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**SPECULATION IN THE CURRENT CRISIS: ORANGE COUNTY, CA:
A CASE STUDY IN ECONOMIC SOCIOLOGY**

by

JANICE LYNNE BRIGGS

A dissertation submitted to the Graduate Faculty in Sociology in partial fulfillment of the requirements for the degree of Doctor of Philosophy, The City University of New York

2000

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This manuscript has been read and accepted for the Graduate Faculty in Sociology in satisfaction of the dissertation requirement for the degree of Doctor of Philosophy.

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CONTENTS

ACKNOWLEDGEMENTS	iv-v
INTRODUCTION	1-3
CHAPTER 1: A WEALTHY COUNTY GOES BANKRUPT	4-47
CHAPTER 2: CAPITALIST CRISIS, RESTRUCTURING, AND SPECULATION: THE NATIONAL AND GLOBAL CONTEXT	48-69
CHAPTER 3: CAPITALIST CRISIS, RESTRUCTURING, AND SPECULATION: THE NATIONAL AND LOCAL CONTEXT	70-84
CHAPTER 4: SPECULATION, GAMBLING AND CULTURAL CHANGE	85-106
CONCLUSION	107-116
SELECTED BIBLIOGRAPHY	117-126

INTRODUCTION

At the end of 1994 a surprising event made the news—a US county—one of the wealthiest—had declared bankruptcy. Speculation with public money had occurred; criminal activity was suspected. Was this just a peculiar California affair, or might it be likened to an earlier fiscal problem in New York City? Orange County's bankruptcy got extensive coverage in the newspapers. Journal articles appeared and a book was later published. None of them, however, probed further than to castigate the treasurer or question the dangers of derivatives. Though Orange County's treasurer was surely in the wrong, and derivatives do have risks for the unwary, this dissertation will attempt to place the troubles of Orange County into the wider perspective of changes in the world economy and demonstrate that Orange County can be viewed as an example of the fallout from attempts to restore profit to a system in crisis.

The social benefits of capitalism appear to be limited by the inherent needs of production and accumulation. In the current crisis some attempts were made to maintain many of these benefits, but were superceded by the survival needs of capital itself. Speculation was unbound and upheld in order to insure accumulation that could not occur through work, production, and sales. Speculation may have worked to maintain some of the social supports, as well as to sustain accumulation; but, as crisis continued, accumulation took precedence. Restructuring, with speculation as an important element, was lubricated by a change in ideology which took contradictory forms. In the current crisis there was an attempt to rigidify social mores where they concerned sexuality (a

traditionalist approach for control), and a relaxation of mores concerning the methods for amassing money. This last took on a distinct class difference, however, with lower class criminals severely treated while white collar and corporate criminals were ignored or lightly penalized. Thus, class differences have been socially and economically accentuated.

This dissertation argues that the Orange County bankruptcy is an example of the expansion and acceptance of speculation in the current economic crisis. Further, I propose that speculation is a necessary accompaniment to any crisis where the financial sector must dominate when production no longer provides increasing profit. That the crisis is not over (despite financial booms) is evident from the fact that investment remains heavily financial. Speculation, a strategic tactic, appears to have become a way of life over the decades of economic disruption. What speculation is and the history of its growth will be elaborated in the body of the dissertation.

The Orange County bankruptcy can be connected to this rise in speculation not only because it was the method used to maintain county benefits, but because Orange County's speculation may be seen as related to larger structural changes occurring within capitalism. Furthermore, the acceptance of speculation in Orange County illustrates how speculation became normative through altered laws; just as gambling has become normative through national legalization. While Mark Baldassare's book is the most important previous work on the Orange County bankruptcy, and I have used his insights to explain how the bankruptcy and Citron's speculation with public money happened in terms of the county and state level; Baldassare does not move beyond those levels. He does go beyond the popular notion of blaming only Citron the gambler to spread blame to

voters, county officials, the press, and Wall Street lenders. More importantly, he notes: “three factors are at the heart of the Orange County financial crisis: political fragmentation in local government, voter distrust of local government officials, and the condition of fiscal austerity in the state government” [Baldassare, 1998: 16].

This dissertation proposes to answer the following questions: Why did Robert Citron speculate with public funds? In what way can we connect his actions and the local crisis of the OC bankruptcy to the larger capital crisis? Why have finance and speculation predominated in this crisis? How has public compliance to speculation been accomplished?

It is important for the expansion of human-centered economic wealth that we understand how the global influences the local. To “think globally and act locally” makes no sense if we do not understand the connections between the two. By examining a local issue as a social process dependent upon national and international alterations—rather than as an limited and individual act—I hope to raise the case of the Orange County bankruptcy to just such a level.

.....

CHAPTER 1: A WEALTHY COUNTY GOES BANKRUPT

On December 2, 1994 the news of financial disaster in Orange County, California hit the papers. Five days later on December 7th one of the wealthiest counties in the United States announced it would file for bankruptcy (the largest municipal filing ever¹). It was the last bang of the first year of explosions involving the newly developed financial instruments, derivatives.²

Few were prescient enough to have foreseen such an event, but an alarm had been sounded about derivatives and losses connected to them earlier that year. A financial analyst noted that complex analyses must be used to fully comprehend derivatives, and that municipalities are not equipped with this expertise.³ While that is true, Frank Partnoy's insider book, *F.I.A.S.C.O.* (1997), informs us that the facts about derivatives were purposely hidden from buyers in order to earn huge fees for investment banks (regardless of eventual losses for their victims). Some of their victims, from 1992 through 1994, were the "more than 24 cities, counties and school districts...[which had] lost

¹ *Business Week*, Dec. 19, 1994, pp. 28-30. Spiro, L. and Byrnes, N. "Today, Orange County...impact of bankruptcy on muni bond market." The first loss that year was on April 12th: Gibson Greetings, Inc. with a loss of \$20 million (Partnoy, 1997: 92).

² The standard definition of a derivative is: "a financial instrument whose value is linked to, or derived from, some security, such as a stock or bond" (Partnoy, 1997: 31). Derivatives will be further elaborated later in the chapter.

³*New York Times*, Dec. 2, 1994, D1:6. Wayne, L. "\$1.5 billion loss seen for county."

hundreds of millions of dollars from investments in derivatives.”⁴ For Orange County, “the combination of leverage⁵ and derivatives more than tripled the amount of risk.”⁶

Questions were asked about the responsibility of bond raters⁷ and disclosure requirements of Orange County and Wall Street firms.⁸ Arthur Levitt, chairman of the US. Securities and Exchange Commission (SEC), noted that the bankruptcy would have an impact on the lives of Orange County residents, those of other communities, and the bondholders of municipal debt (1995: 9).

Though this type of failure has occurred beyond Orange County and has systemic implications, first reports pointed to the culpability of local officials. A group of the most unusual suspects was rounded up, with major blame being placed on the only Democrat in an all Republican county, Treasurer Robert Citron.⁹ Censure was soon extended to Merrill Lynch’s bond salesman, Michael Stamenson,¹⁰ Merrill’s investment strategist

⁴*New York Times*, Dec. 3, 1994, 39:6. Hofmeister. “California fund woes worsening.”

⁵ Leveraging is the process of borrowing to purchase. The buyer invests a small amount of capital and borrows the rest. This allows the buyer to control more stock than would be possible given the buyer’s current resources (Shafritz & Oran, 1990: 294).

⁶*Wall Street Journal*, Dec. 5, 1994, A3. Jereski & Vogel, Jr. “Orange County borrowed \$1 billion even as its investment losses piled up.”

⁷*Wall Street Journal*, Dec. 6, 1994, C, 1:2. Vogel, Jr., T. “Orange County had green ratings.”

⁸*Wall Street Journal*, Dec. 5, 1994, A3. Jereski & Vogel, Jr. “Orange county borrowed \$1 billion even as its investment losses piled up.”

⁹*New York Times*, (Late New York Edition), Dec. 11, 1994, Section 1, p.1. Margolick, D. “Ill-fated fund’s manager: Mr. Main St., not Wall St.: Orange County, California treasurer R. L. Citron.”

¹⁰*Newsweek*, v. 124 (Dec. 19, ‘94) p.47. McGinn, D. “Who is Michael Stamenson? Merrill Lynch broker involved in Orange County bankruptcy.”

Charles Clough (accused by Citron),¹¹ and investment companies in general.¹² Orange County's attorneys were criticized,¹³ as were Federal Home Loan Banks.¹⁴ These suspects were joined by some of the usual ones: greed, pride, and deceit.¹⁵ Later reports noted a spread of Orange County type troubles to other California counties, to Florida and Texas (where a state-wide fund had lost sixty million), to a Louisiana state pension fund and the City Colleges of Chicago (which lost most of its investment portfolio), and also revealed the existence of an earlier crisis in an Ohio county.¹⁶

The analysis in the media focused largely on the level of individual characters and characteristics, though some account was taken of financial instruments, institutions, and regulations. Rarely considered was the process of speculation which, according to Robert Guttman, dominates investing today.¹⁷ Why might Orange County officials make such speculative decisions with public money? Indeed, why is there a national, if not

¹¹*Wall Street Journal*, Jan 18, 1995, C, 1:3 . Powell, W. "Heard on the street: Investment strategists rally to defend Merrill expert."

¹²*Barron's*, Jan 2, 1995, 42:1. Craven, B. "Incentive for disaster."

¹³*Wall Street Journal*, Dec. 16, 1994, B, 8:1. Stevens, A. "Lawyers and clients: Attorneys may share blame by not disclosing risk in Orange County" (mistake in *WSJ*).

¹⁴*American Banker* Jan 11, 1995, 3:1 ; R. Meredith "Home Loan Banks criticized for issuing structured notes."

¹⁵*Los Angeles Times*, Jan 2, 1995, B, 7:5. McEnery, T. "Greed, hubris and municipal mendacity." Another article tags Citron rather than the municipality: *Wall Street Journal*, Jan 18, 1995, A, 1:6. Emshwiller, J. and S. Lubman, "Before the fall: Hubris and ambition in Orange County: Robert Citron's story."

¹⁶*Wall Street Journal*, Dec. 7, 1994, A6:1. "Bitter fruit: Orange County, mired in investment mess, files for bankruptcy."

¹⁷ Mentioned by Robert Guttman, author of *How credit-money shapes the Economy: The United States in a global system* (1994), in a talk he gave on credit on February 15, 1995, at the Brecht Forum in NYC.

international, trend for investment strategies to focus on speculation over enterprise (Guttman, 1994: 297-301)? The case of the Orange County bankruptcy allows us to familiarize ourselves with an effect of speculation's growth. Connections can then be made from the local to the systemic level. Other chapters will investigate the place of speculation in a long-term economic crisis, the restructuring meant to end that crisis, and the creation of a milieu of speculation. The conclusion will return us to Orange County in order to tie the ends together. While some general aspects of speculation will be considered briefly within this chapter, its full consideration will be left for later.

This chapter will consider the actors (individual and institutional), the Orange County investment pool and municipal bonds, the makeup of the investment package, and why this risky investment was undertaken, rated highly, and not overseen by other county officials. In order to more fully understand the county disaster, the chapter will discuss Orange County's history and longtime ideological bent, the considerable changes that have occurred since it was a sleepy suburb, and how those changes have led to transformations in class relations and governmental structure. The losses suffered by the citizens of Orange County will be discussed here, and an update of the continuous unfolding of the event will be given.

The Players And The Pool

During twenty-four years of its recent history the treasurer of Republican Orange County had been one continuously reelected person—the Democrat, Robert Citron (1970-1994). As county treasurer, his job was to oversee the collection of taxes and to

invest funds for the county (amounting in 1994 to approximately \$7.5 billion). The money on deposit from almost 200 public entities such as cities in the county, many of their school and sanitation districts, water authorities, and pension funds (which are of growing importance in the bond market) were pooled in the Orange County Investment Pool (OCIP) (Jorion, 1995: 7-8).¹⁸ The County Supervisors allowed their award-winning treasurer, whose strategy had brought phenomenal returns, to invest without their intervention; though subsequently they asserted they had not been informed (Jorion, 1995: 8). This investment was to be supervised by the laws of the state and the county's five member Board of Supervisors. However, in the wake of the tax revolt by voters, a property tax restriction (Proposition 13, discussed in depth later) was enacted in 1978 and the State began a series of gradual deregulations concerned with investing by county treasurers. In particular, investments in repurchase and reverse repurchase agreements (see below) were authorized in 1979; and then, between '79 and '92 both the amount invested and types of investments permitted were increased. In addition, county treasurers were granted the right to leverage their portfolios. This leveraging was based on funds borrowed from Wall Street firms and backed by local governments' principal on deposit. These changes were lobbied for by the investment industry and some were written by Citron. Thus, over the years, county treasurers were granted greater rights in a series of attempts to respond to the fiscal problems prompted by Proposition 13, which heavily curtailed revenues received. With the fiscal crisis that California faced in the 80s and the recession of the early 90s, an added crunch on local government arose from the

¹⁸ By pooling their deposits, smaller entities are able to purchase securities with higher yields than they would if they invested separately [Baldassare, 1998: 89].

fact that the State withdrew funding to localities at a time of economic downturn [Baldassare, 1998: 71-75, tables 3-4 and 3-5, & p. 74, footnote 3].¹⁹

Between 1991 and 1993 the Orange County Investment Pool (OCIP) brought in \$500 million in interest income to the county despite the 1990-1992 recession (Jorion, 1995: 8). Inasmuch as property values, and thus revenues, had tumbled in the early 1990s, the income from this investment pool had become an important source of earnings to pay for county expenditure. Earnings from the pool climbed from 3 percent of the budget in fiscal 1992 to 35 percent in fiscal 1993. During the same period the percentage of county income from property taxes decreased from 60 to 25 percent (Jorion, 1995: 15). Due to the fiscal crisis of the State of California, a smaller pool of property revenue was transferred from the state to local governments. For Orange County this meant a loss of \$100 million in state funding for fiscal year 1993-1994. Interest income earned from the OCIP, which had more than doubled between 1989 to 1993 (from \$37 to \$82 million) jumped by \$100 million in the same year that the state reduction occurred [Baldassare, 1998: 84-86]. The jump in income was mainly achieved through borrowing from Wall Street to leverage the pool's portfolio [Baldassare, 1998: 89].

The use of bonds²⁰ for borrowing (though not necessarily using those borrowed funds to leverage investments) had become more important over the years as other

¹⁹ Baldassare's thesis is that the bankruptcy occurred due to political fragmentation in the county government structure, voter distrust (and thus, Proposition 13), and state fiscal austerity in California. These are good reasons at these levels, but Baldassare does not go beyond that level to consider the reasons for the fiscal crisis of the states; that is, the national level. He also does not, as I do, link Citron's speculation to cultural changes and economic crisis; nor expand on the growth of speculation.

²⁰ Any bond is a document representing a long-term debt of a government body or corporation. It provides interest payments to the holder (the individual or group that has loaned the stated amount of money to the issuer of the bond).

funding sources dried up. This was not an isolated phenomenon, but part of a gradual and general overall growth of the use of debt in the US. We do know that by 1975, with the New York City fiscal crisis, the municipal bond market and its relation to a municipality's ability to borrow money through issuing bonds had become widely understood. Purportedly, the credit-worthiness of localities was now more scrupulously investigated by lenders (Sbragia, 1983: 5). In 1980 alone, public borrowing through the capital market by state and local governments was employed for infrastructural projects, cash flow problems, and to lend to private sector institutions. This amounted to almost \$80 billion nationally. Thus, there are strong "links between the investment community and local policymaking."

Indeed, much of the borrowing growth by the mid-70s went for "quasi-public purposes." Money borrowed through the issue of municipal bonds may be used to fund public projects or make capital purchases, but in the mid-70s local governments began to use these borrowed moneys to fund "hospitals, public power projects, private sector housing, industrial pollution control, convention and sports centers." This lending for quasi-public purposes involves the purchase of financial assets such as mortgages or leasing agreements, rather than real²¹ assets. This had become an expanding share of local and state long-term borrowing (Sbragia, 1983: 67-8).

Sbragia notes that "state and local debt has increased since World War II at a proportionately greater rate than has federal government debt"—with local borrowing

²¹ Every asset, real or financial, is exchangeable. It has market value. A "real" asset is tangible (for example, a manufacturing plant), but a financial asset is not. A financial asset is a claim or title to collect income or some form of value (Pearce, 1989: 20).

being greater than state borrowing (Sbragia, 1983: 69). However, she does not analyze why the use of debt has increased. Much of this public borrowing is carried out by specially created statutory authorities and districts within local government. Since they are revenue producing bodies without taxing powers, they do not need voter approval for securing debt and can avoid the kind of voter controls on borrowing that were significant in the 1960s (Sbragia, 1983: 71-2). Further, when the interest is on borrowed millions, the very smallest change in the interest rates (even 1/100th, or one basis point) is far more significant than a one percentage point interest change on a small loan—debt can increase exponentially with a rise in rates. Interest rate rises also reduce funds available for expenditures and affect the users of public facilities. For instance, tenants of public housing faced growing rental fees (Sbragia, 1983: 70). For the type of borrowing and investing that Citron engaged in for Orange County, the significance of a rise in interest rates meant bankruptcy.

It is difficult to pinpoint a date for the shift to borrowing in order to leverage the portfolios of local government pools, but after the Orange County bankruptcy a survey found that fourteen counties out fifty-eight in California were involved in leveraging (and the use of derivatives, which are explained below) [Baldassare, 1998: 120]. Some states still allow leveraging and derivatives' use by public entities, though California has restricted them [Baldassare, 1998: 233].¹

¹ Baldassare worries in '98 that these restrictions in California will be watered down or done away with as time passes [1998: 233].

Municipal Bonds

Public borrowing is done through the floating of municipal bonds; borrowing instruments which are used in place of bank loans. These tend to be long-term, unlike municipal notes which are for short-term borrowing. When a bond is issued and sold to an investor (the lender) it is a pledge (by the borrower/state or municipality) to pay back the loan/debt at a specific time, and to pay the agreed interest periodically. While notes are backed by expected future tax revenues or anticipated long-term loans from the long-term bond market; bonds are backed by the power of the borrower (government) to tax, or the expected revenue from government projects or services (Sbragia, 1983: 72). This is why long-term bonds might have been affected by the passing of Proposition 13, a 1978 California tax limitation measure, which placed constraints on municipal taxing power. Before that proposition, municipal default seemed “both rare and manageable” to Wall Street analysts. As Sbragia stated before the Orange County fiasco, “Bankruptcy—entailing a formal declaration in court of inability to pay lenders and creditors—is regarded by analysts as so unlikely, and perhaps so complicated, that no one interviewed on Wall Street had thought seriously about the implications flowing from a local government borrower filing for bankruptcy.” In fact, there had been no bankruptcies by such borrowers “since the Great Depression.” The New York City fiscal crisis of 1975, the closest any large municipality had come to bankruptcy, had been successfully managed by federal and state intervention. Any municipal bankruptcy filing would be a benchmark case (Sbragia, 1983: 83-83). Orange county has now given us our benchmark.

Orange County's Investments

The structure of the investments made by Citron for the OCIP is frustratingly complex for those who have little background in finance. Basically, successively higher-yielding securities are layered with serial loans. This strategy is known as “borrowing short to go long.” That is, Citron would borrow a short-term bond to buy a long-term bond (with higher yield than the short-term loan’s interest rate) and use that bond to buy another short-term bond with which he would buy another, but higher yielding, long-term bond. This strategy requires either a stable or falling interest rate environment. Should interest rates fall, then the yield on the long-term bonds would increase (see footnote number ??). However, should they rise, his short-term borrowing costs would increase as the value of his long-term bond decreases. Over time he had won that bet, but 1994 was different. A further complication is the fact that his long-term bonds had relatively long duration (averaging 2.3 years). This could create liquidity problems should he be required to pay higher costs for the short-term bonds or to pay them back at the end of their shorter duration. In addition, Citron purchased derivatives and complex instruments such as inverse floaters (see below). Inverse floaters are also sensitive to interest rate rises [Baldassare, 1998: 90-91].

The portfolio was divided unequally in terms of the amount of borrowed funds and the amount that came from the deposit funds of the pool investors. This can be looked at as a division between debt and assets. The twenty billion dollar portfolio²³ of the county’s municipal investment fund had been accumulated by borrowing a little under two-thirds from various investment banks, putting down just over one-third from the

²³ *New York Times*, Dec. 2, 1994, D1:6. Wayne, L. “\$1.5 billion loss seen for county.”

county's investment pool, and speculating that interest rates would go down. That is, both the borrowed funds and the pool deposits were used to buy a variety of securities from which the investors earned interest. The 1994 rise in interest rates brought a fall in the value of underlying bonds²⁴ and led Wall Street firms to demand increased collateral to cover Orange County's borrowing. The county's fund announced a one and one-half billion dollar loss. A subsequent fall in the county's bond ratings seriously jeopardized the county's ability to meet its budget and threatened severe cuts to social services.²⁵

The following are rounded figures describing the distribution of the approximately \$20 billion portfolio as of April 30, 1994 (a description of the types of investments and instruments will follow). Of the \$20 billion that was invested, Robert Citron invested the majority (\$14b or 70.5%) in federal agency securities (both fixed-rate and floating-rate notes) such as: Federal Home Loan Bank (FHLB), which included leveraged and derivative securities; Federal National Mortgage Association (FNMA or Fannie Mae), and other federal agency debt (also including leveraged and derivative securities). Treasury Securities accounted for 3% (\$.6 billion) more. Corporate notes (which Jorion distinguishes from the commercial paper noted below) comprised about \$2 billion (10%) and Certificates of Deposit (CDs) about \$1.6 billion (8%). The rest, about

²⁴Bond prices are negatively related to interest rates; as rates rise the price of bonds decrease, and vice versa. Angell, G. (1983: 185-186). The rise in interest rates in 1994 which affected the portfolio was from 5% to 7% (Jorion, 1995: 156). This will be discussed further below, but it can be briefly explained in this way: if you hold a bond that is giving you 5% interest, but interest rates have jumped two points to 7%, you might want to sell the bond you hold to buy one that will give you a higher rate of interest. However, the value of the first one has declined since no one wants to buy a bond with a lower rate than they can get elsewhere. Therefore, the price of the bond at 5% will decrease to compensate for the loss of interest.

²⁵*Wall Street Journal*, Dec. 5, 1994, p A3-4. Jereski, L. and Vogel Jr., T. "Orange County borrowed \$1 billion even as its investment losses piled up."

\$1.6 billion (approximately 8%), was in mortgage-backed securities (\$.13b), mutual funds (\$.4b), discount notes (\$.7b), and commercial paper (\$.35b) (Jorion, 1995: 92, table 10.2).²⁶ See Table 1. below for a clearer illustration of the breakdown of the OCIP investments.

