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Citibank charges into the financial mine field

by David Goldman

"Liquidate farm, liquidate labor, liquidate capital."

A specter is haunting Wall Street: the specter of Andrew Mellon, the self-professed warlock, collector of occult manuscripts, and disciple of Carl Jung, whose dictum of 1931 is quoted above. New York's Citicorp has begun the festivities of the Great Crash of 1987, in grand style, by breaking ranks with the creditors' cartel which rolled over the bad loans and beat down the debtors after the 1982 Mexico crisis. By writing off $3 billion of Third World debt, and taking (some of) its losses up front, America's largest bank has begun a general process of liquidation, that will take down some $7-8 trillion of debt internationally before the dust settles.

Of the thousands of lines of newspaper copy devoted to the big write-off, the closest truth is to be found in a few lines of the May 21 *Wall Street Journal* editorial: Despite the usual attitude that "the only useful policy is to keep rolling over the bad debt. . . . Citicorp has decided that it can't do much worse dealing with the problem unilaterally. If this is not exactly a vote of confidence in current economic management, neither is the bearish tone of the markets. The markets know that we are not currently on anything resembling a steady march toward sounder international economy. That's probably why gold hit a four-year high of $480 in London yesterday. . . . The economists who were talking about balancing trade with a 120-yen dollar are now talking 100 yen. If we ever reach 100, they will be talking 60. Yet it is not clear that even the U.S. Treasury has abandoned these notions. In the midst of this confusion, Citicorp has decided to chart its own course. In a world where public policies were better ordered, it might have felt more comfortable staying on the team. That fact calls for some serious contemplation by the people who make U.S. economic policy."

The principal omission in the above statement involves the self-fulfilling nature of Citibank's prophecy. As an internal briefing to Citibank employees and clients warned May 20, the bank's action heavily constrains the Federal Reserve from raising interest rates to support the dollar, now bouncing slightly above its all-time lows against both the German mark and the Japanese yen. That leaves the Treasury to stumble back toward a cheap-dollar program, as if the dybbuk of G. William Miller had possessed Treasury Secretary James Baker III.

That also implies that the 9% level for long-term U.S. government bond yields, the highest in 14 months, will become a blissful memory in a matter of weeks, probably before the Benedictine fathers of the Venetian island of San Giorgio Maggiore wave farewell to their guests—the heads of state attending the June economic summit there.

Since the middle of last year, the principal purchasers of U.S. government securities have been the central banks of West Germany, Japan, Canada, and Taiwan. During the first quarter of 1987, former Council of Economic Advisers Chairman Alan Greenspan argues, they financed the entire U.S. trade deficit, by purchasing nearly $30 billion later reinvested in Treasury securities. Foreign private investors gave up long ago. That suggests that the dollar's foundation is far shakier than even the dollar's crash to date indicates; another study, a private one by Morgan Guaranty Trust, shows that Japanese institutions were major net sellers of U.S. securities during the first quarter.

What happens if foreign central banks stop using the dollar as a principal reserve currency? That is already on the agenda for the Venice summit. Italian Foreign Minister Giulio Andreotti has already said that he will tell the summit that the world monetary system should divide into three blocs: a

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dollar bloc embracing Ibero-America, a yen bloc for Asia, and an ECU (European Currency Unit) bloc for Western Europe, in emulation of the pre-World War II monetary collapse. The consequences for the dollar, i.e., the absence of central-bank support, would be apocalyptic. Of course, Andreotti's advice will only thicken the Venetian fog around the summit; but what appears an extreme position may be the refuge of central banks within weeks or months.

The International Monetary Fund already warns that the U.S. dollar "is on a treadmill, where higher interest rates give a perverse signal," i.e., the dollar falls in response to higher interest rates, rather than rises, as it is supposed to. It recommends that the U.S. monetary authorities "visibly and dramatically sterilize the monetary effect of foreign exchange intervention," i.e., keep out of the banking system all the dollars that the Japanese and other central banks purchase to support the dollar's level on the foreign exchange markets. That implies a drastic monetary crunch. It also calls for much higher taxes and drastic budget cuts, to reduce the U.S. federal budget deficit.

