The Fed's State and Municipal Lending Is a Bad Idea

The COVID-19 pandemic has caused sweeping changes in economics and politics. Many have been publicly analyzed and debated. But not all. In particular, the Federal Reserve's extraordinary new policies haven't received the scrutiny they deserve. Totaling a planned $2.3 trillion in asset purchases and loans, the Fed's actions take monetary policy into uncharted territory. Although effective at stabilizing markets in the short term, Fed policy comes with significant long-term costs.

Case in point is the Fed's Municipal Liquidity Facility. Authorized by Congress under the CARES Act, this facility is intended to help "governments better manage cash flow pressures in order to continue to serve households and businesses in their communities." Through the Municipal Liquidity Facility, the Fed makes direct loans to state and local governments, purchasing up to $500 billion in debt. This represents a significant expansion of the Fed's emergency lending powers, as specified in Section 13(3) of the Federal Reserve Act. Traditionally, the Fed only extended emergency credit to non-banks in the event of serious distress in the financial system. While state and local government finances are important, it is very hard to make the case that they are an integral component of financial stability.

This expansion of the Fed's mandate comes with serious consequences. Many of them are bad.

First, the Fed's municipal and state lending results in a misallocation of credit. The whole point of the Fed's programs is that state and local governments can get loans on better terms than they could get elsewhere. This reallocates purchasing power away from other entities in the market to those whose bonds the Fed purchases. The cost to society is the difference between the value of the projects pursued by state and local government with those resources and the value of the projects other entities could have pursued with those same resources.

Second, Fed lending undermines fiscal federalism. History's greatest political minds, including the framers of the U.S. Constitution, regarded the "power of the purse" as the most significant government power. It's the political version of the Golden Rule: He who has the gold, makes the rules. For state and local governments, citizens within those jurisdictions are supposed to bear the costs of providing collective goods, such as emergency services and infrastructure. But the Fed's new programs set a troubling precedent: State and local governments can turn to central bankers for the funding they need. While governments could always borrow from those outside their jurisdiction, the Fed is special. Its monopoly on high-powered money production gives it greater financial wiggle room than other funding sources. As a result, governments will become more dependent on Fed loans, and less responsive to voters.

Third, there is a very real risk Congress will hijack the Fed and turn it into a de facto fiscal policy agent. There are signs that this is already happening. Sen. Charles Schumer (D-N.Y.) recently urged the Fed to grant New York's Metropolitan Transportation Authority (MTA) access to the Municipal Liquidity Facility. The Fed expanded the criteria for accessing the facility, allowing MTA and several others to take part. Due to the change in Fed policies created by the CARES Act, Congress has an incentive to use the Fed to make spending and budgeting decisions in ways that lack democratic oversight.

Markets are recovering from state-level lockdowns. Unemployment is falling. The stock market is rallying. The Fed's new policies undoubtedly helped. But in this case, the cure may be worse than the disease. The Fed's actions impede market allocation of resources, weaken the accountability of local governments and present new avenues for political capture by Congress.

Unless we address these problems soon, we risk the Fed becoming permanently ineffective and unaccountable. If this happens, the next time economic trouble comes knocking, the Fed won't be able to help us.

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