Table 1. The breakdown of the OCIP investments

Total Portfolio		\$20.0 billion
------------------------	--	-----------------------

Types of Investments	Percentage of Total Investment	Amount in Dollars
Federal Agency Securities	70.5%	\$14.0 billion
Treasury Securities	3%	\$.6 billion
Corporate Notes	10%	\$ 2.0 billion
Certificates of Deposit (CDs)	8%	\$ 1.6 billion
Assorted Investments*	8%	\$ 1.6 billion

* Mortgage-backed Securities, \$.13b; Mutual Funds, \$.4b; Discount Notes, \$.7b; Commercial Paper, \$.35b.

The borrowed portion of the \$20b portfolio, or \$12.5 billion, came from short-term loans that were then reinvested in bonds (Jorion, 1995: 156). That amount accounts for the two-thirds of the total that was *leveraged* (borrowed to permit a larger investment than current funds would allow). An “opportunity” loss of about \$1.6 billion can be

²⁶ I have added additional information to Jorion’s from: *Wall Street Journal*, Dec. 8, 1994, A3:1. Staff. “Orange County expects to maintain public services.”

accounted for by figuring the difference that would have accrued on the portfolio had the interest rate stayed at 5% rather than climbing to 7% (Jorion, 1995: 156).

It may surprise many that the government issues (Fannie Mae, etc.) contained derivatives; but they did. Frank Partnoy records that even federal regulators were unable to decipher the “leveraged bets” hidden within investments in purportedly safe, triple AAA rated, government bonds issued by Fannie Mae and others (Partnoy, 1997: 55 & 68). The major question, though, is why a County Treasurer would place such risky bets with public money? But also, why they were risky? What are derivatives? How did the leveraging further jeopardize the portfolio? We may also wonder: if federal regulators were unaware of the risk, could a county treasurer have been more aware?

Derivatives, Leveraging, And Risk

Derivatives are contractual financial transactions that grant returns based on the movement of some less complicated underlying asset (Jorion, 1995: 166), a reference rate (such as interest rates), or some index (such as LIBOR²⁷) (Group of 30 Study, cited in Reynolds, 1995: 48). The underlying assets may be bonds, currency, or even a commodity. In terms of rates and indices, the contract is an agreement drawn up between two parties whereby returns on their money are based on whether or not interest rates or an index move up or down. In these cases, yield would be derived from the movement of the rate or index, not a change in the value of an asset.

²⁷ LIBOR is the London interbank offer rate, a money-market index based on “the cost of funds for large banks in the London market” (Jorion, 1995: 47-48).

Derivatives predominantly consist of forward and futures contracts and options (all of which are standardized), and swaps (which are custom-built) (Jorion, 1995: 39). They may all appear, however, in a bewildering variety of subgroup names. Briefly, *forward contracts* are obligations to buy and sell some asset at an agreed upon future date; *futures contracts* are obligations (negotiable) to deliver or accept delivery of some commodity at an exchange established price in a particular month. *Options* are similar to futures except they are optional. That is, the decision to buy or sell at a predetermined time is noncompulsory. *Swaps* are formula-based agreements to “exchange a stream of cash flows in the future” (Jorion, 1995: 166-169). That stream of cash flows may be interest from bonds or dividends from stock (Henwood, 1997: 34). All of these contracts may become assets themselves, since they may be purchased and sold (Jorion, 1995: 39).

These are the basics, but innovations in customizing them have made derivatives extremely complex to understand, unravel, and price. Before 1980 many of the now current varieties did not exist and most were invented in the late 1980s (Partnoy, 1997: 51ff). *Structured notes*, a type of derivative, are customized bonds which, to the unaware, look like bonds but act like “leveraged bets on foreign exchange rate” (Partnoy, 1997: 55). It is these which have given the most trouble to unsuspecting buyers. Trustworthy companies, and agencies such as Fannie and Sallie Mae, issue them. Repayment of the principal is based on a formula which is tied to the exchange rates of assorted foreign currencies. Since this essence is hidden, buyers are betting without understanding, or understand but wish to avoid legal restraints on their investments. Salespeople garner extraordinarily high commissions by selling these derivatives as low-risk bonds (Partnoy, 1997: 54-55). Additionally, securities (which are assets, not contracts) may contain a type

of contract within them. To add to the confusion, derivatives contracts based on interest rates may also involve inverse floaters and repurchase/reverse repurchase agreements (Jorion, 1995: 11).

An *inverse floater* is any type of derivative contract that has been structured so that its yield varies inversely with the movement of interest rates up or down. Thus, returns on a loan/derivative fall when interest rates rise and vice versa. This property “makes them hypersensitive to rate changes.”²⁸ According to Arthur Levitt, inverse floaters are one of a variety of structured notes (Levitt, 1995: 10, note 22). Loans which are structured as inverse floaters have a reaction to fluctuations in interest rates much greater than fixed or floating rate loans (Levitt, 1995: 10-11).²⁹

Any *repurchase agreement* is a contract between two parties (Jorion, 1995: 11). One party (the lender) lends their money, receives interest for the loan, and agrees to hold and later sell back the collateral (securities) of the borrower at an agreed upon time and price. The risk the lender is taking is not so much the default of the borrower (since the lender holds the securities), but the possibility that interest rates will rise and result in a lowering of the price of the securities used as collateral (which must be sold to recoup the loan principal if bankruptcy of the borrower occurs). The other party (the borrower) is seeking cash, willing to pay interest, and willing to put up their securities as collateral for the loan. They risk the lowering of interest rates which will mean that, in the face of the

²⁸ *Wall Street Journal*, Dec. 2, 1994, A3:1. Knecht, G. “Derivatives lead to huge loss in public fund.”

²⁹ This is because the value of the bond’s coupon (coupons are attached to the bond and are detached and submitted for payment at stated intervals (Shafritz & Oran, 1990: 145)) is calculated by subtracting the underlying rate from a generally high percentage rate (Partnoy, 1997: 160). For instance, if the higher rate is 15% and the underlying rate is 5%, the value of the coupon is 10%. If the underlying rate increases to 8% the value drops to 7%, and so on.

lender going bankrupt, they are left with less money than the value of their securities which now has risen. Thus, both the lender and borrower face risks which are negotiated to the benefit of one or the other (Stigum, 1978: 314). Since the value of the contract is dependent upon changes in interest rates, the repurchase/reverse repurchase agreements are derivatives as defined above.

The following illustration has relevance to Orange County though stated in more general terms. The lender in a repurchase agreement may be the water district of a municipality which has been granted funds for operation and wishes to invest/lend these funds. This may be done in order to pay for current operating expenses by using the interest gained on the investment without losing the principal. In return, the lender/district receives securities as collateral from the borrower (usually a dealer). Should the borrower/dealer be unable to make the interest payments or pay back the principal at the date specified, the water district may keep or sell the borrower's security.³⁰ The borrower/dealer is said to hold a *repurchase agreement* (a repo); an agreement/contract to repurchase the security. The lender/water district holds a *reverse repo*; an agreement/contract to sell back the security held as collateral (unless there is a default on the part of the borrower). (Jorion, 1995: 11-12). Obviously, the water district will lose money if the dealer cannot buy back the securities and their value has plummeted.

Both repurchase agreements and inverse floaters "represent a way to borrow at short-term rates and invest in longer term rates."³¹ Many of the reverse repurchase

³⁰ However, if the value of the collateral declines (as interest rates rise) the lender will lose out should the borrower default and the collateral must be sold at a lower price.

³¹ *Wall Street Journal*, Dec. 7, 1994, A6:1. Staff. "Bitter fruit: Orange County, mired in investment mess, files for bankruptcy."

agreements that Citron invested in were inverse floaters. That is, their value would fall as interest rates rose. Citron was gambling that this would not occur.

The Orange County fund encountered other risks through the process of *leveraging*. Leveraging is a credit arrangement. The buyer of a financial asset pays by making a partial payment of his or her own, and borrowing to pay off the rest. The extent of the leveraging is found by dividing the total value of the assets by the initial down payment (Jorion, 1995: 167). For example, an asset valued at \$3 million that is purchased with a down payment of \$1 million has a 3 to 1 ratio. The higher the ratio the greater the borrowed funds/long-term debt to the actual capital employed (Pearce, 1989: 241). Should the stock price change, leveraging will greatly increase the future profit or loss compared to the money actually invested (Shafritz & Oran, 1990: 294).

Leveraging makes for greater sensitivity “not only to rising rates, but also to the gap between floating-rate borrowings and the yield on investments.”³² Robert Guttman calls leveraging “credit pyramiding,” because larger returns than an investor might be able to make with just their own capital are possible for any particular increase in security prices. On the other hand, larger losses are also possible should prices drop (1994: 304). Leverage is added to leverage in the hopes of receiving returns far above the average. This intensifies the risk.³³ Nor, adds Marshall B. Front of Stein, Roe & Farnham Inc. (a mutual fund and money management house), can individuals judge how sensitive their position is to interest rate risk. Front also remarked that “many of those strategies have

³²*Wall Street Journal*, Dec. 9, 1994, C1:6. Vogel Jr. “Texas faces some risks with bonds.”

³³*New York Times*, Dec. 4, Sec 3:2:6. Herring. “California dreamin’.”

been proven to have been far more risky than they seem on the surface."³⁴ Long-Term Capital Management (LTCM), founded by two Nobel Laureates, was using a computerized, probability-based, risk-management model called "value-at-risk" (VAR) to assess possible losses over time, when the fund nearly melted down in 1998.³⁵

Citron used fixed-income securities³⁶ as collateral to borrow from financial institutions, leveraging the basic investment by about three-to-one. To do this he contracted to buy back the same securities for a higher price at a date in the future (reverse-repurchases). Using the basic investment plus the borrowed/leveraging funds, he invested in a variety of instruments. The proportion of derivatives in the investment had grown to more than 40% by the time of the bankruptcy announcement. Most of these derivatives were inverse floaters and so their yield fell when interest rates rose.³⁷ When the value of the investment fell, the financial institutions could demand an increase in collateral. This means that Citron would have had to come up with additional collateral (in a declining portfolio) and might even have had to sell the portfolio at a loss.

In the fall of 1998 another leveraging/derivative problem occurred that had eerie similarities to Orange County, as well as differences. On September 23, 1998, Long-Term Capital Management [LTCM], a hedge fund, was on the verge of collapse. LTCM,

³⁴ *Wall Street Journal*, Apr. 15, 1994, C1:3. Gottschalk, Jr. E. "Derivatives roil California political race" (my emphasis).

³⁵ This is a risk-management model that is favored by banks. *The Economist*, "The risk business," found on the web at www.cba.uh.edu/~rsusmel/7386/hfrisk.htm .

³⁶ Fixed income securities are "government, corporate, or municipal bonds and other such instruments (notes, bills, etc.) that pay fixed interest (the interest rate does not change over the life of the bond) until maturity. At maturity the "full face value" is paid by the issuer (Jorion, 1995: 22)

³⁷ *Wall Street Journal*, Dec. 2, 1994, A3:1. Knecht, G. "Derivatives lead to huge loss in public fund."

called “the speculative hedge fund,”³⁸ was leveraged about 50 to 1 [some reports say 20 to 1] on a basic investment of \$3 billion.³⁹ Complex derivatives played a big part.⁴⁰ Though there were no public funds involved in the LTCM, nevertheless, there were US banks, “tax-payer insured,” which had loaned huge sums to LTCM.⁴¹ This was why the Fed stepped in to arrange a private bailout (\$3.5 billion) by banks and brokerages. There was a truly international list of those who would have faced great losses had LTCM been allowed to fall: Central Bank of Italy, Ing Barings of Britain,⁴² Dresdner Bank A. G. of Germany, Credit Suisse Group, and UBS A.G., “Europe’s largest bank” and the bank having the largest exposure.⁴³ All in all, there were sixteen institutions which also included Goldman Sachs, Merrill Lynch, Morgan Stanley Dean Witter, Travelers Group, UBS Securities,⁴⁴ Discover & Co.,⁴⁵ Rockefeller Foundation, Presidential Life, Bank

³⁸ *New York Times*, October 2, 1998, C1, Kahn, J. “Merrill cites 1.4b exposure to Long-Term.”

³⁹ *New York Times*, October 1, 1998, A30, Norris, F. “Risking everything on one big gambler.”

⁴⁰ *New York Times*, October 11, 1998, 6 (Week in Review), Eaton, L. “If hedgehogs could talk, this is what they would say.”

⁴¹ *New York Times*, October 1, 1998, A30, Norris, F. “Risking everything on one big gambler,” and AP story by D. Skidmore, October 1, 1998, “Lawmaker’s ask who’s watching funds.” Found on the web at http://ilhawaii.net/webnews/wed/cs/Agreenspan-fund-rescue.RSp_801.html.

⁴² *New York Times*, October 3, 1998, C2, Cowell, A. “Big Swiss bank is shaken up by hedge funds.”

⁴³ *New York Times*, September 26, 1998, Khan & Truell. “Hedge fund’s bets are now estimated to total \$1.25 trillion.”

⁴⁴ AP story, A. Fraser, September 25, 1998. Found on the web at http://ilhawaii.net/webnews/wed/an/Afund-rescue.R7Tx_8SO.html.

⁴⁵ *The Recorder*, October 5, 1998, K. Alexander of *Legal Times*. “Long-Term Capital’s journey into night.”

Julius Baer, McKinsey & Co., and Chase Manhattan Corp.⁴⁶ Federal Reserve Chairman Alan Greenspan stated, “Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own.” Others called it a “financial Armageddon,”⁴⁷ and suggested that it threatened a “meltdown of [the] financial system.”⁴⁸

There are similarities to Orange County in types of risks taken, but not in scale. There are differences in the scale of possible consequences and differences in the major players. While Citron was not known for his smarts, the partners in LTCM were Nobel prize winners and considered to be a “collection of uniquely intelligent men,” and “among the best and the brightest.”⁴⁹ While Citron used his own home-grown assessment of risks (added to that of his brokers), LTCM depended upon a sophisticated risk model, “value-at-risk” [VAR], which was also used by many banks. The model had, among others, a flaw based on the assumption that the financial world fits into a normal curve. Given the many financial crises, just since 1987, that curve does not work.⁵⁰ These were

⁴⁶ *Bank Industry News Items*, October 5, 1998, no author. “Hedge fund may have \$1.5t in positions.” Found on the web at <http://www.snl.com/bank/19981005.html>.

⁴⁷ *New York Times*, October 1, 1998, A30, Norris, F. “Risking everything on one big gambler.”

⁴⁸ AP story, A. Fraser, September 25, 1998. Found on the web at http://ilhawaii.net/webnews/wed/an/Afund-rescue.R7Tx_8SO.html.

⁴⁹ *New York Times*, October 11, 1998, Sec. 3: 1, Frantz and Truell.

⁵⁰ *The Economist*, no author given. Online at <http://www.cba.uh.edu/~rsusmel/7386/hfrisk.htm>.

high rollers placing bets with the funds of large banks and people whose net worth is at least one million,⁵¹ while Citron...

Why Such Risky Investments And So Little Oversight?

Why did Citron engage in such risky investment? Firstly, it is important to understand that it was Citron who fought for and succeeded (in 1979) in having state regulations impacting county treasurers relaxed (Jorion, 1995: 11). A *New York Times* article stated that Mr. Citron wished freedom (for his investment strategy) from “interference by local elected officials.” After the regulation was loosened, supervisors were not required to oversee extra borrowing, only to approve.⁵² Citron was now free to invest in more risky instruments such as repurchase agreements (Jorion, 1995: 11).

We may never fully understand Citron’s motives for his campaign to achieve regulation abatement, but this change did enable Citron to enter the previously forbidden world of securities’ manipulation using the public’s funds. Citron invested based on the predictions of Merrill-Lynch’s chief investment strategist, Charles Clough, Jr.,⁵³ that interest rates would remain low throughout the 1990s (Jorion, 1995: 14). Citron also listened to Merrill-Lynch broker Michael Stamenson. Jorion feels that Citron should have understood that brokers, whose job it is to sell more investments, have a conflict of interest that ought to make their predictions suspect (Jorion, 1995: 14-15).

⁵¹ AP story by D. Skidmore, October 1, 1998, “Lawmaker’s ask who’s watching funds.” Found on the web at http://ilhawaii.net/webnews/wed/cs/Agreenspan-fund-rescue.RSp_801.html

⁵² *New York Times*, Dec. 8, 1994, D17:5, Hofmeister. “A strategy’s creator also drafted the law.”

⁵³ Mr. Clough continues to be cited frequently by the Wall Street Journal and the New York Times.

Citron's strategy had two parts: 1) the approximately \$12.5 billion in reverse repos were leveraged and the cash put into "notes or bonds," and 2) \$8 billion in structured notes were used to increase the leverage. When losses became apparent in 1994 he bought notes with greater maturity rather than retaining cash to cover any 'paper' losses that did not disappear (Jorion, 1995: 87-88). The reasoning behind this exacerbation of a bad situation appears to come from the predictions noted above. Thus, Citron may have felt that the first rise in interest rates was an anomaly rather than a trend. Jorion notes that interest rate movements have a tendency to follow preceding changes, but that "forecasting interest rates is a notoriously difficult job." Still, there were many who agreed with Citron (Jorion, 1995: 89). Looking at rates from 1980 to 1995, there was a peak at 14 percent in 1981 and a bottom at 3 percent in 1992-3.⁵⁴ While it is possible to imagine a further decline, the likelihood becomes more doubtful the lower rates move. Citron seems to have forgotten that the money he was gambling with was public money; that he was jeopardizing the welfare of communities. His main concern appears to have been high yield. However, yield should not be the first concern of any public finance officer—rather, it should be safety (Lemov, 1995: 60). This emphasis on yield is not so surprising, though, when one considers that the drop in interest rates as the 80s progressed had made "safe cash management instruments" lower yielding. Added to this was the fact that California was "fiscally stressed," and balancing budgets at the local level had become increasingly difficult (Lemov, 1995: 60). Citron was not the only

⁵⁴ US Department of Commerce (1995). *Statistical abstract of the United States 1995*. Section No. 819 (page 528) lists the Federal Reserve Bank of New York discount rates from 1980 to 1995.

official to seek higher yields, but he went beyond that. Citron was also involved in fraudulent practices.

“Citron later pleaded guilty to six felony counts, including making misleading statements for the purpose of selling securities, misappropriating funds for the county, and falsifying accounting records. He was not accused of losing \$1.7 billion” (Jorion, 1995: 91). Jorion asserts that county officials cannot claim lack of information since reports of the Orange County Investment Portfolio [OCIP] listed all the securities (Jorion, 1995: 93). A New York Times reporter conjectured a tendency toward fantasy in a county “with both Disneyland and a *John Wayne Airport*.”⁵⁵ Yet, as Frank Partnoy has demonstrated, a list of securities that involve derivatives is not transparent, and the county officials were not alone in their misperception. Well into 1994 rating agencies were withholding high bond ratings unless the bond’s proceeds be put into the Orange County pool (Jorion, 1995: 94). Neither the Securities and Exchange Commission (SEC), credit rating agencies, an independent auditor, nor the county auditor found any market risk in the portfolio (Jorion, 1995: 90). Indeed, a judge in Orange County advised a father to invest the insurance award of the father’s son in the Orange County fund.⁵⁶ Even though it should be understood that California treasurers do operate independently of their boards except in three counties,⁵⁷ and even if deregulation had taken away some of

⁵⁵ *New York Times*, Dec. 4, 1994, Sec 3, 2:6. Herring. “California dreamin’.”

⁵⁶ *Wall Street Journal*, Dec. 9, 1994, A6: 3. Knecht, “Advice from judge to invest in fund spikes controversy.”

⁵⁷ *New York Times*, Dec. 8, 1994, D17:5, Hofmeister. “A strategy’s creator also drafted the law.”

their power, the County Board of Supervisors did overlook signs of risk (Jorion, 1995: 90).

Interest rates began to rise in 1994. In response to this and messages from the supporters of John Moorlach (Citron's 1994 opponent for Treasurer), the "highly leveraged" and "rate-sensitive" investments were criticized by *The Wall Street Journal*,⁵⁸ *Bond Buyer*, and *Derivatives Week*. But the county still reacted to these pronouncements with support for Citron (Jorion, 1995: 16). Considering that the county was in the middle of a hotly contested election, this is not surprising. If Citron seemed upset by these challenges to his record of success and by the interest rate changes, he nevertheless held out for his strategy and denied the importance of these "paper" losses as late as the end of September (Jorion, 1995: 17).

Too many municipal officials failed to question Citron's spectacular results. They did not bother to analyze his strategy, nor investigate the instruments he used. For Jorion these mistakes were a result of "addiction to success" (Jorion, 1995: 94). After all, Citron's investments gave the county an average return of more than 7 percent⁵⁹ a year on its investment when other counties were getting half as much.⁶⁰ Citron assessed the average yield for the 15 years before the debacle as even higher, 10.1 percent.⁶¹ In terms

⁵⁸*New York Times*, Apr. 15, 1994, C, 1:3. Gottschalk, Jr., E. "Derivatives roil California political race." Also see, *New York Times*, Apr. 20, 1994, C, 21. Staff. "County official lists securities, derivatives attracted criticism."

⁵⁹*New York Times*, Dec. 4, 1994, Sec 3, 1:1. Norris. "Wild gambling and deception bring big losses."

⁶⁰*New York Times*, Dec. 15, 1994, A28:1. Editorial. "Orange County's Fatal Error." This source and the source in the previous footnote do not clarify the extent of the time period they are averaging. Therefore it is not possible to compare their findings with Citron's statement.

⁶¹*Wall Street Journal*, Dec. 2, 1994, A3:1. Knecht, G. "Derivatives lead to huge loss in public fund."

of his management of public funds, Jorion considered Citron as “uncommonly adventurous.” Jorion’s analysis of Citron as a gambler who lacked understanding of financial instruments (Jorion, 1995: 13),⁶² county officials as lax due to success, and higher officials and credit rating agencies as blind has merit, but his analysis does not move much beyond this level. Blaming the gambler only skims the surface of social relations. Not considered are the broader reasons for the growth of speculation since the early 1970s. Not considered are the many intervening levels of state and federal decisions and their connection to wider changes in the national and international financial system and the global economy.

On the first of December 1994 an announcement was made. The fund had lost about \$1.5 billion. Attempts were made to sell off the portfolio, but within the week Orange County announced that it was bankrupt (Jorion, 1995: 17-8). Why this county? Was there something unique about this county that brought it to bankruptcy?

The Place: Orange County, California, USA

Known as “Reagan country,” Orange County has been conservative and change resistant since its beginnings (Pritchard, 1970: 247). Its participation in the 1920’s boom was accompanied by speculation in real estate and stock. By 1930, Orange County had a high concentration of private ownership in agricultural land and substantial development in oil. Its local leaders were patriots of an anti-central government stripe. This was the

⁶² Citron, as Jorion notes, was not personally a gambler. In fact, he portrays Citron as “personally conservative.” Citron has claimed that he neither drank, smoke, gambled, nor owned one share of stock (Jorion, 1995: 13).

home of the self-reliant, the ruggedly individual, and the fiercely anti-regulatory; local control was considered primary, if not sacred.

