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CHAOS IN THE MUNICIPAL BOND MARKET

HEARING

BEFORE THE

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CONTENTS

WITNESSES AND STATEMENTS

MONDAY, SEPTEMBER 28, 1981

SUBMISSIONS FOR THE RECORD

MONDAY, SEPTEMBER 28, 1981

CHAOS IN THE MUNICIPAL BOND MARKET

MONDAY, SEPTEMBER 28, 1981

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee) presiding.

Present: Representatives Reuss and Wylie.

Also present: James K. Galbraith, executive director; and William R. Buechner, Chris Frenze, and Paul B. Manchester, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, CHAIRMAN

Representative REUSS. Good morning. The Joint Economic Committee will be in order for its inquiry into the status of the municipal bond markets.

Earlier this year the administration was assuring the Congress that interest rates would begin to decline as soon as Congress enacted the President's program and that the Nation would see a government serious about reducing inflation and as inflationary expectations declined, so would interest rates.

Congress did precisely what the President asked and now look at what we've gotten—unconscionably high interest rates, with new records being set; 18-percent-mortgage rates that have brought the housing market to a standstill; the municipal bond market in chaos with some cities paying over 14 percent on tax-exempts; and small businesses being driven to the wall by bank loans carrying an interest rate of 20 to 22 percent.

With interest rates still grotesquely high, with the stock and bond markets in shambles, and with the projected budget deficit ever-widening, confidence in the President's program is disappearing.

In the municipal bond market, first, the President's program cut $13 billion in various forms of Federal assistance to State and local government. Second, the liberalized depreciation allowances for businesses will knock out another $2 billion of State and local revenues because many States tie their tax codes to the Federal code. Third, the ill-conceived all-savers certificates will pile a further burden on State and local governments by siphoning away investors who are attracted by tax-exempt returns, adding as much as $1 billion to the borrowing costs of the municipalities next year. Finally, the damage done by the spending and tax provisions of the President's program is being reinforced by the administration's high interest rate policies.

This morning the Joint Economic Committee will discuss the municipal bond market with three experts in the field: Peter Trent, chairman of the Public Securities Association; Mr. Roger Altman, managing director for Lehman Bros. Kuhn Loeb, Inc.; and John Petersen of the Municipal Finance Officers Association.

Gentlemen, we appreciate your coming here to help us. Each of you has prepared a comprehensive statement and under the rule those will be received in full in the record without objection.

Also the opening statement of Congressman Rousselot will be received in the record.

[The opening statement of Hon. John H. Rousselot follows:]

Opening Statement of Representative Rousselot

Mr. Chairman, high interest rates depress bond prices. Restortion of a stable currency and reductions in the Federal debt will ease pressures on high interest rates.

The double-digit inflation of calender year 1979 and 1980 has inspired investors to look for higher returns. In order to sell Federal debt, the Treasury Department offers high-yield debt instruments discounting the present value of fixed-return bonds.

The Federal Government is reponsible for providing stable currency, balanced budgets, and a fair return on investment after taxation.

Mr. Chairman, enactment of the $16 billion budget recissions proposed by President Reagan for fiscal year 1982 will reduce the Federal deficit, provide more capital for private development, and, placing downward pressure on interest rates, enable long-term debt instruments to retain their value.

Representative Reuss. We now would like to ask you to proceed in any way you want, restricting your presentation to approximately 10 minutes. Mr. Altman, would you lead off?

STATEMENT OF ROGER C. ALTMAN, MANAGING DIRECTOR, LEHMAN BROS. KUHN LOEB, INC.

Mr. Altman. Thank you, Mr. Chairman. With your permission, I'd like my prepared statement inserted in full into the record and I will simply summarize it here.

Mr. Chairman, the committee's attention to the subject could not be more timely because, as you said in your opening comments, the credit markets—all of the municipal, taxable, and other—have been in a state of unprecedented decline in recent months and in recent weeks and in fact this morning in most sectors of the markets interest rates are touching their alltime highs, at least since the post-war period.

Indeed, a long-term borrowing by the U.S. Treasury today, which is the strongest borrower in the world, would require approximately 15.5 percent interest rate which I think is a level I think all of us would agree we would have considered inconceivable until very recently.

Representative Reuss. What term was that borrowing?

Mr. Altman. Well, the Treasury is going to sell this week $1.7 billion of 20-year bonds.

Mr. Chairman, you have asked me to particularly address the presently depressed state of the municipal market, yet many of the factors responsible for that market's difficulties—and of course, they have been severely difficult—are the same factors responsible for the difficulties throughout the credit markets. So I would like to begin by just ticking off two factors which are affecting the markets as a whole and to stress that the municipal market cannot be looked at separately from the others because the broad factors which are responsible for its problems are the same as those responsible for problems throughout the credit market and I would argue, as you will see, that those broader factors substantially outweigh the narrower ones specific to the municipal market—outweigh in terms of their influence.

First of all, as you mentioned at the outset, interest rates have been rising not just for the past few months but as the first appendix to my prepared statement indicates rising more or less steadily for the past 5 years, and I think there's little doubt that the central reason, although there are many, behind that rise has been the rising inflation.

Mr. Chairman, the Joint Economic Committee has received enormous amounts of testimony on that subject and I'm not going to go into it in any detail except to stress that numerous studies have shown really beyond much doubt that there's a close and positive correlation between levels of inflation and levels of interest rates, and it makes common sense because as the St. Louis Federal Reserve Bank particularly has shown lenders, whether it's the general public or a bank or any other lender, in pricing loans calculate an anticipated real return to themselves, a profit, after deducting the anticipated effect of inflation. And so anticipated inflation trends is the single most in-influential factor on current interest rates.

Now one might ask why interest rates have risen sharply in recent months while inflation has admittedly abated somewhat and at first glance that strikes a lot of people as surprising and contradictory, but let me offer one or two comments about it.

First of all, participants in the markets are clearly expecting inflation to begin to rise again. As I mentioned, it's expectations of future trends rather than today's actual statistics which influence interest rates because, of course, bonds pay interest in the future. Mr. Chairman, that expectation of rising inflation, while not shared in all quarters, is quite widespread in the markets and it reflects the judgment, which I myself share, that the recent sharp changes in the fiscal policy of this country are more likely to promote inflation than to reduce it, and my testimony goes into a series of arguments as to why I believe that to be the case.

But essentially we have embarked on a policy of fiscal stimulus, Mr. Chairman, and have done so at a time while our economy, while not as robust as we would like, nonetheless, is relatively resiliant. It's not sinking like a stone and the effect of that new stimulus are likely to be upward pressure on final prices and thus upward pressure on inflation.

Second of all, Mr. Chairman, the new stimulus places even more responsibility for the inflation fight on monetary policy and also has a major factor to the recent rise in interest rates. We have, in effect, an inconsistency because fiscal policy is stimulative and the net stimulus has recently increased and monetary policy is restrictive and as that new stimulus begins to take hold on October 1, in terms of the tax and Federal spending changes, the pressure on the Federal Reserve Board will intensify in order to maintain the relatively moderate rate of growth in the money supply which recently has been the case.

So the market is expecting the Federal Reserve Board's task to become even more difficult and that is a second factor contributing to the recent surge in interest rates.

A third, Mr. Chairman, is the anticipated effect of what are projected to be record budget deficits on the U.S. Treasury financing needs. The financial community today is expecting the 1982 deficit to be consideralby larger than the administration's $42.5 billion estimate, even if the recently proposed $16 billion package of deficit-closing measures is enacted. In fact, Mr. Chairman, I think it is important to note that most private sector estimates of the Treasury's 1982 need for borrowing for new cash is substantially higher than the administration's estimates.

Last, there are certain special factors which have reduced the ability on the part of financial institutions who typically are the major buyers of bonds to continue their past pattern of purchasing and I'm referring specifically to commercial banks, insurance companies, and pension funds. Their appetite for purchasing bonds—and I'm referring both to taxable and to tax-exempt bonds—is abnormally low at this point in our business cycle as compared to historically similar moments. Commercial banks are less liquid and insurance companies and pension funds less willing. And again, my testimony goes into detail on those subjects.

Having cited a few reasons, Mr. Chairman, which explain or try to explain the current severe weakness in the overall credit markets, let me turn to a series of factors then that affect the municipal markets in particular, and I'll mention the all-savers certificates which you earlier referred to.

Mr. Chairman, the municipal market has declined even more severely in 1981 than the taxable markets. The widely followed bond buyer index now stands at 12.57 percent, which is a historical high, and, as you may know, 2 weeks ago the State of Washington public power system, which is a AAA rated and very well-known borrower, was required to pay a 15-percent-interest rate on a large new 30-year public issue which is fully tax exempt. Those are astonishingly high rates, Mr. Chairman, which have a debilitating effect on State and local budgets and thus has ominous implications for the abilities of those governments to afford to maintain the current level of services.

I have identified four reasons which are affecting negatively the municipal market today. The first, Mr. Chairman, is the volume. The volume of State and local and related borrowings has risen very sharply in recent years. It has approximately doubled since 1975 and this year's estimated—by our firm, as approximating $50 billion.

Mr. Chairman, this increased volume doesn't primarily reflect major increases in State or local government tax levy budgets, but rather the proliferation of local agencies which have tax-exempt borrowing authority and in particular borrowings by industrial development authorities, housing authorities, and public power authorities have accounted for more than 80 percent of that increased volume of municipal issues since 1975.

A second factor, Mr. Chairman, is the so-called inverse yield curve which has been prevailing in the taxable markets for the last year or slightly longer. By that, I mean the short-term interest rates have been higher in those markets than medium and longer-term interest rates and that insurance companies and commercial banks, who are the two largest institutional borrowers of tax-exempt securities, have been rewarded much more so than in the past by maintaining their investments in the shortest maturity taxable range. So it's required unprecedented tax-exempt yields to induce them them to purchase longer-term municipal bonds.

The third factor, Mr. Chairman, involves the financial institutions deregulation with which we are all familiar which has occurred since 1977. As you know, deposit interest rate ceilings are being phased out and open market interest rates increasingly are being paid to depositors. That means the financial institutions are seeking to place as high a share as possible of their assets in floating rate instruments so as to earn a "spread" above these new floating rate liabilities. Since municipalities' municipal issuers in many cases are not able—some cases not willing—to issue floating rate securities, the basic appetite for municipal issues is declining from the commercial bank sector.

Finally, Mr. Chairman, the recently passed tax bill has had and will continue to have a negative effect on the municipal market, The 25-per cent reduction in personal income tax rates over 3 years means that the incentive for individuals to invest in municipals has been reduced. Looking at it another way, tax-exempt interest rates now must be higher to attract individual investments because after-tax yields on taxable securities now will be higher. It's not possible, Mr. Chairman, to quantify the effect of these personal rate cuts on municipal borrowing costs, but those effects appear to be substantial.

The other aspect of the 1981 tax bill which has begun to weaken the market is the advent of all-savers certificates. As you know, these instruments will begin to be offered next week by commercial banks and savings institutions across the country and they will initially carry a 12.61 percent interest rate, tax-free, and, of course, be permitted in maximum amounts of $2,000 per person.

Mr. Chairman, the all-savers certificates will put upward pressure on municipal rates because they will attract certain funds which otherwise could have been invested in municipal bonds. The certificates primarily will draw funds from money market mutual funds and 6 month money market certificates. As of August 31, those two pools of funds totaled approximately $750 billion and so it would not be surprising, at least to me, to see up to a $250 billion shift into all-savers certificates.

Now that is a very large number, but I should emphasize that the effects of that shift on the municipal bond market would be meaningful but not severe and the reason for that is that most of the individuals who currently have funds in money market mutual funds and money market certificates might shift them into all-savers certificates are not, at least historically, investors in the municipal market, and I cite certain statistics to support that, Mr. Chairman, in my prepared statement, but I think therefore that the effects of the all-savers certificates will be negative but not severely so.

Mr. Chairman, I go on in the prepared statement to make a couple of suggestions on broader macroeconomic issues, but I think I will close here to give my fellow panelists a chance and, of course, I will be happy to answer any of your questions.

[The prepared statement of Mr. Altman follows:]

Prepared Statement of Roger C. Altman

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE

It is an honor to address this distinguished Committee on the subject of recent developments in the U.S. credit markets and their implications for economic policy.

The Committee's attention to this subject is timely because the longer term credit markets recently have been in a state of severe decline. Indeed, at this moment, medium and long term interest rates are touching their all time highest postwar levels. A longer term borrowing by the U.S. Treasury, the strongest of all borrowers, today would involve approximately a 15½% interest rate. This is a level that would have been considered inconceivable just two years ago.

My experience is not that of an economist, but of one whose professional life has been devoted to public and private finance, including the four years during which I served in the Treasury and was responsible for its financing program. The relationship of federal economic policy to interest rates and the financial markets is one which I have long studied.

You have asked me to particularly address the currently depressed state of the municipal bond market. Many of the factors responsible for that market's difficulties, however, are the same as those responsible for current weakness in all the credit markets. I would like to begin by describing these broader factors, Mt. Chairman, and then turn to specific municipal market problems.

It should be emphasized at the outset that interest rates have risen more or less steadily in recent years, particularly the last five years. Appendix A to my testimony outlines this trend by tracing the interest rates on long term Treasury securities since 1977.

There are a number of reasons for the sustained increase in interest rates, but the central factor has been rising inflation. This Committee has received enormous amounts of testimony on that subject, and I won't go into detail except to stress one aspect of it. Careful studies, particularly by the St. Louis Federal Reserve Bank, have shown a clear and positive correlation between levels of interest rates and levels of inflation. In pricing loans, lenders seek a real return, after deducting the <u>anticipated</u> effects of inflation.

As you know, the underlying rate of inflation more than doubled during the past decade. It should not be surprising, therefore, that, on average, long term interest rates also more than doubled. My opening point today, then, is that the decade of the 1980's inherited a high level of interest rates primarily reflecting an inflation-ridden and volatile economy.

Yet, there has been an extremely sharp increase in interest rates during 1981, despite a modest abatement in the rate of inflation. At first glance, this strikes many as surprising and contradictory, but let me offer a few explanations.

First, participants in the credit markets generally are expecting inflation to begin to rise again. Expectations of future economic trends have a greater influence on interest rates than today's conditions because bonds pay interest in the future. Whether the future interest received is at a favorable or unfavorable rate depends on economic circumstances at that future time.

This expectation of rising inflation obviously is not shared in all quarters, but it is widespread. It reflects a judgment, which I share, that the recent, sharp changes in U.S. economic policy are more likely to promote inflation than to reduce it.

The Administration proposed, and Congress agreed, to implement a fiscal policy which is clearly stimulative. For 1982, the tax and budget legislation passed this summer would reduce taxes by approximately $54 billion and increase defense spending by approximately $27 billion, as compared to 1981. In contrast, the reductions in non-defense, discretionary programs are estimated at $46 billion. There is a clear stimulus which will have a net demand multiplier effect. This stimulus will take effect in the midst of a relatively resilient economy, not a sinking one. The expectation, therefore, is that there will be upward pressure on prices.

Secondly, the new stimulus places even more responsibility for the inflation fight on monetary policy, and this also has contributed to higher interest rates. The Federal Reserve Board has been pursuing a relatively restrictive monetary policy anyway, since mid-1980, in an effort to slow previously excessive rates of growth in money and credit and thus slow inflation. This has been evidenced by the unusual "inverse yield curve" in the taxable markets, i.e. that short term interest rates, under the pressure of tight Federal Reserve policies, had been higher than long term rates for many months. One need only glance at Appendix B to see the pattern of money supply growth in the second half of the 1970's, its correlation to inflation, and why such a restrained monetary policy had been needed.

Yet, U.S. fiscal policy has now moved sharply toward economic stimulus, at the same time that our monetary policy remains restrictive. As the tax and spending changes take effect, economic activity will begin to increase as will the demand for money and credit. To restrain monetary growth, the Federal Reserve will have little choice but to continue, if not tighten, its restrictive policy. The supply of credit thus will not expand in line with this rising demand for it, and interest rates will rise. Markets typically discount such future events, and thus interest rates already have risen in anticipation of the effects of this inconsistency between fiscal and monetary policy.

A third factor which has contributed to the recent surge in interest rates is the anticipated effect of record budget deficits on the U.S. Treasury's financing needs. Currently, the financial community expects a 1982 deficit considerably higher than the Administration's $42.5 billion estimate, even if the recently proposed $16 billion deficit closing package is enacted. In turn, numerous private estimates of the Treasury's 1982 new cash borrowing need - covering both the on-budget deficit and the Federal Financing Bank - range upward of $75 billion.

Let me put that borrowing need in perspective. Appendix C demonstrates that the portion of total credit in our economy consumed by the Federal Government rose to near record levels in 1980, after having trended downward since 1976. This "consumption rate" has remained near historic highs this year and, in light of the worsened deficit and Treasury financing outlook, may even rise in 1982.

This anticipated, high 1982 consumption rate has put upward pressure on interest rates because it will occur in a period of somewhat increasing economic activity and rising private demands for credit. In other words, both the federal demand for credit and private demands will be rising simultaneously, and, coupled with a restrained monetary policy, the price of credit can only rise. Again, the discounting character of markets has meant that this interest rate rise is taking place now.

The fourth and final explanatory factor which I will mention involves a reduced ability to purchase bonds on the part of certain major types of financial institutions. Historically, the major buyers of medium and longer term bonds have been commercial banks, insurance companies and pension funds. At this point in our business cycle, however, their appetite for such securities is abnormally low.

Specifically, commercial banks are less liquid than under similiar economic conditions in the past. As previous recessionary conditions faded and recovery began, corporations typically repaid bank loans from the proceeds of longer term borrowings and made banks liquid. With that liquidity, banks purchased large amounts of federal and municipal securities.

Today, with economic activity expected to rise soon, such loan repayments have been limited and bank liquidity is low. Businesses have been unable or unwilling to borrow on a longer term basis to reduce their dependence on bank loans.

Among insurance companies and pension funds, attitudes towards investments in medium and longer term bonds have changed, at least temporarily. The inverse yield curve of the past year has meant that investing in very short term instruments has been the most rewarding strategy. Also, the nearly uninterrupted bond market decline of recent years has meant that longer term securities consistently have fallen to price levels below those at which they were bought. Indeed, today, no longer term bond exists which is selling in the market above its originally issued price.

This means that the performances of bond portfolio managers at insurance companies and other institutions have been much worse than in previous market cycles. Their attitudes toward major, new commitments to bonds are generally negative, and their institutions thus have provided less buying support to this bond market than in the past.

Mr. Chairman, these are four of the broad factors which have contributed to the current, overall bond market weakness. All sectors of the bond market, including the tax exempt sector, move together broadly and thus are affected by these factors. Indeed, they are the principal reasons, in my view, for the problems of the municipal bond market, as well as the taxable markets.

Nevertheless, there are narrower factors which weigh more heavily on one sector of the market than on another. You requested that I particularly address the problems of the municipal market and the possible effects of the All-Savers Certificates on that market. Let me turn now to those subjects.

The municipal bond market has declined even more severly in 1981 than the taxable markets. The widely-followed Bond Buyer Index of tax-exempt securities now stands at 12.57%, a historic high. Also, just two weeks ago, the Washington (State) Public Power System, an AAA rated and well known borrower, was required to pay a 15% interest rate on a large, new 30-year public issue which is fully tax exempt. By any standard, these are astonishingly high rates. They have a debilitating effect on state and local budgets, and thus have an ominous implication for the abilities of those governments to afford to maintain current levels of services.

It seems to me, Mr. Chairman, that there are at least four reasons why municipal borrowing costs have risen even more sharply than others.

First, there has been an enormous rise in the volume of state and local borrowings. In 1975, approximately $29 billion of new municipal bonds was issued. In contrast, the comparable 1981 figure is expected to approximate $49 billion.

