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Committee on Financial Services
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"Creating a Municipal Liquidity Facility at the Federal Reserve
that Works for Communities during Economic Crises"

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I greatly appreciate this opportunity to testify on the Federal Reserve's Municipal Liquidity Facility. I will focus today on ways to strengthen this emergency lending program for State and local governments in the next crisis.

My proposals to improve the Municipal Liquidity Facility are the following:

- Tailor eligibility and loan terms to State and local governments in financial distress.
- Use local economic conditions during the crisis to make those determinations.
- Improve the administrative systems before the next economic crisis.

Swift and effective relief from the Congress and Federal Reserve is crucial during crises. I began my career at the Fed in 2007 and saw firsthand the immense toll on families, businesses, and communities from the Global Financial Crisis and the Great Recession. The Fed stepped in immediately to save Wall Street with trillions of dollars in lending, but Main Street suffered. Stock prices bounced back quickly—as they have now—but millions of families did not.

During the Covid-19 crisis policymakers moved forcefully to support Main Street. Congress enacted about $5 trillion in fiscal relief, including three rounds of stimulus checks, money for small businesses, and extra benefits for the unemployed. Even so, the recovery is incomplete. The S&P 500 is up over 30% since February 2020, but we are still missing more than 5 million workers. Encouragingly, we are living a sea change in fiscal and monetary policy.[2] And so it is imperative that we study the results from all the relief programs and improve them.

The Municipal Liquidity Facility at the Federal Reserve deserves careful review and improvement in order to better prepare for crises in the future. My critique of the program and my proposals to improve it draw on recent research on the program and data on the budgetary stress among State and local governments during the Covid-19 crisis.[3]

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[1] I am grateful for the helpful comments from Louise Sheiner, Senior Fellow and Policy Director at the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution, provided me in preparation for my testimony. The views here are my own.

[2] Claudia Sahm (2021). "COVID-19 Is Transforming Economic Policy in the United States" for an *Intereconomics* forum discusses the ongoing shift in monetary and fiscal policy during the Covid-19.

[3] Examples are Alan Auerbach, William Gale, Byron Lutz, and Louise Sheiner in "Fiscal Effects of Covid-19" assessed State and local budgets as of fall 2020; and Sophia Campbell and David Wessel in August 2021 in "How well did the Fed's intervention in

Background on the Municipal Liquidity Facility

The broad goal of the lending program was, according to the Federal Reserve:

> "to help state and local governments better manage the cash flow pressures they are facing as a result of the increase in state and local government expenditures related to the COVID-19 pandemic and the delay and decrease of certain tax and other revenues." [4]

Its key features were:

- Authority to make up to $500 billion in loans with $35 billion allocated for losses.
- States, along with cities and counties above certain population sizes were eligible.
- Loan's maturity could not exceed three years and interest rates were above market.

The program began on April 9, 2021, and it ended on December 31, 2021. During that time, the municipal bond market stabilized, and the Fed made two loans for a total of $6.56 billion.

Program Details

Congress gave the Fed the authority to make up to $500 billion in loans directly to State and local governments, with $35 billion set aside to cover any losses. The facility along with the $300 billion for Main Street Lending program for medium-sized businesses was the Fed's first emergency program not aimed at Wall Street, large corporations, or foreign governments. Its innovative nature led to delays in its launch, disagreements between the Fed and Treasury about its exact structure, as well as subsequent debates about its effectiveness.

The Fed and the U.S. Treasury Department created the guidelines for the Municipal Liquidity Facility and Main Street Lending Program. The facilities launched in April, putting them among last of the emergency facilities. Most opened in March as soon as the financial market disruptions began. The delay occurred despite the fact that the interest rates on municipal bonds moved up sharply as soon as the crisis began.

The eligibility for the Municipal Liquidity Facility was largely determined by population size. States and the District of Columbia, as well as cities with populations larger than 250,000, counties with populations larger than 500,000, and some other select institutions were eligible for loans.[5] The Fed would only purchase short-term loans such as tax anticipation notes (TANs) that are typically repaid within a year after tax season. No loan with a maturity of more than three years was eligible. In contrast, in the Primary Market Corporate Credit Facility for corporations, included bonds with a duration up to four years.

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the municipal bond market work?" provide an excellent summary research on the Municipal Liquidity Facility, as well as the Commercial Paper Funding Facility and for the Money Market Mutual Fund Liquidity Facility which also supported the municipal bond market.

[4] "The Municipal Liquidity Facility" webpage from the Federal Reserve provides the program details. See also the details in the Fed's fact sheet on the program. Information on all the emergency lending and liquidity programs are here.

