Advance Readings for the Sept. 27, 2012 discussion of "*American & European debt reduction strategies*" at the Burlington Public Library

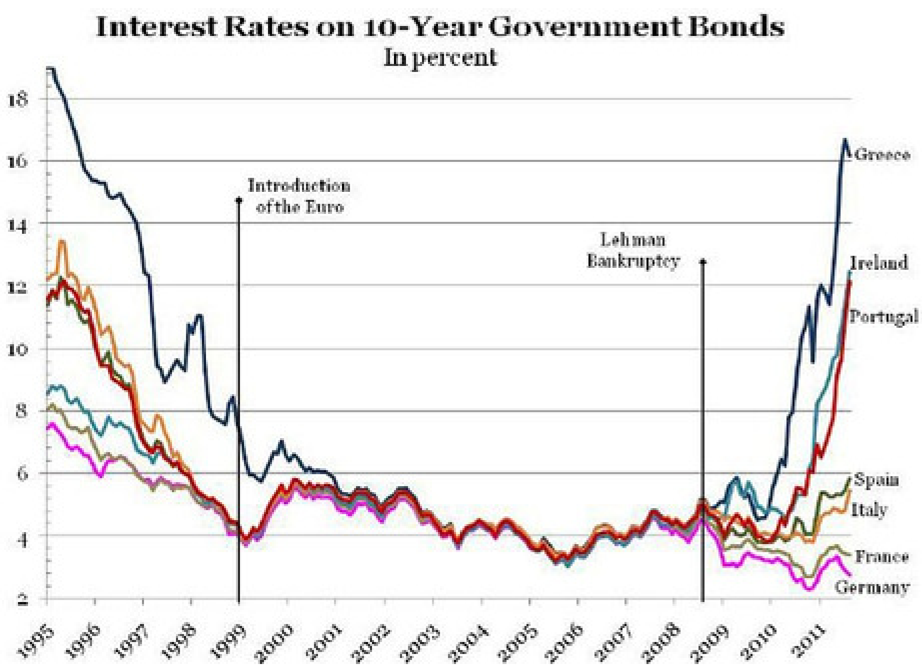
The Crisis In Europe, Explained **From NPR.**

June 4, 2012

by Jacob Goldstein

In a speech, George Soros just explained the past and present of the euro crisis, and made a prediction about the future. Lots of people are talking about it. You can read it here. [Soros made his speech at the Festival of Economics, Trento Italy. The first part of his speech is his view of why economic theory as typically expounded is incorrect. The comments on Germany are summarized below by Goldstein]

The speech reminded me of this amazing graph that made the rounds last year:



Enlarge Thomson Reuters Datastream

European yields.

Taken together, the speech and the graphic give a quick, dramatic overview of Europe's crisis. There are three basic parts to the story.

1. The Convergence

Before the euro was introduced, governments in Greece, Spain and Ireland, among others, had to pay a lot more to borrow money than governments such as France and Germany. But after the euro was introduced, there was this amazing convergence. Suddenly, all the countries could borrow at the same rate.

Soros explains the convergence:

When the euro was introduced the regulators allowed banks to buy unlimited amounts of government bonds without setting aside any equity capital; and the central bank accepted all government bonds at its discount window on equal terms. Commercial banks found it advantageous to accumulate the bonds of the weaker euro members in order to earn a few extra basis points. That is what caused interest rates to converge which in turn caused competitiveness to diverge.

Translation: European officials essentially told banks: Bonds from all euro zone countries are identical. It doesn't matter whether they're sold by Greece or Germany or whoever. They're all the same. So banks rushed to lend money to the weaker euro zone countries, and their borrowing costs plummeted.

2. The False Dream

For roughly a decade, it seemed that the dream of the euro was coming true. Borrowing costs were almost identical for all of the countries in Europe. But under the surface, Europe was actually growing apart. Soros writes:

Germany, struggling with the burdens of reunification, undertook structural reforms and became more competitive. Other countries enjoyed housing and consumption booms on the back of cheap credit, making them less competitive.

Translation: Germany got better at selling stuff to the rest of the world over the past decade. Other countries in Europe had a false sense of prosperity. They borrowed lots of money to buy stuff and build houses, and they got worse at selling stuff to the rest of the world.

The euro made it easier for Germany to sell stuff to countries on the periphery of Europe, both by making German goods cheaper for people in those countries, and by making it easier for people in those countries to borrow money to buy stuff from Germany.

3. The Crisis

After the financial crisis, it eventually dawned on everybody that the countries that shared the euro are, in fact, a bunch of different countries, with vastly different economies — and that, despite what the officials said, not all eurozone government bonds are identical.

Soros writes:

It took some time for the financial markets to discover that government bonds which had been considered riskless are subject to speculative attack and may actually default; but when they did, risk premiums rose dramatically. This rendered commercial banks whose balance sheets were loaded with those bonds potentially insolvent. And that constituted the two main components of the problem confronting us today: a sovereign debt crisis and a banking crisis which are closely interlinked.

Translation: Once everybody realized that some eurozone countries might not be able to pay back their debts, they started demanding higher interest rates to lend to weaker countries. That, in turn, hammered the banks that had loaned all that money to those weaker countries.

Those two, related problems — rising borrowing costs for weaker countries, and trouble for banks that have loaned money to those countries — are at the core of the European crisis.