This increased volume does not reflect major increases in state or local government tax levy budgets, but rather the proliferation of local agencies which have tax exempt borrowing authority. Specifically, borrowings by industrial development authorities, housing authorities and public power authorities accounted for more than 80% of the increased volume of municipal issues since 1975.

A second factor involves the prevailing inverse yield curve to which I have referred before. Short interest term rates in the taxable markets actually have been higher than medium and longer term rates. This has meant that insurance companies and commercial banks - the two largest institutional purchasers of tax-exempt securities - have been rewarded much more so than in the past by maintaining investments in the shortest maturity taxable range. It has thus required unprecedented tax-free yields to induce them to purchase longer term municipal bonds.

Perhaps the third reason for the relatively greater difficulties of the municipal bond market involves the effects of the financial institutions' deregulation which has occurred since 1977. In particular, deposit interest rate ceilings are being phased out and true, open market rates increasingly being paid to depositors. Financial institutions thus are adapting to a new environment wherein they are paying floating rates on their deposit and other liabilities. This has caused them to aggressively seek floating rate assets (loans) which will earn them a "spread" above their floating rate liabilities.

State and local issuers have not been willing, or in some cases able, to issue floating rate securities. As a result, banks and other depository institutions have been increasingly reducing the percentage of their assets in municipal bonds.

Finally, Mr. Chairman, the recently passed tax legislation has had a negative effect on the municipal bond market. The 25% reduction in personal income tax rates over three years means that the incentive for individuals to invest in municipal securities has been reduced. Put another way, tax exempt interest rates now must be higher to attract individual investments, because after tax yields on taxable securities now will be higher. It is not yet possible to quantify the effect on municipal borrowing costs of this tax change, but it appears substantial.

The other aspect of the 1981 tax bill which has begun to weaken the municipal market is the advent of All-Savers Certificates. These instruments will begin to be offered next week by commercial banks and savings institutions across the U.S. These certificates initially will carry a 12.61% tax free interest rate and will be permitted in maximum amounts of $2,000 per individual.

All-Savers Certificates will put upward pressure on municipal rates because they will attract certain funds which otherwise could have been invested in municipal bonds. The certificates primarily will draw funds from money market mutual funds and six-month money market certificates. As of August 31, those two pools of funds totalled approximately $150 billion and $500 billion respectively. It is not unlikely, therefore, that All-Savers Certificates could attract $150-250 billion.

89-433 O - 82 - 2

This is an enormous potential amount, but the effects of such a shift on the municipal bond market probably may be modest. Most of the funds which today are invested in money market mutual funds and money market certificates, both of which are taxable, are not funds which are available to the municipal market. They generally represent the assets of small investors who, at least historically, have only participated in the municipal bond market to a limited degree. As evidence of this, the assets of money market mutual funds will increase by approximately $70 billion in 1981, whereas the assets of municipal bond funds will rise by $10 billion or slightly less. Only a fraction of the funds which will flow into All-Savers Certificates, therefore, will be drawn from the municipal market.

Having tried to explain the recent severe weakness in our credit markets, Mr. Chairman, I would like to close with an observation as to how this weakness might be rectified and interest rate levels reduced. In my judgment, the economic growth and employment goals which we all share will not be attainable except in an environment of substantially lower interest rates.

Yet, interest rates are not likely to decline on a sustained basis unless the public believes that inflation will decline. Of paramount importance, therefore, is a serious and sustainable anti-inflation policy. We are relying exclusively on monetary policy today, however, and that is but one component of a successful policy. Moreover, to rely on it exclusively is counterproductive. Interest rates cannot be reduced sufficiently to finance the productivity-enhancing investments which will increase supplies and promote growth.

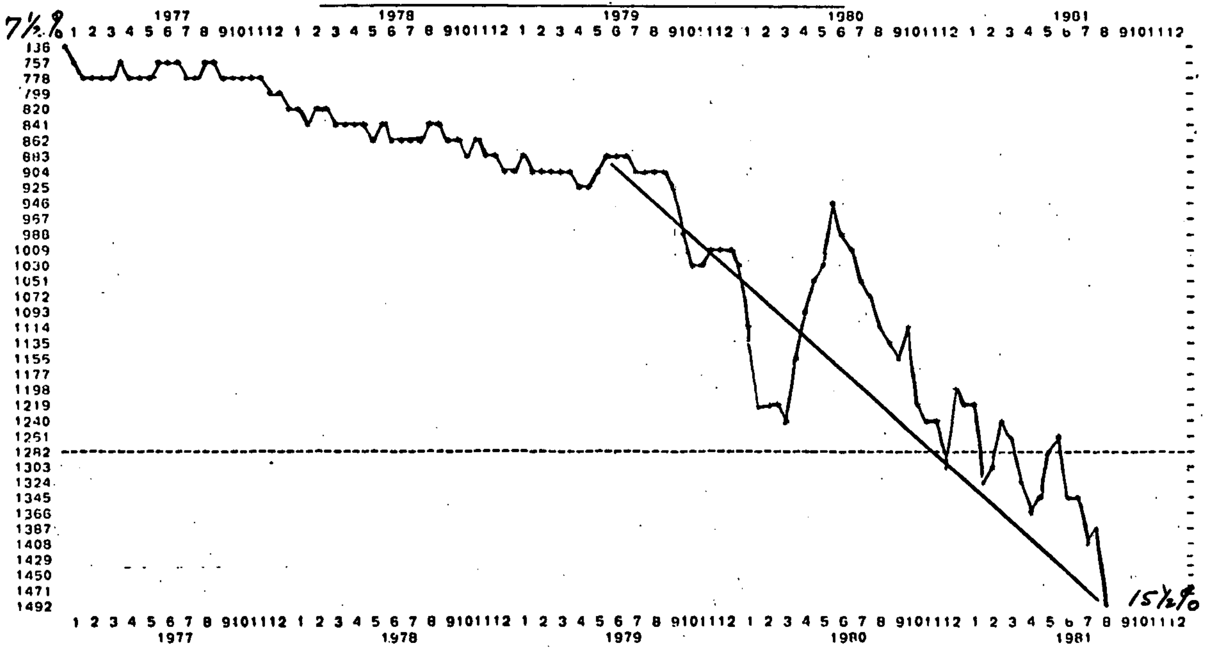
The new U.S. fiscal policy which has been launched is stimulative at a time when moderation is needed for inflation restraint. Demand pressures on prices will be somewhat rekindled and federal deficits will be large.

There has been much discussion, Mr. Chairman, on whether deficits are or are not inflationary, and under what circumstances. It seems to me that this debate is somewhat beside the point because the general public has come to view deficits as contributing to inflation. And, the key task in reducing inflation is to reduce inflationary expectations, which are deeply embedded in our individual patterns of economic behavior. Those expectations are not likely to be changed - as they relate to wage settlements, product pricing and interest rates - unless reduced deficits are underway and the public thus believes that inflation may truly abate.

I realize that it is easy to urge inflation restraint and much harder to implement a policy aimed at it. Moreover, a more moderate fiscal policy is but one of several elements of a comprehensive and long term effort at non-inflationary growth. It is a crucial element, however, and one which is acutely needed today.

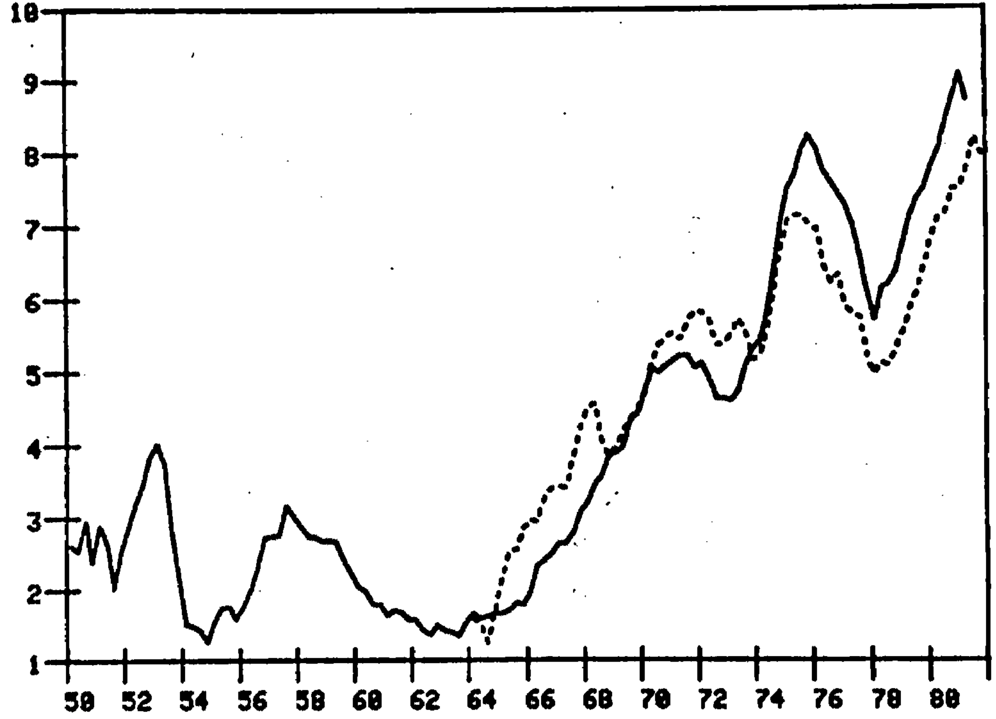
# # # #

PRICES OF 20-YEAR U.S. TREASURY SECURITIES
1977 - 1981



APPENDIX A

GROWTH IN MONEY SUPPLY-M1B(DOT)
(LAGGED 2 YRS)COMPARED WITH
GNP DEFLATOR(LINE)



APPENDIX B

IMPACT OF FEDERAL GOVERNMENT ON CREDIT MARKETS
(fiscal years, dollars in billions)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
A. Federal borrowing (budget financing)	19.4	19.4	19.3	3.0	50.9	82.9	53.5	59.1	33.6	70.5
B. Federally-assisted borrowing (outside of budget)	14.0	20.5	28.3	21.4	14.0	15.3	26.0	35.3	48.0	53.8
C. Total (A+B) 1/	33.5	40.0	47.5	24.4	64.9	98.2	79.6	94.4	81.7	124.4
D. Total funds advanced in credit markets	125.7	163.5	207.7	193.4	181.3	251.8	314.4	385.3	414.3	348.0
E. Federal participation rate (percent)	26.6	24.5	22.9	12.6	35.8	39.0	25.3	24.5	19.7	35.7

1/ May not sum to total due to rounding.

Source: Special Analyses, Budget of the United States Government, Fiscal Year 1982. Total funds advanced in U.S. credit markets from Federal Reserve Board Flow of Funds Accounts.

APPENDIX D

ANNUAL GROSS ISSUANCE OF TAX-EXEMPT BONDS

($ billions)

	YEARS 1975	1981 (est.)
Housing	-	7.0
Industrial	4.5	7.0
Public Power	1.5	6.0
Other	23.0	25.0
TOTAL	$29.0	$45.0

Source: Daily Bond Buyer

Representative REUSS. Thank you very much, Mr. Altman. Mr. Petersen.

STATEMENT OF JOHN E. PETERSEN, DIRECTOR, GOVERNMENT FINANCE RESEARCH CENTER, MUNICIPAL FINANCE OFFICERS ASSOCIATION, WASHINGTON, D.C.

Mr. PETERSEN. Thank you, Mr. Chairman.

My name is John Petersen and I'm director of the Government Finance Research Center of the Municipal Finance Officers Association. My statement this morning represents my own views as an individual and do not necessarily reflect those of the Government Finance Research Center or the Municipal Finance Officers Association.

Like, Mr. Altman, I appreciate the opportunity to testify and believe the hearings this morning are most timely. As I shall detail in my statement, the tax-exempt securities market is currently in bad shape. Whatever the ultimate advantages of the overall economic programs being put together these days in Washington as reflected in the budget and in tax policies, we must be cognizant of the immediate pressures on the State and local government sector in particular and the municipal bond market. These pressures are severe.

The reasons for these difficulties are manifold and I can only hit a few high spots in this morning's statement. Therefore, I would like to supply an analysis of the All-Savers Act for the record which I think has a direct bearing on the sources and consequences of the difficulties in the municipal bond market.

The Federal budget and newly passed tax legislation were enacted in hopes of stirring up the juices of the Nation's economy. The new economic revitalization program may in fact prove to be a shot in the arm, a stimulus for the private economy. But, so far, it has had severe consequences for State and local government finances. Taken together, the combined Federal tax and spending policies, and accompanying monetary policies being implemented by the Federal Reserve Board, have represented a triple whammy for State and local government finances. They have brought on a combination of severe reductions in grant receipts, adverse impacts to the municipal bond market and to State and local tax systems arising from the recent tax revisions, and crowded and uncertain capital market conditions flowing out of the continued Federal deficits and the tight monetary policies.

No place have the immediate unfortunate outcomes of these combined policies been more visible than in the chaotic performance of the municipal bond market.

As Mr. Altman has pointed out, municipal borrowers are sharing in the high interest rates and generally turbulent conditions of the financial markets, but as I would like to stress, they have come in for some special problems. As of mid-September, the bond buyer 20-bond index had spiralled to 13 percent and the revenue bond index—that is the rates on 30-year revenue bonds—peaked at over 14 percent. I would point out that for a taxpayer in the 50-percent-tax bracket this is equivalent to pretax rates of return of over 26 and 28 percent, respectively.

Since that time the market had a slight recovery and, because of its volatility, last week once again rose to extremely high rates in the tax-exempt sector. As a consequence, tax-exemption as a means of decreasing the borrowing costs of State and local governments and giving them market access has lost much of its value.

On a relative basis, long-term, tax-exempt rates are nearly 80 percent of those on comparable corporate bonds and are 90 percent or more of those on long-term Treasury bonds. These high ratios of tax-exempt to taxable rates are far above the traditional values and are evidence of severe erosion in the usefulness and value of tax-exemption to State and local governments.

Many observers have pointed out that coming in the wake of large budget cuts the new tax bill has compounded the problems of State and localities and their sagging revenue systems. State and local governments are being called upon to bear the brunt of Federal fiscal adjustments that call for reduced Federal spending. Of the $35 billion in spending reductions in fiscal year 1982 contained in the omnibus budget reconciliation, approximately one-third will come from intergovernmental grant programs. At present, there is a further effort to reduce the Federal deficit and yet an undetermined amount is slated to be what could be from State and local assistance as part of the $13 billion needed in further spending reductions. We don't know the details of these reductions, but certainly the signs are ominous.

Financing the Federal deficit without expanding the money supply will mean continuing tight money and, thus, will mean continuing high borrowing costs for State and local governments. These pressures will be magnified for State and local borrowers because of the recently enacted tax breaks that reduce or dilute the demand for tax exemption.

I'd like to briefly look at the demand for municipal securities and then the supply of them and talk about some of the factors which are leading to the extremely high borrowing costs we see today.

Looking first at the demand side, there are several negative trends revolving around the changing composition of investors and recent changes in the Federal tax code. During the first half of 1981, the municipal bond market followed the classic pattern of a tight-money period demand for tax-exempt securities, institutional investor support, normally provided by commercial banks and fire and casualty insurance companies, has evaporated.

Correspondingly, the household sector—that is, individual and mutual fund investors—have acquired approximately 75 percent of the net increase in State and local debt outstanding. Commercial banks and fire and casualty insurance companies—which in the late 1970's acquired 80 to 90 percent of the net increase—have proved to be disinterested in acquiring municipal securities. Mr. Altman touched on some of the reasons for this. I would like to stress in particular the lack of commercial bank demand as banks have gone in for techniques of spread banking whereby they look for assets that have variable rates of return which they can match off on the fluctuating notes they pay on their liabilities.

Municipal bonds through the years have served a very important function as a source of secondary liquidity to commercial banks. It appears as though this function has gone up in smoke and been replaced by other methods. Furthermore, there has been a secular decline in the need of high commerical banks for tax shelter as municipal securities have been out competed in this area by other forms of tax shelter. This pattern of diminished demand illustrates the critical importance of the individual investor to the municipal securities market and, again, I want to stress that the individual investor is critical to the market in periods of tight money when the major institutional investors are not buying.

Now the changes enacted in the Economic Recovery Tax Act of 1981 will cause systematically higher rates of interest for municipal bonds as compared to those on taxable securities.

Looking first at those provisions of the Tax Act that will affect individual taxpayers, several will have an adverse impact on tax-exempt interest rates.

First of all, the reduction in personal income tax marginal rates, especially the lowering of the top bracket from 70 percent on unearned income to 50 percent for all income, will lessen the need for tax shelter.

The associated reduction in the capital gains rate, which will drop from a maximum of 28 percent to 20 percent, thereby improves the attractiveness of equity holding in relationship to fix-income securities.

The reduction in the estate and the gift taxes will lessen the need for municipal securities as a means of tax avoidance, as will expansion of income sheltering opportunities in individual retirement savings plans—IRA and Keogh—and the partial exemption of interest income and indexation of marginal tax brackets commencing in 1985. As Mr. Altman pointed out, these changes have a heavy influence on investor expectations in terms of the kinds of tax shelter they will need in the distant future and optimism in that regard can lead to higher interest costs for State and local borrowers as the need for tax shelter in the future is lessened.

The creation of the all-savers certificate has resulted in a superior tax-exempt, short-term instrument that is federally guaranteed and highly competitive with conventional municipal securities.

Looking at the corporate tax side of the ledger, the following provisions in the new tax law will have adverse impacts expansion of leasing tax shelter; increase in the investment tax credit; and accelerated depreciation schedules. These changes will both enhance the rate of return on alternative investments and lessen the need for corporate tax shelter from municipal securities. Expansion of the leasing opportunities as a tax shelter may prove to be especially significant in further reducing commercial bank demand for municipal securities.

Turning to the supply side of the equation, there are several factors that portend a continued weakness in the market for long-term, tax-exempt securities. First, as high as they are, tax-exempt interest rates still present favorable savings for private sector borrowers that can gain access to the tax-exempt market. During the first half of 1981, municipal bond sales were heaviest for the uses of industrial pollution control, industrial revenue bonds, and public utilities.

Unabated growth of industrial development bonds, in particular, is causing supply pressures on the market. Such private aid financing is largely unreported but may amount to $9 billion a year or roughly 20 percent of total tax-exempt borrowing. These loans are directly competitive with traditional Government issuers in investor portfolios. Commercial banks have switched to tax-exempt loans for these purposes as opposed to investing in traditional general obligations bonds—that is, when commercial banks are investing in tax-exempts at all. Even at higher rates of interest, private firms still find tax-exempt interest yields attractive as opposed to paying fully taxable rates. As long as that spread between taxable and tax-exempt rates can remain at 200 basis points or more, it appears as though it makes sense to continue with the industrial development bond financing as opposed to conventional means.

Special concerns are also presented by the huge growth in tax-exempt public power financing and the numerous problems besetting their activities. Caught in mid-stream of large projects, utility borrowers will continue their demand for funds even in the face of extremely high interest rates. Higher rates of interest, in turn, lead to higher debt service reserves and capitalized interest needed to be borrowed during construction. Nuclear projects have presented special problems with their huge capital needs, long construction periods, technological uncertainties, and high levels of public opposition.

Increased pressure on States and localities to borrow will also be attributable to the loss of Federal grants. Federal grants, over the last decade, have financed approximately 37 percent of all State and local construction spending. Reduction in those grants will require increased borrowing if the projects are to go forward. This means potentially a much larger supply of bonds, if borrowers can meet the greatly increased debt service requirements, an outcome, I believe, is unlikely.

Governments, of course, have been reacting to the high rates in the long-term market by considerably shortening maturities and employing new forms of borrowing, such as commercial paper. However, these devices present some problems of their own. Because they are being used to avoid selling long-term bonds, they do constitute an accumulation of pent-up demand for funding projects. This pent-up demand, in turn, will cause future supply problems and keep rates from dropping very rapidly in the market.

