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Between state and market: Hegemony and institutions of collective action under conditions of international capital mobility

TIMOTHY J. SINCLAIR
Department of Political Science and Center for International and Strategic Studies, York University, Toronto, Ontario, Canada M3J 1P3

Abstract. This article rejects the atomistic conception of international capital mobility as individual, uncoordinated decision-making. It argues that non-state institutions exist in the global political economy which condition the thoughts and actions that comprise the investment process. Because these structure investment, such institutions can be understood as private makers of global public policy. Credit rating agencies are used as an example of these mechanisms. The article examines transformations in the organization of capital markets which underpin the greater influence of these agencies. Functional accounts of rating institutions are evaluated, and their scope for transcending a strict agency role with regard to investors is assessed, based on their possession of specialized forms of knowledge from which they derive control. Some description of the agencies, their international growth and the ratings process is provided. Three arguments about the pressures on the economic and financial structures identified by Zysman (1983) generated by rating agencies are considered. Rating institutions create pressures for fundamental analyss of investment, for a particular view of appropriate management forms and policy lines along new constitutionalist lines, and contribute to a more abstract investment process which is likely to have the effect of transforming social relationships within the dominant alliances of social forces. The article concludes with some consideration of the implications of these hybrid forms of authority and policy for world order.

International capital mobility is often conceived in atomistic terms, as decisions made by unconnected market players in an increasingly deregulated global marketplace (eg., Wriston, 1992).[1] These players are understood to make decisions to maximize their self-interest based on many different sources of information. If they act collectively, so this view contends, it is only because they have separately and simultaneously perceived opportunities for themselves. This article rejects this view of international capital mobility as an inadequate understanding of the social dynamics involved in the allocation of capital. It argues instead that institutions exist within the data gathering processes of investors which have the effect of coordinating capital allocation behavior by structuring information and subsequent decisions in particular ways. These institutions affect the thought and action of those trying to borrow funds, and can be understood as governance mechanisms; that is, as non-state means through which authority is exercised in markets and a form of policy created (Miller and Rose, 1990; Ferguson and Mansbach, 1991; Rosenau, 1992; Sinclair, 1994). In a context of dynamic economic activity, this structuring of information is giving rise to changes in the ways major features of economic and political life are arranged, with implications for the maintenance of hegemonic forces.

This article will focus on bond rating agencies as an example of the governance implications of data structuring. Rating agencies have typically been studied by those looking for better ways of predicting their determinations so that borrowers can more effectively present themselves with the hope of improving their rating and lowering their interest costs (Cluff and Farnham, 1985). Little work has been done on the collective consequences of their activities, although others have suggested that the rating agencies are probably important in these terms (Mintz and Schwartz, 1987). This article argues that bond rating agencies are being transformed into private makers of public policy, as rating institutions acquire power and authority within a context of a global economy of mobile financial resources. Rating agencies, like national states, are an example of what Cox has termed a 'transmission belt' in the process of globalization (Cox, 1992: p. 31). This is demonstrated by examining three major ways in which bond rating agencies seem to be contributing to the transformation of the financial and economic structures identified by Zysman (1983). The emergence of private makers of public policy at the global level indicates a new phase in the development of the Global Political Economy (GPE) in which a more narrowly prescribed hegemony of political and economic interests is discernible.

This article begins with a discussion of changes in the international allocation of capital. This is the context in which rating institutions operate. The following section focuses on the agencies themselves, how they come to have power and authority, what they do and how they have reacted to these changes in their environment. The subsequent section examines three pressures on the structures identified by Zysman that are attributable to rating institutions.

Disintermediation and capital allocation

The way in which wholesale borrowers obtain funds is changing. This change is significant because it provides the context in which the determinations of the rating agencies have acquired greater salience. Traditionally, borrowers have sought funds from banks. Banks obtained funds from depositors and lent this money out at a premium above the interest they paid. The bank made the decisions and assumed the risk that the borrower would repay on time with interest. If the borrower failed to repay, depositors were not directly affected, unless, of course, repayment problems were endemic across the bank's borrowers, placing the bank as a whole in financial jeopardy. Even these risks were lessened by regulation such as the Glass-Steagall Act of 1933, which prevented American commercial banks from underwriting the issue of securities such as bonds, and by the Federal Deposit Insurance Corporation, also dating from 1933, which guaranteed depositors' money in member institutions up to certain limits (Downes and Goodman, 1991: pp. 173, 139). These measures were attempts to inject more predictability into

economic affairs in response to the Great Depression, and were copied in various forms around the world (Polanyi, 1957 [1944]).

Outside the United States, the dominance of banks in the business of lending funds has been even more pronounced, as pointed out by Zysman (1983) in his discussion of different systems of financial organization. He identified three sets of financial arrangements. The first of these is what he called the capital market form, characterised by competitive price allocation, arm's length relations between government and industry, company-led adjustment and the absence of conscious development strategy. The second form, the credit-based system with government-administered prices, was designed to facilitate government intervention and state-led adjustment. The last system Zysman discussed was a variant on the credit-based system of capital allocation, in which financial institutions use market power to influence industrial investment decisions by corporations. Zysman saw the United States as the classic example of the first system, Japan and France as exemplifying the second, and Germany as an expression of the third (Zysman, 1983: p. 18).