The impact of the 30s' depression revealed a contradiction between the anti-government belief system promoted in the county and the county's reliance on the central government for assistance in many areas. Indeed, most of the public buildings of Orange County were built with contributions from the federal government during the Roosevelt administrations. Orange was one of the nine counties in California considered to be most in need of assistance. Though Orange County voted for Roosevelt in his first run (by a small margin) and the Democratic Party briefly held power, the arrival of a degree of prosperity by 1936 brought the voters back to the Republicans. This also reflected a national conservative turn away from Roosevelt who was seen as moving to the left after 1935. As the Roosevelt administration called for "a new social order," which would come to be known as the New Deal, and unions grew in strength, the local Orange County press began to see the specter of total socialism or a form of despotism looming (Pritchard, 1970: 260). It was at this point, that communism and socialism came to be linked to the new term "un-American," and anti-communism became an issue that has remained strong in the county ever since (Pritchard, 1970: 260). This was the environment out of which Ronald Reagan arose to eventually call the Soviet Union the "evil empire."

Orange County Changes, Urban Transformation, And Industry

In the 1950s, the open spaces of Orange County offered a location for urban "overspill" of a growing postwar middle class. Its conservative political inclinations (then as now) made it an attractive place for business. With the growth of the military

procurements of the fifties, Orange County grew to be a complex of interlinked industries (Scott, 1988: 166-7). It represented the military-industrial complex Eisenhower warned against.⁶³ The development of Orange County into one of the most developed hubs of industry, largely high technology, started in the middle of the 1950s and accelerated through the 60s and 70s. The high technology firms in aerospace and electronics employ skilled technicians, researchers, and engineers; mainly producing for the federal government.⁶⁴ The communications production sector, the major employer and “directly tied in to federal defense and space spending,” tends to expand and contract in relation to the size of federal appropriations (Scott, 1988: 161-3).

By 1963, the county had earned the designation of a standard metropolitan statistical area [SMSA]. It was no longer suburban. The growth of industry, followed by the growth of population, resulted in a division of labor with social, economic, and residential differences represented by the split between “managerial and technical cadres on the one hand, and blue-collar manual workers on the other” (Scott, 1988: 172-3). Most of the manual labor increase was recruited from the Latino immigrant population, with immigrant Asians joining in the ranks later (Scott, 1988: 174).⁶⁵ Segregation has occurred and is made more likely by the location of small manufacturers near the county’s center. The county employers seem to “avoid” hiring African Americans who might press for

⁶³ Scott, however, does not mention this.

⁶⁴ It seems strange that a county that has been the beneficiary of both government spending in the Depression and government contracts since the middle of the century should be home to some of the most vigorous opponents of big government. But it appears that big government for them means a government involved in social spending that benefits others than themselves.

⁶⁵ This is connected to Scott’s thesis that the complex is devolving into a greater reliance on low-paid and unskilled or semiskilled labor.

unionization or at least the kind of rights of which many immigrants tend to be ignorant⁶⁶ (Scott, 1988: 176-177).

During the 1970s and 1980s Orange County grew rapidly, becoming a new industrial center of the Sunbelt.⁶⁷ One of the nation's richest counties, Orange County is not without its internal problems. Once a quiet, suburban "bedroom" community of Los Angeles, its population had grown (by the mid-80s) to 2.6 million with wide economic disparity among its multiethnic residents (Lopez and Mirande, 1988: 125-6). The county has been subject to broad national trends as well as those specific to California. One such broad trend was the growing ill will toward the property tax. Orange County homeowners joined the chorus of complaints across the nation as inflation and a shift of tax burdens led to increasing property taxes for homeowners (Jorion, 1995: 12). In California, this was made more pertinent by California's higher than national rate of tax increase, booming property values coupled with efficient assessment practices, and a governor and legislature unable to agree on tax relief (Pfiffner, 1983: 48-9). The rising property taxes had especially hit those on fixed incomes. Many of these were elderly, so it should not be surprising that the activists who constructed and gained passage in 1978 of Proposition 13 (limiting property taxes) were a "pair of elderly populists" (Pfiffner, 1983: 49).

⁶⁶ Even when not ignorant, undocumented workers are unlikely to create a stir by demanding rights.

⁶⁷ Orange County can be found to be the reverse of industrial decline in the Frostbelt despite the fact that both regions have been created "within a similar overarching set of capitalist social and property relations." They illustrate the unevenness of capitalist development, yet show "the genius of capitalism for constructing and deconstructing the social and geographical conditions of its own existence as each new regime of accumulation and mode of social regulation comes and goes." Despite the endless changes within capitalism one feature remains: "production [is] for accumulation." However, Scott considers his findings provisional and needing additional research into how such manufacturing areas emerge and develop (Scott, 1988: 201).

Over the late 60s and early 70s the defense industry had been contracting, in California as elsewhere, as federal defense appropriations dried up. By 1981 there had been a sharp decline, but the Reagan defense build-up turned that around and an acceleration of growth followed. The communications industry and aircraft and missile firms recovered. As job opportunities increased so, too, did the population (Scott, 1988: 165-6). Some of Reagan's policies were bonanzas for industry in Orange County, but other policies hurt the local area in terms of diminishing funding for social services that would need to be paid for by local taxes. However, that boom (particularly for McDonnell Douglas Space Systems, which had employed 10,500) ended by the 1990s with the shrinking of aerospace and defense contracts. Real estate values also slumped.⁶⁸ Orange County's budgets, which had been funded through taxation of the county's underlying real economy even with the effects of tax limitation measures, joined a national trend, and funding was shifted to *financing through investment earnings*. This occurred even though the basic economy creates a \$68 billion annual gross economic output—despite the problems of slump and shrinkage.⁶⁹

By the late 80s to early 90s, Orange county had become a metropolitan region with a mixture of wealthy, mostly white and suburban, coastal cities and a Northeastern urban area that contained a growing ethnic population.⁷⁰ The median family income in

⁶⁸ *Wall Street Journal*, Dec. 8, 1994, A, 12:2-3. "County expects to maintain its services, bolstered by scheduled tax payments."

⁶⁹ *New York Times*, Jan 10, 1995, D, 18:1. Wayne, L. "County's crisis is conservatives lab."

⁷⁰ *Wall Street Journal*, Dec. 8, 1994, A, 12:3. "County expects to maintain its services, bolstered by scheduled tax payments."

this county of about 2.5 million in population was \$54,413.00. However, there was a 6 percent rate of unemployment at the time of the bankruptcy.⁷¹ Underemployment, due to part-time work, had hit female single-headed families the hardest (Wright & Riave, 1989: 103). There were suburban gangs of every stripe and urban problems due to the growing cheap labor sector (Lopez and Mirande, 1988). The county had a shortage of housing for these workers and was showing transportation strains (Wright and Riave, 1989: 97). Nevertheless, housing for an expansion of Disneyland, a major source of revenue for Orange County, was an unproblematic priority—at least until the December 1994 catastrophe.

Though there are more top-level employees in the county, blue-collar labor has been expanding rapidly. This is the reverse of what is happening in the US in general. Scott argues that “this idiosyncratic trend in Orange County is to some significant degree the result of the susceptibility of local manufacturing plants to “vertical disintegration” of their productive functions. Vertical disintegration involves “the systematic transfer of work from large plants to small plants...from plants with relatively highly unionized workers to plants with very low rates of worker unionization...and smaller managements...” (Scott, 1988: 179). The division of labor there has spread in relation to this move and there has developed an area in which labor is “finely honed in the workplace and socially reproduced and sustained in the community at large” (Scott, 1988: 179-181). Educational facilities in the communities have become structured in relation to the needs of industry for technologically-educated labor (Scott, 1988: 182).

⁷¹ *Wall Street Journal*, Dec. 7, 1994, A6:1. Staff. “Bitter fruit: Orange County, mired in investment mess, files for bankruptcy.”

The aerospace and electronics industries in Orange County are linked nationally and internationally, yet also locally. There are also entrepreneurial “spin offs” from maturing firms. Vertical disintegration has decreased labor costs by shifting to lower paid, often undocumented, and nonunionized labor (Scott, 1988: 185-8). Orange County has “the lowest rate of worker unionization” in California, but this is due to a US trend as well as the county’s particular form of industrial organization (Scott, 1988: 189). The “average remuneration levels (in constant dollars) have actually *decreased* in Orange County manufacturing establishments since the late 1960s.” This tells us that despite trends for wages to creep upwards and despite labor shortages in the county, wages have been held down by this reorganized form of production (Scott, 1988: 190).⁷² For Scott, writing in 1988, “Orange County is a foretaste of a novel and still only dimly apprehended pattern of industrial development and urban growth. It is a part of a new landscape of capitalism....” (Scott, 1988: 202).

Transformations In Class And Government Structure

The composition of the top elites in Orange County began to change as the decade of the 60s wore on. Productive output shifted from small local entrepreneurs and large ranchers (the old guard) to those who owned large corporations (the new elite). Corporate leaders emerged as the dominant group. Along with this shift came several changes in the business and political life of the county. Appointed officials replaced elected ones with the change to a council-manager form of government administration (a depoliticization/de-democratization). “Business organizations and public administration”

⁷² However, the decrease in real wages over the 70s and 80s was a national phenomenon as well.

activity became centralized with the formation of a Chamber of Commerce, a League of Cities, the Citizens' Committee on Industrial Development—and by 1967—the creation of a county administration officer post. Clashes between the old guard and new erupted over zoning and the interpretation of proper land use. Regional development plans of the new guard were blocked, however, by local firms represented on city councils. This change in class leadership represented a move *away from* the local and *toward* the larger and more removed business, county, state, and federal structures. Though battles continued, corporate elites were now generally able to direct municipal concerns to their advantage according to Olin (1991: 233-4).

Baldassare, however, had found a strong “local orientation” among voters; a preference (whether Democrat or Republican) for power residing in the city government rather than the county or region. Land use battles existed between the local and the county, and “resistance [by locals and by the county] to regional governance in the years leading up to the bankruptcy.” It was county officials who were disinclined to take part in the regional agencies of Southern California (Baldassare, 1998: 53-55).

By the late 1970s, international trade had become an important part of the county's business. By the late 80s, three county banks were selling financial services to go with this trade. Those involved in international trade and services (part of the new corporate elite) began to push once again for a regional form of government. They saw the county's business expansion as related to national and world factors. However, the continuing divisions at the local level kept this from occurring (Olin, 1991: 234-7). With the creation of the Industrial League of Orange County and its growth to national

stature⁷³ by 1982, lobbyists began to push the Orange County Board of Supervisors for policies conducive to the kind of infrastructural growth and regionalization that would push the county into the international market (Olin, 1991: 237-8, 242, & 248 n39).

According to Baldassare, the fact that county leaders (such as the five supervisors who represented the top of the county political chart) were structurally oriented to the local, rather than county, level since they were elected by districts, and that there existed political fragmentation by virtue of the way elected and appointed officials were mixed in the structure of the county government, “led to a lack of oversight of the county treasurer” who had a broader electoral base than any supervisor. An example of the political fragmentation was the fact that an appointed county administration officer “had no authority over the heads of any county agencies” [Baldassare, 1998: 46-49]. Greater fragmentation and removal of voter control occurred with the creation of “special-purpose metropolitan districts”⁷⁴ (such as water, sewer, park, etc.) for the county.

Resistance to the growth policies of the larger and international corporations by the smaller and local commercial firms was made possible by organizing citizen demands at the local level where those demands could affect the elected power structure (Olin, 1991: 238-9). Given the locals’ preference for their city governments, their original

⁷³The extent of its power may be surmised from the prestige of some of its core companies: First Interstate Bank, Hughes Aircraft Company, the Irvine Company, Northrop Corporation, and Rockwell International. Its goal, according to Olin, was “to promote coordination among representatives of national and international capital.” Starting with Orange County industries, this league eventually brought in industries across the United States (Olin, 1991:238).

⁷⁴ There are 126 special districts out of “186 local government entities” [Baldassare, 1998: 52].

reasons for moving to Orange County (suburban “paradises”⁷⁵), and the environmental and fiscally conservative orientations of some, local voter response to anti-growth messages of the old guard would seem assured. In actuality, Baldassare found that they supported no- or slow-growth policies because of dissatisfaction with local government, local services, and the perceived speed of growth [Baldassare, 1986: 98-99].

Nevertheless, during the mid- to late-1980s, drives to slow county growth were defeated through the money and pressure of the larger companies, large landholders, and the building industry. According to Olin, the failure of citizen efforts meant that the political process was not capable of being easily and effectively used by the locals (Olin, 1991: 239-241).

In summarizing his findings, Olin notes that “regional [old guard] capitalists, whose economic and political influence was predominant in the years immediately following World War II, slowly and perhaps inexorably had given way to global capitalists” (Olin, 1991: 242). Orange County is feeling the effects of the development of international firms, but even more, the county was affected by the desire and ability of these firms to align with nonlocal interests and promote nondemocratic forms. These international firms react to international changes in ways that lead it to push for its own interests within county and region—ways not always in harmony with local residents’ wishes and needs. The political fragmentation and voter distrust noted by Baldassare [1998: 16-17] as two of the conditions that made the bankruptcy possible are evident here. At the local and county level oversight was made difficult by the decentralized form

⁷⁵ According to Kling, Olin and Poster’s chapter “The emergence of Postsuburbia” [1991: 11], some of the dissatisfaction of locals had arisen as they saw “hillsides turn to tracts and open roads become clogged with commuter traffic.”

of government which had officials purportedly in charge of oversight but politically unable to control other officials with differing electoral bases. Voter distrust and a struggle within the capitalist class made for further fragmentation.

The Consequences

Robert Citron had gained respect, prestige and reelection when he succeeded (Jorion, 1995: 96), but got jail, condemnation, and infamy when he failed and was subsequently found to have acted criminally. The bankruptcy of late 1994 came on the heels of a recession (1991-93), environmental disaster (floods and one of California's most serious earthquakes), and defense spending cuts that hit a county in which the aerospace industry figures importantly (Jorion, 1995: 155).

Early in December of 1994 there had been worry that the Disneyland expansion and the new stadium to keep the LA Rams in Anaheim might become impossible, threatening the county's economic recovery.⁷⁶ With the bankruptcy and by the end of January 1995, Disneyland had postponed the \$2.75 billion development project that was expected to create 27,000 jobs.⁷⁷ In March of 1995 county layoffs were announced; about 10 percent of the county workforce.⁷⁸ County assets were to be sold, services were cut, new bonds issued, and (in keeping with the national direction) privatization of public property and businesses were promised. A sales tax increase of one half of one percent

⁷⁶ *Wall Street Journal*, Dec. 8, 1994, A3:1. Staff. "Orange County Expects To Maintain Public Services."

⁷⁷ *New York Times*, Feb. 1, 1995. (AP). "A plan to expand Disneyland is canceled."

⁷⁸ *New York Times*, March 8, 1995, B7:6. (AP). "Orange County discloses plan to trim jobs and services."

was proposed. The greatest burden, as ever, would fall on those least likely to be able to weather it, while the wealthy would hardly feel the changes—if not profit from them. Some county residents saw the assault on the less fortunate as a boon, hoping that the poor would move to New York.⁷⁹ The ethical tone of the county was sounded not only in this hope, but also in the fact that Orange County had resorted to bankruptcy rather than levy new taxes.⁸⁰

Losses from the investment disaster were borne by county residents, but “commercial banks, investment banks, hedge funds, [and] corporations” also lost (Jorion, 1995: 156). The sale of county assets was expected to amount to at least \$100 million. Help from the state by way of a speed up of payments and regulatory loosening was an important part of the recovery plan. The budget was slashed so thoroughly that a split had occurred between those worried about lawsuits against the county for services denied and a declining standard of living which could hurt business and those who felt the cuts should be larger.⁸¹ Bondholders, however, were warned that they might have to swallow a year’s delay in repayment.

Financial analysts saw each of the county’s moves as a way to avoid its responsibilities⁸² and debts. County leaders hired lawyers to “challenge in court the basic

⁷⁹ *New York Times*, March 28, 1995, A14:1. Mydans. “Orange County faces future with anxiety.”

⁸⁰ *New York Times*, June 4, 1995, Sec 3, 1:5. Wayne. “Banging a tin cup with a silver spoon.”

⁸¹ *New York Times*, June 1, 1995, A14:1. Sterngold. “Orange County: Reluctant fiscal test case.”

⁸² In turn, the wealthy, the conservative, and the officials of the county call the residents irresponsible. “People aren’t willing to take any responsibility.” “This is a tremendous era of selfishness,” stated the city manager of Brea (an upper-middle-class section of Orange County). This was echoed by Robert Poole, president of the conservative Reason Foundation, and William J. Popejoy, the temporary chief executive of

underpinnings of municipal finance—the moral and legal obligation of a municipal borrower to pay its debts.” In addition, the county’s bankruptcy was being solved more like a corporate⁸³ than a municipal bankruptcy. Bankrupt corporations are not required to make full payment to investors. Given the general obligation pledge of all municipalities, full payment should have been made when bonds became due, but instead the talk was of paying a percentage of the whole (“a cents-on-the dollar strategy”). “And in a move many in municipal finance say would be unconscionable, several county officials were also talking about possibly repudiating, or not paying back at all, \$600 million in taxable notes the county issued last summer.”⁸⁴ By May of 1996, creditors had accepted a negotiated recovery plan. While the bankruptcy affected the municipal-securities market much less than expected, services for the poor were cut to the bone. Money was diverted from transportation, parks, harbors and beaches, and flood management in order to pay the bondholders. With the successful sale of “about \$800 million in new bonds,” bondholders will receive full payment with interest, notes Sterngold in *Wall Street Journal*.⁸⁵ However, this is not quite true. “When [the time] schedule [of principal

Orange County. *New York Times*, June 1, 1995, A14:1. Sterngold. “Orange County: Reluctant fiscal test case.”

⁸³ Could this be because the new elite of the county are a corporate elite?

⁸⁴ *New York Times*, June 4, 1995, Sec 3, 1:5. Wayne. “Banging a tin cup with a silver spoon.”

⁸⁵ *New York Times*, May 3, 1996, D1:6. Sterngold. “Orange County creditors said to accept plan.”

payments] is not met, the value of the bonds fall, and interest is lost because funds are unavailable for reinvestment.”⁸⁶

By June 12, 1996 the 18 month bankruptcy was over. However, the belief that municipal bonds are safe investments is now less secure. The risks have been revealed. Residents and investors now know that bankruptcy may occur, that default is not impossible, and that elected officials may make risky decisions and then lack the resources and/or the good will to pay their debts. A decrease in general obligation bonds, an increase in SEC oversight of public officials and public investment, and an amendment of the Federal Bankruptcy Code decreasing the likelihood of municipal filing are possible. Though there has been Federal concern for strengthening regulation over either municipal finance or particularly risky investment instruments, regulators have indicated that these changes are unlikely.⁸⁷ Orange County was able to sell the additional long-term debt of \$800 million in new bonds to pay back the bondholders, and county officials were hit with both criminal and civil charges. Seen as a “near miss,” municipalities may be entering a future in which their debt will be judged in like manner to that of private debt.⁸⁸

⁸⁶ *New York Times*, May 3, 1996, A22:5. Thomas S. Johnson, chairman and chief executive of the Greenpoint Bank, NY A letter to the editor.

⁸⁷ *Wall Street Journal*, Jan 5, 1995, A, 4:1. Anderson, M. and Connor, J. “Changes in municipal-bankruptcy law are being studied by US regulators.”

⁸⁸ *New York Times*, June 13, 1996, D1:3. Wayne. “Orange County: Hard lesson in safety of municipal debt.”

What did Robert Citron and others do that brought criminal charges and litigation and how has the story of the Orange County bankruptcy unfolded since the early days of conjecture?

By the end of January 1995 external auditors had found that Robert Citron had cheated buyers of Orange County bonds (agencies and local governments) of about \$250 million by (among other actions) shifting losses from investments in derivatives (such as bets on the direction of interest rates) out of the most highly leveraged fund (Fund 100) and onto other pool participants.⁸⁹ In November of 1996 Robert Citron was found guilty of six felonies, including misrepresentation and fraud, and fined \$100 thousand. A sentence of 6 years time in state prison was stayed, but he was given a one-year jail term,⁹⁰ one thousand hours of community service, and ordered to seek psychological counseling. The picture that emerged from the trial was of a psychologically confused and intellectually limited man whose arrogance carried others along with him and denied him insight into his own victimization by brokers.⁹¹ The SEC issued a report on the Board of Supervisors of Orange County which found them responsible for “reckless

⁸⁹ *Wall Street Journal*, Jan 30, 1995, A4. Pasztor, A. & Jereski, L. “Orange County’s auditors say fund shortchanged agencies by \$250 million.”

⁹⁰ Citron actually served 8 of those 12 months in a work-release program. Banham, R. (1998). Local Hero. *Treasury and Risk Management Magazine*. October issue or see the Web at <http://www.cfonet.com/html/Articles/TRM/1998/98OCloca.html>.

⁹¹ Reckard, E. Scott (AP business writer), *Source News & Reports*, <http://sddt.com/files/librarywire/96wireheadlines/>, November 19, 1996.

conduct within the meaning of the antifraud provisions” for not investigating the disclosures given to them by Citron. This report does not carry any enforcement power.⁹²

The results of investigations and settlements allows us to suspect, but not prove, that deception was allowed within brokerages, and that discrimination was lacking by accountants and lawyers. However, we know from Partnoy’s insider story that lying and cheating were just part of the scene. Merrill Lynch made their first settlement rather than face criminal charges by New York investigators. This was an out-of-court settlement of \$27 million to Orange County in June of 1997⁹³ which leads one to wonder what Merrill Lynch wanted to hide. The list of recent settlements is long, though only extending from May of 1998 when Credit Suisse First Boston was forced to pay \$52.5 million to Orange County up to December of the same year when Fuji Securities Inc. settled for \$7.9 million. The largest settlement, however, was by Merrill Lynch for \$437 million in June of 1998. Again, they avoided a trial in which they had been accused of “fraud, breach of fiduciary duties and other offences.”⁹⁴ Others who settled during that same year were: Goldman, Sachs & Company at \$4.8 million, Morgan Stanley Dean Witter & Company at \$117.5 million, LeBoeuf, Lamb, Greene & MacRae at \$45 million, Bear Stearns at \$7 million, Brown and Wood (a law firm) at \$23 million, and KPMG Peat Marwick (an accounting firm) at \$75 million. That brought the grand total to about \$900 million.

⁹² Orrick, Herrington & Sutcliffe, LLP. “SEC report on conduct of Orange County Board of Supervisors,” 1998. This is available on the Web at <http://www.orrick.com/news/mfp/9604/01.htm>.

