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The Fed Has a Not-So-Secret Weapon to Fill Stimulus Void.

A borrowing facility for states and cities should be extended for another year and provide more affordable financing.

It's abundantly clear that U.S. lawmakers aren't going to agree on the amount of aid to send to state and local governments. President Donald Trump has made such support into something of an "us versus them" issue ahead of Election Day, claiming House Speaker "Nancy Pelosi is asking for $2.4 Trillion Dollars to bailout poorly run, high crime, Democrat States, money that is in no way related to COVID-19," in a tweet on Tuesday that called off fiscal stimulus negotiations.

In reality, the two sides weren't even that far apart. Republicans, led by Senate Majority Leader Mitch McConnell, said they would be willing to give states and cities $250 billion in federal aid, up from an earlier $150 billion, while Democrats wanted about $436 billion, down from an initial $1 trillion. Whom to blame for the inability to bridge that gap most likely depends on your political leanings.

Then there's more technocratic Federal Reserve. It's no secret that Chair Jerome Powell has been pushing Congress for more fiscal aid, noting just hours before Trump's tweet that "the risks of overdoing it seem, for now, to be smaller. Even if policy actions ultimately prove to be greater than needed, they will not go to waste." This wasn't directly about providing funds for states and municipalities, but it doesn't take much of a leap to read it that way. Is it truly such a tragedy if governors and mayors have some leftover cash to retain employees, maintain public services and shore up pensions to ensure payments to retired teachers, firefighters and police officers?

And yet, on the same day that Powell was making his case for congressional action, the Fed posted this deadline regarding its Municipal Liquidity Facility, which can extend loans to state and local governments:

Any Eligible Issuer that wishes to issue Eligible Notes to the [Municipal Liquidity Facility] must submit an [Notice of Interest] no later than 30 calendar days before the Facility's stated termination date. The present termination date of the MLF is December 31, 2020, unless the Board of Governors and the Treasury Department extend it.

Given the state of stimulus negotiations, Powell and Treasury Secretary Steven Mnuchin should extend the termination date immediately, perhaps taking a cue from legislation passed by House Democrats earlier this year that would keep the MLF running until the end of 2021. There's simply too much uncertainty around what the coronavirus pandemic will look like in the coming months to even think about removing this backstop for states and cities.

Besides, given how the facility is structured, it's practically a costless exercise. The MLF has an impressive $500 billion in potential firepower to deploy in the $3.9 trillion municipal market, yet so far the Fed has extended only two loans worth a combined $1.65 billion. New York's Suffolk County might become the third borrower, Bloomberg News's Amanda Albright reported this week, and New Jersey has also floated the option of tapping the central bank's program.

Still, this effort falls far short of the “whatever it takes” mantra that Powell brandishes when asked about the central bank’s other initiatives, such as buying corporate bonds and exchange-traded funds in the secondary market and increasing the Fed’s balance sheet by $3 trillion in just three months. I’ve written practically since its inception that the MLF pricing scale is simply too punishing for all but the most desperate borrowers.

Some Fed watchers say this is exactly what central bankers intended. As my Bloomberg Opinion colleague Tim Duy put it on Twitter, “The Fed views it as fiscal policy; if Congress wanted to help munis, it would. Arguably, the Fed would be going against the will of Congress if it just opened the floodgates.” Meanwhile, others argue, “market conditions for municipal securities have improved significantly,” so an overwhelming majority of states and cities can simply go through the traditional debt market to raise money. Top-rated two-year munis yield just 0.16%, while single-A revenue bonds due in two years yield just 0.44%, Bloomberg data show.

All of this has been true for months. And yet, in mid-August, the Fed announced it would cut borrowing costs by 50 basis points in the MLF anyway. At the time, I said this was evidence that central bankers realized their attempts to jawbone congressional leadership into action had failed, even though a compromise was still an option at that point. It was more of a gentle reminder to Congress that the financial health of state and local governments would be crucial to any rebound from the coronavirus crisis while also tiptoeing toward a more active role in the municipal-bond market.

Now that negotiations are over, it’s time for the Fed to take to take a more forceful stand. In addition to extending the MLF for at least another year, the central bank should take another hard look at its pricing scale and make it more affordable for a broader swath of states and cities.

At this point, I’ve already proposed more than one pricing scale. In fact, the yield I suggested in June for borrowers on the brink of junk turned out to match the Fed’s adjusted rates in August. But that was just smoothing out the otherwise haphazard differences between certain credit ratings. It wasn’t meant to be overtly stimulative.

The most drastic action the Fed could take would be to adopt the guidelines from the Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act, which would “ensure that any purchases made are at an interest rate equal to the discount window primary credit interest rate” of 0.25%, regardless of credit grades. That’s probably too far for the Fed — lower-rated states, cities and agencies might rush to max out their credit lines under those conditions.

So here’s another proposal: Start the pricing scale for triple-A issuers at the discount window primary credit interest rate. Top-rated three-year muni yields haven’t exceeded 0.25% since mid-July anyway, and there’s virtually zero risk that a state holding such a pristine grade would default in the coming years (or would want to take on a pile of new debt and risk a downgrade). Create a more uniform scale from there. Here are two ways that might look:

The first option could encourage more higher-rated states and cities to use the Fed’s facility, which may or may not be what the central bank wants. The second would disproportionately benefit triple-B rated municipalities, which are more in need of cheap funding. Either way, the MLF would be far more likely to put money in the hands of governors and mayors who are trying to balance their budgets, either directly or by strong-arming muni-bond buyers into accepting lower yields.

While it’s understandable that the Fed would want to avoid getting caught in political crossfire, is that enough reason to jeopardize an economic recovery? It’s possible that Powell sees preserving the central bank’s independence as crucial. But a persistent onslaught of criticism from the president before the coronavirus crisis already threw that into doubt.

Making affordable loans to states and cities — even if they turn out to be primarily led by Democrats — is rooted in pragmatism, not politics. That’s why Congress failed. And it’s why the Fed must do more.

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By Brian Chappatta

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