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OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

September 19, 1975

MEMORANDUM FOR BILL SEIDMAN

From: Dave Gergen *DS*

Subject: Speech for Economic Club of New York

Secretary Simon asked if you would be kind enough to review this draft and return your comments to his office. He would very much appreciate it if you could respond before the end of today.

Many thanks



Working Copy

ADDRESS BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
TO THE NEW YORK ECONOMICS CLUB
SEPTEMBER 23, 1975 *^ ?*

DRAFT
9/19/75

I WANT TO THANK EACH OF YOU FOR YOUR KIND INVITATION
TO SPEAK HERE TONIGHT. I HAVE BEEN LOOKING FORWARD TO THIS
OCCASION FOR SOME TIME BECAUSE I COULD THINK OF NO BETTER
FORUM TO DISCUSS A MATTER OF GROWING CONCERN TO MANY OF US
IN THIS CHAMBER: THE CONDITION OF THE NATION'S FINANCIAL
~~MARKET~~ STRUCTURE.

AS YOU KNOW, THERE IS AN OLD ADAGE ON WALL STREET
THAT "THE MARKET IS ALWAYS TELLING YOU SOMETHING." THE
SIGNALS ON ANY SINGLE DAY OR WEEK MAY BE CONFUSING OR
CONTRADICTIONARY, BUT IF THERE ARE PRONOUNCED TRENDS OVER A
LONG PERIOD OF TIME, YOU CAN IGNORE THEM ONLY AT YOUR OWN
PERIL.



ITSELF IS UNDER INCREASING STRESS. LET ME BE SPECIFIC ABOUT
THE SYMPTOMS THAT CONCERN ME:

*ACCESS TO THE BOND MARKETS TODAY IS FOR ALL PRACTICAL
PURPOSES LIMITED TO ONLY TOP-RATED COMPANIES. EXCEPT IN
RARE INSTANCES, A GOOD COMPANY WITH LESS THAN A PRIME RATING
CAN NO LONGER TAP THE LONG-TERM PUBLIC DEBT MARKET AS A



- 3 - OR THE NEW GROWTH COMPANY,
ON EVEN ^AVERY ^PSOLID BUT NOT
SOURCE OF LONG-TERM FUNDS. THE MARGINAL COMPANY HAS ^A-RATE.
BEEN SHUT OUT ALTOGETHER. _{COMPAN}

* IN THE EARLY 1960s, THRIFT INSTITUTIONS PAID "FINDERS FEES" JUST TO HAVE THE CHANCE TO INVEST IN 5-5 1/2% MORTGAGES. TODAY THEY WORRY ABOUT HANGING ON TO THEIR DEPOSITS WHILE RELUCTANTLY MAKING A FEW HOME MORTGAGES AND THEIR MORTGAGE RATES ARE CLOSE TO 10%.

* AT A TIME WHEN OVER 60% OF THE SECURITIES LISTED ON THE NEW YORK STOCK EXCHANGE ARE CURRENTLY SELLING BELOW BOOK VALUE, THE STOCK MARKET HAS ALMOST DRIED UP AS A SOURCE OF NEW LONG-TERM FUNDS.

* LENDERS ARE INCREASINGLY RELUCTANT TO MAKE LONG-TERM COMMITMENTS. MANY MORE NEW SECURITIES TODAY ARE OF INTERMEDIATE-TERM DURATION (7-10 YEARS) RATHER THAN ²⁵~~30~~ OR ³⁰~~40~~ YEARS DURATION WHICH WERE COMMON NOT THAT LONG AGO.



* THE DEBT BURDEN OF CORPORATIONS HAS INCREASED PHENOMENALLY OVER THE PAST DECADE SO THAT DEBT RELATIVE TO EQUITY HAS APPROXIMATELY DOUBLED. SINCE INTEREST COMMITMENTS ARE FIXED AND MUST BE MET NO MATTER WHAT THE ECONOMIC CIRCUMSTANCES, BUSINESS FIRMS NOW RUN A SIGNIFICANTLY GREATER RISK THAT EVEN A MODEST-SIZED BUSINESS CONTRACTION COULD SHARPLY REDUCE THEIR PROFITS AND COULD EVEN SQUEEZE THEM OUT OF EXISTENCE.

* PENSION FUNDS, ESPECIALLY IN THE PUBLIC SECTOR, ARE WELL SHORT OF BEING FULLY FUNDED, SO THAT SERIOUS QUESTIONS MUST NOW BE FACED ABOUT THEIR FUTURE. IF THEY ARE TO BE FUNDED, HOW IS IT TO BE DONE? WHO WILL PAY THE BILL? AND IF THEY ARE NOT TO BE FUNDED, WHAT THEN?

* IN SOME INSTANCES, WHOLE INDUSTRIES SUCH AS THE AIRLINES AND UTILITIES ARE NOW HAVING SERIOUS FINANCIAL PROBLEMS.




* THE CAPITAL BASE OF COMMERCIAL BANKS HAS SO SHRUNK
RELATIVE TO DEPOSITS THAT THE FEDERAL RESERVE HAS SEEN FIT
TO "ENCOURAGE" BANKS TO ADOPT A MORE "PRUDENT" EXPANSIONARY
PHILOSOPHY.

Too many
* ~~LESS THAN PRIME RATES~~ COMPANIES ARE VIRTUALLY
DEPENDENT NOW ON SHORT-TERM BANK BORROWING FOR WHAT AMOUNTS
TO LONG-TERM EXPANSION NEEDS.

* MANY STATE AND LOCAL SUBDIVISIONS ARE UNDER INCREASING
FINANCIAL PRESSURE, WITH NEW YORK CITY OF COURSE CLEARLY
HAVING EXTENDED ITSELF BEYOND REASONABLE LIMITS.

* AND WITH THE RECOVERY STILL IN ITS EARLY STAGES,
INTEREST RATES ARE NOW AT LEVELS WHICH 10 YEARS AGO WOULD
UNREALISTIC & PERHAPS
HAVE BEEN CONSIDERED POSSIBLE ONLY AT THE VERY PEAK OF A
VERY STRONG ECONOMIC EXPANSION.



I DO NOT MEAN TO CAST A PALL OF GLOOM OVER OUR FUTURE
ECONOMIC HOPES. THE RECOVERY THAT BEGAN EARLIER THIS YEAR

PROMISES TO BE VIGOROUS AND HEALTHY. ^{CHOOSE OUR POLICIES} IF WE MANAGE ¹ ~~IT~~ WISELY,
IT SHOULD ALSO BE DURABLE AND LASTING. BUT I DO THINK IT
IS ESSENTIAL THAT WE FACE UP TO THE PROBLEMS THAT ARE
ACCUMULATING IN OUR FINANCIAL MARKETS AND THAT WE ACT MORE
DECISIVELY TO ELIMINATE THE UNDERLYING CAUSES. WE MUST
PROVIDE AN ENVIRONMENT IN WHICH THE NATURAL SELF-CORRECTIVE
FORCES OF THE MARKET PLACE CAN FUNCTION. IF WE FAIL IN
THAT EFFORT -- IF WE ALLOW THE CONDITIONS OF RECENT YEARS TO
FESTER AND SPREAD -- THEN I THINK WE ARE INVITING MUCH MORE
SERIOUS TROUBLE ONLY A FEW YEARS FROM NOW. THE FINANCIAL
MARKETS WILL NOT, NOR SHOULD THEY BE EXPECTED TO TOLERATE
A LONG PERIOD OF SEVERE AND UNRELIEVED PRESSURE.

LET US TURN THEN TO A CONSIDERATION OF THE CAUSES
WHICH LIE BENEATH OUR PRESENT TROUBLES AND WHAT MUST BE DONE
TO RELIEVE THEM.



ORIGINS OF THE FINANCIAL STRESS

THE CAUSES ARE MANY AND COMPLEX. THEY REQUIRE A CAREFUL ANALYSIS OF THE PAST ECONOMIC, POLITICAL AND SOCIAL TRENDS -- A TASK THAT SOME HISTORIANS CAN DEAL WITH IN A THOROUGH WAY AT SOME FUTURE DATE. STILL, THERE ARE SOME IMMEDIATELY IDENTIFIABLE ECONOMIC REASONS WHICH HAVE OBVIOUSLY CONTRIBUTED TO THE CURRENT STRAINS IN THE FINANCIAL SYSTEM, REASONS WHICH ARE BASIC AND INTERRELATED: NAMELY, THE EXTRAORDINARILY HIGH RATES OF INFLATION EXPERIENCED IN RECENT YEARS AND THE SHORT SIGHTED GOVERNMENT AND PRIVATE POLICIES WHICH HAVE CONTRIBUTED TO THE INFLATION.

THE INFLATION AND ITS IMPACT ON FINANCIAL MARKETS DID NOT JUST HAPPEN BUT WERE THE NATURAL AND LARGELY PREDICTABLE RESULT OF A SERIES OF OCCURRENCES WHICH FOR THE MOST PART COULD HAVE BEEN AVOIDED:



FIRST, OUR FEDERAL GOVERNMENT HAS BEEN LIVING BEYOND ITS MEANS FOR FAR TOO LONG. IN FISCAL YEAR 1962 THE FEDERAL BUDGET EXCEEDED \$100 BILLION FOR THE FIRST TIME IN HISTORY. BY FISCAL YEAR 1971 IT EXCEEDED \$200 BILLION. BY FISCAL YEAR 1975 IT EXCEEDED \$300 BILLION AND A FIGURE OVER \$400 BILLION IN FY 1977 IS NOW CERTAIN. IN OTHER WORDS FEDERAL GOVERNMENT OUTLAYS FOR THE PAST DECADE HAVE BEEN GROWING AT A RATE OF OVER 10% PER YEAR OR ALMOST 25% MORE THAN THE GROWTH OF THE TOTAL ECONOMY. AS A RESULT, THE GOVERNMENT'S REGULAR BUDGET AGENCIES AS WELL AS THE OFF-BUDGET AGENCIES -- THE CREATURES SET UP A FEW YEARS AGO PARTLY TO AVOID THE DISCIPLINE OF THE BUDGET PROCESS -- HAVE TOGETHER BEEN FORCED TO BORROW OVER A THIRD OF A TRILLION DOLLARS FROM OUR PRIVATE MONEY MARKETS OVER THE PAST DECADE -- MONEY THAT MIGHT OTHERWISE HAVE BEEN USED TO BUILD NEW PLANTS AND TO CREATE NEW JOBS IN THE PRIVATE SECTOR. IT IS NO WONDER THAT INFLATION HAS ACCELERATED AND INTEREST RATES HAVE RISEN TO RECORD LEVELS. SUCH HUGE SIZED BORROWINGS PUT PRESSURE ON FINANCIAL MARKETS AND



INTEREST RATES. WHEN THE U.S. TREASURY GOES TO THE HEAD OF THE LINE TO MEET ITS BORROWING NEEDS -- AS IT ALWAYS DOES -- AND WHEN THOSE NEEDS ARE CONTINUALLY OVERSIZED, THEN INTEREST RATES ARE NATURALLY DRIVEN UP, SOME PRIVATE NEEDS ~~GO~~ UNFULFILLED AND PRIVATE INVESTMENT SUFFERS. THIS IS THE ESSENCE OF THE "CROWDING OUT" PROBLEM THAT I BEGAN POINTING TO LAST YEAR AND WHICH HAS NOW SO OBVIOUSLY SURFACED IN OUR MARKETS.

