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[Putting the Muni in the Fed's Munificence?]

Pressure is intensifying for legislative policymakers to frame Stimulus 4.0 in a way that provides relief to state and local governments, but that pressure is more and more working its way toward the central bank as well.

The Municipal Liquidity Facility unveiled by the Fed four months ago helped the muni market on the margins. But only one borrower has directly tapped the facility, and the Fed has only extended out $1.2 billion of credit from a $500 billion facility. The rates are said to be too high. That seems — how to put it — counter-intuitive, but basically, most municipalities do not struggle for a lack of access to debt capital in the capital markets. The reason why the Fed cannot yet extend its municipal lending operation is that it is currently limited to six-month maturities for direct purchases. The legislation in the House-passed Stimulus 4.0 bill would extend this to ten years. It is not presently legal for the central bank to go longer than "short term paper." The House bill provides that the Fed can lend (even up to ten years) at the Fed's discount rate level (a less than demanding 0.25 percent).

I am quite sure the Fed does not want to be making 0.25 percent money available to governments who have displayed the kind of spending discipline we have seen in California, Illinois, and New York.

But as long as Congress gives the Fed the flexibility to buy muni bonds at maturities greater than six months (and I am increasingly convinced it will), the way rates play into it will get resolved (ask the corporate bond market). Fed interventions to lower the spread in muni borrowing (relative to Treasuries) would provide a huge boost to current muni investment returns (as yields would come down and prices up), and it would lower forward borrowing costs for municipal issuers. But it also might be the final chapter in getting an attractive yield going forward in this market (for investors). I am quite sure the capital needs of the states and cities is more on the mind of legislators than the distorted effects on savers and investors.

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