These ideal types are no longer wholly accurate accounts of the way capital is allocated. The 1980s and 1990s have seen a dynamic of disintermediation unleashed upon the markets for capital. This has changed the role of banks and heightened the importance of other institutions in capital allocation, at the same time changing the very nature of allocation itself. What is this disintermediation process, why has it occurred and what are its implications? Disintermediation is a process of eliminating the 'middleman.' It has occurred on both sides of the balance sheet. Depositors have found more attractive things to do with their funds at the same time as borrowers have increasingly been obtaining funds from sources other than banks. Mutual funds, which sweep depositors' money directly into securities and money markets now contain $2 trillion in assets, not much less than the $2.7 trillion held in US bank deposits. In 1994, 28 percent of American households owned a mutual fund, up from 6 percent in 1980. However, the proportion of household assets held in bank deposits fell from 1980 to 1990, from 46 to 38 percent. The shift on the borrowing side is just as marked. In 1970, commercial lending by banks made up 65 percent of the borrowing needs of corporate America. By 1992, the banks' share had fallen to 36 percent, with the balance made up of securities of various types (*The Economist*, 1994: p. 11).[2] As would be expected, based on Zysman's work on the differences in financial organization across the globe, the proportions attributable to bank and non-bank sources of capital vary greatly depending on locality. In Germany, for instance, International Monetary Fund figures indicate that in 1980 63.1 percent of corporate borrowing was in the form of bank loans, while the comparable figures for Japan and the United States were 67.4 and 33 percent respectively. However, a recent IMF-sponsored study notes that despite these 'pronounced differences ... the evidence indicates that the trend is toward a disintermediated, liquid, securitized structure' (Goldstein et al., 1992: pp. 2–3).

Why has disintermediation taken off? A tentative answer revolves around the inherent costs of banking and the heightened competitive pressures of the GPE. Intermediation costs money. Banks have to establish and maintain infrastructures to check the creditworthiness of potential borrowers. They have to set the terms and conditions of loans, and administer and monitor them, often in ways considered unattractive to borrowers who want to manage their own affairs. In cases of default, banks have to assume the burden of reducing their losses, which often involve them in expensive litigation (*The Economist*, 1992: p. 9). Moreover, the environment in which banks have been doing business has changed in recent years, making this way of operating less attractive to depositors and borrowers. Because competitive pressures have been heightened by lower average growth and fewer barriers to trade, borrowers are much more concerned to reduce their costs in whatever form, including the cost of capital. This cost-reduction impulse has been stimulated in borrowers just as the average cost of bank intermediated loans has risen due to the Basle capital adequacy standards which mandate banks to hold a certain ratio of reserve assets to loans outstanding. This is money that could otherwise be earning market-level returns. Lowell Bryan of McKinsey, the management consultancy, has calculated the relative costs of bank intermediation versus securities financing. He found that the associated costs of lending money in the traditional way added over 200 basis points (hundredths of a percent) to the total price of loans, whereas the total for securities financing was only around 50 points (*The Economist*, 1994: p. 11).

What are the probable implications of the disintermediation trend? The most obvious consequence of disintermediation is for banks. They will change roles. Increasingly, they will give up the business of being intermediaries in wholesale capital. Instead, they will take on the role of active market participant: they will trade, package loans into securities, and devise new types of financial products. The distinction between commercial banks and brokerage firms will become increasingly fictitious as commercial banks seek new sources of fee and arbitrage income. A recent example of this transformation is the explosion of bank interest in derivatives (Moody's, 1994). The significance of this process is that banks are being forced to abandon their role as authorities in the financial markets. Contrary to the image of a dichotomy between state and market exchange, banks represented a fusion of these roles. They have operated as hybrid institutions of collective action, between state and market, that acted to control risks and reduce the uncertainties for the political authorities, as well as for borrowers and lenders (Taylor and Singleton, 1993: p. 204). Although banks are private institutions, they everywhere have been agents of the self-regulation of financial markets and of the economy more generally, acquiring public functions in arrangements that Moran has termed 'meso-corporatism.' Meso-corporatism refers to the 'appropriation of a regulatory role by private interests; the transformation of private, voluntary associations into authoritative bodies; [and] the restriction of political and economic competition' (Moran, 1991: p. 15). As

new financial institutions have become established, the hybrid authoritative role of banks has diminished. The public acknowledgement of this transformation came in the mid-1980s, exemplified in popular culture by such books as Tom Wolfe's *Bonfire of the Vanities*, and the movie, *Wall Street*.

Are rating agencies simply the new banks? Has the old type of intermediation by banks given way to a new intermediary in the form of rating agencies? Rating agencies do not have the same relationship to borrowers and lenders as banks do. They neither lend nor borrow like banks and thus they have entirely different legal obligations from banks. Nor do they place their balance sheets directly on the line when they issue a rating. While their credibility is at stake, and the importance of this cannot be understated, this does not have the same implications as entering into a financial relationship. There is no pecuniary advantage to the rating agency from any particular rating determination, whereas this is the case with financial transactions between banks and their customers. The nature of the contract in either case places different incentives on banks and rating agencies which lead to different pressures on capital allocation. Raters simply want to issue a rating which reflects the probability of repayment at the contracted rate of interest. Banks want to minimize their cost of borrowing and maximize their real return from lending, within the context of competing suppliers of capital. Banks and rating agencies are different types of institutions, performing different tasks.

