Colossal Financial Collapse: The Truth behind the Citigroup Bank "Nationalization"

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On Friday November 21, the world came within a hair's breadth of the most colossal financial collapse in history according to bankers on the inside of events with whom we have contact. The trigger was the bank which only two years ago was America's largest, Citigroup. The size of the US Government de facto nationalization of the $2 trillion banking institution is an indication of shocks yet to come in other major US and perhaps European banks thought to be 'too big to fail.'

The clumsy way in which US Treasury Secretary Henry Paulson, himself not a banker but a Wall Street 'investment banker', whose experience has been in the quite different world of buying and selling stocks or bonds or underwriting and selling same, has handled the unfolding crisis has been worse than incompetent. It has made a grave situation into a globally alarming one.

'Spitting into the wind'

A case in point is the secretive manner in which Paulson has used the $700 billion in taxpayer funds voted him by a labile Congress in September. Early on, Paulson put $125 billion in the nine largest banks, including $10 billion for his old firm, Goldman Sachs. However, if we compare the value of the equity share that $125 billion bought with the market price of those banks' stock, US taxpayers have paid $125 billion for bank stock that a private investor could have bought for $62.5 billion, according to a detailed analysis from Ron W. Bloom, economist with the US United Steelworkers union, whose members as well as pension fund face devastating losses were GM to fail.

That means half of the public's money was a gift to Paulson's Wall Street cronies. Now, only weeks later, the Treasury is forced to intervene to de facto nationalize Citigroup. It won't be the last.

Paulson demanded, and got from a labile US Congress, Democrat as well as Republican, sole discretion over how and where he can invest the $700 billion, to date with no effective oversight. It amounts to the Treasury Secretary in effect 'spitting into the wind' in terms of resolving the fundamental crisis.

It should be clear to any serious analyst by now that the September decision by Paulson to defer to rigid financial ideology and let the fourth largest US investment bank, Lehman Brothers fail, was the proximate trigger for the present global crisis. Lehman Bros.' surprise collapse triggered the current global crisis of confidence. It was simply not clear to the rest of the banking world which US financial institution bank might be saved and which not, after the Government had earlier saved the far smaller Bear Stearns, while letting the larger, far more strategic Lehman Bros. fail.

Some Citigroup details

The most alarming aspect of the crisis is the fact that we are in an inter-regnum period when the next President has been elected but cannot act on the situation until after January 20, 2009 when he is sworn in.

Consider the details of the latest Citigroup government de facto nationalization (for ideological reasons Paulson and the Bush Administration hysterically avoid admitting they are in the process of nationalizing key banks). Citigroup has more than $2 trillion of assets, dwarfing companies such as American International Group Inc. that got some $150 billion in US taxpayer funds in the past two months. Ironically, only eight weeks before, the Government had designated Citigroup to take over the failing Wachovia Bank. Normally authorities have an ailing bank absorbed by a stronger one. In this instance the opposite seems to have been the case. Now it is clear that the Citigroup was in deeper trouble than Wachovia. In a matter of hours in the week before the US Government nationalization was announced, the stock value of Citibank plunged to $3.77 in New York, giving the company a market value of about $21 billion. The market value of Citigroup stock in December 2006 had been $247 billion. Two days before the bank nationalization the CEO, Vikram Pandit had announced a huge 52,000 job slashing plan. It did nothing to stop the slide.

The scale of the hidden losses of perhaps the twenty largest US banks is so enormous that if not before, the first Presidential decree of President Barack Obama will likely have to be declaration of a US ‘Bank Holiday’ and the full nationalization of the major banks, taking on the toxic assets and losses until the economy can again function with credit flowing to industry once more.

Citigroup and the government have identified a pool of about $306 billion in troubled assets. Citigroup will absorb the first $29 billion in losses. After that, remaining losses will be split between Citigroup and the government, with the bank absorbing 10% and the government absorbing 90%. The US Treasury Department will use its $700 billion TARP or Troubled Asset Recovery Program bailout fund, to assume up to $5 billion of losses. If necessary, the Government’s Federal Deposit Insurance Corporation (FDIC) will bear the next $10 billion of losses. Beyond that, the Federal Reserve will guarantee any additional losses. The measures are without precedent in US financial history. It’s by no means certain they will salvage the dollar system.

The situation is so intertwined, with six US major banks holding the vast bulk of worldwide financial derivatives exposure, that the failure of a single major US financial institution could result in losses to the OTC derivatives market of $300-$400 billion, a new IMF working paper finds. What’s more, since such a failure would likely cause cascading failures of other institutions. Total global financial system losses could exceed another $1,500 billion according to an IMF study by Singh and Segoviano.

The madness over a Detroit GM rescue deal

The health of Citigroup is not the only gripping crisis that must be dealt with. At this point, political and ideological bickering in the US Congress has so far prevented a simple emergency $25 billion loan extension to General Motors and other of the US Big Three automakers—Ford and Chrysler. The absurd spectacle of US Congressmen attacking the chairmen of the Big Three for flying to the emergency Congressional hearings on a rescue loan in their private company jets while largely ignoring the issue of consequences to the economy of a GM failure underscores the utter lack of touch with reality that has overwhelmed Washington in recent years.

For GM to go into bankruptcy risks a disaster of colossal proportions. Although Lehman Bros., the biggest bankruptcy in US history, appears to have had an orderly settlement of its credit defaults swaps, the disruption occurred before-hand, as protection writers had to post additional collateral prior to settlement. That was a major factor in the dramatic global market selloff in October. GM is bigger by far, meaning bigger collateral damage, and this would take place when the financial system is even weaker than when Lehman failed.

