

Under Strain, Cities Are Cutting Back Projects  
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Cities, states and other local governments have been effectively shut out of the bond markets for the last two weeks, raising the cost of day-to-day operations, threatening longer-term projects and dampening a broad source of jobs and stability at a time when other parts of the economy are weakening.

The sudden loss of credit, one of the ripple effects of the current financial turmoil, is affecting local governments in all parts of the country, rich and poor alike. In New York, a real estate boom has suddenly gone bust. Washington has shelved a planned bond offering to pay for terminal expansion and parking garages already under construction at Dulles and Reagan National Airports.

Billings, Mont., is struggling to come up with \$70 million more for a new emergency room. And Maine has been unable to raise \$50 million for highway repairs.

"We really are in terra incognita here," said Robert O. Lenna, executive director of the Maine Municipal Bond Bank, which helps that state's towns and school districts raise money. He said he had worked in public finance for 34 years and had never seen credit evaporate so completely.

Maine had already begun some of its road work when the bond markets stopped functioning, so now it is scrambling for bank loans to keep the dump trucks rolling. If money does not start flowing soon, Mr. Lenna said, Maine will have to cancel some of its road and bridge projects.

The only alternative would be what New York City did on Monday: Go into the locked-up markets and whip up demand by offering to pay investors a very high return.

Analysts said the dysfunction in the municipal bond markets appeared to signal the end of an era of relatively cheap money for governments and, probably, the start of an era of tough choices for communities. When the market starts moving again, they said, it will look a lot like the municipal bond market of 10 years ago, before the arrival of financial wizardry in the form of structured-finance products, which lowered borrowing costs but added big new risks. Instead, governments will probably be issuing plain-vanilla bonds with fixed rates of interest, higher than they are accustomed to.

And higher rates suggest some degree of belt-tightening, especially difficult in places where tax revenues are being squeezed because of falling real estate values and the slowing economy.

Municipalities will probably be able to function, but may not expand services, said John V. Miller, chief investment officer at Nuveen Asset Management, a municipal bond investment firm. "For some, the level of service they provide will decline."

Some governments, already straining to balance their budgets, will have to cut payrolls, he said, and others may decide to raise taxes.

Last year, governments across the country issued about \$23 billion of fixed-rate municipal bonds in September. This September they issued \$15 billion — all but about \$2.2 billion of it in the first two weeks of the month, according to Municipal Market Advisors, a research and strategy firm.

Tight money is already becoming apparent in some states. In Montana, officials had planned to sell \$130 million of bonds to the public last December to pay for a new emergency room, cancer center and improvements at the Billings Clinic, a 272-bed hospital in the state's largest city. But they were dissuaded by higher interest rates even then.

"I've been second-guessing it since then," said Michelle Barstad, executive director of the Montana Facility Finance Authority. "Things just keep getting worse and worse."

The authority borrowed \$60 million of the total cost from private lenders in May, but is now unsure where to get the remaining \$70 million. Ms. Barstad said one option under consideration was to borrow about \$20 million from local banks and scale back the project, at least for now.

"We're just sitting on our hands like everybody else, trying to figure out what to do and how we do it," said Ms. Barstad, adding that she would welcome a return of the days of simple, fixed-rate bonds.

The credit crisis caused Athens-Clarke County, Ga., to delay a \$221 million bond issue planned for the day Lehman Brothers declared bankruptcy. The county has been planning for 10 years to upgrade three sewage treatment plants built more than 40 years ago when the population was much smaller.

The county's finance director, John Culpepper, said he had delayed the issue rather than raise the monthly sewer bills to the system's 39,000 customers.

"We're going to wait it out for the next month or two, until the market returns to more normal conditions," he said.

The Washington Metropolitan Airports Authority has already begun construction of a bigger international arrivals building at Dulles, a new parking deck at Reagan National and other major projects, and said it intended to forge ahead using cash and commercial paper.

New York City decided to brave the markets on Monday and ended up having the whole place to itself. It managed to issue \$300 million of bonds for public schools, the only issue of the day. The New York Transitional Finance Authority will pay 5.75 percent on those 30-year bonds, the equivalent of a 10.5 percent interest rate to New York City residents, who will not have to pay city, state and federal tax on the income.

Yet even with that rate, the issue was not completely sold, said Mr. Miller of Nuveen.

"This is for a very well-liked name, a very well-known name," said Mr. Miller, explaining that New York City's bonds usually sell out quickly.

Mr. Lenna said Maine's advisers had warned that it might end up paying interest as high as 10 percent if it brought its highway bonds to market now. "We're not going to go out and incur these costs," he said.

The municipal bond markets had already hiccupped before the latest turmoil. But analysts say the gridlock began in mid-September, when Lehman Brothers declared bankruptcy.

Lehman Brothers was one of several Wall Street firms that had created structured-finance products for municipalities for the past few years. These products could be hybrids, allowing a local government to issue what seemed like a fixed-rate bond that could in turn be bought by an investor who received a variable rate of interest.

Governments generally prefer fixed-rate bonds because the cost is predictable — but variable-rate bonds were attractive because of their generally lower rates. Securities firms tried to merge the best of both worlds by linking derivatives contracts to municipal bonds. One structured product was a variable-rate demand note, which gave the investor the option of putting the note back to the securities firm if the investor decided the rate was too low.

The notes were often bought by mutual funds for their tax-exempt bond funds. The booming demand for those funds, in turn, held down the price of borrowing for states and cities, at least for a while. But when Lehman collapsed, the mutual funds suddenly perceived a risk: the securities firms that had created the products might go out of business. So, owners of the notes put them back to the securities firms that had sold them.

The prices investors were willing to pay for the notes plunged, driving up short-term rates for municipal bonds. Securities firms, under pressure, unwound the notes and reconstituted them as old-fashioned fixed-rate bonds.

None of this had anything to do with the behavior of local governments or their ability to repay their debts, but it brought the municipal bond market to a halt.

Thomas G. Doe, president of Municipal Market Advisors, said his firm was fielding calls this week from government contractors asking how much credit might be available next year. For insight, he pointed to municipal bond data from the 1930s.

"During the first few years after the '29 crash, municipal issuance dropped 24 percent," he said. "It wouldn't be unreasonable to think that we could see municipal issuance go from a total of \$430 billion last year, to something like \$350 billion next year, which would be a drop of 25 or 30 percent."

This would not mean widespread bond defaults, he said, just greatly narrowed local budgets.

"It's no different from a family budget," he said. "We're not going to go out to dinner any more. We're not going to buy a new car. That's the similarity."