SPIEGEL ONLINE
01/05/2012 05:32 PM

Ponzi Planet

The Danger Debt Poses to the Western World

By Alexander Jung

Countries around the world, particularly in the West, are hopelessly in the red, with debt rising every day. Even worse, politicians seem paralyzed, unable -- or unwilling -- to do anything about it. It is a global disaster that threatens the immediate future. But there might be a way out.

When Carlo Ponzi, a dishwasher from Parma, Italy, immigrated to the United States in 1903, he had $2.50 in his pocket and a million-dollar dream in his head. He was able to fulfill that dream, at least temporarily.

Ponzi promised people that he would multiply their money in a miraculous way: by 50 percent in six weeks. With his carefully parted hair and charming accent, Ponzi beguiled investors and fueled their avarice. The first investors raked in fantastic returns. What they didn't know was that Ponzi was simply using the next investors' money to pay them their profits.

The scheme continued. Ten investors turned into 100, and 100 investors turned into 1,000, until the scam was discovered. Ponzi spent many years in prison, and he died a pauper in 1949. But his name remains important to every criminologist today -- and every economist.

Economists use the term "Ponzi scheme" to describe a disastrous mechanism in which someone pays off old debt by constantly taking on new debt. The repayment of the debt -- the most recent loans, plus interest -- is deferred into the distant future, fueling an eternal process of debt refinancing.

It's the classic pyramid, or snowball scheme, practiced by thousands of con artists after Ponzi. The most spectacular case was that of New York financier Bernard Madoff, who was responsible for losses of about $20 billion by 2008. Snowballs are set into motion, becoming bigger and bigger as they roll along. In the worst case, they end in an avalanche that takes everything else with it.

Western economies have not acted much differently than the fraudster Madoff. In 2011, they were virtually inundated with bad news and old sins. Almost everyone -- in Europe and in the United States -- has been living beyond their means, from consumers to politicians to entire countries. Governments have become servants to the markets upon which they have become dependent.

Bigger Snowballs

On an almost weekly basis, the reports have become more worrisome and the sums of money involved more staggering. Many are now concerned that, as 2012 begins, the snowballs will only get bigger -- and roll faster:

- There are the banks in Europe, which will have to repay about €725 billion in combined debt in 2012, including €280 billion in the first quarter alone. With the private market largely off-limits to them, the banks have had to rely on the European Central Bank (ECB) to bail them out. The ECB is now lending them fresh money -- as much as they want -- at minimal interest rates.
- There is a country like Italy, which has an exorbitant amount of debt to service at the beginning of the year. About €160 billion in debt will mature between January and April; the total for the entire year is about €300 billion. The government in Rome is already having trouble finding buyers for its bonds.
- There is the ECB, which is creating billions essentially out of nothing. On an almost weekly basis, it

is acquiring bonds that no one else would buy from Portugal, Spain and Italy and, in the process, it is turning into a reluctant financier of nations. This financial aid already amounts to €211 billion.

- There is the European Commission, whose president, José Manuel Barroso, supports the use of so-called euro bonds. These bonds, which would be issued jointly by the countries in the monetary union, would amount to an accumulation of collective debt on top of national debts.
- There is the €440-billion euro bailout fund, of which €150 billion are already promised to Greece, Ireland and Portugal. But because this amount is still not enough, the finance ministers have decided to "leverage" the fund, a seemingly harmless term for bringing in additional lenders, thereby multiplying the volume of credit.
- And then there is the United States, which only remains solvent because the Congress in Washington keeps raising the debt ceiling. The American government already owes its creditors about $15 trillion. Stay tuned for the next installment.

In other words, there are plenty of snowballs that have started rolling and getting larger with each rotation. Some aspects of the economic system in the industrialized countries resemble a gigantic Ponzi scheme. The difference is that this version is completely legal.

Living on Credit

Old debts are paid with new ones, with borrowers giving not the slightest thought to repayment. This has been going on for a long time, far too long, in fact. It was only with the eruption of the financial crisis in 2007 and the outrageously expensive bailouts of banks and economies that many people realized that the entire world is living on credit.

"Debt is rising to points that are above anything we have seen, except during major wars," economists at the Bank for International Settlements (BIS) concluded in a recent study. "The debt problems facing advanced economies are even worse than we thought."