In addition, a second, and potentially far more damaging issue, has been largely ignored. The advocates of letting GM go bankrupt argue that it can go into Chapter 11 just like other big companies that get themselves in trouble. That may not happen however, and a Chapter 7 or liquidation of GM that would then result would be a tectonic event.

The problem is that under Chapter 11 US law, it takes time for the company to get the protection of a bankruptcy court. Until that time, which may be weeks or months, the company would need urgently 'bridge financing' to continue operating. This is known as 'Debtor-in-Possession or DIP financing. DIP is essential for most Chapter 11 bankruptcies, as it takes time to get the plan of reorganization approved by creditors and the courts. Most companies, like GM today, go to bankruptcy court when they are at the end of their liquidity.

DIP is specifically for companies in, or on the verge of bankruptcy, and the debt is generally senior to other outstanding creditor claims. So it is actually very low risk, as the amount spent is usually not large, relatively speaking. But DIP lending is being severely curtailed right now, just when it is most needed, as healthier banks drastically cut loans in the severe credit crunch situation.

Without access to DIP bridge financing, GM would be forced into a partial, or even a full liquidation. The ramifications are horrendous. Aside from loss of 100,000 jobs at GM itself, GM is critical to keep many US auto suppliers in business. If GM failed soon most, possibly even all of the US and even foreign auto suppliers will go under. Those parts suppliers are important to other auto makers. Many foreign car factories would be forced to close due to loss of suppliers. Some analysts put 2009 job losses from a GM failure as high as 2.5 million jobs due to the follow-on effects. If the impact of that 2.5 million job loss is seen in terms of the overall losses to the economy of non-auto jobs such as services, home foreclosures caused and such, some estimate total impact would be more than 15 million jobs.

So far in the face of this staggering prospect, the members of the US Congress have chosen to focus on the fact the GM chief, Rick Wagoner, flew in his private company jet to Washington. The Congressional charade conjures up the image of Nero playing his fiddle as Rome goes up in flames. It should not be surprising that at the recent EU-Asian Summit in Beijing, Chinese officials mooted the idea of trading between the EU and Asian nations such as China in Euro, Renminbi, Yen or other national currencies other than the dollar. The Citigroup bailout and GM debacle has confirmed the death of the post-1944 Bretton Woods

Dollar System.

The real truth behind Citigroup bailout

What neither Paulson nor anyone in Washington is willing to reveal is the real truth behind the Citigroup bailout. By his and the Republican Bush Administration's adamant earlier refusal to take an initial resolute action to immediately nationalize the nine or so largest troubled banks, he has created the present debacle. By refusing on ideological grounds to instead reorganize the banks' assets into some form of 'good bank' and 'bad bank,' similar to what the Government of Sweden did with what it called Securum, during its banking crisis in the early 1990's, Paulson and company have created a global financial structure on the brink.

A Securum or similar temporary nationalization would have allowed the healthy banks to continue lending to the real economy so the economy could continue operating, while the State merely sat on the undervalued real estate assets of the Swedish banks for some months until the recovering economy made the assets again marketable to the private sector. Instead, Paulson and his 'crony capitalists' in Washington have turned a bad situation into a globally catastrophic one.

His apparent realization of the error of his initial refusal to nationalize came too late. When Paulson reversed policy on September 19 and presented the nine largest banks with an ultimatum to accept partial Government equity ownership, abandoning his original bizarre plan to merely buy up the toxic waste asset-backed securities of the banks with his $700 billion TARP taxpayer money, he never revealed why.

Under the original Paulson Plan, as Dimitri B. Papadimitriou and L. Randall Wray of the Jerome Levy Institute at Bard College in New York point out, Paulson sought to create a situation in which the US 'Treasury would become an owner of troubled financial institutions in exchange for a capital injection—but without exercising any ownership rights, such as replacing the management that created the mess. The bailout would be used as an opportunity to consolidate control of the nation's financial system in the hands of a few large (Wall Street) banks, with government funds subsidizing purchases of troubled banks by "healthy" ones.'

Paulson soon realized the scale of crisis, largely triggered by his inept handling of the Lehman Brothers case, had created an impossible situation. Were Paulson to use the $700 billion to buy up toxic waste ABS assets from the select banks at today's market price, the $700 billion would be far too little to take an estimated $2 trillion ($2,000 billion) in Asset Backed Securities off the books of the banks.

The Levy Economics Institute economists state, 'It is probable that many and perhaps most financial institutions are insolvent today — with a black hole of negative net worth that would swallow Paulson's entire $700 billion in one gulp.'

That reality is the real reason Paulson was forced to abandon his original 'crony bailout' TARP plan and opt to use some of his money to buy equity shares in the nine largest banks.

That scheme as well is 'dead on arrival' as the latest Citigroup nationalization scheme underscores. The dilemma Paulson has created with his inept handling of the crisis is simple:

If the US Government paid the true value for these nearly worthless assets, the banks would have to write down huge losses, and, as Levy economists put it, 'announce to the world that they are insolvent.' On the other hand, if Paulson raised the toxic waste purchase price high enough to protect the banks from losses, $700 billion 'will buy only a tiny fraction of the 'troubled' assets.' That is what the latest nationalization of Citigroup is about.

It is only the beginning. The 2009 year will be one of titanic shocks and changes to the global order of a scale perhaps not experienced in the past five centuries. This is why we should speak of the end of the American Century and its Dollar System.

How destructive that process will be to the citizens of the United States who are the prime victims of Paulson's crony capitalists, as well as to the rest of the world depends now on the urgency and resoluteness with which heads of national Governments in Germany, the EU, China, Russia and the rest of the non-US world react. It is no time for ideological sentimentality and nostalgia of the postwar old order. That collapsed this past September along with Lehman Brothers and the Republican Presidency. Waiting for a 'miracle' from an Obama Presidency is no longer an option for the rest of the world.

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