

States May Not Be Immune To Possible European Recession

By Kelly Nolan
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Should the European region slip into a recession, some already strapped U.S. states may not be immune to its effects.

The link between the states and Europe is indirect. Data shows U.S. states do not derive a large amount of exports from the euro-zone as a percentage of their gross domestic product. But RBC Capital Markets research shows some have relied heavily on emerging market countries, like China and Brazil, to fuel economic growth in post-recession years.

That's a problem because emerging market countries depend on funding from euro-zone banks, which are expected to deleverage in the second half of this year due to new capital requirements, said Chris Mauro, RBC's muni analyst. That's also when many states will be trying to find solutions to bridge billions of dollars in budget gaps.

"If some of these external pressures from the euro zone and emerging markets begin to weigh, it's not going to take a very large move in states' GDPs to get back to recessionary levels... something states can ill afford to deal with at this point," Mauro said.

In Mauro's view, the more reliant a state has been on exports for economic growth, the greater its vulnerability to "global economic contractions or financial dislocations."

He identifies 14 states that derived more than half of their 2009-2010 GDP growth from exports, and in three of those states—New

Hampshire, Utah and Vermont—the export-to-state GDP calculation exceeded 100%. The other states on Mauro's list include Michigan, Texas, Idaho, South Carolina, Louisiana, Mississippi, Maine, Georgia, Florida, Missouri and Alabama.

To be sure, when looking at the most obvious link between the states and the euro-zone, European exports as a percentage of a state's GDP, the situation appears less dire. According to research from investment firm Janney Montgomery Scott, states' exposure to exports to Europe is just 1.80% of their overall GDP. Only Utah, South Carolina, West Virginia, Louisiana and Kentucky have state GDPs that have exposure to Europe of more than 3%.

But understanding what drives state GDP growth is important because such growth is highly correlated with major revenue sources for state budgets, and is therefore "a significant determinant of state health," Mauro said. He noted that in the most recent recession, declines in state GDP contributed to drops in revenue, such as personal income taxes, corporate income taxes and retail sales taxes. That revenue makes up about 60% of a state's budget on average, with federal aid making up the rest, he said.

Unfortunately, the potential timing for another hit to some U.S. states isn't ideal. Mid-year, or about the time European banks may be reducing their exposure to emerging markets, is when many states will be hammering out their fiscal 2013 budgets. States will need to close a combined budget gap of \$40 billion in fiscal 2013, according to Pew Center on the States, a nonprofit nonpartisan research in-

stitution. That is down from \$174 billion in fiscal 2010, but tax revenue is just now back to pre-recession levels, according to the Nelson A. Rockefeller Institute of Government, and unemployment remains stubbornly high.

According to the Rockefeller Institute, state tax revenues increased by 7.3% in the third quarter last year versus the same quarter in 2010. While that marked the seventh straight quarter of gains, it was a noticeable slowdown from second quarter 2011's 10.8% year-over-year growth.

For investors, Mauro's research serves as a reminder of how interconnected the world

economy is. But it's impossible to know exactly how devastating the impact of a European slowdown would be. After all, the U.S. economy is starting to show signs of improvement, even in the stubborn job market.

"There's no question [municipalities] may get caught" in a global slowdown, said Richard Ciccarone, chief research officer at McDonnell Investment Management in Oak Brook, Ill., which managed \$8.2 billion in municipal bond assets as of September. "But we don't know what the impact will be until all these variables come together."