A final problem has to do with the creditworthiness of municipal bonds. The credit quality of State and local borrowers has deteriorated appreciably over the last year and a half, at least in the opinion of the credit-rating agencies. For example, the number of municipal downgradings exceeded the number of upgradings by Moody's Investment Service in the year 1980, a trend which has continued into the first 6 months of this year. I might point out that that trend reverses the situation in the 1970's when typically many more units were being upgraded than downgraded. The decline in credit quality can be attributed to deterioration in the structure and performance of State and local government revenues from their own sources. These have become pinched and uncertain, a situation exacerbated by investor concerns as to the impacts of the large cutbacks in the intergovernmental assistance. There are, of course, continued concerns as to the reliability of State and local governments in honoring their debt obligations in view of widespread adoptions of expenditure and tax limitations. Propositions 13 and 2½ are leading, but not isolated examples of this behavior.

In summary, for the above reasons, the long-term prognosis for the tax-exempt bond market is not good. This is not to say that long-term, tax-exempt interest rates will not drop with the general market movement, but rather, that in relationship to tax able rates, they will remain at a much higher level than they have seen traditionally. Furthermore, because of the loss of Federal grants and general pressure on current operating budgets, demands for borrowing to finance capital facilities will increase. Individual and institutional investors, however, will be using other outlets to shelter income and will generally be in less need of tax shelters. The shrinkage of and pressure on general government budgets will also mean a deterioration in credit quality and continuing high risk premiums.

Finally, the competition from private users of tax-exempt securities will generate a continuing supply problem that will squeeze conventional government issuers—that typically have less financing flexibility and are more sensitive to interest rates—out of the market. Unless steps are taken to diminish the supply of tax-exempt securities or unless other tax shelters or other methods are found to finance public capital facility needs, the most probable outcome seems to be that the tax-exempt market will have to continue giving up a large share of its historic advantage in terms of lower interest rates and easier access to the bond market for State and local governments. Thank you.

[The attachment to Mr. Petersen's statement follows:]

AN ANALYSIS OF THE IMPACT OF THE ALL SAVERS CERTIFICATE PLAN ON THE MUNICIPAL SECURITIES MARKET

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NOTE: This analysis reflects the views of the author and does not necessarily reflect the views of the Government Finance Research Center or the Municipal Finance Officers Association.

STUDY HIGHLIGHTS

An Analysis of the Impact of the All Savers Certificates Plan on the Municipal Securities Market

This study stems from concerns about the effect that the All Savers Certificate Plan will have on the tax-exempt municipal securities market. Under the All Savers Plan approved by the Senate Finance Committee, savings and loans, banks, and credit unions would be allowed to issue one-year, tax-exempt savings certificates. Individuals could earn up to $1,000 and couples up to $2,000 in tax-free interest on certificates which would be federally insured. The House Ways and Means Committee also has agreed, in concept, to assist financial institutions, but is studying the possibility of targeting the proceeds from any such assistance to finance residential mortgages.

The following analysis demonstrates that, under plausible assumptions, the All Savers Certificate Plan, as now designed, would have substantial impacts on the interest rates in the municipal securities market. Direct competition would be most severe in the short-term securities area, but not restricted to it. The formula proposed for the All Savers Certificate, pegging it to 70 percent of the Treasury bill rate, would have produced rates of return far above the yields on prime municipal notes, by as much as 2.8 percentage points in the first half of this year. Clearly, municipal rates would have to rise to much higher levels, both in the short-term and long-term areas of the municipal market, to effectively compete with the All Savers Certificate rates of return.

The following are the major findings:

- Assuming the historical volumes of borrowing by state and local governments and a full adjustment in municipal note yield and a partial adjustment in yields on long-term securities to match the returns on the All Savers Certificate, it is estimated that for the year 1980, short-term, tax-exempt rates would have been approximately 220 basis points higher and longer-term rates, on average, 110 basis points higher.* At these rates, annual interest costs paid by state and local borrowers would have been $825 million greater. At present levels of borrowing and interest rate differentials (as of mid-1981), the increased annual borrowing cost would have been on the order of $1 billion per year.

- Refining the analysis of the effects of the All Savers Certificate on the municipal securities market requires a detailed consideration of how individual investors would react. The All Savers Certificate is aimed at the individual investor, which is also playing a crucial role in the tax-exempt securities market. At present, households are acquiring approximately one-half of the dollar volume of new municipal bond and note issues. Analysis of recent securities demand and the behavior of individual investors leads to the conclusion that such demand for tax-exempt securities would be weakened by a switching of their investments in part to the All Savers Certificates.
- Were the demand for new state and local securities by the household sector to decrease by $10 billion from current levels of nearly $20 billion, it is estimated that the tax-exempt rates, on average, would rise by one percentage point (100 basis points). Such a rise in rates could be expected to be greatest in the short-term area of the market and least in the long-term. A 100 basis point increase in

A basis point equals .01 of a percentage point.

rates at present market levels would increase annual interest costs paid by state and local governments by approximately $620 million. This latter estimate is believed to be conservative as to the effects of the implementation of All Savers Certificates since it implies only a slowing down of net acquisition of tax-exempt securities by households, and not a disinvestment in municipal securities by that sector. These effects of the All Savers Certificate Plan on the municipal secu ties market, as substantial as they are, will most likely be exacerbated by uncertainty caused in the major shifting of funds resulting from the creation of $100 - $180 billion in new tax-exempt securities under the All Savers Certificate Plan. Also, other tax changes which have been proposed will further lessen the underlying demand for state and local securities by both individuals and institutions by lowering marginal tax rates and enhancing the tax-shelter attractiveness of other forms of investments. These factors, and the generally stringen condition of the financial markets, will lessen the possibility of relief to the tax-exempt securities market from other investor groups.

Both the U.S. Senate Finance Committee and the House Ways and Means Committee have given tentative approval to a new type of tax-exempt savings certificate which would be offered by savings and loans and other financial institutions. Under the All Savers Certificate (ASC) Plan approved by the Senate Finance Committee, financial institutions (savings and loans, banks, and credit unions) would be allowed to issue one-year, savings certificates, the interest income of which would be exempt from the federal income tax. Individuals could earn up to $1,000 and couples up to $2,000 in tax-free interest on certificates which would be federally insured. The interest rate on the tax-exempt certificates would be pegged at 70 percent of the rate for a one-year Treasury Bill. The Ways and Means Committee has also agreed in concept to assist financial institutions, but is studying the possibility of targeting the proceeds from any such assistance to finance residential mortgages.

The ASC plan would work as follows: Currently, one-year Treasury Bills are yielding just under 15 percent; thus, the one-year tax-exempt certificates would be issued at approximately 10 percent and they would be federally insured. These tax-exempt yields would be progressively more attractive to investors, the higher their marginal tax bracket. For investors in the 50 percent bracket, the yield would be equivalent to a 20 percent before-tax-yield. The ASC returns would be higher than the returns now available on prime one-year tax-exempt securities which were approximately 7 1/2 percent as of late June. The $1,000 and $2,000 interest income limitations effectively would -- at a 10 percent yield -- limit individual portfolios to $10,000 and $20,000, respectively, for single- and joint-return taxpayers. At lower rates, portfolios could be bigger and retain tax exemption.

There are numerous objections that can be raised regarding the economic efficiency, tax costs and equity, and poor precedent embodied in the All Savers Certificates (ASC) plan. However, the immediate purpose of this analysis is to examine the impacts of such a plan on the borrowing costs of state and local governments. The certificates, being federally insured tax-exempt obligations and readily available at convenient locations with no transaction cost, would represent instruments highly competitive with tax-exempt municipal securities. Such competition would be most severe and direct with premium-grade short-term municipal notes. However, as is argued in this analysis, the competition would continue throughout the spectrum of municipal securities and have cost implications for both the tax-exempt note and bond markets. The dimensions of the potential capital flows are gigantic. It has been estimated that anywhere between $100 to $180 billion of ASC liabilities would be created within a year. Such a massive creation of tax-exempt securities practically over night is unprecedented and would have profound implications for the municipal securities market. As of the end of 1980, there was approximately $330 billion in long-term-debt and $14 billion in short-term debt outstanding.[1/] Adding in the sales of ASCs would increase total tax-exempt debt outstanding by 35 to 50 percent in one year.

Such drastic changes in financial aggregates makes analysis of the impacts especially difficult -- but, critically important.

In the analysis we will examine first the possible impacts of the ASC on tax-exempt interest rates, make projections as to the consequences for state and local borrowing costs, and, finally, discuss the pivotal role of the household sector and individual investors ... at whom the ASC plan is targeted ... in the determination of interest rates and borrowing costs in the municipal securities market.

1/ By convention, short-term debt issues are those having an original maturity of one year or less (unless sold as part of a longer-term offering of serial bonds.)

Interest Rate Impacts

Because of direct competition under the ASC plan, the rate of return available on municipal securities of prime quality would need to rise to levels comparable to those on the certificates. Since the ACS would be convenient, available in thousands of locations, and involve no transaction costs, there can be little doubt that they would prove to be a most attractive investment for investors in the 30-percent or greater marginal income tax brackets, with the relative advantages increasing, the higher the taxpayer's bracket. Such individuals also form a major part of the demand for municipal securities, particularly in times of market stress and high interest rates.

The practical implication of the competition between the ASC and municipal securities would be, first of all, that short-term rates on municipal securities would rise to the level available on ASCs. This would establish a yield available on essentially risk-free tax-exempt instruments. In the municipal securities market, there currently exists a tax-exempt security that carries a federal guarantee and, thus, is considered to be of super-premium quality. That security is the Public Housing Project Note (Prime Housing Notes), which are issued by public housing agencies, and secured by an unconditional federal government guarantee to make a loan to the local authority in an amount sufficient to pay the principal and interest on the notes. These notes are widely traded and the new issue volume is approximately $16 billion a year.1/

How would the ASC rate have compared with those actually paid on Prime Housing Notes? Table 1 traces on a quarterly basis the rate of return on one-year Treasury Bills, 70 percent of that one-year rate (the rate on ASCs, were they available), and the average rate on one-year Prime Housing Notes for the

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1/ This figure includes Urban Renewal Notes (Preliminary Loan Notes) which are also secured by the full faith in credit of the United States Government. In 1980 $15.6 billion in Prime Housing Notes and $400 million in Urban Renewal Notes were sold.

TABLE 1

COMPARISON OF ONE-YEAR TREASURY BILL
AND PRIME HOUSING NOTE YIELDS

		(1)	(2)	(3)	(4)
Year	Quarter	Average Yield for a One-Year Treasury Bill*	70% of the Average Yield for a One-Year Treasury Bill	Average Yield for a One-Year Prime Housing Note	(.7)x(T-Bill Yield) minus (Prime Housing Note Yield)
1975	1	6.36	4.45	3.87	.58
	2	6.27	4.39	3.83	.56
	3	7.18	5.03	4.08	.95
	4	6.78	4.75	3.80	.95
1976	1	5.95	4.16	3.20	.96
	2	6.26	4.38	3.40	.98
	3	6.13	4.29	3.27	1.02
	4	5.35	3.74	2.87	.87
1977	1	5.28	3.70	2.80	.90
	2	5.54	3.88	2.95	.93
	3	6.07	4.25	3.07	1.18
	4	6.88	4.82	3.50	1.32
1978	1	7.14	5.00	3.63	1.37
	2	7.68	5.37	4.05	1.32
	3	8.39	5.87	4.45	1.42
	4	9.59	6.71	5.05	1.66
1979	1	10.34	7.24	5.42	1.82
	2	10.12	7.09	5.27	1.82
	3	9.79	6.85	5.03	1.82
	4	11.89	8.32	6.53	1.79
1980	1	13.16	9.21	6.33	2.88
	2	11.87	8.31	6.35	1.96
	3	9.59	6.71	5.38	1.33
	4	12.98	9.09	6.73	2.31
1981	1	14.21	9.95	7.08	2.87
	2	14.27	9.99	7.27	2.72

* Bond yield basis

Source: Salomon Brothers, An Analytical Record of Yield Spreads, Part III, Table 5, pp. 3-5.

period 1975 through the first half of 1981. In the last column is found the differential between 70 percent of the one-year T-Bill rate and the yield on Prime Housing Notes.[1] As may be seen, over the period Housing Notes yielded considerably less than 70 percent of the Treasury Bill rate for comparable maturity. As of the first half of 1981, the yield on Housing Notes would have had to be approximately 280 basis points greater to equal that available on 70 percent of the Treasury Bill rate, which under the All Savers plan, would be the rate available on the ASC tax-exempt certificates.

The ASC security would form a base-line riskless rate far higher than that on conventional tax-exempt notes. But, of course, individual state and local government borrowers would have to pay a premium for the level of risk that is inherent in their securities, since they do not enjoy a federal government guarantee as found in the ASC and PHN securities. This risk premium is paid in the form of higher rates of return to compensate investors to hold the lower grade securities. Table 2, using the rates of return on one-year maturities of general obligation municipal bonds (which are essentially short-term obligations, although part of a larger issue of longer-term securities), reflects the premiums that were paid by securities by rating category in comparison to the highest rating (Aaa) on average during 1980.[2] Thus, for 1980, one-year maturities of the lowest investment grade, Baa, were paying a 68-70 basis point premium in rates above that being paid on the highest-grade paper, Aaa. Thus, an increase in short-term rates of the highest grade, would be reflected throughout the rating categories, driving all short-term rates up systematically in order to continue compensating investors for the risk found in individual credits, not having the benefit of a federal guarantee.

1/ All rates are on a bond-yield basis as opposed to a discount basis. The former measure gives a rate approximately 150 basis points higher at a discount-basis rate of 10 percent at one-year maturity.

2/ For technical reasons (including frequency of interest payment), tax-exempt notes carry somewhat higher rates of return than one-year bonds of equivalent rating. Thus, prime-grade (Aaa) municipal bonds often carry slightly lower yields than PH notes.

TABLE 2

YIELD DIFFERENTIALS ON ONE-YEAR MATURITIES
OF TAX-EXEMPT GENERAL MOODY'S OBLIGATION BONDS
BY RATING CATEGORY
(1980 ANNUAL AVERAGES)

Rating Categories Compared		Basis Points Difference 1/
(Aa, Aa-1) - Aaa	=	22
(A, A-1) - Aaa	=	36
(Baa, Baa-1) - Aaa	=	68

1/ Basis point equals .01 a percentage point

Source: Public Securities Association, "Municipal Market Developments" (February, 1980).

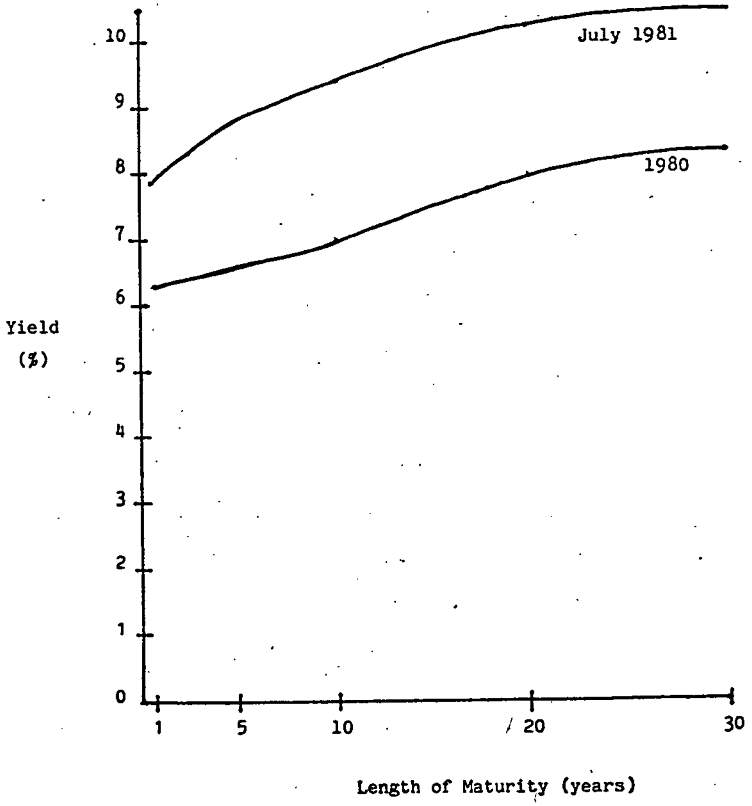
The impact of the ASC would not be limited to one-year bond maturities or to municipal notes. Securities of longer maturity are interest-rate sensitive substitutes for the shorter-term security. Typically, investors need to be attracted to extend their investment over longer periods of time by higher yields to compensate for less liquidity and greater uncertainty. Furthermore, higher yields in the short-term market tend to raise yields in the market for longer-term bonds in that investors are attracted to stay short and, by withholding their funds from longer-term commitments, create a lack of demand for the longer-term maturities. Again, to attract investors back to long-term commitments, long-term yields must increase.

It is rational to expect that a large rise in short-term interest rates, other things being equal, will tend to pull long rates up with them. This phenomenon is particularly true in the tax-exempt market, which -- unlike the taxable securities market -- has never seen a period where short-term yields exceeded those on longer-term instruments (an inverse yield curve).

Chart 1 gives a representative yield curve by maturity on municipal bonds, based on the average interest rates for the year 1980 and as of July, 1981. A realistic assumption is that the yield curve would shift upward in response to an increase in short-term rates, with the largest increases occurring in the short-term rates, where there is direct competition with the ASC, and with smaller increases in the longer maturities. An initial estimate of response can be formed by assuming that over the full length of the yield curve, short-term rates would go up by the full amount of the differential between the ASC and PHN yields and at the longest term (30 years), there would be little impact. This amounts to saying that the increase in yields over the continuum of the curve on average would equal one half of the differential between the PHN and ASC yields. Thus, if the one-year rate were to increase

CHART 1

YIELD CURVE FOR NEW OBLIGATION BONDS:
1980 ANNUAL AVERAGE
AND JULY, 1981



Source: Based on Good Grade General Obligation Yields (Aa to highA) as reported by Salomon Brothers, "An Analytical Record of Yield and Yield Spreads."

by 200 basis points, the 15-year rate would increase by approximately 100 basis points, and the 30-year rate would be generally unchanged. The dollar volume affected depends on the distribution of borrowing among maturities. There is no recent detailed information, but approximately one half of the dollar volume of municipal long-term bond issues is in maturities of 12 years or less and half exceeding 12 years, based on the historical distribution of maturities in municipal securities. Thus, on a dollar-volume basis, total annual interest costs on long-term borrowing would go up by the dollar volume of borrowing times one-half the increase in short-term rates.

Chart 2 gives a depiction of the historical relationships between the average annual yield on a one-year Treasury Bill, .70 of that yield (which would be equivalent to an ASC yield), the yield on one-year Housing Notes, and the differential between the ASC and Housing Note yields for the period 1959 through 1980. As may be seen, had the ASC been in effect, the yield would have been consistently higher (at .70 of the T-Bill rate) than that available on Housing Notes. This gap provides an approximation of the degree to which short-term rates (and, to an extent, as discussed above, long-term rates) would have had to increase in order to be competitive with the ASC securities.

Added Borrowing Costs

Using the above data, a first approximation of the impact of the ASC on municipal note and bond rates and total borrowing costs can be derived, given historical volumes of borrowing. At the outset, however, it should be understood that the increase in interest rates undoubtedly would have diminished the amount of tax-exempt borrowing that would have taken place. However, the indicated increase in borrowing costs does reflect an opportunity cost (in the form of both higher realized costs and displaced borrowings and capital spending) that would have been absorbed by state and local borrowers had the ASC plan been in effect.