SECOND, THERE HAS BEEN AN EXCESSIVE EXPANSION OF THE MONEY SUPPLY OVER THE PAST DECADE RELATIVE TO SUSTAINABLE NEEDS. ULTIMATELY THIS EXPANSION ALSO SERVES TO RAISE THE RATE OF INFLATION AND INTEREST RATES. A GOOD DEAL OF THIS MONETARY EXPANSION, I MIGHT ADD, IS RELATED TO THE CHRONIC FEDERAL BUDGET DEFICITS BUT ANOTHER PART IS ALSO ATTRIBUTABLE TO POLICIES WHICH TRIED TO FINANCE OUR WAY QUICKLY OUT OF RECESSION. THESE POLICIES HAVE SHOWN THEMSELVES TO HAVE BEEN LATE IN TIMING AND FAR OFF THE MARK QUANTITATIVELY IN TERMS OF NEED. NEEDLESS TO SAY, THIS PROCESS HAS CONTRIBUTED



TO THE APPARENT INCREASING VOLATILITY OR STOP-GO NATURE OF THE GOVERNMENT'S ECONOMIC POLICIES.

THIRD, THE HIGHER RATE OF INFLATION IN RECENT YEARS HAS RAISED THE DOLLAR COST OF PHYSICAL INVESTMENT NEEDS. THOSE HIGHER COSTS, COUPLED WITH ACCOUNTING PROCEDURES THAT ARE UNABLE TO ADJUST TO HIGH RATES OF INFLATION AND A TAX STRUCTURE THAT IS BIASED AGAINST EQUITY FINANCING, HAVE FORCED COMPANIES TO SEEK MORE AND MORE EXTERNAL FINANCING, PARTICULARLY IN THE DEBT MARKETS. IN TURN, THERE HAVE BEEN GROWING DISTORTIONS IN CORPORATE BALANCE SHEETS AND INCREASING ILLIQUIDITY WITHIN THE COMPANIES THEMSELVES. THIS PROCESS HAS PROCEEDED TO THE POINT WHERE IT IS QUESTIONABLE WHETHER MANY CORPORATIONS WILL HAVE THE ABILITY TO FINANCE THE RECORD CAPITAL NEEDED IN THE DECADE AHEAD.

FOURTH, THE HIGHER INFLATION PLUS THE GREATER VOLATILITY IN FINANCIAL MARKETS RELATED TO GOVERNMENT POLICIES HAS UNDERSTANDABLY MADE LENDERS MORE LEARY ABOUT LONG-TERM



COMMITMENTS. HIGHER INTEREST RATES ARE DEMANDED AND RECEIVED
TO HEDGE AGAINST FUTURE INFLATION AND TO COMPENSATE FOR
HIGHER RISK. MOREOVER, SHORTER MATURITIES AND GREATER
CALL PROTECTION ARE ROUTINELY REQUESTED IN ORDER TO ~~BE HEDGE~~
~~AGAINST THE POSSIBILITY THAT~~ ~~PROTECTED IN CASE~~ ~~FUTURE RATES OF INFLATION SHOULD PROVE TO~~ ~~BE~~ ~~DIFFERENT FROM~~ ~~THAT~~ ^{THOSE} ANTICIPATED. ^{MIGHT BE}

FIFTH, THE COMBINATION OF ALL OF THESE CONDITIONS HAS
CAUSED CORPORATE TREASURERS TO FOCUS ONLY ON VERY PROMISING
PROJECTS WITH HIGH RETURNS, ACCENTUATING THE PATTERN OF
UNDERINVESTING IN RECENT YEARS.

^{HAVE WE SEEN} WHAT THEN ~~DO WE SEE~~ ^{AN EXCESS} IN OUR ECONOMY? ~~A PLEA~~ ^{OF STOP-GO}
BEHAVIOR, SECULARLY RISING INTEREST RATES, SLOW REAL GROWTH,
^{DISAPPOINTING} ~~POOR~~ WORKER PRODUCTIVITY, HISTORICALLY HIGH RATES OF
INFLATION AND A BODY POLITIC CALLING FOR SOME QUICK CURE ALL THAT
DOESN'T EXIST. IT SHOULD COME AS NO SURPRISE THAT OUR
FINANCIAL STRUCTURE -- STILL A WONDER IN TERMS OF GROSS
CREDIT FLOWS AND ALLOCATION -- IS FEELING THE STRAIN. WE



REALLY HAVE OURSELVES TO BLAME FOR THIS PREDICAMENT. IT TOOK MANY YEARS TO DEVELOP, BUT AT THE SAME TIME, WITH SOME PATIENCE, THE DIFFICULTIES CAN BE REVERSED.

THE FUTURE DEMANDS ON THE FINANCIAL STRUCTURE

THE BASIC ECONOMIC FUNCTION OF THE FINANCIAL STRUCTURE IS, OF COURSE, TO FACILITATE THE ENORMOUS FLOW OF CAPITAL WITHIN OUR ECONOMY. IT IS THE TRANSMISSION MECHANISM THAT ENCOURAGES THE ACCUMULATION OF REAL PHYSICAL CAPITAL -- FACTORIES HOUSING, TOOLS, ET CETERA. THAT CAPITAL IN TURN CREATES NEW JOBS, ENABLES WORKERS TO BECOME MORE PRODUCTIVE, AND GENERATES A HIGHER REAL LIVING STANDARD, HELPS US TO MEET FOREIGN COMPETITION, CONTAINS THE PACE OF INFLATION, PROMOTES A GROWING ECONOMY, AND ENABLES US TO MEET EXPANDING DEMANDS FROM THE PUBLIC. INVESTMENT CAPITAL THUS PROVIDES THE DRIVING FORCE BEHIND ECONOMIC GROWTH, AND IT CAN WORK EFFECTIVELY ONLY IF OUR FINANCIAL MARKETS ARE WORKING SMOOTHLY.



THE ISSUE THEREFORE IS TO GAUGE THE FUTURE NEEDS FOR CAPITAL IN OUR SYSTEM AND THEN SEE WHETHER THE FINANCIAL STRUCTURE IS CAPABLE OF HANDLING THE FINANCING FLOWS REQUIRED FOR THAT INVESTMENT. IN MY JUDGMENT, THE ANSWER IS THAT THE FINANCIAL SYSTEM CAN RISE TO THIS CHALLENGE, BUT ONLY IF WE CHART A NEW AND SIGNIFICANTLY DIFFERENT COURSE IN OUR GOVERNMENTAL POLICIES.

THE FUTURE NEEDS FOR CAPITAL -- THE SO-CALLED "CAPITAL *GAP* C SHORTAGE" IF YOU WILL -- ARE ENORMOUS.

THE MOST IMMEDIATE NEED FOR MORE CAPITAL IS TO CREATE JOBS FOR OUR RAPIDLY GROWING LABOR FORCE. BETWEEN NOW AND 1985 THE LABOR FORCE WILL EXPAND BY ROUGHLY 15 MILLION PERSONS. IN ADDITION, THERE ARE AT LEAST 3-4 MILLION UNEMPLOYED PERSONS IN THE LABOR FORCE TODAY WHO MUST ALSO HAVE JOBS. BY COMPARISON TO THE 18-19 MILLION ^{*JOBS*} THAT THAT WILL THUS BE NEEDED IN THE COMING DECADE, OUR ECONOMY CREATED



APPROXIMATELY ¹⁶~~13~~ MILLION JOBS DURING THE PAST DECADE,
~~AND FOR THE MOST PART THAT WAS DURING A PERIOD THAT WAS~~
~~CHARACTERIZED BY STEADY ECONOMIC GROWTH.~~ THE TASK AHEAD IS
THUS VERY FORMIDABLE INDEED.

IN ADDITION TO THE CHALLENGE OF CREATING NEW JOBS, A
SECOND BROAD SET OF CAPITAL NEEDS AHEAD CENTER AROUND
SPECIFIC PUBLIC POLICY OBJECTIVES: THE DEVELOPMENT OF NEW
ENERGY RESOURCES TO BECOME MORE SELF-SUFFICIENT; AN IMPROVEMENT
IN THE QUALITY OF OUR ENVIRONMENT; SAFER WORKING CONDITIONS
TO PROTECT THE WELL BEING OF OUR LABORERS; AND THE PROVISION
OF MORE AND BETTER QUALITY HOUSING TO SATISFY THE NEEDS OF
A GROWING POPULATION. CLEARLY, THESE REQUIREMENTS ARE NOT
ABSOLUTE AND THE LIST CAN BE EXPANDED. FURTHERMORE, THERE IS
NO SINGLE "CORRECT" DOLLAR TOTAL THAT CAN BE IDENTIFIED WITH
THESE OUTLAYS. BUT WE KNOW THAT THE LEVELS ARE EXTRAORDINARY.
IN THE ENERGY FIELD ALONE, ^{SOME}~~MANY~~ ESTIMATES OF CAPITAL NEEDS
OVER THE COMING DECADE ARE ^{CLOSE TO}~~IN THE RANGE OF~~ \$1 TRILLION.



WHEN THE TWO BROAD CATEGORIES OF NEEDED CAPITAL FOR THE LABOR FORCE AND FOR SPECIFIC PUBLIC POLICY GOALS ARE ADDED, THE TOTAL PRIVATE INVESTMENT¹ OUTLAYS REACH A TOTAL SOMEWHERE BETWEEN \$4-4 1/2 TRILLION OVER THE NEXT DECADE. BY STARTING² CONTRAST, THE CUMULATIVE TOTAL OVER THE PAST DECADE WAS \$1.5 TRILLION. THUS, YOU CAN SEE THAT OUR CAPITAL EXPENDITURES IN THE DECADE AHEAD WILL HAVE TO BE ^{ROUGHLY} THREE TIMES AS LARGE AS THOSE OF THE PAST DECADE.

