

THE NATION AND NEW YORK

Remarks of

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I'm delighted to be here again in the Great Northwest, to share with you my thoughts about the business scene and the problems that might hamper the recovery. To give you my conclusion right at the start, the recovery from "the worst postwar recession" is proceeding on schedule--but as always seems inevitable in such situations, we will be faced for some time to come with the wreckage created by the recession and the preceding inflationary boom. It's been a field day for headline-writers. You know the list: W.T. Grant down to its last five-and-dime; the airlines fast losing altitude; the tanker industry on the rocks; the jerry-built REIT's crashing to the ground; and New York City desperately trying to sell Brooklyn Bridge. Indeed, the nation's largest city now appears to be the nation's largest problem, so I will devote a good portion of my talk to that particular problem.

Nonetheless, the overall business picture is steadily improving, although at an uneven pace in certain industries and certain regions of the country. Business leaders here in Washington are undoubtedly more familiar than others with how this type of script unfolds, because you went through your very own recession-and-recovery scene just several years ago. For that matter, your present situation appears equally instructive, because of the mixture of developments from home and abroad that are now impacting on the regional economy.

You'll remember how the severe slump began at the beginning of this decade, with all of the state's major "export" industries-- aerospace, aluminum, farming and forest products--going into a decline

at about the same time. You'll remember also how the recovery then got underway, with first agriculture and then the other key industries contributing to the upturn. Well, in some respects the 1975 picture is similar to that of 1970-71. Washington's overall performance has been somewhat stronger than the nation's in the recent slump, but yet, in the past year, we have seen weakness developing in aerospace, aluminum, and forest products, so that much of the burden of recovery has been shifted to agriculture.

I think we'll all agree that 1976 looks like a pretty mixed bag for the state's economy. Aerospace prospects are dimmed by the obvious weakness of the airline business, but until we see an improvement in air travel, new defense contracts should continue to come in handy--after all, defense spending here has been running about twice the level of the early 1970's. Aluminum and forest products will improve as the national markets for their products expand--a slow but almost certain process. Agriculture has the problem of what can you do for an encore? Washington's cash farm receipts doubled just between 1972 and 1974, and it will be hard to beat that record--and with costs rising, it will be hard to match the earlier peak in net farm income. Still, with the present bumper crops of wheat and apples, and with the heavy worldwide demand for all of this state's products, the farm sector looks quite solid. Add to that the construction work on the Trident submarine base and--above all--Washington's contribution to the Alaska pipeline boom, and you get some pretty strong pluses in the outlook. Everything considered, I have little doubt that Washington will outpace the nation in the late 1970's, just as it has in the past several years.

Factors Affecting the Recovery

Let's consider now some of the major factors involved in the national business upturn, because of their importance for the state's outlook. We begin with the realization that the recession was over almost six months ago. Unfortunately, whenever any public official makes that point, he's denounced as a heartless wretch, whereas he's only stating an obvious statistical fact. Certainly it's true that almost one-third of the theoretical capacity of the nation's industrial plant remains unutilized, and certainly it's true that roughly one-twelfth of the labor force remains unemployed. Nonetheless, the major aggregates of production and employment have risen substantially in recent months, to mark indisputably the beginning of the recovery. Indeed, the percentage of the working-age population actually employed during this "worst postwar recession" is somewhat higher than in most earlier recessions, and is actually near record levels for both adult women and teenagers.

The recovery script was written during the spring months, when consumer spending rose at more than a 6-percent annual rate (in real terms), reflecting an unparalleled 22-percent rate of gain in real disposable income. Take-home pay was boosted by the front-loading of the \$23-billion Tax Reduction Act, which included not only the tax reductions but also some increases in social-security and other transfer payments. That stimulus was reinforced by a slowing of the inflation rate to about half of the year-ago level. Indeed, at present income levels, where a one-percentage-point drop in the inflation rate means an \$11-billion boost to real disposable income, we obtain roughly the

same income stimulus from a two-percentage-point drop in inflation as we got from the tax-cut legislation.

The strong consumer showing was repeated in the third quarter, and at that time also, the second major element in the recovery script surfaced, in the form of an improved inventory situation. Business inventories declined at a \$25-billion annual rate in the first half of this year--and at almost half that pace in the third quarter--so that stock-room shelves have now been cleared of most of their excess supplies. Just ending the cutbacks, without any net increase in inventories, would thus remove a substantial depressant on GNP. Another important factor has been our continuing strong foreign-trade balance; as Washingtonians probably know better than anyone, the nation's exports have doubled within the last three years, contributing to a shift in the trade balance from a \$6-billion deficit in 1972 to a \$12-billion rate of surplus to date in 1975. Also, the housing industry, for all its structural problems, has improved substantially since last winter's lows.