[5] In August 2020, the Fed substantially lowered the population thresholds from the initial 1 million for cities and 2 million for counties. See Claudia Sahm, "The Money Machine That Can Save Cities" *New York Times Opinion* for a discussion of how the initial thresholds limited its ability to help the cities hit hardest by the pandemic. The updated terms in August also allowed for other non-government institutions to participate in the program, such as transit authorities.

In addition, the interest rates that the Fed offered were higher than the market rates—referred to "penalty rates"—with the intention that municipalities would turn to private lenders first and would have an incentive to pay back its Fed loans as soon as financial and economic conditions improved. The penalty rates depended on the long-term credit rating of the loan, ranging from 100 basis points (AAA, Aaa) to 330 (BBB-, Baa3) to 540 (below investment grade).[6]

The Fed interpreted the Municipal Liquidity Facility's goal—as with its other emergency lending facilities—as the stabilization of municipal bond markets. In fact, soon after the announcement of the program, the interest rates offered on municipal loans, both short- and longer-term ones, which were not eligible for this program, began to decline. The interest rates on loans with high credit ratings were back to pre-pandemic levels by May, though that did not occur until September for low-rated loans.

However, the Fed made only two loans with this facility, which raised several concerns about the program's effectiveness. The State of Illinois and the New York Metropolitan Transit Authority borrowed $3.2 billion and $3.36 billion, respectively. That was about 1% of the authorized amount of loans. While the tax revenue shortfalls were less than expected when the program was enacted in spring 2020, as discussed below, more than two State and local governments and related institutions experienced budgetary distress due to the Covid-19 crisis.

Secretary Steve Mnuchin decided to end the Municipal Liquidity Facility on December 31, 2020. The Federal Reserve stated publicly that, in its opinion, the facility should be extended, but it complied with the Treasury's decision. Then the fiscal relief package than Congress enacted in December 2020 stated that the program would expire at year's end and could only be restarted by an act of Congress not the Treasury.

Altogether, the Municipal Liquidity Facility was an innovative program and served at least some of its purposes well. That said, the program should be improved before its future use. The remainder of my testimony proposes three changes to the program.

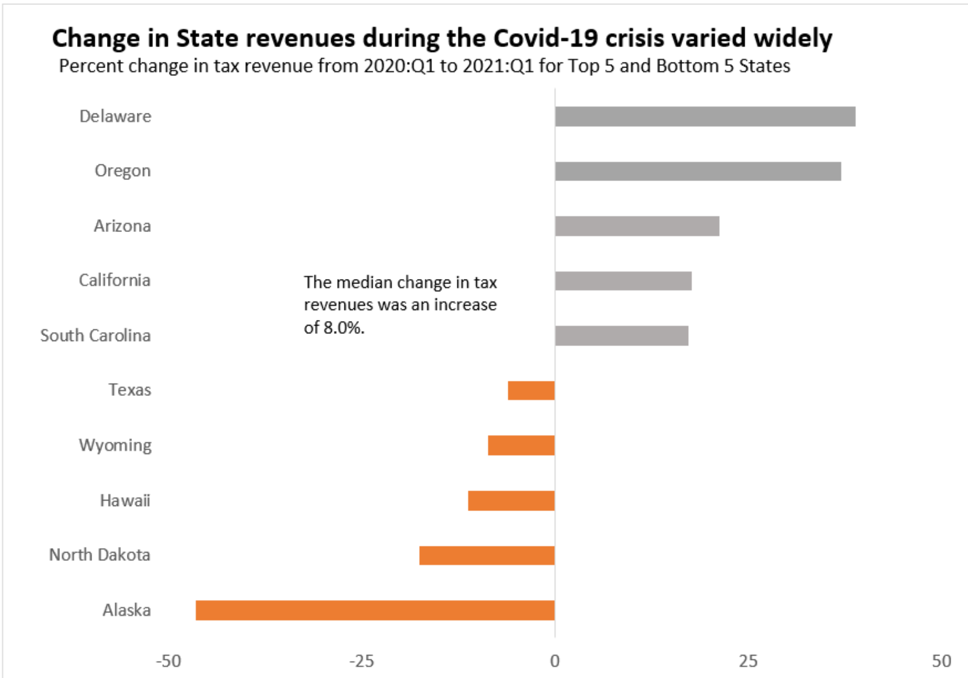
Proposal 1: Target Eligibility

So far, during the Covid-19 crisis, State governments received about $400 billion in federal relief.[7] Nearly three quarters of aid was enacted in the American Rescue Plan in March 2021. States and large cities also had access to the Fed's Municipal Lending Facility since May 2020. In both cases, the relief was poorly targeted.