CHART 2

YIELDS ON ONE-YEAR PUBLIC HOUSING NOTES, TREASURY BILLS,
&) PERCENT OF T-BILLS, AND DIFFERENCES:
ANNUAL AVERAGES, 1959 TO 1980

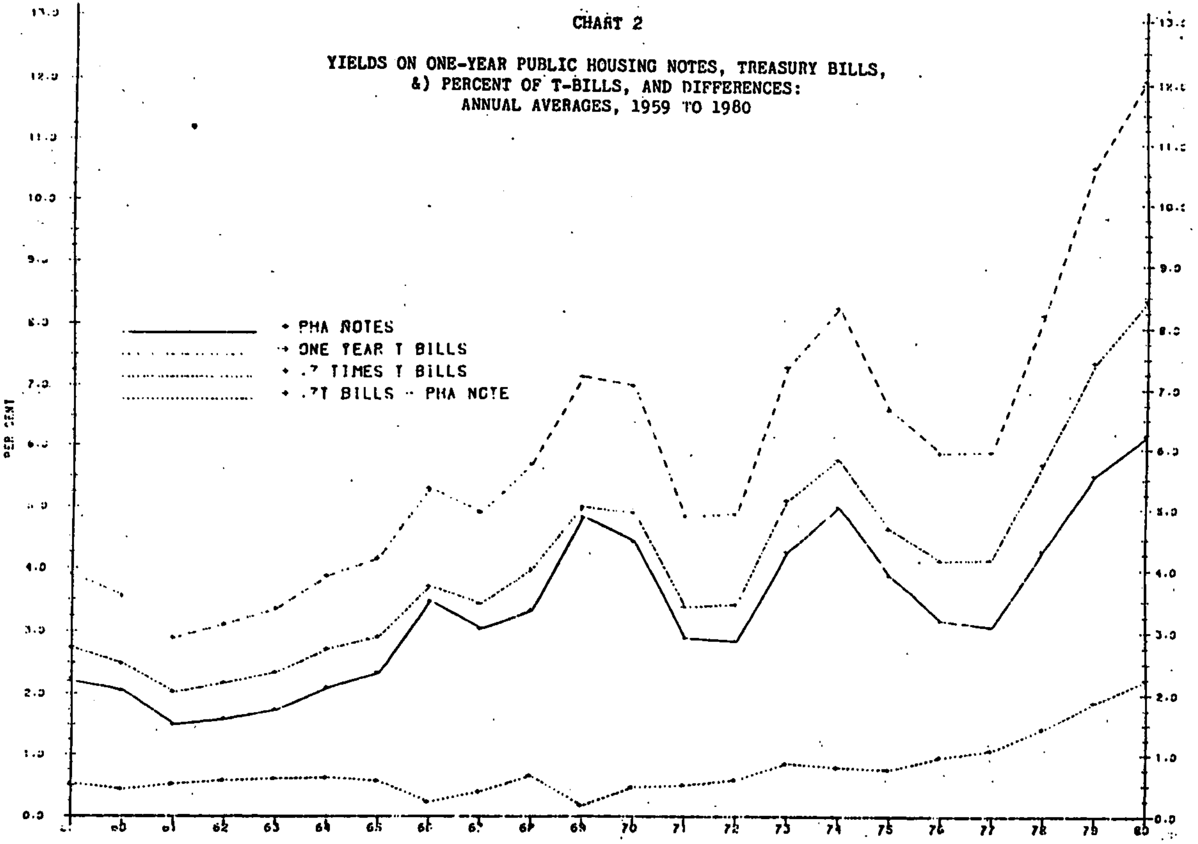


Chart 3 depicts the estimated increase in state and local government annual borrowing costs for both short-term securities and long-term bonds sold during the respective years, assuming borrowings occurred at historic levels. This is derived by multiplying the amount of short-term debt outstanding and total annual long-term bond sales by the interest rate increases attributable to the competition resulting from an ASC.[1/] In the early years, added interest costs are not great because of the small spread between an ASC yield and that on Housing Notes (see Chart 2). However, in later years, the annual added borrowing costs rapidly increase. For example, for the year 1980, when the spread between an ASC certificate and a Housing Note would have been 223 basis points, the estimated increase in annual borrowing costs on short-term debt would have been $300 million (.0223 x 13.6 billion) and that on long-term debt, $525 million (.01115 x 47.2 billion). This gives a total increase in annual borrowing costs for 1980 of $825 million, under the assumed behavior. It is important to note that the added increase in long-term borrowing costs would persist for many years after bond sales because of the borrowers' commitment to pay interest at that interest rate. In other words, assuming a 12-year average maturity, an increase of 111 basis points in interest rates on $47.2 billion would amount to paying an additional $6.3 billion in interest costs over the 12 years the bonds are outstanding.[2/]

These numbers should also be updated for current activity in the market. For the first half of 1981, the average spread between ASC and PHN notes was

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1/ Assuming that short-term rates go up by the full amount of the ASC-PHN difference, and long-term rates by one-half the difference.

2/ For the long-term interest impact, added interest on bonds over their outstanding life should be discounted to a present value figure. Using a 10 percent discount rate and assuming a 12-year average life for the $47.2 billion in bonds sold in 1980, the present value of the $6.3 billion in added interest cost over the life of bonds would have been $3.94 billion.

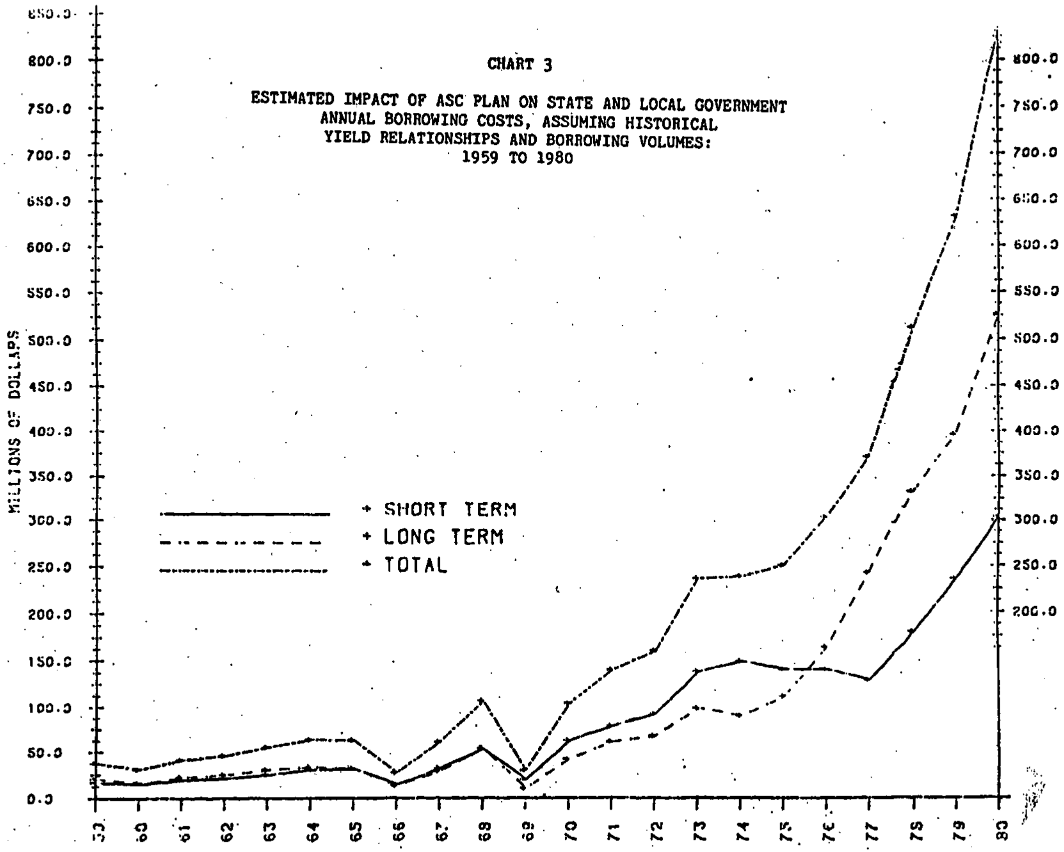

CHART 3
ESTIMATED IMPACT OF ASC PLAN ON STATE AND LOCAL GOVERNMENT ANNUAL BORROWING COSTS, ASSUMING HISTORICAL YIELD RELATIONSHIPS AND BORROWING VOLUMES: 1959 TO 1980
MILLIONS OF DOLLARS
SHORT TERM
LONG TERM
TOTAL

approximately 280 basis points. At a $47 billion annual level of bond sales, and assuming that long-term rates would have increased by an average of 140 basis points, the added annual cost would be $650 million for long-term debt and $420 million in increased short-term borrowing costs (assuming $15 billion in short-term debt outstanding). This sums to a total of $1.1 billion in added interest costs in 1981 were the ASC to have been in effect, using the foregoing assumptions as to interest rate behavior and current borrowing volumes.

Modifications and Uncertainties

The above effects on tax-exempt interest rates and borrowing costs are the results of preliminary and partial analysis. Pegging a rate on a prime tax-exempt security so far above the going market and the sudden onslaught of billions of new tax-exempt securities are such fundamental changes as to overwhelm standard analysis. Practical questions of investor and borrower behavior in the face of rapidly rising rates remain to be explored in refining the initial findings to comport with how we think the market will achieve equilibrium.

Three factors might serve to dampen the upward rise in tax-exempt interest rates. First, not all household investments will be eligible for the ASCs because of the limitation on the amount of tax-exempt ASC interest earnings per tax return. This may limit the magnitude of the household sector investment that can profitably be shifted into ASCs. Second, as tax-exempt rates begin to rise in response to the shift to ASCs, two things will happen: (1) other investors (very large individual investors and institutions -- banks, and property and casualty insurance companies) will be attracted back to the market; and (2) issuers of tax-exempt securities will postpone or cancel their issues, reducing the demand for funds. Both these effects should limit the rise in rates. Third, the increased profits of commercial bank investors -- in particular -- as the ASCs lower their costs of borrowed capital, may set off a "reflow" of demand for tax-exempt securities, thereby improving the demand for tax-exempt securities.

Offsetting these actions to limit the increase in tax-exempt rates are several factors that will exacerbate the upward pressures in rates. The lowering of marginal income tax rates for corporations and individuals will lessen the demand for tax-exempts, as will expansion of the shelters available to retirement plan contributions. The new accelerated depreciation provision will provide also increased tax shelter opportunities for both traditional and potential investors, especially commercial banks. Most difficult to quantify but perhaps most important will be the effect on investor expectations. The creation of over $100 billion in new tax-exempt short-term instruments -- hot money liabilities for the financial institutions -- will create enormous pressure to retain and expand the ASC to avoid future outflows. That can only mean a massive overhang of increasing competition, a further dilution of tax exemption's value, and market uncertainty.

Additional insights as to the implications of institution of the ASC plan can be gained by examining the likely behavior of the household sector. The ASC plan is targeted at that sector and attracting its investments by the granting of tax exemption to interest income. In this respect, it is in direct competition with the traditional safety net investor in municipal securities. By all indications, state and local governmental borrowers have never been in greater need of support from the household investors.

In the following section, the role of household demand for tax-exempt securities is discussed and its likely response to the availability of the ASC, examined in greater detail. This approach provides another avenue for estimating the impacts of the ASC on tax-exempt notes and borrowing costs.

Household Investment

The household sector is an important factor in the tax-exempt market, especially at present. Furthermore (as discussed in the note to this analysis), its actual participation in the market has in all likelihood been seriously underestimated in recent years. The crucial role of the household sector in the tax-exempt bond market has been documented for some time. In periods when money is tight and interest rates are high, the household sector ... consisting of individuals, trusts, and bond funds ... has been called upon to absorb the supply of bonds. This role is particularly critical at present with the lack of appetite for tax-exempt securities now being displayed by banks and property and casualty insurance companies. Currently, it is estimated that approximately 50 percent of new tax-exempt bonds are being sold at "retail" to the household sector.

Less well known is the recent great importance of the household sector to the market for short-term tax-exempt securities. A survey of recent short-term note sales by the Public Securities Association indicated that over half -- 55 percent -- of the new issue sales were made to individuals, bond funds and unit trusts, or bank-administered personal trusts. The results of this survey are appended to this analysis. So far this year, tax-exempt money market funds have grown by approximately $1 billion to an outstanding amount of $3.1 billion as of the end of March (up from $650 million a year before). Open-ended mutual funds and unit-investment trusts also have been growing rapidly and reportedly are frequently investing in short-term tax-exempts.1/

1/ As of the first quarter of 1981, tax-exempt mutual funds had $3.3 billion in assets and unit-trusts, approximately $15 billion. Currently, they are estimated to be growing at a rate of $3 and $5 billion, respectively, annually in holdings.

The results of these surveys are corroborated by other evidence regarding the pivotal role of households in absorbing the new supply of municipal bonds. As documented in the note on the household sector, it would appear that at present rates of activity, the sector is adding to its tax-exempt holdings at an annual rate approaching $20 billion in new acquisitions, with an estimated $5 billion of this going into short-term investments and the remainder — approximately $15 billion — going into long-term bonds.

With ASC certificates by formula yielding considerably more at the outset, it can be readily assumed that much of the demand in tax-exempt money market funds and a good share of the individual investment in the mutual fund and unit-trust would shift directly into the ASCs, along with much of the direct investment in tax-exempts by individuals. Overall, it is estimated that a reduction of $10 billion would occur in household acquisitions of municipals, given the magnitude of initial rate differentials and the holdings involved. Changes in household sector holdings of tax-exempts have fluctuated by as much as $7 billion a year before, with much larger swings in annual rates of change seen on a quarterly basis.

It can be argued that any massive shifts in household holdings would be moderated by the effective limitation of principal that can be held in ASCs, to $10,000 for single and $20,000 for joint returns at present rates of interest. It should be noted, however, that this calls for maintaining an effective segmentation in the market, where large, more sophisticated investors will observe unsophisticated small savers receiving higher rates of return on risk-free tax-exempt income than the former can receive on conventional (and riskier) municipal holdings. Clearly, there will be an inducement to put the first $10,000 to $20,000 of investment into ASCs. Furthermore, the small investor is the most active in the tax-exempt market today. For example, the average size of individual holdings as of the end of 1980 were reported to be $13,000 in open-end bond funds and average retail transactions on new note issues (which includes purchases by funds and trusts) were reported to be in the $25,000 to $40,000 range in the PSA survey. Thus, a loss of half the net new acquisitions by individuals -- either directly or through withdrawal of participation in funds -- seems realistic if not somewhat conservative. To put this assumption in perspective, it amounts to saying that household holdings would increase over the next year by $10 billion instead of $20 billion, at current annual rates, because of the competition from the ASC.

The consequences of this shift in response to the short-term rate differences for longer-term tax-exempt rates, as noted above, is a matter of informed guesswork. Studies of the impact of changes in the supply of bonds on interest rates have resulted in a variety of econometric estimates. In terms of the impact on rates per billion dollars of added supply, the most relevant studies indicate an effect of from approximately 5 to 15 basis points, on average, with larger impacts in immediate geographic areas or on closely substitutable securities.1/ The reduction of the supply of funds from the household sector to the extent of $10 billion may produce approximately the same results. Under current market conditions, the impact should be relatively severe ... on the order of 10 basis points per billion in reduced demand for the market as a

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1/ Impacts of added supply have been estimated to cover a greater range of values. When the major institutional investors are active, the effects would be smaller, 3 to 5 basis points. However, periods when institutional demand is weak (and rates relatively high), the impacts of added supply have been found to be greater. For a review of recent studies regarding the interest rate effects of incremental supplies of tax-exempt bonds, see Ronald Forbes, et al, "An Analysis of Tax-Exempt Mortgage Revenue Bonds," Municipal Study Group, State University of New York at Albany (May 1979) Appendix III.

89-433 O - 82 - 4

whole. Thus, a $10 billion decline in individual net acquisitions would be consistent with a full percentage point increase in borrowing costs. The effect, as discussed above, should be especially severe in the short-term market. Despite the limitations on ASC interest income, it is difficult to see how the short-term tax-exempt market can be insulated from an increase in rates approaching that available on the ASC certificates. Longer-term rates might be less affected. Again, to be conservative, we might argue the two effects will average out.

A market-wide average increase in tax-exempt rates of 100 basis points at current volumes of borrowing would amount to added annual interest costs of approximately $620 million. We believe this is a relatively conservative figure for the interest cost impacts in view of the likelihood that short-term rates would rise by considerably more than one percent.

A Note on Household Sector Holdings of State and Local Government Securities

As of year end 1980, it was reported in the Federal Reserve "Flow of Funds" that the household sector held $74.1 billion in municipal securities, equal to 22.3 percent of all outstanding municipal debt. For reasons discussed in this note to this analysis, we believe that actual household holdings in municipal securities have been understated. This understatement is important in understanding the increasingly key role the household sector, in fact, has been playing in the municipal securities market, especially at the present time.

The major problem comes in how the Flow of Funds estimates for the household sector are put together.

As presented in the Flow of Funds, the household sector consists not only of individual investors directly owning municipal obligations, but also includes such important institutional investors as bank-administered trust funds, not-for-profit corporations, and -- in the case of municipal bonds -- unit investment trusts, managed mutual municipal bond funds, and the new tax-exempt money market funds.

Although we know its components, tracking the household sector's participation in the tax-exempt bond market is difficult because of various data problems. The sector is a catch-all for investor groups not reported elsewhere. Its holdings of municipal securities are calculated as a residual: the reported ownership of municipal securities by institutions for which holdings are regularly collected (such as banks, insurance companies, savings institutions) are subtracted from an estimate of the total amount of bonds outstanding to arrive at an estimate of household holdings.

As documented in a recent report by the Congressional Budget Office, total sales of new issue tax-exempt debt have been underestimated due to the growth in unreported sales of small-issue industrial development bonds (IDB). As is shown in the accompanying table, such sales were evidently underreported to the extent of an estimated $7 billion in 1980. At annual rates, they are being underreported by $9.8 billion so far this year. 1/ The amount of the underreporting can be attributed to household sector acquisitions because the institutional investors, primarily banks and insurance companies, do report regularly their holdings of tax-exempt securities. Thus an understatement of total sales results in an understatement of the household sector's holdings because it is the residual sector.

The consequences of the understatement are seen by comparing the household share as reported in the Flow of Funds Accounts and as adjusted for the understatement of IDB sales. As may be seen, the impact has become very large in recent years. For example, it is estimated that the household sector acquired in net balance (purchases minus sales and maturities) $10.3 billion in municipal bonds in 1980 rather than the reported amount of $3.3 billion. This means it accounted for over 32 percent of the net increase in holdings rather than the 13 percent reported in the Flow of Funds.

For the first quarter of 1981, preliminary Flow of Funds estimates show an annual rate of $7.8 billion in net acquisitions; but the adjusted estimate gives a total of $17.6 billion. In the text, in recognition of the extraordinary role being played by household investment at the current time, we have estimated that household acquisitions are approaching $20 billion per year, as institutions have greatly retreated from the tax-exempt market.

1/ The 1981 estimate is derived on the basis that reported sales have increased by 40 percent for the first quarter of this year, according to Public Securities Association's "Municipal Market Developments."

It should be noted that through 1980, IDB sales (and the household sector's acquisition) had been understated by approximately $18.4 billion (counting sales since 1975). If this is added both to the stack of total debt outstanding and to the household sector's holdings, the latter's share of state and local debt outstanding would be approximately 26 percent rather than 22 percent as reported.

