2011: The Municipal Meltdown. More than 100 US Cities Could Go Bust

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As the Guardian noted last week:

> More than 100 American cities could go bust next year as the debt crisis that has taken down banks and countries threatens next to spark a municipal meltdown, a leading analyst has warned.
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> Meredith Whitney, the US research analyst who correctly predicted the global credit crunch, described local and state debt as the biggest problem facing the US economy, and one that could derail its recovery.
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> "Next to housing this is the single most important issue in the US and certainly the biggest threat to the US economy," Whitney told the CBS 60 Minutes programme on Sunday night.
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> "There's not a doubt on my mind that you will see a spate of municipal bond defaults. You can see fifty to a hundred sizeable defaults – more. This will amount to hundreds of billions of dollars' worth of defaults."

Here's the must-watch 60 Minutes program:

(Or read the transcript.)

The Guardian continues:

> Cities from Detroit to Madrid are struggling to pay creditors, including providers of basic services such as street cleaning. Last week, Moody's ratings agency warned about a possible downgrade for the cities of Florence and Barcelona and cut the rating of the Basque country in northern Spain. Lisbon was downgraded by rival agency Standard & Poor's earlier this year, while the borrowings of Naples and Budapest are on the brink of junk status. Istanbul's debt has already been downgraded to junk.
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> US states have spent nearly half a trillion dollars more than they have collected in taxes, and face a $1tn hole in their pension funds ….
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> Detroit is cutting police, lighting, road repairs and cleaning services …. The city, which has been on the skids for almost two decades with the decline of the US auto industry, does not generate enough wealth to maintain services for its 900,000 inhabitants.
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> The nearby state of Illinois has spent twice as much money as it has collected

> and is about six months behind on creditor payments. The University of Illinois alone is owed $400m …. The state has a 21% chances of default, more than any other, according to CMA Datavision, a derivatives information provider.
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> California has raised state university tuition fees by 32%. Arizona has sold its state capitol and supreme court buildings to investors, and leases them back.
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> Potential defaults could also hit Florida ….
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> "It's all part of the same parcel: public sector indebtedness needs to be cut, it needs a lot of austerity, and it hit the central governments first, and now is hitting local bodies," said Philip Brown, managing director at Citigroup in London.
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> In Italy, Moody's and S&P have threatened to downgrade Florence, while Venice has been forced over the past few months to put some of the palazzi on its canals up for sale to fund the deficit.
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> "Cities are on their own. Governments won't come to their rescue as they have problems of their own," said Andres Rodriguez-Pose, professor of economic geography at the London School of Economics. "Cities will have to pay for their debts, and in some cases they will have to carry out dramatic cuts, such as Detroit's."

Of course, as I've pointed out early and often, it only "hit the central governments" because they took on the toxic debts of their "too big to fail" banks. That's why "governments won't come to their rescue as they have problems of their own".

For example:

> As I noted in December 2008, the big banks are the major reason why sovereign debt has become a crisis:
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>> The Bank for International Settlements (BIS) is often called the "central banks' central bank", as it coordinates transactions between central banks.
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>> BIS points out in a new report that the bank rescue packages have transferred significant risks onto government balance sheets, which is reflected in the corresponding widening of sovereign credit default swaps:
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>>> The scope and magnitude of the bank rescue packages also meant that significant risks had been transferred onto government balance sheets. This was particularly apparent in the market for CDS referencing sovereigns involved either in large individual bank rescues or in broad-based support packages for the financial sector, including the United States. While such CDS were thinly traded prior to the announced rescue packages, spreads widened suddenly on increased demand for credit protection, while corresponding financial sector spreads tightened.

> In other words, by assuming huge portions of the risk from banks trading in toxic derivatives, and by spending trillions that they don't have, central banks have put their countries at risk from default.

A study of 124 banking crises by the International Monetary Fund found that propping banks which are only pretending to be solvent doesn't hurts the economy:

> Existing empirical research has shown that providing assistance to banks and their borrowers can be counterproductive, resulting in increased losses to banks, which often abuse forbearance to take unproductive risks at government expense. The typical result of forbearance is a deeper hole in the net worth of banks, crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance.
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> Cross-country analysis to date also shows that accommodative policy measures (such as substantial liquidity support, explicit government guarantee on financial institutions' liabilities and forbearance from prudential regulations) tend to be fiscally costly and that these particular policies do not necessarily accelerate the speed of economic recovery.
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> All too often, central banks privilege stability over cost in the heat of the containment phase: if so, they may too liberally extend loans to an illiquid bank which is almost certain to prove insolvent anyway. Also, closure of a nonviable bank is often delayed for too long, even when there are clear signs of insolvency (Lindgren, 2003). Since bank closures face many obstacles, there is a tendency to rely instead on blanket government guarantees which, if the government's fiscal and political position makes them credible, can work albeit at the cost of placing the burden on the budget, typically squeezing future provision of needed public services.

Of course, there are other causes to the cities' budget woes in addition to states bailing out big banks.

As Business Insider points out:

> First, the expiration of Build America Bonds will make it harder for cities to raise funds. [See this.]
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> Second, city revenues are crashing and keep getting worse. Property taxes haven't reflected the total damage from the housing crash. High joblessness is cutting into city revenues, while increasing costs for services.
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> The next default could be a major city like Detroit, or it could be one of hundreds of small cities that are on the brink.

The fact that housing is going into a double dip and that the government is exacerbating the unemployment problem (which has reduced consumer confidence) does not bode well for the cities.

Of course, if the cities and states had actually funded their pensions and other obligations during the good times, or at least made more realistic investment projections, they wouldn't be in such a big hole now. See this.

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