UPDATE 3-S&P lowers California debt rating, more cuts seen

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(Adds background)

By Jim Christie

SAN FRANCISCO, Feb 3 (Reuters) - The downgrade of $46 billion of California's general obligation bonds by Standard and Poor's sets the stage for similar actions by Moody's Investors Service and Fitch Ratings as the state's budget crisis persists, analysts said on Tuesday.

California and Louisiana had been paired at the bottom of Wall Street's rankings of state general obligation debt. With the downgrade by Standard & Poor's Ratings Services late on Monday, California became the state with the lowest-rated general obligation bonds.

"It's a red flag," said Christopher Thornberg, an economist with Beacon Economics in Los Angeles. "What they're responding to is the fact that the state is running out of cash."

S&P cited the state's weakening finances and slow talks between Gov. Arnold Schwarzenegger and lawmakers over closing a budget gap topping $40 billion through this fiscal year and the fiscal year beginning in July.

The agency cut its rating late on California's GO debt, which is backed by the state's general fund, to "A" with a stable outlook from "A+."

The final straw was California's cash shortage. "It just to us indicated another level of distress in the overall situation," said S&P director Gabriel Petek.

California's cash account is on the brink of running dry and the state controller on Monday began withholding tax refunds to have money for higher priority payments, including debt payments.

"Rating agencies are very reluctant to downgrade states so it's a big move," said John Moorlach, an Orange County, California supervisor. "When S&P says 'We're downgrading' that should be a signal that things aren't going as they should."

THREATS TO RATING

S&P had warned in December of a possible downgrade, which puts California, the biggest U.S. issuer of public debt, at risk of increased borrowing costs and may prompt Wall Street's two other major rating agencies to follow with downgrades.

Last month Moody's warned it may cut California's GO rating and Fitch said its GO rating was slated for review.

"The big three rating agencies tend to rate in similar directions," said James Hawley, co-director of the Elfenworks Center for the Study of Fiduciary Capitalism at St. Mary's College of California.

If California borrows to help balance its books its GO rating could slide to the "Baa/BBB" level, where it stood during the state's 2004 financial crisis, said Dick Larkin, director of credit at municipal bond broker Herbert J. Sims.

"They're going to have to ask people to lend them money to get over this hump," he said. "It's not the kind of thing a single-A credit does -- issue bonds to pay for this year's bills."

PUSHING BUDGET TALKS FORWARD

S&P's downgrade could have a bracing effect on budget talks by prodding Schwarzenegger and lawmakers toward measures to help balance the current and next budgets with spending cuts opposed by Democrats who control the legislature and revenue increases through new or higher taxes opposed by Republicans.

"It could add some pressure," Hawley said. "Everyone knew it was out there, but the stark reality of a downgrade is very different from the threat."

Schwarzenegger spokesman H.D. Palmer said budget negotiators aim to address Wall Street's concerns about California's shortfalls this year and next, the result of revenues falling harder and faster than expected in the wake of the crisis in financial markets.

"The goal is to close the entire $41.6 billion gap in one shot," Palmer said.

S&P in a statement said its lower rating reflects its view of the state's inability to reach agreement on a midyear budget revision and the state's rapidly eroding cash position.

A ray of hope for California may come from federal stimulus funding, S&P said. The most populous state could receive nearly $8 billion for "fiscal stabilization funding" and nearly $22 billion for other purposes, including public works and health and social program according to initial estimates, S&P said.