Department of the ***TREASURY*** **NEWS**

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STATEMENT OF THE HONORABLE W. MICHAEL BLUMENTHAL
SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear before you to report on New York City's fiscal condition. My testimony will cover three basic topics. Initially, I will review City budget and financing trends since the 1975 enactment of the Seasonal Financing Act. In particular, my remarks will address New York's recent unsuccessful effort to reenter the public note market. Next, I will describe the City's current fiscal status. My testimony will conclude by addressing the City's uncertain financing outlook and those steps which must be taken to improve it.

To begin, let me observe that many in Washington and elsewhere have the impression that the New York City fiscal situation has not changed at all since the 1975 near bankruptcy. That impression is not correct. Much fiscal progress has been made during the past two and a half years. I would like to summarize that progress, at the outset, to provide a better perspective for my later discussion of the current situation and further outlook.

Review of the 1975-1977 Period

First, I think it is instructive to recall the circumstances prevailing when Congress enacted the 1975 legislation to authorize federal seasonal financing for the City.

New York then was incurring a deficit of $968 million annually in its operating budget. Moreover, another $800 million in operating expenses was carried in its capital budget. The real deficit in fiscal 1976, therefore, approximated $1.8 billion. In addition, the City's accounting and financial record keeping systems were in disarray.

Faced with the spectre of bankruptcy, New York began to take large and painful steps to reduce expenses. It also initiated serious efforts to modernize its accounting and financial information systems. Let me mention a few of these difficult, but important steps.

- The City reduced its work force substantially. The current level of City employment involves 60,000 fewer jobs than the early 1975 level. Overall employment there, today, is 300,000.

- It also negotiated a two and a half year wage freeze, ending during the March-June period next year.

- The nearly $1 billion deficit in its operating budget has been eliminated. During this fiscal year, that operating budget is balanced as defined under existing State law.

- More than $4 billion of short-term notes, which were outstanding in mid-1975, has been converted into long term MAC bonds.

- For the first time, tuition payments have been initiated at City college, covering all students.

- The City has implemented a $16 million management information and expense control system (IFMS). It provides sharply improved financial controls which combine, in a common data base, the major budgeting and accounting functions.

Mr. Chairman, these steps illustrate that New York has made major progress to improve its fiscal condition. Indeed every step that it pledged to take, in discussions before Congress in 1975, has been taken.

The Seasonal Loan Program

Let me turn now to a review of the Seasonal loan program itself. The City has complied with all provisions of the legislation.

During City fiscal 1976, $1.26 billion was borrowed and repaid with interest, on time or ahead of schedule. In fiscal 1977, the City borrowed $2.1 billion and repaid it with interest, again on time or ahead of schedule.

Last spring, the City presented us with a 1978 Financial Plan which included a $14 billion budget and $2 billion in seasonal borrowing. I said before this Committee in May that Treasury would only begin this final year of the loan program if we were convinced that the City's budget was balanced (as defined under State law) and that, relative to the first loan request, there was "a reasonable prospect of repayment."

During June, we evaluated that budget and the related cash flow outlook, with the help of our consultants -- Arthur Andersen & Co. I assure you that it was a careful evaluation. We concluded that the proposed budget would result in balance and that seasonal loans made in July could be repaid. Accordingly, on July 5, we provided a $300 million loan, the first during this current City fiscal year.

In recent months, Treasury has extended an additional $1.325 billion in seasonal loans after determining, in each case, that a reasonable prospect of repayment existed. All loans mature during April, May and June of 1978 and are fully collateralized by State aid payments to the City. We continue to believe that all of these loans will be repaid on time or ahead of schedule.

The City has borrowed or expects to borrow an additional $400 million this month, on the same basis. This will represent the final loan this year, barring unforeseen circumstances. Such borrowing will raise total loans to the City during this fiscal year to $2.03 billion.

Let me highlight one aspect of this year's program which differs from its first two years. This year, our Credit Agreement requires the City to make every effort to borrow in the public markets before submitting a loan request to Treasury. Specifically, Section 6.11 of that Agreement requires that the City "certify" in writing to us exactly what steps it took to borrow from conventional sources. As I also said to you in May, we have taken this "certification" requirement literally all year. We have scrutinized each proposed loan request to satisfy ourselves that the City actually could not borrow elsewhere. The steps the City has taken to fulfill this requirement have satisfied us, in each instance, that a "best effort" was made.

Since its inception the New York City loan program has not cost the U.S. taxpayer anything. Under the law, Treasury is required to charge the City one percent more than the rate on outstanding government obligations of comparable maturity. As a result, the program will yield a net surplus of approximately $12 million this year. As you know, this amount will be returned to Treasury's general fund.

