materially.

The deterioration of the market for municipals of less than the highest quality has been especially pronounced for obligations of New York City, New York State, and certain of the State agencies. In the case of the State proper, investors have become concerned that the resources being diverted to the City are damaging the financial position of the State itself. Some of the State's agencies that issue "moral obligation" securities rather than "full faith and credit" obligations have been unable in recent months to finance themselves in the public market. There now appears to be some tendency on the part of investors to underestimate the financial strength of these agencies -- an attitude that stems at least in part from the temporary default earlier this year by the Urban Development Corporation. To a lesser extent, there has also been some reluctance by investors to acquire the securities of similar agencies in other States.

During the past week or so, the impact of the market's unease has spilled over to a wider range of securities. Significant increases in yields have occurred in the case of some outstanding bonds of governmental units that enjoy a high financial standing. Moreover, a few issuers have not received any bids for their bonds, or have rejected the bids received because the interest cost was deemed excessive. These developments reflect increasing concern over the crisis of New York City.

If the weakness of the market for municipals were to persist and spread further, many soundly run, creditworthy communities and public agencies could have great difficulty -- or suffer excessive costs -- in raising needed funds. Holders of municipal securities, among which financial institutions are numerous, would to some degree be affected, and so might others less directly involved. Hence, if the New York City crisis remains unresolved, and if the fate of New York State remains tied to the City's, the process of economic recovery now under way in our nation could be injured.

Until this most recent turn of events -- which I trust will prove to be a transitory phenomenon -- the market for municipal securities, taken as a whole, functioned very effectively. During the third quarter of this year, even as pressures associated with the New York City problem intensified, new bond issues amounted to about $9.5 billion. This is by far the largest volume ever for a third quarter, and it would have been a record even in the absence of the $2.4 billion of MAC bonds sold during the period.

In seeking ways to resolve New York City's crisis, the suggestion has occasionally been advanced that the Federal Reserve might serve as a source of emergency credit. No formal application for such credit was ever received by the Board or the Federal Reserve Bank of New York. But I want to explain why we probably would have disapproved such an application had it been made.

As the ultimate source of financial liquidity in the economy, the Federal Reserve has certain powers to extend emergency credit even to institutions that are not members of the System. But the use of that authority is tightly circumscribed. The basic provision -- contained in Section 13, paragraph 13, of the Federal Reserve Act -- states that emergency loans with maturities no longer than 90 days may be made by the Federal Reserve Banks on the basis of promissory notes backed by Treasury or Federal agency securities. To qualify for credit assistance under this provision of law, a local government would have to possess sizable amounts of unencumbered Federal obligations. This would be an unusual situation for any distressed borrower and it obviously does not apply to New York City.

The lending authority under paragraph 3 of Section 13 of the Federal Reserve Act is broader, permitting the Board, in unusual and exigent circumstances, to authorize Reserve Banks to make loans on the kinds of collateral eligible for discount by member banks. Such paper may not have a maturity of more than 90 days and must afford adequate security to the Reserve Bank against the risk of loss. Furthermore, in view of restrictions of law and Congressional intent, certain conditions must be met in order to permit the extension of emergency credit under this authority. Among these conditions is a requirement that an applicant has exhausted other sources of funds before coming to the Federal Reserve, that the borrower is basically creditworthy and possesses adequate collateral, and that the borrower's need is solely for short-term accommodation. It does not appear that New York City is now in a position to meet all these requirements. Certainly, its finances would hardly permit early repayment of emergency borrowings.

In addition to the emergency lending provisions in Section 13 of the Federal Reserve Act, the Reserve Banks have authority under Section 14(b) to purchase short-term obligations of State and local governments issued in anticipation of assured revenues, subject to regulations by the Board. Legislative history indicates that this authority was designed to assist the Federal Reserve Banks in meeting their operating expenditures, and also to enable them to make the discount rate effective when little borrowing took place at the discount window. There is nothing in the Federal Reserve Act or its legislative history to suggest that Section 14(b) contemplated the purchase of municipal securities as a means of aiding financially distressed communities.