For all these reasons, I can visualize a fairly strong upward movement for the national economy throughout 1976, along with continued improvement--but unfortunately a slow improvement--on the unemployment and inflation fronts. Let me say a few words about the latter problem, especially about that development which has been at the root of our economic miseries throughout the past decade--the impact of soaring Federal deficits on private markets and public policy.

Deficits and Monetary Policy

The nation was 186 years old before it first recorded a \$100-billion

budget. It took nine years to exceed \$200 billion, four years to exceed \$300 billion, and it will probably be only two years more before we exceed \$400 billion in Federal spending. Earlier increases reflected the costs of past and future wars (including interest on the rising debt), but the recent explosion has largely reflected the vast expansion of health-education-welfare programs. To a great extent, this phenomenon represents the federalization of many functions that were formerly handled by families, by private agencies, and by state and local governments. The basic difficulty of course has been the failure of Federal budget-makers to find the funds to pay for these growing responsibilities, and it has been aggravated by the impact of inflation on the growing number of retirement and welfare programs. The problem threatens to swamp the new Congressional budget committees at the very inception of their activities, but it is one which they must grasp and bring under control.

More Federal spending would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. This is the well-publicized and all-too-real problem of "crowding out." It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But if the Federal deficit substantially exceeds the Congressional budgeteers' \$72-74 billion target, total credit demands could rapidly outrun the available supply of funds, forcing interest rates higher and crowding many non-Federal borrowers out of the market. We've already seen interest rates turning

up, when typically they continue falling during the early recovery period. Certainly it's very unusual at this stage of the cycle to see Treasury bill rates hovering between $5\frac{1}{2}$ and 6 percent, or the prime business-loan rate between $7\frac{1}{2}$ and 8 percent.

Mounting credit demands could be satisfied--at least for a short time--without an increase in interest rates if the Federal Reserve accelerated the growth of money and credit. But if done for too long, or to an excessive degree, such an action could generate inflationary pressures which would soon become imbedded in our ratchet-like price structure. And as we have learned, inflation would be accompanied by high and rising interest rates.

To complicate matters, policymakers at this stage of the recovery have to be equally alert to the need to provide the financial basis for continued recovery. In a word, we must maintain a prudent but not parsimonious monetary policy. This stance is seen in the monetary growth path specified by Chairman Burns last week for the period between the third quarter of 1975 and the third quarter of 1976--a growth rate of 5 to $7\frac{1}{2}$ percent in the narrowly defined money supply. This is roughly in line with the average growth rate actually experienced over the past half-decade.

Growth within this range is quite appropriate in the present environment of high unemployment and unused industrial capacity. On the other hand, it is on the generous side by long-term historical standards. Thus, we could endanger the fight against inflation if we continued

expanding the money supply indefinitely at today's specified pace. As the economy returns to higher rates of resource utilization, we'll have to reduce the rate of monetary and credit expansion, in order to lay the foundation for a prolonged era of prosperity without inflation.

This year, the financial community has been gradually regaining its strength with the help of the supportive monetary policy that I've described. Commercial banks, with good reason, have been building up their loan-loss reserves, because of the necessity to pay today for the poor decisions of the past decade. They have been cautious in their lending policies, and in a strong drive for liquidity, they have sharply increased their holdings of Treasury securities. On the deposit side, they have relied much more heavily on stable consumer-type time deposits than on purchased CD money. This increasingly favorable picture is even more evident among regional banks than at the big money-center banks, and as a result, lending activity has expanded at a faster pace at the regional banks. Yet overshadowing this scene of increasing strength is the shadow of New York.

Evolution of New York's crisis

William F. Buckley described that unhappy situation in these words, "New York City is in dire financial condition, as a result of mismanagement, extravagance, and political cowardice. . . New York must discontinue its present borrowing policies, and learn to live within its income, before it goes bankrupt." The interesting thing is that Buckley said this in his race for mayor ten years ago. PS. He lost the election.

A winning candidate for mayor, Abe Beame, recently said, "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 some of the other problems I mentioned. Finally everyone realized that a condition could not continue where, for an entire decade, expenses increased on the average of 12 percent a year, while revenues increased less than 5 percent a year. This occurred even though New Yorkers are the most heavily taxed people in the country; last year, New York State residents paid 17 percent of their income in personal taxes, compared with a 15-percent figure for the nation.