This is even true of seemingly rock-solid Germany. In the third quarter of 2011, German public debt amounted to €2.028 trillion, an increase of €10.8 billion over the debt level just three months earlier. Germany's public debt grew by about €120 million a day -- or more than €80,000 a minute -- between July and September.

To make matters worse, this increase occurred in a quarter marked by plentiful tax revenues and a significant decline in unemployment. But debts increase independently of whether times happen to be good or bad.

The End of the System

The same thing is happening almost everywhere. In the first decade of this century, which was by no means a weak period economically, countries more than doubled the level of debt -- to an estimated grand total of $55 trillion by the end of 2011.

The United States leads the pack with its national debt of $15 trillion, followed by Japan with about $13 trillion. Germany's €2 trillion looks almost paltry by comparison. Today, the three major rating agencies award their highest credit rating to only 14 countries in the world.

The fact that nations are continually spending more than they take in cannot turn out well in the long run. The word "credit" comes from the Latin "credere," which means "to believe." The system will only function as long as lenders believe in borrowers. Once the belief in the creditworthiness of borrowers is destroyed, hardly anyone will be willing to buy their securities.

When that happens, the system is finished.

This is precisely what happened with Carlo Ponzi's scheme. And now entire countries are suffering suspiciously similar fates. They are no longer being taken seriously.

Greece is effectively insolvent. Italy and Spain are forced to offer higher interest rates to find buyers for their government bonds. And France threatens to lose its impeccable credit rating. The debt crisis has arrived in the heart of Europe.

Meanwhile, it is also flaring up in the United States once again, with Democrats and Republicans blaming each other for the nation's debts. Instead of taking responsibility and consolidating the budget, President Barack Obama prefers to rail against the Europeans' approach to crisis management. They, in turn, refuse to tolerate any interference, especially from the United States, which they blame for being the source of the financial crisis in the first place.

In this fashion, the Old World and the New World are tossing the blame back and forth, while confidence in politics and its ability to avert collapse is dwindling on both sides of the Atlantic. Is there still a way to stop the avalanche, or at least to diminish is destructive force? Why do countries that collect taxes have to borrow money in the first place?

Of Good Debt and Bad Debt

Lutz Goebel is used to borrowing money. The 56-year-old businessman is the managing partner of the Henkelhausen Group, a German mid-sized company that specializes in motors in the western German city of Krefeld, with 240 employees and €65 million in annual sales. The debt Goebel incurs is of a completely different nature than the country's debt.

Five years ago, Goebel had the opportunity to buy another company's gas-engine service division. Goebel was convinced that it was a worthwhile investment, and that the resulting net revenues would ultimately exceed the €1.5 million he had to borrow to pursue the deal. "It paid off," he says today.

As president of the German Association of Family-owned Businesses, Goebel represents the interests of 5,000 companies throughout the country. The owners of these businesses usually borrow funds only when they intend to make significant changes or build something new. For them, debt is a necessary part of developing their companies.

There are undoubtedly good reasons to go into debt. Companies use debt to finance investments. Private citizens use it to pay for major acquisitions, like automobiles or real estate. Most are aware that they have to economize as long as they are using current revenues to pay off the principal and interest on their debt.

It can also make perfectly good sense for governments to go into debt, such as when a government seeks to stabilize its economy with additional spending to ward off a recession. It particularly makes sense when governments borrow money to pay for real assets that will also benefit future generations, like a bridge or a kindergarten.

Everyone Benefits

Finance experts call this form of the solidarity principle "pay as you use," in which future generations are expected to pay for the rest. In addition to leaving the assets -- bridges, kindergartens and the like -- to its children and grandchildren, the current generation also leaves a portion of the financing up to future generations, and everyone benefits from it.

The only problem is that countries hardly ever use this instrument in such a productive and far-sighted manner. Nowadays, governments usually borrow money to finance their daily expenditures, like paying the salaries of government employees or servicing existing debt.

Of course, there are also people who live unrestrained financial lives. Readily available credit at every bank makes it more likely than ever that they will be tempted to abuse it. Living on credit used to be considered somewhat disreputable, but not anymore. In the third quarter of 2011, Americans had $700 billion in outstanding credit card debt. There are likewise undoubtedly many companies with lax payment policies. The number of major corporations with excellent credit ratings has been consistently declining for years.