Disintermediation has not just reduced the role of banks from agents of self-regulation to market participants. It has changed the nature of capital allocation and increased the salience of institutions connected to this transformed process. Capital allocation in its traditional form was centralized. The pattern that is emerging would appear to destroy the idea that allocation is anything other than the disparate decisions of unconnected market players. In fact, as is shown below, the process of disintermediation has changed the form of allocation so that it is unrecognisable to those used to the agency of banks. This new system of allocation has given much greater weight to the determinations of the rating agencies to which the discussion now turns.

Rating agencies as private makers of global public policy

The argument is that the changes in the markets have begun a process of transformation in the role of rating agencies, mutating them into what can be thought of as private makers of global public policy. Mintz and Schwartz have argued that a process of governance exists in the American economy, which they refer to as 'financial hegemony,' in which the 'centralization of the financial sector (commercial banks, insurance companies, and investment banks) allows for coordinated decision-maing over the disposition of investment capital.' This hegemony can have what might be thought of as policy effects: the 'leverage resulting from the concentration of investment capital can sometimes be applied to a broad spectrum of companies simultaneously, thus

providing the power to implement economic policies without the intervention of the state' (Mintz and Schwartz, 1990: p. 205). This private policy making role can also be conceived in non-behavioral terms as the structural power of capital (Gill and Law, 1993: pp. 93, 105). Structural power has to do with the different resources of political and economic actors, and the incentive this gives those dependent on them to tailor their ideas and actions to those which are favored by the actors who possess these resources (Gill and Law, 1988: p. 73).

What is the source of the financial hegemony or policy making role attributable to rating agencies? There is no sustained account of the 'function' of rating agencies. However, one can readily be inferred from neoclassical assumptions about institutions. These assumptions center on the cost-reducing benefits of institutions such as rating agencies. These can be understood to centralize the credit assessment function in order to secure economies of scale. In this view, rating agencies are proxies for market judgements and will be replaced should their judgements be shown to be inaccurate.[3]

The study of collective action problems and principal-agent relationships is increasingly displacing purely functional neoclassical assumptions about institutions (March and Olsen, 1984; Yarbrough and Yarbrough, 1990; Pratt and Zeckhauser, 1985; White, 1985; Ostrom, 1990; Taylor and Singleton, 1993). In these terms, rating agencies can be considered endogenous solutions to the uncertainty that exists when a lender does not know the reputation of a borrower, due to the lack of community in capital markets (Taylor and Singleton, 1993: p. 198). Rating agencies operate as the agents of investors in these situations (Pratt and Zeckhauser, 1985). Agency is an 'intermediate' way of getting things done, between formal organization (such as a bank) on the one hand, and markets, on the other. It is a means of control that transcends the 'atomistic cognitive' behavior of the single transaction (White, 1985: pp. 189, 204). The continuing existence of agents is dependent on an ongoing relationship with the principal. But principal-agent solutions to uncertainty are fraught with 'agency problems.' This intermediate process of control through agency gives rise over time to specialization on the part of the agent. At least two sorts of specialization are interesting for our purposes. The first is professional specialization, which has to do with specialization in analytical skills. The second is rooted specialization, which is linked to local knowledge. The problem with specialization, according to White (1985: p. 205), is that there is a 'tendency toward reversal of control; ...the principal comes under the control of the agent after the latter becomes a specialized purveyor.' This problem creates the opportunity for other dynamics not connected to the original functional purpose of the principal-agent relation to exert control through the agent.

Rating agencies are specialists in the area of credit research. They possess both professional specialization in terms of analytical capacities and rooted specialization in terms of ongoing knowledge of the affairs of vast numbers of issuers of debt securities. The disintermediation process has heightened the

authority of bond rating agencies because their analytical and local specialization has increased absolutely, as they now rate more issues in more locations, and relatively, because comparable specialists (banks, for instance) are less active. The industry literature is full of criticism of the agencies as being unresponsive, backward looking, and so forth (*Euromoney*, 1991; Elliott, 1988). This is evidence that there are problems in the principal-agent relationship, as seen from the point of view of the principal, which support the notion that rating agencies seem to be most clearly understood as hybrid forms of authority, between state and market. There is a case here then for theoretical and empirical analysis of their activity because they possess the resources necessary to transcend the market proxy role assigned to them in neoclassical thinking.

