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The Fed Will Buy State and Local Muni Bonds. It Might Not Cover the Virus Shortfall.

State and local governments will get budgetary breathing room from the Federal Reserve to cover at least some revenue lost in coronavirus-related shutdowns, but likely not enough to fully plug shortfalls.

The Fed's program, called the municipal liquidity facility, can directly buy up to $500 billion in municipal bonds from states, cities with more than one million people, and counties with more than two million people. That means the program isn't open to most local governments as there are only 10 cities and 16 counties in the U.S. that meet the Fed's criteria. Each muni-bond issuer must obtain Fed approval to use the facility, and states can ask the Fed to lift their borrowing caps on behalf of smaller municipalities and other entities that are ineligible.

State and local governments will be able to sell only bonds maturing in two years or less to the Fed. Each transaction's pricing will depend on the credit rating of the state or municipal government at the time of the bonds' purchase, according to the central bank's term sheet.

It isn't clear whether the $500 billion will be enough to cover the shortfall that state and local governments will face from the pandemic. The answer to that question depends on the size of the budget gaps that remain once Congress's $150 billion appropriation for coronavirus relief for domestic governments is taken into account.

There is a threshold for Fed success, however: The Fed's facility will be able to cover municipalities' budget gaps if they lose no more than 20% of their normal tax revenues.

Here's why: The Fed says it will buy new municipal notes worth up to 20% of each municipality's 2017 revenues, the most recent data available, excluding intra-governmental transfers and including utility revenues. For state and local governments across the entire country, those revenues added up to nearly $2.6 trillion in 2017. And 20% of that total is $515 billion, only a slightly larger sum than the $500 billion of financing the Fed will make available.

In other words, if state and local governments lose nearly 20% of one year's revenues from income taxes, property taxes, sales taxes and utilities, the Fed should be able to lend them money to cover all of that with a two-year loan.

But once that two years is over, the municipalities will need to either refinance their Fed-owned notes with bonds, or hope that the economy has recovered enough to repay the principal.

What's more, some Wall Street strategists don't think the program will even be enough to patch up the hole that the coronavirus will create near-term state and municipal budgets.

"This program does not plug state government budget gaps," wrote Goldman Sachs. "We continue to expect Congress to provide [an additional] $100-200bn in fiscal aid."

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