
[Fed to Lower Rates for Cities, States Seeking Short-Term Loans.]

Interest-rate spread on tax-exempt notes will be reduced by 0.5 percentage point

The Federal Reserve said Tuesday it would reduce the rates it charges cities and states seeking short-term loans from an emergency lending program that has seen little takeup so far.

Changes to the program must be agreed upon by the Treasury Department, which has approved $35 billion to cover losses on up to $500 billion in loans extended by the Fed.

Municipal bond strategists and some Democratic lawmakers have expressed disappointment in recent weeks over the degree to which the Fed positioned the program as a backstop, though Fed officials say the mere announcement of the program in April helped reduce borrowing costs significantly for highly rated municipal issuers.

With Tuesday's changes, the Fed will reduce by 0.5 percentage point the interest-rate spread on tax-exempt notes, and it will also reduce the amount by which rates for taxable notes are adjusted relative to tax-exempt notes.

The Fed is walking a careful line in a series of lending programs it has created to backstop credit markets. It announced the programs in late March and early April when many markets weren't functioning well, but the announcement of those programs has encouraged private investors to lend, reducing demand for Fed loans.

That is raising difficult questions for the Fed and Treasury over how aggressively to use money approved by Congress to encourage additional lending. In June, the Fed tweaked its corporate-debt lending program to actively purchase bonds from nearly 800 eligible firms even if they haven't sought Fed help.

The Fed has repeatedly broadened the number of local governments eligible for the lending program to allow more than 300 municipal issuers. So far, the Fed has purchased only one such note. The state of Illinois sold $1.2 billion of debt to the central bank in June at a rate more than 1 percentage point below the rate at which it was previously able to access markets in May.

Both the municipal program and a separate Fed program to jump start corporate debt issuance have seen very little takeup. But critics have said the lack of demand for municipal debt is a problem because local governments are already responding to the downturn with layoffs and cutbacks in services that could be avoided if borrowing from the Fed's program were cheaper.

More than 50 House Democrats called on Fed Chairman Jerome Powell in a letter last week to buy municipal debt of up to five years, from the current limit of three years, and to reduce rates to near zero.

"At present, the harsh terms and penalty rates for the [program] make it functionally unusable for the vast majority of the state and local governments that are technically eligible, which severely undermines the program's intent to help states and cities struggling from unprecedented financial hardship," the letter said.

Chicago Fed President Charles Evans said last week he was sympathetic to that criticism but suggested the Treasury, not the Fed, needed to also be convinced of the need for any changes.

"I do take the point—I've heard it from others—that it is not a very attractive setting, so something that is a lower interest rate would be more welcome," he said. Such lending programs require a partnership with the Treasury, "and I think sometimes there are differences of perspective there," Mr. Evans said.

For the highest-rated municipal borrowers, yields have returned to their pre-pandemic levels and are now near all-time lows. But yields on lower-rated securities are still somewhat higher than before the pandemic.

Fed officials have said that demand for emergency credit from the central bank could hinge on how much aid Congress provides states in any future economic-relief legislation.

Talks over another round of fiscal help have broken down, and a dispute over how much relief is needed for cities and states is at the center of the impasse. House Democrats approved legislation in May to provide $1 trillion in aid, but Senate Republicans last month didn't include any such relief in their proposal.

"There is a tension that's brewing where the fiscal follow-through is not really coming to fruition, so there needs to be more thinking about how they can use the authority they have," said Skanda Amarnath, research director at Employ America, a liberal advocacy group. "They're caught in a hard place."

Earlier measures have approved more than $200 billion, primarily to address costs related to the coronavirus pandemic, but cities and states face larger budget shortfalls because the virus has led to big revenue declines on everything from sales tax receipts to public transit fees.

"Getting liquidity is helpful, but it doesn't solve their bigger problem, which is they have a fiscal hole," Dallas Fed President Robert Kaplan said in an interview last month.

"They need grants, and if they don't get some fiscal relief, they're going to need to cut back at a time when they're at the forefront of trying to get schools reopened and…spend more on a whole range of services in their states and in their communities to help fight the virus."

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By Nick Timiraos

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