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**Statement by**

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**Vice Chairman, Board of Governors of the Federal Reserve System**

**before the**

**Subcommittee on Commerce, Consumer and Monetary Affairs**

**of the**

**Committee on Government Operations**

**House of Representatives**

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Mr. Chairman:

I am pleased to appear before you today to present the Board's views as to the use of Federal Reserve credit facilities in providing emergency assistance to financially troubled cities. I want to state at the outset that we interpret the System's present powers to engage in such lending operations, except as member banks are involved, to be quite narrowly circumscribed by law.

The recent financing difficulties of New York City provide a case in point. These difficulties cumulated rapidly during this past winter and spring, and reflected the growing reluctance of private investors to purchase the City's short-term note issues. Since the City already had a very large amount of short-term debt outstanding, and was incurring a substantial current operating deficit as well, any inability to issue new debt raised immediate problems in finding the cash to pay off maturing obligations and meet the City's current bills. In searching for alternative means of resolving the developing financial crisis, there were at times suggestions that the Federal Reserve might be a possible source of credit in its role as an ultimate source of liquidity to the economy. However, no application for credit was received from the City, either at the Federal Reserve Bank of New York or the offices of the Board of Governors.

If a formal request had been received by the Federal Reserve for the emergency credit accommodation of New York City under the circumstances that had prevailed, however, I am obliged to state that, in my judgment, the Federal Reserve would have had to turn it down. The City had not fully exhausted possibilities for State assistance, and its basic need for credit did not appear to be of a temporary character since no near-term means of repayment--while continuing to provide the City's basic services--appeared to be at hand.

Direct extensions of emergency credit to institutions that are not members of the Federal Reserve System can be provided under either paragraph 3 or paragraph 13 of Section 13 of the Federal Reserve Act. Paragraph 13 provides that any Federal Reserve Bank, subject to such regulations as the Board may prescribe, may lend to any individual, partnership or corporation on promissory notes secured by direct obligations of the U. S. Government or an agency thereof. Loans under this paragraph are limited to 90-day maturities. Unless an entity in need of assistance possesses large amounts of direct government obligations, the ability of a Reserve Bank to provide credit assistance under this paragraph is very limited.

Paragraph 3 of the Act empowers the Board of Governors, in "unusual and exigent circumstances" and by an affirmative vote of at least five members of the Board, to authorize the Federal Reserve Banks to make certain types of direct loans to individuals,

partnerships or corporations. Paper discounted by Federal Reserve Banks under this paragraph must be of the "kinds and maturities made eligible for discount for member banks under other provisions" of the Federal Reserve Act. This means, among other things, that the paper may not have a maturity of more than 90 days at the time of discount. The paragraph further provides that the paper shall be "endorsed or otherwise secured to the satisfaction of the Federal Reserve Bank," which the Board has construed to mean that a Reserve Bank should ascertain that the security offered is adequate to protect the Reserve Bank against the risk of loss.

In light of these restrictions in the law and the background as to the intent of the law, the Board has concluded that, in considering the extension of emergency credit to particular borrowers, the following conditions must be met:

- (1) unusual and exigent circumstances exist;
- (2) potential borrowers have exhausted other sources of funds;
- (3) the borrower is solvent and has adequate collateral;
- (4) the borrower's need is for short-term accommodation and its basic financial position will permit early repayment; and
- (5) failure to obtain Reserve Bank credit would have a significant detrimental economic and financial impact on the surrounding area, the region, or the nation.

These criteria highlight the essentially low-risk and temporary character of System emergency lending, as well as the general economic purpose behind it. Such lending is intended primarily to provide liquidity. Though short-term needs of this type can develop among either large governmental units or business enterprises, in most cases the need can be accommodated without relying directly on the Federal Reserve simply by turning to commercial banks--who will rely on their own or Federal Reserve resources--to extend the needed credit. When this is not possible, as seemed to be the case with New York City, it is likely that the difficulties encountered in the private credit markets reflect more fundamental credit-risk problems and that temporary credit accommodation will not be sufficient to correct the situation.