HOUSEHOLD NET ACQUISITION OF MUNICIPAL SECURITIES:
ADJUSTMENT OF FLOW OF FUNDS DATA TO REFLECT UNDERREPORTING
OF SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS
AND IMPACT ON HOUSEHOLD SECTOR NET FLOWS 1/

ITEM	YEAR						
	1975	1976	1977	1978	1979	1980	1981 2/
Total Net Change Reported	$16.1	$15.7	$23.7	$28.3	$18.9	$25.0	$30.7
IDB Adjustment	.8	1.1	1.5	2.6	5.4	7.0	9.8
Adjusted Total (billions)	16.9	16.8	25.2	30.9	24.3	32.0	40.5
Household Change Reported	$ 6.2	$ 2.5	$ 2.6	$ 3.3	$-2.4	$ 3.3	$ 7.8
IDB Adjustment	.8	1.1	1.5	2.6	5.4	7.0	9.8
Adjusted Household Change (billions)	7.0	3.6	4.1	5.9	3.0	10.3	17.6
Household Share Reported (4) as % of (1)	38.5%	15.9%	11.0%	11.7%	-12.7%	13.2%	25.4%
Household Share Adjusted (6) as % of (3)	41.4%	21.4%	16.3%	19.1%	12.3%	32.2%	43.5%

1/ Based on Federal Reserve Board Flow of Funds Accounts, First Quarter 1981 (May, 1981) and Congressional Budget Office Small Issue Industrial Revenue Bonds (April, 1981) for estimates of estimated IDB sales (p. 14).

2/ Based on 1st Quarter, 1981 results only.

Representative REUSS. Thank you, Mr. Petersen.
Now Mr. Trent.

STATEMENT OF PETER C. TRENT, CHAIRMAN, PUBLIC SECURITIES ASSOCIATION

Mr. TRENT. Thank you. I wish to thank the chairman and the members of this committee for the opportunity to present the views of the Public Securities Association regarding the state of the municipal securities market. My name is Peter C. Trent and I am executive vice president of Shearson/American Express, Inc., and chairman of the Public Securities Association [PSA]. PSA is the national trade association which represents some 300 securities dealers and dealer banks which underwrite and provide secondary markets for State and local government securities.

I believe that this committee's inquiry centers about one issue: What can be done to lower interest rates and insure the efficiency of the market?

First and foremost, is bringing down the rate of inflation which has devastated all the fixed income markets. The present inflation "premium," and the perception that inflation will continue in the future, is costing all borrowers untold additional billions of dollars.

For an extended period, borrowers were benefiting from inflation at the cost of lenders. A fundamental change is taking place in the credit markets, which is redressing this imbalance. If lenders continue to demand a "real" rate of return, a reduction in interest rates can only occur with a belief that inflation can be brought under control.

In March 1981, the PSA board of directors adopted the following resolution:

> Recent inflationary pressures have forced the markets for fixed-income securities to experience historically high interest rates and unacceptable volatility which have increased significantly the borrowing costs of State and local governments and the U.S. Government and its agencies. The health of these markets is vital to the continued efficient operation of government at all levels of our society.
>
> We support Federal efforts to implement a comprehensive economic plan that would reduce the rate of inflation and control Federal spending. We believe that the major components of any such economic plan would consist of a Federal budget which will restore the public's confidence in the government's ability to control the growth of Federal spending; the adoption of a tax policy which would stimulate savings and investment; the elimination of excessive and unnecessary Federal regulation; and implementation of a Federal program that would reduce the Treasury's use of the public credit markets and establish a disciplined monetary policy. We believe this type of program will serve to improve investor confidence and the efficiency of the public credit markets.

Today we reaffirm that resolution and urge that Congess reduce Federal spending further and with it the inflationary fears of investors.

Second, there must be a proper balance between supply of and demand for credit. The decade ahead promises to be one of unprecedented demands for capital, both public and private. The thrust of the recent tax legislation attempts to address one side of this challenge by creating incentives to save and invest, in an effort to increase the supply of capital. PSA supports this effort.

As for the demand side of the equation, market forces and government policies will determine the priorities. Unquestionably, the Federal

Government and its agencies are the largest factors in the demand equation. The market correctly perceives that unless the budget is brought into balance, either through reduced spending, increased revenues, or a combination of both, serious damage will be done to the fixed income markets and the economy. If the Federal Government chooses to monetize the debt, strong inflationary pressures will result. If the choice is to compete in the capital markets for the existing supply of credit, all interest rates will rise substantially and many creditworthy borrowers may be unable to obtain credit at any price.

State and local governments also must consider the extent of the demands they can place on the tax-exempt market. We believe these decisions can and should be made at the State and local level rather then by the Federal Government.

Third, changes in tax law and incentives should not be at the direct expense of State and local issuers. By their nature, financing options of municipal governments are limited. They can't sell equity, they derive no benefit from accelerated writeoffs or depreciation, and they are generally not run as profitmaking operations.

I might also add, just parenthetically, there's a full page ad in the paper today typical of many relating to all-savers which I will get to in a minute, but I caught this line—they are giving away Corningware, GE radios, and Kodak Partytime cameras to people who put $5,000 or more in the bank. That's another option that's really not open to municipal borrowers.

The fundamental role of government is to provide services to society in the most efficient way at the lowest cost. The continued health of the municipal bond market is vital to local governments' continued ability to raise capital for public improvements.

For this reason, PSA was particularly concerned about the effect of the all-savers certificate on the market for municipal bonds. We opposed the bill, and strongly urge that Congress not extend it. This device will compete directly with municipal issuers and promises to divert substantial resources from the market.

Various circumstances, including changes in the Tax Code, have taken many of the traditional institutional investors out of the municipal market. Approximately three-quarters of all new long-term municipal issues are now bought by individuals. Broadening this market is of critical importance to keeping credit available, but the all-savers certificate competes in exactly that marketplace, and provides an alternative that is in certain ways more attractive than municipal issues.

Fourth, to reach a new and expanding group of investors, we must have a healthy and active dealer community. Bonds do not sell themselves, and local borrowers must realize they have to compete for investor attention in an increasingly competitive environment. This can only be accomplished through the enthusiastic efforts of the dealer community. The volatility of fixed income market has severely damaged the credibility of long-term investments, and cost investors and dealers billions in realized and paper losses.

In general, the market badly needs more stability to rebuild the confidence and appetite of investors, traders, and underwriters. I must applaud the Federal Reserve System for attempting to bring stability back into this marketplace. Unfortunately, the results to date have been disappointing. But I do believe they have been forthright and steadfast in their positions, perhaps more than the markets have been willing to acknowledge. We believe their course is correct and that it will accomplish its objectives.

In addition to a change in market environment, some specific areas should be addressed.

One. Capital is the lifeblood of a dealer operation. This is particularly important in the municipal market, which is so dependent on principal transactions and must have a wide variety of local and national dealers to function efficiently. Smaller, regionally oriented dealers have been particularly important to local issuers in many parts of the country. In reassessing capital rules, it is critical that these rules not be unduly restrictive. The secondary market, because of its nature, depends on the willingness and ability of the dealer community to position inventory, which means maximizing the efficient use of capital within the bounds of protecting investors and the public.

Two. In addition, the costs of maintaining inventories has increased with interest rates. Most dealers borrow to finance inventories. The interest they pay on such loans is not deductible and is much higher than the interest earned on such inventories. This has been a strong disincentive to maintain secondary market positions, which has in turn contributed to the volatility of this market. This volatility increases risk, and is a deterrent to developing investor interest. PSA recommends changing the tax laws to allow legitimate registered dealers to deduct borrowing costs to finance trading positions. This should bring considerable liquidity and breadth back to the secondary market.

Three. Efforts are being made to improve the efficiency of bond clearance. The present antiquated form in which bonds are issued is cumbersome and costly. PSA has supported efforts toward immobilization, automated clearance, net settlement and other plans to modernize this area. Improving efficiency in this area will contribute to the attractiveness of municipal bonds as investments.

Four. There is deep concern with a continuing tendency on the part of the Federal Government, particularly the Treasury and the IRS, to interfere with the municipal market through administrative actions and regulatory announcements, at times retroactive, which have been done without benefit of hearings or legislative action. These rulings have at times had serious disruptive effects in the market, and we urge that such actions not be taken without full discussion and review.

Five. A fundamental underpinning of the municipal market is the perception that State and local bonds are safe, sound investments. We encourage and support efforts to reduce the Federal presence in State and local government. This obviously means reduced financial support as well. Municipalities must adjust to these new realities, and they will, but we urge the Federal Government to exercise care that reductions are not so abrupt or draconian to impair the financial strength and creditworthiness of local governments.

Although the municipal market has suffered in the recent past, we will continue to work in partnership with State and local governments to enable them to provide for the needs of their citizens in the most efficient manner. We believe that the States and localities will meet these challenges now before them with continued resourcefulness, creativity, and responsibility.

Congress could provide substantial assistance by creating a national economic environment free of the burdens of inflation. We have a long prepared statement which we would like to enter into the record and I want to thank you very much for inviting us.

[The prepared statement of Mr. Trent follows:]

Prepared Statement of Peter C. Trent

The Public Securities Association represents dealers and dealer banks active in the public fixed income markets. We currently have nearly 300 regular members, whose offices are located in all 50 states. Last year our members participated in over 95% of the dollar volume of new issues of state and local bonds, and they also comprise the vast majority of firms active in the secondary market. Our membership participates in the full range of dealer activities, including small firms dealing in special assessment issues and local financings, multimillion dollar investment banking powers, full service wire houses with offices spanning the nation, major money market center and regional dealer banks. Our membership also includes approximately 75 associate members (such as bond counsel, accounting firms, and clearing corporations), whose activities are closely related to the municipal bond market. Therefore, we feel particularly qualified to speak on behalf of this marketplace.

Basic Market Characteristics

The municipal bond market is one of the largest fixed income markets in the world. Current estimates indicate that there are $325 billion in state and local government bonds outstanding, and current volume of long-term new issues probably exceeds $50 billion annually.

Local governments have three principal sources of money to provide the means of supplying governmental service to our society; these are tax revenues, transfer payments from other levels of government, and the sale of fixed income securities. The current trend towards taxpayer revolts and a changing perception of the role of the Federal government as a supplier of financial support threaten to curtail two of these major sources of revenue. For this reason, the continued health and efficiency of the municipal bond market is of critical importance to the continued ability of states and localities to meet the needs of their citizens and in turn to the continued health and efficiency of our Federal system of government.

The municipal market has several basic characteristics which set it apart from other fixed income markets. First and foremost, the interest paid on state and municipal bonds is exempt from Federal income taxes. This Constitutionally affirmed principle enables local governments to borrow at rates substantially below other taxable fixed income rates, and has provided a benefit to society of billions of dollars. In many states, state and local issues also benefit from exemption from various state taxes further reducing costs.

Second, the municipal market has provided municipal investors with unparalleled investment safety. The creditworthiness of municipal securities is an important component in their marketability. Their continued financial health is essential to allow them to provide for the needs of society.

Three, this market is characterized by a staggering variety of individual issues. Estimates vary, but there are approximately

50,000 political entities that have debt outstanding. The vast majority of issuers sell long term bonds in serial maturities, each one constituting a separate "issue." For this reason, the universe of outstanding municipal issues approaches 1-1/2 million. This precludes maintaining continuous two-sided markets in most municipal issues. Because of the infrequency of activity in any given specific issue, there is little opportunity to utilize some of the fundamental techniques of other securities markets, such as a centralized exchange, an effective "auction" market, and the ability to sell "short." Despite this, there is a very active, sophisticated and competitive secondary market for most municipal issues.

Investor Demand for Municipals*

Since the mid-1950's three categories of investors have dominated the municipal securities market. Of the $325 billion of municipal debt outstanding at the end of 1980, we estimate that commercial banks held approximately 46.4 percent, or $151 billion. Households held $63 billion, or 19.3 percent, and property and casualty insurance companies held $90.2 billion, or 27.7 percent.

The relative importance of each of the three major investors has shifted over the years. Through much of the 1960's, commercial

* Statistical information concerning investor demand for municipal securities was provided to PSA by Dr. Ronald Forbes, Director, Municipal Finance Study Group, School of Business, State University of New York at Albany.

banks absorbed two-thirds of all new municipal issues. In the 1970's, they took on less than one-third. Casualty insurance companies took up much of the slack with some help from the household sector. Tax bracket creep and the development of open-end bond funds and unit investment trusts have increased the participation of individuals in the market.

Commercial Bank Demand

Commercial bank demand for municipals increased steadily throughout the 1960's, peaking in 1971 with a $12.6 billion net increase in bank holdings of tax-exempt securities, accounting for 72 percent of the market in that year. Generally, bank demand for municipals since 1971 has diminished. Current statistics show that municipal securities are a relatively minor portion of the assets of commercial banks--10 percent as opposed to 22 percent in 1971. Table 7 shows bank demand for municipals since 1971.

One of the reasons for a slackening in bank demand is that commercial bank profitability has not been strong in recent years. In addition, leasing operations, through which commercial banks make use of investment tax credits have become increasingly popular as a means of sheltering income from taxes. This practice is likely to expand as a result of accelerated depreciation changes in the 1981 tax law.

Another market force may affect bank investment patterns in municipals. Traditionally, commercial banks have shown a marked preference for short and intermediate term municipal securities. A survey by the American Bankers Association shows that in 1980, 42 percent of all bank holdings of municipal securities were of maturities of five years or less. Thirty-one percent of bank holdings were in the 6-10 year maturity category and only 27 percent of bank municipal portfolios had maturities of more than 10 years. (See Table 8).

Another recent survey of bank portfolio managers suggests that commercial banks are increasing their preference for short-term municipals. Planned purchases of municipal securities by banks in 1981 was 67 percent concentrated in the less than 5-year range and 25 percent concentrated in the traditional "bank maturity range" of 6-10 years. This is largely due to the increased sensitivity of bank liabilities to short-term interest rates. Thus, banks are endeavoring to match their interest rate sensitive assets with their rate sensitive liabilities. This practice, known as Asset-Liability or "Spread" management is likely to prevail as Regulation Q ceilings are phased out and the use of variable rate commercial and real estate loans grow.

Property and Casualty Company Demand

Property and casualty insurance companies have been important participants in the long-term municipal revenue bond market. The basic motivation for property and casualty company demand for municipals is the same as for commercial banks--

profitability. Their demand for municipal securities is directly related to underwriting profits (or losses). Insurance company profits are cyclical; therefore their purchases of municipal securities follow these cycles.

Property and casualty company participation in the municipal market peaked in 1978-79 (see Table 9). As Table 10 shows, property and casualty companies have experienced severe and steadily rising underwriting losses since 1979. Since these institutions are expected to have record losses in 1982, it is unlikely that they will be major buyers of municipals in the near future.

Another factor influencing property and casualty company purchases of municipal securities has been their disaffection for common stocks. Their holdings of common stocks declined from 34 percent of assets in 1965 to 14 percent in 1977. Conversely, their holdings of municipal securities increased from 24 percent of assets in 1965 to 42 percent in 1977. A sustained rally in the equities market could lead to a reallocation of assets by property and casualty companies to common stocks as underwriting profits return.

Individual Investor Demand

The individual has traditionally been regarded as the "residual" element in the demand equation for municipal securities. Their activity in the market fluctuates widely, with the greatest volume of purchases normally when municipal rates are near their highest levels. In 1969, to take one extreme example, interest rates were at their cyclical peak and individuals accounted for the purchase of almost 97 percent of net new municipal issues. In 1974 and 1975, municipal rates rose to unusually high levels compared to corporate rates (see Table 2), and individuals were again attracted to the market by high interest rates to absorb more municipal bonds than any other single group of investors.

With reduced demand for municipals by commercial banks and property and casualty companies, individuals have been an important element of the municipal market during 1981. Table 11 shows participation in the municipal market by individuals from 1971 through the first quarter of 1981. At present, individuals are purchasing approximately seventy-five percent of the new long-term financings of state and local governments. For the short-term market the figure is about fifty percent.

Although total holdings of municipal securites by the household sector has not increased significantly in recent years, a larger number of individuals probably have participated in the market through unit investment trusts and open-end funds purchasing municipal securities. At the end of 1980, unit trusts held $23 billion of municipal securities and open-end funds accounted for $4.8 billion.

Recent Innovations in Municipal Finance

State and local governments have become more innovative in their financing strategies. Traditionally, municipal bond issues consisted of serial maturities and term bonds due in 30-40 years. Short-term notes, generally one year or less in maturity, have traditionally been issued to bridge the gap in anticipation of income tax revenues on new issues of bonds.

Investor concern over future inflation and significant demand for shorter maturities have been the impetus for several new developments in municipal finance.

A number of municipal issuers have issued "put-option" bonds. Also known as "option-tender" bonds, they allow an investor to redeem bonds at par value on specified dates many years before stated maturity. This feature is designed to provide investors with a hedge against future interest rate increases.

Another innovation is the use of letters of credit, usually issued by a major bank. These letters of credit provide additional assurance that funds will be available to retire bonds at maturity, or in the case of "put" bonds, on the option dates.

Variable note securities, keyed to current interest rates, have also been sold by municipal issuers. Interest rates are adjusted periodically usually in relation to the rates on government bonds. This is designed to provide protection to investors in a rising rate environment and reduced interest costs to borrowers if rates decline.

Municipal lease obligations are designed to provide money for various capital investments, often of short useful life. They generally provide for rapid repayment of principal and interest, and have been used at times to avoid some of the problems of debt issuance, such as voter approval.

To date, about 16 state and local governmental units have issued tax-exempt commercial paper. This concept, which was originally developed for municipal revenue bond issuers, has now been used by at least one city (Columbus, Ohio), one county (San Diego, California) and, just last week, the State of Connecticut, which issued $115 million in commercial paper at interest rates ranging from 8 percent to 8-1/2 percent. To date, about $1 billion of municipal commercial paper has been issued.

Concerns over the ability to meet debt service obligations has spurred the use of new issue insurance. Several billion dollars in par value of issues has been insured as to principal and interest by two companies that specialize in this area.

The Current Municipal Market

1980 was a record year for new issues of municipal securities. A total of $76 billion of securities were issued. New issues of long-term debt exceeded $50 billion and short-term debt amounted to nearly $28 billion. Even with the record volume of new issues and credit market volatility experienced in 1980, the tax-exempt market provided state and local governments with interest cost savings of 35 percent for long-term issues and 58 percent for short-term issues, as compared to taxable securities of equivalent risk and maturity. It is estimated that in 1980 for the long-term market alone, the tax-exempt feature saved states and local governments about $2.5 billion.

The municipal market has grown considerably since 1970.

In that year, long-term and short-term borrowing together totalled only $36 billion. The volume of new issues of municipal securities for the period 1970-1981 and the cost savings resulting from the tax exemption for this period are shown in Tables 1 and 2 in the Appendix.

New issue volume has been off somewhat during the first eight months of 1981. During this period, $29.2 billion of long-term debt and $22.7 billion of short-term debt was issued, amounting to $51.9 billion. Tables 3 and 4 show 1981 volume by month, along with monthly comparisons of tax-exempt and taxable yields for both long and short-term issues.

Table 5 shows the steady increase since June 1980 in the Bond Buyer Index for municipal general obligation bonds and the Bond Buyer Index for revenue bonds. The Bond Buyer G.O. bond index peaked at an all-time record high of 13.21 percent on September 10, 1981, as did the revenue bond index at 14.24 percent. In the last two weeks, municipal rates have come down somewhat. On September 25, the G.O. bond index was at 12.57 percent and the revenue bond index was 13.62 percent.

The Effect of High Interest Rates

Yet, while the borrowing costs of states and local governments have increased substantially, their costs have not increased relative to those of other borrowers. Our figures show that the traditional relationship between tax-exempt and taxable rates of interest remains basically the same. (See Appendix,

Table 4). For example, the relationship between short-term tax-exempt interest rates and short-term taxable rates has remained at its basic level of approximately 44%. The relationship between long-term tax-exempt and taxable interest rates while higher than normal, for the most part has remained within historic bounds of approximately 70% - 75%.

This relationship probably underestimates the true spread. If taxable borrowers such as corporations and the Federal government were placing similar demands on the long-term market the interest rates they would have to pay would be substantially higher than is currently indicated.

