Research Department
Federal Reserve
Bank of
San Francisco

October 24, 1975

Perils of Abe Beame

Silent-movie fans will remember how the Perils of Pauline were always averted, every Saturday afternoon, by improbable last-minute rescues. So it is with New York today. Default—that fate worse than death—has been averted ever since last spring by a series of rescues by noble but generally reluctant heroes, ranging from Big Mac to the teachers' pension-fund trustees. But all the while, the endangered heroine has pined for help from the white hats from the Potomac.

Evolution of a crisis

In Mayor Beame's words, "Substantially all the factors talked about now were known to the financial community for years. It was quite well known that deficit financing was going on. It was quite well known that items were capitalized which should have been in the expense budget." True enough, but investors probably never understood the growing magnitude of the problem, nor its ability to aggravate a financial situation which had already been unsettled by other market problems.

By the end of 1974, New York City's outstanding debt amounted to over $13 billion, much of it in the form of obligations maturing in a year or less. Faced with dwindling investor confidence, the city found it ever more difficult to pay current bills and to refinance maturing obligations, and it thus turned to the state for help. The state legislature thereupon organized, in mid-June, the Municipal Assistance Corporation (MAC), substituting Big Mac's good credit for the city's deteriorating credit. This agency was empowered to sell up to $3 billion of debt obligations, which were to be backed by certain tax revenues that otherwise would have gone to the city, and then to make the proceedings of its borrowing available to the city. But this approach failed to satisfy a suspicious investment community, and soon even Big Mac's securities came under a cloud.

To ward off the city's imminent default, the state legislature met in special session on September 9 to adopt a set of firmer measures. First, control of the city's finances was turned over to a state-dominated Emergency Financial Control Board. Second, Big Mac's power to issue debt securities was enlarged. Third, the state agreed to arrange $2.3 billion in financing, including $750 million in state loans as well as MAC financing. The package was designed to tide the city over until early December, at which point the city's financial soundness hopefully would be restored under the aegis of the new Control Board. But even this new rescue plan threatened to come apart because of the investing community's growing suspicion of New York State's own financial soundness, which then led state and city pension-fund trustees to drag their feet on participation. The crunch came last week, when the city met payments on $453 million of notes maturing October 17 only

(continued on page 2)

Research Department
Federal Reserve
Bank of
San Francisco

when the trustees of the city-employees retirement system lifted their threat to withdraw from the refinancing plan.

Impact on the markets
The New York crisis unsettles a municipal-financing market that already has had more than its share of troubles. The enormous volume of tax-exempt securities coming to market—more than $51 billion of bonds and notes in 1974 and probably even more this year—has not been matched by a corresponding increase in demand for such securities. In addition, the anticipation of future inflation caused by heavy Federal deficits has dampened investor interest in committing funds for the long term. Also, the problems of New York City and other jurisdictions have all accentuated investor awareness of the growing risks in this market.

In these circumstances, the municipal market generally has held up remarkably well. Traditionally, a 30-percent spread exists between tax-exempt and taxable issues of comparable quality—say, between long-term prime municipals and prime utility issues—and that spread has been maintained until quite recently. Of course, with the stresses developing in all segments of the capital market, yields on even the highest-rated tax exempts are now at record levels.

Still, the most striking aspect of the current scene is the growing selectivity of investors, and the resultant widening of yields between lower-and higher-rated issues. Thus, the average yield on A-rated muni bonds 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 earlier 1970's. Between April and August alone, the spread almost doubled to 115 basis points. (One percentage point equals 100 basis points.) The deterioration has been especially marked for any securities with the name New York attached. The obligations of New York State have been tarnished by the fear that it can ill afford to divert resources to the city's aid, being faced with a $600-million deficit of its own, and being entangled with wobbly state agencies that issue "moral obligation" bonds rather than "full faith and credit" obligations.