Two American agencies dominate global rating activity: Moody's Investors Service (Moody's) and Standard & Poor's Ratings Group (S&P). Each rates around $3 trillion worth of debt (Emmer interview). Until the mid-1980s, these New York-based corporations had very little in the way of foreign operations, although John Moody opened an office in London just after World War I (Moody's, 1993: p. 7). In the last decade either or both of the two 'global' agencies have established offices in Tokyo, Toronto, Hong Kong, Frankfurt, and Paris, amongst other locations. The circumstances of these operations vary. Sometimes they are new start-ups, but purchase of a local company and subsequent incorporation into the parent company is equally common. These branch openings are linked to the deregulation of the local capital markets by respective national governments.[4] These changes create a flood of new debt securities and thus provide commercial opportunities to the rating agencies. However, the new branches are not autonomous from the New York headquarters. Although both agencies endeavour to hire mainly local officials in order to establish regional specialization, training and the all-important rating committees, where rating determinations are actually made, are routed through New York. The objective in the case of both agencies is globally comparable ratings (so that an AA on a steel company in South Korea is equivalent in credit risk terms to an AA on a pulp mill in British Columbia, or a similar rating on a software company in California). New York remains the analytical core, where rating expertise is defined and reinforced.

At the same time as the major American agencies have become global a large number of minor agencies have been established. Small agencies have existed for a decade or so in Canada and in Britain, and three second tier agencies focus on niche markets in the US.[5] Japan has four 'local' agencies. What is new is the flood of agencies in emerging markets, such as China, Thailand, Malaysia, India, Brazil, Chile, Mexico and South Africa. National governments in these countries have fostered the development of rating, often by making the rating of issues mandatory, as in Malaysia, or by equity interest, as in Thailand (Balakrishnan, 1993; Smith, 1989; Handley, 1993). Given the greater volatility of capital flows in a context of deregulation and heightened global competition it seems probable that the newly established local rating

institutions will have great difficulty creating and maintaining credibility with investors outside their national context because they lack the global coverage and thus are unlikely to become private makers of public policy in the global sense identified here.

The rating process itself remains largely opaque to the outside world.[6] There is some variation between the major agencies on this issue. Moody's, true to its corporate culture, tends to be much less revealing about the criteria it uses to arrive at its determinations than its major rival. The reason for this, according to Moody's, is that publishing rating criteria which indicate, for example, acceptable financial ratios for particular industries tend to distort expectations amongst issuers (Abbott interview). Criteria based on quantitative information tend to 'confuse people' when their issue does not achieve the expected rating for other than quantitative reasons. In contrast to this position, S&P publishes a great number of criteria books that are packed with guidelines on appropriate financial ratios for different types of credits. *S&P's Corporate Finance Criteria* contains a whole section that links ratios with specific ratings. For example, if you are a utility company distributing, say, gas and you want an AA rating you will need to ensure that your 'funds flow interest coverage (x),' that is, the number of times cash flow covers interest payments, equals 4.25 or better. For a BBB rating, the company will need to ensure coverage is in the range 2.25 to 3.5. If you want to issue junk bonds in the upper ranges, anything under 2.5 is deemed adequate (S&P, 1992: p. 65).

The different stances of the major agencies on the issue of ratios represent different strategies for handling the public perception of rating determination. These views of the ratings process tend to revolve almost exclusively around the numbers. Here can be seen the dominance of economic and financial analysis in popular perception. The assumption is widely held that quantitative indicators will be the exclusive form of data incorporated into the determination process, and that that process is therefore technical rather than judgemental in nature. However, as John Diaz, a Vice President at Moody's has commented, 'ratios really are a starting point... all a ratio gives you is a historical look at a company. Where a company has been. And by the time an account comes out, it is old anyway' (quoted in Bruce, 1992). Although raters do on occasion make comments such as this which support the idea that rating mixes qualitative and quantitative data producing a fundamentally qualitative result, a judgement,[7] they are adept at using the cloak of economic and financial analysis to hide behind the numbers when it is easier than justifying a judgement to a hostile audience.

Rating agencies disavow any ideological content to their rating judgements. Their concern, they assert, is with the financial flexibility or 'bottom line' of the issuer (Streeter interview). Concern with government policy flows from this, they insist. However, rating agency officials here follow common sense understandings of rationality in identifying ideology as the opposite of scientific deliberation. In this view, ideological thought is that type of thinking

clouded by political bias and incapable of producing the cool, calm and collected judgements rating officials value. However, this negative view of ideology, as having little cognitive value can be contrasted with a positive conception of ideology as simply an expression of a particular set of interests. This positive view assumes, of course, that there is no such thing as a disinterested stance, but that analysis reflects assumptions and methodology which stem from a particular world view and set of interests (Larrain, 1979: p. 14). On this criteria, rating agency judgements, and the views of the world within which these arise occur within an ideological context and have ideological significance. Such an acknowledgement by no means implies a conspiratorial view of the agencies. In conjunction with the discussion of the principal-agent basis of rating agency activity, it opens up the territory for an analysis of the significance of rating agencies in the GPE.

Pressures on structures of economic and financial life

This section examines three arguments about the pressures on economic and financial structures which rating agency judgements generate. The first of these arguments concerns what is here called fundamental analysis, the second has to do with questions of rating agency views of management and policy. The last argument focuses on the hegemonic implications of the tendencies identified. In each case, these arguments are offered as evidence of tendencies and trends, and not as tight functional accounts of cause/effect relationships.