Although the historical relationship between taxable and tax-exempt rates has persisted, the increase in cost, although less percentage wise, is borne in full by state and local governments. Private borrowers can deduct interest costs, making the Federal government a partner in any increase. Public borrowers do not have this luxury. For example, a corporation in a 46% tax bracket only pays 54¢ for each additional $1 in interest cost. If the historical spread between taxable and tax-exempt bonds remains at 70% then a long-term municipal issuer would pay 70¢ in additional interest for each $1 that taxable rates increased. But the municipality must pay the full 70¢. Even though its rate of interest does not increase as much as a taxable borrower, its actual costs increase more.

The high interest rates experienced by the municipal securities market are a result of a number of factors, the most important of which are: inflation; vast demand for capital both by the private sector and the Federal government; and a monetary policy intended to alleviate the effect of the preceding two factors.

The cost of higher interest rates to state and localities is substantial. By way of example, each additional one percent will cost state and local governments an additional $500 million annually on an estimated volume of $50 billion in long-term financing. If one assumes an average life of the securities of 15 years, this would be a cost of $7.5 billion.

During the 1970's the Bond Buyer Index (BBI) averaged 6.95%. So far this year, the BBI has averaged 9.88%. This differential of 293 basis points means an added interest cost of $1.5 billion per year or $22.5 billion over the estimated life of the debt, based on current estimates of new long-term financing.

Recent inflation has caused the value of outstanding municipal bonds to decrease substantially. Dealers and investors have realized billions of dollars in paper losses and confidence in the long-term fixed income markets has been seriously impaired.

We believe that the primary factor affecting the municipal market is inflation and the fear of investors that the Federal government will not persevere in the fight against it. Persistent inflation has plagued all participants in the fixed-income securities markets.

In March 1981, the PSA Board of Directors adopted the following resolution:

Recent inflationary pressures have forced the markets for fixed-income securities to experience historically high interest rates and unacceptable volatility which have increased significantly the borrowing costs of state and local governments and the U.S. Government and its agencies. The health of these markets is vital to the continued efficient operation of government at all levels of our society.

We support Federal efforts to implement a comprehensive economic plan that would reduce the rate of inflation and control Federal spending. We believe that the major components of any such economic plan would consist of a Federal budget which will restore the public's confidence in the Government's ability to control the growth of Federal spending; the adoption of a tax policy which would stimulate savings and investment; the elimination of excessive and unnecessary Federal regulation; and implementation of a Federal program that would reduce the Treasury's use of the public credit markets and establish a disciplined monetary policy. We believe this type of program will serve to improve investor confidence and the efficiency of the public credit markets.

Today we reaffirm that resolution and urge that Congress reduce Federal spending further and with it the inflationary fears of investors.

The Effect of Other Factors

In addition to inflation PSA is deeply concerned with certain other factors which have had an adverse effect on the market.

(1) The enactment of legislation authorizing issuance by depository institutions of the so-called "All-Savers" certificate has created an investment security which competes directly with state and local issuers. During consideration of the 1981 tax bill, PSA and state and local government groups warned Congress of the harmful effects of this credit allocation device on municipal borrowing costs. A study by the Municipal Finance Officers Association predicted that the "All-Savers" bill could cost state and local governments between $620 million and $1.1 billion annually in increased borrowing costs. However, those estimates may be too conservative. This study was based on estimates of certificate issuance that were substantially less than is now believed to be the case. Further, at the time of the study, it was believed that individual investors composed half of the municipal market. At this time, data of the Federal Reserve Board indicates that individual investors are purchasing over two thirds of all municipal securities issued. Thus, the certificate, which will be purchased exclusively by individual investors, will compete for the segment of the municipal market currently purchasing the majority of securities being issued.

(2) There is deep concern with a continuing tendency on

the part of the Federal government, particularly the Treasury and the IRS, to interfere with the municipal market through administrative actions and regulatory pronouncements, at times retroactive, which have been done without the benefit of hearings or legislative action. These rulings have at times had serious disruptive effects on the market, and we urge that such actions not be taken without full discussion and review.

In April 1979, a bill was introduced in the House of Representatives to restrict state and local government housing programs funded by mortgage revenue bonds. The bill was drafted to apply to mortgage bond financings initiated on or after the date of the legislation's introduction, April 24, 1979. ~~March 24, 1980.~~ Even though the legislation was not enacted until December 1980, the bill caused uncertainty and market congestion for more than a year and one-half while the legislation was pending.

In December 1980, the Internal Revenue Service issued Revenue Procedure 80-55, which would have disallowed all deductions for interest paid by financial institutions on time deposits made by state and local governments which were secured by pledges of tax-exempt bonds. The IRS ruling, which reversed a long-standing interpretation of the tax laws, was to apply retroactively. Its potential adverse effect was immediately apparent to participants in the municipal market. For example, at the time of the ruling, commercial banks held 43 percent of the $325 billion of outstanding municipal securities. This ruling was subsequently withdrawn, but only after concerted efforts by state and local governments and members of Congress.

(3) Municipal securities issuers must pay serious attention to the demands that they can place on the market and what priorities should be set for various types of financings. The recent Congressional Budget Office study on industrial revenue financing has generated some concerns which are shared by many PSA members. It is our belief that this subject should be approached within the broader context of overall credit demands and is best resolved at the state and local level.

(4) Concerns have been raised over the effects of the recent tax legislation on the demand for tax-exempt securities. Aside from the previously discussed effect of "All-Savers" we are not prepared to state unequivocably what the effects will be of the broader tax reductions. Although reduced marginal tax rates may have some negative effect this may well be offset by the additional income made available for investment, some of which will undoubtedly reach the municipal bond market.

(5) Capital is the lifeblood of a dealer operation. A large and healthy dealer community is vital to this market. Smaller, regionally oriented dealers have been particularly important to local issuers in many parts of the country. In reassessing capital rules, it is critical that these rules are not unduly restrictive. The secondary market, because of its nature, depends on the willingness and ability of the dealer community to position inventory, and this means allowing the broadest use of capital within the bounds of protecting investors and the public.

(6) In addition, the costs of maintaining inventories has increased with interest rates. Most dealers borrow to finance inventories. The interest they pay on such loans is not deductible. This has been a strong disincentive to maintain secondary market positions, which has in turn contributed to the volatility of this market. This volatility increases risk, and is a deterrent to developing investor interest. PSA recommends changing the tax law to allow legitimate registered dealers to deduct borrowing costs to finance trading positions. This should bring considerable liquidity and breadth back to the secondary market.

(7) Efforts are being made to improve the efficiency of bond clearance. The present antiquated form in which bonds are issued is cumbersome and costly. PSA has supported efforts toward immobilization, automated clearance, net settlement and other plans to modernize this area. Improving efficiency in this area will contribute to the attractiveness of municipal bonds as investments.

Conclusion

Although the municipal market has suffered in the recent past we will continue to work in partnership with state and local governments to enable them to provide for the needs of their citizens in the most efficient manner. We believe that the states and localities will meet these challenges now before them with continued resourcefulness, creativity, and responsibility.

APPENDIX

Table 1

STATE AND LOCAL BORROWING, 1970-1981
(All figures in Billions)

Year	Long-Term	Short-Term	Total	Number of Issues
(Jan-July) 1981	$23.1	$18.1	$41.2	3758
1980	48.4	27.7	76.1	7933
1979	43.3	21.7	65.0	7453
1978	48.3	21.4	69.7	8066
1977	46.7	24.8	71.5	8333
1976	35.3	20.1	55.4	6932
1975	29.3	29.0	58.3	8107
1974	22.8	29.0	51.8	7701
1973	23.0	24.7	47.7	8147
1972	22.9	25.2	48.1	8420
1971	24.4	26.3	50.7	8811
1970	17.8	17.9	35.7	7604

Source: Public Securities Association
Municipal Securities Data Base

Table 2

MUNICIPAL YIELDS AS A PERCENTAGE OF CORPORATE YIELDS

Year	Long-Term*	Short-Term**
(Jan-July) 1981	70%	43%
1980	65	43
1979	61	46
1978	63	46
1977	65	47
1976	70	49
1975	74	53
1974	68	50
1973	66	N/A
1972	69	N/A
1971	69	N/A
1970	75	N/A

Source: Moody's Bond Survey. Percentage calculations prepared by Public Securities Association

* Moody's yearly averages of yields on Aa municipal to Aa corporate bonds.

** Yearly averages of yields on tax-exempt 90-day project notes to 90-day commercial paper yields

Table 3

NEW ISSUES OF MUNICIPAL SECURITIES BY MONTH
(Amounts in billions)

Month	Long-Term	Short-Term	Total
January	$ 2.7	$ 2.4	$ 5.1
February	3.0	2.3	5.3
March	4.0	1.7	5.7
April	5.2	2.0	7.2
May	3.5	5.8	9.3
June	4.9	3.9	8.8
July	3.2	2.5	5.7
August	2.8	2.0	4.8
Jan-Aug 1981	$29.2	$22.7	$51.8
Jan-Aug 1980	$32.1	$19.9	$51.9
Dollar Change	($ 2.9)	$2.8	($ .1)
Percent Change	(9.1%)	14.0%	(.2%)

Source: Public Securities Association
Municipal Securities Data Base

TABLE 4 - TAX EXEMPT/TAXABLE YIELD RATIO

	SHORT TERM	LONG			
		Aaa	Aa	A	Baa
1978 Annual Average	44.2	63.1	63.4	65.5	66.0
1979 Jan.	45.5	64.3	63.4	65.8	70.5
Feb.	47.5	61.1	61.6	63.8	66.7
Mar.	47.4	62.1	62.2	62.5	62.5
April	48.5	61.8	61.2	61.3	60.5
May	45.4	61.2	60.8	62.4	60.9
June	43.9	59.6	60.2	61.2	59.6
July	42.9	60.7	61.7	61.0	59.4
Aug.	41.1	62.0	61.4	61.7	61.4
Sept.	42.6	59.7	63.4	62.2	61.4
Oct.	40.4	61.7	63.1	67.8	64.4
Nov.	43.8	60.3	59.9	60.7	63.9
Dec.	43.6	60.5	60.0	60.1	61.5
1979 Annual Average	44.4	61.3	61.6	62.5	62.7
1980 Jan.	38.5	59.3	58.1	59.3	61.2
Feb.	39.3	58.8	59.0	60.4	59.8
Mar.	39.4	63.0	62.0	64.8	71.3
April	42.3	66.0	62.3	62.0	64.8
May	55.8	61.9	58.2	60.1	60.9
June	42.9	67.2	64.2	64.3	62.8
July	42.2	66.4	66.3	66.9	66.9
August	42.0	69.0	69.1	69.5	70.3
September	47.7	68.9	69.2	69.5	68.2
October	39.4	68.1	67.9	69.7	66.1
November	40.0	67.2	66.7	68.5	66.5
December	39.2	71.5	69.9	69.9	70.3
1980 Annual Average	42.4	65.6	64.4	65.4	65.8
1981 January	40.2	70.1	68.0	68.7	65.9
February	38.9	70.9	70.1	69.2	66.0
March	43.4	71.3	70.5	69.7	67.8
April	44.3	70.5	70.8	71.1	69.7
May	40.0	69.0	69.5	70.2	70.5
June	43.0	71.7	71.5	71.4	70.9
July	44.9	71.0	71.9	71.9	71.4
August	46.2	74.5	77.7	78.6	78.2

SOURCES: Short Term: Federal Reserve Bulletin, Bank of America Quote Sheet, Weekly Money Market Summary of Continental Illinois National Bank and Trust Company

Long Term: Moody's Bond Survey

Table 5

THE BOND BUYER INDICES JUNE 1980-JUNE 1981

AVERAGE MUNICIPAL BOND YIELDS

Date	Twenty General Obligation Bonds	Twenty-Five Revenue Bonds
June 26, 1980	7.76%	8.52%
July 31, 1980	8.59	9.31
August 38, 1980	8.85	9.78
September 25, 1980	9.18	10.02
October 30, 1980	9.45	10.27
November 26, 1980	9.61	10.51
December 31, 1980	9.76	10.81
January 29, 1981	9.91	11.07
February 26, 1981	10.27	11.07
March 26, 1981	10.09	10.80
April 30, 1981	10.94	11.71
May 28, 1981	10.64	11.45
June 25, 1981	10.74	11.54

THE BOND BUYER INDICES BY WEEK JULY-SEPTEMBER 1981

AVERAGE MUNICIPAL BOND YIELDS

July 1, 1981	10.85%	11.66%
July 9, 1981	10.97	11.73
July 16, 1981	11.09	11.87
July 23, 1981	11.34	12.01
July 30, 1981	11.44	12.12
August 6, 1981	11.63	12.34
August 13, 1981	11.94	12.55
August 20, 1981	12.49	13.04
August 27, 1981	12.97	13.89
September 3, 1981	13.10	14.10
September 10, 1981	13.21	14.24
September 17, 1981	12.79	13.78

Table 6

MAJOR INVESTORS IN STATE AND LOCAL GOVERNMENT BONDS

Percentage Share of Bonds Outstanding for Selected Years, 1955-1980

Year	Percent Held by Households	Percent Held by Commercial Banks	Percent Held by Property and Casualty Insurance Companies
1955	42.2	28.2	9.1
1960	43.5	25.0	11.4
1965	36.3	38.7	11.3
1970	31.9	48.6	11.8
1975	30.4	46.0	14.9
1980	19.3	46.4	27.7

Source: Federal Reserve Flow of Funds Accounts

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Table 7

SELECTED MEASURES OF COMMERCIAL BANK DEMAND

(Dollar Amounts in Billions)

		Changes in Commercial Bank Holdings		
Year	Net Change in Municipals	Dollars	As % of Net Municipals	As % of Change in Bank Assets
1981(1Q)	30.7	13.0	42%	10%
1980	25.0	13.6	54	13
1979	18.9	9.5	50	7
1978	28.3	9.6	34	7
1977	23.7	9.2	39	9
1976	15.7	3.0	19	5
1975	16.1	1.8	11	6
1974	16.5	5.4	33	8
1973	14.7	5.7	39	7
1972	14.7	7.2	49	9
1971	17.4	12.6	72	22

Source: Board of Governors of the Federal Reserve System Flow of Funds Accounts, First Quarter 1981

Table 8

COMMERCIAL BANK MUNICIPAL SECURITIES: MATURITY PREFERENCES, 1980

Maturity of Municipal Portfolios

Bank Size (Assets)	Less than 5 Years	6-10 Years	Over 10 Years
26-100 Mil.	49%	37%	14.7%
100-250 Mil.	41	32	27
250-500 Mil.	45	30	15
500-1 Bil.	46	26	28
1-10 Bil.	39	34	27
Over 10 Bil.	27	24	49
All Banks	42	31	27

Source: American Bankers' Association; 1981 Survey Commercial Bank Municipal Securities Portfolios

Table 9

PROPERTY AND CASUALTY INSURANCE COMPANY

PARTICIPATION IN THE MUNICIPAL MARKET
(Dollar Amounts in Billions)

Year	Net Change in Municipals	Changes in Casualty Company Holdings: Dollars	As % of Net Municipals	As % of Changes in Financial Assets
1981(1Q)	30.7	8.3	27%	42
1980	25.0	8.4	34	41
1979	18.9	12.3	65	61
1978	28.3	13.1	46	67
1977	23.7	10.7	45	53
1976	15.7	5.4	34	36
1975	16.1	2.6	16	36
1974	16.5	2.2	13	47
1973	14.7	3.6	24	56
1972	14.7	4.3	29	54
1971	17.4	3.5	20	53

Source: Board of Governors, Flow of Funds

Table 10

UNDERWRITING PROFIT (LOSS)

PROPERTY AND CASUALTY INSURANCE COMPANIES

(Stock)

Year	Underwriting Profit or Loss ($ Billion)
1982	(7.5) estimated
1981	(6.0) estimated
1980	(2.7)
1979	(1.0)
1978	N/A
1977	.8
1976	(1.4)
1975	(2.9)
1974	(1.7)
1973	.2
1972	.9
1971	.7

Source: 1971-77, Best's Aggregates and Averages
1979-82: Estimates by Value Line Investment Survey

Table 11

PARTICIPATION IN THE MUNICIPAL MARKET BY INDIVIDUALS
(Dollar Amounts in Billions)

Year	Net Change in Municipals	Dollars	Household Sector as % of Net Municipals	Purchases as % of Change In Financial Assets
1981(1Q)	30.7	7.8	25.4%	3.2%
1980	25.0	3.3	13.2	1.2
1979	18.9	(2.4)	(12.7)	(.9)
1978	28.3	3.3	11.7	1.3
1977	23.7	2.6	11.0	1.1
1976	15.7	2.5	15.9	1.3
1975	16.1	6.2	38.5	3.9
1974	16.5	8.3	50.3	6.3
1973	14.7	5.3	36.1	3.5
1972	14.7	2.3	15.6	1.8
1971	17.4	.1	.6	.01

Source: Federal Reserve Board of Governors, Flow of Funds

Representative REUSS. Thank you, Mr. Trent.

On the subject of the effects as of October 1 of the all-savers certificates on the already troubled municipal bond market, I have the impression that members of our panel see that threat in somewhat different ways. Some think it's worse than others. I, myself, think it's serious and I'd like to tell you why I think it's serious and then have you comment and tell me that I'm being hysterical or not.

Here you've got—I think you said, Mr. Trent—almost three-quarters of the municipal bond market is now individuals; banks and insurance companies having diminished their portfolios. So I'm an individual owner of a municipal security. What has been the capital attrition for municipal securities since last January, 9 months ago?

Mr. TRENT. It's been substantial, depending on the maturities, but on long-term bonds it's been as much as 35 or 40 percent.

Representative REUSS. All right. This is the last year under the Reagan tax program in which you can get maximum benefits for a capital loss deduction. Is that not so?

Mr. TRENT. Yes.

Representative REUSS. Better times are coming for wealthy people in the tax system and therefore take your losses this year. Why aren't hundreds and thousands of present owners of municipal bonds showing capital losses on the order of 35 or 40 percent going to take those, at least to the extent of $16,000 per family, and get themselves the finest capital loss deduction they will ever have? It will never be that good again. And buy one of these government guaranteed—wait a year and, you know, your principal will be there—all-savers tax-exempt certificates?

Mr. TRENT. Well, if I may——

Representative REUSS. And then if you still like municipals you can buy in a year later, meanwhile having enjoyed the benefits of tax exemption across the board. Assuming investors are in possession of their buttons, why isn't that going to happen in large amounts with very poor effects for an already beleaguered municipal bond market?

Mr. TRENT. Well, if I might, I think there are really two aspects of this question. One of the things we have been able to almost guarantee people in recent years is an annual tax loss in their investments in long-term bonds, which has been unfortunate, but the point of tax selling and tax swapping—and there will be a great deal of it this year and there already has been—there was a great deal of it last year—is the simultaneous or near simultaneous reinvestment of the money in a similar discounted obligation at the same par value.

You see, the reason many people would take tax losses and will take them and will not go into an all-savers certificate as it gives them no ability to recapture that capital loss. If you bought a bond at par and it's now worth 50 cents on the dollar, if you sell it and establish that loss, you go and buy another bond, a similar bond, at 50 cents on the dollar and somewhere down the line you have the expectation that you will recover that capital at some point in the future.

Representative REUSS. If I may interrupt, but such has been the travail of owners of municipal bonds this year, for instance, that every time—in March, April, May, June, July, August, and September—they thought that the precipitate declines are passing and it turned out they were wrong, and even though it seemed impossible, things got worse. Aren't some of them going to feel that maybe the time has come to blow the whistle on this excessive optimism and find a snug harbor for a year in a tax-exempt certificate?

Mr. TRENT. I think there will be obviously a great deal of money that will go into all-savers. Some of it may be from sale of securities that people have taken losses in. I don't think that's where the major part of the funds will come from though. I think it's more new money. There will be diversion of money out of taxable investments and quite a bit of diversion out of new money investments that otherwise would have gone into short-term, intermediate, or long-term municipals, depending on the preferences of the investor himself.