WHETHER THE FINANCIAL MECHANISM CAN HANDLE THE HUGE FLOW OF SAVINGS, INVESTMENT AND CREDIT ASSOCIATED WITH THE CAPITAL NEEDS OUTLINED ABOVE WITHOUT BECOMING MORE ILLIQUID, BRITTLE AND LESS FLEXIBLE IN WITHSTANDING EXTERNAL ADVERSE SHOCK IS AN OPEN QUESTION. THE RISE IN CORPORATE DEBT OVER THE PAST DECADE WITH ITS FIXED OBLIGATIONS³ TO PAY RAISES CLEAR QUESTIONS ABOUT THE ABILITY TO FINANCE FUTURE CAPITAL OUTLAYS. IT IS JUST NOT CLEAR WHETHER THE SYSTEM CAN ACCOMMODATE ^{A LOT} ~~MUCH~~ MORE DEBT. INDEED, THE SHEER EXPANSION OF CORPORATE DEBT RELATIVE



TO ASSETS OR EQUITY ON THE BALANCE SHEET WILL CAUSE CREDIT RATINGS TO DETERIORATE AND INTEREST COSTS TO RISE. CHRONIC FEDERAL BUDGET DEFICITS WHICH DRAIN THE SAVINGS POOL OR CROWD OUT PRIVATE BORROWERS WOULD MEAN LESS INVESTMENT, LOWER PRODUCTIVITY AND HIGHER INFLATION. THIS WOULD PUT SEVERE STRAIN ON THE TRADITIONAL THRIFT INSTITUTIONS AND ESPECIALLY ON THE OUTLOOK FOR HOUSING.

IN MY VIEW, AS I HAVE SAID, OUR ABILITY TO MEET THESE CAPITAL REQUIREMENTS AND THE ABILITY OF THE FINANCIAL SYSTEM TO ACCOMMODATE THESE NEEDS WILL ONLY BE ASSURED IF THERE ARE SOME RATHER PRONOUNCED SHIFTS IN PUBLIC POLICY. WHAT WE NEED IS A FINANCIAL MECHANISM CONDUCTIVE TO GROWTH AND THAT MECHANISM IS PLAINLY NOT COMPATIBLE WITH AN ENVIRONMENT OF HIGH INFLATION, SLOW GROWTH AND ERRATIC STOP-GO GOVERNMENT POLICIES.

GENERAL POLICY NEEDS

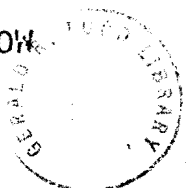
I WOULD LIKE TO OFFER FOUR CONCRETE SUGGESTIONS FOR



FUTURE POLICY DIRECTIONS.

FIRST, I BELIEVE WE MUST ELIMINATE THE STOP-GO BEHAVIOR ON THE PART OF THE GOVERNMENT IN SETTING AND PURSUING ECONOMIC POLICIES. SUCH POLICY CHANGES ARE TYPICALLY A RESPONSE TO SHORT-RUN DEVELOPMENTS IN THE ECONOMY AND IT IS NOT UNCOMMON FOR THE ECONOMY TO FOLLOW A ZIGZAG COURSE. BECAUSE THERE IS TYPICALLY A LAG BETWEEN THE DEVELOPMENT OF A NEW POLICY AND ITS IMPACT ON THE ECONOMY, ABRUPT POLICY CHANGES TEND TO COME TOO LATE TO ACCOMPLISH THEIR ORIGINAL GOAL AND CAN OFTEN WORK AT CROSS PURPOSES WITH CURRENT NEEDS. INDEED, SINCE THE MID-60S, RATHER THAN ACTING TO STABILIZE THE ECONOMY, SUCH SHIFTS HAVE ^{TENDED TO} ACCENTUATED ^{THE} THE ECONOMY'S BASIC CYCLICAL ^{TO SOME EXTENT THEY} SWINGS, ^{AND} HAVE BECOME DESTABILIZING.

SPECIFICALLY, IT SEEMS TO ME THAT THE MIX OF MACRO-STABILIZATION POLICIES OF THE PAST SHOULD BE RADICALLY ^A SHIFTED AWAY FROM ~~THE~~ PATTERN WHICH HAS EMPHASIZED GENERAL TAX CUTS TO STIMULATE THE ECONOMY AND TIGHT MONEY TO SLOW



IT DOWN. OVER TIME, SUCH A MIX CREATES AN INADVERTANT BUT STILL PRONOUNCED ANTI-INVESTMENT BIAS TO GOVERNMENT POLICIES WHICH ARE TOTALLY INAPPROPRIATE TO OUR LONG-TERM CAPITAL NEEDS AND TO THE VERY FUNCTIONING OF OUR FINANCIAL STRUCTURE. ^R AT A MINIMUM, THE GROWTH IN GOVERNMENT SPENDING MUST BE BROUGHT INTO CLOSER LINE WITH THE GROWTH OF THE ECONOMY AND AN APPROPRIATE NET BUDGET BALANCE MUST BE EFFECTED. IN FACT, WE SHOULD AIM FOR A SURPLUS BUDGET POSITION AT FULL EMPLOYMENT IN ORDER TO REDUCE THE DRAIN ON THE PRIVATE SAVING STREAM AND TO PROVIDE FUNDS FOR FUTURE CAPITAL GROWTH. THE COUNTRY CANNOT AFFORD TO HAVE THE TREASURY USE ITS MUSCLE TO CROWD OUT PRIVATE BORROWERS. TO DO SO WOULD FRUSTRATE THE ACCUMULATION OF SUFFICIENT CAPITAL RESOURCES RELATIVE TO OUR NEEDS AND WOULD IMPOSE GROWING PRESSURE ON AN ALREADY WEAKENED FINANCIAL MECHANISM.

SECONDLY, WE MUST MAINTAIN A CONSISTENT EFFORT TO LOWER THE RATE OF INFLATION -- NOT JUST TO THE 6-8% RANGE BUT



EVENTUALLY TO SOMETHING MUCH LOWER. [AND WITH THAT EFFORT,
WE MUST ALSO LOOSEN THE GRIP OF THE INFLATIONARY PSYCHOLOGY
THAT IS NOW SO STRONG.] PARTS OF OUR FINANCIAL STRUCTURE AS
IT NOW EXISTS WILL NOT REMAIN VIABLE ~~WITH~~ WITH SUSTAINED
HIGH SINGLE-DIGIT INFLATION, LET ALONG A DOUBLE-DIGIT PACE.
FURTHERMORE, THE HIGH INFLATION IS DISTORTING THE WORKINGS
OF THE MARKET MECHANISM IN THAT:

-- IT ENCOURAGES LENDERS TO DEMAND VERY HIGH RATES
OF INTEREST IN REFLECTION OF EXPECTED HIGH FUTURE RATES OF
INFLATION, AND

-- IT DISCOURAGES BORROWERS FROM UNDERTAKING INVESTMENT
PLANS BECAUSE FUTURE RETURNS ^{ARE MUCH} ~~AS~~ LESS PREDICTABLE.

A THIRD SET OF ACTIONS WHICH ARE CLEARLY NEEDED IS TO
ELIMINATE EXCESSIVE GOVERNMENT REGULATIONS IN MANY SECTORS SO
THAT RESOURCES CAN BE ALLOCATED MORE EFFICIENTLY AND WITHOUT
THE ENORMOUS UNNECESSARY COSTS THAT ARE NOW PASSED ON TO



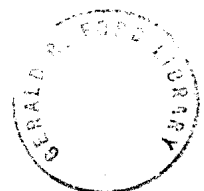
THE CONSUMER. RAILS, TRUCKING, AIRLINES, NATURAL GAS -- ALL OF THESE AND MORE ARE NOW SUFFERING UNDER THE HEAVY HAND OF THE GOVERNMENT. LET US AT THE SAME TIME RESIST SEDUCTIVE CALLS TO RETURN TO WAGE-PRICE CONTROLS "TO SLOW INFLATION AND LOWER UNEMPLOYMENT." THE SO-CALLED BENEFITS ARE SHORT-LIVED AND ARE FAR LESS THAN THE SERIOUS LONG-TERM COSTS AND DISTORTIONS SUCH CONTROLS BRING ABOUT. CAN THERE BE ANY DOUBT THAT IN THE LONG RUN CONTROLS CONTRIBUTE TO SHORTAGES, MORE INFLATION AND A HIGHER UNEMPLOYMENT RATE? THE LESSONS OF HISTORY, I WOULD SUGGEST, ARE ABUNDANTLY CLEAR.

FOURTH, THE TAX STRUCTURE ITSELF MUST BE CHANGED TO END THE TAX BIAS AGAINST EQUITY CAPITAL. THE TAX DEDUCTABILITY FEATURE OF INTEREST PAYMENTS HAS CREATED A STRONG EMPHASIS UPON DEBT FINANCING -- SO MUCH SO, AS I HAVE NOTED, THAT SHARP DISTORTIONS HAVE APPEARED ON CORPORATE BALANCE SHEETS. TO REDRESS THIS GROWING FINANCIAL DIFFICULTY, TO



INCREASE THE SUPPLY ^{OF} ~~TO~~ TOTAL SAVING IN THE ECONOMY, AND TO
TREAT THE INCOME FROM CAPITAL ON A MORE EQUITABLE BASIS,
THE ADMINISTRATION PRESENTED TO THE CONGRESS LAST JULY 31
THE "CORPORATE INTEGRATION" PLAN. IT IS MOST IMPORTANT
THAT PROPOSALS SUCH AS THESE BE ENACTED INTO LAW TO DEAL
WITH THE SERIOUS AND GROWING CORPORATE FINANCE PROBLEMS.
OTHERWISE THE CAPITAL NEEDS OF THE NEXT DECADE WILL NOT BE
MET.

FINALLY, THERE MUST BE A RESTRUCTURING OF PUBLIC ECONOMIC
POLICY-MAKING AWAY FROM SHORT-RUN, ^{OFTEN} POLITICALLY MOTIVATED
REACTIONS TO DEVELOPMENTS IN THE ECONOMY. TO ADVOCATE A
CHANGE IN BASIC POLICY BASED ON THE LATEST MONTHLY INFLATION
FIGURE, OR THE LAST 10 DAYS ANNUAL RATE OF AUTO SALES, OR
LAST WEEK'S CHANGE IN THE MONEY SUPPLY IS AN INAPPROPRIATE
WAY OF DECIDING SENSIBLE AND EFFECTIVE GOVERNMENT POLICIES.
SUCH A "REACTION RESPONSE" WILL NOT ONLY CONTRIBUTE TO MORE



MORE VOLATILE AND ERRATIC ECONOMIC BEHAVIOR BUT IN THE
LONG RUN WILL ADVERSELY AFFECT THE STABILITY OF THE ECONOMIC
SYSTEM ITSELF AND DO FURTHER DAMAGE TO THE FINANCIAL STRUCTURE.