Fundamental analysis

Rating generates a greater emphasis on 'fundamental analysis' in investment. Fundamental analysis has to do with the basic macroeconomic environment and the potential of the entity being rated to achieve its goals in this context. This trend is most clearly seen in rating decisions about municipalities in the US, where analysis of long run population and tax base potential has become increasingly important compared to technical analysis of city budgets. Emphasis on fundamental analysis brings the 'bean counters' much closer to judgements on more structural dimensions of corporations and governments. This is in contrast to more immediate decisions about, for example, hedging foreign currency and interest rate exposures that dominate the activity of financial institutions.

Detroit is a good illustration of the trend to fundamental analysis. The city is as sad a case of economic and political conflict as one would ever wish to encounter outside of a war zone. Subject to 'white flight' to the suburbs, Detroit's median household income was $18,742 in 1989, ranking it 538th out of 555 American towns and cities with a population over 50,000 (*The*

Economist, 1993c: p. 26). Its fortunes have been directly linked to the changing size of the automobile industry. As Grossman (1977: p. 10) puts it, the 'automobile industry was the principal factor in its population expansion from 285,784 in 1900, to 993,687 in 1920, to 1,568,662 in 1930.'

In recent years, Detroit city officials have responded to rating agency expectations proactively, reflecting their awareness of the agencies' authority, albeit without success. In July of 1992, Detroit was downgraded by Moody's from the bottom rung of investment grade (Baa) to the top level of speculative grade (Ba1). What is interesting about this downgrade is that city officials were not being punished for incompetence or lack of attention to city finances. Indeed, city officials maintain that Moody's should have 'come to praise, not bury' (Noble, 1992). According to the city's financial director in the administration of former Mayor Coleman A. Young, 'Detroit responded to criticism from the agency almost two years ago by undergoing fiscal surgery that led to the relative leanness of the [1992/93] $2.12 billion budget and to the city's determination to keep a scalpel in hand' (Noble, 1992). Indeed, Moody's acknowledges that the city has 'diligently maximized its immediate resources, attacking budget deficits, cutting wages and employee benefits, channelling money to repay bonds and swelling its debt service reserves' (Noble, 1992).' What ultimately cost Detroit its investment grade rating were long term 'extraordinarily weak creadit fundamentals' having to do with the shrinking population (quoted in Noble, 1992). The influence of these factors led to a public controversy as Detroit officials and others argued they should not be judged for these types of variables.

Raising money in the debt markets implies a much longer term time horizon for lenders than was the case with bank lending because bond maturities are much longer than loan repayment schedules. This means that corporations and sovereign governments that are accessing the debt markets for the first time after being bank clients will now be judged on quite different variables by rating agencies. These variables will increasingly be economic and not merely financial in nature. This change is significant because financial and economic analysis, although related, have different purposes. While financial analysis is focused on the entity and its goals, and is essentially pragmatic in orientation, economics and related disciplines (demography, for example) focus less on entities than on the collective situation. Much broader conclusions about the efficiency (and thus appropriateness) of institutional arrangements, and about the probability of future events are common in these disciplines. Their incorporation into the analysis of debt means a much more pervasive scrutiny of the objectives and organization of institutions will be possible by lenders, based on much more robust models of probable futures.

What are the likely consequences of the incorporation of fundamental analysis into debtor evaluation by the rating agencies? Three pressures can be extrapolated. The first has to do with the internationalization of the forms of knowledge associated with fundamental analysis. Because broader judgemental frameworks are being incorporated into risk analysis, borrowers will

have a strong incentive to adopt these forms of knowledge themselves. Over time this will challenge established forms of knowledge, such as, for example, those associated with Islam. The second pressure is related to the first. Although risk analysis will be more broadly based because it will in principle have a longer time horizon and more strategic view of the environment, it will be narrower in that it will be based on positivist social science which emphasizes the universal applicability of functional principles of economic and political relations. This will create a pressure to interpret and respond to issues in terms of 'cookie cutter' conceptions of problems and their solutions. The last pressure also has to do with the functional nature of fundamental analysis as it is practiced by the rating agencies. Fundamental analysis assumes that all societies are the same in their essentials because they are driven by similar dynamics, such as, for example, individual self-maximization. Such an assumption is at odds with a developmental view of the world, which implies a world order in which societies are qualitatively as well as quantitatively differentiated. Accordingly, fundamental analysis is likely to have effects that reinforce the status quo in this dimension.

Management and policy

Credit rating is a mixture of quantitative and qualitative factors, central amongst which is managerial capacity. Because credit rating assumes a relatively long time from issue of debt to repayment, there is a concern with the ability of those persons running the enterprise or government to keep it a going concern. Because debt repayment is premised on both capacity and willingness to repay, judgements about the ability of management or officials to manage and govern, and the likelihood of them be willing to repay, are central. As Moody's note,

> Countries as diverse as Poland, Argentina, South Africa, and the Philippines have defaulted on or have rescheduled their foreign debts to commercial banks for other than strictly economic or financial reasons. Very often, an admixture of political, social, and cultural considerations – such as the inability to impose austerity, radical or political uprisings, or lack of public confidence in the central authorities – were at the root of a country's liquidity crisis (Moody's, 1991: p. 163).