BONUS: Why a euro zone breakup would be bad for Germany

Soros argues that, in the end, Germany will try to save the euro in order to protect its own interests. He writes:

...the likelihood is that the euro will survive because a breakup would be devastating not only for the periphery but also for Germany. It would leave Germany with large unenforceable claims against the periphery countries. The Bundesbank alone will have over a trillion euros of claims arising out of Target2 by the end of this year, in addition to all the intergovernmental obligations. And a return to the Deutschemark would likely price Germany out of its export markets...

Translation: The end of the euro would hurt Germany in two main ways.

First, it would mean Germany's central bank would never be able to recover a huge amount of money it's owed as part of Europe's current system.

Second, the end of the euro would make German exports much more expensive in the rest of Europe. That would be a big blow for a key part of Germany's economy.

But the version of the euro that survives may be ugly, Soros writes:

Germany is likely to do what is necessary to preserve the euro – but nothing more. That would result in a eurozone dominated by Germany in which the divergence between the creditor and debtor countries would continue to widen and the periphery would turn into permanently depressed areas in need of constant transfer of payments.

Translation: The deep problem facing the euro zone isn't just debt. It's the vast gap between the economies in the struggling countries and the economies in the stronger countries. If Germany does the bare minimum to keep the euro afloat, those differences will persist — and the struggling countries will continue to struggle indefinitely.

Soros argues that Germany should do more than the bare minimum, to try to change the broader economic picture in Europe. But he says that's not likely to happen.

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19 June 2012 Last updated at 09:10 ET

Eurozone crisis explained From BBC News

World leaders probably spend more time worrying about the eurozone crisis than anything else nowadays.

But as eurozone governments struggle to agree the best way out of the crisis, are they missing what caused it?

- The eurozone has agreed a new "fiscal compact"
- Eurozone parliaments are in the process of ratifying a tough set of rules - insisted on by Germany - that will limit their governments' "structural" borrowing (that is, excluding any extra borrowing due to a recession) to just 0.5% of their economies' output each year. The pact, which will come into force once 12 out of the 17 eurozone member states have ratified it, will also limit their total borrowing to 3%. These rules are supposed to stop them accumulating too much debt, and make sure there won't be another financial crisis.
- But didn't they already agree to this back in the '90s?
- Hang on a minute. They agreed to exactly the same 3% borrowing limit back in 1997, when the euro was being set up. The "stability and growth pact" was insisted on by German finance minister Theo Waigel (centre of image). What happened?
- So who kept to the rules?
- Italy was the worst offender. It regularly broke the 3% annual borrowing limit. But actually Germany - along with Italy - was the first big country to break the 3% rule. After that, France followed. Of the big economies, only Spain kept its nose clean until the 2008 financial crisis; the Madrid government stayed within the 3% limit every year from the euro's creation in 1999 until 2007. Not only that - of the four, Spain's government also has the smallest debts relative to the size of its economy. Greece, by the way, is in a class of its own. It never stuck to the 3% target, but manipulated its borrowing statistics to look good, which allowed it to get into the euro in the first place. Its waywardness was uncovered two years ago.
  - **3/9 Italy**
    Worst offender
  - **5/9 Germany**
    First to break rules
  - **6/9 France**
    Offender
  - **9/9 Spain**
    Top of the Class
- But the markets have other ideas
- So surely Germany, France and Italy should be in trouble with all that reckless borrowing, while Spain should be reaping the rewards of its virtue? Well, no. Actually Germany is the "safe

haven" - markets have been willing to lend to it at historically low interest rates since the crisis began. Spain on the other hand is seen by markets as almost as risky as Italy. So what gives?

- So what really caused the crisis?
- There *was* a big build-up of debts in Spain and Italy before 2008, but it had nothing to do with governments. Instead it was the private sector - companies and mortgage borrowers - who were taking out loans. Interest rates had fallen to unprecedented lows in southern European countries when they joined the euro. And that encouraged a debt-fuelled boom.
- Good news for Germany...
- All that debt helped finance more and more imports by Spain, Italy and even France. Meanwhile, Germany became an export power-house after the eurozone was set up in 1999, selling far more to the rest of the world (including southern Europeans) than it was buying as imports. That meant Germany was earning a lot of surplus cash on its exports. And guess what - most of that cash ended up being lent to southern Europe.
- ...bad news for southern Europe
- But debts are only part of the problem in Italy and Spain. During the boom years, wages rose and rose in the south (and in France). But German unions agreed to hold their wages steady. So Italian and Spanish workers now face a huge competitive price disadvantage. Indeed, this loss of competitiveness is the main reason why southern Europeans have been finding it so much harder to export than Germany.
- ...and a nasty dilemma
- So to recap, government borrowing - which has ballooned since the 2008 global financial crisis - had very little to do with creating the current eurozone crisis in the first place, especially in Spain (Greece's government is the big exception here). So even if governments don't break the borrowing rules this time, that won't necessarily stop a similar crisis from happening all over again.

  Spain and Italy are now facing nasty recessions, because no-one wants to spend. Companies and mortgage borrowers are too busy repaying their debts to spend more. Exports are uncompetitive. And now governments - whose borrowing has exploded since the 2008 financial crisis savaged their economies - have agreed to drastically cut their spending back as well. But...