Nevertheless, there is still a difference between private and public debt. Citizens and companies usually have real assets to serve as collateral against their debt. The value of a government, on the other hand, is

-- with the exception of a few companies, properties and land -- primarily virtual, namely, that it enjoys the priceless privilege of being able to issue bonds. It borrows money from citizens who, in return, receive a bond that promises repayment of the principal plus interest.

In the 14th century, northern Italian rulers applied this principle for the first time. The British historian Niall Ferguson sees the invention of the government bond as "the second great revolution" in the economic world, following the introduction of credit by banks. It served as the foundation for the ascent of money, according to Ferguson.

No Incentive for Responsibility

Since then, the state has been able to constantly print new securities, which it uses to replace the old ones. Debts are not repaid but "refinanced." In other words, they are passed on to future generations. This trick seduces governments into treating their finances with less solemnity, and it deprives them of any incentive to live within their means.

They have also provided the securities with a special advantage: Banks, savings banks and insurance companies, the main purchasers of European sovereign bonds, are not required to back the bonds with equity capital, unlike with loans to private citizens or companies. The bonds have been treated as "especially safe" -- at least until now.

Everyone benefits from this system. Through the bonds, the banks acquire from the issuing governments apparent security on their balance sheets, fictitious assets. And, for governments, the banks serve as constant new buyers for their securities.

The state creates the illusion of freedom from risk to satisfy its self-indulgence, at least until the Ponzi moment arrives: when the last shred of confidence has been gambled away and no one buys bonds anymore.

Were a business owner to run a business in the same way, he or she would soon be forced to declare bankruptcy. "Family business owners borrow money to invest it. Usually the government borrows money to consume today," says German business leader Goebel. And, he adds, "while a businessman takes on the risk and liability for his company, in the case of countries, it is almost always the next generation that suffers."

Debt is thus a double-edged sword. When used prudently and in moderation, it enhances prosperity. "But, when it is used imprudently and in excess, the result can be disaster," the BIS economists warn in their study. Today's world has become a Ponzi planet.

Germany's True Liabilities

Just how much the German government struggles with financial planning is evident in its handling of pensions for the country's 1.7 million civil servants. The 16 German states already spend about 15 percent of their tax revenues to pay for the retirement benefits of government employees, a percentage that Bernd Raffelhüschen, an economist in the southwestern city of Freiburg, predicts will grow considerably. In fact, he sees a veritable wave of costs rolling toward Germany in the middle of the coming decade.

All of the civil servants who were hired in the 1970s and 80s will soon go into retirement. German federal, state and local governments hired so many people between 1970 and 1980 that personnel costs tripled to about €75 billion.

Raffelhüschen, working for the Market Economy Foundation, regularly investigates which financial obligations the government and the social insurance agencies enter into without establishing any reserves for the time when the benefits will come due. His conclusions represent Germany's true debt burden.

In addition to the official national debt of roughly €2 trillion, there are €4.6 trillion in future benefit promises to retirees, the sick and people requiring nursing care -- commitments that are not documented anywhere. When these commitments are included, Germany's real debt is not 80 percent of GDP, as quoted officially, but 276 percent.

Simply Doesn't Concern Them

The social security coffers contain absolutely no reserves for members of the baby-boomer generation. "As a result of our government's generosity, we are creating substantial financial burdens for future generations," says economist Raffelhüschen. But no one really wants to hear this. Besides, all of this will happen so far in the future that many feel it simply doesn't concern them.

Next to pensions, health insurance is the second-largest item on Raffelhüschen's list, accounting for a shortfall of €2 trillion. The inevitable aging of society will only exacerbate the problem. With age or, more precisely, with the number of old people, healthcare spending rises dramatically.

In Germany, a gainfully employed person under 65 costs the government health-insurance system an average of €134 a month. The average for people older than 65 is €379, or almost three times as much.

As a result, an invisible mountain of social insurance debt rests on every German citizen's shoulders. According to Raffelhüschen, to pay off this debt, each citizen would have to pay the government €307 a month throughout his life -- all because the government makes financial promises it cannot keep. It even touts its promises as benefits, and yet citizens are the ones paying for them in the end. The method has been part of the system for generations.