CONCLUDING COMMENTS

WHAT DOES ALL THIS MEAN? IT SEEMS TO ME THAT THE MARKET
TODAY IS MOST ASSUREDLY TELLING US SOMETHING ABOUT THE BEHAVIOR
OF OUR ECONOMIC AND FINANCIAL SYSTEM. SOMETHING IS UNQUESTIONABLY
OUT OF BALANCE. THIS CERTAINLY DOES NOT MEAN THAT COLLAPSE OR
EVEN CRISIS IS NEAR AT HAND NOR THAT THE FINANCIAL SYSTEM
CANNOT PLAY ITS PART IN BRINGING ABOUT THE HUGE SAVINGS AND
INVESTMENT NEEDS OF THE NEXT DECADE. BUT IT DOES MEAN THAT
WE HAVE TO CHANGE OUR WAYS. INFLATION MUST BE SHARPLY
REDUCED. GOVERNMENT POLICIES MUST BE REDIRECTED TOWARD A
LONGER-TERM TIME HORIZON AND SHIFTED TOWARD A BETTER MIX OF
FISCAL AND MONETARY POLICIES THAN EXISTED OVER THE PAST
DECADE. THE TAX BIAS AGAINST CAPITAL FORMATION MUST BE
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REDRESSED.



IF THESE STEPS ARE TAKEN, WE CAN LOOK FORWARD TO
BETTER GROWTH, MORE JOBS, HIGHER INCOMES, A CLOSER FULFILLMENT
OF OUR BROAD PUBLIC POLICY GOALS, A LOWER RATE OF INFLATION,
A MORE STABLE ECONOMIC SYSTEM AND A ROBUST FINANCIAL STRUCTURE.
IF THROUGH INERTIA, POLITICAL DIFFERENCES OR PLAIN MISJUDGMENT
WE FAIL TO ACT RESPONSIBLY, THEN WE CAN LOOK FORWARD TO
CONTINUED TROUBLE, WORSE INFLATION, LOWER GROWTH, FRUSTRATED
AMBITIONS, CONTINUED EROSION OF OUR FINANCIAL BASE AND
ULTIMATELY, A GROWING INSTABILITY IN OUR POLITICAL SYSTEM.

THE LATTER SCENARIO ADMITTEDLY SOUNDS PESSIMISTIC, BUT
IT IS CERTAINLY NOT INEVITABLE. WE KNOW FAIRLY WELL HOW
WE GOT INTO THE CURRENT ECONOMIC SITUATION. IT HAS NOT
RESULTED FROM A RANDOM SERIES OF "BAD LUCK" EVENTS BUT
RATHER FROM MANY YEARS OF SHORTSIGHTED POLICIES. WE ALSO
KNOW HOW TO GET OUT OF THE CURRENT SITUATION IF WE PURSUE
SOUND, PRUDENT POLICIES. THIS WILL REQUIRE PATIENCE,
UNDERSTANDING AND SUPPORT FROM THE PUBLIC, BUT I HAVE



FAITH THAT WE CAN RESPOND TO THIS CHALLENGE AND SUCCESSFULLY
MEET THE CURRENT AND FUTURE NEEDS THAT WE ALL KNOW EXIST.

THANK YOU.

#



STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE JOINT ECONOMIC COMMITTEE
WEDNESDAY, SEPTEMBER 24, 1975, 11:00 A.M.

NEW YORK CITY'S FINANCIAL SITUATION

MR. CHAIRMAN AND MEMBERS OF THIS DISTINGUISHED COMMITTEE:

I AM HERE TODAY AT THE EXPRESS INVITATION OF THE
CHAIRMAN, WHO HAS CALLED UPON ME TO TESTIFY ABOUT THE POSSIBLE
IMPACT OF A FINANCIAL DEFAULT BY NEW YORK CITY.

THIS IS AN OCCASION THAT NONE OF US CAN WELCOME. ALL OF
US SHARE THE HOPE THAT A DEFAULT CAN BE AVOIDED. PERSONALLY,
I AM CONFIDENT THAT IF THE PROPER STEPS ARE TAKEN, DEFAULT
WILL BE AVOIDED. ONE OF THE GREAT PLEASURES IN MY LIFE WAS
TO SPEND SOME 20 YEARS WORKING IN THE FINANCIAL COMMUNITY IN



DOWNTOWN MANHATTAN. I GAINED FROM THAT EXPERIENCE NOT ONLY A LOVE FOR THE CITY BUT ALSO ENORMOUS RESPECT FOR THE WISDOM AND STRENGTH OF ITS PEOPLE. I SINCERELY BELIEVE THAT IF THOSE GREAT RESOURCES ARE PROPERLY MARSHALED, NEW YORK CITY WILL EMERGE FROM ITS CURRENT DIFFICULTIES.

AS YOUR INVITATION TO ME RECOGNIZES, HOWEVER, IT IS ALSO IMPORTANT THAT WE SEEK TO UNDERSTAND WHAT THE IMPLICATIONS WOULD BE IF DEFAULT DOES OCCUR. I AM SURE THAT THE MEMBERS OF THIS COMMITTEE, AS WELL AS THE AMERICAN PEOPLE, WANT THIS INQUIRY TO BE AS HONEST AND OBJECTIVE AS POSSIBLE. THIS CANNOT BE A TIME WHEN WE DELUDE OURSELVES WITH EXCESSIVE OPTIMISM AND THUS FAIL TO ACT WISELY. BY THE SAME TOKEN, WE SHOULD NOT ENGAGE IN EXCESSIVE PESSIMISM. IMPASSIONED STATEMENTS THAT A DEFAULT WOULD HAVE CATASTROPHIC CONSEQUENCES FOR THE FINANCIAL MARKETS AS WELL AS THE ECONOMY -- STATEMENTS WHICH HAVE NO FOUNDATION IN OBSERVABLE FACTS -- CAN ONLY MAKE



THE SITUATION WORSE. THIS IS A TIME, THEN, FOR AN HONEST APPRAISAL, DEVOID OF EMOTIONALISM OR PARTISANSHIP. MY TESTIMONY TODAY IS OFFERED IN THAT SPIRIT.

THE FEDERAL GOVERNMENT HAS BEEN SERIOUSLY CONCERNED WITH THE PROBLEMS ASSOCIATED WITH NEW YORK CITY'S FINANCES FOR A LONG WHILE. WE HAVE HELD REPEATED MEETINGS WITH THE LEADERS OF NEW YORK CITY, THE MUNICIPAL ASSISTANCE CORPORATION, AND NEW YORK STATE. A CONSIDERABLE AMOUNT OF STAFF TIME WITHIN THE TREASURY DEPARTMENT HAS BEEN DEVOTED TO THIS MATTER. AT THE PRESIDENT'S DIRECTION, I HAVE ESTABLISHED AN INFORMAL, INTER-AGENCY TASK FORCE, CHAIRED BY MY UNDER SECRETARY EDWIN H. YEO III, TO CLOSELY MONITOR THIS SITUATION ON A DAILY BASIS AND TO DEAL WITH EVERY ASPECT OF A POTENTIAL DEFAULT BY THE CITY. THE EVALUATIONS AND THE PLANS OUTLINED IN MY TESTIMONY THIS MORNING ARE THE PRODUCT OF THOSE EFFORTS.



OUR BASIC CONCLUSIONS, WHICH I SHALL EXPAND UPON IN
A FEW MOMENTS, ARE THESE:

FIRST, ALTHOUGH THE CHALLENGES AND THE TASKS AHEAD
ARE GREAT, NEW YORK CITY, WITH THE ASSISTANCE OF NEW YORK
STATE, HAS BOTH THE MECHANISMS AND THE RESOURCES TO AVOID
DEFAULT.

SECOND, IF DEFAULT WERE TO OCCUR DESPITE THEIR BEST
EFFORTS, ITS EFFECTS WOULD PRIMARILY BE LEGAL IN CHARACTER:
THE BASIC SERVICES OF THE CITY SHOULD REMAIN INTACT.

THIRD, WHILE A DEFAULT COULD ADVERSELY AFFECT THE
CAPITAL MARKETS, THOSE MARKETS HAVE ALREADY ADJUSTED TO
THAT POSSIBILITY TO SOME EXTENT AND THE EVENT OF DEFAULT
WOULD REQUIRE ONLY A MODERATE DEGREE OF FURTHER ADJUSTMENT.
IN OTHER WORDS, THE EFFECTS OF DEFAULT UPON THE CAPITAL
MARKETS WOULD BE TOLERABLE.

FOURTH, A DEFAULT WOULD CAUSE LITTLE, IF ANY, DAMAGE



TO OUR OVERALL FINANCIAL STRUCTURE: THE BANKING SYSTEM WOULD REMAIN INTACT; NO BANK CUSTOMERS WOULD LOSE THEIR DEPOSITS; AND THE SYSTEM WOULD CONTINUE TO BE ABLE TO PROVIDE CREDIT TO ALL LEVELS OF THE ECONOMY, INCLUDING CONSUMERS.

FIFTH, THE COSTS AND RISKS ASSOCIATED WITH ANY PROGRAM TO PROVIDE SPECIAL FEDERAL FINANCIAL ASSISTANCE TO PREVENT DEFAULT SUBSTANTIALLY OUTWEIGH THE BENEFITS.

FINALLY, WE BELIEVE THAT THE FEDERAL GOVERNMENT DOES HAVE A RESPONSIBILITY TO THE NATION TO ENSURE THAT IF A DEFAULT DOES OCCUR, PROPER STEPS ARE TAKEN TO LIMIT AND CONTAIN ITS IMPACT. TOWARD THAT END, WE HAVE DEVELOPED A PROGRAM WITHIN THE ADMINISTRATION. DEVELOPMENT OF THAT PLAN SHOULD NOT BE MISUNDERSTOOD AS AN ANTICIPATION OF DEFAULT; RATHER, IT IS A STANDBY MECHANISM WHICH PRUDENCE SURELY DEMANDS. WHILE MY TESTIMONY WILL DEAL IN MORE DEPTH WITH ITS DETAILS, LET ME SUMMARIZE THAT PROGRAM NOW:



-- TO INSURE ADEQUATE FINANCIAL RESOURCES
TO MAINTAIN ESSENTIAL SERVICES AND TO AVOID
POTENTIAL DISRUPTION AND CONFUSION CREATED
BY CONFLICTING LITIGATION, WE HAVE PRE-
PARED, AND WILL SHORTLY SUBMIT TO THE
CONGRESS, LEGISLATION AMENDING CHAPTER 9
OF THE FEDERAL BANKRUPTCY ACT TO FACILITATE
USE OF THAT ACT'S PROTECTION BY NEW YORK
CITY.

