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18.03.2009 

US TAXPAYER BAILS OUT DEUTSCHE BANK HEDGE FUNDS



The **AIG story** gets ugly. **OUR PARTNERS** [Wall Street Journal](#) (hat tip [Naked Capitalism](#)) has a story that [AIG](#) paid money to a hedge fund – set up by [Deutsche Bank](#) – that speculated on falling house prices. The article has the details on how this happened, but the ballpark is that AIG received \$50m in fee income, or less, in exchange for a payout of \$800m. This was a fund Deutsche Bank set up to speculate on falling US house prices. This

looks like blowing into a major scandal, as the US media, and Congress, are getting extremely angry.

Treasury Secretary Jim Geithner once again looks weak and defenseless. The beginning of a discussion series on new currency regimes. [Ronald McKinnon](#) argues that the four priorities for reform should be to stabilise the economy, begin to address large trade imbalances, suppress carry trades, and reduce counterparty risk.

German banks hesitant to pass over interest rate cuts

The ECB has criticised the German banking sector for insufficiently passing over the interest rate cuts to their customers, reports the [FAZ](#). What the ECB lowered is not a sustainable system. [The ECB lowered interest rates from 4.25% to 1.5%, new mortgage rates only fell by 0.5pp since last October \(similar also for commercial credits\). At the same time banks lowered deposit rates significantly \(from 5 to 2.5% for 1year deposits\), thereby widening their profit margins. The ECB's Jurgen Stark reminded them their responsibility and called on the banks to lower their interest rates. The article goes on saying that the criticism is not entirely justified as refinancing conditions are still costly, although improved, and that amid a recession the banks better prepare for the rise in future defaults.](#)

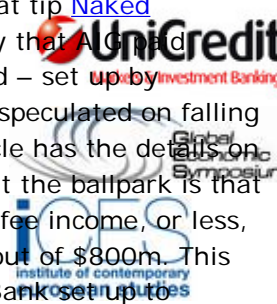
Another market rally – and some good news on US housing (sort of)

The market rally continued yesterday, as US stocks are now up some 15% from the trough a week ago. But before you get too excited, here is a graph from [Calculated Risk](#), putting the latest rally into perspective. We are still on the same trajectory as the stock market during the Great Depression.

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DEBATE
A New Bretton Woods

05.02.2009
By: Ronald McKinnon

 [The beginning of a discussion series on new currency regimes.](#) [Ronald McKinnon](#) argues that the four priorities for reform should be to stabilise the economy, begin to address large trade imbalances, suppress carry trades, and reduce counterparty risk.

The need for concerted action

23.01.2009
By: Jörg Bibow

 [What is presently holding the ECB back? It is not a sustainable system.](#) **EMU MONITOR**
The banks divide within Europe
18.01.2009
By: Zsolt Darvas and Sean P. Fisher
[bruegel](#) Bruegel

New EU member states are at a disadvantage due to a combination of own policy errors and euro area policy errors. [The financial crisis.](#)

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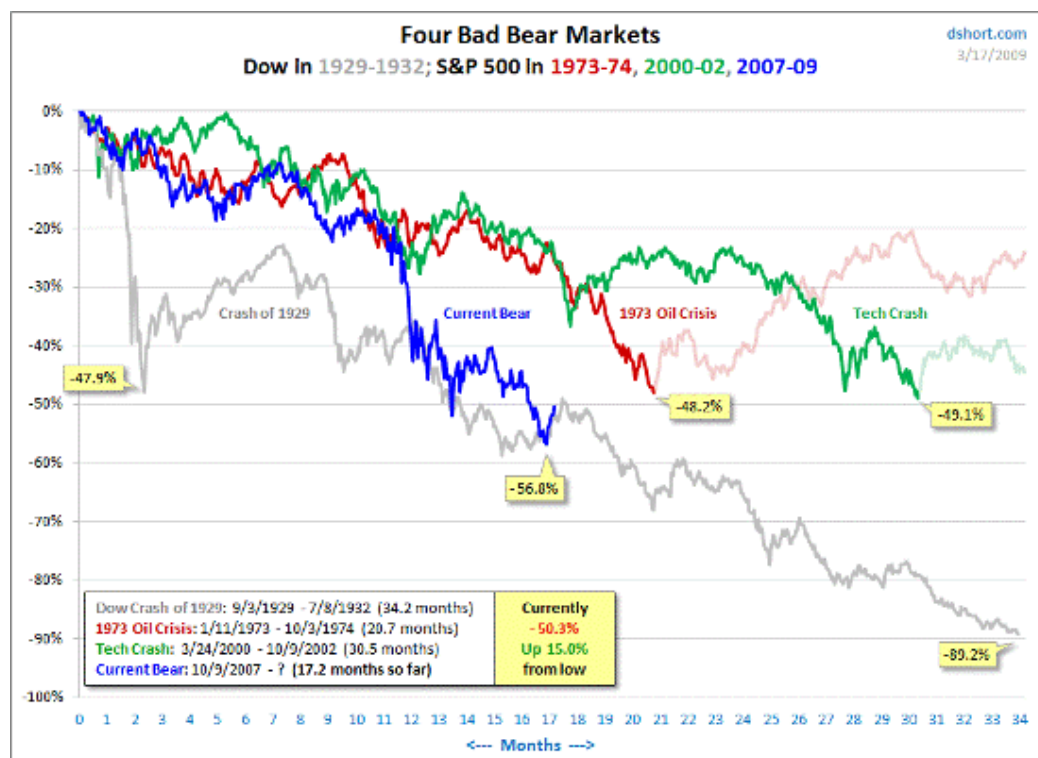
13.03.09

