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The Economist: What Do the Woes of Detroit Mean for Muni Bonds?

Choosing the bleakest statistic from a report issued by Kevyn Orr, Detroit's emergency manager, on his city's financial health is like choosing the wettest raindrop in a monsoon. It could be the $1.3 billion general-fund deficit Detroit is forecast to run, absent restructuring, by the 2017 fiscal year. It could be the $200m revenue decline since 2008, the roughly $3.5 billion in unfunded pension liabilities or its $5.7 billion in non-pension retiree liabilities.

On June 14th Mr Orr announced that Detroit would miss a $40m unsecured-bond payment, and proposed a restructuring that would mean some holders of the city's unsecured debt receiving pennies on the dollar. If creditors reject Mr Orr's offer bankruptcy looms. Detroit would be the largest-ever American city to go bust, but hardly the first. In recent years issuers of municipal bonds that have filed for Chapter 9 protection from creditors have included Stockton, Vallejo and San Bernardino in California; Central Falls, Rhode Island; Jefferson County, Alabama; and Harrisburg, Pennsylvania. Others have defaulted without going bust. America's $3.7 trillion muni-bond market has long had its doomsayers. Is this their moment?

The situation remains grim. According to the National League of Cities, an advocacy group, American cities in 2012 experienced their sixth straight year of constant-dollar declines in general-fund revenues. Year-on-year sales-tax collections rose modestly in 2012 but income-tax collections fell for the third year in a row. So did property-tax collections, despite a recovery in housing markets; assessed values, which determine property-tax rates, usually lag the market by at least 18 months. Cash reserves have fallen by almost 50% since 2007 to 12.7% of expenditures, their lowest level since 1996. (The picture is a bit rosier for states, which tend to have more flexibility in raising revenue than cities do.)

Borrowing costs are going the wrong way. Municipal-bond yields have been rising in anticipation of the Federal Reserve scaling back its bond-buying. American municipal-bond funds saw billion-dollar outflows during the weeks ending June 5th and June 12th. Some may also be worried by Barack Obama's proposal, released in his budget in April, to limit the tax-exempt status that most municipal bonds enjoy (although getting that passed would require a degree of backbone currently absent from American politics).

None of this means a wave of defaults is around the corner, however. Assured Guaranty, a municipal-bond insurer, has exposure to roughly 11,000 different municipal bonds; it expects to take losses on fewer than 12. The high-profile cases of Detroit and Jefferson County are idiosyncratic. Detroit has been shedding population for years, and the decline of its car industry has destroyed its tax base. The woes of Jefferson County—which this month proposed a plan to emerge from bankruptcy that also involved creditors taking losses—stemmed from a sewer project that stank of corruption and mismanagement.

Bart Mosley, a co-president of Trident Municipal Research, calls these cases "exceptions that prove the rule that state and local-government credits are solid…[and] highlight the extent to which state and local governments have been much more fiscally responsive" than the federal government during the crisis. Mr Mosley points to narrowing yield spreads over the past two years between A-rated and AAA-rated municipal bonds as evidence that fear of default has been priced in.

The concern for the municipal-bond market is less about an imminent deluge of defaults, and more about the lasting precedents set by places like Detroit. Cities and states face huge long-term pressures from health-care costs and pension obligations. Investors are used to seeing governments raise taxes and cut spending to ensure repayment. They are learning that "full faith and credit" has its limits.