A Short History of Debt

There was a time when the government had no trouble amassing reserves. In the 1950s, then-Finance Minister Fritz Schäffer took in so much revenue -- or spent so little -- that he was able to save. There was talk of the so-called "Schäfferturm," or Schäffer Tower, an allusion to the Julius Tower in Berlin, where the Germans stored the gold paid to them by the French in war reparations following the Franco-Prussian War in 1870-1871.

Of course, Schäffer benefited from the fact that the 1948 monetary reform provided West Germany with a new fiscal start. The old money was hardly worth anything anymore, with 100 Reich Mark being exchanged for 6.5 deutschmark. In addition, the country's liabilities were reduced -- by a factor of 10 to 1. In other words, the conditions were favorable for the pursuit of sound economic policy.

Six finance ministers later, when Social Democrat Alex Möller assumed the office in 1969, the zeitgeist had changed -- and so had the payment morale. The economy was booming, there was more work than available labor, and it seemed that the coalition government of the center-left Social Democratic Party (SPD) and the pro-business Free Democratic Party (FDP) could pay for anything, including such extras as winter bonuses for construction workers, bypass roads for rural communities and fitness programs sponsored by the government health-insurance system to combat the adverse effects of affluence. The government health-insurance system more than doubled its expenditures between 1970 and 1975.

When Möller resigned in 1971 to protest such profligacy, his fellow Social Democrat Karl Schiller ("Don't congratulate me; send me your condolences instead") took his place. But Schiller lasted only a year, and when he resigned he said he was unwilling to support the government's devil-may-care policy.

A Taste of What Was to Come

That, though, was just a taste of what was to come. The economy began to slow, especially after the oil price shocks of 1973 and 1979, and unemployment rose steadily, but the government of then Chancellor Helmut Schmidt (SPD) behaved as if Germany were still in the midst of its economic miracle, spending far more than it took in. During Schmidt's chancellorship, sovereign debt grew from €39 billion to €160 billion. It was this ballooning debt that eventually brought down Schmidt's governing coalition in 1982.

The next surge of new borrowing occurred seven years later, after the fall of the Berlin Wall. Instead of just raising taxes, then Christian Democratic (CDU) Chancellor Helmut Kohl decided to finance German reunification on credit. Some €1.5 trillion in costs relating to reunification remain unpaid to this day. Most of the money went into consumption -- far too little was used for investment. It was the same old mistake.

Finally, it was the financial crisis that, beginning in 2008, sharply drove up the national debt once again. The bank bailouts in addition to the economic stimulus packages have been a heavy burden on public coffers. The German government has forked over about €80 billion for various programs, including the controversial cash-for-clunkers program.

Governments are invoking John Maynard Keynes, the great British economist, as they use borrowed money to stimulate the economy, and yet they are consistently ignoring the second, unpleasant part of the equation: paying off the debt. Not a single German finance minister has balanced the budget since 1970.

The Failures of the Political Class

Why is this the case? For Lars Feld, the answer is short and unambiguous: "political failure." The 45-year-old Freiburg-based academic, the youngest member of the German Council of Economic Experts, which advises the government on economic issues, combines economic expertise with insights from other disciplines, especially political science. For Feld, the concept of "fragmentation" is essential to explaining the tendency to accumulate debt.

According to the fragmentation concept, debt levels increase the more parties are involved in the government -- and competition there is for funds among cabinet ministers to satisfy their respective constituents. The Americans refer to this as pork barrel politics. Each tries to take as much as possible while contributing as little as possible.

For politicians, this means: "Every member of parliament tries to bring as many public projects as possible into their election district in order to secure re-election, hoping to distribute the costs across the entire population," Feld explains. It is also true that the more often a government is replaced, the faster the government debt increases.

Is a Dictatorship More Responsible?

The reverse is also true. Strong governments with absolute majorities have the lowest tendencies to incur debt, especially when a powerful finance minister remains in control for a long period of time. Does this suggest that parliamentary democracy, which naturally promotes fragmentation, is to blame for unsound fiscal policy? Or, to put it cynically: Is a dictatorship more responsible when it comes to fiscal policy?

Aside from the fact that dictators have also been known to devastate their countries financially, voters ultimately have themselves to blame for the excesses. Scientists refer to "rational ignorance" when citizens deliberately avoid dealing with uncomfortable issues. People overestimate the benefit of current tax cuts and fail to recognize that today's debts are automatically tomorrow's debts, as well. In other words, people want to be deceived.