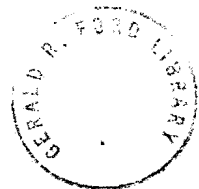
-- TO ASSURE THE CONTINUED FLOW OF CURRENT
ASSISTANCE PAYMENTS, WE HAVE IDENTIFIED
ALTERNATIVE METHODS OF OPERATING THOSE



PROGRAMS IN THE EVENT LOCAL RESOURCES
TEMPORARILY BECOME UNAVAILABLE.

-- TO PROTECT THE BANKING SYSTEM AND THUS
ASSURE THE CONTINUED AVAILABILITY OF RESOURCES
THAT SYSTEM PROVIDES TO CONSUMERS, CORPORATIONS
AND GOVERNMENTS:

-- THE FEDERAL RESERVE SYSTEM WILL
PROVIDE LIQUIDITY THROUGH ITS
DISCOUNT FACILITIES IN THE EVENT
ANY INSTITUTION FACES UNEXPECTED
CASH WITHDRAWALS;



-- AS A LAST RESORT, IN APPROPRIATE CASES,
THE FEDERAL DEPOSIT INSURANCE CORPORATION
WILL PROVIDE CAPITAL TO INSTITUTIONS WHERE
SUCH ACTION IS NECESSARY TO MAINTAIN
SOLVENCY.

LET ME REPEAT, WE DO NOT BELIEVE DEFAULT IS INEVITABLE
AND WE BELIEVE IT ESSENTIAL TO MAKE ALL REASONABLE EFFORTS
TO AVOID DEFAULT. MOREOVER, IF DEFAULT OCCURS, APART FROM
THE BANKRUPTCY AMENDMENT -- WHICH WE BELIEVE TO BE DESIRABLE
IN ANY EVENT -- WE DO NOT EXPECT TO NEED ANY PART OF THIS
PROGRAM. BUT IT IS OUR RESPONSIBILITY -- TO THE CONGRESS
AND TO THE NATION -- TO BE PREPARED FOR ANY EVENTUALITY.

CURRENT STATUS

LET US NOW CONSIDER THE CURRENT EFFORTS OF NEW YORK CITY
AND NEW YORK STATE TO PREVENT A DEFAULT.



ON SEPTEMBER 9, A SPECIAL SESSION OF THE
NEW YORK STATE LEGISLATURE ENACTED LEGISLATION CALLING FOR

- CREATION OF A STATE DOMINATED EMERGENCY FINANCIAL
CONTROL BOARD TO ASSUME PLENARY CONTROL OVER THE
CITY'S FINANCES;
- AUTHORITY TO ISSUE \$750 MILLION IN SHORT TERM
STATE NOTES, THE PROCEEDS TO BE USED TO PURCHASE
MAC BONDS;
- A MANDATE TO STATE AND CITY EMPLOYEE PENSION PLANS
TO PURCHASE \$750 MILLION IN MAC BONDS (AND RELIEF
FOR THE STATE COMPTROLLER WITH RESPECT TO HIS
FIDUCIARY RESPONSIBILITIES REGARDING THESE PLANS);
- AN INCREASE IN MAC'S BORROWING AUTHORITY FROM \$3
BILLION TO \$5 BILLION;
- AUTHORIZATION FOR THE CITY TO FILE A PETITION IN
BANKRUPTCY UNDER CHAPTER 9 OF THE FEDERAL BANKRUPTCY AC



TWO DAYS LATER, NEW YORK STATE SOLD \$755 MILLION OF SHORT TERM NOTES, INCLUDING \$250 MILLION EARMARKED FOR THE CITY. NAC IS BEGINNING TO RAISE FROM OTHER SOURCES THE \$800 MILLION NECESSARY TO COMPLETE THE \$2.3 BILLION PACKAGE REQUIRED TO FINANCE THE CITY THROUGH DECEMBER 1.

AT THE CITY LEVEL, MEANWHILE, MAYOR BEAME HAS APPOINTED A TOP FINANCIAL EXECUTIVE TO SERVE AS THE CHIEF FINANCIAL OFFICER OF NEW YORK CITY AND TO DEVELOP, BY MID-OCTOBER, AN EXPENSE REDUCTION PLAN TO RETURN THE CITY TO A SOUND FISCAL BASIS. THESE LAUDABLE EFFORTS REFLECT A RENEWED SENSE OF DEDICATION TO ATTACK THE CAUSES OF THE PROBLEMS I DISCUSSED WITH CONGRESSMAN ROSENTHAL'S SUBCOMMITTEE LAST JUNE.

WILL THESE MEASURES WORK? CAN THE CITY DO ENOUGH BETWEEN NOW AND DECEMBER TO RESTORE INVESTOR CONFIDENCE?



SOME HAVE ANSWERED IN THE NEGATIVE, BUT I CANNOT AGREE. I WOULD BE LESS THAN CANDID WITH THIS COMMITTEE IF I SUGGESTED THE TASK WILL BE EASY. I WOULD BE LESS THAN CANDID IF I FAILED TO SAY THAT MORE IN THE WAY OF IMMEDIATE ACTIONS -- IMMEDIATE EXPENSE REDUCTIONS -- IS REQUIRED NOW THAN WOULD HAVE BEEN REQUIRED AT SOME EARLIER TIME. BUT IT WOULD BE EQUALLY UNTRUTHFUL TO SUGGEST THAT THE JOB CANNOT BE DONE. APPROPRIATE MECHANISMS ARE NOW IN PLACE. IT IS ESSENTIAL THAT THEY BE USED PROMPTLY AND WELL.

IMPACT OF A DEFAULT

NECESSARY CONCEPTS

TO SET THE FRAMEWORK FOR MY ANALYSIS OF THE IMPACT OF DEFAULT IT IS IMPORTANT TO DEFINE SOME RELEVANT TERMS AND CONCEPTS. I SENSE THAT THE DIALOGUE CONCERNING THE ISSUE HAS BEEN HAMPERED BY CONFUSION OVER THE MEANING AND IMPORT OF CERTAIN KEY WORDS. FIRST, THERE IS "INSOLVENCY" WHICH, SIMPLY STATED, MEANS THAT A PERSON OR A CITY HAS CURRENT



OBLIGATIONS WHICH EXCEED ITS AVAILABLE FUNDS. "DEFAULT" IS A TECHNICAL LEGAL TERM DESCRIBING A DEBTOR'S REFUSAL OR INABILITY TO PAY A CREDITOR WHO HAS DEMANDED PAYMENT.

"BANKRUPTCY" DESCRIBES A LEGAL PROCEEDING -- PROVIDED FOR IN THE CONSTITUTION -- UNDER WHICH AN INSOLVENT PARTY IN DEFAULT TURNS OVER TO A COURT THE JOB OF DECIDING HOW HIS FINANCIAL RESOURCES WILL BE APPORTIONED AMONG CREDITORS.

IN LOOKING AT DEFAULT AND BANKRUPTCY, WE SHOULD ALSO DRAW A DISTINCTION BETWEEN THE OPTIONS AVAILABLE IN THE EVENT OF A CORPORATE DEFAULT AND THOSE AVAILABLE WITH RESPECT TO A MUNICIPAL DEFAULT. IF A CORPORATION DEFAULTS AND IS SUBSEQUENTLY BROUGHT UNDER THE JURISDICTION OF A FEDERAL BANKRUPTCY COURT, ONE OPTION -- ALBEIT OFTEN NOT THE MOST DESIRABLE ONE -- IS LIQUIDATION: THE SALE OF ASSETS TO SATISFY



THE CLAIMS OF CREDITORS AND THE SUBSEQUENT DISAPPEARANCE OF THE CORPORATION AS A CONTINUING ENTITY. BOTH COMMON SENSE AND CONSTITUTIONAL PRINCIPLES PRECLUDE SUCH AN OPTION WITH RESPECT TO MUNICIPAL DEFAULTS.

IN THIS RESPECT, A DEFAULT BY A STATE OR LOCAL GOVERNMENT IS CLOSELY ANALOGOUS TO A DEFAULT BY AN INDIVIDUAL PERSON. IN EITHER CASE, IF A BANKRUPTCY PROCEEDING ENSUES, RESOURCES ESSENTIAL TO THE MAINTENANCE OF LIFE IN THE ONE CASE AND ESSENTIAL SERVICES IN THE OTHER, ARE PROTECTED FROM THE DEMANDS OF CREDITORS.

IT IS IMPORTANT TO RE-EMPHASIZE THIS POINT: IF NEW YORK CITY DEFAULTED, IT WOULD CONTINUE TO EXIST AND TO OPERATE. TAX PAYMENTS, FEDERAL AND STATE ASSISTANCE PAYMENTS AND OTHER SOURCES OF REVENUE WOULD CONTINUE TO FLOW. SCHOOLS AND HOSPITALS WOULD REMAIN OPEN; POLICE, FIRE AND SANITATION SERVICES WOULD BE PROVIDED AND PAID



FOR. EVEN DEBT SERVICE ON THE LONG TERM BONDS WOULD APPEAR
TO BE WITHIN THE CITY'S MEANS IN THE EVENT OF DEFAULT.

IN SHORT, IT IS ESSENTIAL NOT TO CONFUSE THE LEGAL
AND IDIOMATIC MEANINGS OF THE TERM BANKRUPTCY. IN COMMON



PARLANCE, WE MAY USE BANKRUPTCY TO DEFINE A CONDITION DEVOID OF SUBSTANCE OR RESOURCES. BY THAT DEFINITION, NEW YORK HAS NOT BEEN, IS NOT NOW, AND WILL NOT BE BANKRUPT.

IF NEW YORK CITY DOES DEFAULT, HOWEVER, TO DEAL WITH ITS CREDITORS IN AN ORDERLY WAY, A PROCEEDING UNDER THE FEDERAL BANKRUPTCY LAWS IS THE MOST APPROPRIATE SOLUTION.

AS I HAVE OFTEN SAID, NO OBSERVER WHO IS ASKED TO PREDICT THE IMPACT OF A DEFAULT CAN DO SO WITH ABSOLUTE CERTITUDE. A DEFAULT LIKE ANY MAJOR FINANCIAL REVERSAL -- HAS TWO ASPECTS: A TANGIBLE, OBJECTIVE ASPECT ON THE ONE HAND AND A PSYCHOLOGICAL ASPECT ON THE OTHER. IT WOULD BE INADEQUATE TO LIMIT THE ANALYSIS TO ONLY ONE OF THESE ASPECTS. AND CONFUSING THE TWO WOULD FURTHER CLOUD OUR EVALUATION OF THE



IMPACT OF DEFAULT. INDEED, I SENSE THAT SUCH CONFUSION IS IN LARGE PART RESPONSIBLE FOR SOME OF THE MORE EXTREME PREDICTIONS WHICH HAVE BEEN MADE IN RECENT WEEKS.

