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Profits on Citigroup Stock: Can They Be the Basis for Financing Stimulus?

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Last month the government announced plans to sell the stock it obtained in November of 2008 as part of its bailout package of Citigroup. The media jumped on the fact that, at the stock's current market value, the government stands to earn an $8 billion profit on this stock. This profit was widely touted as evidence of the success of the bailout.

In reality, the government's profit on Citigroup stock was primarily the result of its own willingness to back up Citigroup. The increase in Citigroup's stock price was largely driven by investors' realization that the government would not let Citigroup fail.

While this fact makes the media celebration somewhat silly, it does suggest a mechanism for escaping the deficit fears that are preventing the government from taking more effective measures to reduce unemployment. If the government's gains from bestowing its good credit to Citigroup can pass as "profit" in the minds of the media and elite Washington circles, then this mechanism can be used in other ways to finance job creation. The government can do this by using its credit to drive up the price of other stocks and then share in the gains. It can then use these gains to spend as much as is necessary to restore health to the economy without incurring the wrath of deficit hawks.

How We "Made a Profit" on Citigroup

The basis for the $8 billion profit claim is fairly straightforward. The calculation is based on a $27 billion investment in preferred Citigroup stock that the government made in November of 2008. At the time, the company was flirting with bankruptcy and private investors would not go near it. The government's preferred stock was later converted to common shares. The government announced its intention to sell these shares last month, which would be worth close to $35 billion at the current market value.

The simple arithmetic suggests an $8 billion profit. However, this assessment misses most of the story. The reason that the price of Citigroup's stock increased so much was not an improvement in the bank's prospects in the sense of more profitable lending opportunities or fewer losses on bad loans. Rather, the main reason that Citigroup's stock went up was that investors

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realized that the government was committed to supporting the bank. Citigroup was protected by the security blanket of "too big to fail" (TBTF), the idea that if the bank's losses put its survival in jeopardy, the government would step in with aid, as it did in November of 2008.

The belief in TBTF protection had been temporarily shaken by the decision to allow Lehman to collapse in September of 2008. Lehman's creditors lost tens of billions of dollars when Lehman went bankrupt. However, in the actions taken subsequent to this collapse, such as the Citigroup rescue, the government effectively convinced the markets that it was committed to TBTF protection and that no major banks would again be allowed to collapse.

This importance of TBTF protection is demonstrated by a huge increase in the advantage enjoyed by large banks in getting lower-cost funds than smaller banks. The gap between what the big banks pay for the money they borrow and what smaller banks pay exploded during the financial crisis. Even though Citigroup, Bank of America and other large banks were in a very precarious state at the time, they were able to borrow money more cheaply than their smaller competitors. This gap in funding costs amounted to a subsidy of as much as $34 billion a year to the large banks.[1] In addition to the general TBTF protection, the government also made a variety of loans available to Citigroup through the Federal Reserve Board and the FDIC at below-market interest rates.

This directly relates to the government's profit on Citigroup stock, since it was the government's TBTF guarantee, along with the below-market loans from the Fed and the FDIC, that was the basis for the increase in the stock price from the levels of November 2008. With the government able to convince investors that it would not allow the bank to fail, Citigroup was able to get funds at much lower cost than would otherwise be the case. Therefore the bank was more profitable and its stock rose in value.

The government's TBTF guarantee raised the value of all Citigroup stock, including the shares it owned. While the government could claim a profit of $8 billion on its holdings, private investors earned more than twice as much on the 73 percent of Citigroup stock not held by the government. The top executives of Citigroup also profited from this arrangement, since they were able to pocket multi-million dollar compensation packages. These pay packages would not have been possible if the bank had been forced into bankruptcy.

The great twist in this story is that the government is being seen as profiting from an arrangement in which it used the value of its own credit to raise stock prices. Let's call this the Citi Profit Trick: Rather than raising the deficit, this use of the government's credit to insure Citigroup is seen as lowering the deficit and the government's outstanding debt. The deficit-reducing effect of this action was even touted by the arch deficit hawks at the Washington Post's editorial board ("No One Likes the TARP: But It's Working" (4-1-10; A14)).

Applying the Citi Profit Trick to Financing Stimulus

The Citi Profit Trick raises a fascinating possibility for financing an economic recovery. With the unemployment rate at 9.7 percent, the economy is operating at far below full employment levels of output. The obvious route to reducing unemployment would be to stimulate demand with more government spending or tax cuts.[2] If we had more spending in the economy, it would mean more demand for workers, which would move us back toward full employment. However, the possibility of going this route is blocked at present over concerns about the budget deficit. Deficit hawks from both parties are insisting that the government has to start reducing its deficit and are preventing Congress from passing any spending or tax measures that are large enough to substantially reduce the unemployment rate.