If the weakness should spread beyond the state's borders, many credit-worthy communities and agencies elsewhere could find new financing to be very costly or even impossible. Holders of municipals—principally New York's but other securities as well—could be severely affected if the value of their holdings plummeted. According to a recent Treasury survey, 72 national banks with total assets of $7.3 billion hold in their portfolio's New York (city and state) obligations which exceed 50 percent of the gross capital funds. With default, many of these banks ultimately would lose substantial portions of their capital, and this could trigger major deposit withdrawals—including withdrawals of CD and Eurodollar funds—and force the banks to seek help from the regulatory authorities to stay afloat.

Towards a solution

If New York should default, a number of contingency plans could come into play. (The city has even hired some bankruptcy lawyers to help handle the problem.) In recent Congressional testimony, Chairman Burns argued that neither the Federal Reserve Act nor its legislative history make any provision for extending Federal Reserve credit directly to financially troubled communities. In case of default, however, the System could provide special loans to commercial banks though the discount window, and the proceeds of those loans could be used to help other municipalities endangered by the repercussions, securities dealers or other bank customers who find themselves short of cash because of unsettled market conditions.

Pressure for direct Federal-government assistance continues to increase. The U.S. Conference of Mayors has called for either Federal guarantees of municipal bonds or direct emergency loans through a 1975 version of the Reconstruction Finance Corporation—with assistance under these programs being made available to all threatened municipalities. The Congressional Budget Office meanwhile has argued that New York's own contribution is limited at this point, since substantial service cutbacks or tax increases necessary to balance the budget and pay off accumulated debt would be self-defeating. In its view, such actions would simply provoke an exodus of higher-income taxpayers and business establishments, continuing the vicious circle of an eroding tax base and still bigger deficits.

Responding to such pressures, Congress might conceivably come up with an aid package by December 1, when the next cliff-hanging melodrama of maturing notes is scheduled. This would be in keeping with an increased central-government presence in city halls and state houses throughout the land; Federal grants-in-aid have jumped from $3 billion to $52 billion over the past two decades, or from 10 to 23 percent of total state-local government receipts. Indeed, many European observers remain amazed that the New York crisis should even arise, since European municipalities generally have direct access to central-government finances. The same may eventually occur here, but in the process, much of the freedom and flexibility associated with the American federal system could disappear.

William Burke

Research Department
Federal Reserve
Bank of
San Francisco

Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

FIRST CLASS MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/08/75	Change from 10/01/75	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	87,575	+ 1,147	+ 2,566	+ 3.02
Loans (gross, adjusted)—total	65,664	+ 897	− 2,597	− 3.80
Security loans	2,253	+ 1,230	− 377	− 14.33
Commercial and industrial	23,044	− 83	− 1,202	− 4.96
Real estate	19,548	− 16	− 365	− 1.83
Consumer instalment	10,052	− 3	+ 315	+ 3.24
U.S. Treasury securities	9,165	+ 143	+ 5,012	+ 120.68
Other securities	12,746	+ 107	+ 151	+ 1.20
Deposits (less cash items)—total*	87,032	+ 358	+ 6,005	+ 7.41
Demand deposits (adjusted)	24,310	+ 285	+ 1,329	+ 5.78
U.S. Government deposits	228	+ 1	− 68	− 22.97
Time deposits—total*	60,719	− 63	+ 4,360	+ 7.74
States and political subdivisions	5,798	+ 45	− 453	− 7.25
Savings deposits	21,059	+ 81	+ 3,097	+ 17.24
Other time deposits‡	30,037	− 155	+ 1,277	+ 4.44
Large negotiable CD's	16,198	− 211	+ 912	+ 5.97

Weekly Averages of Daily Figures	Week ended 10/08/75	Week ended 10/01/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	11	131	+ 20
Borrowings	8	135	63
Net free (+) / Net borrowed (−)	+ 3	− 4	− 43
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (−)	+ 1,383	+ 129	+ 760
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (−)	+ 661	+ 439	+ 1,152

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 397-1137.