The 1992 upgrade of Argentina provided evidence of this concern of rating agencies with management and policy. In upgrading Argentina to B1 (from B3), four notches below investment grade,[8] Moody's pointed to 'significant steps in dismantling administrative and regulatory controls within the country' (Waters, 1992: p. 21). At the same time, Moody's did not upgrade Brazil, despite a recently concluded debt accord between Brazil and its bank creditors. This is very suggestive of the view that rating agencies have quite definite

ideas about appropriate and inappropriate management and policy strategies. The analysis of sovereign rating methodology presented in *Global Credit Analysis* suggests that Moody's favours what Gill has called the 'new constitutionalism' (Gill, 1993: p. 10). New constitutionalism is a

> doctrine and associated set of social forces which seek to place restraints on the democratic control of public and private economic organization and institutions... The new constitutionalism is intended to guarantee the freedom of entry and exit of internationally mobile capital with regard to different socio-economic spaces... The scope of these constraints in an era of substantial mobility of capital mean that political leaders will need to be perhaps as accountable to international market forces as they are to electorates (Gill, 1993: pp. 10–11).

In *Global Credit Analysis*, Moody's comment: 'Especially important [in their rating determination] is the institutional pattern of decision-making power with respect to economic policy.' Here Moody's cites examples such as the 'degree of independence on critical monetary policies that the central bank has over the treasury,' a core new constitutionalist theme (Moody's, 1991: p. 162). This stance may give rise to a more favourable view of certain ways of governing economies rather than others within the rating agencies, in which Asian countries may be favored in comparison to those in Latin America, according to John F. H. Purcell, director of emerging markets research at Salomon Brothers, the New York investment bank (*The Economist*, 1993: pp. 88, 90).

American municipalities again provide an example of the pressures that rating agencies can generate. Philadelphia was subject to the negative appraisal of the major rating agencies in 1990 and 1991 when its standing as a debt issuer fell to speculative grade, cutting it off from access to lower cost financing. It seems that the incumbent Mayor could not deal with the ongoing imbalance between costs and revenues in city finances, other than by requesting additional taxes. As Anita A. Summers, professor of public policy at the University of Pennsylvania's Wharton School of Business commented, he could not contain and reduce operating costs because, '[t]he Mayor can't enforce productivity changes on the unions...' (quoted in de Courcy Hinds, 1990). In November of 1991, a new Mayor was elected (the law did not permit Goode to run again, should he have wanted to). Almost immediately perceptions of the new executive were positive in the bond rating agencies, which observed 'some progress' in moving the city out of fiscal paralysis (quoted in de Courcy Hinds, 1992a). Subsequently, the *New York Times* reported progress had been achieved in getting the city back on track when a 'major rating agency... increased the city's credit rating by a notch' (de Courcy Hinds, 1992b). The new Mayor's '[d]raconian' five year fiscal plan called for $1.1 billion in savings through cutting labor costs, management efficiencies and stricter tax collection. A five year wage freeze for the city's 25,000 employees

was a central part of the cost savings plan. Change in Philadelphia's circumstances came quickly. No deficit was generated in 1992/93 (ending June 30, 1993) and none was predicted by city officials for 1993/94. 'The only test for the city is to keep up the momentum,' commented a Moody's official (quoted in de Courcy Hinds, 1993). This rapid turn around in the city's fortunes suggests that much of the reason for the fiscal paralysis had been political rather than financial. As in the state of New York during the same period, the seemingly intractable conflicts between interests which dominated the mayor's office, the city council, and state government prevented any major rethinking of the way in which the city did business (Kolbert, 1990; Gasparino, 1992). Only when the bond rating agencies cut off access to cheap credit through downgrades was the management and policy deadlock shattered and the political will necessary to create an agreed plan of action generated.

Rating agency views of management and policy seem to change over time as the prevailing views of economic and financial orthodoxy change. In his study of New York City's fiscal crisis of the 1970s, Lichten identified the broad sweep of this change in mainstream views. According to Lichten,

> Austerity has become the policy of the 1980s, and no mainstream American politician has mounted a campaign against it. Instead, conventional political 'wisdom' now asserts the historical inevitability and absolute necessity of an austere public sector. Austerity, with its underlying ideology of scarcity and Social Darwinism, goes unchallenged... (Lichten, 1986: p. 2).

This ideological consensus or intersubjective idea – what Lichten (1986: p. 3) refers to as the 'austerity state' – about the parameters of feasible policy-making is characterized by agreement on the need to reduce social policy expenditures and increase the influence of the private sector in the market. This trend in thinking seems to have had two major implications for rating agencies' views of governments. The first of these has to do with the re-establishment of a connection between remuneration and productivity in the public sector (*The Economist*, 1993a: pp. 23–25). The second has to do with the privatisation of services. The first of these considerations is ubiquitous in almost any review of governmental finance, and was certainly a factor in the rating of Philadelphia and New York City. The second issue is a global phenomenon. Two aims are usually in mind: 'one is to shrink the state, in pursuit of greater economic efficiency; the other is to raise cash' (*The Economist*, 1993b: p. 18). The most obvious examples of this trend are the major telecommunications and energy privatizations recently undertaken in Britain and Latin America. However, at the municipal level, a similar trend has developed in, amongst other things, garbage removal and airport management. Perhaps ominously, in the United States this trend has gone as far as to include law enforcement, where private spending on security amounted to $52 billion in

1992/93, overshadowing public spending by 73 percent, up from 57 percent a decade ago (Blumenthal, 1993).