Representative REUSS. It's the same thing, in terms of the municipal bond market, whether it comes directly from the municipal bond market by somebody selling a municipal bond or indirectly by somebody deciding to change his mind and not buy the municipal bond which he was about to buy. In either event, it seems to me an already tortured municipal bond market is going to have a few more turns of the rack in the days ahead.

What do you others think?

Mr. PETERSEN. I might pick up on that point, Mr. Chairman. We did an analysis in early July on the impact of the all-savers certificate which indicated very harmful results for the nunicipal securities market, a great deal of pressure on interest rates, higher costs of borrowing for issuers. One of the interesting outcomes of the analysis was showing that it did not require a tremendous shift in household demand in the securities to have those harmful results.

For example, in the first quarter of this year, households were on a net basis acquiring municipal bonds to the tune of about $20 billion a year. In other words, they were basically the entire market. If we only had a shift of about $10 billion in household demand—that is not taking them entirely out of the municipal bond market but simply cutting their rate of acquisition in half—we calculated it would increase municipal security interest rates by roughly 100 basis points. And, in fact, I think that the market has, of course, already been discounting that impact simply because even though the tax-exempt market is good-sized, it's only part of a very, very large financial market. When we start putting so much pressure on a particular investor group—and it's the individual, and the individual operating through the mutual fund, that's carrying the municipal bond market on its back—and if we start having just a few of these households shift out, relatively speaking, to acquire all-savers certificates instead of acquiring municipal securities, then the market must price bonds, as Peter knows, lower and lower with higher rates of return. That's because we're having to dip down into lower and lower tax brackets of investors to absorb the supply.

The WPPSS bond sold at 15 percent, that's on a AAA security. That security was considered as tantamount to a federally guaranteed bond yielding 30 percent on a pretax basis for an investor in the 50-percent-tax bracket. So, in other words, rates have had to be elevated to such a high level already, I think the market can ill-afford any further attrition in demand.

Another factor I'd like to pick up, too, as Mr. Altman pointed out, is the importance of expectations. I think that not just individuals in the market but institutional buyers are wondering about what's going to happen when the all-savers certificate comes up to the end of its expiration in 15 months and we see thrift institutions and others with $125 billion in tax-exempt securities outstanding and contemplate the kind of arguments they are going to make in terms of the need to retain this instrument. It is possible—and I certainly hope it is not the outcome—it is possible there will be great pressure to extend the program, perhaps to extend the maturities and further erode the market.

When the municipal securities market has to start competing with the general housing market, we're in bad trouble.

Representative REUSS. Mr. Altman, would you differ from the views expressed?

Mr. ALTMAN. Only in degree. My point really is that, yes, the all-savers certificates already are having a negative effect on the municipal market, and from that and other perspectives, my own view is that they are a bad idea. Nevertheless, they are outweighed substantially—this is where I might be slightly different than my colleagues—by other factors weighing on the municipal bond market.

To the extent that, in some hypothetical sense the all-savers program suddenly should be canceled, I don't think you would see a major improvement in the municipal bond market.

Representative REUSS. Well, I wasn't suggesting that all-savers certificates were the sole malady of the bond market. The big one is the one that you have all pointed out—high deficits, excessive Treasury borrowing, high interest rates—that's ruining the municipal bond market. That's it, isn't it?

Mr. ALTMAN. Yes, and I would say also, Mr. Chairman, there's an interesting and I think correct case which many in the financial community and other places have been making, that the municipal bond market not only has suffered more than the other markets—the taxable markets, Federal and corporate—but will continue to suffer more unless these broader factors aren't cured. And the reason for that is really that the municipal market, as Mr. Petersen and Mr. Trent pointed out, has less access, if you will, to certain pools of capital than other markets tap. The Treasury borrowing of $75 billion of new cash next year plus $150 billion or so of amounts to be refunded—$225 billion—is basically annihilating the municipal market in terms of who competes for those funds.

So I don't want to belabor this point but, yes, those broader factors are far more important then this admittedly negative one of the all-savers certificate.

Representative REUSS. Mr. Petersen, did you and your group bring the potentially harmful effects on the municipal bond market of the all-savers certificate to the attention of the Treasury last summer?

Mr. PETERSEN. Yes, we did, Mr. Chairman.

Representative REUSS. What did they tell you? To cease worrying?

Mr. PETERSEN. Well, I believe the general upshot of it was that a lesser of evils seemed to be to enact this legislation to assist the savings and loan associations and the thrift institutions. Certainly they were advised of our concerns and given our analysis. We were not alone in this. We worked closely with other State and local interest groups but we were unsuccessful ultimately.

Representative REUSS. How do the banks get in on that all-savers certificate? Savings and loans are hurting. The banks are not hurting.

Mr. PETERSEN. The idea, of course, was to try and stimulate the supply of credit to the housing industry or, at least to assist in the financial flows going into the savings and loan associations in particular. The banks, however, were involved in the legislation and to the extent they can satisfy the requirements of the legislation in terms of their portfolio, then they can issue the all-savers certificates. The requirements basically are that 70 percent of the proceeds of these certificates be put into some housing security. That includes Federal agency securities as well as direct mortages

Representative REUSS. Banks have no problem putting 70 percent into FNMA in paper, which doesn't result in any new building.

Mr. PETERSEN. I would think not. Of course, FNMA has come out with special certificates to make this all possible without financial institutions having to go out and acquire mortgages. It should improve the profit situation for these institutions.

Representative REUSS. Over the years, from what I have been able to observe of the people, Mr. Petersen, in your trade association—that is, the investment houses which sell municipal bonds—they have not been, as far as I can see, offensive in conning people who really didn't belong in municipal bonds to buy them. Thus, if an unemployed worker who recently lost his job came to one of your association members and said, "Look, I'm on unemployment compensation now but I do have some savings and I'd like to take them out of wherever they are and put them into tax-exempt bonds," my impression is that the bond dealer would say, "Oh, no, this isn't for you. This is for somebody with a lot of income." Is that not so? I have never heard of your association members attempting to get people who really don't belong in those bonds to do so. Plenty of banks and plenty of S. & L.'s are now indulging in the most unconscionable con game on lower income people, selling them these 12-percent securities when they aren't in an income bracket to make out on that. They do much worse than if they bought 17-percent money market funds and paid the tax on them.

Mr. PETERSEN. Mr. Chairman, the Municipal Finance Officers Association has many associate members who are bankers and underwriters and dealers for whom we are grateful for their participation. But I think really the best individual to respond to that is Mr. Trent of the Public Securities Association.

Representative REUSS. Mr. Trent.

Mr. TRENT. Well, of course, all dealers and dealer banks operate under regulations, among which include tests of suitability for customers. It would be unethical practice to try and——

Representative REUSS. Whose regulations?

Mr. TRENT. It's part of the municipal securities rulemaking board regulations which are enforced by various regulatory agencies, depending on the nature of the dealer or dealer bank involved, but there are suitability rules and there are ethical concepts that would preclude trying to put an unemployed individual into a tax-exempt security.

I would agree, I think, that some of the advertising that's going on has certainly been the type of thing that the SEC or MSRB would not condone as far as the sale of securities is concerned.

Representative REUSS. Aren't they perpetrators of these scams? Aren't they subject to any regulations?

Mr. TRENT. Well, I'm not sure. That's a banking question. I would think in terms of advertising rules, that the Federal Reserve and the FDIC or whoever the appropriate banking regulator is, would have some concern with that, but that's separate from the dealer operations. So I really can't answer that authoritatively.

I would like to get back to your point, though, which is relative to this. As everybody has mentioned, the individual market has become the mainstay of the municipal market. The WPPSS issue has been mentioned by various people. I think it's a little bit anomalous because it is a borrower that's had some very bad publicity and problems. I don't think there's any question about the creditworthiness, but they have had a lot of adverse publicity.

In any event, we were a participant in the distribution of that paper and our average sale was in the neighborhood of approximately $15,000 to $20,000 transactions, which again is right at the heart of the type of money—the amount of money that would go into all-savers. We worked with the MFOA recently in preparing some testimony on all-savers that had to do with the disposition of the market in short-term municipals which traditionally has been much more of an institutional area, and even there over 50 percent of the short-term paper—the municipal notes that have been sold recently—have gone to individual investors and, again, interestingly, in the issues that had small denominations, the size transaction has been very closely related to the type of transaction that you have seen in all-savers.

So I think you could conclude there would be some very definite direct diversion of money out of this market into all-savers.

Representative REUSS. Congressman Wylie.

Representative WYLIE. Thank you very much, Mr. Chairman.

May I extend my own welcome to this very distinguished panel. Having been a law officer of a municipality, to wit, Columbus, some years back, I have some acquiantanceship with the problems to which you allude.

You mentioned, Mr. Petersen, several recent new tax laws that will have an adverse effect on the municipal bond market. What would you characterize the health of the municipalities generally as being now?

Mr. PETERSEN. The fiscal condition of municipalities now is stressful. That is a reasonably heroic generalization, but I believe it's been documented in studies done, including surveys done by the Joint Economic Committee of cities' fiscal condition.

You do see several States, for example, that have had their ratings reduced over the last year and, as I indicated in my statement, we find that more municipal bond ratings are being lowered than are being increased throughout the country.

Now the bond rating isn't everything, I'll be the first to say. But, generally, it's a pretty good indicator of the direction of finances and the kinds of pressures governments are under. I could recite several major cities, including cities in Ohio, that have had difficulties. Those are, I think, well known. But the State and local government sector is shrinking. The sector is under increasing pressure. Service levels are being reduced. In many States we find virtually zero growth in revenues and expenditures are having to be cut.

This can be unfortunate for the citizens in many cases. Of course, this, in many cases, happens to be of their own choice. But it does make investors worried because these kinds of pressures and changes can cast doubt on the ultimate ability of jurisdictions to be viable, not just in terms of repaying their debt, but whether or not their economy is going to be able to support activity that will lead to some kind of growth and, perhaps, an increase in their bond rating. We find the trends going the opposite direction now.

Representative WYLIE. You have big cities like Cleveland, St. Louis, Chicago, Detroit, and other large cities like that having their bond rating decline. That has an adverse impact on the municipal bond market too, doesn't it?

Mr. PETERSEN. Yes, it does, and particularly——

Representative WYLIE. I might say that my own city of Columbus has a rather healthy bond rating now. Columbus is still AA, but I think one of the reasons Columbus is still AA is because we have a strong local government. There is expansion of the economic base and a considerable amount of growth, and I don't want to sound like the chamber of commerce, but Columbus was the only municipality above 100,000 which increased population in the Northeast sector of the United States in the last decade.

So there are other factors besides new tax laws which have had decided adverse impact on the marketability of municipal bonds; isn't that true?

Mr. PETERSEN. Yes; there certainly are. For example, in the case of Cleveland, they have made good strides in improving their condition of getting the rating back and getting into the market. But I might point out that just a couple years ago in the wake of Cleveland's downgrading, a lot of Ohio municipalities were under considerable trouble and the State had to create a special financing authority to help them. The State's bond rating itself was lowered from AAA to AA, the State of Ohio. One of the reasons given for that reduction in addition to the general economic travail, was the fiscal condition of Ohio's local jurisdictions.

So I agree that there are some good signs on the horizon for some jurisdictions. But, generally, it's a very difficult situation and one which is exacerbated by the rapid decline in Federal assistance. In many cities that aid has accounted for 20 or 30 percent of their general revenues coming in. It's very hard to replace that kind of money, as you know.

Representative WYLIE. Well, I don't want to be one who added trouble to the municipality. I'm great for local government and local stuff and all those good things, you know. So if you were pressed to make a choice or a recommendation, which of the provisions in the new tax laws would you identify as being particularly harmful to municipal securities? Are you in a position to help us in that regard?

Mr. PETERSEN. I can point out those which I think had a particularly hurtful impact. But, I want to be very clear in terms of simply indicating this is an unintended side effect. I realize that simply preserving a strong municipal bond market cannot dictate all tax policy in this country and what taxes should be lowered. The particular provisions I think that have hurt the municipal bond market are, first of all, the all-savers certificate, as we discussed, not just its immediate impacts for the present but what may be coming down the road.

Second, lowering the top marginal tax brackets for individuals from 70 to 50 percent. That may have a good effect on the productive juices of the economy, but nonetheless, it really struck at a very important investor group in the municipal securities market.

Third, I don't think we have sorted it all out yet, but I believe that the competition created by the accelerated depreciation and the liberalized leasing provisions will drive another nail in the coffin of bank demand for municipals in particular. Banks have been very active in using leasing arrangements as a method of tax shelter.

Fourth, in association with the general lowering of tax brackets, I think the lowering of the tax on capital gains. If you look at individual portfolios, oftentimes the tradeoff appears to be between municipal securities and equity holdings. A lower capital gains rate over the long haul will probably encourage more holdings in equity. This will cause downward pressure on municipal securities prices.

I would identify those four in particular.

Representative WYLIE. Mr. Altman, would you care to respond to that question?

Mr. ALTMAN. On the second point to your second question, Congressman Wylie, I basically agree with Mr. Petersen. I might choose a different order of factors, but I particularly agree with his comment about the future demand for commercial banks which have traditionally supported the market. Realities are that the largest banks today are paying very little tax and that the tax bill will, as John says, likely reduce even further their appetite for tax-free income. So that underpinning of the market is being undone; as you say, inadvertently, by the tax bill.

Also, of course, the personal rate cuts and the capital gains tax reduction are having unintended effects. But I repeat what I said before you came in, which is that even a tax bill and all of its effects is but a secondary factor in the problems of this market and, again, in a hypothetical sense, if the tax bill were suddenly taken off the books and we were going to be after October 1 where we are now, I don't think you would see much of a sustained improvement in the municipal market. The tax bill has hurt the municipal market, but the fact that this market has declined more or less in line with the overall markets tell you that the tax bill is not a huge element in that decline. Nonetheless, it is negative.

Representative WYLIE. What would you say was the primary elements?

Mr. ALTMAN. The broader factors that the chairman referred to earlier are all too familiar in terms of, first and foremost, inflation. Any study one wants to look at makes clear the extent to which inflation and interest rates are closely correlated and the extent to which inflation has devastated credit markets over the past decade.

Today, the expectation that inflation is going to rise again which is weighing most heavily on the market.

In preparing this testimony I called a variety of people in the municipal market, people who actually trade bonds in both municipal and the taxable markets, and asked. In most instances it's the expectation that inflation is going to be rising and therefore these individuals don't want to have substantial bond positions looking out more than a very short period.

Second, of course, it's the role of monetary policy here where the perception is widespread that the Federal Reserve, which as Mr. Trent said, is doing a commendable job, is going to be under even greater pressure as the tax and Federal spending changes take effect on October 1, because those will have a net stimulus on the economy and a net stimulus in terms of the demand for money and credit, and thus if the Fed is going to stay the course will put more pressure on the Fed to not only maintain but tighten the policy.

Then you have the effect of the Treasury need for funds which is so large, reflecting the indicated deficit which is going to be larger, in the view of the market, than the administration's forecast. Even if the $16 billion deficit-closing package is enacted, these other factors are the series of broad ones, Mr. Wylie, which really quite outweigh the effects of this tax bill on the municipal market.

Representative WYLIE. So inflationary pressures and high interest rates and expectations of high interest rates really are taking a toll on the municipal bond market is what you're saying, and that's the primary factor.

Now in that regard, in order to try to do something about inflationary expectations and high interest rates, a lot of people have been going to money market funds; isn't that correct, Mr. Trent?

Mr. TRENT. That's correct.

Representative WYLIE. And I would have to think that that might even have more of an impact than the all-savers certificate which really hasn't gone into effect yet until October 1.

Mr. TRENT. Yes. I think one of the great problems with the long-term market has been the competition from short-term instruments and when people can earn 17 percent or more on a short-term liquid asset there's very little inducement to go out and lock up in a long-term basis unless there's a very strong perception that interest rates are going to decline over a protracted period of time.

At this point, that expectation is not there in the marketplace and I don't think you could expect any substantial downward movement in rates until the perception changes and until short-term rates come down substantially from where they are now.

Representative WYLIE. You mentioned that people were actually selling municipal bonds below par value in order to get the money or make it available to invest in other things, and I think basically they are going to money market funds very frankly. Is that a fair observation on my part?

Mr. TRENT. Some money may be going into that from those sources. Some of it is being reinvested in other similar long-term bonds, as I say, at similar discounts. Some of it is being put in equity markets. There are any number of investor preferences or opinions. That's what makes horse races and markets. But I don't think you can necessarily conclude that there's a direct correlation there, but some of that money I'm sure is getting into that.

Representative WYLIE. To what extent would an expansion in the money supply or the credit vis-a-vis monetary policy have an impact on the municipal bond market? Would it have any?

Mr. ALTMAN. Mr. Wylie, if I can try that, it would have an impact and it would be negative. One of the misconceptions I find widespread is that the way to improve the markets and lower interest rates is to have the Fed ease its monetary policy. And I think it and I think you see widely in the financial community a feeling that that would be negative for interest rates and negative for the marketplace because it would result in even more pessimism over inflation and expectations of inflation than now is the case.

The Fed, even by the administration's admission, is the fighter against inflation. After all, there is a stimulative fiscal policy. There's no incomes policy. There's no energy conservation policy and other things. The administration's inflation policy is the Fed. If the Fed decides to ease, therefore the fight against inflation is eased, as it relates to future trends, and I think the markets and interest rates would react accordingly and in the negative.

Now one could debate whether a different Fed approach to inflation might not permit the Fed to ease and have a different effect, but when you have an inflation policy which is the Fed and then the Fed eases in a period when inflationary expectations are high, it's negative. If you have a comprehensive inflation policy involving some other elements like a more responsible fiscal policy and an incomes policy and things like that, and the Fed eased, it might have a different effect, but not under the present circumstances.

Representative WYLIE. Well, I think we are in the throes of making some changes in fiscal policy and changes where the emphasis will be placed. I happen to agree with you that up until now our inflation policy has been directly handled by the Fed or directed to the Fed. What about budget cuts? What about the budget cut bill and the budget reconciliation bill that's passed on the recommendations the President made last Thursday? Won't that help the bond market?

Mr. ALTMAN. I'm sure my colleagues would like to respond to that, but I would just start by saying that the President made that speech Thursday night and the bond market fell like a very heavy weight off a cliff on Friday. Why did that happen?

Representative WYLIE. That's what I want to know.

Mr. ALTMAN. That happened because investors, just principally credit markets, don't think that, on the one hand, that $16 billion if enacted is likely to bring the deficit within the types of levels that would be conducive to lower interest rates; and second, that it isn't likely to be, at least in most of its form, enacted.

So to ask me to put it in perspective, you see fears that the size of the tax cuts are going to overwhelm changes like that—$16 billion—to a point where the deficit and the Treasury financing needs are overwhelming, and that's why people are so bearish.

But last Friday was a good example—or was one example, I should say—of the magnitude of the problem. The $16 billion, right or wrong, is viewed as a very small amount in terms of interest rates.

Representative WYLIE. Would you like to comment on that, Mr. Petersen?

Mr. PETERSEN. Well, I think the State and local government sector presents some particular problems. The proposed budget cuts of $13 billion will come from the roughly $100 billion in domestic nonentitlement expenditures on which you can operate. As I indicated in the testimony, intergovernmental transfers represent a fairly large portion of that, somewhere on the order of $75 to $80 billion next year. So when it comes to a further reduction, you're talking about even a further cutback in aid to State and local governments. This goes back to my opening comment, Mr. Wylie, on the triple whammy effect. We seem to get it coming and going—a tight credit market, changes in the Tax Code to make the market even tighter, and on the other side of the equation, very rapid reductions in Federal grants in aid.

Representative WYLIE. While we would all agree we have to cut spending a little more, I would say parenthetically, what if we can find another place to make those spending cuts?