- Cut spending...
- ...and you are pretty sure to deepen the recession. That probably means even more unemployment (already over 20% in Spain), which may push wages down to more competitive levels - though history suggests this is very hard to do. Even so, lower wages will just make people's debts even harder to repay, meaning they are likely to cut their own spending even more, or stop repaying their debts. And lower wages may not even lead to a quick rise in exports, if all of your European export markets are in recession too. In any case, you can probably expect more strikes and protests, and more nervousness in financial markets about whether you really will stay in the euro.
- Don't cut spending...
- ...and you risk a financial collapse. The amount you borrow each year has exploded since 2008 due to economic stagnation and high unemployment. But your economy looks to be chronically uncompetitive within the euro. So markets are liable to lose confidence in you - they may fear your economy is simply too weak to support your ballooning debtload. Meanwhile, other European governments may not have enough money to bail you out, and the European Central Bank says its mandate doesn't allow it to. And if they won't lend to you, why would anyone else?

23 May 2012 Last updated at 08:52 ET

Q&A: Bonds, project bonds and Eurobonds Governments auction bonds to raise funds

The idea of eurozone economies clubbing together to issue bonds representing all 17 member nations has been gathering momentum.

And it has some pretty influential backers, including new French President Francois Hollande, Italian Prime Minister Mario Monti, and the President of the European Commission, Jose Manuel Barroso.

But those that really matter are less keen.

The German government has said eurobonds "don't make sense" right now, given that individual member states conduct their own economic policies. It is also concerned the introduction of such bonds could reduce the resolve of highly-indebted governments to balance their budgets.

There does, however, appear to be a compromise in the works. The Germans seem open to the idea of "project bonds" that can be used to finance infrastructure investment across Europe.

But what are eurobonds and project bonds (neither of which actually exists yet), and what are the government bonds on which they are based?

What is a government bond?

Governments borrow money by selling bonds to investors. A bond is an IOU. In return for the investor's cash, the government promises to pay a fixed rate of interest over a specific period - say 4% every year for 10 years. At the end of the period, the investor is repaid the cash they originally paid, cancelling that particular bit of government debt.

Government bonds have traditionally been seen as ultra-safe long-term investments and are held by pension funds, insurance companies and banks, as well as private investors. They are a vital way for countries to raise funds.

What is a bond market?

Once a bond has been issued - and the government has the cash - the investor can hold the bond and collect the interest every year until it is repaid. But investors can also buy and sell bonds that have already been issued on the financial markets - just like buying and selling shares on the stock market.

The price of the bond will fluctuate as the outlook for interest rates changes. So, for example, if the markets think that interest rates are going to rise sharply, then the value of a bond paying a fixed rate of 4% for the next 10 years will fall. Bond prices will also fall if investors think that there is a risk of the government that issued the bond not being able to make the annual interest payment or repay it in full on maturity - and these are the fears which have been pushing down Spanish bond prices.

What is a bond yield?

The bond yield tells the investor what the return on their investment is, and can be calculated based on the current price of the bond in the market. If a 100-euro bond is paying 4% fixed interest - in other words, 4 euros per year - and the bond can be bought for 100 euros, then the yield is 4%. If the bond price falls to 90 euros, then the yield will rise. That's because the investor is still getting paid 4 euros every year, and 100 euros at maturity, which is a much bigger return compared with the 90 euros they must put down to buy the bond.

Why do bond markets matter?

Because they determine what it costs a government to borrow. When a government wants to raise new money, it issues new bonds, and has to pay an interest rate on those bonds that is acceptable to the market. The yield at which the market is buying and selling a government's existing bonds gives a good indication of how much interest the government would have to pay if it wanted to issue new bonds. So, for example, Spanish 10-year bond yields have risen above 6% in recent years. That means that if the Spanish government wants to borrow new money from the bond market for 10 years, it would have to pay an interest rate on the new bond of more than 6%.

So what is a eurobond?

A eurobond would operate in exactly the same way as a government bond, except that all 17 member states of the eurozone would collectively guarantee the debt rather than a single government.

There are, however, many important questions about how a eurobond might work that remain to be answered. For example, if one government could not pay its share of the bond payments, would the other 16 governments step in and make the payments on its behalf? Would the government that got into trouble be required to prioritise its eurobond payments over its other debts? Would government bonds of the individual member governments continue to exist alongside the eurobonds? Who would decide how to spend the money raised via eurobonds? If individual governments could spend the money, then how much would each government be allowed to borrow using eurobonds and under what conditions?

How might a eurobond solve the crisis?

During the financial crisis, investors have been much less willing to buy the bonds of troubled southern European countries, and much more willing to buy the bonds of Germany and some other financially stronger countries. That has made it much cheaper for Germany to borrow, and prohibitively expensive for Greece, the Irish Republic and Portugal to borrow. The worry is that

Spain and Italy may also find it too expensive to borrow. Introducing eurobonds would level the playing field - all governments would be able to borrow at the same interest rate.

Why does Germany object to eurobonds?

Germany has three basic objections. First of all, the Germans do not see why they should be on the hook for all of the debts racked up by their southern neighbours, which is what a eurobond would entail. Secondly, it may make it more expensive for Germany to borrow, because markets may consider the eurozone as a whole to be a more risky borrower than the financial strong Germans on their own. Thirdly, and most importantly, the German government is afraid that if they guarantee the debts of their eurozone neighbours, that will simply encourage the southern Europeans to borrow and spend more freely, making their debts even bigger and more unsustainable.

What about these "project bonds"?

The details are unclear, but it seems these would be issued by the European Commission. The borrowed money would be spent by the Commission on infrastructure and other growth-enhancing investments, and would ultimately be responsible for repaying the project bonds.