The transfers from the federal government and eligibility for the Municipal Liquidity Facility were largely allocated by State population, despite the fact, that the budgetary strains varied considerably across the country. Lucy Dadayan, a Senior Research Associate at the Urban-Brookings Tax Policy Center estimates that the change in State tax revenues from first quarter

[6] Initially, the penalty rates were 50 basis points higher for each rating and were lowered in August 2020.

2020 to first quarter 2021 ranged from a decline of 46% in Alaska to an increase of 39% in Delaware.[8]



Source: Urban-Brookings Tax Policy Center. Taxes include sales, personal and corporate income, and fuel taxes.

Yet, Alaska, North Dakota, and Hawaii—the three hardest hit States—are fourth, fifth, and twelfth smallest, respectively by population. As a result, proportional aid did not serve the disproportionate stress in these areas. In contrast, tax revenues in California—the largest State in the country and recipient of the most aid—rose 18% during the crisis. To be clear, State tax revenues only offer a partial picture of economic stresses from Covid-19. As one example, most State and local governments had to spend more on public health due to the pandemic. Even so, in terms of tax revenue, the federal aid was not targeted to the greatest need. Moreover, some local governments within a State experienced larger shortfalls than the State overall.

The Fed's emergency lending facilities was only somewhat better in its targeting. All States, as well as some large cities, were eligible for loans from the Fed. But in practice, the above-market interest rates made the program of interest only to State governments in budgetary distress. In that way it was more targeted than the other federal to State and local governments, and the two loans from the Fed, in fact, went to institutions in financial distress. However, no loans from the Municipal Lending Facility went to areas with double-digit declines in State tax revenues, which is a sign that the program could be better targeted in the future.

[8] Dadayan, Lucy. (2021). "Strong Tax Revenue Growth in the First Quarter of 2021, but Tax Volatility and Fiscal Uncertainties Continue." State Tax and Economic Review, 2021 Quarter 1." *Urban-Brookings Tax Policy Center* Research Report.

Proposal 2: Use Economic Conditions for Tailoring

Economic conditions, specifically in local labor markets, offer a good basis for decisions about eligibility, lending terms, and program duration for the Municipal Liquidity Facility. Effective targeting would offer more relief to the hardest hit communities while encouraging those experiencing less economic distress to use private markets. By narrowing the eligibility, the Fed could also lower the penalty rates and better support the smooth operating of public services and employment in those areas. Congress could allocate subsidies to borrowers to cover the penalty rates. Tying the duration of the program to economic conditions ahead of the crisis would free up policymakers' time to address problems unique to the crisis, and it would provide more certainty to State and local governments, as well as investors in municipal bond markets.

The employment estimates from the Bureau of Labor Statistics could be used to gauge economic conditions. The Bureau publishes high-quality, official statistics on the employment situation in States, metropolitan areas, and counties each month on conditions in the prior month. The official statistics are closely followed and cannot be influenced by any institutions or individuals. Moreover, decisions at the State and local level would have a limited influence on the overall payroll employment since the private sector accounts for the vast majority of jobs.

During the Covid-19 crisis, the decline in employment and the pace of recovery varied widely across the United States. The relative patterns in employment losses at the State level largely correspond to the budget shortfalls.

It is worth noting that large declines in employment during the current crisis occurred in States with large fossil-fuel and related sectors. An area of disagreement among policymakers on the Main Street Lending program was whether medium-sized businesses in those sectors should be eligible for loans. Tying eligibility to total employment regardless of industry would limit such debates about the Fed's emergency lending facilities relief during the crisis. That said, the programs are limited to the crisis and do not program long-term support to any particular industry. Each crisis has unique features, so it is impossible to predict which industries and by extension which local labor markets will be most affected.