However, the Citi Profit Trick presents a path around this constraint. There is nothing magic about Citigroup stock or even bank stock more generally. The government can use its good credit to drive up the price of any stock. A government guarantee of support will reduce the cost of borrowing for any company. This will make it more profitable and drive up its stock price.

For example, the government could buy a 25 percent stake in Verizon, Boeing, or Intel. It can then put in place a special guarantee for the company insuring all its debt obligations for 5-10 years into the future. It can then sell the stock at a profit and use the money to finance job creation measures. The people who applauded the profit that the government made on Citigroup stock should be fine with this path since the stimulus would be fully paid for from the profits made on the stocks of these companies.

In fact, the government can go one step further. Suppose that it created trust funds that had purposes like rebuilding infrastructure, financing higher education, weathering homes and businesses. It can then have these trust funds buy up the bulk of the stockholdings of a certain set of companies. The government could then step in and guarantee the debt of these companies. In this case, instead of following the Citigroup example and just getting 27 percent of the stock gains that resulted from the government's commitment of support, and allowing the rest to accrue to private investors, the trust funds could garner the vast majority of these gains. This money could then be used to support the public purpose for which the trust fund is committed. And, following the logic of the Citi Profit Trick, it can all be done without driving up the deficit.

A More Serious Look at the Actual Profit on Citigroup's Stock

The media's discussion of the profit on Citigroup's stock, like its discussion of many basic economic issues, largely missed what was actually going on. The government can always bestow its implicit credit guarantee on a corporation, state and local government, or other entity. This guarantee has enormous value, even though it never appears on the government's books as an outlay. The government can take back part of the value of this guarantee, as it did with Citigroup, by owning a stake in the entity that is benefiting from the guarantee – in this case Citigroup.

While issuing a guarantee will typically be costless to the government, it does have a cost to the economy in normal times. If the economy were operating near its capacity, then the guarantee provided to Citigroup would mean that capital that might have otherwise gone to support investment at other companies would instead be used by Citigroup. If Citigroup were a less productive use for this capital, then this reallocation would result in lower output and growth. To do a serious profit/loss calculation on the support given to Citigroup and other banks we would have to put a price on the explicit and implicit guarantees extended as well as the subsides implied by below-market loans.

However, these are not normal times. In the current downturn, there is a huge excess supply of capital, labor and other resources. There is no basis for concern that a government guarantee for Citigroup will pull resources from more productive uses. Essentially, this is about putting resources that would otherwise be idle to productive use, boosting the economy and creating jobs.

The same point holds for stimulus more generally. If Congress were to increase annual spending by 3-4 percentage points of GDP ($450 to $600 billion), and to finance it with bonds sold to the Federal Reserve Board, there is no reason to be concerned that this would drain resources from other purposes. In the current downturn, if the resources were not used on the stimulus, then they simply would not be used and go to waste.

If the Fed bought up the debt used to finance the stimulus, then interest rates need not rise, since there will be no need to attract private investors to purchase that debt. In fact, there would not even be a greater interest burden to pass onto our children since the Fed would be holding the newly issued government debt. This means that the Fed would collect the interest, which in turn would be refunded back to the Treasury at the end of the year. This means that we can boost the economy today without imposing any additional interest burden on our children and grandchildren. Of course boosting the economy today would also mean improving the infrastructure, the capital stock and the education of our workforce, thereby making the economy and our children more prosperous in the future.

Unfortunately, the deficit hawks have prevented Congress from going this route. They refuse to allow the passage of additional stimulus that could put 15 million unemployed Americans back to work. But, if we can't just do this through normal spending channels, then we might as well use the Citi Profit Trick. It apparently can fool the deficit hawks.

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1 Baker, Dean and Travis McArthur. 2009. "The Value of the Too Big to Fail Subsidy," Washington, DC: Center for Economic and Policy Research. Available at http://www.cepr.net/index.php/publications/reports/too-big-to-fail-subsidy/.

2 If we can't raise GDP by enough to bring the economy back to full employment, an alternative is to divide up the available work through work sharing. This mechanism has kept the unemployment rates from rising in Germany and the Netherlands during the downturn, even though their GDP has fallen by a larger amount than in the United States.