MOREOVER, AS I CAUTIONED IN MY LETTER OF LAST WEEK, IT IS IMPORTANT TO BE SENSITIVE TO THE RISK THAT THE EVALUATION PROCESS ITSELF MAY AGGRAVATE REACTION TO A DEFAULT. LET US SUPPOSE, FOR EXAMPLE, THAT LEADERS OF MAJOR FINANCIAL INSTITUTIONS CONTEND THAT THEIR INSTITUTIONS AND THE MARKETS IN WHICH THEY FUNCTION WOULD BE DEVASTATED BY A DEFAULT. OBJECTIVE FACTORS NOTWITHSTANDING, SUCH CONTENTIONS WOULD MEASURABLY ENHANCE THE IMPACT OF DEFAULT.

LET ME TURN TO A SECTOR-BY-SECTOR ANALYSIS.



ESSENTIAL SERVICES

IF NEW YORK CITY DEFAULTED ON AN OBLIGATION TO REDEEM A MATURING NOTE ISSUE FOR CASH, A QUESTION OF IMMEDIATE IMPORTANCE IS WHETHER THE CITY COULD CONTINUE TO PROVIDE ESSENTIAL SERVICES: POLICE AND FIRE PROTECTION, SANITATION, MASS TRANSIT, WATER AND SEWERAGE FACILITIES, AND THE LIKE. WE EVALUATED THE OUTLAYS REQUIRED TO PROVIDE THESE SERVICES AGAINST THE CITY'S LEVEL OF RECEIPTS. WHILE, AS I HAVE INDICATED ON EARLIER OCCASIONS, LEVELS OF OUTLAY FOR THESE SERVICES ARE EXTREME IN RELATION TO THE OUTLAYS OF OTHER CITIES, NEW YORK CITY'S REVENUES APPEAR SUFFICIENT TO PROVIDE AN ADEQUATE LEVEL OF SERVICES IN THE EVENT OF DEFAULT.



FEDERAL ASSISTANCE PROGRAMS

ANOTHER POTENTIAL CONCERN RELATES TO CONTINUATION OF THE VARIOUS FEDERAL ASSISTANCE PROGRAMS WHICH BENEFIT THE CITIZENS OF NEW YORK. THE OFFICE OF MANAGEMENT AND BUDGET AND THE DOMESTIC COUNCIL HAVE COMPLETED A SURVEY OF THE MOST IMPORTANT OF THESE PROGRAMS WITH THE OBJECTIVE OF IDENTIFYING METHODS FOR MAINTAINING SCHEDULED ASSISTANCE FLOWS IN THE EVENT LOCAL MECHANISMS TEMPORARILY BECOME UNAVAILABLE. IT IS OUR BELIEF THAT A DEFAULT WOULD NOT MATERIALLY INTERFERE WITH THE PROVISION OF CURRENT ASSISTANCE.

AT THE SAME TIME, THE ADMINISTRATION IS CONDUCTING A REVIEW OF THE ASSISTANCE PROGRAMS WITH THE OBJECTIVE OF MAKING THEM MORE EFFICIENT AND LESS BURDENSOME AT THE



LOCAL AS WELL AS THE FEDERAL LEVEL. I HAVE FREQUENTLY
CRITICIZED THE WELFARE PROGRAMS. THEY ARE TOO EXPENSIVE
AND OFTEN MISS THE TARGET INsofar AS HELP TO THE TRULY
DISADVANTAGED IS CONCERNED. THERE IS NO QUESTION THAT
THESE PROGRAMS IN THEIR CURRENT FORM HAVE ADDED TO
NEW YORK CITY'S FINANCIAL BURDEN.

THE PRESIDENT HAS ASKED VICE PRESIDENT ROCKEFELLER,
AS CHAIRMAN OF THE DOMESTIC COUNCIL, TO CONDUCT A THOROUGH
REVIEW OF ALL OUR ASSISTANCE PROGRAMS AND TO DEVELOP
PROPOSALS FOR REFORM. WHILE THAT REVIEW IS NOT YET COMPLETE,
MY VIEWS ARE WELL KNOWN. I HAVE LONG FAVORED A SIMPLE
PROGRAM OF INCOME MAINTENANCE AS THE LEAST BUREAUCRATIC
AND MOST EFFICIENT APPROACH TO OUR RESPONSIBILITIES IN
THIS AREA.



DEBT ADJUSTMENT

THE REQUIREMENT THAT THE CITY CONTINUE TO PROVIDE AND FINANCE ESSENTIAL SERVICES UNDERSCORES THE IMPORTANCE OF INSURING THAT THERE IS AN ORDERLY MECHANISM FOR ALLOCATING THE CITY'S FINANCIAL RESOURCES AND EFFECTING A RESTRUCTURING OF THE SHORT TERM DEBT. ABSENT SUCH A MECHANISM, THERE IS THE RISK OF A MULTITUDE OF LAWSUITS, EACH SEEKING A LEGAL INJUNCTION AGAINST THE PAYMENT OF CITY FUNDS TO ONE CLASS OF CREDITOR OR ANOTHER.

IT IS FOR THIS REASON THAT WE HAVE PREPARED, AND WILL SUBMIT SHORTLY TO CONGRESS, LEGISLATION AMENDING CHAPTER 9 OF THE FEDERAL BANKRUPTCY ACT. THIS LEGISLATION IS DESIGNED TO INSURE THAT THE CLAIMS OF ALL LEGITIMATE CREDITORS WOULD BE DEALT WITH IN A SINGLE PROCEEDING. IT WOULD BE COMPLEMENTARY TO THE LEGISLATION ENACTED BY THE NEW YORK STATE LEGISLATURE AUTHORISING NEW YORK CITY, IN THE EVENT OF DEFAULT, TO SEEK REORGANIZATION OF ITS DEBT UNDER THE PLENARY JURISDICTION OF A FEDERAL COURT.



SPECIFICALLY, OUR PROPOSAL WOULD MODIFY EXISTING LAW BY ELIMINATING THE EXISTING REQUIREMENT THAT A CITY MUST FILE A REORGANIZATION PLAN AND WRITTEN ASSENTS TO THE PLAN FROM 51% OF THE CREDITORS BEFORE OBTAINING THE PROTECTION OF A FEDERAL BANKRUPTCY COURT. UNDER THE REVISED PROCEDURE, FEDERAL PROTECTION WOULD BE PROVIDED UPON THE FILING ONLY OF A SIMPLE PETITION BY THE CITY. AS IS THE CASE WITH RESPECT TO OTHER TYPES OF REORGANIZATIONS UNDER OUR BANKRUPTCY LAWS, THE REORGANIZATION PLAN AND THE CREDITORS' ASSENT THERETO WOULD BE DEVELOPED IN THE COURSE OF THE PROCEEDING. IN THE INTERIM, HOWEVER, THE CITY WOULD BE PROTECTED FROM CONFLICTING CLAIMS AND INJUNCTIONS REGARDING ITS RESOURCES, AND COULD CONTINUE TO CONDUCT ITS AFFAIRS IN AN ORDERLY MANNER.

I WOULD POINT OUT THAT THIS PROPOSAL IS SUBSTANTIALLY CONSISTENT WITH THE RECOMMENDATIONS OF THE NATIONAL COMMISSION ON THE REFORM OF THE BANKRUPTCY LAWS, EMBODIED

IN S. 235.



FINANCIAL MARKETS

IN ASSESSING THE IMPACT OF A DEFAULT ON THE FINANCIAL MARKETS, WE ARE DEALING IN THE REALM OF JUDGMENTS; AS I HAVE SAID ABSOLUTE CERTAINTY IS SIMPLY NOT POSSIBLE. OUR ANALYSIS IS BASED ON A DETAILED REVIEW OF ALL THE FACTUAL CIRCUMSTANCES DISCUSSIONS WITH A WIDE RANGE OF MARKET PROFESSIONALS IN THE PRIVATE SECTOR, AND MY OWN CONCLUSIONS, BASED ON MORE THAN TWENTY YEARS OF EXPERIENCE IN THE INVESTMENT BANKING BUSINESS.

THE IMPACT OF A DEFAULT ON MARKETS OTHER THAN THE MUNICIPAL MARKET IS, IN THE FINAL ANALYSIS, CLOSELY RELATED TO THE IMPACT ON THE OVERALL ECONOMY. AS I SHALL DISCUSS MORE FULLY IN A FEW MOMENTS, IT IS OUR JUDGMENT THAT A DEFAULT WOULD NOT DAMAGE THE PROSPECTS FOR THE NATION'S ECONOMIC RECOVERY. THE PUBLIC UNDERSTANDS THAT NEW YORK CITY'S PROBLEMS ARE UNIQUE IN MOST IMPORTANT RESPECTS. MOREOVER, OVER THE PAST SIX MONTHS AND IN THE MONTHS TO COME, THE PUBLIC HAS HAD, AND



WILL HAVE, AMPLE OPPORTUNITY TO DECIDE WHETHER A DEFAULT BY NEW YORK CITY IS MERELY REPRESENTATIVE OF A MORE FUNDAMENTAL FLAW IN OUR ECONOMY. ONLY IF SUCH A CONCLUSION WERE REACHED AND THERE IS NO OBJECTIVE REASON WHY IT SHOULD BE -- COULD WE EXPECT A SERIOUS AND LASTING ADVERSE IMPACT ON OUR MARKETS.

MUNICIPAL BOND MARKET

OUR CONCLUSIONS WITH RESPECT TO THE MUNICIPAL BOND MARKET ARE AT ONCE MORE PRECISE AND MORE COMPLEX. OVER AT LEAST THE PAST YEAR, THE MUNICIPAL MARKET HAS BEEN UNSETTLED DUE TO A VARIETY OF COMPLEX FACTORS.

FIRST, THE ENORMOUS VOLUME OF TAX-EXEMPT SECURITIES COMING TO MARKET -- MORE THAN \$51 BILLION OF BOND AND NOTES IN 1974 AND MORE THAN \$40 BILLION IN THE FIRST EIGHT MONTHS OF



THIS YEAR ALONE -- HAS NOT BEEN MATCHED BY A CORRESPONDING INCREASE IN DEMAND FOR SUCH SECURITIES. SECOND, INFLATION AND NOW ITS INEVITABLE HANDMAIDEN -- THE ANTICIPATION OF FURTHER INFLATION -- CAUSED BY MASSIVE FEDERAL DEMANDS ON THE MARKET HAS DAMPENED INVESTOR INTEREST IN COMMITTING FUNDS FOR THE LONG TERM. FINALLY, A SERIES OF EVENTS -- THE REPEAL OF THE PORT AUTHORITY COVENANT BY THE LEGISLATURES OF NEW YORK AND NEW JERSEY; THE DEFAULT BY UDC, OCCASIONED BY THE NEW YORK STATE LEGISLATURE'S INITIAL REFUSAL TO CARRY OUT ITS "MORAL OBLIGATION;" AND THE PROBLEMS OF NEW YORK CITY ITSELF -- HAVE ALL SHARPENED INVESTOR AWARENESS OF RISK AND CREATED AN ELEMENT OF DOUBT ABOUT THE WILLINGNESS OF PUBLIC BODIES TO CARRY OUT THEIR FINANCIAL OBLIGATIONS.

