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Statement by

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Committee on Banking, Currency and Housing

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I am here to discuss with this Committee 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.

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. In the absence of clear-cut remedial measures by the City, the possibility of default on the City's obligations became very real, and it was so portrayed almost daily in our 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 instrumentality -- the Municipal Assistance Corporation (MAC). This agency was empowered to sell up to $3 billion of its debt obligations, to make the proceeds of its borrowing available to the City, 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. These included creation of a State-dominated Emergency Financial Control Board to manage the City's finances, expansion of MAC's authority to issue securities, and a plan to arrange additional financing of $2.3 billion for the City. This financial package was designed to tide the City over until early December. It was hoped that by that time a strong program of budgetary restraints would be in place and that it would enable the City to resume the sale of its securities to the investing public.

But the new financial plan failed to elicit any enthusiasm on the part of investors. The financial community has remained skeptical about the City's ability to avert default and rebuild its financial strength. Moreover, the intertwining of the State's finances with the City's finances has troubled investors and has damaged the State's credit standing. The concern of market participants was heightened this past week by the extraordinary difficulties encountered in arranging for the City's refunding needs on October 17, and default was averted by only an hour or two. Thus, the stresses and strains that began to develop in the municipal securities market in the summer have become more acute with the passage of time.

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. Underwriters of municipal issues have generally reduced their participation in new offerings, and some have withdrawn 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 behavior of investors and dealers in recent months has resulted in a rise of yields on municipal securities to the highest level ever experienced in the tax-exempt market. Yields for even the highest-rated borrowers have risen conspicuously, but a part of this increase is doubtless due to the enormous volume of municipal securities issued during the third quarter.

In the past two to three weeks, open-market interest rates have declined somewhat. The municipal market has benefitted from this development, as well as from various indications that the Federal Government is becoming more concerned about New York's financial problems. Nevertheless, investors in municipal securities remain highly selective. The obligations of New York City, New York State, and certain of the State's agencies continue to be shunned by investors. And the effects of investor uncertainty have spilled over to other governmental units as well, some of which have not received any bids for their bonds or have rejected bids because the interest cost was deemed excessive.

If the weakness of the market for municipal securities were to persist and to spread further, many soundly run, credit-worthy communities and public agencies could have difficulty -- or suffer very heavy costs -- in raising needed funds. This would tend to induce cutbacks or stretchouts in local spending programs. In addition, holders of municipal securities, which include many banks and other financial institutions, would to some degree be affected, as might the attitudes of 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 impaired.

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 has been 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 law, 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 have already indicated in testimony before the Joint Economic 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 Federal 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 agencies have plans to revise procedures that apply to the valuation of defaulted securities, so that any writedowns 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 might ultimately require writedowns that could seriously reduce 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 portfolios. 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 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 default by New York City would probably be shortlived.

Indeed, the possibility of such a default has already been discounted to a considerable 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 indicates 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 to other hard-pressed communities, even though their distress may have been brought on by gross negligence or mismanagement. Substantial Federal aid -- 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 governments would necessarily inject a major Federal presence in local spending and taxing decisions.

These longer-run dangers have a vital bearing on our Nation's future; but they can be exaggerated, just as the immediate consequences of a New York default can be -- and perhaps are now being -- exaggerated. It is entirely clear to me that if the Federal Government had previously yielded to the entreaties for aid that New York officials kept pressing, neither the City nor the State would have gone as far as they now have in restoring some hope for eventual order in the City's finances. Earlier intervention would have been a disservice to the people of New York as well as to the Nation at large. But it also seems to me that the effort thus far made by both the State and the City is still inadequate. And while I take a more serious view of the potential economic consequences of a New York default than I did three months ago or even three weeks ago, I am not ready to recommend to the Congress that financial assistance to New York is now required in the Nation's interest.