They would be similar to eurobonds to the extent that the EU governments are collectively bound to support the Commission and make sure that it can repay the debts. However, the amount of money involved in the project bonds would be far smaller than what is envisioned by the advocates of eurobonds. The Commission's entire budget is equivalent to about 1% of the EU's GDP, whereas most EU government budgets are equivalent to about 50% of their respective GDPs. Nor would project bonds do anything to reduce the borrowing cost of the southern European governments, although it might help indirectly if markets think that the infrastructure spending by the Commission will significantly help the southern European economies to grow.

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23 July 2012 Last updated at 07:06 ET

Eurozone crisis explained

Spain experienced a massive property boom in the good years which has now turned sour. Worries are increasing that Spain may become the fourth eurozone country to require a full bailout. It has already asked for help with its banks - its main problem - and will receive up to 100bn euros ($125bn; £80bn) to be targeted at its financial sector.

But with its economy in recession it is struggling to balance its books and further pressure is coming from its regional governments, who are starting to ask Madrid for financial help to deal with their own debt issues.

What went wrong with Spain?

Spain's story illustrates the fact that the eurozone's problems run far deeper than the issue of excessive borrowing by ill-disciplined governments.

Greece, Portugal and Italy all had way too much debt.

But the Spanish government's borrowing was under control - that is, it ran a balanced budget on average - every year until the eve of the 2008 financial crisis.

And as Spain's economy grew rapidly before 2008, its debt-to-GDP ratio was falling. Germany's, by contrast, continued to rise.

When Spain joined the euro the Spanish government resisted the lure of cheap loans, but most ordinary Spaniards and its banks did not.

The country experienced a long boom, underpinned by a housing bubble, as Spanish households took on bigger and bigger mortgages.

House prices rose 44% from 2004 to 2008, at the tail end of a housing boom, according to ministry of housing data. Since the bubble burst, they have fallen by 25%.

The economy, which grew 3.7% per year on average from 1999 to 2007, has shrunk at an annual rate of 1% since then.

So, although the Spanish government still had relatively low debts, it is now having to borrow like crazy to deal with the effects of the property collapse, the recession and the worst unemployment rate in the eurozone.

What has happened at the regional government level?

Spain's 17 regional governments collectively have large debts of their own.

They run and pay for most of their own services, including social services, health and education, with the central government in Madrid funding less than 20% of national spending.

In the boom years they spent lavishly on new infrastructure and big projects like airports and swimming pools.

Valencia, which built an airport at which not a single plane has landed, asked the central government in Madrid to help it. Neighbouring Murcia is likely to follow.

Others, including giant Catalonia and Andalucia, Castilla La Mancha, the Balearics and the Canary Islands are other possible candidates.

They are under pressure from the central government to cut spending, but local politicians are reluctant to take unpopular action.

The regions collectively need to refinance 36bn euros in debt this year.

Not all of them have large debts though, the coal-mining region of Asturias in the north of the country is relatively debt-free. The region of Madrid itself has said it has already covered all its refinancing needs for the year, while Navarra, Galicia, Cantabria, Aragon and the Basque Country all seem to be on a sounder financial footing.

Crisis jargon buster

Use the dropdown for easy-to-understand explanations of key financial terms:

Bailout

The financial rescue of a struggling borrower. A bailout can be achieved in various ways:
- providing loans to a borrower that markets will no longer lend to
- guaranteeing a borrower's debts
- guaranteeing the value of a borrower's risky assets
- providing help to absorb potential losses, such as in a bank recapitalisation

What is the problem with the banks?

It's another tale of high-living in the boom years followed by an uncomfortable return to reality.

Before the credit crunch, the banks had been thriving thanks to the rapid expansion of the property sector.

But its collapse brought default from borrowers who were suddenly bust and a plunge in the value of the assets the loans were based on.

Since the onset of the recession, which is expected to continue throughout this year and next, losses on loans have continued to mount as borrowers struggle to make repayments.

The situation has been made worse by the fact that the banks borrowed the money on the international markets to lend to developers and homebuyers, a much riskier strategy than using the deposits they get from savers.

They are sitting on massive losses whose size is not yet fully known - some say it could be as much as 180bn euros.

Not all of the banks are in this situation, however. The International Monetary Fund said a large part of the banking sector, including Santander and BBVA, is well run and resilient.

What has been done to help troubled banks?

Spain has begun to restructure its banking sector.

Many of its smaller, weaker banks have had to merge or have been rescued by larger ones. The number of branches has been cut by 15%, and 11% of the jobs in the industry have gone.

Up to the end of April, the government had injected 34bn euros into its banks, according to the IMF.

That is not including the 19bn euros Bankia, Spain's fourth-largest bank, asked for shortly before it was nationalised.

Bankia itself was formed when several regional banks, or cajas, were brought together because they were too small to bear the knock from the economic downturn.

With the crisis of confidence in the markets about the state of the banking sector and its impact on government finances, it has become increasingly expensive for the government to borrow on the markets.

Like credit card companies, investors demand higher interest the riskier a prospect they think you are. As a result, Spain has had to turn to emergency funding from its eurozone partners.

How will the bank bailout work?

Spain will be able to borrow up to 100bn euros. But it isn't a bailout or rescue, it insists.

The help it gets will differ from the bailouts given to Greece, Portugal and Ireland in a number of ways.

The loans will come from eurozone funds set up to help members in financial distress: the European Financial Stability Facility and/or the European Stability Mechanism, which is supposed to come on stream in July.

In previous cases, money has come from the troika of international authorities - the European Union and the International Monetary Fund as well as the eurozone.

Also, the money will be targeted specifically at Spain's banks, rather than at the economy as a whole through central government.