The Congress, of course, could amend the Federal Reserve Act so as to relax the requirements for extending Federal Reserve credit to financially troubled governmental units. But the Board of Governors would have the gravest doubts about any such action. If loans were to be made to State or local governments, the Federal Reserve would have to involve itself in the activities of these governmental units, including particularly their expenditure budgets and the adequacy of their revenues. Moreover, since numerous demands for credit might ensue, the Federal Reserve would have to set standards of eligibility. Being thus placed in the position of having to allocate credit among governmental units, the nation's central bank would inevitably become subject to intense political pressures, and its ability to function constructively in the monetary area would be undermined.

The Board fully recognizes that the Federal Reserve System has the responsibility, subject only to restrictions under existing laws, to serve as the nation's lender of last resort. Over the years, we have therefore developed contingency plans to deal with possible emergency situations. As I previously informed the Chairman of this Committee, our plans have been adapted recently to cope with the financial strains that might be associated with the default of a major municipality.

In that event, I assure you, the Board is prepared to act promptly. The contingency plan calls for lending to commercial banks through the Federal Reserve discount window beyond the amounts required by normal discounting operations. Credit provided in this manner would assist banks in meeting their temporary liquidity needs. Not only that, the proceeds of the special loans made at the discount window could also be used by the banks to assist municipalities, municipal securities dealers, and other customers who are temporarily short of cash because of unsettled conditions in the securities markets. In addition, the System would, of course, be ready to use its broad power to stabilize markets through open market purchases of Treasury or Agency securities.

In the event this contingency plan has to be activated, the Board will make funds available on whatever scale is deemed necessary to assure an orderly financial environment. The Board recognizes that sizable extensions of Federal Reserve credit would run the risk of leading to a substantially larger expansion of bank reserves and the money supply than is consistent with longer-run monetary objectives. Clearly, therefore, any such expansion must be only temporary. In time, any excessive growth in bank reserves would need to be corrected through offsetting open market operations and through repayment of bank borrowing from the System.

There are also certain supervisory and examination questions that may arise with respect to banks in the event of a major municipal default. In this connection, the Board and other regulatory agencies have plans to revise procedures that apply to the valuation of defaulted securities, so that any write-downs may be postponed until the market has had a few months to stabilize and thus provide more reliable indications of their value.

Even so, a default may ultimately require writedowns that could seriously impair the capital of some banks. In that event, the Federal Deposit Insurance Corporation has statutory powers to assist Federally insured banks that might find their capital impaired by a decline in the value of securities in their portfolio. I understand that the Corporation is prepared to implement, with appropriate safeguards, its contingency plans for dealing with insured banks that require a temporary infusion of supplemental capital for the above reason.

I think it evident from the far-flung scope of our contingency plans that we believe a default on debt obligations by New York City could produce serious strains in securities markets. For a time, it could also adversely affect municipalities that need to issue new debt. The like is true of financial institutions that hold such securities in significant volume, and also of individual investors who have part of their life savings at risk in these bonds. I still believe that the damage stemming from a prospective default by New York City is likely to be short-lived. Indeed, the possibility of such a default has already been discounted to an appreciable degree by the market. But I am also aware of the uncertainty that inherently attaches to a judgment on this score; and I recognize that a default, besides being a very serious matter for the City and State of New York, could have troublesome consequences for the nation at large.

The very fact that this Committee and other committees of the Congress are holding hearings on New York City's finances implies that concern is spreading that a New York default may injure the economic recovery now in process. I have said enough to indicate that I feel this possibility can no longer be dismissed lightly. That, however, does not ease the task that the Congress faces in dealing with the New York problem; for the precise issue is whether Federal financial assistance to New York may not cause national problems over the long run that outweigh any temporary national advantage.

As this matter is debated by the Congress, the adverse effects of a New York City default will undoubtedly receive full attention -- as they indeed should. I would only urge that the longer-run risks also be considered thoroughly. A program of Federal assistance to the City may well lead to demands for similar assistance for other hard-pressed communities, even those whose distress was brought on by gross negligence or mismanagement. Substantial Federal credit -- whether through insurance, guarantees, or direct loans -- would compete directly with the already huge amounts of Federal financing needs. Most important of all, the provision of Federal credit for local government will necessarily inject a major Federal presence in local spending and taxing decisions.

It is highly important, therefore, to recognize that the issue of assistance to New York City goes to the very heart of our entire Federal system of separation of powers -- a system that, despite enormous economic and social changes, still prevails in our country.

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