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 the Municipal Assistance Corporation, 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 proceeds 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. And why were investors suspicious? Among other reasons, because Big Mac bonds were "moral-obligation" securities rather than "full faith and credit" obligations, and investors had suddenly become leery of that type of morality when New York State's Urban

Development Corporation temporarily defaulted on similar obligations last February. Incidentally, Governor Carey's request to the Federal Reserve last week for a \$576-million loan involved four state agencies which rely upon that now-suspect form of financing.

To ward off the city's imminent default, the state legislature met in special session in early September 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 began to come apart because of investors' 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. At that point, the final crunch became all but inevitable.

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. Finally, 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. 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 \$700-million deficit of its own, and being entangled with wobbly state agencies that have issued all those moral-obligation bonds as a means of avoiding constitutionally-required voter approval for state borrowing.

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--meanwhile could face write-downs on their municipal holdings. The nation's commercial banks could be affected by the New York problem, since they hold roughly \$3 billion--almost one-fourth--of the city's publicly-held securities. Moreover, there are 102 banks throughout the country whose holdings of New York City obligations exceed 50 percent of their total capital accounts or net worth. Altogether, the nation's commercial banks hold about \$102 billion in all types of tax-exempt municipal securities--about 14½ percent of their total loans and investments--but of course very few of these investments are in any question.

Planning for Default

Needless to say, contingency plans have been developed to meet the emergency. 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 through the discount window, and the proceeds of those loans could be used to help other municipalities endangered by the repercussions, as well as securities dealers or other bank customers who find themselves short of cash because of unsettled market conditions.

A default on a general-obligation bond of course does not mean a total (or even partial) ultimate loss on the investment. In contrast to (say) W. T. Grant, a governmental entity like New York will continue in

existence and its economic tax base will remain as a source of revenue. New York's default thus would mean a temporary loss of liquidity for the investor, and perhaps some loss of current earnings, rather than a permanent loss of face value on the securities held.

In view of the high probability of ultimate repayment--in view of the fact that the defaulted securities should continue to have a substantial market value--the supervisory agencies have agreed that they would allow as much as six months' time before requiring that banks write down the book value of any defaulted holdings to market value. But for purposes of accounting and reporting to shareholders, a default which resulted in unpaid interest or a markdown of security values would have to be reflected in the period in which it occurred. In the case of interest, which is exempt from Federal taxes, it would be fully reflected in a bank's net operating earnings. In the case of a determination in loss of value, it could show up either in net operating earnings before securities transactions or in the bottom-line net income figure, depending on the manner in which the write-down was handled.

Now, we should realize that the amount charged off against a bank's capital account is not a projection of ultimate loss, but rather a conservative judgment to assure that the bank's capital is adequate for the other purposes to be served. In any event, such a charge-off undoubtedly would be far less than the book value of the securities involved.

As for the broader solution, the Administration (as you know) has rejected the several Congressional proposals that would provide either for Federal guarantees of New York securities or for direct emergency loans. Instead, the Administration's plan would grant sufficient authority

to the Federal courts to preside over an orderly reorganization of the city's financial affairs. The plan would prevent the city's funds from being tied up in lawsuits; it would provide the framework for a schedule of payments to creditors to be developed; and it would provide a way for new borrowing to be secured by pledging future revenues. During the past week, several Congressional committees as well as Big Mac's board have tried to put together various complex financing plans--but meanwhile, the clock ticks on.

Concluding Remarks

Let me repeat what I said at the outset--that despite New York's problems and the other difficulties which I mentioned, the business recovery is proceeding on schedule. I've noted the strength of those forces which have generated and sustained the upturn, but also highlighted those counterforces which could yet undermine the recovery. In particular, I've suggested the way in which an outsized Federal deficit could endanger the upturn, either by draining funds from the financial markets that are needed by private borrowers, or by forcing a shift to an open-handed monetary policy that could set off another double-digit inflation.

New York is linked to this budget problem, because some of the proposed rescue plans would only add to the deficit while increasing the already massive central-government presence in city halls and state houses throughout the land. Over the past two decades, Federal grants-in-aid have jumped from \$3 billion to \$52 billion--or from 10 to 23 percent of total state-local government receipts. The trend may well continue because of the problems of New York and other troubled metropolitan centers. But if it does, it could endanger our present efforts to bring the Federal budget under control, and could undermine a long and honorable tradition of metropolitan home-rule.