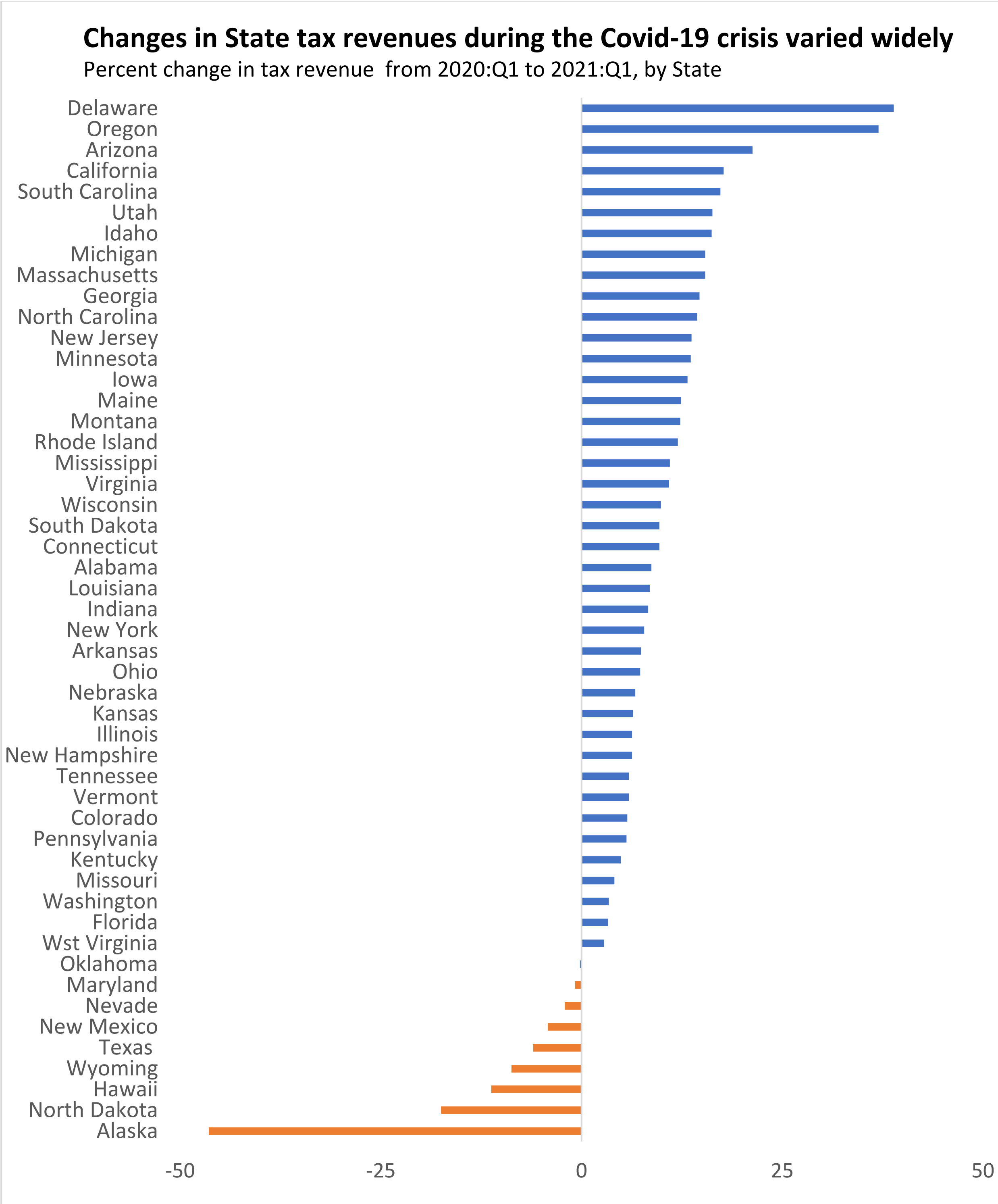
Proposal 3: Improve and Prepare Administrative Systems

The Municipal Liquidity Facility was the Fed's first attempt at lending directly to municipalities during a financial crisis. The delay in the start of the program and changes to the eligibility criteria and loan terms mid-way underscore the need to improve the administrative systems ahead of time. Moreover, State and local officials would benefit from more streamlined application processes and guidance about the program prior to the crisis. Officials in the hardest hit areas during the Covid-19 crisis had the least time and resources to learn about new programs. Uncertainty about the program and changing program rules discouraged borrowing from the program. While the mere announcement of the program quickly helped to stabilize municipal bond markets, the most straightforward way to address budget shortfalls is to get money directly to those in distress. Finally, by establishing the systems ahead of time, Congress could also ensure that other support programs for State and local government work well in tandem. In fact, some of the same targeting recommended for the Municipal Liquidity Facility could be used to target other aid to State and local government. A well-administered, well-targeted relief effort would be the most effective in supporting the recovery and in using federal government responsibly. It is difficult to achieve those two goals with policies crafted during the crisis.