TO A SIGNIFICANT EXTENT, THESE DOUBTS HAVE ALREADY LED TO SOME ADJUSTMENTS IN THE MARKET. IN THE EVENT OF DEFAULT,



WE WOULD EXPECT ONLY A TEMPORARY PERIOD OF MODERATE ADJUSTMENT AND OVER A SLIGHTLY LONGER TIME FRAME, WE CAN SEE SOME POTENTIALLY FAVORABLE SIGNS. WE UNDERSTAND THAT NUMEROUS INTERMEDIARIES AND INVESTORS ARE CURRENTLY WITHHOLDING FUNDS FROM THE MUNICIPAL MARKET BECAUSE OF THE CURRENT UNCERTAINTIES. WHEN THE NEW YORK CITY SITUATION IS RESOLVED -- ONE WAY OR ANOTHER -- WE CAN EXPECT A SUBSTANTIAL RETURN OF FUNDS TO THE MARKET, IMPROVING LIQUIDITY AND LOWERING BORROWING COSTS.

BUT THE IMPLICATIONS ARE BROADER THAN SHORT RANGE FUND FLOWS OR PRICE ADJUSTMENTS. SINCE AT LEAST THE BEGINNING OF THIS DECADE, THERE HAS BEEN A MARKED INCREASE IN THE TENDENCY OF INVESTORS TO RESTRICT THEMSELVES TO HIGHER-GRADE INSTRUMENTS. A SHIFT IN QUALITY PREFERENCES TO USE THE TECHNICAL TERM, INFLATION AND ITS BY-PRODUCTS IS THE PRIMARY CAUSE, BUT THERE IS LITTLE QUESTION THAT MAJOR FINANCIAL REVERSALS -- THE PENN CENTRAL DEBACLE, FOR EXAMPLE -- HAVE SERVED AS IMPORTANT CATALYSTS.



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CLEARLY, NEW YORK CITY'S SITUATION HAS CAUSED THIS
TREND TO ACCELERATE. - ISSUERS WHOSE OBLIGATIONS ARE
VIEWED AS LESS THAN PRIME ARE PAYING HIGH RATES OF INTEREST
RELATIVE TO THE GENERAL STRUCTURE OF INTEREST RATES.
CONVERSELY, WELL-RUN ISSUERS ARE BENEFITING IN THE FORM OF
LOWER RATES.

IN SHORT, AS WE MOVE FROM A PERIOD OF UNCERTAINTY,
UNDERLYING CREDIT CHARACTERISTICS -- FINANCIAL SOUNDNESS --
WILL BE THE DOMINANT FACTOR IN THE PRICING OF ALL MUNICIPAL
DEBT. THE RESULT WILL BE A BETTER AND MORE EFFICIENT
MUNICIPAL BOND MARKET.

AT THE SAME TIME, WE CANNOT IGNORE THE WAY IN WHICH
THE MUNICIPAL MARKET HAS PERFORMED EVEN UNDER THESE
SERIOUSLY UNSETTLED CONDITIONS. DURING AUGUST ALONE,
FOUR STATES AND 255 MUNICIPALITIES RAISED NEARLY \$2.6 BILLION
IN LONG TERM DEBT. AND CONTRARY TO WIDELY HELD OPINION,
SUCH FUNDS WERE RAISED AT A COST NOT GROSSLY DISPROPORTIONATE

HISTORICAL LEVEL



TRADITIONALLY, THERE HAS BEEN A 30% SPREAD BETWEEN TAX-EXEMPT AND TAXABLE ISSUES OF COMPARABLE QUALITY. WHEN WE HEAR COMPLAINTS ABOUT THE RECORD RATES MUNICIPALITIES ARE PAYING FOR FUNDS, WE MUST KEEP IN MIND THAT CONDITIONS IN THE CORPORATE MARKET ARE NO BETTER. THIS MONTH, THE SPREAD BETWEEN LONG TERM PRIME MUNICIPALS AND COMPARABLE UTILITY ISSUES WAS SQUARELY ON THE 30% FIGURE.

THIS IS NOT TO SUGGEST THAT THE MUNICIPAL MARKET HAS NOT BEEN IMPACTED BY THE UNCERTAINTY SURROUNDING NEW YORK CITY'S CONDITION. BUT IT DOES PLACE THE REACTION OF THE MARKET IN A MORE ACCURATE PERSPECTIVE THAN SOME OF THE RHETORIC OF RECENT MONTHS.

FINALLY, THE DISRUPTIONS WHICH HAVE OCCURRED IN THE MARKET PLACE CAN PROVIDE AN IMPETUS FOR SOME VERY IMPORTANT REFORMS. ONE REASON OUR CAPITAL MARKETS ARE THE FINEST IN THE WORLD IS THAT, UNDER OUR LAWS AND PROCEDURES, INVESTORS ARE PROVIDED WITH DETAILED AND ACCURATE INFORMATION



CONCERNING POTENTIAL INVESTMENTS. TO THE EXTENT INVESTORS BEGIN TO RECEIVE SUCH INFORMATION FROM TAX-EXEMPT ISSUERS, THE MARKET WILL CLEARLY BENEFIT.

NEW YORK STATE AND ITS AGENCIES

WE HAVE TAKEN A PARTICULARLY CAREFUL LOOK AT THE CREDITS WITHIN NEW YORK STATE TO DETERMINE WHETHER ANY CREDIT WOULD BE ABLE TO WITHSTAND AN INCREASED LEVEL OF SCRUTINY. WE NOW BELIEVE THERE IS LITTLE RISK THAT A DEFAULT BY NEW YORK CITY WOULD DIRECTLY PRECIPITATE A DEFAULT BY NEW YORK STATE.

THERE IS A BASIS FOR MORE CONCERN REGARDING SOME OF THE AGENCIES OF THE STATE, PARTICULARLY THE NEW YORK STATE HOUSING FINANCE AGENCY. IN DIFFERENT TIMES, THE ABILITY OF SUCH AGENCIES TO MEET THEIR OBLIGATIONS WAS TAKEN AS A MATTER OF FAITH. BUT THE INCREASED LEVELS OF SCRUTINY HAVE, WE ARE TOLD, PRODUCED INVESTOR MISGIVINGS CONCERNING CERTAIN ASPECTS OF THE PROGRAMS SPONSORED BY THESE AGENCIES. OUR OWN ANALYSIS OF THE PROGRAMS INDICATES THAT THEIR SHORT-



COMINGS CAN BE CORRECTED BY PROMPT ACTION BY THE STATE.
AND THE EXPENSE OF MAKING THE NECESSARY CORRECTIONS, WHILE
MEANINGFUL, IS SMALL IN RELATION TO THE FINANCIAL BURDEN
ON THE STATE IF IT WERE REQUIRED TO AVERT DEFAULT BY
CARRYING OUT ITS MORAL OBLIGATION PLEDGE.

IN OTHER WORDS, IT IS IMPORTANT THAT ACTION BE TAKEN,
AND TAKEN QUICKLY. HOPEFULLY, THE TOO LITTLE, TOO LATE
SYNDROME WHICH FOR MONTHS CHARACTERIZED THE RESPONSE OF
OFFICIALS TO NEW YORK CITY'S PROBLEMS WILL NOT APPLY TO
THE FUNDAMENTALLY DIFFERENT SITUATION CONFRONTING THE
STATE AGENCIES.



LET ME BE CLEAR. NEW YORK CITY'S DIFFICULTIES DID NOT CAUSE THESE PROBLEMS FOR THE AGENCIES OF NEW YORK STATE. AND A RESOLUTION OF NEW YORK CITY'S PROBLEMS WILL NOT MAKE THEM GO AWAY. FOR THE STATE, AND INDEED ALL ISSUERS OF TAX-EXEMPTS, INCREASED SCRUTINY OF CREDIT IS NOW A FACT OF LIFE IN THE MUNICIPAL MARKET, AND FISCAL SOUNDNESS IS NOW A CONDITION OF ENTRY.

IMPACT ON THE BANKING SYSTEM

AS THE COMMITTEE IS AWARE, THE TREASURY DEPARTMENT, IN CONJUNCTION WITH THE COMPTROLLER OF THE CURRENCY, THE FEDERAL RESERVE BOARD AND THE FDIC, HAS TAKEN A CLOSE LOOK AT THE HOLDINGS OF NEW YORK CITY SECURITIES IN OUR BANKING SYSTEM. WHILE SIGNIFICANT AMOUNTS OF NEW YORK CITY'S DEBT IS HELD BY COMMERCIAL BANKS, WE DO NOT BELIEVE A DEFAULT WOULD HAVE A MATERIAL IMPACT ON THE BANKING SYSTEM.



BUT AS IS THE CASE IN OTHER AREAS, WE HAVE FELT AN OBLIGATION TO DEVELOP MECHANISMS TO MINIMIZE ALL RISKS, HOWEVER, SMALL. ACCORDINGLY, WITH RESPECT TO ANY BANK WHICH MAY BE IMPACTED, VARIOUS MECHANISMS ARE NOW AVAILABLE TO INSURE THAT NONE WILL FAIL AS A RESULT OF A DECLINE IN THE VALUE OF THEIR HOLDINGS OF NEW YORK CITY OBLIGATIONS. BANK CUSTOMERS HAVE NO NEED TO FEAR FOR THEIR FUNDS.

1. WHERE POSSIBLE, BANK DIRECTORS WILL BE REQUIRED TO CONTRIBUTE ADDITIONAL CAPITAL.
2. CERTAIN BANKS MAY BE SOLD TO, OR MERGED WITH, OTHER BANKS OR BANK HOLDING COMPANIES.
3. AS A LAST RESORT, IN APPROPRIATE CASES, THE FDIC MAY PROVIDE CAPITAL IN THE FORM OF CONVERTIBLE



SUBORDINATED DEBT, AT THE SAME TIME IMPOSING
APPROPRIATE SANCTIONS ON THE BANK OFFICIALS DIRECTLY
AND INDIRECTLY RESPONSIBLE FOR THE BANK'S EXPOSURE.

