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Citi can sleep — in peace

The US government's bail-out of Citigroup, which was the most valuable bank in the world before it lost 83 per cent of its value over the past 11 months, would seem to be a smarter (and fairer) package than what the British government announced last month, in that it probably addresses Citi's problems without getting into state control of a bank. More importantly, it salvages a bank whose sharply dropping share price had raised fears of panic withdrawal of cash by depositors, and the dread prospect of a major bank failure. It has clearly been another busy week-end for the Treasury, the Federal Reserve and the Federal Deposit Insurance Corporation, the three organisations that have cobbled together the bail-out package.

The package that has been announced recapitalises the bank quite substantially, and takes the heat off the bank by extending a guarantee on $306 billion of troubled loans (out of a total asset base of about $2 trillion). The guarantee lowers the risk weight on these assets, thus further bolstering the bank's capital. Since the bank has already lost $20 billion in the last four quarters because of write-downs on derivatives and housing loans, and made provisions for another $24 billion, the guarantee (which is 100 per cent for a base slab and 90 per cent beyond that) should probably be enough to restore confidence in the bank's future.

Shareholders who have already suffered a battering in the market will pay a further price, since their shares will have a dividend cap of 1 per cent for three years, while the bank pays the government an 8 per cent coupon rate on the $25 billion preferential capital that it is getting. The end-game could still be positive if one assumes that they will get an upside on the stock price. There will be no management change, so Vikram Pandit keeps his job, but the top management will have to accept some pay cuts that are an inescapable part of the government's troubled assets relief programme.

At the end of the whole exercise, the government could end up owning nearly 8 per cent of Citigroup (some of it because of money given earlier), with no management control. If the bank does well from here on, that will give tax payers (who are funding the whole package) a chance to share the upside—but for that the stock has to more than double its present value. The deal is better than the UK government's taking majority control of the Royal Bank of Scotland and 40 per cent ownership of the merged LloydsTSB and HBOS. Those banks lost in value on the market following the UK government move, whereas Citi shares gained yesterday in some European markets.

The Citi bail-out raises questions about the true extent of the US financial sector's problems, especially since Mr Pandit assured stakeholders at every turn that the bank was safe and strong in every way—which clearly was not true. The problem seems to have arisen from sharply increased trading activity by the bank, without proper risk management—which points to internal management failures on a scale that raises troubling questions about the quality of management in any financial undertaking. The origin of the problem seems to have been new regulations that allowed banks to get into riskier activity, and the arrival on the executive floor of Robert Rubin, ex-Goldman Sachs (and treasury secretary under President Clinton). This episode adds to the weight of the arguments that run in favour of more comprehensive and tighter regulation of all financial sector activities.

A different need

The warning by the United Nations' Food and Agriculture Organisation (FAO) that the global economic crisis will negatively impact agri-

available in only a few items, notably wheat and rice and to some extent cotton. To be sure, the government makes sure that tariffs are adjusted periodi-

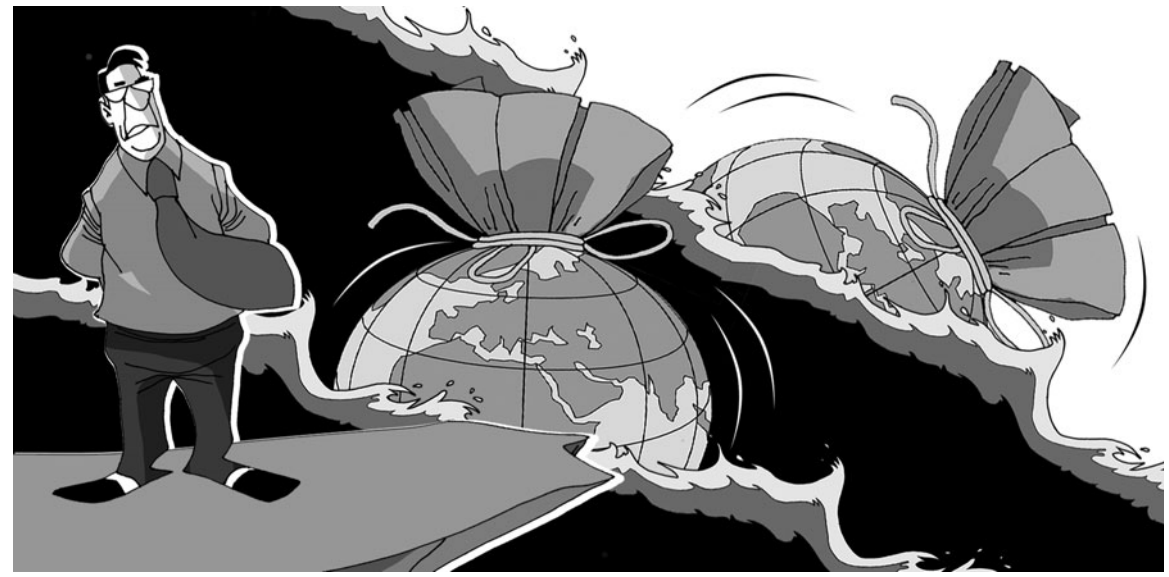

Illustration by BINAY SINHA

The global financial crisis

Unlike the Third World debt crisis of the 1980s, bailouts today are the norm not the exception, says DEEPAK LAL

The 1980s Third World debt crisis and the current global financial crisis have great similarities but different outcomes. Why?