Credit Default Swaps - Quantum Hedges - Part 2

By: Satyajit Das
13.03.09

German industry declines at an annualised rate of over 50%

12.03.09



The blog also has an [interesting discussion](#) on US housing starts. While this series may have bottomed, it does not mean that house prices have also bottomed. In the bloggers' estimate, the decline in US house prices has one or two more years to go.

EU Commission seeks influence over state aid to Commerzbank

The German government and the European Commission are at odds over pending state aid of €10bn to Commerzbank, reports [FT Deutschland](#). The Commission believes Commerzbank to be in some trouble, an assessment that if reaffirmed would make an EU approval conditional on the bank to draw up a restructuring plan. The German government announced in January that it would provide €10bn to the ailing bank after a first capital injection of €8.2bn last year. In an attempt to secure some influence over national state aid packages, EU Commissioner Neelie Kroes said banks might be too large to fail but not to restructure.

The [editorial in FT Deutschland](#) argues that states have made themselves vulnerable by bailing out unhealthy institutions. There are no real options to escape this policy trap, only if the state was no longer under the "obligation" to save an ailing institution at any price.

No more Glass Steagall

The [FT editorial](#) argues that calls to revive the Glass Steagall Act, which barred commercial banks (which take deposits and make loans) from securities and insurance business until 1999 are ill-founded, as it could not have prevented today's crisis. "Bear Stearns and Lehman Brothers, without depository subsidiaries, never fell foul of it. And the main villains of the still-unfolding tragedy, mortgage-backed securities, were exempt from Glass-Steagall's restrictions." The root of the problem is rather that the growth of a shadow financial system enabled companies to perform bank-like functions while eluding bank-like regulation. The regulatory answer is not to constrain who does what,

but to control the risk. Firms must pay the price for risks they impose, and institutions whose failure threatens the system must meet stricter requirements.

France seeks to close hole created by VAT cut

After the French finally won German approval for President Nicolas Sarkozy's plan to cut VAT on restaurant meals from 19.6% to the EU minimum of 5.5%, France is now debating how to finance the unpalatable €4.2bn bill and what the government can ask from the restaurant industry in return, reports [the FT](#). Experts estimate that the rebate will not entirely be passed on to consumers while the industrial lobby groups promised to create jobs, raise wages and cut prices.

Germany fears US to enter inflation spiral

[This FT](#) article highlights the reasoning for why Germany prefers to focus on financial market regulation rather than stimulus in the debate ahead of the G20 meeting. It quotes Christoph Schmidt, one of the five 'wise men' to advise the German government on economic policy, who warned that mounting public debt and excessive liquidity in the economy could tip the US into an inflationary spiral. The Princeton-educated economist did not see such a risk in Europe. "When adopting fiscal stimuli, you have to balance their benefits against the dangers of rising public debt. There is a trade-off and I think countries like France and Germany have found the right balance."

Martin Wolf on the global stimulus

In his FT column [Martin Wolf](#) starts with the observation that the debate about global stimulus is essentially a debate between the US and Germany. He calculates that the fiscal effects of a global 2% per year stimulus 2009-2010 should be easily containable, provided governments have the political will to rein in deficit later. That is true even for Japan. The alternative is a global depression.

New vs Old Keynesian multipliers

The Wall Street Journal (12 March) had an interesting article on a new paper by two US and two German economists - John Cogan and John Taylor of Stanford and Tobias Cwik and Volker Wieland of Goethe University - who argue that the stimulus calculus is different under a New Keynesian framework. "What the four economists found is that the Administration's estimates for stimulus growth were six times as high as they could produce under a modern Keynesian simulation. By their estimates, the stimulus would produce, at most, 600.000 jobs and add perhaps 0.6% to GDP at its peak. That's nowhere near a multiplier of 1.5 and suggests the 800 billion dollar would have been better devoted to business tax cuts or fixing the financial system. That's 1.3m dollars in spending per job, for those keeping score at home."

Francesco Daveri on America vs Europe

Writing in Lavoce, [Francesco Daveri](#) argues that there are two reasons why the US and Europe have reacted differently to the crisis. The first is because we have no United States of Europe, and the second is Europe's welfare net, which automatically kicks in once unemployment rises.

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