Spain was desperate to avoid this, as the sovereign bailouts have previously come with demands to cut spending and raise taxes and close supervision of the countries' finances.

Prime Minister Mariano Rajoy has unveiled another set of austerity measures, including another 65bn euros of spending cuts and a rise in VAT from 18% to 21%.

At the meeting of eurozone finance ministers on 9 July, it was agreed that Spain could borrow an initial 30bn euros to support its banks.

The final figure of how much of the 100bn euros offered that Spain will want to borrow may not be known until September.

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22 August 2012 Last updated at 05:08 ET

Eurozone crisis explained

Greece's centre-right Prime Minister Antonis Samaras wants a two-year "breathing space" to meet the tough budget targets attached to Greece's bailout from the EU and IMF.

He insists it does not mean a further bailout - just more time, as political turmoil this year delayed some fundamental economic reforms.

Yet after months of refusing to countenance the possibility of Greece leaving the euro, eurozone politicians have slowly come round to thinking there may be no option but to let the heavily indebted country go.

Mr Samaras formed a new coalition after the general election on 17 June. But the powerful left-wing Syriza bloc, hostile to the bailout, came second - not far behind Mr Samaras's New Democracy party.

Germany, the most powerful economy in the eurozone by far, insists that the loan terms are not negotiable.

Why is Greece in trouble?

Greece was living beyond its means even before it joined the euro. After it adopted the single currency, public spending soared.

Public sector wages, for example, rose 50% between 1999 and 2007 - far faster than in other eurozone countries.

And while money flowed out of the government's coffers, its income was hit by widespread tax evasion. So, after years of overspending, its budget deficit - the difference between spending and income - spiralled out of control.

When the global financial downturn hit, therefore, Greece was ill-prepared to cope.

Debt levels reached the point where the country was no longer able to repay its loans, and was forced to ask for help from its European partners and the International Monetary Fund (IMF) in the form of massive loans.

In the short term, however, the conditions attached to these loans have compounded Greece's woes.

What has been done to help Greece?

In short, a lot.

In May 2010, the European Union and IMF provided 110bn euros ($140bn: £88bn) of bailout loans to Greece to help the government pay its creditors.

It soon became apparent that this would not be enough, so a second, 130bn-euro bailout was agreed earlier this year.

As well as these two loans, which are made in stages, the vast majority of Greece's private creditors agreed to write off more than half of the debts owed to them by Athens. They also agreed to replace existing loans with new loans at a lower rate of interest.

However, in return for all these loans, the EU and IMF insisted that Greece embark on a major austerity drive involving drastic spending cuts, tax rises, and labour market and pension reforms.

These have had a devastating effect on Greece's already weak economic recovery. The European Commission expects the Greek economy to shrink by another 4.7% this year. Greece has already been in recession for four years.

Without economic growth, Greece cannot boost its own income and so has to rely on aid to pay its loans. Many commentators believe even the combined 240bn euros of loans and the debt write-off will not be enough.

Crisis jargon buster

Use the dropdown for easy-to-understand explanations of key financial terms:

Default

Strictly speaking, a default occurs when a borrower has broken the terms of a loan or other debt, for example if a borrower misses a payment. The term is also loosely used to mean any situation that makes clear that a borrower can no longer repay its debts in full, such as bankruptcy or a debt restructuring.
A default can have a number of important implications. If a borrower is in default on any one debt, then all of its lenders may be able to demand that the borrower immediately repay them. Lenders may also be required to write off their losses on the loans they have made.

What happens next?

The result of the general election on 17 June was greeted with relief in eurozone capitals, the EU and IMF.

The win for New Democracy has, for the time being, eased fears that Greece is about to leave the eurozone.

Yet major problems remain and the financial markets are still nervous.

It Greece's economy continues to contract sharply, the country may not be able to repay its debts, meaning it will need further help. If the rest of Europe is no longer willing to provide it, then Greece may be forced to leave the euro.

There is, of course, the possibility that the Greek people, fed up with rising unemployment and falling living standards, will make it impossible for the government to continue with austerity.

However, European leaders are hoping that the Greek economy will slowly begin to recover, thanks to the wide-ranging reforms insisted upon by the EU and IMF, allowing Greece to make its repayments and once again, stand on its own two feet.

Why does this matter for the rest of Europe?

It matters a lot.

If Greece does not repay its creditors, a dangerous precedent will have been set. This will make investors increasingly nervous about the likelihood of other highly-indebted nations, such as Italy, or those with weak economies, such as Spain, repaying their debts. If investors stop buying bonds issued by other governments, then those governments in turn will not be able to repay their creditors - a potentially disastrous vicious circle.

