

Statement of
Frank E. Morris, President
Federal Reserve Bank of Boston

Before the
Conference for the Investor
"Wall Street and the Economy 1976

The New School
New York, New York

January 24, 1976

The municipal bond market, which has seen relatively little change for several decades, is likely to see a great deal of change in the years immediately ahead. Forces for change have gradually been accumulating during the past five or six years, but the whole process has been accelerated by the drama of the financial problems of New York City.

Most fundamental of the items on the agenda is the division of responsibilities between the Federal Government and State Governments. Governor Michael Dukakis of Massachusetts, among others, has argued that the Federal Government should take over all programs involving the redistribution of income, particularly welfare and health programs. The States, he argues, do not have the financial capacity to manage such programs, particularly in recession years. In addition, inter-State competition causes problems. Private investment capital tends to drift toward States with the least ambitious programs of income redistribution. States with the most ambitious programs find their economic base eroding. New York and Massachusetts are clear examples of this phenomenon.

At the opposite extreme is former Governor Reagan's proposal that all social programs be lodged in the States. Whatever other advantages might accrue from such a shift, it is clear that the one great advantage to the conservative is the limited financial capacity of the States to handle such programs.

This issue is complex and is not likely to be resolved soon. But it is likely to occupy a prominent place on our political agenda for a number of years. The manner in which it is resolved will have the most profound effect on the future of the municipal bond market.

Turning to issues that might be addressed in the more immediate future, the most significant are the growing structural weakness in the municipal bond market arising from the withdrawal of the commercial banks from that market and the set of reforms that the Congress is likely to set in place to deal with the crisis of confidence that the problems of New York City produced. These are quite separate issues but they have tended to become intertwined.

Back in 1970, I wrote an article in which I argued that the commercial banks would not be able to support the municipal bond market in the decade of the seventies to the extent that they did in the decade of the sixties, when they absorbed 70 percent of the new issue volume. Having observed the market since 1955 when I was Research Director for what was then called the Investment Bankers Association, it was clear that the market worked well when the commercial banks took the bulk of the new offerings and it did not work well when the banks withdrew from the market.

It took no special insight to forecast in 1970 that commercial bank participation in the municipal bond market would have to be cut back. It was a matter of simple arithmetic. At the end of 1960, municipal bonds amounted to less than 9 percent of commercial bank portfolios; by the end of 1970 this had risen to more than 15 percent. At the same time, banks were sharply increasing the relative size of business loans in their portfolios.

This combination was made possible only by the fact that the banks reduced the percentage of their assets held in United States Government securities from about 31 percent at the end of 1960 to a little over 13 percent by the end of 1970. As a matter of simple arithmetic, this was a portfolio shift which could not be repeated in the future.

It was this arithmetic which led me in 1970 to advocate the broadening of the municipal bond market with an optional, taxable municipal bond with a Federal Government interest subsidy, an instrument which would permit State and local governments to tap the life insurance companies and the pension fund market.

Since 1970, a recession year in which the commercial banks took 96 percent of the new issue volume, the commercial bank take has steadily declined--72 percent in 1971, 50 percent in 1972, 42 percent in 1973, 32 percent in 1974 and less than 15 percent in the first three quarters of 1975. The largest commercial banks actually reduced their holdings of municipals in 1975. Only the middle-sized and small banks were still net buyers of municipals.

1975 was the first recession year in my memory in which the commercial banks did not buy all, or virtually all, of the new issue volume. This fact has led to a revival of support for the taxable municipal bond with a Federal Government interest subsidy. The weak base of the present market has eroded opposition to the idea.

I expect to see in the years ahead a strong dual market developing for municipal bonds. Underwriters will typically be asked to bid on both a taxable and a tax-exempt basis. A common bidding pattern is likely to be one in which the shorter maturities are offered on a tax-exempt basis with the longer maturities moving into the taxable market. The result will be substantial interest savings for State and local governments. The savings will stem both from the direct interest subsidy on taxable bonds and from the fact that yields on tax-exempt securities will decline relative to taxable yields.

Longer term municipals, since they will now be relatively scarce will tend to rise in value relative to other debt instruments. The Congress which will have created this enhanced value may see fit to impose a special capital gains tax on the increment.

The extent of the change in the municipal bond market will be a function of the level of the subsidy. If the Congress establishes a 30 percent subsidy, as recommended by the Administration, the volume of the activity in the taxable municipal market will tend to be relatively limited except during periods, such as 1975, when the tax-exempt market is under heavy pressure.

On the other hand, if a 50 percent subsidy, which some have proposed, were adopted, the tax-exempt market would be eliminated, the base of the market being too thin to attract much underwriting interest.

I recommended to the House Ways and Means Committee in 1973 that the optimum subsidy level is 40 percent, the level now embodied in the Kennedy-Reuss Bill. With a 40 percent level, we should see a continuous dual market established for municipal bonds. The financial flexibility of State and local governments would be optimized and the interest costs savings to State and local governments would be maintained at a high level relative to the cost of the dual subsidy program to the United States Treasury.

The taxable municipal bond has not been welcomed by the underwriting community. Nevertheless, I have no reservations whatsoever as to the ability of the underwriting community to market effectively to the new investor groups a taxable municipal bond. Those firms now in the municipal bond business that are not actively planning to develop their capabilities for marketing taxable municipals are likely to be left by the wayside.

Turning from the long-run structural problems of the municipal bond market, it is clear that many changes are on the way as a consequence of the crisis of confidence in the market generated by the trauma of New York City. Four decades with few defaults had accustomed the investor to look upon municipal bonds as essentially risk free. He tended to buy securities in a rather uncritical

fashion without the elaborate analysis that customarily accompanied investment in corporate securities. Congress had no basis for questioning its decision to exempt municipal securities from the surveillance of the SEC and the disclosure requirements' imposed on private corporations.

All of that is now behind us. At least for another generation, investors will not again look upon municipal bonds as essentially risk-free securities. It seems to me certain that this Congress will impose some sort of disclosure requirements on State and local governments. Just what form Federal surveillance will take is not clear at this moment, but one necessary ingredient will be the imposition of federally mandated uniform accounting standards. With the present infinite variety of State and local government accounting systems, comparability is difficult, if not impossible and, therefore, disclosure would be of limited value.

Another major item on the agenda is what to do about cities and States on the verge of default. As you know, there are bills which have passed the House and the Senate which will make it much easier for a city to go into bankruptcy than under the present provisions of Chapter 9. This, it seems to me, is highly questionable legislation. To facilitate bankruptcy is to add a new element of risk to municipal bonds which must be reflected in a risk premium of some sort, however modest on these securities.

It seems to me it would be much more cost effective in the long run to keep the present Chapter 9 provisions and to establish a lender of last resort for State and local governments. Legislation establishing a lender of last resort should be so restrictive that no city or State would be eligible until it had taken every reasonable step to meet its requirements and had exhausted all of its internal resources.

This lender of last resort function should not be given to the Federal Reserve for two reasons. First, such an added lender of last resort responsibility, carried out with high-powered central bank money could impair our ability to control the money supply adequately. Second, while the Federal Reserve has some expertise in lending to financial institutions, we have no such expertise in lending to State or local governments. I would suggest that this lender of last resort function should more appropriately be lodged in the Treasury Department.

One thing seems certain. The municipal bond market of 1980 will be far different than the one we have been accustomed to. But it will be a market far better equipped to handle the burdens imposed upon it than was the market of 1975.