Rating agencies' views of appropriate management and policy can be seen to have implications for the mixture of public and private goods provided in a locality.[9] Bond rating agencies reinforce a more privatized pattern of supply of social goods in the US. Their focus on the financing arrangement, and the judgements they make in light of this focus, reinforces a pattern of provision with heavy emphasis on identifying 'revenue producing' projects that are not dependent on general revenue sources derived from taxation (Grossman interview). From a rater's point of view, this makes sense when taxation sources are perceived to be less reliable than other types of income because of their vulnerability to political gridlock and recessionary contraction, amongst other things (Grossman interview). Dedicating revenue sources has the effect of specifying, reducing, and allocating risk and return. However, this has other than purely public finance implications. Influencing the public/private goods distinction, for example, through specifying cost recovery mechanisms such as toll roads and bridges, amongst other things, has implications for the way in which costs are allocated across the economy and the access that different social groups may have to government-provided goods.

Rating agency concern with management and policy is creating pressures for institutional change and confirmity amongst borrowers at the corporate, municipal and sovereign levels. The agencies seem to have become carriers and enforcers of the new constitutionalism which places a premium on the separation and ring-fencing of economic and financial institutions from 'political' institutions, narrowly defined. This role is magnified by the fact that credit rating is very centralised in comparison to bank intermediation. The implications of the new constitutionalist view taking hold in the rating agencies, as seems to be the case, are therefore much greater.

Investment, knowledge and hegemony

Rating agencies will contribute to the transformation of what Gramscian-inspired scholars call the domestic 'historic blocs' which underpin investment in the western advanced countries, and perhaps in the long run in developing countries.[10] This can be linked to dominant forms of knowledge production and validation. There is a transformation occurring in the knowledge structure in which economic and financial analysis takes place outside the US. Strange introduced the notion of knowledge structures (Strange, 1988: pp. 115–134). She considers that a knowledge structure 'determines what knowledge is discovered, how it is stored, and who communicates it by what means to whom and on what terms' (Strange, 1988: p. 117). The structure consists of a certain pattern of incentives and constraints on the development of forms of knowledge, determined by the dominant social forces in terms of their major interests. As capital markets displace banks and as rating agencies

establish a wider list of rated entities in Europe, Asia and Latin America, there is a long slow process of displacement going on in which knowledge based on history, location, and tradition exemplified by what they call 'names' in London, is giving way to more abstract, verifiable and 'transparent' knowledge forms. Authority will increasingly be derived from such sources.

The knowledge structures that surround investment are likely to be internationalized by the desire of non-US issuers to access the relatively low interest rate environment in the US: the 'Yankee'-bond market.[11] Accordingly, non-US borrowers have an interest in adopting US models of financial orthodoxy such as GAAP (Generally Accepted Accounting Practices). Because rating agencies want comparability across credits and across countries, despite attempts to create local knowledge by the agencies, there will increasingly be an 'operating system' (Lipschutz, 1992: p. 418) around which judgements will be derived that will be centred on hegemonic norms and values. Because the US agencies are most likely to express this framework convincingly, they will dominate 'local' agencies and eventually eliminate or incorporate them, other things being equal. More broadly, the hegemonic norms and values reinforced by the rating institutions will, most probably, add to pressures to shift the prevailing patterns of financial organization in various localities to arrangements more in line with the capital market form described by Zysman (1983).

Investment is premised on relations between different social forces. The growth of capital markets in which rating agencies provide the major informational link between buyers and sellers of debt are likely to lead to a change in relations within dominant historic blocs. What seems probable is a *desocialization* of investment. Desocialization here refers to the displacement of existing accommodations amongst social interests as technically or abstractly driven arguments determine investment decision-making. This desocialization of investment will lead to a *delinking* of fractions within the historic bloc, weakening it and potentially exposing it to challenges.[12] The breakdown of lender/bank/borrower ties, or orthodox financial intermediation, will weaken relations between those who have funds and those who seek them, because loss reducing mechanisms (banks) have been reduced in importance. These act as social buffers amongst the hegemonic social interests. An example of the weakening of these ties are the recent spate of law suits in the United States by investors against brokerage firms related to losses in the derivatives market, perhaps the most extreme example of the phenomenon under consideration. Although domestic historic bloc ties may be weakened by these developments, more abstract investment standards will establish greater potential for ties between domestic and foreign interests, as cultural chauvinism may well be reduced, at least amongst socially hegemonic forces. Outside the bloc, the distancing of borrower and lender in this way, and the enlargement of the role of rating agencies, may well reinforce the impression that investment is a neutral, technical activity rather than a struggle for resources between competing societal interests. Although the hegemonic alliance itself may weaken endogenously, its exogenous position may in fact be enhanced.