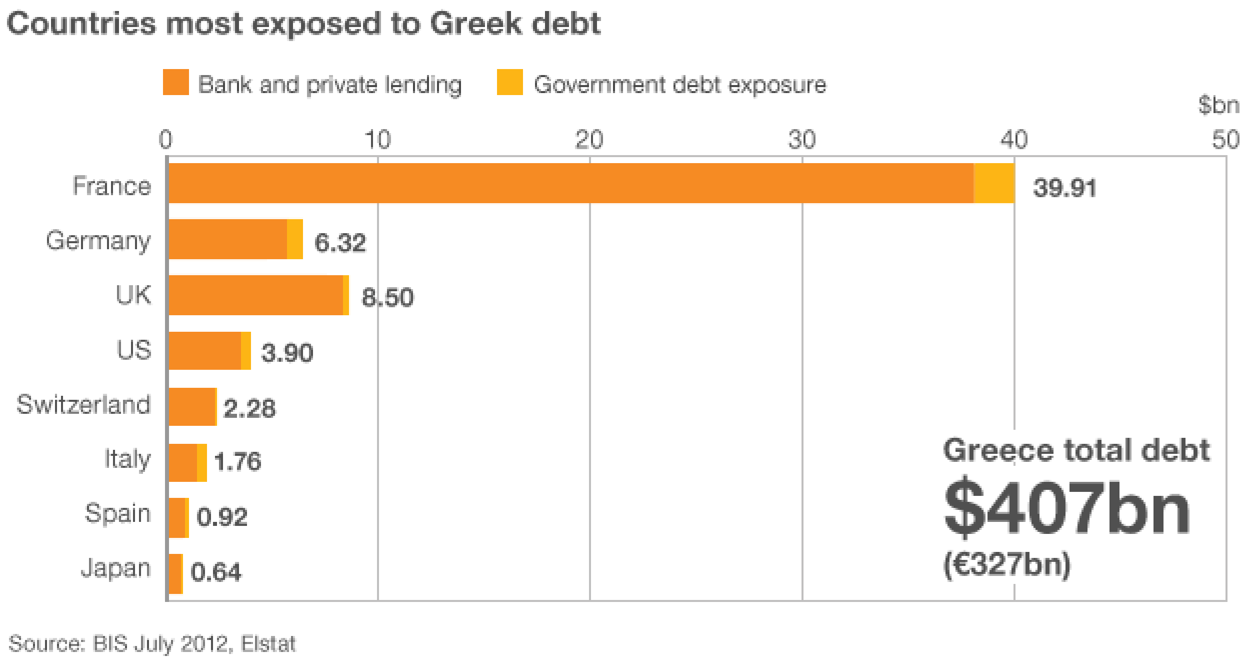
To combat this risk, European leaders have agreed a 700bn-euro firewall to protect the rest of the eurozone from a full-blown Greek default.

Equally, if banks that are already struggling to find enough capital are forced to write off money over and above that which they have already agreed to, they will become weaker still, undermining confidence in the entire global banking system. Banks would then be even more reluctant, and less able, to lend to one another, potentially sparking a second credit crunch, where bank lending effectively dries up.

For example, Greece owes French banks $38bn, German banks $5.5bn, UK banks $8.2bn and US banks $3.5bn.

This problem would be exacerbated by savers and investors taking money out of banks in vulnerable economies, such as Greece, Portugal and Spain, and moving it to banks in safer economies such as Germany or the Netherlands. This could lead to more banks defaulting on their loans.

These potential scenarios would be made immeasurably worse if Greece were to leave the euro. The country would almost certainly reintroduce the drachma, which would devalue dramatically and quickly, making it even harder for Greece to repay its debts.



Charlemagne

Autumn renewal?

Having survived a difficult month, the euro zone is grappling with its taboos

Sep 15th 2012 | from the print edition of The Economist

PINCH yourself. Much that could have gone wrong in the euro zone suddenly seems to be going right. Germany's constitutional court in Karlsruhe has given the go-ahead for a new rescue fund. A banking union is taking shape. The ever-awkward Dutch have swung back to pro-EU mainstream parties in this week's election. This builds on a recent pledge from the European Central Bank (ECB) to act to stop the break-up of the currency. Even angry talk of expelling the Greeks from the euro has died down.

But don't rejoice quite yet. The fine print of the Karlsruhe judgment may yet cause problems. Even Dutch centrists are wary of handing over cash and sovereignty. Nobody yet knows how to defuse the ticking bomb of Greece. The ECB's commitment is untested. And nobody yet knows whether and when Spain will accept the offer of ECB help. Then there is the danger of complacency: debtor states might slow down reforms; creditors may lose the will to repair the euro's fatal flaws.

Messily, perhaps, European leaders are at least debating some of the right questions: what degree of fiscal federalism and risk-sharing does the euro zone need to overcome the crisis? In his grandly named "state of the union" speech this week, José Manuel Barroso, president of the European Commission (the EU's civil service), urged the euro zone to march towards a fully fledged "federation of nation-states".

Others are using the F-word, too. Mario Draghi, the wily ECB president, thinks a full federation would "set the bar too high". Yet Pierre Moscovici, the French finance minister, last week surprised many by speaking of federalism and floating an intriguing idea: a Europe-wide unemployment-insurance fund.

All this will feed into a process led by Mr Barroso, Mr Draghi and the presidents of two other European institutions—Herman Van Rompuy of the European Council and Jean-Claude Juncker of the Eurogroup of finance ministers—to draw up plans by the end of the year for a "genuine economic and monetary union". In June they had already set out four "building blocks": a banking union (to stabilise the banks), a fiscal union (leading to joint debt issuance), an economic union (to reform labour markets and boost competitiveness) and a political union (to give the whole thing more democratic legitimacy).

Most of these blocks are unlikely to take full shape—at least this side of the German election in the autumn of 2013. Take the banking union. The commission has proposed giving the ECB power to supervise all of Europe's 6,000 banks, paving the way for the EU's rescue funds to recapitalise troubled banks directly. But for now, each country will be left in charge of restructuring and winding down banks deemed insolvent by the ECB. And the commission has set aside the idea of a joint euro-zone deposit-insurance scheme because of German objections to pooling liabilities. Without such risk-sharing, though, much of the euro zone could be one bank run away from meltdown.