Short of this, the dollar is headed for the 100-yen level that the old Carter administration economists like Boston's Rudiger Dornbusch want, and the world is headed for a general breakup of the monetary system.

End of the creditors' cartel

Citicorp's action marks the end of the creditors' cartel formed at the London headquarters of the Ditchley Foundation in 1982, and guided in its first phase by former Swiss National Bank president Fritz Leutwiler. Said Rudiger Dornbusch of the Massachusetts Institute of Technology, "The more you have episodes like this, the harder it is to keep the cartel of banks together."

"With Citicorp's action, the collegiality among the largest United States banks could very well fall apart," wrote the *New York Times* May 21. "By building its reserve, Citicorp has placed immediate pressure on other institutions to bolster their own reserves. Yet weaker institutions such as Manufacturers Hanover, the Bank of America, and some banks in Texas are not in a position to take such a move.

"The resulting resentment toward Citibank, along with an unwillingness to work side-by-side with the giant bank in future debt negotiations, could run deep. At a minimum, debt experts say, negotiations will be hobbled by the friction that will undoubtedly exist henceforth between Citicorp and its rivals," concluded the *Times*. Citicorp has 137% of shareholders' capital in Third World loans, against 108% for Bank of America, and 157% for Manufacturers Hanover. But its other loan losses are relatively lower.

Citicorp Chairman John Reed said May 19, "The debt problem will be with us into the 1990s, and we see nothing in the global economy that would enable (Third World) countries to get out of their situation. . . . The global economy is less robust today than was expected when the present approach was devised in 1982; trade figures in the debtor countries were less strong than we believed they would be."

Reed's former mentor, retired Citicorp chairman Walter Wriston, has told friends the same thing, but without the euphemisms. "Why agree to half the interest payments, when [the debtors] will just renege on those payments, too? We might as well take a tough line right now," Wriston reportedly argued.

Days before Reed's announcement, the so-called Baker Plan gasped its last, when the World Bank's bid for the role of global debt-crisis manager fell apart. Reagan appointee Barber Conable, the World Bank president, wanted to make the International Monetary Fund's sister-institution the vehicle for the Baker formula: new loans in return for political and economic reorganization. However, the World Bank's role depended on its ability to draw the commercial banks in behind its own, relatively limited, lending programs. The executive responsible for the contacts with the banks, World Bank Treasurer Eugene Rotberg, decided instead to quit the bank and take a high-paid position at Merrill Lynch, rather than try the impossible on a civil-service salary, discrediting the entire effort.

Reed has not come out and said that there will be no more loans for developing nations. He said May 19, "We want to be in a position to trade out and reliquefy our loan portfolio. In the next two to three years, we will engage in debt-equity swaps, debt sales, and other approaches. . . . A loss on a debt-equity swap would have no impact on our advancing new money to a country that adopted sound growth-oriented policies."

In fact, the "new money" offered to developing nations has not much more substance than the proverbial boardinghouse soup made from the shadow of a chicken that had died of starvation. Timid Third World ministers had acceded to bankers' conditions in the hope of "new money," while the bankers lent themselves the funds to pay part of their interest. On February 22, Brazil broke the pattern by declaring a debt moratorium against the banks; Citicorp's response says, "We'll write you off, then cut you off and starve you out."

In fact, the Citicorp write-off cuts off not only lending to the developing nations, but to the entire world economy. "The biggest casualty," wrote the *New York Times* May 21, "will be new lending, which lies at the heart of the plan by Treasury Secretary James A. Baker III to deal with the world's debt burden."

As other banks are compelled to follow suit, and build loan reserves against a considerably smaller capital base than Citicorp's, their capacity to extend credit will constrict dramatically. Big loan write-offs could "tip the economy over," warned Hudson Institute economist James Wheeler says. "That makes the banks more susceptible to a tight monetary policy," Wheeler added. "They will be forced to cut back lending sharply." He predicted that the Fed will be pressured to keep monetary policy loose, a warning made in a May 20 private Citibank briefing to customers. "That means it's time to sell the dollar short."