Recently Aborted Public Note Offering

I would like to discuss now, Mr. Chairman, the specific circumstances surrounding the City's recent effort to re-enter the short-term market. A minute ago, I described our Credit Agreement requirement that New York make every effort to borrow on its own this year. In keeping with that requirement, we have been insisting all year long that the City remove all obstacles, within its control, to re-enter this market. Accordingly, City officials worked diligently for several months to prepare for a public offering of short-term notes.

It is worthwhile to review here what that effort entailed.

- -- Virtually, all of the $1.8 billion of so-called "moratorium notes", held both by the public and financial institutions, have been retired. These were short-term notes, on which principal payments had been unilaterally deferred by the City.

Retirement of this enormous amount of notes, through both cash payments of principal and exchanges of MAC bonds, removed a key obstacle to re-entering the markets. Had these notes not been retired, those financial institutions holding these "defaulted" notes would have been understandably reluctant to buy new ones from the same issuer.

-- This accomplished, the City turned to structuring the note itself in a way which, under the circumstances, would offer appropriate collateral to investors. As this Committee knows, State legislation was necessary to allow the City to segregate revenues to appropriately secure these new notes. The Governor cooperated and called a special session of the State legislature, which quickly enacted the necessary legislation.

-- The City engaged Merrill Lynch and First Boston, two of the nation's leading investment banking firms, to serve as managing underwriters for the offering. Their legal counsel worked with the City's counsel to prepare the massive disclosure document (prospectus) necessary for this first offering since 1975.

These efforts consumed the July through October period, and the City completed its preparation for this offering during the first week in November. The underwriters' intention was to sell $200-450 million of notes. The only remaining step was to obtain a sufficient credit rating from Moody's Investors Service, Inc., a recognized rating agency for municipal securities.

Unfortunately, as you know, Moody's surprised and disappointed City officials and the financial community by assigning its lowest rating -- MIG-4 -- to the proposed notes. In light of the strong collateral arrangements, the managing underwriters and the overall financial community had expected a higher rating. When the MIG-4 rating was received, they concluded that an underwriting was not possible.

One day later, a group of underwriters offered to try selling some City notes on an unorthodox basis involving no underwriting commitment. In their view, however, there was no certainty that any meaningful amount could be sold. The City Comptroller concluded that this approach involved a high risk of complete failure -- in a way which would delay even further the City's eventual return to the short-term market. We checked carefully with various municipal bond experts, who concurred in his judgment. Accordingly, we did not try to influence the City to accept this approach.

Naturally, Mr. Chairman, we were disappointed by the failure of this effort to re-enter the short-term market. My staff worked extensively with the City officials to make an offering possible and to clear the obstacles encountered along the way. But the outcome demonstrates conclusively that there is no market, at the moment, for City notes. Yet, New York came very close to a modest re-entry and that is cause for some encouragement. As I will discuss later, we think that prospects are reasonably good for achieving such re-entry during fiscal 1978.

The Recent SEC Staff Report

As you requested, let me also mention the recent SEC staff report on the City's security transactions during the October 1974 - March 1975 period.

We have reviewed the report, but have not undertaken our own investigation of these events. We have neither the staff nor the Congressional mandate to do so. I am not prepared, therefore, to comment on any of the specific allegations in the report.

I will say, however, that this report covers events of nearly three years ago and should be viewed in that context. No one, least of all Treasury, would argue that the City's financial and accounting practices were acceptable then. It is fair to say, however, that these practices have improved significantly during the intervening years. In addition, this SEC report is not a major factor preventing the City from regaining access to the credit markets today.

New York City's Current Fiscal Condition

I would like to discuss now the City's current budget and cash flow condition. This year's operating budget is balanced, as defined by the emergency State legislation of 1975. Operating revenues have materialized as expected and operating expenditures have been consistent with the City's projections.

Despite achieving this "defined balance", however, New York City's budget outlook remains uncertain. The City's projections for next year, fiscal 1979, indicate a "potential gap" in the operating budget of $249 million. Moreover, this estimate does not include any increases in salaries for City employees, whose contracts will be negotiated this spring. These projections concern us, and, I'm sure, concern this Committee.

The City faced a similar "gap" this year, and closed it through legitimate budget measures. City officials again assert that next year's potential gap also will be closed; indeed, it must be closed under State law. The unfortunate problem is that city revenues are growing more slowly than its expenditures so that there will be a potential gap of similar proportions in each of the next several fiscal years.

Closing this $249 million "potential gap" in next year's operating budget will not be easy. Nevertheless, as I will describe later, it must be done. The overall budget balancing task is, moreover, much larger than this potential gap. The latter, after all, assumes a phase-out of the $600 million of operating expenses in the capital budget over an unduly long eight year period. That phase-out period must be shortened.

Turning to the present financing situation, Mr. Chairman, it is even more uncertain. Currently, New York borrows $3 billion annually -- $2 billion on a seasonal basis and approximately $1 billion on a long-term basis.