Fiscal union is even harder. Germany will not hear of joint Eurobonds. And France does not want to give Brussels more power to dictate national economic policies. This impasse, in turn, prevents progress on economic and political union. "There is an unholy alliance between those who refuse to share sovereignty and those who refuse to share risks," complains one Eurocrat.

Yet a new idea is emerging: promoting what is called "fiscal capacity", meaning a central euro-zone budget that could start to act as a counter-cyclical economic tool. The American federal budget accounts for some 24% of GDP; the Swiss one is roughly 12%. The EU budget, by contrast, amounts to just 1%. Mr Moscovici's unemployment-insurance scheme (part of a fifth building block he calls "social union") may create an automatic stabiliser: countries would receive money to help support the unemployed in bad times, and contribute in good times.

Would the Germans accept such a leap towards a "transfer union" they have always opposed? Many would worry that such a scheme would be a step towards the French Socialists' long-held dream of harmonising minimum wages and welfare standards across the EU. Germany, by contrast, wants to make European labour markets more flexible and reform social-security systems.

And yet, Angela Merkel, the German chancellor, has privately said she is ready to consider bigger transfers. Her officials speak of giving more money to reformist countries, say, to help retrain jobless workers. Some Eurocrats think the French and German approaches can be reconciled. European unemployment insurance could be limited to topping up benefits for short-term jobless. Long-term unemployment would still be for national governments to finance. Costs should be limited (0.25% of GDP perhaps). Helping the jobless may be more palatable than bailing out feckless states. And it may soften Germany's image as the heartless enforcer of austerity.

Get it right

The idea of unemployment benefits is far from accepted by the French or German governments, or even by EU institutions. But transfers of some kind may well come to pass. They would give President François Hollande something to show for his vague idea of *intégration solidaire*. And for Germany, transfers worth billions may be preferable to taking on the seemingly unlimited liability for debt and bank deposits across the euro zone.

By themselves transfers will not be large enough to end the crisis. Still, done right, they could send a signal of political unity and help make reforms more acceptable. Done wrong, though, they could harden labour-market sclerosis and create permanent dependence on German subsidies. The danger is that instead of fostering solidarity they could sharpen resentment and deepen the schism between debtors and creditors.

BIPARTISAN POLICY CENTER

How the Sequester Works if the Joint Select Committee Fails

Posted Aug. 5, 2011

UPDATE: Everything You Ever Wanted to Know About the Sequester, May 18, 2012

The third in a series of posts on the Budget Control Act.

By Loren Adler and Shai Akabas

Now that the Budget Control Act (BCA) has been signed into law, the focus shifts to the Joint Select Committee on Deficit Reduction (JSC) tasked with finding $1.5 trillion in spending cuts and/or revenue increases over the next ten years (These savings would come on top of the roughly $900 billion saved up-front from capping discretionary spending; for details, see our earlier post). But what happens if they fail to come to an agreement? That's what the "sequester" is for. It will act as a "sword of Damocles" hanging over the JSC in the hopes of forcing action.

Each party would face cuts to spending categories that it generally tries to protect – the hope being that both parties will have sufficient incentive to move towards the middle and strike a deal. Motivating Democrats are potential cuts to domestic discretionary programs, the Affordable Care Act's (ACA) cost-sharing (exchange) subsidies, Medicare, and a couple other mandatory spending programs. On the Republican side, defense spending would be cut by a hefty 10 percent. If the JSC cannot agree to at least $1.2 trillion in deficit reduction (or the package fails to be enacted into law), these automatic sequester cuts would take effect to roughly bring the budget savings up to $1.2 trillion through 2021.

UPDATE: Everything You Ever Wanted to Know About the Sequester, May 18, 2012

The sequester would be implemented beginning in 2013 as an across-the-board cut to all non-exempt budget accounts. (The cut to most of the Medicare program is capped at 2 percent.) Like most previous sequesters, however, this one is riddled with exemptions. Social Security, veterans' benefits, Medicaid, the Children's Health Insurance Program (CHIP), unemployment insurance, Temporary Assistance for Needy Families (TANF), food stamps (SNAP), and a host of other programs (mostly those benefitting individuals with low incomes) are all exempt from sequester – see the Statutory Pay-As-You-Go Act of 2010, starting on page 22, for a list of most of the exempt programs. Revenues, which many Democrats were arguing to be included in the sequester, are also exempted. But, as detailed above, important priorities of both parties are still laid on the chopping block.

New Report

Indefensible: The Sequester's Mechanics and Adverse Effects on National and Economic Security

A joint report from BPC's Task Force on Defense Budget and Strategy, a joint effort of the Economic Policy Project and the Foreign Policy Project
June 2012

Now for the fun details – if numbers aren't your thing, you should probably stop reading:

1. If the JCS fails to report or its recommendations are not enacted, then the Office of Management and Budget (OMB) is required to cut (by means of a sequester) $1.2 trillion from the budget during the years 2013-2021.

2. To account for the fact that part of this $1.2 trillion will come in the form of interest savings, the BCA instructs the OMB to reduce the size of the sequester by 18 percent, to $984 billion.

3. The dollar amount of the cuts must be evenly divided in each of the nine years, meaning an annual cut from the baseline of $109 billion.

4. The cut is split evenly between the non-exempt portions of defense (function 050) and non-defense spending, requiring approximately a $55 billion annual cut to each. Aside from exempt programs (of which there are many – see above), these cuts are spread among both mandatory and discretionary spending.