OVERALL ECONOMIC IMPACT

As I suggested earlier, we cannot conclude that a
default by New York City would result in a broad-based decline
in consumer or investor confidence or in the adoption of
unnecessarily restrictive lending policies by financial
institutions. The American people know the reasons New York
City is having financial difficulties and they know that
there is little, if any, direct relationship between these
difficulties and the condition of the national economy.
New York City is facing a possible default because for
years it has spent far more than it takes in. New York City
is facing a possible default because, until recently,



IT HAS NOT SHOWN ITSELF WILLING TO IMPLEMENT THE NECESSARY REFORM MEASURES REQUIRED TO RESTORE CONFIDENCE AND REGAIN ACCESS TO THE CAPITAL MARKETS. NO CHANGE IN THE NATIONAL ECONOMIC PICTURE WILL MEASURABLY IMPROVE CONDITIONS IN NEW YORK. AND BY THE SAME TOKEN, NO CHANGE IN NEW YORK'S CONDITION WILL MATERIALLY INFLUENCE THE ECONOMY AS A WHOLE.

FEDERAL FINANCIAL ASSISTANCE

THE ONLY EVENT WHICH COULD MODIFY THIS CONCLUSION WOULD BE THE PROVISION OF FEDERAL FINANCIAL ASSISTANCE TO AVERT A DEFAULT. INDEED, SUCH ASSISTANCE -- BE IT IN THE FORM OF A GUARANTEE OR A LOAN, INSURANCE OR A GRANT -- WOULD, IN MY VIEW, ONLY THREATEN THE PROCESS OF RECOVERY.

AS THE CHIEF FINANCIAL OFFICER OF THIS GREAT COUNTRY I HAVE A RESPONSIBILITY TO ALL THE PEOPLE, NOT SIMPLY TO PARTICULAR GROUPS OR SECTORS AT PARTICULAR TIMES. MY JOB, IN ESSENCE, IS TO PROTECT AND RESTORE THE ERODING



FISCAL AND FINANCIAL INTEGRITY OF THE UNITED STATES FOR THE BENEFIT OF EVERY CITIZEN. TO STATE MY VIEWS ON SPECIAL FINANCIAL ASSISTANCE FOR NEW YORK CITY MOST DIRECTLY: I WOULD BE IGNORING THIS FUNDAMENTAL RESPONSIBILITY IF I WERE TO SUPPORT SUCH ASSISTANCE.

FOR YEARS, GOVERNMENT AT ALL LEVELS HAS BEEN PROMISED MORE THAN IT CAN DELIVER. THIS IS THE CAUSE OF NEW YORK CITY'S PROBLEM AND IT IS THE CAUSE OF OUR SEVERE PROBLEMS AT THE FEDERAL LEVEL AS WELL. MORE AND LARGER DEFICITS AND THE INCREASED LEVEL OF FEDERAL BORROWING REQUIRED TO FINANCE THESE DEFICITS HAVE COMBINED TO THREATEN OUR ECONOMIC SYSTEM WITH FUNDAMENTAL CHANGE: NO LONGER CAN WE BE CONFIDENT THAT OUR PRIVATE SECTOR WILL HAVE ACCESS TO THE CAPITAL REQUIRED IF IT IS TO MEET THE NEEDS OF ALL OUR CITIZENS. YET SOME WOULD HAVE US ACCELERATE THESE CHANGES TO DEAL WITH THE CONSEQUENCES OF FISCAL IRRESPONSIBILITY AT THE LOCAL LEVEL.



ANY FORM OF FINANCIAL ASSISTANCE WOULD DIRECTLY INCREASE THE BURDEN THE FEDERAL GOVERNMENT IMPOSES ON THE CAPITAL MARKETS. WHO WOULD SUFFER? ALL BORROWERS, INCLUDING EVERY OTHER STATE AND LOCAL GOVERNMENT, WOULD PAY HIGHER INTEREST RATES. AND CERTAIN SECTORS -- HOUSING, SMALL AND MEDIUM-SIZED COMPANIES, FOR EXAMPLE -- COULD DISCOVER THAT FUNDS WERE NOT AVAILABLE AT ANY PRICE.

MOREOVER, WE DO NOT ESCAPE THESE PROBLEMS BY MAKING THE ASSISTANCE SLIGHTLY LESS DIRECT; BY PROVIDING A GUARANTEE OR INSURANCE FOR MUNICIPAL DEBT. INDEED, SUCH A PROGRAM WOULD CREATE A SECURITY SUPERIOR TO THOSE OF THE FEDERAL GOVERNMENT ITSELF: BACKED BY THE FULL FAITH AND CREDIT OF THE UNITED STATES AND EXEMPT FROM FEDERAL TAXES. THE IMPACT ON ANY MUNICIPAL ISSUER WHICH DID NOT HAVE A GUARANTEE WOULD BE DIRECT AND SEVERE: THE GUARANTEED BONDS WOULD SKIM THE CREAM OF THE MARKET AND ALL OTHER ISSUERS WOULD PAY SUBSTANTIALLY HIGHER RATES.



AND WHAT WOULD SUCH A PROGRAM DO TO FISCAL POLICIES AT THE LOCAL LEVEL? TODAY, THE DESIRE TO MAINTAIN ACCESS TO CREDIT AT THE LOWEST POSSIBLE RATE IS THE MOST IMPORTANT INCENTIVE FOR FISCAL RESTRAINT. A FEDERAL GUARANTEE PROGRAM WOULD PROVIDE ALL PARTICIPANTS WITH THE CREDIT OF THE UNITED STATES: THIS CRITICAL RESTRAINT ON SPENDING WOULD BE LOST ENTIRELY.

BUT, SOME WILL ASK, WHY NOT HAVE THE FEDERAL GOVERNMENT IMPOSE THESE RESTRAINTS AS A CONDITION FOR THE GUARANTEE? THAT POSSIBILITY CONCERNS ME MORE PERHAPS THAN ANYTHING ELSE. WE WOULD HAVE TO CREATE A NEW BUREAUCRACY, SIMPLY TO CONCOCT AND ENFORCE THE GUIDELINES AS TO LOCAL PRIORITIES WE HERE IN WASHINGTON WOULD BE IMPOSING ON THE GOVERNMENTS OF THE NATION. WE WOULD BE CONFRONTED WITH THE SORRY SPECTACLE OF DULY-ELECTED LOCAL OFFICIALS LINING UP OUTSIDE MY DOOR, ATTEMPTING TO PERSUADE ME THAT THEY WERE CARRYING OUT THEIR RESPONSIBILITIES IN A SATISFACTORY FASHION. WE WOULD, IN SHORT, BE CONTRAVENTING CONSTITUTIONALLY -- IMPOSED PRINCIPLES



OF FEDERALISM; PRINCIPLES WHICH LIE AT THE HEART OF THE
STRUCTURE OF GOVERNMENT IN THIS NATION.

THOUSANDS, PERHAPS TENS OF THOUSANDS, OF GOVERNMENTS
WOULD RESIST THIS INTRUSION INTO LOCAL AFFAIRS. AND
THEY WOULD BE ABSOLUTELY RIGHT. BUT IN THE FINAL ANALYSIS,
THEIR CHOICE WOULD BE A HOBSON'S CHOICE: SUBMIT TO FEDERAL
CONTROL OR PAY THE PRICE OF INDEPENDENCE IN THE BOND MARKETS.
ARE WE REALLY PREPARED TO INFLICT THIS CHOICE ON THE NATION?

FINALLY, THERE ARE THOSE WHO SAY THAT NEW YORK CITY
IS A SPECIAL CASE; THAT HELPING NEW YORK WILL NOT OBLIGATE
US TO HELP OTHER CITIES IN THE FUTURE. BUT WE ARE ALREADY
OBLIGATED. WE ARE OBLIGATED TO LOCAL OFFICIALS THROUGHOUT
THE COUNTRY WHO HAVE RISKED THEIR CAREERS BY INSISTING ON
FISCAL RESTRAINT. WOULD FINANCING THE *deficits of* ~~MOST PROFLIGATE~~ OF
New York City
~~OUR CITIES~~ BE CONSISTENT WITH OUR OBLIGATION TO THEM?

AND CAN WE REALLY DRAW THE LINE AT NEW YORK CITY?

I DOUBT IT. ASSISTANCE TO ONE CITY WOULD CREATE AN INTOLERABLE
PRECEDENT FOR THE FUTURE.



BEFORE CONCLUDING, I MUST RETURN ONCE AGAIN TO AN IMPORTANT POINT. AS STRONG AS OUR ECONOMY AND OUR FINANCIAL SYSTEM MAY BE, IT REMAINS SOMEWHAT VULNERABLE TO ATTACKS FROM WITHIN. TO THOSE WHO CONTINUE TO INSIST THAT A DEFAULT BY NEW YORK CITY WOULD DEVASTATE THIS GREAT NATION, I SIMPLY ASK: PROVIDE SOME OBJECTIVE BASIS FOR YOUR FEARS AND, IF YOU CANNOT, PLEASE REMAIN SILENT. WE IN THE ADMINISTRATION HAVE DONE ALL WE CAN TO EVALUATE THE RISKS A DEFAULT PRESENTS AND, WHERE POSSIBLE, TO PROVIDE MECHANISMS TO MINIMIZE THOSE RISKS. BUT IF I MAY BORROW A THOUGHT FROM JUSTICE HOLMES, THE MOST ELABORATE FIRE PROTECTION SYSTEM IN THE WORLD MAY NOT PROTECT THEATERGOERS FROM THE MAN WHO CRIES "FIRE."

MR. CHAIRMAN, FISCAL RESTRAINT IS NOT AN EASY TASK FOR ANY ECONOMIC UNIT IN OUR SOCIETY -- A PERSON, A CORPORATION, A PARTNERSHIP, A CITY. I DO NOT WANT TO DEVIATE FROM THE SUBJECT AT HAND, BUT I MUST POINT OUT THAT EVEN WE AS A NATION ARE NOT IMMUNE. ONLY OUR PRINTING PRESS ALLOWS US A



GREATER OPPORTUNITY FOR POSTPONEMENT, WHILE WE DAILY RISK MORTGAGING AWAY THE FINANCIAL HEALTH AND PROSPERITY OF FUTURE GENERATIONS.

BUT OUR ECONOMY -- HOWEVER WEAKENED BY EXCESSES AT THE FEDERAL LEVEL -- REMAINS ABLE TO WITHSTAND EVEN THE MOST SEVERE SHOCKS. I DO NOT WISH A DEFAULT UPON NEW YORK CITY. I DO NOT BELIEVE IT HAS TO DEFAULT AND I EXPECT IT TO TAKE THE MEASURES NECESSARY TO AVOID SUCH AN EVENT. BUT IF IT DOES DEFAULT, THE ECONOMY OF THIS NATION AND ITS FINANCIAL SYSTEM WILL SURVIVE, WITH ENOUGH STRENGTH NOT ONLY TO REPAIR THE DAMAGE, BUT ALSO TO START OUR GREATEST CITY ALONG THE ROAD TO RECOVERY.