⁹³ *New York Post*, June 20, 1997: 32. Out-of-Court settlements are not publicly accessible and therefore bury the full story.

⁹⁴ While the information in this paragraph comes from a multitude of newspaper sources, the quote given is from Larry Gerber, AP, on a June 3, 1998 newswire. This is available on the Web at http://ilhawaii.net/webnews/wed/af/Aorange-county.R2Ln_8u2.html.

Though there were other outstanding suits as late as 1999, Orange County was stymied, as of October of 1998, by a federal judgement that threw out the county's claim that Citron was not authorized by law to engage in the transactions which led to bankruptcy. The county planned to appeal.⁹⁵ Thus far, more than half of the \$1.64 billion loss has been recovered. Even earlier, in June of 1996, the county had been able to sell its bonds again, but with added expenses of \$43.8 million.⁹⁶

Derivatives have not been cleared of blame despite the support shown by many financial analysts and writers. Gradually, they have been accorded the status of "risky" and, as stated earlier, were at the center of LTCM's hedge fund bailout of 1998. This was not the first time a problem with hedge funds had erupted. In fact, the same year of the Orange County bankruptcy was also the year of Askin Capital Management's collapse. The three hedge funds they managed filed for bankruptcy in April of 1994. In this case, as in Orange County, brokerage firms were found to have accelerated a downfall which involved leveraging, fraud, and interest rate bets. Investors lost \$630 million, but Askin was merely ordered to compensate investors \$50 thousand.⁹⁷ The lesson of such soft treatment was, perhaps, not lost on other hedge fund managers. The year 1994 has been called "the bond market crash."⁹⁸

⁹⁵ *New York Times*, October 24, 1998, from the online archives at www.nytimes.com. Pollack, A. "Orange County Is Set Back In Efforts to Recover Losses."

⁹⁶ *The Tech*, June 7, 1996, Volume 116, Number 27: 3, no author given. This is available on the Web at <http://wild-turkey.mit.edu/V116/N27/newsbriefs2.27w.html>.

⁹⁷ Jinny St Goar, "The lessons in the ashes." This is available on the Web at <http://www.assetpub.com/archive/ps/96-06psjune/june96PS48.html>.

⁹⁸ *The Economist*, no author given. Online at <http://www.cba.uh.edu/~rsusmel/7386/hfrisk.htm>.

Following the 1987 stock market crash (between 1989 and 1995), there were other spectacular failures involving derivatives: speculation by the borough of Hammersmith & Fulham (England), management failure in Metallgesellschaft A.G., the speculation by Askin Capital Management already mentioned, speculation with bad investment advice by Proctor & Gamble, Gibson Greetings Inc., and the Mead Corporation; leveraged speculation by Air Products & Chemicals, by Orange County, and speculation without sufficient oversight by Leeson of Barings Bank.⁹⁹ Added to those were the losses by other governmental bodies: TexPool, San Diego County, West Virginia's pool, and back in 1984 the city of San Jose's fund.¹⁰⁰ Obviously, Robert Citron was not the only one incapable of understanding the risks. Was the problem derivatives, lack of knowledge, lack of oversight and communication, or the acceptance and use of speculation? Derivatives are risky, poorly understood, poorly or criminally misrepresented, and used speculatively to gain or maintain a high level of income. There is disagreement over the value of derivatives, but derivatives are a tool—albeit a risky tool. It is ironic that US Representative Janis Leach, writing in 1993, felt that “prudent use of derivatives helps market participants guard against volatility.”¹⁰¹ Why this volatility? Why did derivatives' creation and use grow in the 1970s and through the 1990s? What

⁹⁹ McLellan, N. “Derivative Debacles.” April 23, 1998. This is available on the Web at <http://econ.massey.ac.nz/nmclella/FE.htm>.

¹⁰⁰ Ruyter, T. “Hitting the lifeboats.” This is available on the Web at <http://www.assetpub.com/archive/ps/95-03psmarch/march95PS18.html>.

¹⁰¹ McGinn, C. “Derivatives—the regulation debate.” June, 1997. This is available on the Web at <http://www.bit.net.au/~colinmcg/derivative.html>.

connection, if any, is there between these problems and “an expansion that began in 1991 and begat a stock market that recognized no ceiling.” This purportedly new “golden era” driven by “business investments in technology”¹⁰² seems to have had a full share of disasters. Why?

If you look to financial history for answers, you will find that historians note a decrease in common sense driven by greed and envy in times of prosperity.¹⁰³ This is abetted by belief in famous people (such as Nobel prize winners). But as Mark Twain is quoted “There are two times in a man’s life when he should not speculate: when he can’t afford it, and when he can.”¹⁰⁴

The passage of time has not meant a decrease in the importance of speculation and leveraging in derivatives, etc. The story of Orange County has revealed how the structure of county government, voter decisions, the California state fiscal crisis, the deregulation of laws governing public investments, the decisions of officials to risk public money, and the criminal actions of both Citron and the possibly criminal actions of Merrill Lynch combined at this level to bring a county to bankruptcy. In the next two

¹⁰² *New York Times*, October 11, 1998: sec 3: 4. Stevenson, R. D. “A pessimism as irrational as that old exuberance.”

¹⁰³ Prosperity, boom times, are analyzed by Durkheim in *Suicide*. Against the intuitive sense that a boom should decrease unhappiness and thus suicide, Durkheim finds that suicide actually increases. His analysis points to sudden changes or large restructuring of society whether it be prosperity or crash (Durkheim, 1951: 241-246). The following quote, of interest in relation to speculative finance today, actually is dealing with the upheaval Durkheim himself was witnessing in 1890s’ France with the development of industrial society. “Ultimately, this liberation of desires has been made worse by the very development of industry and the almost infinite extension of the market ...Now that he (the producer) may assume to have almost the entire world as his customer, how could passions accept their former confinement in the face of such limitless prospects” (Durkheim, 1951: 255-256).

¹⁰⁴ *Wall Street Journal*, October 14, 1999, Browning, E.S. “Why this decade’s spate of fraud recalls patterns and players of other golden ages.” The quote from Twain is cited in this article as coming from his “Following the Equator,” 1897.

chapters, the level of capitalism as a system, its national and international aspects, and the influence of its changes on norms will be considered and then reconnected to the local.

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CHAPTER 2: CAPITALIST CRISIS, RESTRUCTURING, AND SPECULATION: THE NATIONAL AND GLOBAL CONTEXT

Introduction

Orange County's bankruptcy may appear to be an isolated instance of rash decisions, criminality, and broker and trader pressures—which it is—but, it should also be considered in the light of larger historical changes that have occurred in national and international structures and processes within the capitalist system. These changes have occurred as a result of a systemic economic crisis in which accumulation through production was jeopardized. One result of the crisis has been the growth in speculation as a means of accumulation; indicating a shift in importance to nonproductive capital. Both the crisis and the shift required the restructuring of international and domestic institutions and agreements. This restructuring has been accomplished largely through the process of deregulation, but it has also been accompanied by ideological and normative changes.¹⁰⁵ Crisis, shifting power, institutional changes, and disorder in the heart of capitalism's economic and financial globalization has led to increased instability and fragility that is the breeding ground for speculation.

It is a given of sociology that norms are institutionalized in order to assure their maintenance, reproduction, and longevity. This occurs at the local, national and international level. Structures emerge from this process that assure a degree of stability for the social relations among individuals, groups, organizations, and nations. Such social

¹⁰⁵ These last will be dealt with in the following chapter.

constructions that are part of the economic system “shape the interests of various economic actors, routinize and regularize various social practices, and provide information to reduce uncertainty, thus creating a stable, predictable economic climate” (Shoch, 1994: 174). This chapter concentrates on the results of actions taken by policy makers and other actors who, in the face of crisis and instability, make decisions that alter agreements, institutions, and social relations which (under capitalism) ensure the orderly accumulation of capital.

Capitalist Crisis

The Orange County bankruptcy and the speculation that led to it is a story of crisis and restructuring, nationally and internationally. By the 1950s, a strong postwar economic recovery resulted in the first deregulation of controls on private businesses. Transactions formerly routed through central banks could now be conducted in foreign money markets without interference, countries were required to convert to the foreign currency of any current account transactions, and the fixed-exchange rate mechanism was established. Also with recovery, private liquid capital grew and international capital flows increased (Krause, 1973: 174). Technological developments in computers and telecommunications in the 50s and 60s engendered the financial system we now have. But, according to Webber and Rigby, the start of production problems which began after the mid-60s signified the unequal progress of this period (1996: 25-26).

The change in US banking policies, which eventually made possible the separation of productive and nonproductive circuits of capital (see the section to follow on restructuring) and the rise of accumulation through nonproductive means, had its start

in a 1950's deregulation: the 1956 Bank Holding Company Act (van der Pijl, 1984: 178-179). This act allowed banks to acquire firms that were related to banking activities (such as auditing, investment counseling, safe deposit, banking insurance, etc.) (Dougall & Gaumnitz, 1975: 43-4), and may be seen as the initial move in the unification of investment capital with banking capital which had been divided by New Deal legislation (van der Pijl, 1984: 179).

The mid- to late 60s period was a turning point from postwar expansion to contraction (Aglietta 1987 ed., DuBoff 1989, Guttman 1994, Lipietz 1987, Mandel 1978 ed., Wolfson 1986, and others). Inflation accelerated toward the end of the 1960s and then altered its characteristics (Guttman, 1994: 120-1). After 1968, inflation was combined with stagnation as growth contracted. This combination (called *stagflation*) caused recessions when attempts were made to cut inflation. As these two, inflation and stagnation, fed each other stagflation worsened over time. Guttman explains stagflation as a "new form of structural crisis" which can be seen to replace or modify depression (Guttman, 1994: 125-7).

Though inflation was severely restrained in the early 80s, stagnation was still part of the national and international scene into the 90s. Speculative markets and financial crises have not gone away. Among the many works addressing the crisis of the 1970s, Michael Webber and David Rigby's analysis offers one of the most cogent analyses for explaining the growth of finance, the sea of surplus capital, and the prevalence of speculation. It also helps us understand why a large amount of manufacturing was transferred out of the United States.

Webber and Rigby's basic assumption is that crisis resulted when production profits slowed and stayed low because investment costs in "plant, equipment, and raw materials per worker" increased faster than the rise in profit. In reaction, manufacturers in the advanced economies then cut their investments, and this slowed production growth rates by the start of the 1970s (Webber & Rigby, 1996: 499). The underlying theory is that "changes in the rate of profit depend on the manner in which technical change and accumulation interact with the demand for and supply of labor, commodities, and capital" (Webber & Rigby, 1996: 490). This crisis was internal to capitalist relations that had developed over the "so-called" golden age of the 50s and 60s (Webber & Rigby, 1996: 10-11).

As for the boom in global finance, Webber and Rigby assign major importance to three causes while acknowledging that there are many more. Firstly, with declining investment in manufactures at home the profit rates possible in financial markets competed successfully for those investment funds. Liquidity had also grown globally due to "petrodollars"¹⁰⁶ and West German and Japanese surpluses. Secondly, new technologies in electronics, telecommunications, and computer processing of information led to falling costs and rising ease of transaction transference. This development educated investors about the "differences in risks and yields on assets in different markets," and, at the same time, "increased the instability of global financial markets." Thirdly, deregulation "removed interest rate limits, aided the creation and development of money markets for commercial paper and treasury bills, eased reserve requirements and credit

¹⁰⁶ In the 70s, enormous profits made by oil exporting countries that were not needed domestically were deposited in European and American banks in dollars. The banks used these funds to invest in LDCs (Guttmann, 1994: 226).

controls on banks and other deposit taking institutions, opened stock exchanges to foreign companies, removed exchange and capital controls, and encouraged financial concerns to widen their range of activities” (Webber & Rigby, 1996: 30-31). When there are surplus funds looking for higher profit rates, along with new methods of transaction which speed the rate at which funds can be turned over, and fluctuating rates for currency, interest, etc., then the means, method, and opportunity to speculate are present.

How different this response to crisis was from the crisis of the 30s. If the response to the more recent capitalist crisis was deregulation of financial processes, the response to the 1930s crisis was a series of regulations meant to end “conflicts of interest, market manipulation, and abusive practices.” During the New Deal and in response to what was seen as the excesses of the pre-1929 Crash period, a minimum down-payment was imposed on the purchase-on-credit of stock or other securities (or “margin credit purchases of stocks”) —an attempt to control speculation.¹⁰⁷ The Glass-Steagall Act¹⁰⁸ (1933) separated investment banking from commercial banking so that a bank could not have both creditor and underwriting (risk insuring) relations with a corporation (Guttman, 1994: 84-85). These legislative moves, as well as others, created the institutions of the Keynesian-New Deal socioeconomic management that carried the US through to the end of World War II.¹⁰⁹ Combined with the international arrangements of Bretton Woods, they survived to 1971 and, though brittle, fragmented, and opposed,

¹⁰⁷ This shows that regulatory control was considered important for decreasing speculation.

¹⁰⁸ As I write in October of 1999, the Glass-Steagall Act has been jettisoned. See footnote no. 177.

¹⁰⁹ However, many of the laws and regulations have either been annulled or made ineffectual.

somewhat beyond. The Bretton Woods system, a “*postwar monetary regime*,” was an example of a historical regime for the support of accumulation which used a complex of institutions for international stability. This system was created in July of 1944 from the earlier Keynesian-based attempts in the United States and incorporating some of its principles (Guttman, 1994: 88).

One of Bretton Woods most important monetary institutions was the creation of a gold-backed, international currency standard based on a national currency, the US dollar (Mayer, 1974: 449-450). Bretton Woods did, to some extent, promote currency stabilization and maintain world liquidity. However, gold production had been declining as trade had increased, and both speculation and the de jure convertibility of all European currencies by 1958¹¹⁰ put pressure on the US gold supply. That is, though conversion was agreed upon legally, its inconvertibility due to insufficient gold reserves became an accomplished fact. Between 1958 and 1960, there was a demand for conversion to gold that led to a massive drop in US gold reserves. Yet, by 1959, the increased direct foreign investment by US multinational firms (because of the creation in 1957 of the European Economic Community) led to an even greater outflow of dollars that could be cycled back for conversion. When a “speculative run” to gold occurred in October of 1960, the price of gold climbed and the US reacted by placing capital controls¹¹¹ on US multinational firms in order to slow the flow of dollars abroad

¹¹⁰ Most texts dealing with this issue do not state why conversion did not involve all European countries before this date. However, there is one reference which implies that it was related to “the cautious return of the weakened European powers to a normal peacetime regime of free financial exchanges” (Shonfield, 1976: 1).

¹¹¹ According to Guttman, part of this 1964 control was voluntary, calling on banks to restrain the amount of credit given to foreign firms and citizens. The other part consisted of a tax on foreign currencies, the

(Guttman, 1994: 138-139). This was one of the early examples of the growing power of currency speculators.

Problems continued to beset the dollar and in the 60s a dilemma¹¹² faced the United States. It chose to utilize its “seignorage”¹¹³ benefits; the right to finance its debt through successive extensions of credit by foreign nations. Instead of a policy of fiscal and monetary restraint; domestic taxes were cut by Kennedy in the early 60s, and Johnson increased social expenditure domestically and military expenditure in Vietnam in the mid 60s. This domestic inflation weakened the dollar. By 1968 confidence in the dollar had been delivered a severe blow due the combination of the inability to convert and the relative overvaluation of the dollar. This crisis of the dollar required that the US government act. A series of compulsory controls on direct foreign investment were instituted and Johnson increased taxes and tightened money by the end of 1968. Though this did strengthen the dollar, it also precipitated the 1969 to 1970 recession. As money

Interest Equalization Tax (Guttman, 1994: 499, n2). Strange explains this, I think better, as a control, through increased costs, on “foreign borrowing in US money markets.” This led to US multinational firms borrowing in the unregulated, untaxed Eurocurrency market (Strange, 1976: 181 & 213).

¹¹² The US was faced with making choices, but those choices were arranged on either side of the contradiction inherent in being the international reserve currency. That contradiction has been expressed as the “Triffin Dilemma.” If the US attempted to decrease its payments deficit and run a surplus, world liquidity would drop and negatively affect the expansion of world trade. But, if instead, the US increases its payments deficit foreign confidence in the dollar would wane and result in demands for convertibility (Guttman, 1994: 139). Eberhard Reinhardt, the Swiss economist who wrote of this contradiction in 1972, also noted that the economic privilege of the reserve currency nation allowed it to “extend its people’s living standards or its industry’s foreign investment far beyond the limits of its own economic potential” (Reinhardt, as cited in Mayer, 1974: 450 & 453).

¹¹³ The “seignorage benefit” represents the profit for the creator of money; direct profit for kings at one time, indirectly for governments today. Domestically, the government gains greater tax revenues due to inflation when it monetizes public debts. Internationally, the government issuing currency that is utilized as world money is able to earn net income because its liabilities are short-term while its assets are long-term (Guttman 1994: 498 n16).

tightened, banks from the US borrowed from the mostly unregulated Eurodollar market¹¹⁴ and this briefly eased the excess dollar supply (Guttman, 1994: 139-142). Repercussions, though, would soon occur.

In 1970 Nixon was inaugurated as President. Unemployment was rising as economic crisis grew and his policies, meant to alleviate unemployment (increasing government spending *and* the money supply) led to accelerated inflation, decreased trade, and pressure to devalue the dollar as loosened credit returned the US to a large outflow of dollars. A serious crisis of the dollar followed. Nixon, however, left the problem of these excess dollars to the central banks of foreign countries. Inflation spread to Europe. In August of 1971 the US showed a trade deficit; the first since 1893. A congressional subcommittee recommended a devaluation of the dollar. As demands mounted for conversion (by European countries eager to dump inflated dollars), Nixon suspended convertibility. The dollar was no longer backed by gold (Guttman 1994: 141-142). The international dollar and the domestic dollar had become the same -- *credit money*.¹¹⁵

¹⁰⁷ Money could be moved in and out with great ease, facilitating speculation. As Guttman states, "That unregulated and globally integrated banking system thus became a perfect conduit for currency speculation" (Guttman, 1994: 142).

¹¹⁵ There are two forms of money: commodity money and credit money (Guttman, 1994: 87-9). Most money today is credit money. That is, it is not backed by any commodity. Rather it is a promise to pay (Lapavitsas, 1991: 307). Credit money has had two paths of creation; state currency backed by faith in the government rather than gold, and newly-issued bank money created on the basis of excess bank reserves that are loaned out (Guttman, 1994: 33). It is this interest-bearing capital that creates the flows of credit money (Lapavitsas, 1991: 304-5). The elasticity of this form of money allows firms to pay for the cost of plant and equipment with debt, and made the postwar "debt economy" possible by facilitating inflation through expanding liquidity in response to demand (Guttman, 1994: 99-100). "Without credit money there would be no inflation, low prices and high asset values, but there would be slow growth with consequences of increased unemployment, low wages, and increased poverty. That is, the interests of rentiers would be well served, but at the expense of the working class and national economic growth. There would be greater security for capital, but greater insecurity for labor. Many on the extreme right continue to deplore the existence of credit money or what they call fiat money; they point out the dangers of inflation that credit money creates and argue for returning to the gold standard, a position that Greenspan held early in his career. Many other influential people hold this position and are called 'gold bugs'" (correspondence from Dr. Roslyn Bologh).

Inconvertibility had become *de jure* with Nixon's decision -- a decision which solved the demand for conversion and the dollar's overvaluation. Gold's importance in the international monetary system had shrunk, leaving the dollar standing alone as world money. Late in 1971, Western Europe, Japan, and the United States signed the *Smithsonian Agreement*. This adjusted currency prices and the fixed exchange system with a revaluation of all currencies and added some flexibility of rates (Guttman, 1994: 142-3). By March of 1973, however, the system of fixed exchange rates had totally collapsed and currency prices were left without regulations. The world moved from a system of trade agreements with a stabilized currency into instability and even greater uncertainty. As shown below, profits from speculation had grown enormously by this time. During the course of the 1970s, and with increasing stagnation, the deregulation of exchange through "flexible exchange rates" (the 'float')¹¹⁶ led to competitive devaluations among currencies. This stoked inflation and led to the speculative collapse of two transnational banks (Franklin National Bank of New York and Bankhaus Herstatt of Germany) in 1974.¹¹⁷ The major banks of the Euromarket feared that chaos would spread and in 1975 leading central bankers (the "Group of Ten") agreed to the *Basle Concordat*. Under the authority of the Bank of International Settlements (BIS), the Group of Ten became the lenders-of-last-resort for the Euromarket banks, providing them with

¹¹⁶ The float means that currency rates will vary according to market supply and demand. In general, central bank's do not intervene, but if they do try to intervene in currency rates, it is called a "managed" or "dirty" float.

¹¹⁷ Keohane stated that "The dollar standard that persisted after 1971 was not accompanied by stable financial conditions or by effective intergovernmental action to control world liquidity growth; the result was an immense increase in international liquidity which appears to have contributed to the world inflation of 1973-1974" (Keohane, 1978:171).

some regulations and supervision (Guttman, 1994: 148 & 501, n15). Along with this came access to loans as a bailout to avoid collapse in the case of a bank crisis among the Euromarket banks, which were providing the liquidity for the European economy.¹¹⁸

The inability of the institutions of the international monetary system to maintain a stable environment signaled the collapse of the viability of the Bretton Woods system. Ending the gold backing of the dollar led to “an exponential growth of the mass of international liquidity.” With the growing size of bank capital there was a rentier revival. Since banks were now able to avoid Keynesian regulations through the Eurodollar market, the circulation of international capital was removed from the grasp of regulations and a “wave of internationalization” followed Nixon’s move. At the same time, multinational firms broke through territorial restrictions and mass production and consumption no longer needed to share the same land base. The capital-labor accord of the New Deal was no longer necessary (van der Pijl, 1984: *xvii-xviii*).¹¹⁹

By 1974, Nixon was gone. The Ford administration was followed by Carter’s, and by 1978 new International Monetary Fund [IMF] amendments (bending to the inevitable) permitted each member nation to practice an exchange rate they so chose. Guidelines were issued and nonconstraining “surveillance” ensued; yet, during this floating-rate period, there was more intervention to keep a modicum of stability of rate movement than there had been under the Bretton Woods system in which currency exchange rates were

¹¹⁸ Correspondence with Dr. Roslyn Bologh.

