Research Working Papers

Unconventional Monetary Policy and Local Fiscal Policy

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Central bank municipal bond purchases increase private investment but have muted effects on state and local government spending.

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Following the onset of the pandemic, in a novel program the Federal Reserve directly intervened in municipal bond markets. We characterize the fiscal and macroeconomic implications of such central bank actions in a New Keynesian model of a monetary union. We assume that state and local governments are subject to a loan-in-advance constraint, to capture the observation that with lumpy cash flows, they often finance a fraction of expenditures by issuing short-term bonds. This municipal debt is held by financial intermediaries, who also supply credit to the private sector. Direct central bank purchases can transmit to the economy through two main channels: 1) by alleviating cash flow problems of the regional governments and 2) by accelerating lending in the economy if credit constraints ease more broadly. We quantify the importance of these channels and show that the transmission of the Federal Reserve's intervention is markedly different from direct federal government aid through intergovernmental transfers. Importantly, action by the central bank leads to more sizeable increases in private investment but has more muted effects on state and local government expenditures.

Article Citations

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