Today, Washington's lawmakers began hearings on the massive fiscal problems the Great Recession dumped on American states and cities. The looming possibility of municipal defaults, which some say could total hundreds of billions of dollars, is causing grave concern.

Hedge funds are also deeply concerned about America's municipal debt crisis. They worry about how to best profit from it.

The Wizards of Wall Street have looked over the catastrophe of cash-strapped America and found it good for business. In their corporate laboratories, they are working furiously to whip up wondrous new financial products that will allow them to reap millions from misery. You might think that after plunging the country into said Recession with their fancy financial products, these Wizards might feel a little indelicate about gearing up for a game of shorting a community near you. Clearly you don't know Wall Street. The *Financial Times* reports that once-boring muni bonds are suddenly sexy:

For decades, this $3,000bn bond market was safe, predictable and dull. The traditional buyers of the bonds issued by states, cities and other local bodies were wealthy local residents lured to them by the tax breaks on offer for individual investors. They bought the bonds, held them until they matured and then bought more. Not now. State deficits have ballooned, local authorities are grappling with huge public sector pension liabilities and triple A bond insurance that used to prop up even the riskier municipal bonds is harder to find. The mounting concern over "munis" has brought with it hedge funds and financial institutions who want to bet on the bonds' creditworthiness, or make money on the back of volatile "spreads" -- the premiums at which munis trade relative to benchmark debt.

So much suffering. So many ways to squeeze money from it. The *FT* quotes the head of municipals at Arbor Research and Trading, who sums up the current hedge fund frenzy building: "There is a lot of blood in the water in the municipal space. Hedge funds smell that blood and are trying to figure out the best way to make money in the marketplace."

What the Wizards have to do is figure out how to take short positions that will soar in value as the creditworthiness of munis fall into the crapper. And it's to credit default swaps -- those "innovative" financial products that helped bring you the financial crisis -- that the hedge hogs are turning. Credit default swaps are like insurance. Except that unlike insurance, which you can only buy on assets you really own, you can buy these goodies on your neighbor's house, too. The moral hazard problems of this sort of nonsense are well known, which is why Wall Street fought so hard to make sure credit default swaps were not regulated like insurance. Once upon a time, as my colleague Tom Ferguson explained to me, English insurers discovered that scoundrels would buy insurance on ships they didn't own and then leak voyage details to the French navy, so they could collect. Guess who sells most municipal bonds? Many of the same people who'll be betting on their failure now. See a problem here? If you don't own the underlying asset, then credit default swaps are simply gambling. So what we are talking about is an extension of casinos to every state and city in America. The European Union is finally moving on these vultures. But not us, it seems.

The perversity of gorging on suffering never seems to bother the American financial sector. JPMorgan feeds on our hunger with its lucrative food stamp card business. And AIG gets into the game of letting strangers bet on your life. Why shouldn't hedge funds make a little extra dough from the collapse of your hometown?

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