¹¹⁹ The New Deal had been a collaboration of labor and capital to expand production, increase wages, and increase employment. This was no longer necessary. “Corporate profits were decoupled from labor demands at the same time that profits from capital were becoming increasing decoupled from production itself (through a revival of rentier capital)” (correspondence from Dr. Roslyn Bologh).

pegged to the dollar (Mayer, Duesenberry, & Aliber, 1981: 714-16). The arrival and official blessing of the float signaled, for Kees van der Pijl, the complete end of central bank intervention “in foreign money markets.” Instead, countries financed (versus balancing) their deficits in the “booming capital markets.” This was a large contributing factor to the above-mentioned shift in the profit share toward all forms of money (rentier) capital (1984: 263). The market was to rule, and the financial market was preeminent. The float period extended through the 70s and into the 80s. Nevertheless, by 1985 and in reaction to international fears of currency speculation as the dollar began to sharply decline, Reagan abandoned his laissez-faire stance and joined in the *Plaza Agreement*¹²⁰ for central bank control (Guttman” 1994: 380). This agreement led to Federal Reserve involvement to ensure stabilization (the “managed float”) (Guttman” 1994: 350-1). Speculation had forced changes.

Restructuring

In order to understand the process of restructuring it is necessary to step back from the 1980s. By the time of the 1970’s deregulation of exchange, years of growth of “large private international capital flows” had already taken place (as states loosened control over private enterprises in the 1950s, as mentioned earlier). This flow meant that

¹²⁰ The Plaza Agreement of 1985, by the Group of 5 (US, Germany, France, Great Britain and Japan), was a strategy to intervene in currency markets to devalue the dollar via interest rate decreases. Meant to step in and depreciate in an orderly manner, rather than leaving the depreciation to speculators, the devaluation (by mid-1986) had gone so far as to revive both fears of inflation and speculative dollar dumping. This led to the Louvre Agreement of February 1987, by the Group of 7 (Canada and Italy added), to stabilize exchange rates. This was a repetitive and expensive process and eventually ineffective as domestic priorities of member nations dissolved the accord. According to Guttman, “since then, international economic cooperation has gone adrift” (Guttman, 1994: 314-315 & 380-382).

financial markets (of the industrial nations) grew without government planning and led to the establishment of unregulated money markets which hampered states' use of monetary instruments (Krause, 1973: 174-5). This "Eurodollar" market got its start in the late 1950s when the excess outflow of US dollars led European banks to "accept dollar-denominated deposits and loans" (Guttman, 1994: 141). Since regulations by national authorities generally only control deposits in their own currency, and the US had no control over dollar deposits in other countries, a basically unregulated market in short-term money developed. There, it was possible to get higher rates of return on money (Kindleberger, 1970: 172-4). The establishment of the European Economic Community in 1957 also contributed to the acceleration of the internationalization of capital (van der Pijl, 1984: 238). Strategic use of this market by the Soviets who held dollars, as well as by those US multinational firms fleeing possible capital controls at home, increased the market's growth (Kindleberger, 1970: 172-4).

The float and the privatization of international lending arrangements also brought important institutional changes at the international level. Indeed, Federal Reserve Chairman Volcker's 1979 switch to higher interest rates was "heavily influenced by the new [private] international financial system" with its huge and unrestricted reserves¹²¹ which eclipsed those of the IMF (Lash & Urry, 1987: 206). The power of the IMF was weakened and then altered as it became a *partner* with "private sector banks" forcing the restructuring of less developed countries [LDCs] in the 1980s (Llewellyn, 1986: 20-1).

¹²¹ Internationally the change to flexible rates in '73 and the occurrence of competitive devaluations to gain markets, led to the "explosive" growth of "private international dollar liquidity" [my emphasis]. Deficits were now financed in the growing capital markets, swelling them even more. The circuit of "finance" capital in the Atlantic region was thus increased by bank capital after the liberalization that had occurred (van der Pijl, 1984: 262-3).

By the close of the 80s, a system of “regulated competition” had all but completely replaced the New Deal banking structure. The Fed had sharply increased interest rates in 1979, and by 1980 mounting pressures forced the enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) despite citizen “distrust of concentrated financial power” and the political clout of those with vested interests in maintaining the status quo. This deregulation of interest rates¹²² turned them over to the market by slowly withdrawing Regulation Q deposit ceilings, ending geographic as well as product restrictions for thrifts, raising FDIC insurance to cover \$100,000 deposits, and allowing commercial banks to offer NOW¹²³ accounts (Vietor, 1994: 22-23).¹²⁴

¹²² There is a strong connection between the deregulation of exchange rates in 1973 and DIDMCA, the deregulation of interest rates in 1979-1980. Both represented shifts from government-regulated to market-“regulated” prices of rates. Both rates control the price of money. Exchange rates give the external (international) price and interest rates the internal (domestic) price of money. The deregulation of exchange rates led to increasing volatility in currency exchange prices (with the added effect of systemic instability which attracted speculation). In an attempt to stabilize that volatility, the U.S. was manipulating domestic interest rates by the end of the 1970s—a losing game. It was Keynes who insisted that international exchange rates should be stabilized in order to keep domestic interest rates stable and under the control of national governments (to secure full employment). That was the basis for the postwar international monetary regime under which stabilization had been achieved. Throwing exchange rates to the market also meant loss of control over the internal price of money (Wachtel, 1995: 39), and by implication loss of control over the nation’s economic growth and employment.

¹²³ A NOW account, or Negotiable Order of Withdrawal account, is not technically a checking account, though like one, since it gives interest and the bank can place a hold on the account (Shafritz & Oran, 1990: 332).

¹²⁴ This did not stop a wave of bank failures during the 1981-82 recession attended by high interest rates. The Congress passed the Garn-St. Germain Act in a panic response to those failures of the second recession. The passing of DIDMCA and the Garn-St. Germain Act led to increased competition as financial institutions fought to attract depositors and borrowers, but as prices fell costs were passed on to the customers. Savings and Loans/Thrifts took over when commercial banks cut back on loans because of the worsening condition of their oil and LDC loans. They went on a lending orgy knowing that federal insurance would back up deposits. From 1983 to 1987, credit flowed freely from S&Ls into markets no one else would serve. The ensuing S&L crisis would eventually be paid by taxpayers to the tune of at least \$300 to \$400 billion. Consolidation of failing institutions led to the end of interstate restrictions (an end to the McFadden Act of the New Deal) and the presence of huge money center and ‘super regional’ banks (Vietor, 1994: 22-23).

These deregulations added to the growing clout of financial capital. The dominance of nonproductive (financial) capital appears to be found in contracting (“defensive”) economic periods, while productive (industrial) capital is related to periods of economic expansion (capital on the “offensive”). According to orthodox economic theory, financial, or nonproductive, capital would thus have the transitional job of accumulating capital in its money form so that when new technical means are introduced investment funds will be available. According to van der Pijl, financial capital is also more strategically functional for restructuring capital and production (1984: 278). The dominance of any one fraction of capital means that a greater share of profit and power is distributed to that fraction. Thus those whose income is dependent on dividends, interest, etc. ascended to power in the 1970s (the rentier revival), accompanied by a shift away from the welfare state and toward the market and orthodox liberalism (van der Pijl, 1984: 278 & 285). This meant that a redistribution of wealth, which is one piece of the overall process of restructuring,¹²⁵ took place through the 70s and 80s. The “trickle down” propaganda of the 80s was useful for a time in hiding the fact that wealth was being ‘pumped’ to those at the top, but its deception became glaringly apparent with the 1996 publication of the extraordinarily increased gap between the rich and the poor in the US (Henwood, 1997:64-66).

With financial capital leading the restructuring process, we should expect to find other structural, as well as political and ideological, shifts occurring. One such thrust of restructuring, which can be explained in part by a shift to nonproductive capital, is

¹²⁵ The shift to financial capital led to a particular form of restructuring that featured an attack on labor. Restructuring in the 1930s, on the other hand, was accomplished with an alliance of business, government, and labor.

privatization. This is an umbrella process covering the reduction of state intervention and ownership in the economy and the increase of private ownership set free from government regulations. Basically an institutional alteration of the economic structure from socialized to market-directed, privatization leads to changes in the political and social structure (Krusselberg, 1994: 283-4). Privatization may be championed by those who feel they will get a bargain in denationalized businesses, and it may be driven forward by the fiscal crisis of the state, the debt crisis, and middle class tax revolts of the late 70s (Kolko, 1988: 239-240); but it is also a frontal attack by the financial fraction of capital.

According to Trajtenberg and Vigorito, it is capitalists with mainly transnational interests who are the flag wavers of liberalization of trade and “privatization of the world economy” (1983: 220-221). Privatization is thus strongly linked to the internationalization process (Willoughby, 1985: 310). In terms of the desires of financial capital, privatization of countries other than its own means that money can be invested in, by financing corporate purchasing of, those firms that move from the public to private arena. Domestic privatization serves this purpose also, but it also reduces government spending and thus government taxation (and government borrowing). It increases private borrowing (for purchasing newly privatized firms). This more recent phase of internationalization has set up a new historical context in which privatization is occurring on both national and international levels.¹²⁶

¹²⁶ Correspondence with Dr. Roslyn Bologh.

Crisis And The Growth Of Speculation

Unparalleled, relentless, and extraordinarily heavy speculation, which had been curbed in the second half of the 1940s and through the 50s, returned in 1960 and remained throughout the decade. This speculation, occurring within the still viable Bretton Woods monetary system, represented a struggle between government and private banks for control of that system. Moffitt regards the total mass of speculation during 1972-73 as the “midwife in the transition from a government-dominated regime to a market-oriented one” (1983: 71-76). The struggle over control of international finance between public institutions and the private market was won by the private market, using speculation to batter fixed rates and force the float (Webber & Rigby, 1996: 28). The biggest stimulant to increased currency trading and speculation was Nixon’s move to floating exchange rates in 1973. Henceforth, currency values would fluctuate according to supply and demand in the marketplace, with the values of more than 100 currencies moving around in response (Moffitt, 1983: 136). Public power had declined in relation to private; a new cycle had begun.

The decade of the 70s’ was a boom time for the growth of the “first global money market.” International banking expanded over 25 percent annually—side by side with the slow down in global production (stagnation) (Moffitt, 1983: 217). Ironically, it was those capital controls (mentioned earlier) instituted by the US in the 60s (to stem the outflow of dollars) that had led to the growth of that virtually unregulated Eurocurrency market. Lending by international banks grew three times as fast as world trade and almost five times global production. Direct investment by producers fell as financial investment grew and by late 1989 the private capital market far outpaced the reserves of central banks

(Webber & Rigby, 1996: 27-29). Webber and Rigby do not spell out the types of lending and investments by banks, except to say that “foreign capital was purchased at bargain prices with an inflated dollar” (1996: 28). Thus, this was currency trading, money market speculation, rather than investment in, loans for, production.

Michael Moffitt details this growth of speculation. The volume of currency exchange¹²⁷ went from about \$25 billion in 1970 to \$110 billion by the end of 1973 (1983: 83). By 1977 this turnover amounted to \$50 trillion while world trade volume was about \$2 trillion. Trading in currency far surpassed trading in gold, silver, and oil (Moffitt, 1983: 136). Between 1967 and 1978, as estimated by Robert Aliber, global speculative *profits* amounted to \$12 billion net (Moffitt, 1983: 78). In 1979 a speculative run on a weak dollar and a switch to gold by both corporations and banks led to a dramatic drop in the dollar’s value and Volcker was forced to raise interest rates¹²⁸ (Moffitt, 1983: 169-171). For Moffitt, then, Paul Volcker’s move was due chiefly to the “growing chaos in the international money markets rather than the problem of domestic inflation, though the two were obviously interrelated.” More important than inflation was preserving the dollar as the universal currency, but decision making had already been turned over to the market (Moffitt, 1983: 196, 215). Thus, what has been heralded as a political and economic benefit (the switch to market “management”) was in reality a surrender to the forces of crisis and speculation.

¹²⁷ This volume of exchange is market turnover.

¹²⁸ It is interesting that the two major changes of the 1970s, Nixon’s float and Volcker’s interest rate rise, were both connected to speculative attacks.

By the early 1980s some corporations themselves had gained enough expertise to speculate in currency for profit. Dow was an early speculator, and since it credited and distributed its speculative profits to its treasurers there was an incentive to increase the speculation. A Dow treasurer stated that money was being used as a raw material to make more money (Moffitt, 1983: 137-139). Though multinational corporations had been involved in the currency speculation that brought down the monetary system of Bretton Woods, they tend to deny that they engage in speculation (it is bad public relations)—using instead “euphemistic terminology...[such as]...‘hedging risks’...or ‘serving clients’ currency needs” (Moffitt, 1983: 77-78). After the 1982 crisis of foreign lending (the debt crisis from loans to the Third World), bank loans switched to providing funds for “every form of corporate speculation and merger movement” (Kolko, 1988:104).

During the 1980s, currency futures trading grew as a source of profit *separate* from industrial profit for both banks and corporations and illustrates the switch to investment in financial capital. Stephan Schulmeister (1987) found that markets for foreign exchange became “speculative circuits” when exchange rate volatility grew with the start of the float in 1973 (as cited in Guttman, 1994: 503, n17). By the 1980s, Guttman asserts, speculation “became a permanent activity and deeply embedded in the structure of our economy” (Guttman, 1994: 301). An important issue is Guttman’s (along with Schulmeister’s) finding that banks and corporations have shifted their investments into financial assets and highly speculative trading in currency futures as a profit center separate from industrial profit. This ties together the growth of financial capital, the process of deregulation, and the shift in investment priorities. The issue of

investment and speculation cannot be separated, of course, from the issue of the underlying crisis.

The growth in the volume of currency trading over the past 30 years has been mainly speculative; the proportion that is actually due to real business needs for foreign currency is estimated to be between 5 and 10 percent of the total. Beside currency speculation, Hamilton states, “Bits of paper have now been introduced to speculate against other bits of paper, and one type of borrowing has been crossed with another to produce entirely different [financial] products.” Trading in futures based on stock indices (wholly theoretical) made up 98.7% of the total \$7.9 billion traded on the New York Stock Exchange on a record day in August 1984 (Hamilton, 1986: 50-51). By the early 90s, Hargrove found that “seven out of eight dollars that crosses international borders is now linked to speculation rather than facilitating economic activity” (Hargrove, 1995: 7). What has made this possible physically, is the technical advance in computers and communications; what has given it freedom to operate, is deregulation—the “liberalization” of capital and financial institutions, the internationalization of markets, and the removal of regulatory boundaries between markets and instruments—deregulation from the float to domestic banking. The freeing of capital movements and exchange controls led to a change in investor behavior from long-term productive and rentier investment to rentier speculation and protection of funds. As investors began to shift their money geographically, innovative techniques and instruments sprung up (Hamilton, 1986: 52).

By the late 70s and early 80s, banks were “highly leveraged” and their “potential exposure” to each other’s problems grew with the growth of interbank loans (banks

loaning to banks within the Euromarket) (Moffitt, 1983: 224-5). At this particular juncture, there were fears that the Feds might not be able to come to the rescue in a major banking crisis and Kindleberger had called for “a strong international ‘lender of last resort’” (Moffitt, 1983: 226-7). As early as September 1982 Woljnilower (then First Boston’s chief economist) was concerned that banking deregulation in an institution addicted to borrowing, gambling, and “asset-price speculation” would lead to crisis. The greatest danger introduced from banking deregulation is the close linkage among multinational banks through the “Eurocurrency interbank market.” Though smaller bank failures are likely to be endured without too much spread of crisis to others, failure of big banks could reverberate throughout the system. It was international currency speculation which caused the failure of the two major banks, mentioned earlier—Bankhaus I. D. Herstatt of West Germany and New York’s Franklin National Bank (in 1974) — educating the world on the dangers of linkage through this market (Moffitt, 1983: 90). This explains the emergence of the governmental crisis management policy of supporting banks “too big to fail.”

There was additional danger brought by the multiplying “speculative instruments, such as financial futures” (Moffitt, 1983: 242-3). Derivatives were one such speculative instrument. Calls for rudimentary standards to oversee derivatives did not emerge until a 1993 publication, and this came from international initiatives. Not until 1996 did a “harmonized regime of international standards for the regulation of derivatives activities” emerge (Cornford, 1996: 505). The Orange County bankruptcy occurred a year after the first proposals for regulation. But the previous decade of the 80s, and particularly the period of the Reagan administration, had been characterized by an “explosion” of

speculation enhanced by technological development (Cleaver, 1995: 166-7). Thus, the need to profit from surplus capital that could not be invested, and the deregulations in currency and banking may have contributed to the expansion of a new norm for economic behavior—speculation as superior to productive or prudent investment. Calls for regulations are then like spitting in the wind.

Perhaps all of these details may obscure a few broader issues. While the cause of this momentous change can be located in a global economic crisis, using one analysis of the origin of crisis or another, it seems to me that Webber and Rigby's explanation best explains the flood of money and the choice of speculation. The growth of surplus capital due to declining investment in production and the subsequent fall in profit leaves capital without a productive place to go. This generates the means with which to speculate. We can also add that the elasticity of credit money allows for greater liquidity. Innovations in financial instruments and technological developments provide better methods. Credit instruments and leveraging broaden the capacity to exploit fluctuation, while electronic transfer speeds up the transfer of money.¹²⁹ While there is never a dearth of opportunities for speculation, the lively fluctuation of various rates created by deregulation expands the domain. It is within this new environment that Orange County Treasurer, Robert Citron, was convinced of the value and correctness of speculating with public funds.

¹²⁹ The 1980s financial innovation, extending the use of futures contracts for commodities to indices, currencies, and stocks, had the effect of creating an additional speculative mechanism and multiplying the value of trading in futures far beyond actual trading of stocks, bonds, and currency (Hamilton, 1986: 72-74). By the mid-eighties financial innovations, "products" as they are called, brought greater opportunities to gamble without investing your own capital. "Stocks and bonds in high-risk companies virtually tripled between 1980 and 1985, and sales of real estate trusts rose sixfold." The higher returns helped the switch from investment to speculation. "When productive investment stalled, currency speculation became an important source of profits (Kolko, 1988: 79).

While both international and national financial institutions and regulations were thus going through such momentous changes, crisis was also affecting other US domestic institutions and processes. Orange County did not escape the consequences of economic crisis.

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CHAPTER 3: CAPITALIST CRISIS, RESTRUCTURING, AND SPECULATION: THE NATIONAL AND LOCAL CONTEXT

National Level Effects On Orange County

It has already been mentioned in Chapter One that Orange County, as a California county, was suffering from high property taxes along with inflation, and that this had led to the local invention of Proposition 13—a limitation on taxation. This, however, is not independent of crisis-related international, national, and local changes.

Restructuring within the United States, beginning in the early 1970s in reaction to the economic crisis, was accomplished through a series of specific decisions made by national industries and the government. If the goal is to reinstate growth in a crisis environment, the state will attempt to set up conditions conducive to its recovery (Kolko, 1988: 188). Government action/reaction did indeed occur (though not without contradictions). Restructuring comprised many industrial changes: regulatory and other policy alterations, fiscal and financial experimentation,¹³⁰ regional shifts, and reactions to these transformations. Choices were made to move the economy as closely as possible to complete dependence on “steering” by market forces (the mythic “invisible hand”) and away from the managed solution of the New Deal.¹³¹

¹³⁰ Joyce Kolko considered monetarism in the US and Great Britain to be experiments to alter economic conditions (1988: 11).

¹³¹ The notion that an economic system can function without planning is clear in the Liberal expression “laissez-faire,” but it was Durkheim, a sociologist, who spoke of the importance of planning, or steering, the economy for the benefit social aims (Durkheim, 1947: 253). Habermas has written that steering

Despite the systemic nature of this crisis of capitalism, high labor costs were singled out as *the* root cause of inflation (Kolko, 1988: 18). State support of labor and labor's participation in market regulation is a policy capitalism will only support in times of growth—so labor becomes the scapegoat in crisis (Kolko, 1988: 188). This ploy was the ideological prop behind calls in the 1980s for the elimination of New Deal wage indexing,¹³² allowing the growth of unemployment above levels previously agreed upon, the piecemeal reduction of the welfare system, and reducing the regulation of business—all major policy shifts (Kolko, 1988: 53). Along with this, financial markets were deregulated and privatization of previously nationalized or subsidized sectors was demanded.

Transnational corporations (TNCs)¹³³ had emerged as a significant corporate form in the 1960s (Kolko, 1988: 80),¹³⁴ but much of the relocation of production in the 1970s was not branching or growth; rather it was part of the attempt to resolve economic crisis. Policy decisions helped to make this relocation possible. For instance, the number of maquiladoras (assembly plants along the Mexican border with the US) reached 1,800 by

problems (“structurally insoluble system contradictions”), which are highlighted in crisis, allow us to make an economic analysis into a sociological analysis. That is, systemic contradictions which are visible in crisis “unmask[ing] the opposition of social classes, ...provide[s] a practical critique of ideology of the market’s pretension to be free of power” (Habermas, 1973: 29-30)—somehow mysteriously guided by a *classless* invisible hand.

¹³² Wages were adjusted to changes in the prices of a bundle of goods (price index) (Pearce, 1989: 196, 338).

¹³³ Which are “centrally commanded transnational producers of component parts seeking production sites with the lowest costs” (Kolko, 1988: 80).

¹³⁴ Perhaps we can see this as part of what Alain Lipietz has called “global Fordism,” or the move of Fordist processes to the global level (Lipietz, 1987).

1965, but they grew to full-scale manufacturing plants when tariffs were reduced on transport of goods to the US in the early 70s.¹³⁵ Before relocation these plants had employed US workers who now found themselves on the unemployment line (Bartlett & Steele, 1992: 35). According to Kolko, 1976 was the year that governments began to shift from worrying about unemployment to worrying about inflation (Kolko, 1988: 32). Yet, transfer out of the US was not the only form of relocation. There also occurred plant shutdowns in the northeast and Midwest and their removal to cities in the south and southwest—the Sunbelt gaining what the Frostbelt lost (Bluestone & Harrison, 1982).

Frostbelt to Sunbelt

As the postwar boom was ending and foreign competition from cheap imports increased, the traditional northeast-Midwest manufacturing belt (Frostbelt) of the US began to break apart. Whether it was due to high fixed capital investment, the decrease in investment in research and development (Cohen & Zysman, 1987: 132ff),¹³⁶ or the ensuing stagflation, a squeeze on profits in many production sectors occurred. The new Sunbelt industrial centers, which developed over the '70s and '80s, are part of the geographic reorganization of American production. They brought about changes in urbanization patterns and shifts in power on the political as well as the cultural level

¹³⁵ In another instance, the creation of subsidiaries of American manufacturing plants grew substantially when the 1976 Tax Reform Act amended regulations to allow for the transfer of profits from external subsidiaries to parent companies in the US (Bartlett & Steele, 1992: 95).

¹³⁶ Cohen and Zysman argue that the decrease in R & D for innovation for technological advance, that was occurring in the US even before the crisis, is linked to falling productivity. When this occurs, wages come from profit—thus a profit squeeze occurs. They propose that, as their title states, “manufacturing matters.” A recent book by Fingleton proposes that the information industry can not take the place of manufacturing as the “key to future prosperity” (Fingleton, 1999).