Mr. PETERSEN. Of course, I think there was a lot of interest as to whether or not the entitlement programs in particular could be reduced. One of the things about State and local governments is that to the extent you do have reductions in these entitlement programs and transfers to individuals, it still leaves States and local governments holding the bag because many of these people have got to go somewhere and in many cases be taken care of. Again, you see what we have is a transfer of the Federal deficit to the State and local sector in many cases to balance the budget on the Federal level which will require a greater hardship and financial pressure on the State and local governments, and I'm afraid it's a closed-in system for our jurisdictions in particular, and I just think that should be borne in mind when we look at some of these other effects such as we're discussing today and why the bond market perhaps is not only reacting to general pressures, but peculiarly concerned about the municipal securities market and the general obligations credit. It is a sector which grew rapidly in the 1960's and 1970's and which is now in retrograde.

Construction by State and local governments is off 20 percent in the first two quarters of this year. So it's difficult.

Representative WYLIE. Mr. Trent.

Mr. TRENT. Well, I'd like to preface with a couple things and then comment on some other effects of the tax law.

One thing that strikes me is we talk about budget cuts and what we are really talking about is reductions in increases, because from the figures you've got you still have the Federal budget under the administration figures for 1982 which is about 22 percent above what the spending was in 1980. So I think it still illustrates there's a great deal of impact from the Federal expenditure side on the marketplace one way or another that has to be financed either in the market or through increases in revenues from other sources, and either side I think puts a great deal of pressure on the marketplace directly or indirectly.

I'd also like to say it seems to me, whether or not the program is enacted, if it's going to prove to be effective, nobody knows. There are varying degrees of healthy despair about that, but one thing that's clear is that the major part of it hasn't even been implemented yet and it seems to me it is a little early to sound the death knell on something that hasn't even been gotten underway.

There's no doubt the markets have reacted very negatively to it. That may prove to be a very sound assessment. In the long run it may prove to be an incorrect one. But it does seem a little premature to express one's opinion over something that hasn't been tested yet.

In terms of the effect on the municipal market of some of the changes in the tax package, I respectfully disagree to some extent with some of my cotestifiers here. It's been our experience—and we are a firm that deals a great deal with individual investors—that people that are in the 70-percent bracket have shown a lot more interest in things like deferred annuities or tax shelters or other forms of deferring taxes than just tax-exempt investments alone. Even with the drop to 50 percent, I think those people who were still inclined—who were inclined to buy municipal bonds still will be. There will still be a definite advantage for them to do so. The other side of it is as you reduce those rates it presumably does make more money available for savings, some of which could get into the municipal bond market. So I'm not sure you can conclude that overall the reduction in rates is going to mean a lessened demand from individuals for municipal bonds.

I do agree that one of the very important elements in the marketplace is getting the institutions back into the market. The banks seem to be out and probably for a protracted period of time. For the casualty companies, it may be a shorter period. They are in a cyclical phase now which has taken them out. But I think something that induces or reawakens their interest in the municipal market would be the greatest positive thing that could be done for the marketplace and that really gets more into the effect of shelters and deferrals and accelerated writeoffs and some of the other areas where they have been able to shelter income.

I think another possible way to go at this is to perhaps consider discouraging the attractiveness of borrowing. I think that the municipal market basically has kept its historic relationship to taxable rates. They have moved to the upper limits here recently, but I think in looking over a longer period of time they are within the historical ranges they have been. But the real cost to a municipality of this or a tax-exempt issuer is for every 1 percent the taxable rates go up, if you assume that tax-exempt rates go up three-quarters of a percent, that municipality or that borrower pays that full 75 cents of that dollar of the full increase, whereas for private borrowers the Federal Government and State governments are partners in that increase because a great deal of that additional interest cost is a deductible item. So the impact, even though the relationship may stay the same, the actual cost to the municipal issuer has increased substantially.

I think bringing down the amount of deficit borrowing or borrowing in the economy as a whole, not just the Federal deficit—that's not the only profligate borrower. State and local governments have gotten themselves into those problems, too. But bringing more balance into the financial and fiscal affairs of State and local government, as well as the Federal Government, I think would help, too.

Representative WYLIE. I'm a little surprised or amazed I think at the reaction of the stock market—or, more specifically, of the bond market. That may be a little bit more reflective of future expectations. Is that a fair statement?

Mr. TRENT. Well, I would say, speaking for myself and I think a number of other participants in the market, we are all very confused at this point. The reaction seems to be certainly more adverse and deeper than many people had expected.

Representative WYLIE. The reason I say that—and this is a hypothetical question, maybe an inflammatory question—didn't the rise in interest rates start long before the enactment of the Reagan economic program?

Mr. TRENT. Yes, it did.

Representative WYLIE. And we didn't see this kind of reaction when the interest rates were rising and inflationary pressures were rising along those several years.

Mr. TRENT. Well, I think markets are composed of rational expectations and irrational reactions too, and I think at any point in time, markets are a combination of both. There seems to be a great deal of nervousness, skittishness in the markets now, both the equity and the fixed income markets, and I think a lot of that is concern as to what the future brings.

There's a new approach. There's a new program that's being attempted and I'm not sure even its stronger advocates are really that sure what the results are going to be. I think it's also clear, though, that if we were looking at what may have been even greater deficits, the problem might have been even more intense.

Representative WYLIE. What makes the difference is the state of the economy.

Mr. TRENT. Well, I think it can have a profound impact on investment decisions which, let's face it——

Representative WYLIE. You mean businessmen are likely to take their savings out of a money market fund and invest in plant and equipment based on the fact that we have a new tax cut program that's going to be very beneficial to them?

Mr. TRENT. Well, I think one thing, business decisions and government decisions take time to implement and I think we have had, for over a decade, a very strong institutional bias toward inflation in this economy and I don't think that can be turned around in a matter of 30, 60, or 90 days.

The plans of either business or government to build new facilities, to make investments, usually take a number of months or even years to put into play, and that process presumably—or I think some would argue—is in the process now of being reassessed.

Representative WYLIE. Your bottom line recommendation is that we reduce Federal spending more and try to reduce the deficit more?

Mr. TRENT. Yes; I think that's a very important element in the market.

Mr. PETERSEN. Will you keep lending us money, Peter? Because I'm afraid a good part of that reduction is going to come on top of an already sizable reduction for State and local governments.

Mr. TRENT. We'll keep trying to find people to lend money to you, John.

Mr. PETERSEN. Thank you. I think one of the particular problems for the State and local sector, besides taking on their fair share—or more than fair share—of the burden, has to do with the changes in the tax code.

I don't want to sound too parochial, but I do think they are important. We talked about those impacts directly on the municipal securities market. But, also, we had State taxes which were reduced, again inadvertently, because they were tied in with the Federal income and corporate taxes. In particular, accelerated depreciation is going to mean a reduction is State corporate income tax receipts.

Now if you just keep adding to these kind of problems, along with the reduction in Federal assistance that's taking place, you cause some very considerable financial strains. Looking at it solely from the perspective of what might have helped this sector make the transition, perhaps a Federal fiscal policy that would not have had the sharp reduction in the taxes coming as they did. The sharp tax cut has obviously caused the current second go-around for even further reductions in spending. Looking at it from the standpoint of the State and local sector, I think further spending reductions will be more harmful than will be increased taxes to continue funding governmental activities which many of our people believe are important and should be performed.

Representative WYLIE. Where would we increase the taxes, thought? I really am glad to have the benefit of your expertise because we are going to have to make some very difficult decisions.

Mr. PETERSEN. This is purely my personal observation, Mr. Wylie. Efforts are being made, say a reconsideration in revenue needs, that do, interestingly enough, tie into the municipal securities market—a reconsideration as to the scope of that market and some of the financing of private activities that's taken place in that market.

I'm referring in particular to the small-issue industrial development bonds and the pollution control bonds. These are corporate financing devices that have had access to the municipal securities market. They do certainly increase the supply of tax exempts. I believe—I do not know the details—that proposals will be made by Treasury to seal off access to these particular uses by corporations on the basis that they now have other methods of financing and that there may be some favorable revenue impacts as a result.

Other than that, it's never popular to try and backcast and think about what taxes might not have gone down so quickly. But generally speaking, a little slower approach to the tax reductions would have been helpful from the standpoint of not causing so much pressure on the spending side of the budget.

Representative WYLIE. What was the total amount of State and local spending in 1979 and 1980 vis-a-vis Federal spending? Has the State and local spending even increased faster than Federal outlays?

Mr. PETERSEN. You're talking about the total amount of Federal assistance or total State and local outlays?

Representative WYLIE. Total State and local outlays.

Mr. PETERSEN. Those are currently running around $400 billion or so a year. Federal aid has been in the vicinity of around $90 billion and will be dropping precipitously.

Representative WYLIE. Do you have any figures or can you call to mind what the figures might be for 1970—what has been the increase over the decade?

Mr. PETERSEN. The rate of increase in State and local spending was approximately 10 percent a year in the decade of the 1970's. At the present time it's around 8 percent, a little under the rate of inflation. I would be happy to supply these numbers.

Representative WYLIE. Those numbers for the record I think would be helpful. Thank you, very much.

[The information referred to follows:]

LEVELS AND RATES OF GROWTH IN FEDERAL AND STATE AND LOCAL EXPENDITURES, 1970; 1979; 2D QUARTER, 1980; AND CURRENTLY (2D QUARTER, 1981)

[Dollar amounts in billions]

	Federal Government	State and local government
Calendar year expenditures:[1]		
1970	$204.2	$132.2
1979	509.0	330.0
1980	602.0	354.9
1981 (2d quarter)	669.4	377.7
Period: Annual rates of growth (percent):		
1970 to 1979	10.7	10.7
1980 (2d quarter) to 1981 (2d quarter)	14.0	7.9

[1] Expenditures are on a national income accounts basis.

Source: Board of Governors of the Federal Reserve Board, Flow of Funds Accounts.

Comment: For the decade of 1970 through 1979, State and local and Federal expenditures grew at the same rate of 10.7 percent per annum. During the most recent year interval (2d quarter 1980 through 2d quarter 1981), Federal expenditures rose by 14 percent while those of State and local government rose by 7.9 percent.

Representative REUSS. You've asked some questions which I otherwise would have had to propound and I think we have had a remarkably helpful session. Thank you. We are very grateful to you and we hope that out of this may come a more sensible view of how the Federal Government ought to conduct its intergovernmental relations with State and local governments.

We now stand in adjournment.

[Whereupon, at 11:35 a.m., the committee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record:]

STATEMENT OF THE NATIONAL LEAGUE OF CITIES

Mr. Chairman and Members of the Committee: Thank you for this opportunity to submit our comments on the state of the municipal bond market and the problems confronting it. As you know, NLC represents about 15,000 cities across the country, directly and through membership in state municipal leagues. Our direct member cities range in size and diversity from New York City to Sun Valley, Idaho.

We appreciate your holding this hearing. The timing could not be any better since we have just gone through eleven straight weeks of increases in tax-exempt bond rates. Those rates are at all-time highs, and they have moved significantly closer to taxable rates. It is not our intention here to detail for you the current condition of the market since you have assembled other witnesses more expert at doing that than we. What we do want to share with you is how cities have had to respond to bad market conditions, our thoughts on some of the disturbing trends we see in the market, and our recommendations as to steps that can be taken to ease market problems.

In thinking about how high interest rates have affected cities, we are reminded of a story told many years ago by former Congressman Brooks Hayes. He once asked a farmer in his district how he was coping with the Depression. The farmer replied that the Depression would not really be so bad if it had not come in the middle of hard times!

These are hard times for cities. We, along with our colleagues in the states and other local governments, are facing substantial cuts in federal aid--more, in fact, than our fair share. Housing assistance has been cut a third. The public service jobs program expires this week. Funding for wastewater treatment plants will end unless major reforms in the law are made and, even then, funding will be cut by $1.2 billion. Community and economic development aid has also been cut. Now, in addition to more cuts in all of our programs, we are battling a threat to reduce our most important program, General Revenue Sharing.

In the wake of these cuts in federal assistance, cities that turn to their governors and state legislators for help will find empty pockets turned inside out. Various state-imposed caps on spending and revenues and barred access to some revenue sources also limit the ability of local governments to raise needed funds.

If cities turn to their own devices by using the bond market, they now find fewer willing buyers and interest rates that have gone through the roof. The situation is double jeopardy for cities that are financially strapped and that need to use the short-term market to ease cash flow problems. To obtain that cash, they have to pay nearly double the rates of only a year ago.

Cities are responding to the bond market conditions in all of the ways you might guess. Some are taking a look at the interest rates and deciding to delay capital improvements. Earlier this year 13 communities in New Hampshire, for example, that planned to issue a bond through the New Hampshire Municipal Bond Bank decided to put it off because of high interest rates. A few that have been delaying projects, hoping for interest rates to decline, are proceeding anyway since they think rates may go higher. Others are going through all of the trouble to bring a bond to market but then deciding to withdraw it when the bids are too high. St. Cloud, Minnesota is one such example.

Innovative financing techniques are being tried, too. Baltimore recently issued a "put" bond which guarantees to the buyer he can redeem his investment at certain intervals before maturity. In general, cities are trying to shorten the maturity period of bonds to take advantage of lower interest rates, as high as they are. An example of this is Atlanta which has issued notes to finance the expansion of its convention center that it intends to roll over into permanent financing three years from now.

During this period of high interest rates, we would expect to see a decline in overall volume in the market, but yet it is on a record pace. We would point out that short-term financing is up, probably reflecting tight financial situations for issuers. Moreover, most of the participation in the market is by issuers other than cities who have better sources of revenue. We will return to this subject in a moment.

Let us turn now to some of the disturbing trends we see in the market.

One of the obvious explanations as to why tax-exempt rates are so high is the tight monetary policy of the Federal Reserve Board. It would be easy to argue that this is a temporary condition and that we should simply ride this one out until inflation rates come down. At that time, tax-exempt rates should return to normal levels. If we thought patience might put an end to the problems in the market, we might be prepared to wait. However, we think the difficulties run much deeper for two reasons.

First, there are some recent developments that cause us to believe that changes in the market are more permanent. There is widespread belief among financial analysts that banks --traditionally the largest purchaser of bonds holding 45 percent of all outstanding issues--may not return to the market in a big way. One reason for this is that they see greater advantages in sheltering their income through leasing, a break made even better by the recently enacted Economic Recovery Tax Act of 1981. The tax bill also cut the top tax bracket for individuals from 70 percent to 50 percent, further reducing the likelihood that high income individuals will feel the need to buy tax-exempt bonds.

Moreover, buyers who are in the market now and who have seen the worth of their portfolios drop substantially and the secondary market grow razor thin may be reluctant in the future to buy as many tax-exempt bonds.

Another blow was dealt the municipal bond market with enactment of All Savers Certificates. NLC led the opposition to this plan, not because we were against helping the ailing savings and loan industry, but because of the unintended impact on the bond market. For the first time, Congress has deemed it appropriate to grant to private industry the use of tax-exempt securities, which enjoy the benefit of federal deposit insurance, as well. We have no doubt that these certificates will drive up rates in our market and siphon off capital.

We take little solace in the fact that these certificates are authorized to be issued for only 15 months. Once financial institutions get used to tax-exempt money, it will be very difficult to wean them off it and pressure will be applied to extend the program.

A second reason we think the problems of the market run much deeper than temporary fluctuations caused by tight monetary policy is the growing number of purposes for which it is being used. It is actually a misnomer to refer to the "municipal bond market." Municipalities issue less than one-fourth of all bonds. When states, counties, and schools are added in, the percentage still comes to only 50 percent. Half of all bond volume is issued by special districts and various statutory authorities, many of which are governed by bodies not directly elected by the voters.

The types of bonds issued are not for municipal-type purposes either. About 60 percent of all long-term bonds issued last year were for single-family home mortgages, industrial and commercial development, hospitals, pollution control devices for private industry, public power, and student loans. In other words, a minority of all bonds were issued for such things as schools, sewers, roads, and bridges --items that the common citizen probably thinks tax-exemption ought to be used for.

Agreeing to characterize the market as the tax-exempt bond market, though, does not address two more fundamental issues.

First, for what purposes should tax-exemption be used? Second, what types of entities should be permitted to issue tax-exempt bonds?

With respect to the first question--for what purposes should the market be used--more is at stake than whether or not K-Mart or McDonald's ought to be using tax-exemption to further their corporate expansion plans. The larger issue is whether the market will continue to be a viable method to finance traditional public needs in an economical way. Another way to look at it is: will general obligation bonds, backed by unpopular property taxes, sell in the future when competing against revenue bonds secured by funds virtually guaranteed by revenues passed on to consumers in increased costs?

The irony in all this is that our highways and bridges, water and sewer facilities, port and transit facilities--traditional items usually financed through tax-exemption--are said to represent the vital underpinnings of our economic system. Supposedly, without their certain and efficient operation, the life and commerce of our nation could not exist. The fact of the matter is that the tax-exempt market may not be able to finance both the commerce of the nation and its vital infrastructure, as it is being called upon to do more and more.

Not unrelated is the issue of what entities should be able to use tax-exemption. This issue is dramatically illustrated in the case of Washington Public Power, which made news a few weeks ago when it sold tax-exempt bonds at 15 percent. Attention rivited on the issue because of the record interest rates, but no one questioned why any public entity should agree to finance debt at that level. No city would have gone ahead and sold the bonds at that rate. Why, then, did Washington Public Power? The answer is simple--it passes those costs on to its customers in the form of higher utility bills. In this case, we are not questioning the public purpose of the bonds; we are asking the question, can cities and counties and states compete in such a marketplace?

In the final analysis, there is no real threat to the continued functioning of the tax-exempt market--we have no doubts it will always continue to function. It is a matter of at what cost to the taxpayers and at what sacrifice to true public needs.

We realize that our comments thus far raise more questions than answers and more problems than solutions. We don't profess to have all the answers and solutions, but we do have some concrete recommendations that we believe will ease a few of the problems in the tax-exempt market and restore some of its integrity.

First, the tax-exempt market does not need any additional competition for funds or any new types of tax-exempt securities. To that end, we can assure that the 15-month authorization for All Savers Certificates is not extended when its authorization expires. The Congress should also refrain from passing any legislation to in any way expand the use of the tax-exempt market that plainly does not serve a public purpose.

Second, Congress should make a relatively simple change in law that would permit commercial banks to underwrite and deal in investment quality municipal revenue bonds. At a time when the bond market has never been in worse shape, there is every need to expand the number of dealers and buyers of municipal bonds. The prohibition on commercial bank underwriting that has existed since 1933, when the Glass-Steagall Act was enacted, is not now practical and should be removed. It only makes good sense to provide as many outlets as possible for sale of bonds.

Such legislation to remove the prohibition on commercial bank underwriting is now pending before both the Senate and House Banking Committee. In the House, where many attempts over the last decade to get this legislation enacted have been stymied, the bill now carries 185 co-sponsors. The broad support for this legislation and its obvious good sense merit its passage now.

Third, both tax-writing committees of Congress should undertake a broad review of the tax-exempt market and the purposes for which it is being used, with an eye toward eliminating those which do not clearly serve a public purpose. As a result of this review, NLC would hope the Congress will act to limit the issuance of industrial revenue bonds in such a way that IRB's become a true economic revitalization toll instead of the nearly universally available tax break that they now are.

In addition, NLC supports the elimination of pollution control bonds used for private facilities or improvements that bear no relationship to municipal services or functions. The issue of pollution control bonds, perhaps better than any other, points up the difficulty in defining the public purpose. Of course it is in the public interest to have clean air and clean water, but in every instance for which a bond has been issued, it is easy to identify the source, or potential source, of the pollution. We feel that those industries ought to be responsible for cleaning up their pollution without public assistance.

Over the longer term, we need to examine the types of issuers in the market and the methods used to issue bonds. The outcomes of this effort would be to devise ways to assure that there are relatively equal competitors for tax-exempt funds and that all bond issues stand the test of public scrutiny.

As a concluding comment, it should go without saying that the market will benefit if interest rates come down. However, when they do, we should not forget that other serious problems in the market will remain.

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