# US: Cities, education funds, transport authorities hit by credit crisis

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**19 February 2008**

The deepening credit crisis is hitting US cities as well as quasi-governmental state education and transportation authorities, sharply increasing the interest they must pay on their long-term debt and jeopardizing their ability to finance daily operations.

Many such entities borrow money on a long-term basis, but at interest rates that are set at regular, often weekly, credit auctions. Last week the market for these so-called “auction-rate securities” collapsed. Nearly 1,000 auctions failed due to a lack of investors willing to buy the debt.

As a result, the state of Michigan suspended a major student loan program and the Port Authority of New York and New Jersey saw the interest rate it pays jump from 4.3 percent to 20 percent. Weekly interest payments on the Port Authority’s $100 million in auction-rate securities will soar to $389,000 from $83,000.

New York’s Metropolitan Museum of Art is now paying 15 percent on auction securities. Other recent victims of the market collapse include universities such as Georgetown in Washington DC, student loan providers such as the College Loan Corporation, municipalities such as Washington DC, and cultural institutions such as the de Young Museum in San Francisco.

The municipal liquidity crisis compounds broader problems facing US cities and states as the US slides into recession. The bursting of the housing bubble has already begun to sap local tax revenues, and a recession will further reduce taxable income while placing greater demands on state and local social programs.

The failure of the auction-rate securities market is itself part of a more general worsening of the US and global credit crisis. Last week, Moody’s Investor Services downgraded the debt of the third-largest US bond insurance company, Financial Guaranty Insurance Company (FGIC), from AAA to A3, a drop of six levels, with a warning that it could be reduced to the lowest investment grade level of Baa. FGIC thus became the first major bond insurer to be downgraded by all three major ratings firms.

The two largest bond insurers, MBIA and Ambac, have also been threatened with credit downgrades. If a bond insurer is downgraded, then all of the bonds it insures—most of which are held by banks, hedge funds and other financial institutions—must also be downgraded, leading to a new wave of losses by Wall Street firms.

The bond insurance companies insure some $2.4 trillion in debt against the risk of default. These companies originally limited themselves to insuring low-risk municipal debt, but during the latter years of the housing bubble, they increasingly got into the business of covering mortgage-backed securities and other complex debt instruments.

Under pressure from New York State, FGIC announced plans to spin off its operations dealing with municipal bonds into a new firm, which would likely retain a triple-A credit rating. However, this would leave the original firm with its liabilities related to failing mortgage-backed securities while stripping it of its business in more solvent municipal-related debt. As a result, the banks which were insured by FGIC would be forced to write off more bad investments.

Long-term interest rates continue to inch up amid growing inflationary expectations. Consumer prices grew by 4.1 percent in 2007, up from 2.5 percent in 2006. And according to figures released Friday, import prices rose 1.7 percent in January and 13.7 percent compared to January 2006, in the highest monthly increase since the Labor Department began keeping track in 1982.

The rise in long-term interest rates, which are linked to mortgage lending rates, bodes ill for homeowners' ability to refinance, and the increase in consumer prices is significantly cutting into consumer spending. Both of these developments are likely to contribute to a growth slowdown.

Meanwhile, US consumer confidence has fallen to a 16-year low, according to a recent survey by Reuters and the University of Michigan. The survey indicates that 82 percent of Americans believe that the US is in a recession now. This is the highest reported proportion since 1982, during the worst recession of the post-war period.

"Past declines of this magnitude have always been associated with subsequent recessions," said Richard Curtin, who directed the survey.

A separate report issued Friday showed that manufacturing activity in the state of New York dropped for the fourth month in a row to the lowest level since 2003. The National Association of Realtors also announced last week that median single-family home prices dropped by 5.8 percent in the fourth quarter of 2007 over the year before, in what may be the steepest fall in home prices since the Great Depression.