(Scott, 1988: 10-13). Overall, though, manufacturing jobs have shrunk in both areas, with the Frostbelt contracting more (Scott, 1988: 15). Part of the Sunbelt growth was from the branching of older plants, but autonomous high-technology manufacture was growing as well (Scott, 1988: 12). This national relocation was not deurbanization, but “reorganization and restructuring” (Scott, 1988: 25). Orange County is a prototype of this change (Scott, 1988: 160).

The Frostbelt environment had always had strong minority mobilization, an impressive supply of social service programs, unions for municipal employees, patronage, and an anti-businessman bias. Over the years municipal jobs had replaced private sector jobs, and taxes had to be raised to pay for these jobs. However, when local businesses started feeling the pinch on their profits those higher taxes led to increased uprooting of business from the Frostbelt (Sbragia, 1983: 2). The Sunbelt had attractive weather, lower levels of taxation, and a welcoming business atmosphere for those migrating. The Sunbelt has historically resisted unionization (especially of the public sector) and been adverse to public aid for the poor or minorities (Sbragia, 1983: 3).

Prior to Ronald Reagan’s election the uncomfortable pressures on both belts were handled by infusions from the federal government (part of Nixon’s New Federalism, explained below) (Sbragia, 1983: 4). From the 1960s and up to 1976, areas of growth were given more aid by the Federal government than were declining cities (Sbragia, 1983: 19). This aid allowed cities such as Phoenix and Houston to help their huge population in poverty (poverty due to low wages). It was in 1975, during the New York City fiscal crisis, that President Ford refused to aid the city (Tabb, 1982: 27). Later, during the 1976-77 period of block grants, political decisions led to more funds going to

the declining areas. Carter continued this with his policy of rehabilitation. Officials of the growing Sunbelt organized to fight back (Sbragia, 1983: 18-19). The Sunbelt argued that the poor were the responsibility of the Federal government, while the Frostbelt contended that local governments which are prosperous ought to be obligated to help (Sbragia, 1983: 21). Voters began the squeeze on local spending in 1978—also the year in which federal spending on local and state governments peaked and began its decline (DeGrove, 1984: 353). In the early 1980s, Reagan severely cut back the funding for “sewage systems, waste water treatment systems, mass transit, economic development projects, and other programs dispensing federal grants for capital facilities” (hurting growth areas in particular) (Sbragia, 1983: 21-22). This cutback, while destructive, damaging, and dangerous in the long term to all (but notably to urban areas with deteriorating facilities), was disastrous in the short term to the newly growing Sunbelt, where funding for new building of capital facilities was needed.

In the context of a restructuring that hit the working class especially hard as manufacturing accepted the Sunbelt’s promise of low wages and no unionization, Reagan slashed federal aid growth. With these cuts, voter pressures against spending by states, the taxpayer revolt against climbing property taxes, and continuing high levels of social service requirements, local officials in the 1980s continued to be battered by “contradictory pressures.” Reagan’s *new* New Federalism (discussed below) meant that federal aid to localities was decreasing on the one hand, while cuts in federal aid to the poor increased the pressure on localities to supplement program assistance for the poor (Sbragia, 1983: 4). Orange County was no exception to this policy and illustrates the predicament that all local officials felt. An increasing population seeking jobs, tax relief,

and services negatively impacted parts of the Sunbelt. Especially unfavorable was the shift of federal funds away from the Sunbelt in 1976-77 (Sbragia, 1983: 19). This last policy increased taxes for local taxpayers burdened by spiraling inflation which had steadily depreciated non-union wages and the fixed incomes of large numbers of homeowners—the retired. Californians reeled with unusually large and rapid property tax increases (Gayk, 1991: 284, 294; Jorion, 1995: 12).

Taxpayers' Revolt And Proposition 13

For California and the rest of the Sunbelt, that 1976 switch of funding toward declining cities was a turning point. California, specifically Orange County, became the birthplace of the taxpayers' revolt two years later. While restructuring had severely impacted both belts, it was perhaps the Sunbelt's (and Orange County's) political culture that made it likely that this revolt occurred first in a Sunbelt state. As Sbragia puts it: "the South and West are suspicious of government intervention to help minorities and the poor, [and] hostile to taxation." For Sbragia, the Frostbelt's ability to respond to the changes induced by restructuring had been limited by prior decisions of its officials (in New York City, for instance, the misuse of borrowed funds). For the Sunbelt, it was political culture, including attitudes toward business, unions, and individual or collective means of problem solving, which limited their competence to deal with restructuring moves (Sbragia, 1983: 3).

The Jarvis-Gann initiative, or Proposition 13, appeared on the California primary ballot of June 6, 1978 (Gayk, 1991: 282-4). Property assessment taxes were limited by Proposition 13 to "1 percent of the market value of property," and any increases

following the initial assessment could rise no more than 2 percent. This widely supported proposition drastically changed the funding of local government (Gayk, 1991: 284-5).

Local Sunbelt governments which had been plagued with contradictions between federally mandated service programs and declining federal funds to pay for them, and hit with problems of growth in an economic downturn, were now squeezed by voters.

Proposition 13 was a revolt of homeowners, businesses, senior citizens on fixed incomes, and conservative voters in general, but the effects were spread broadly. Cities and school districts were hit the hardest when the tax cut went into effect, but it was landlords and business property owners who gained the largest tax abatements. Homeowners lost some of their tax relief since they now had to pay more state and federal taxes (due to lower deductibles) (Pfiffner, 1983: 50-1). In addition, since homes are sold more often than businesses, reassessments occurred more often for homeowners. Thus a reversal occurred in who paid the greater percent of property taxes. In the year before Proposition 13 passed, businesses paid 57 % and homeowners paid 47%. The year after, the percentage reversed and the gap widened thereafter (Pfiffner, 1983: 53). This does not mean that homeowners did not gain, but the greater burden shifted mainly downward and to tenants (Hirsch, 1983: 52-58). Interestingly, tax limitations led to the reverse of what proponents had wanted. Instead of giving more power and autonomy to local government, the limitations made locals more dependent on higher levels of government. Thus, centralization of power was actually increased (Pfiffner, 1983: 56).

The passage of Proposition 13 illustrates the way local tensions develop when attempts are made to deal with and shift the costs of crisis. It was restructuring, with its great industrial and population displacements and pressures to raise taxes, which had led

local governments to raise taxes on property owners. Owners struck back against municipalities and forced changes in government financing. In Orange County, as noted above, voters already had forfeited much of their control as decisions were transferred to appointed officials.

At first, the expected large cutbacks in local services did not occur. The California state government allocated monies from its surplus to restore those funds lost by the tax cuts (Pfiffner, 1983: 51). It was not until the surplus ran out in 1982 that the tax revolt effects really hit. The state was showing a \$1-2 billion deficit at the fiscal year halfway mark, and the mood changed (Pfiffner, 1983: 53). Inefficiencies increased due to across the board cuts to government departments¹³⁷ (Hirsch, 1983: 58-62). When the crunch hit local government in '81-'82, new ways to improve efficiency and increase revenue were sought. According to Werner Hirsch, these "competitive pressures" are beneficial since they "tend to make production more capital-intensive, persuade workers to be more productive, procure nonlabor inputs at lower prices, seek to hold down the wage demands, and explore new technology" (Hirsch, 1983: 64). This view would not find favor among workers, but as Allen Scott found, Orange County industrial organization had already done just that in the private sector.

¹³⁷ For example, it was found that "after the passage of Proposition 13, attrition was abnormally high in California's local government health services. As a result of low salary levels, increasing caseloads, and lower organizational morale, the younger and better qualified employees were leaving in record number, and there were problems retaining good managers, planners, and skilled clerical employees. Those whose skills were most in demand and most easily transferable to the private sector left first" (Pfiffner, 1983: 60). Public employee layoffs resulted in the worst workers remaining. Jobs for minorities, who traditionally climb the ladder through public employment, shrank. Union opposition was expected to increase, and the hoped for modernization of industry would be hurt because newly-built plants face higher taxes than older plants (Hirsch, 1983: 62-63).

Support for the 1978 Proposition 13 had been higher in Orange County than in the rest of California. Even though nearby counties supported sales tax increases in order to improve transportation, Orange County said “no” (Gayk, 1991: 287). The consequence of this proposition was a “fiscal squeeze” which hit Orange County especially hard since they were a rapidly growing county (Jorion, 1995: 13). Twenty-three states enacted fiscal limitation measures between 1970 and 1980 (Pffinner, 1983: 37), but the squeeze was not over.

New Federalism

By the early 1980s, legislation pushed by the tax revolt, plus the promised cuts of Reagan and a slowing economy, began to hurt all but a “few energy-rich states.” Reagan’s block grants for funding would go to the states, but the level was cut. This switch to state-level funding set up tension between states and those large local governments which felt that state priorities would not help their areas. Local governments, overly dependent on property taxes in a time of tax revolts, had to switch to reliance on both the state and federal government for their funds. Matching grants from the federal government to localities may be appealing, but they require local fiscal input and also tend to stimulate increases in services which add new costs (Pffinner, 1983: 43-45).

Proposition 13 was a fiscal control on local governments and, according to Swartz and Peck, represented a new fiscal conservatism that spread to the federal level (Swartz & Peck, 1990: 9). The growth of the federal operational budget and continuing deficits had already led, by the end of the 70s and the beginning of the 80s, to a call for a

reduction of funding for state and local governments. President Carter had attempted to help declining cities in traditionally Democratic industrial regions, but world economic stagnation and the tax revolt doomed his policies. Carter had to shift “from revitalizing cities to revitalizing business and industry” (Hill, 1990: 39). Carter, in his 1980 budget, introduced austerity objectives, but Reagan slashed funding far more. Reagan’s New Federalism placed responsibility on localities while legislating spending cuts throughout. Control over spending was to be in local hands, but they would have less to spend (Swartz & Peck, 1990: 10-11).

Though formally voted down and not fully carried out, Reagan’s New Federalism took hold anyway. The greatest burden fell on cities. “Where legislated property tax controls remained, local governments found themselves squeezed from both ends—both internal and external traditional sources of funds were increasingly restricted.” Both Nixon and Reagan had responded to localities, but under Nixon the federal government had shared costs; under Reagan it did not. The removal of compensatory measures that had once offset local and state inequalities meant that “competitive federalism” operated. Thus the way in which public services were provided had changed (Swartz & Peck, 1990: 12-14).

That government should be as efficient as a business was an oft-quoted sentiment of the times. But should government be run like an enterprise? In a response to the Orange County bankruptcy, Public Administration Professor, H. George Frederickson said “no.” Frederickson believes that the prevailing view that governments should compete, take risks, and earn money “was destined to result in something like the Orange County investment scandal.” He emphasizes the principle that “the primary responsibility

of public officials is to vouchsafe the legitimacy of democratic government in the eyes of citizens,” not put that at risk (Frederickson, 1995: 9). Competitive federalism meant that some localities would perish, others grow. The public sector structure would evolve and services pared or raised based on market success. Thus, it is market-driven government (Swartz & Peck, 1990: 4).

Why New, New Federalism?

The shift of fiscal responsibility may be seen as a general feature of Republican decentralization; but, it was the awareness of a major economic downturn which led to bipartisan moves to promote national competition and shrink federal government costs.

Reagan’s policies did have their contradictions. The tax rate was cut, but hugely increased military expenditure resulted in a rising deficit. Funding to states was cut, but not responsibility for carrying the weight of social programs. Government was decentralized¹³⁸ while robbing state officials of discretion by strengthening regulations that held them in check (Kaplan & O’Brien, 1991:9). The switch to this form of New Federalism came at a time when states were financially insecure, yet a most disastrous assault was avoided by some restoration of funding by the federal government, and a somewhat better economic position in ‘83 and ‘84 (Kaplan & O’Brien, 1991: 1-15). In 1987 the market crashed. In the early 1990s a recession hit.

Hill argues that these changes in the relations between the levels of government were “connected to a shift in domestic government priorities from social welfare to

¹³⁸ Kaplan and O’Brien state that actual “actions taken during the 1980s ran counter to the theme of decentralization implicit in New Federalism” (Kaplan & O’Brien, 1991:9).

economic growth.” Though he finds Reagan’s New Federalism (with its aim of dismantling the welfare state) to be an important cause of this shift, he finds that global economic changes and the new competition in the international arena (with declining hegemony for the US) to be more important. “It is global economic change, more than anything else, that has pressured for a realignment of priorities in the US federal system.” The fall in productive growth, the decrease in the rate of profit, and the outflow of capital has brought a conservative reaction to the social and regulatory policies of the 60s and 70s (Hill, 1990: 35).

It is within this environment of restructuring (the Frostbelt-Sunbelt effect, the squeeze on local finance, and the changes in the structure of federal funding and separation of powers) that the Orange County bankruptcy occurs. While this restructuring and the reaction of one local treasurer, attempting to solve fiscal tightening, might seem sufficient to explain the bankruptcy, the story behind the story does not stop there.

The Switch To Financing

We have seen how changes at the local and state level are connected to decisions made by industry and government in response to economic crisis. We have looked at the movement of both fiscal and political control. But Citron’s actions involved financial investments. When tax monies are not available and the squeeze is on, public debt¹³⁹

¹³⁹ It is interesting that the very conservative forces that forced the shift to public debt at the local level, through their tax resistance, are opposed by the views of Hume, Smith, and Ricardo. All three opposed public debt and preferred tax revenue, based on their belief that the issuance of public debt for financing leads to a decrease in investment, while tax financing leads to a decrease in consumption. In particular, Ricardo criticized public debt as blinding citizens to “unproductive public expenditures,” since citizen focus is switched to the growing burden of interest payments. Adam Smith saw public debt as a transfer from productive to nonproductive interests (Andel, 1986: 2-5).

becomes a major source for local government expenses. The question of when debt is appropriate is a matter of considerable debate, but it is the speculative manner in which debt was handled that concerns us here.

When Proposition 13 passed in 1978, the global economic crisis and the fiscal crisis of the states was being felt at the local level across the US. The chaos, the volatility of the market in a time of crisis, carried an implicit danger that was understood by most officials. That danger was loss of credit. When crisis hits the local level, lenders to city and county governments are not concerned, according to Sbragia, whether that government is “providing for its poor, trying to reduce inequality, or providing avenues of political participation.” Lenders want to know whether the economic base is healthy, what kind of gap exists between revenue and government spending, and what the cash flow is.¹⁴⁰ In response to a choice between its constituents and lenders (who may deny credit), local officials generally choose the latter (Sbragia, 1983: 101). With housing now seen as an investment, homeowners echo this lender’s logic. They see local government as the upholder of a “financial enterprise,” rather than “a dispenser of services” (Sbragia, 1983: 102).¹⁴¹ It is in this intersection of global crisis, restructuring of industry and government, taxpayer revolt, local elite changes, loss of local control, and the need for local governments to turn to lenders, that the seeds of the Orange County bankruptcy were sown.

¹⁴⁰ Following the 1975 New York City fiscal crisis, municipal borrowers began to be more rigorously examined by lenders (Sbragia, 1983: 3).

¹⁴¹ Whether this view of Sbragia is correct or not is open to question. It could be that their response is a reaction to taxation.

During periods of interest rate volatility, such as the late 70's/early 80's, municipal bonds (and other bonds as well) do not sell readily (Sbragia, 1983: 109n 56).¹⁴² Yet, this was the time (with tax limitations and aid cutbacks) that they became most indispensable. In order to make bonds more attractive (and profitable for buyers) it was necessary for sellers (governments) to pay substantially higher interest. Thus, government debt service dollars were now heavily involved in paying interest rather than repaying principal. Out of this situation came innovative instruments for long- and short-term borrowing to assist both sellers and buyers in a period of uncertainty (Hamilton, 1983: 22). One such innovation was the floating, or flexible, interest rate bond¹⁴³ which varies according to the rise and fall of interest rates. Not surprisingly, the floater is an attempt to stabilize risk when interest rates are volatile (Hamilton, 1983: 25). According to Hamilton, these newer "fiscal instruments" began to supplant "traditional general obligation bonds and revenue bonds....no longer always suited to market conditions." Nevertheless, Hamilton warned that benefits must be weighed against risks (Hamilton, 1983: 31). These instruments, plus more to come over the 80s, may have been a response to volatility, but once invented they remained.

¹⁴² "The reason is straightforward. If an investor buys a municipal bond paying 8 percent interest and then [later] has to sell it in the secondary market [at a time] when interest rates are 10 percent, he or she will have to sell the bond at a price lower than that at which he bought it and will therefore lose money. Investors, accordingly, are not eager to buy bonds if they expect interest rates to climb" (Sbragia, 1983: 109, note 56).

¹⁴³ Unfortunately, Randy Hamilton did not supply the date on which this type of bond became available. He does note that one new instrument for public administration (the Zero coupon bond) was not available before 1978 (Hamilton, 1983: 23), and discusses a flexible interest rate bond of the State of Washington issued in 1981. However, he does say that flexible interest rate bond was "an adaptation from the Eurocurrency markets" (Hamilton, 1983: 23), which might mean that it had an earlier introduction.

Interest rates fell from 1982 to 1992. They remained stable until May of 1994, when they began to rise again. Bonds should sell well when interest rates are falling *and* people expect them to continue that fall.¹⁴⁴ Citron was able to buy bonds in this market of falling rates, but he was also using new instruments to gamble (with public money) that the rates would continue to fall. Robert Citron and Orange County got caught when rates began to rise again.

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¹⁴⁴ “When rates are falling or expected to fall, there is an incentive not only to buy bonds to lock in a higher rate of interest, but also to profit from trading them in the future; selling them at a higher price than one paid for them. The higher price is due to their becoming more valuable at a later time when the interest rate on the same investment (bond) is lower. Hence a period of (volatile) declining interest rates leads to increased buying of bonds” (correspondence from Dr. Roslyn Bologh).

CHAPTER 4: SPECULATION, GAMBLING AND CULTURAL CHANGE

The previous chapters have described some of the crisis-driven changes to structures, processes, and practices at the international, national and local level. This chapter moves to the level of group and individual practices and introduces the notion of milieu for understanding alterations in these practices.¹⁴⁵ Milieu is a fuzzier concept than decade, regime, or social structure of accumulation¹⁴⁶. Like its synonym, environment, milieu suggests a sense of flow in contrast to the notion of inflexible borders. The term inflexible is used deliberately here, since there are studies which note the appearance of the concept of flexibility within the time frame of the crisis and link the desire for flexibility to the needs of financial capital (Martin, 1994 & Harvey, 1989). Milieu and flexibility are transitional notions appropriate to what appears to be a transitional period within capitalism.

As shown in the previous chapter, speculation increased over the duration of the crisis. A milieu of speculation, verging on the normative by the end of the 80s and

¹⁴⁵ For Don Martindale, milieu is social structure (Martindale, 1982: v), but since many of the meanings of milieu suggest the transitory (medium, ambience, stage, locale) and social structure suggests permanency—that is, it already exists as a standard, or tradition and will continue to exist for an unspecified length of time—I am not using Martindale’s meaning. For me, milieu is a prefatory; perhaps containing some legislated norms, but also and mainly pervaded with norms in the making. That some may never achieve relative permanency does not mean they do not have their effects in the meantime.

¹⁴⁶ As Gordon, Edwards, and Reich state, “the accumulation of capital through capitalist production cannot take place either in a vacuum or in chaos. Capitalists cannot and will not invest in production unless they are able to make reasonably determinate calculations about their expected rates of return.” An external “political-economic environment” in which production can go forward and accumulation occur safely can be provided by a set of institutions which effect this process. Gordon, Edwards, and Reich title this set of institutions *the social structure of accumulation*. Three core institutions of this structure consist of “the system ensuring money and credit, the pattern of state involvement in the economy, and the structure of class struggle” (1994: 13-14).

interacting with crisis, had been forming since the late 1960s and early 70s.¹⁴⁷ Robert Citron's actions make sense within this milieu—augmenting the explanation of political and financial pressures made earlier. Added to the pervasive practice of speculation, another newly developing norm is emblematic of this milieu: the acceptance of gambling. Both gambling and speculation as developing norms challenged the more traditional notion of the immorality or dissoluteness of both. This milieu is permeated by both speculation and gambling.

Sociological theory asserts that human beings constitute themselves and their society through learning and acting—in fact, that they constitute themselves as recognizably human by learning the previously institutionalized social rules of their society. However, as Mead has taught us, human beings are more than mere copies. They are capable of developing individuality through their interaction with others (Mead, 1962 ed.: 173-178). Thus, we are not a neat process, though socialization is so important. But what of resocialization?¹⁴⁸ Do we tend to accept that which we are already predisposed to and reject new beliefs that compete with our current values? Are we endlessly flexible? Are there forces which compete so successfully with our value system that we begin to accept the unacceptable? One possibility, as shown below in the case of middle-class acceptance of gambling (a normative reversal), is the likelihood that the removal of an honored sanction may make formerly forbidden behavior permissible.

¹⁴⁷ The process may have started earlier, but it is in the beginnings of crisis that it begins to be embraced.

¹⁴⁸ Here we might consider the work done on professional socialization/resocialization (from Becker et al, 1961 and others later) which show mixed results—as do many resocialization programs which attempt to reverse the attitudes and behavior of rapists, child molesters, etc.

David Harvey,¹⁴⁹ using the concepts of the regulation school,¹⁵⁰ notes that if institutional changes bring economic success, or are seen to be unavoidable, acceptance by the general public must be secured. “The problem, however, is to bring the behaviors of all kinds of individuals—capitalists, workers, state employees, financiers, and all manner of other political—economic agents—into some kind of configuration [structure, order, regulation] that will keep the regime of accumulation functioning” (Harvey, 1989: 121). In the normalization of behavior “education, training, persuasion, the mobilization of certain social sentiments...and psychological propensities...all play a role and are plainly mixed in with the formation of dominant ideologies cultivated by the mass media, religious and educational institutions...” (Harvey, 1989: 123-124). Normalization may be accomplished by repealing or altering existing laws. Ideologically, symbols of authority and expertise may promote chosen ideas and practices. Michael Schudson observes that political rhetoric carries substantial authoritative weight and that

¹⁴⁹ I feel that Harvey’s work can be useful as a guide to understanding the ambiguities of historical change and the normative shift toward values that did not exist to any popular degree pre-1970 (e.g., belief in the rightness of gambling). I am not arguing for the primacy of ideas over economic changes; rather, I am arguing for the usefulness of cultural analysis in interpreting the gap between macro and micro changes. After all, if speculation increases as a way of making money, is highly successful for some, and the bad effects are “papered” over, it is likely that views about speculation will begin to change. By papered over, I am referring to journalistic media’s regular propping up of speculation by defining it only as hedging, and their downplaying or ignoring the long-term effects of crashes and speculative fiascoes. Webber and Rigby give a significant and useful analysis, but attempts to place social relations in the context of economic disarray is also meaningful.