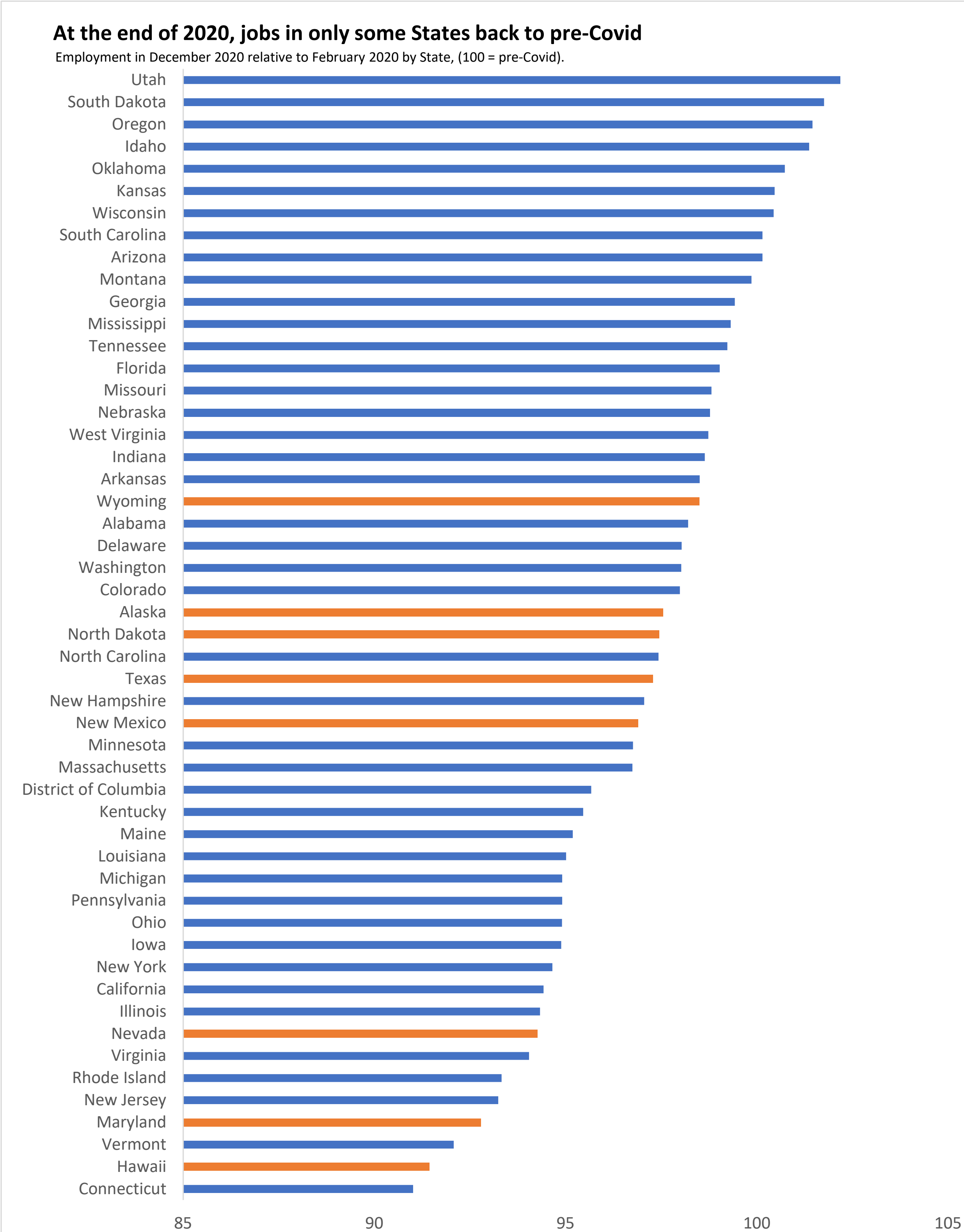
Conclusion

Improvements to the Municipal Liquidity Facility should consider that State and local governments operate under budget rules unlike any other private or public entity. Specifically, the vast majority are required by law not to run a deficit, that is, revenues must not be less than expenditures during a fiscal year. That limits expenditures and it creates more pressure on State and local government officials during times of economic uncertainty, as was the case during Covid, to accurately project their budgets. Given these additional constraints, the lending conditions should be more generous than in other programs, and the administrative processes as streamlined as possible. Such tailoring would allow an emergency lending facility at the Federal Reserve to better achieve its goal of supporting State and local governments in crisis.

Appendix Charts



Source: Urban-Brookings Tax Policy Center. Taxes include sales, personal and corporate income, and fuel taxes.



Note: Source: Bureau of Labor Statistics: Local Area Unemployment Statistics. Statistics are currently available through August 2021. The comparison here to December 2020 was chosen since that is when the Municipal Liquidity Facility expired. States shaded in orange are the ones with an estimated budget shortfall, according to the Urban-Brookings Tax Policy Center.