Conclusions

Based on the investigation and commentary presented here it seems reasonable to suggest that rating agencies are much more socially and economically potent agencies than their 'bean counter' image suggests. Rating agencies seem to be contributing to a new system of governance in which a global framework of rules and norms is in the process of becoming established, in which social forces will increasingly be self-regulating in accord with the limits of this system. Their use of what has been referred to here as fundamental analysis and their views on appropriate policy arrangements along 'new constitutionalist' lines, combined with their newly enhanced role in the context of mobile capital and capital market growth suggests that rating agencies may be in the process of becoming what can be thought of as private makers of global public policy. This new system of global governance is giving rise to institutional convergence around what Zysman (1983) identified as the capital market form of financial organization.

Evaluating the implications of the leverage exerted by 'sovereignty-free actors' such as rating agencies for world order must be based on an historical and situational analysis of their relations with 'sovereignty-bound actors' (Rosenau, 1990: p. 36). Evaluating the role of non-state forms of governance at the world order level brings into relief the dialectical relations between these mechanisms of regulation and national states. This is most clearly the case in the developing world where governments are busy setting up rating agencies, and mandating that issuers obtain ratings (often from designated local agencies) as part of a wider campaign to reform the way in which capital is allocated across economies. However, states seem to coexist rather uneasily with rating agencies, as sovereign downgradings demonstrate. Rating institutions offer states a vehicle through which parts of society, such as capital allocation, can be separated off as 'not political' in a new constitutionalist manner. They also discipline states themselves by conducting surveillance and sending signals about policy and performance to internationally mobile capital.

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Notes

1. 'Capital' is used in this article in the same sense as it is in neoclassical economics, as a term for one of the factors of production. In these terms, capital is 'usually seen as reflecting, and giving valuation to, productive capital' (such as plant and machinery). This way of thinking about capital can be contrasted with Marxist economic theory, in which capital is understood as a social relation of surplus creation and appropriation (Gill and Law, 1988: p. 83).
2. Banking instruments and securities markets instruments differ. Debt securities are a form of borrowing and lending. Although they are similar to bank loans in this way, they differ in that they can be traded so as to increase (or decrease) their yield. The potential for interest rate arbitrage that debt securities provide has given rise to a process of securitization in which banks have sought to convert their loans into tradeable assets (Bannock and Manser, 1989: pp. 183–184). The most common form of debt security is the bond. There are a great many different types of bonds. Secured bonds are backed by collateral which may be sold by the holder in the case of interest or principal default. Unsecured bonds or debentures are backed by the 'full faith and credit' of the issuer, but not by any specific assets. These are sometimes referred to as 'general obligation' bonds in the municipal context (Downes and Goodman, 1991: pp. 42–43).
3. Thanks are due here to Chris Robinson and Timothy J. McKeown for clarifying the orthodox economic view of rating agencies.
4. This is less relevant in the Canadian case, where the motivations of Moody's and S & P seem to be derived from the volume and relative sophistication of the Canadian debt markets.
5. These niche agencies are Fiche Investors Service, Duff & Phelps, and Thomson Bankwatch.
6. For descriptions of the rating process, see Hawkins, Brown and Campbell (1983) and Sinclair (1994).
7. See, for example, *S&P's Corporate Finance Criteria*, page 15, in which S & P notes that 'there is no formula for combining these [quantitative and qualitative] scores to arrive at a rating conclusion.' Accordingly, 'such judgements are highly subjective. Yet that is at the heart of every rating.'
8. An important distinction to be noted here is between investment and speculative 'grades.' These grades, which neatly cleave the rating scale in two, are a result of securities legislation passed during the New Deal which permit fiduciaries to invest only in bonds of a certain level in the scale or grade. Over time this distinction has become a market convention as well, and serves to defne the demarcation between high-yield or 'junk' bonds and those considered to be acceptable for investment purposes. However, despite the label, 'investment grade' ratings 'are not recommendations to buy, hold or sell a security.' They are 'opinions on the relative creditworthiness of corporations, municipalities, sovereign governments, banks, [and] structured financings ... to repay principle and interest when due' (O'Neill interview).
9. Public goods have three characteristics: (1) they yield non-rivalrous consumption in that one person's consumption does not deprive others; (2) they are non-excludable, in that if one person consumes it is impossible to stop all from consuming; and (3) they are non-rejectable because individuals cannot abstain from consuming them even if they want to (Bannock, Baxter and Davis, 1987: p. 335).
10. Historic blocs are an 'historical congruence between material forces, institutions and ideologies, or broadly, an alliance of different class forces' (Gill and Law, 1993: p. 94).

Historic blocs exercise hegemony, which is not simply dominance but adds the element of moral and intellectual leadership, such that consent, rather than coercion, primarily characterizes the relations between social forces, and between state and society (Gill and Law, 1993: p. 93). On historic blocs, also see Cox (1993).

11. The 'Yankee' bond market is a market in dollar-denominated bonds issued in the US by foreign banks and corporations (Downes and Goodman, 1991: p. 520).
12. This is not identical to the process in which economies were disembedded from society with the rise of capitalist social relations (Polanyi, 1957 [1944]; Granovetter, 1992). Delinking and desocialization refer to processes of adjustment in the relationships between hegemonic social forces within the context of broadly capitalist social relations.

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