Yet, the City's two sources of borrowing are each scheduled to terminate next June 30. The Seasonal Financing Act has provided the short-term financing, of course, but it will expire then. Moreover, the City retirement systems, which have supplied long-term loans since 1975, will have completed their commitment to finance the capital budget by that same date. In addition, beyond June 30, their tax-exempt status could be endangered by increasing their total loans to New York -- although reinvestments of maturing principal should be considered.

The likelihood that New York will return to the public markets, beginning July 1, for the full amount of its short and long term needs, is poor. There simply is no market for the public sale of either type of security today, as evidenced by the recent failure to sell a modest amount of short-term notes. This is particularly unfortunate because the City has done everything it originally pledged to do.

Let me say, however, that this delay in New York's full return to the credit markets is not without parallel in modern finance. An analysis of the years immediately following near-bankruptcy by large corporate enterprises, for example, indicates that they generally could not return to the public markets for a number of years. Despite selling or closing large numbers of facilities, which New York obviously cannot duplicate, these enterprises generally needed several years to rebuild the confidence of public lenders in their creditworthiness.

Steps Which Must Be Taken

Let me conclude today, Mr. Chairman, by discussing a series of steps which we think that the City and State must take in order to improve this financing outlook. I met recently with Governor Carey, Mayor Beame, Mayor-Elect Koch and Comptroller Goldin to discuss this matter, and asked that comprehensive budget and financing plans covering the next three years or four years be developed immediately. I advised them that these plans must include a series of major actions to remove the continuing obstacles to returning New York to fully independent borrowing status.

I would like to discuss our views as to the required elements of each plan. First, the budget plan's objective must be to achieve a condition of truly recurring budget balance. Essentially, this means that the operating expenses must be phased out of the capital budget over the plan period.

In addition, the City must close the "potential gap" of $249 million or more which underlies its current operating budget.

This budget plan should specify those actions which the City will take, and which the State will take, to finally eliminate this overall deficit. The plan may assume continuation of certain federal fiscal assistance but the principal actions must be local ones.

Second, all of us here also need a plan for financing the City over this interim period -- one which will "lead" it back fully into the markets at the end of the period. The City already has asked Congress to extend federal lending, and I realize that their plan, whatever form it

finally takes, will involve a role for Treasury. Nevertheless, most of New York's overall borrowing needs should be satisfied locally, and the plan must be convincing in that respect.

It seems to me that one objective of this financing plan should be to reduce the total borrowing need itself. The current need -- $3 billion annually -- may be too large for markets to absorb from a single city, even a more solid one. We think that there may be methods of reducing both the seasonal and the long term borrowing needs, and we await the City's proposal.

We further believe, Mr. Chairman, that the municipal unions and the local financial community, primarily the clearinghouse banks, should be integral elements in both plans. These plans only can work if these private parties provide strong support.

Regarding the unions, they have already made substantial sacrifices to maintain New York's solvency during the past two and a half years. They have both participated in a wage freeze and have financed the capital budget. Their role has been remarkable. Nevertheless, the City cannot regain fiscal stability unless they continue their exemplary record of wage restraint.

Concerning the banks, they also have bolstered the City's finances since mid-1975. They have facilitated several refinancings of City and MAC debt, and have helped underwrite new issues of MAC bonds. Their continued, and perhaps intensified, support also is needed if these plans are to work. We hope that they will begin to again participate in sales of the City's own securities.

One key element in these plans, Mr. Chairman, must be the continuation of a strong and independent budget review mechanism. Such a board is necessary to assure that City budgets remain in balance during the plan period. More importantly, however, it is needed to rebuild the confidence of long-term lenders that budgets will be balanced over many years. It is incumbent on City and State officials, therefore, to reach agreement on a mechanism which will succeed the expiring Emergency Financial Control Board. Determining this successor mechanism could involve, of course, simply extending this present Board. We hope they will reach agreement soon, however, because any proposed legislation to extend federal lending must address this issue.

We want to emphasize once again, Mr. Chairman, that New York City should remain primarily the responsibility of New York State. While the Federal government has supported the City in many crucial ways during this difficult period, we should not allow the City to become a ward of the Federal government. President Carter has stated on many occasions that cities, first and foremost, are political subdivisions of states. We thus encourage Governor Carey and the New York State Legislature to review the State's capacity to provide additional direct financial assistance to the City. In addition, we suggest that the State carefully examine ways to borrow an increased portion of the City's annual short-term financing requirements. Only through the combined commitment and support of the State and City can a workable budget and financing plan be developed.

Let me close by stating that the Administration is studying the City fiscal situation very closely. The President is firmly committed to maintaining New York's solvency. The

recommendations on legislation which we make to this Committee early next year, Mr. Chairman, will reflect both that specific pledge and our overall commitment to restoring an economically healthier and financially independent New York.