- For **defense**, almost the entire $55 billion is cut from discretionary budget authority (since non-exempt mandatory spending on defense is less than $2 billion). In 2013, this amounts to approximately a **10 percent cut** (on top of the cuts that are made initially through the discretionary caps in the BCA). In 2021, since the defense discretionary baseline grows, but the required dollar cut does not, the $55 billion amounts to an 8.5 percent cut.
- For **non-defense** spending, the analysis is a bit more complicated. All of the non-exempt budget accounts will be cut by a uniform percentage necessary to achieve the $55 billion annual cut, except that the reduction to most of the Medicare program is capped at 2 percent (as it was under Gramm-Rudman-Hollings in the 1980s). Therefore, if the percentage reduction to Medicare would have exceeded 2 percent (which it certainly would if the sequester has to comprise the entire $1.2 trillion), then the uniform percentage cut to all other non-exempt programs is increased to a level sufficient to achieve the $55 billion annual cut.
- For example, in FY2015 (mainly selected to illustrate the first full fiscal year for which the ACA's exchanges will be up and running), the uniform percentage reduction required for non-exempt, non-Medicare programs would be approximately 7 percent (on top of the cuts that the discretionary accounts took from the BCA caps). This sequester would translate to a $37 billion cut to non-defense discretionary budget authority, a $1 billion cut to the ACA cost-sharing exchange subsidies, and a $5 billion cut spread across the remaining non-exempt mandatory spending programs (farm subsidies and several other miscellaneous ones). The 2 percent Medicare cut in that year would be about $12 billion (note: some Medicare payments are exempt from the sequester, such as Part D subsidies for low-income beneficiaries and for catastrophic coverage, so the 2 percent cut only applies to roughly $600 billion of the program in FY2015).

The breakdown of the cuts from the sequester is spelled out in more detail in the chart below (which also lays out the up-front savings achieved by the discretionary caps in the BCA). Please note, however, that with respect to discretionary spending, the sequester cuts budget authority (BA), not outlays. Therefore, the actual deficit reduction from the sequester is a bit lower than $109 billion in the first few years.

UPDATE: [Everything You Ever Wanted to Know About the Sequester](), May 18, 2012

Estimated Savings from the Budget Control Act Sequester

(By fiscal year, in billions of dollars)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	Total, 2013-2021
Changes in Non-defense Spending										
Medicare	-6	-11	-12	-13	-13	-14	-15	-16	-17	-118
ACA Cost-Sharing Subsidies / Related Spending	*	*	-1	-1	-1	-1	-1	-1	-1	-7
Other Mandatory	-5	-5	-5	-5	-4	-4	-4	-4	-4	-41
Outlays Resulting from Sequestration of Mandatory Spending[a]	2	3	3	4	3	3	4	4	5	31
Discretionary Budget Authority	-43	-38	-37	-36	-36	-35	-34	-33	-33	-326
Discretionary Outlays	-23	-33	-35	-35	-36	-35	-34	-34	-33	-298
Changes in Defense Spending										
Discretionary Budget Authority [b,c]	-55	-55	-55	-55	-55	-55	-55	-55	-55	-492
Discretionary Outlays	-22	-42	-50	-53	-54	-54	-54	-54	-54	-439
Changes in Debt-Service Costs	0	-1	-4	-8	-13	-19	-26	-32	-39	-142
Total Impact on the Deficit[d]	**-54**	**-90**	**-104**	**-112**	**-119**	**-125**	**-131**	**-137**	**-143**	**-1,015**
Memorandum:										
Percentage Cut to Nonexempt Budget Accounts										
Defense Discretionary	9.7	9.8	9.6	9.5	9.3	9.1	8.9	8.7	8.5	n.a
Medicare	1.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	n.a
Non-defense discretionary[e]	10.0	7.4	7.1	6.8	6.6	6.4	6.1	5.8	5.5	n.a
Non-defense other mandatory	8.6	7.4	7.1	6.8	6.6	6.4	6.1	5.8	5.5	n.a

Sources: Congressional Budget Office, Center on Budget and Policy Priorities, Bipartisan Policy Center calculations

Notes: * = between -$500 million and zero.

a. These estimates reflect subsequent changes in spending for some programs that would offset estimated savings stemming from the original reductions.

b. In 2013, roughly $7 billion of the $55 billion cut comes out of overseas contingency operations funding and roughly $8 billion comes out of unobligated balances from previous years.

c. In 2013, military personnel accounts are assumed to be exempted from the sequester because the president has stated that he will utilize his authority to do so.

d. The net impact on the deficit is lower than the $1.2 trillion figure for defict reduction in the Budget Control Act because: 1) a lag in timing exists between appropriations and subsequent outlays, 2) some reductions -- particularly those related to Medicare -- would have other effects that would boost net spending, and 3) CBO estimates that the reduction in debt-service costs would be lower than the amount of such savings stipulated in the BCA.

e. In 2013, the percentage cut to nonexempt non-defense discretionary programs is higher than the cut to mandatory programs because the exemptions of Pell grants and veterans health care and the 2% limitation on the cut to health centers and Indian health care increase the required cut to other non-defense discretionary programs.

To view and share a larger version of the chart above, click [here]().

Bill Hoagland (former staff director of the Senate Budget Committee under Chairman Pete Domenici and policy advisor on budget and financial matters to Senate Majority Leader Bill Frist) and Barry Anderson (former deputy director and then acting director of the Congressional Budget Office) were consulted.

UPDATE: Everything You Ever Wanted to Know About the Sequester, May 18, 2012

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