¹⁵⁰ The regulation school (Aglietta, 1979; Lipietz, 1986, 1987; Boyer, 1984, 1987 as cited in Kotz, 1994) studies the interrelation of institutional change and accumulation as a process that has economic, political, and (importantly for this chapter) ideological dimensions (Kotz, 1994: 86-87). The term regulation is meant to capture orders, including methods of production (but actually the term encompasses much more than production methods), which become dominant at particular periods and survive because they ensure accumulation (one such order, a controversial one among analysts, is Fordism). However, there are groups within the regulationist school which differ in their analysis and there is strong criticism from outside the school. To fully understand the theory and the various groups’ differences see David Kotz, 1990.

routinization occurs to everyday terms so that they become “what everyone knows” (Schudson, 1990: 117-118).

If there was any figure who carried the message of new and/or revamped old norms to the American people in the 1980s it was Ronald Reagan. (This, it should be remembered, was also the era in which Robert Citron began his speculative activity.) Political pundits and other media personalities may articulate positions that undermine old norms and structures. New institutional practices which favor those who comply, while obstructing those who do not—may result in their further approval among the compliant. These cumulative processes result in a socially created environment, or milieu—a new medium in which we are bathed daily, but which is not assured a long-term existence. If the characteristics of a milieu, seen as a transitional environment, become successfully established, the accepted attributes may disappear from our awareness as they become unreflective normative practices.

Speculation and Gambling

Before considering the development of a milieu in which speculation and gambling are normalized, the meaning of speculation requires clarification. Necessarily, for the purposes of this dissertation, it must be identified in its relation to gambling. Do they only differ by clientele and locations? The debate over the similarities and differences between speculation and hedging and whether or not speculation is gambling has a long history that is not unrelated to changing economic fortunes.

Because of our overly broad general use of the term speculation, John Flynn’s Depression era definition is helpful in narrowing the term: “*Security speculation is an*

operation in which one buys or sells securities with the design to make a profit out of the changes in the market price of such securities” (Flynn, 1934: 4). It can be made more applicable to today’s market by adding the terms currency, interest rate, or speculation based on a changing index. That is, speculation “is an operation in which one buys or sells securities,” *currencies, or contracts* “with the design to make a profit” based on the guess, gamble, or knowledge¹⁵¹ *that security prices or interest rates will or will not change, or that the direction of change of rates or indices will be either up or down.* Flynn has defined speculation as buying and selling price fluctuating securities with profit as the motive.¹⁵² I have added currencies and contracts (such as derivatives). Hedging, though profit may be involved, is *intended* to be insurance against the risks of financial transactions.¹⁵³ This meaning, however, cannot be applied to the major hedge fund gambling which tumbled late in the fall of 1998.¹⁵⁴

¹⁵¹ Recall Jorion’s statement from Chapter One that “forecasting interest rates is a notoriously difficult job.”

¹⁵² Moffitt cites two similar definitions of speculation. The first is from Harry Browne, popular financial writer: “. . . no matter how you try to distinguish speculators’ from ‘investors,’ you’ll probably return to the basic definition that speculation is the purchase of an investment with the hope of selling it at a higher price.” Nicholas Kaldor (as cited in Moffitt, 1983: 78) defines it thusly: “What distinguishes speculative purchases and sales is the expectation of an *impending* change in the ruling market price as the sole *motive* of action” (my emphasis). As general as these are, states Moffitt, they are pertinent to the 1970s’ foreign exchange markets (especially the interbank market). Though their purpose was professed to be the provision of funds for international trade, they became heavily engaged in speculation (Moffitt, 1983: 78).

¹⁵³ The practice of arbitrage is not important for this dissertation and so its difference from speculation is not important here. However, this is mainly the difference between searching for profit from *anticipated* changes in a rate (speculation) rather than from *deviations* between a spread of prices in two different markets, or between the forward and spot-exchange rates of currency (arbitrage) (Mayer, Duesenbery, & Aliber, 1981: 677, & Pearce, 1989: 40; 18-19).

¹⁵⁴ *Wall Street Journal*, September 25, 1998, 1. Wall Street Journal staff. “Bailout Blues: How a Big Hedge Fund Marketed Its Expertise and Shrouded Its Risks.” Long-Term Capital was leveraged to the teeth and was engaged in exceeding risky bets.

The fact that intention is the at the heart of both speculation and hedging makes distinguishing between the two difficult in practice. Intentions or motives, using C. Wright Mills' description, "are accepted justifications for present, future, or past programs or acts" (as cited in Horowitz, 1962: 443). Therefore, the difference between hedging and speculation, if defined by motive, prevents any final determination of causation since it yields only individual description or a normative consensus. Did X mean to profit or mean to ensure against uncertainty? Only X truly knows.

Can speculation be equated with gambling? Motive could again be used as the definition, as unsatisfactory as that is; but, is gambling buying and selling? In the popular idea of the gambler, the action is buying a bet; not selling or reselling it. In gambling these actions are accomplished by two different actors. The difference, here, is a matter of the level of specialization. Does this really matter? The important difference appears to be that the profit in speculation is based on fluctuation, in gambling on coming in first or being picked out of a hat. Is this splitting hairs? Though one can find statements which use the term "gambling" when discussing speculation, leading to the inference that there is at least a congruity in the minds of the writers, there seem to be few brave or foolhardy enough to state that speculation *is* gambling. Yet, Susan Strange considers all markets since the 1970s (Strange, 1986) to be commensurate with gambling,¹⁵⁵ and the Wall Street Journal, after the 1998 hedge fund debacle, routinely refers to hedge fund "investments" as "bets."

David Allen divides speculation into its own specialized aspects. The entrepreneur is a "creative" speculator and produces new wealth. The "price" speculator

¹⁵⁵ Strange even titled her book, *Casino Capitalism*.

creates no new wealth, but profits from price fluctuations. Price speculation is seen as aiding the entrepreneur (or creative speculator) by assuring the entrepreneur advance knowledge of future costs (Allen, 1952: 232-234). Here he is referring to the futures market and gives the typical description of its value for a system of exchange: 1) commodity price speculators assure materials delivery at a constant price and 2) stock and bond market price speculators assure the most efficient and profitable use of resources by moving funds from low profit to high profit areas (following news about a company's change in value) (Allen, 1952: 235). However, price speculation, occurring mainly in the secondary market¹⁵⁶ directs funds to share owners (who play no entrepreneurial role) and not to the more profitable enterprises. Only with initial public offerings (IPOs) does the sale of shares result in funds going to the company.¹⁵⁷ In addition, the assumption that profit level is always a meaningful and verifiable indicator of company/stock value is a poor assumption. Allen's description cannot deal with the fact that the value reported by corporations may be inflated itself with speculative profit. Guttman finds that "corporations and financial institutions have made increasingly large

¹⁵⁶ The term "secondary market" refers to markets, such as the stock market, where already issued securities are traded (Shafritz & Oran, 1990: 425).

¹⁵⁷ "Of course a company retains many shares and when their value rises, the company can use those shares as collateral to get more funding, but that is not the same as the money going directly from share purchase (price speculation) to efficient and profitable use of resources in high profit areas" (correspondence with Dr. Roslyn Bologh). IPOs are shares offered to the public that have been issued for the first time by a company. SEOs, or seasoned equity offerings, are another type of "new stock offerings" that are issued by companies that have been public and, as Henwood states, issue "fresh helpings of paper." When IPOs are offered in a "hot" market, insiders get a chance to buy low and sell high since IPOs typically soar in price in the initial hours or days of their issue (Henwood, 1997: 173-174). Thus, the company gets the lower figure and the insiders (speculators) the higher. According to David Korten's reading of US statistics, only 4 percent of money used to expand production actually comes from IPOs, and thus from share markets. In addition, corporate buy-backs of their stock have actually created a "net negative flow between corporations and stock markets." From www.igc.org, David Korten's article is titled "The financial casino and corporate rule."

bets on movements of currency prices” (using futures contracts with leveraging) since the float of 1973 (Guttman, 1994: 300).¹⁵⁸ Additionally, and according to the Twentieth Century Fund Task Force, trading of securities more frequently than justified leads managers to make decisions for their company and engage in deceptive practices which are based on worrying how the market will react, rather than their company’s actual worth (Twentieth Century Fund Task Force, 1992: 105).¹⁵⁹

Writing in 1952, before the deregulation of currency and interest rates, Allen is unable to see that while price speculation may direct funds to areas that increase the development of the means of production, it may also, or only, go into a creating a bubble. Parsons (1988) argues that speculative bubbles increase specialization of the market. Unfortunately, he does not define “specialization of the market” and gives little support for his point. Allen is writing under New Deal managed capitalism and cannot be aware of the increase in risks that will occur with the deregulation of currency and the float. Nevertheless, he does state: “Where price speculation takes the character of a flier [which means no more than risking money on speculation], it serves no economic function and impedes the workings of the market mechanisms” (Allen, 1952: 229-238). Comparing speculation to gambling, Allen defines gambling as “sheer chance” only. While speculation entails some chance, there is, he states, “at least partial knowledge” which

¹⁵⁸ Guttman mentions that both banks and corporations use “asset-liability management techniques” (Guttman, 1994: 509 n10). This accounting technique makes most accounts of assets “misleading.” Many firms do not report “off-balance sheet” activity of leveraging for derivatives, etc. (Henwood, 1997: 81).

¹⁵⁹ This report also distinguishes between short term and long term investment; identifying the former with speculation.

“exerts some control” (Allen, 1952: 236). Knowledge and control are used to separate the two. But is this meaningful?

The Brenners feel that the use of the term “gambling” to describe stock market activities is a negative judgement call about the skill of the participants. But their own affirming definition of speculation as “betting on an idea,” makes a judgement that privileges theoretical over physical (say, horse racing) activity (Brenner & Brenner, 1990: 90-91). While I would not say there are no differences between gambling and the stock market, there is certainly room for speculation about their similarities. Roger Munting argues that gambling cannot affect results, while aggregate market speculation changes the price of securities. That is, in gambling one cannot influence the outcome through skill, knowledge (unless a crooked game), or the size of ones wager; but speculators have a psychological effect on others and thus on the market (Munting, 1996: 1-3). However, this happens at a race track as well. Long-time track gamblers study the lineage of horses, their past records of success or failure, their breeders and trainers, etc. There is a great deal of skill and knowledge involved. The increased money placed on a horse decreases the value of the win of buyers who bet on the “favorite.” Much of the increase placed on the “favorite” is based on a “psychology of the track.” Replace the security of the market with the horse of the track and the difference evaporates—except that the movement of the price is in the opposite direction. The betting of the fans and experts may not affect the next race, but it does affect the way people bet. So knowledge and skill do not get any closer to a difference; in fact, they seem to create an identity. After all, “knowledgeable” and “skilled” speculators have had great losses over the years,

and there is a long history of speculative mania dealing with financial machination (starting with John Law's 1720 "Mississippi Scheme") (Mackay, 1993 edition: 1ff)

All of the attempts to define the difference between speculation and gambling seem to define away gambling. If Allen's and the Brenners' definition is used, the race track, some card games, etc. are not gambling—especially if done by an expert who has gained knowledge of the odds. Gambling is then left to the slot machines and those bettors who gamble without any knowledge. This certainly limits the field. I prefer, though it too has "motive" problems, the definition that speculation is gambling if one's major motive is to profit quickly without meaning to provide some service or create wealth. That is, speculation is nonproductive while entrepreneurial investment is productive. Price speculation may be partially productive, as in: 1) IPOs, or 2) via the rise in value of those shares owned by the company, and with which they may be able to raise cash for further productive investment. Knowledge of the market (as a defining difference) does not seem to be as complete as some would have it. George Soros felt that the risks of derivatives challenged even "the most sophisticated of investors" (Partnoy, 1997: 97). Partnoy reports this quote about Citron's skill from a "former Merrill salesman": "he knows thirty percent of what he thinks he knows" (Partnoy, 1997: 158). Yet, hubris led to Citron's disdain for the criticism by Goldman, Sachs of the Orange County "investment practices" and the ensuing bankruptcy. According to Partnoy, Citron could not have figured out the value (or the risk) of some of his investments and the banks selling him notes "ripped him off" (Partnoy, 1997: 162). Partnoy states that the "structured notes [they] designed [were meant] to let investors make bets that they were not permitted to make" (Partnoy, 1997: 164).

Unfortunately the term “speculation” has been muddied with multiple definitions, and the term “price speculation” assumes more value for the activity than the activity produces. Today, much of what Allen calls price speculation is just gambling—what he calls “fliers.” In order to distinguish between the more useful form of price speculation and that of fliers, and to avoid being misunderstood by using the term “price speculation,” I prefer the use of the term “speculative gambling.” Speculative gambling means gambling in the market in order to increase earnings without those moneys being used to increase production or productivity.¹⁶⁰ The term, then, has the same meaning as unproductive investment, but avoids the curious (to me) and misleading uses of the term investment. Given the uncertainty of the financial market since the early 70s, both price speculation and speculative gambling have increased. Price speculation has rightfully increased along with increased risks,¹⁶¹ but speculative gambling (seemingly tolerated) may have additional causes such as opportunity (to gamble on rapid fluctuations), shrinking real wages, declining rates of profit from productive investments, and ideological changes. In addition, outside-the-market gambling has increased over that

¹⁶⁰ --Thus these earnings do not come from real economic growth (in production or productivity) , but from a kind of ‘bidding war’ in which ‘investors’ pay more and raise the price of a security or property because they think it will rise in value. Based on this belief, they pump money into the stock or bond or real estate market and the prices do rise. This, in turn, prompts more money to enter the market and move the prices up even higher—a kind of Ponzi scheme in which the basis for the valuation has moved from real underlying value based on real production to value based on (the anticipation of) people bidding up the price (momentum investing as opposed to value investing). This is called a bubble or inflated market” (correspondence from Dr. Roslyn Bologh).

¹⁶¹ In a market environment filled with uncertainty, insurance needs escalate, but this is not without cost. Attraction for gamblers is one such cost (Strange, 1986: 111-112). Strange states that “it can be demonstrated historically that prices have in fact been more volatile since futures trading became widespread, and that there has been waste consequential on that volatility. Not only must the overhead costs of maintaining the markets and their operators in existence be taken into account, but also there are wasteful—because exaggerated—adjustment costs for labour and management in productive sectors.” These costs will be shouldered by “shareholders, customers and consumers” (Strange, 1986: 116-118).

same time period for the last two reasons, as well as legislative moves. The history of legislation relating to gambling (and speculation) has had pendulum swings based on economic and religious motives.

Americans have a history of ambivalence toward speculation and gambling. There have long been contradictions between America's Puritan legacy and its evolving values under the development of capitalism. In 1675, a Massachusetts law put limitations on wages—but also on profits (Jensen, 1955: 441-442). As capitalism expanded, this law was nullified. In early Virginia popular gambling, and card and dice playing were forbidden by law (Morrison, 1965: 90), but moral crusaders (in the guise of reforming the poor) were unable to halt the growth of gambling among those opening up the West. State-supported lotteries, used to raise revenue since the early colonies, were opposed by the middle of the 19th century when the tax base began to widen (Munting, 1996: 28-30). By the end of the Civil War, most states had prohibited lotteries (Rosecrance, 1988: 33). Before the turn into the 20th century there was an inflexible prohibition against “futures trading in commodities where there was no intention to deliver;” that is, on speculation itself (Strange, 1986: 112). The roaring 20s with its ban on alcohol, development of speakeasies, and the rise of the criminal underworld meant that a combination of effects was working, but an increase in gambling over the 20s may also reflect another milieu in which there was a highly speculative stock market¹⁶² (Munting, 1996: 193).

Most of the arguments against gambling and its legalization have been religiously based and show the continuing attachment to Puritan values and the Protestant ethic despite the contradictions. However, the early drive to reinforce the notion of working in

¹⁶² This is not to classify the two periods as exactly alike.

order to invest in and expand a business, rather than spending on one's desires and gambling with earnings, seems to have been weakened somewhat by the shift to a consumer ethos as capitalism has developed. Though gambling has always had some religious disapproval, the level and type of disapproval have varied by history and religion. The moral theology of Catholicism considers gambling as "an acceptable gaming contract" (Commission on the Review of the National Policy Toward Gambling, 1974: 78) and finds no intrinsic evil in gambling (except by virtue of its motive or the circumstances) (Starkey, 1964: 91). Conservative and Orthodox Jews oppose gambling for religious purposes, and some Protestants consider it a "shakedown" of parishioners (Starkey, 1964: 100-102). Two of the many reasons found for objecting to gambling by a late Archbishop of Canterbury were: 1) it ignores the fact that possessions are given to us as a trust ("God expects us to invest ourselves and our possessions wisely with imagination and industry that they may show good social use and an adequate increase") and 2) that Christianity calls for abstinence in all things evil (due to motivation, "chance distribution of wealth," and antisocial consequences) (Starkey, 1964: 103-113). The parallel to Puritan beliefs is startling, but the growth and legalization of gambling illustrates how far the Protestant ethic has become disengaged from the spirit of capitalism.

According to Abt et al, gambling represents a reversal of the Protestant ethic, once a powerful set of cultural values. Instead of entrepreneurial investment tied to self-abnegation, saving and reinvestment for accumulation (investment capitalism), the new values of today's consumer society are avarice, spending money, and consumption (Abt et al, 1985: 22). The prudent investor has been replaced by the reckless stock trader and

unblushing gambler—at least in the popular imagination. This shift represents “a historic cultural change” which corresponds with “changes in capitalism itself over time ” (Abt et al, 1985: 22-23). Munting feels we may have “killed off” the work ethic (Munting, 1996: 215). Nevertheless, there has been a continuing discrepancy between the popularity of gambling and the moral opposition to it (Rosecrance, 1988: 29).

Sociologists have seen gambling both as deviance and norm—the shift in views related to social transformations which were consolidated in legal changes for or against gambling. Gambling research before the 70s found just what one would expect to find before legalization. Bloch (1951) saw gambling as a “retreatist adaptation to the routine and boredom of modern industrial life” and Irving Zola (1963) found it to be practiced mainly by the lower-class (both as cited in Rosecrance, 1988: 58-59). The notion that gambling was a “social problem” was adjusted when a 1976 survey found that gambling was a “widespread American activity.” It was accepted as “conventional behavior” (Rosecrance, 1988: 68). After those findings, subsequent studies inclined toward a positive view of gambling and saw it as representative of the “American way.” Hayano (in 1982) found that media coverage brought poker playing prestige and acceptance which led to its professionalization. Frey (1986), writing in the heady days of the early 80s’ boom market, stated “We admire people who take risks.” By this time it was possible for Frey’s article to be titled “Gambling: America’s National Pastime” (as cited in Rosecrance, 1988: 62-63).

Rosecrance believes government legitimization (legalizing gambling) and the institutionalization of state lotteries is the principal reason for the increase in gambling. Legalization and lotteries were pushed in the 60s and 70s as governments (local, state,

and national) sought funds (Rosecrance, 1988: 2). Budget deficits of the 70s and 80s seem to have played an important role in this change (Rosecrance, 1988: 44-48). While Rosecrance points out that those budget deficits started in the 1970s, he does not consider in depth the economic crisis, the decentralization of government, nor the tax revolt. His emphasis is on the increase in middle class gambling. His major contention is that the acceptance of gambling by the middle class, mainly as a result of legalization, has been a significant element in increased acceptance of gambling in this society. Hitherto, Rosecrance states, gambling had been the province of some elites and “low life” who had access as well as an absence of moral repugnance. That is, gambling’s location, ethical status, and illegality excluded the large middle class (Rosecrance, 1988: 2); but, with legalization came acceptance.¹⁶³ The distaste with which most Americans once viewed gambling has been replaced by approval. There are still pockets of resistance such as the Mormons, but the use of Bingo in order to raise funds (by the Catholic church) helped alter attitudes of moral rejection. Rosecrance argues that American “ambivalence [toward gambling] has been resolved in favor of sustained acceptance and increased participation” (Rosecrance, 1988: 2-9).

The continuing legitimation of gambling, deregulation of the market and finance, and acceptance of speculation, if not encouragement through reflation, may be understood in the 80s as “permissive” policy, unusual in the otherwise morally repressive era of the Reagan administration. While deregulation removed the legal obstacles to speculation and ideological promotion helped provide social acceptance, the legalization

¹⁶³ What is interesting in this analysis, is the power of law, rather than religion, in validating middle class activity.

of gambling and state lotteries normalized the notion of risk and speculation as suitable characteristics—replacing the earlier norms of prudence, saving, and investment. I do not argue that this caused Robert Citron to speculate with public funds. Rather, I argue that this milieu and those altered institutional practices established within markets, touted by media, and supported by the state removed normative restraints on a “proud but stubborn” man who was so financially ignorant that he “seemed unable to grasp the concept of ‘buy low, sell high’” (Partnoy, 1997: 158-159). Robert Citron’s actions and the Orange County bankruptcy illustrate the growth and acceptance of speculative gambling. After all, “Wall Street was full of gamblers, and investment banks often were compared to the casinos...on the boardwalk in Atlantic City” writes insider Frank Partnoy (1997: 69).

Deregulation and legalization appear to be two sides of the same sword which was meant to slash barriers to competition, but actually encouraged speculative and popular gambling. Indeed, the US *economy* was considered speculative by the 1970s; that is, it would need help in settling its debt¹⁶⁴ (Henwood, 1997: 222). What of the growth of popular and market gambling? Do these two practices parallel each other? Are they linked? Even though speculation and gambling are considered to be separate issues, the period of increasing speculation is also marked by the growth of legalized gambling. The use of speculative markets and creation of new instruments have continued through the 1990s, and speculation (as well as borrowing to speculate) in order to escape financial squeeze and amass profits remains. The 1970s and 1980s process of deregulation and

¹⁶⁴ Minsky saw financial units as either hedged, speculative, or Ponzi. A hedged financial unit has no problems meeting its debt with current income; a speculative unit will need asset sales or loan extensions to meet its debt, and a Ponzi unit must find “fresh cash” even to pay its interest charges (as cited in Henwood, 1997: 222).

technological development encouraged innovations that smoothed the way for further speculation. Changes in the instruments of gambling over time echo changes that have occurred in financial instruments. For instance, as competition increased in the gambling industry and bankruptcy occurred, something called “the premium-grind casino” was initiated. This operation “simultaneously catered to high rollers playing games like craps, baccarat, and blackjack and to quarter slot players.” This was reorganization rather than actual innovation in the types of the games, but horse tracks have come up with new betting devices (Rosecrance, 1988: 157-158).