First, both the crises arose because there was a surplus of savings in a number of countries— the oil producers in the 1970s, the Asian economies and commodity exporters today— which was recycled through the international banking system, to maintain world aggregate demand. Second, highly liquid banks imprudently funneled cheap credit to un-creditworthy borrowers: the fiscally challenged and inflation prone countries of Latin America and Africa in the 1970s, the *ninja* (those with no income, no jobs, no assets) sub prime mortgagees of the current crisis. Third, there was a rise in commodity prices and a worsening of the terms of trade of the OECD, posing the stagflation dilemma for their central banks, having aided and abetted the earlier asset boom. Fourth, the imprudent banks sought bailouts from taxpayers, claiming their demise would fatally damage the world's financial system.

But, the outcomes have been different. The 1980s crisis was finally solved after a prolonged cat and mouse game when the banks accepted substantial write downs of their Third World debt, sacked their imprudent mangers and shareholders suffered large losses. But no systemic threat to the world's financial system (or the global economy) emerged. By contrast, today the Western financial system seems to be dissolving before our eyes, and with the US Fed's ever expanding balance sheet, bailouts are no longer the exception, but the norm. Many now foretell a deep and perhaps prolonged recession, with deflation, rising unemployment, and Keynes' famed liquidity trap about to engulf the world's major economies.

What explains this difference in outcomes? It cannot be purported 'global imbalances', which were the origins of both crises. It is the differences in financial structures within which these temporally separated but largely similar crises occurred. In the 1970s the recycling of the global surpluses was undertaken by the offshore branches of Western money centre banks, which were neither supervised nor had access to the lender of last resort facilities of their parent country's central bank. Hence, when their Third World Euro dollar loans went into 'default', there was no direct threat to the Western banking system.

The present crisis emerged in a radically different financial structure: the rise of universal banks from the UK's Big Bang financial liberalisation in the 1980s, and the Clinton era abolition of the Glass-Steagall Act, which had kept a firewall between the commercial and investment banking parts of the financial system since the 1930s. The former had implicit deposit insurance and access to the central banks' lender of last resort facilities. The latter did not. As explained in detail in my columns on the credit crunch (Dec 1997, Jan 2008), with deposit insurance, the public utility part of the financial system which constitutes the payments system must be kept separate from the gambling investment banking part, which is an essential part of a dynamic economy. For these gambles impart the dynamic efficiency through the cleansing processes of creative destruction. But if these gambles are protected against losses by taxpayers, as the payment system activities have to be because of deposit insurance, the gamblers will always win: keeping their gains when their gambles are correct and passing their losses onto taxpayers when their gambles turn sour.

Given this 'moral hazard', many classical liberals have favoured free banking. Banks combining the payment and investment functions and issuing their own notes would be monitored by their depositors, who would stand to lose if their banks undertook imprudent lending. But with the near universality of deposits as a means of payment, there is little likelihood of this monitoring function being effectively exercised. Whilst Demos precludes any government being able to resist pressures to bail out imprudent banks to protect their depositors. This makes deposit insurance inevitable.

The recent emergence of universal banking was followed by a number of public policy mistakes on the path to the current crisis. The first was the bail-out of LTCM in 1998. Its failure posed no obvious systemic threat. Its public salvation changed expectations of market participants that non bank financial institutions could also hope for bail-outs. Next the infamous Greenspan 'put' which put a floor to the unwinding of the dotcom stock market bubble, promoted excessive risk-taking. Third, the promotion of 'affordable' housing for the poor by the Clinton administration through the unreformed and failed Freddie mortgage twins, led to the development of subprime mortgages. Fourth, the Basle II capital adequacy requirements led banks to put their risky assets into off-balance sheet vehicles— the SIVs— leading to the opacity currently being bemoaned. Fifth, when the housing bubble burst, and the credit crunch began with the gambles taken during it turning sour, the Fed chose to bail out Bear Sterns, sending the signal that the Fed's balance sheet was open to non-deposit taking 'banks' as signaled by the earlier LTCM bailout. Sixth, and most heinously given all that had gone before, the US authorities then chose not to bail out Lehman's— like a fallen woman suddenly finding virtue. This dashing of the bailout expectations that the authorities had endorsed only in the spring, led to the intensification of the credit crunch. Seventh, as the authorities finally seemed to tackle the toxic subprime infected financial assets which caused the crisis through TARP, it calmed the markets. Now, with TARP to be used only to recapitalise banks, markets have gone into free fall. The essential step, of forcing banks to come clean on their balance sheets, and then removing the toxic assets they reveal into a newly created institutional 'cordon sanitaire', has not been taken. Worse, instead of recreating a firewall between the payment part and the gambling part of the banking system, even the pure investment banks, like Goldman Sachs, are being pushed into becoming universal banks with access to the Fed's balance sheet and thence taxpayer's money.

Given these public shortcomings, the near universal calls for greater regulation and state intervention is astounding. Public agents, not private ones— who reacted rationally to the implicit or explicit 'rules of the game' promoted— are to blame for the crisis. It would be foolish to blame the puppets for the failings of the puppeteer.