I was asked at a recent Hearing what advice I would give if Congress were inclined to legislate assistance for New York. My reply was that stringent conditions should in that event be laid down, so that no municipality would seek Federal financial aid unless such a request became unavoidable. I proceeded to list a half-dozen conditions; and, if I may, I shall now restate them somewhat more fully.

One essential condition prior to receipt of any Federal assistance would be that the municipality has exhausted all other sources of funds. This would require, of course, that the municipality demonstrate that it is unable to obtain credit through the public issuance of securities, or through private placement of securities, or direct loans from banks or other private lenders.

A second condition that seems to me essential is that the State assume control over the finances of the municipality in difficulty. When a local government reaches the point where no source of funds is any longer available, its management of finances can no longer be relied upon. State control would mean that a local government has lost its fiscal authority, and this should serve as a powerful deterrent to other mayors or city councils across the Nation from ever placing their municipality in such a position.

A third essential condition for Federal assistance, I believe, should be that the State levy a special State-wide tax, the proceeds of which are pledged to cover one-half of the deficit faced by the municipality. The requirement of such a tax would materially strengthen the State's resolve to put whatever pressure is needed on the troubled municipality to work its way toward a balanced budget. It would thus insure that the State will discharge adequately its own responsibility to enforce fiscal discipline on a troubled municipality. No governor or State legislature will welcome the prospect of levying a special State-wide tax for the benefit of a municipality that has mismanaged its affairs. But this very reluctance would provide some assurance that Federal assistance would not be expected until an effective City-State program of remedial action, no matter how politically troublesome this may prove, has been developed.

Fourth, prior to receipt of Federal assistance, a detailed financial plan would need to be presented for approval by the Federal authority charged with administering the assistance program. Criteria for accepting a plan would have to be spelled out -- such as the use of standard accounting procedures, unrestricted access by the Federal authority to all local financial records, provision for retiring short-term debt other than that required to handle seasonal discrepancies between expenditures and receipts, and so on. Clearly, the plan should provide for restoration of sound municipal finances within a relatively short period and certainly within two fiscal years.

Fifth, a municipality that obtains a Federal guarantee for the payment of principal and interest on its issuance of new securities should be required to pay an appropriate guarantee fee. The municipal security should be taxable, but tax-exempt bonds might be permitted in special cases -- for example, if return to non-guaranteed status were thus eased. In such cases, the guarantee fee would naturally have to be much higher than if the security were taxable.

Sixth, and finally, the Federal guarantee program should be of limited scope and duration. The total amount of guaranteed debt should be set at the lowest practical figure. The debt instruments should be of short maturity so that the guarantee may be reconsidered periodically. In order to minimize Federal exposure to risk and to assure compliance with the approved financial plan, the Federal Government should have authority to withhold revenue-sharing funds from a delinquent municipality. At the end of a relatively short period, say three years, all Federally guaranteed debt under the program should have expired.

If conditions along the several lines I have here suggested were included in a legislative plan for assisting troubled municipalities, the number of applicants that might seek Federal aid would be severely limited. It is highly important to recognize that the issue of assistance to New York City goes to the very heart of our system of separation of powers between the Federal and State governments -- a system that, despite enormous economic and social changes, is still honored by our country. If there is to be any legislation on assisting local governments, it should at least be designed so that the longer-run risks to our Federal system of government are kept to a minimum.

Before bringing this testimony to a close, I want to make two additional comments briefly.

First, recent attention to New York City's difficulties has brought to the fore certain shortcomings of our bankruptcy laws. It is highly important that the Congress enact legislation that would enable the judiciary to deal with a municipal default so that reorganization of outstanding debts, service or employee contracts, and other financial obligations may proceed in an orderly and expeditious manner.

Second, the behavior of financial markets has recently been disturbed by the grave uncertainties surrounding New York City finances. A quick but well considered decision by the Congress to assist or not to assist New York is now urgently needed. Almost any resolution of these uncertainties may be better than prolonged debate and controversy. Financial markets do not thrive in such an environment.

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