Has gambling actually grown over the same time period? Illicitly practiced for most of our history, illegal gambling increased in the post World War II years. States tried to tax gambling as citizen resistance to property and income taxation grew (Starkey, 1964: 7). Some legislative changes (starting in the 1950s) were followed in the early 1960s by promotions to legalize gambling and establish a national lottery. Their success led to the creation of the 1963 New Hampshire state lottery (New York following in 1966 and New Jersey in 1970). Off-track betting was regulated by New York state in 1970, the Atlantic City casinos were opened in 1978, and the California lottery (legalized in 1984) found huge success by 1986 (\$2 billion in revenue) (Munting, 1996: 7, 51). According to several studies, interest in lotteries returned in tandem with a widening income gap and job insecurity (Munting, 1996: 193). Munting feels that “the advent of state-sponsored lotteries was a watershed in the American view of gambling. In effect, governments had moved from tolerance to active sponsorship of gaming in a significant policy shift” (see

Munting, 1996: 51-52).¹⁶⁵ The promotions for legalization of gambling itself, starting in the 60s, paralleled the beginning of the growth of speculation.¹⁶⁶

The greatest increase in gambling (and its acceptance) started early in the 1970s, the same time in which our economy came to be seen as speculative (Munting, 1996: 51-52). In the late 70s, the anti-tax movement (coupled with federal cutbacks) stimulated the legalization of sports betting in order to provide for social services (Munting, 1996: 217-218). This links the legalization of gambling and lotteries to the tax revolt in California. That gambling has grown can also be illustrated by the fact that bettors lost (in 1986) approximately \$22.6 billion. Much of this ended up in the coffers of large corporations, states, and illegal “operators.” Rosecrance calculates that “If these revenues were placed into a hypothetical holding company, such a company would be fifteenth on a list of the largest American corporations” (Rosecrance, 1988: 2).

Changing Values

But was deregulation and legalization enough to change values? Rosecrance’s findings appear to show that legislation can change activities and values. He has not, though, considered the impact of influential experts and authorities to transmit ideas (via television, film, newspapers). Though television appears to be more broadly effective, two books of the 80s appear to have had wide circulation and influence. Written by two “leading ideologues” of conservatism they illustrate the tenor of the Reagan

¹⁶⁵ Starkey adds that legalization is a pro-gambling education. In fact, the sponsorship of gambling by churches or the state is believed to give gambling “*respectability by recognition.*” (Starkey, 1964: 84-85).

¹⁶⁶ I wish to make it completely clear that I am not saying that increased speculation caused increased gambling or the reverse; but, that both are reactions to this particular crisis situation.

administration. Milton and Rose Friedman's *Free to choose* and George Gilder's *Wealth and Poverty* praise "inequality, individual greed, and unleashed private enterprise" (Ackerman, 1982: xi). The message of the Friedman's 1980 best seller is that government equals domination and constraint and the market equals freedom; or as Ackerman states it: "Buying and selling are freedom; voting and planning are slavery" (Ackerman, 1982: 20). What kind of an impact might this have had on our public officials (like county boards and treasurers) who were feeling pressures during the early and mid-1980s? The Friedman's proposed that individual, not social, action results in freedom. This disparaging of the social leads to nullifying any social claims on individual activity; responsibility is only to the self. This is "an essentially anti-social understanding of society" (Ackerman, 1982: 22). As the social is condemned and the individual raised to ideological primacy, anything blocking one's way (ethical disapproval, or as in Citron's case, regulations against gambling with public money) may be seen as legitimately unacceptable. "*Free to choose* offers the spurious but seductive promise that, indeed, you could have power over the way things are done, if only the government would let you" (Ackerman, 1982: 25).

John Kenneth White feels that the 1980s was an echo of the 1950s. That echo not only was evident in the 1950 reruns on television (White, 1988: 112), but "the resurrection of the authoritative hero" in early 1980s films (White, 1988: 120). However, White does point out that "Ronald Reagan's use of American values both reflect[ed] and design[ed] American popular culture." He was "as much a creator of the climate in which these shows work so successfully as are any of their producers, performers, or network scheduling czars" (White, 1988: 121). George Wills argues that it was the Reagan era and

Ronald Reagan himself that convinced Americans, once again, that they were “rugged individualists” (Wills, 1988: 452-3). But capitalism, states Wills, is neither individualist nor conservative. “Capitalism is an instrument for change, for expansion, driven toward ever new resources, products, markets. It reorders life drastically...it changes people from providers of self-sufficiency to specialists in a pin factory...It is a roving, restless, innovative force. It must have newer models at shorter intervals. It literally remakes lives in order to have new customers for new models” (Wills, 1988: 452). Why not be remade into a rugged individual like Rambo in Vietnam, or an Orange County hero who carves out a life by hacking away at the jungle of government regulations? Surely that is a more desirable identity than acknowledging that one ought to live within socially constructed regulations that safeguard a democracy.

But as mentioned earlier, political rhetoric carries substantial authoritative weight (Schudson, 1990: 117-118). Reagan exhorted Americans to “just do it” without limits, pitting optimism against “reasonable pessimism” (Wills, 1988:456). If one follows the week-by-week changes of Reagan’s first term, as de Mause did, it becomes obvious that a Puritan ethos preached to reduce spending by the populace was contradicted by the luxury spending induced by his tax cuts (de Mause, 1984: 68 & 83). What we need to see is not how the pinched populace reacted (the tax cuts did not benefit them; their lives were not without limits), but what message those in finance and related areas heard and saw modeled. While the exhortation of the leader of a country and technological change may have powerful effects, and while those who are negatively effected by change may not as easily accept rhetoric, did those in the financial markets and related professions actually believe and act in accord with Reagan’s and others’ rhetoric?

Frank Partnoy reports that a dominant element in the “culture” of Morgan Stanley and First Boston included group gambling jaunts outside of work (Partnoy, 1997: 101-108). Partnoy relates how traders and others from First Boston formed a line to be chauffeured to Atlantic City casinos at the end of the work day (Partnoy, 1997: 44). Derivatives salesmen, states Partnoy, were enthusiastic gamblers (Partnoy, 1997: 50). But, how is it possible to decipher the views of financial analysts and journalists when the very nature of the concept “speculation” that they use, buries the gambling dimension within a larger notion of “investment.” This notion implies the provision of financing for some venture that may succeed or fail. The distinction between a productive investment and unproductive gambling gets lost in the notion of “speculative investment.” Interestingly, the *Wall Street Journal's* account of the 1998 hedge fund disaster¹ did consider the dangerous risks and “gamble” that occurred and opined that there was no “rogue trader” this time. Once again, calls for regulations were sounded, but the successful bailout of Long-Term Capital will likely mean those voices will not be heeded.

According to George Wills, capitalism produces forms of specialization which require cooperation and coordination and therefore regulations to protect what he calls the “vulnerability” of interdependence. Our image of ourselves as the lone cowboy, the individualist, the lone troublemaker, if real, would threaten that interdependence. The loner is not a cooperator, but believed to be successful without the cooperation of others. The image of the successful individual negates the actual complex technological and organizational structure that supports that lone cowboy (Wills, 1988: 451). Yet Citron

¹ *Wall Street Journal*, September 25, 1998, 1. Wall Street Journal staff. “Bailout Blues: How a Big Hedge Fund Marketed Its Expertise and Shrouded Its Risks.

and Leeson were portrayed by the media as “rogue” operators. This negates the existence of a structure of speculation that has been in place and further developed since the earlier 70s.

In the 1980s, Reagan was the pilot and it was he who revived “a cult of ‘heroes’” chopping at the chains of government. “He would arm the passenger on our national ‘jetliner’ of history, and have them ‘settle things’ on their own” (Wills, 1988: 452). The question is how influential this vision was in the construction of Citron’s identity. I do not believe we have the tools to conclusively answer this question. The most that can be done is to establish that a milieu existed and suggest the possibility that, just as pressures in Orange County may have moved Citron to make certain decisions, the permission granted by political leaders, financial experts, and the financial media (in the context of a long-term speculative market and a multitude of instruments for that speculation) may have influenced Citron to step over boundaries he might otherwise not have. When the county’s funding pressures are added, this is even a greater possibility.

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CONCLUSION

This dissertation has ranged widely, from systemic changes to local effects, in order to move beyond the journalistic views of how the world works and why events occur. It was necessary to explore many levels in order to show the pervasiveness of speculation in the current economic crisis. It should, however, be understood that speculation is not seen as original cause; rather, it is servant to change and supporter of capital in volatile times. In this crisis, speculative gambling has extended to large corporations and banks. It is not surprising to find that both gambling and speculative gambling became normative over the past forty years. Gambling outside the stock market is both venture and entertainment for those who speculate in the market and for those who do not.

As time has passed since the Orange County bankruptcy, prudence has not been the lesson learned. Perhaps the fact that the courts found Citron's trades legal¹⁶⁸ (though not all of his activities), the speedy return of normalcy to this rich county, and the ability to blame a rogue or criminal helped to obscure the underlying dangers. The ingredients that made up Citron's speculation continue to be evidenced in the growth of speculative gambling and leveraging to gamble over the 1990s. The spreading gap between the

¹⁶⁸ *New York Times*, October 24, 1998, from the online archives at www.nytimes.com. Pollack, A. "Orange County Is Set Back In Efforts to Recover Losses." A Federal District judge found that Citron did have the authority to engage in the type of risky trades he made with public money.

majority and an extraordinarily rich minority¹⁶⁹ over the 80s and 90s has been well documented.¹⁷⁰ The notion that stock ownership is widely shared is popular despite the fact that 90 percent of stock is owned by 10% of the population.¹⁷¹ Financial firms have begun advertising the buying and trading of stock (online and off) for everyone, though most people do not have enough disposable income to play.¹⁷² The newest television craze, a quiz program called “Do You Want To Be a Millionaire,” feeds into the desire of the have-nots to leap that huge money gap into substantial wealth.¹⁷³ Though the information is available, few seem concerned that much of the money earned on stock gambling (as well as non-market gambling) is based on debt—borrowing to speculate, borrowing to gamble.

Margin debt, one form of leveraging in which an investor or speculator may borrow up to 50 percent (legally set in 1974) for any purchase of stock, is now close to 2 percent (\$179.3 billion in September 1999) in relation to the economy. This form of debt has doubled since 1995. Calls to change that percentage, lowering the ratio of debt

¹⁶⁹ *New York Times*, May 11, 1992, D1.. Nasar, S. “The richest getting richer: Now it’s a top political issue.” An M.I.T. economist’s data showed that the gains of the 1980s went largely to the rich. Even the calculations of those who refute that study show that 70 percent of the gains went to the top 1 percent.

¹⁷⁰ *New York Times*, October 1, 1999, from the online archives at www.nytimes.com. Uchitelle, L. “Rising incomes lift 1.1 million out of poverty.” Even with rising levels of family income in the late 1990s, the gap between the poor and the rich, and between the middle level and the rich has not narrowed, according to a Census Bureau report. Though the poverty rate has declined it has only gone down to the 1979-1980 level. Much of the rise in family income is due to working longer hours—an average of 60 per week.

¹⁷¹ *New York Times*, November 20, 1999, A13 (Op-Ed). Rich, F. “Who doesn’t want to be a millionaire.”

¹⁷² *New York Times*, October 28, 1999, C1. Kahn, J. “The Media Business: Trying to turn stocks into national pastime.”

¹⁷³ *New York Times*, November 20, 1999, A13 (Op-Ed). Rich, F. “Who doesn’t want to be a millionaire.”

allowed, have been refused. Fed chairman Greenspan deprecated this as “ineffective” since margins are less and less indicative of the amount of leveraging. Given that comment, we may assume that other forms of leveraging are higher than that 2 percent. As the writer of this article stated, “Of course, that figure [of margin debt] probably understates the leverage propping up the stock market. In addition to the derivatives that act as a form of leverage” stock is also bought using home-equity loans and credit card advances.¹⁷⁴ According to Martin Mayer, banks have been swapping loans through the use of “credit derivatives” which may have as much as 95 percent leverage. Since these loans are securitized as a package, there is no one overseeing the credit risks here. As leverage builds upon leverage, Mayer foresees a day of reckoning in which “the leverage that once multiplied income will now devastate principal.”¹⁷⁵ Borrowing from both regulated and unregulated dealers of derivatives by some hedge funds is also high. The close call for Long-Term Capital Management involved heavy borrowing.¹⁷⁶

The numbers of debacles involving derivatives in the early 1990s did little, if anything, to curb their use. Globally, from over 20 trillion dollars in 1992 to 55 trillion

¹⁷⁴ *Wall Street Journal*, November 8, 1999, C1. Schlessinger, J. “Despite calls for action, Fed won’t raise margin requirements to curb speculation.” The proposed requirements for trimming margin debt have been cited by Wall Street as “targeting the stock market.” The Fed appears to buy this, stating that it should not, nor does it intend to, target the market.

¹⁷⁵ *Wall Street Journal*, November 20, 1999, from the online archives at www.wsj.com. Mayer, M. “The dangers of derivatives.”

¹⁷⁶ *New York Times*, November 20, 1999, C3, a Dow Jones Report. “Congressional agency faults a report on hedge-fund risk.”

dollars by 1996, derivatives contracts have shown a staggering increase.¹⁷⁷ “Outright bets made on rates, known as interest-rate swaps, in which one investor agrees with another to exchange a fixed rate for a floating rate...account for more than 80 percent of derivatives held at American banks.” These have a notational value of \$25.7 trillion, representing a 28 percent rise in a one year period—1997 to 1998. Since most of these represented bets that the rate would either remain the same or fall, a rise in interest rates would be dangerous to these positions.¹⁷⁸ This sounds familiar—Orange County déjà vu.

New regulations have been proposed over the years and met with procrastination and defeat, while deregulation continues. After giving concessions to banks and financial firms and backing away from formalizing new regulations since 1992, the Financial Accounting Standards Board (FASB) again postponed the effective dates that regulations on derivatives will take place. Depending on fiscal or calendar year basis of firm operations, the new rules are set to start on June 15, 2000 or January 1, 2001.¹⁷⁹ These regulations will require that corporate balance sheets report their derivatives’ fair-market value. Fed Chairman Greenspan was against this in 1997 and it was stated that attempts would be made to have Congress block it. Adding to information about the difficulties of determining the real value of companies made earlier in this dissertation, the chief accountant of the SEC said “Having billions of dollars of derivatives unaccounted for

¹⁷⁷ *Wall Street Journal*, February 21, 1997, C1. McGee & MacDonald. “Pre-emptive strike by derivative players.”

¹⁷⁸ *New York Times*, October 3, 1999, B4: Sec 3. Morgenson, G. “Even if the Fed is idle, rates are on the rise.” This article also points out that the unwinding of these positions would push rates up as well.

¹⁷⁹ *Wall Street Journal*, May 20, 1999, A2. MacDonald, E. “Regulators delay derivatives rules for a second time.”

creates an intolerable risk for investors.”¹⁸⁰ Since the opposition to regulation comes from banks and financial firms (derivatives traders and users) and the rules are to benefit investors, it is clear that purchasing stock has even greater risks than investors know and firms want them to know. According to a *Wall Street Journal* report, the earnings difference of companies that would be revealed (if the new accounting rules go into effect) could be as much as 10 percent.”¹⁸¹ High volatility once again hit the market in late November 1999 with share prices swinging almost as much as they did during the 1987 crash and the 1998 Russian debt collapse (42 percent versus 46.5 in '87 and 44 percent in '98, among the largest stocks).¹⁸² October of 1999 brought the repeal of the Glass-Steagall Act of 1933 separating depository and investment banks. The merger of a bank, an investment house, and an insurance company (becoming Citigroup last year) presaged the end. This Act had been meant to insure that the whole financial system would not be disabled should the stock market collapse—as had happened in 1929.¹⁸³

Last year, in 1998, Wall Street “cheered” as Citron’s right to invest public money in high-risk derivatives was upheld by the courts.¹⁸⁴ This year, 1999, it was reported that

¹⁸⁰ *New York Times*, August 7, 1997, D1. Norris, F. “Greenspan opposes accounting changes on derivatives.”

¹⁸¹ *Wall Street Journal*, February 21, 1997, C1. McGee & MacDonald. “Pre-emptive strike by derivative players.”

¹⁸² *New York Times*, November 21, 1999, from the online archives at www.nytimes.com. Morgenson, G. “The mania of momentum and the cost of trading.” This volatility is due to high prices and aggravated by “momentum investing,” where a mania for investing in rising stock occurs.

¹⁸³ *Wall Street Journal*, October 26, 1999, from the online archives at www.wsj.com. Gordon, J. S. “May Glass-Steagall rest in peace.”

¹⁸⁴ *Wall Street Journal*, October 26, 1998, B8. Pasztor, A. “Orange County ruling cheers Wall Street.”

cities “with weak economies and growing pension obligations” are selling pension-obligation bonds in order to “play the market.” That is, they are borrowing money to gamble. The auditor of Worcester, Massachusetts said, “We naturally wanted to play the equity markets like everyone else;” but an official of Brookline, Massachusetts worried, “it may be good for the town but it’s taking a gamble, like going to Foxwood’s [Casino].” If there occurs a long bear market in which performance is below 6 percent, as it was for sixteen years from 1966 to 1982, cities that speculate/gamble will find themselves with debt payments above income. Then a rash of cities might consider bankruptcy—or might they be privatized by being bought by banks *cum* insurance companies *cum* investment houses?

For Marx, speculation is a risking of *social* property by the individual (Marx, 1967 Ed.: 439). This was true in the case of Orange County and is so for cities speculating today. While most will not see corporate or individual speculation as other than a risk of one’s own money, all can appreciate the social aspects of speculating with public money. This brings speculation home, just as the individual gambling losses of a family member may come home by harming the welfare of the whole family. Given that analogy, Robert Citron might be seen as the gambling spouse to a community. Yet, in both cases, we need to see the world beyond the individual to fully understand the risks they were willing to take with a trust. We make our own choices, but we do not do so in isolation.

Robert Citron risked the funds of a large community—an entire county. He can be blamed and punished for the criminal aspects, as he has been; but what of the speculative gambles he took? They are not considered criminal. In the past they may have been, but

by the 1980s this has changed. True, it was Citron who got the regulations altered in 1979, but who agreed to this and why? Deregulation had been the catchword and action of the 70s, and calls for further deregulation resounded in the 1980s and still echo at the end of the 90s. Deregulation was a revolutionary cry to change a structure that was perceived as coming apart for capital over the 50s, 60s, and 70s. The call for deregulation and the rise of speculation were linked in an interactive manner. Speculation forced deregulation and deregulation presented opportunities for further speculation. Even more significant, the conditions within which deregulation was able to take hold, a slowdown in the rate of profit and its consequence of economic stagnation, were also the conditions that gave rise to financial speculation in the markets. It is the combination of deregulation and financial speculation which we find in the case of Orange County.

Robert Guttman's accounts have been used throughout this dissertation, but I would not place the problem of world-money (just as I do not place speculation) as centrally as he does. While it is true that the use of one national currency (the dollar) as world-money has its "problematic characteristics" (a vulnerability to speculative attack is one), I do not agree that it is this that has led to "a significant element of instability in the world economy" (Guttman, 1994: 368). The threat to the dollar has been important in the decisions of US leaders and their decisions have brought added instability, but beneath that threat is an environment created by this particular economic crisis: an abundance of funds seeking profit that cannot be found via production. Whether or not one agrees with Webber and Rigby's analysis of the foundation of this crisis, it is evident that crisis has altered the relationship between productive and financial capital. Financial capital now is not just an adjunct of or contributor to production, it has amplified its own

profit-making activities beyond its lending activities. Again, this is an interaction between state deregulation support, various technical developments, and the innovations (“products”) of financial capital. Some of those innovations/instruments are mere shells to cover speculative gambling; others “hedge” the risk that has grown from the particular ways this crisis has been “managed.”

I have shaped, from overlapping and interacting decisions and activities, an analysis that has been meant to remove Robert Citron from the appellation of “rogue,” or “lone cowboy.” He did not act alone. He did not act in isolation from his community or his world. The support of his activities, actual, ideological, and by omission, and the exploitation of his failings by “reputable” financiers and financial concerns demonstrates that Citron’s speculation was an element of local and national social life. The funding pressures on Citron were created by wider efforts to restructure and local efforts to avoid heavy taxation. That restructuring (deregulation, privatization, and production relocation) was in response to crisis in our economic system. Privatization releases formerly social assets from democratic regulation. The Orange County bankruptcy, resulting in calls for sales of public assets, may be considered a “desocialization” result on the road to fuller privatization.

The economic system within which the crisis has occurred—capitalism—creates new, and is embedded in older, social processes. The “invisible hand” of the market is socially guided by states and international organizations; though that guidance is now of a more permissive type. Citron was involved in a part of those very human, socially constructed, processes. Whether we look at higher levels or come down to the interpersonal (including propaganda and other forms of influence), Citron did not act

alone. Immersed in a milieu in which both speculation and gambling had become the norm, and battered by the revolutionary effects of crisis, Robert Citron acted in concert (if off key). Today he would be more in tune with the culture, as the culture is more in tune with gambling. "Trying to turn stocks into a national pastime" is not at odds with the past twenty years or so. Todd Gitlin is reported as thinking that "the brokerage firms [advertising in prime time] were capitalizing on broader stock ownership to inculcate a culture of trading."¹⁸⁵ A gambling "culture" is already here. Americans spend much more money per year on gambling than on groceries, according to the 1999 report of the Federal Commission on Gambling.¹⁸⁶

As the 20th century comes to its end, there are persisting crises. The 1997-1998 years were particularly unstable. The Asian financial crisis (precipitated by financial speculation) continued, the Russian crisis ensued, Brazil's crisis menaced, and a major hedge fund's near collapse could have rocked the world. Speculation was a contributive factor in most of these troubles. The growth and continuing presence of speculation illustrates that productive forms of profit-making have not yet regained their former position.

Perhaps some county governments are more wary now (if cities are not), but re-regulation is unlikely in the present environment. The best option may be creating higher educational and new financial licensing requirements for county treasurers and city administrators. I am not an economist and can offer no policy suggestions that do not fly

¹⁸⁵ *New York Times*, October 28, 1999, C1. Kahn, J. "The Media Business: Trying to turn stocks into national pastime."

¹⁸⁶ *New York Times*, November 20, 1999, A13 (Op-Ed). Rich, F. "Who doesn't want to be a millionaire."

in the face of reality. I do believe this is a transitional stage in the development of capitalism and that advances of social justice and welfare will not occur until this transition has passed and been replaced with, once more, a productive economy with curbs on free wheeling finance. The de-democratizing aspects of the restructuring we have gone through mean that citizens have less power to bring about such a change.¹

This, in itself, is a social crisis—a social crisis in which Robert Citron may just be the canary in the *gold* mine.

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¹ As I write this a breath of fresh air has entered the nation. A coalition of citizens' groups has demonstrated in Seattle, Washington, making the population more aware of the dangers of the World Trade Organization, a non-democratic organization with secret decision making. This rule-setting body is telling the citizens of the United States that our gains in human rights, worker rights, health rights, and environmental protection cannot be sustained in a world of "free trade."

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