In addition to the emergency lending powers contained in Section 13 of the Federal Reserve Act, Section 14(b) authorizes the individual Federal Reserve Banks to purchase and sell obligations of State and local governmental bodies. The Act requires that these governmental obligations mature in no more than six months from date of purchase and that they be issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues.

The 14(b) authority had its origin in the original 1913 version of the Federal Reserve Act. The House Report on the Act indicated that the provision was designed to open an outlet through which idle funds of Federal Reserve Banks could be profitably channeled and to provide a means to enable Federal Reserve Banks to make their discount rate

effective in the market at those times when member bank borrowing was slack. There is nothing in the Act or its legislative history to indicate that this authority was intended to be used as a channel for financial assistance to public bodies. Moreover, the authority has not been used since 1933, since enactment of Section 10(b) permitted the Federal Reserve to advance credit to member banks on the strength of their own promissory notes, as well as through the discount of eligible paper. Given this background, the Board does not believe that Section 14(b) contemplates the purchase of municipal obligations as a means of aiding financially distressed communities.

In view of these existing constraints on System emergency lending, it may be asked whether it would be desirable to legislate broader powers that would permit Federal Reserve accommodation of financially distressed communities. While the Board has not considered any specific proposals toward this end, I would strongly caution against any proposals that would provide direct access to central bank credit by hard-pressed governmental units. My reasons for reaching this judgment are as follows:

First, the critical issue for particular municipalities is how governmental functions and sources of revenues are dispersed between it and the State government. Prospective sources of funds must be commensurate with the projected costs and expenditure programs in order to balance out over the longer run. Access to a source of temporary credit will not help to achieve such a balance, and it may

tend to defer or prevent the remedial actions that are necessary, difficult as they may be.

Second, central bank involvement in providing temporary credit accommodation to State and local governmental bodies will necessarily require that standards be set determining which localities will be eligible or ineligible for credit accommodation. This would involve the System in making credit judgments on the finances of numbers of State and municipal governments, thus subjecting the Federal Reserve to intense political pressure to make exceptions for this city or that because of special circumstances. Moreover, the need to exercise administrative discipline over borrowers in order to assure timely repayment would tend to draw the System into political issues of local budgetary policy. A central bank, in our judgment, should leave this issue to other agencies of the Government.

Third, increased access to central bank credit by municipalities suffering some degree of financial distress could lead to similar urgent demands for credit by other kinds of borrowers. If central bank credit is extended to our cities, for example, why not for a host of other purposes, such as the immense investment that will be required to achieve energy independence? A proliferation of demands for credit from the central bank would drastically change the character of the assets of the Federal Reserve System, from prime paper of highest quality to an assortment of soft loans and, in the process, severely damage the Government's access to financing. It

could undermine our ability to control the volume of bank reserves and hence the supply of money. In the extreme, the result could be a debasement of the nation's money and ruinous domestic inflation.

For these reasons, if your Committee should conclude that the financial pressures on key municipalities requires the provision of special Federal financing assistance in the period ahead, the Board would strongly urge that this be done through a separate facility rather than the Federal Reserve. Federal monies or credits would still be expended in any such venture, but it would not involve the use of high-powered central bank funds. Such a separation would thus leave the Federal Reserve free to pursue its other responsibilities for monetary and bank regulatory policies, which are difficult enough in themselves.

I would urge caution, however, even in proposing the establishment of a special Federal financing facility to assist with the financing needs of our State and local governmental bodies. Such a facility must have sufficient oversight powers to permit it to play an effective role in correcting the fundamental financial problems of client communities, if the Federal assistance is to be productive. This would be bound to create a Federal presence in local issues of taxation and spending, a varied and shifting political and social terrain indeed.

In the spirit of our traditional system of separation of powers, it may well be better to leave local problems to local solutions.

The special program of financial assistance which was developed for New York City at the State level through the formation of a new agency-- the Municipal Assistance Corporation--is an illustration of State-local resourcefulness. The Corporation is authorized to provide up to \$3 billion in credit to the City and, as it does so, valuable time will be gained in which the City can take the steps needed to restore its credit standing with the private investment community. I hope that the City's actions will soon make it possible to carry on needed refinancing and other debt operations in the normal manner.