Politicians are all too happy to adhere to this pattern of behavior, while at the same time mercilessly taking advantage of it. In his dissertation, Berlin economist Gerrit Köster found that, between 1964 and 2004, German finance ministers tended to plan tax cuts so that they would come into effect in election years.

Perhaps this also explains why the Social Democratic heads of government in the city-state of Bremen remain popular, despite the fact that Bremen, with a per capita debt of €27,000, is Germany's most heavily indebted state. It is often precisely those municipalities that can least afford it that are the most lavish spenders.

Two Portable Toilets

Economist Adolph Wagner observed the phenomenon in the mid-19th century and used it to formulate his "law of expanding state activity." Wagner contends that the state constantly seeks new activities without paying heed to whether the expansion is even necessary and, most of all, whether it will pay off.

Expansion serves primarily one purpose: to justify a government's existence. Many of the things for which cities, states and the federal government borrow money turn out to be pure waste.

From the €130,000 a year the northern city of Lübeck spent to rent two portable toilets to the €11,000 the western town of Büren paid for four alpenhorns so that local musicians could play music with guests from the Austrian sister town of Mittersill, each year Germany's taxpayers' association documents cases of how poorly government entities manage their funds -- especially when the economy is doing well -- and how little willingness there is to economize.

At least Bremen has now vowed to curb government spending. The state plans to reduce annual new borrowing from the current level of €1 billion to €120 million. It should be noted, however, that these figures apply to the gradual reduction of new borrowing, not the debt itself.

"Bremen can no longer extract itself from this debt spiral on its own," says Bettina Sokol, the president of the state audit office. But how else is it to do so?

Strategies for Reducing Debt

What can a country do to not only curb increasing debt, but also to reduce the size of its overall debt? There are many possibilities, and they are differentiated mainly by the magnitude of the sacrifices, and by who bears most of the burden.

The most brutal method is the debt haircut, which is reserved for hopeless cases like Greece. Creditors are forced to give up a large share of the funds they are owed. Banks and insurance companies and, ultimately, ordinary savers and the insured, whose portfolios and policies also contain Greek bonds, are the ones who suffer.

A government bankruptcy -- which is precisely what a debt haircut amounts to -- is by no means an unusual occurrence in economic history. France declared bankruptcy eight times between 1500 and 1800, while Spain could not meet its obligations seven times in the 19th century alone. "The progress of the enormous debts which at present oppress, and will in the long-run probably ruin all the great nations of Europe, has been pretty uniform," Adam Smith, the Scottish philosopher, wrote in 1776.

In the early 19th century, as a consequence of wars and revolutions, Greece spent half of its time in insolvency or debt-restructuring. The euro-zone countries ought to have been forewarned when they accepted the Greeks into the currency union.

Greece experienced a particularly unusual bankruptcy in 1922, when then Finance Minister Petros Protopapadakis ordered that all banknotes be cut in half. The one half remained currency, but was worth only half as much as the original note, while citizens were required to exchange the other half for a government bond. A quite literal debt haircut.

From Flirtation to Marriage

A softer, almost elegant strategy to achieve debt relief is the path leading through inflation. Prices increase, as do incomes and taxes, while debts remain nominally the same, thereby losing value in relative terms. They are essentially eliminated by means of inflation, with citizens being partly expropriated in the process.

If an inflation rate of 4 to 6 percent were tolerated for several years in a row, as American economist Kenneth Rogoff argues, countries would be able to make significant strides in the direction of solving the debt problem. However, the rate of inflation cannot be controlled at will. As the saying goes, if you start flirting with inflation, you will have to marry it.

Most of all, the inflation solution is only effective for getting rid of old debt. For each new euro a country borrows, creditors will demand higher interest in return, which ultimately increases the debt level even further.

Which leaves the two conventional methods of debt reduction.

First, the government can increase its revenues by simply raising taxes. The financial basis for such an emergency move certainly exists: Germans possess total net monetary assets of about €3 trillion, as well as real estate assets worth about €5 trillion. But the most likely candidate is the inheritance tax. Despite the estimated €300 billion in assets that are transferred to heirs each year, in 2010 Germany collected only €4.4 billion in inheritance tax. Even the electricity tax generates more revenue, at €6.2 billion.

The second option is for the government to reduce spending by limiting goods and services. The government will in fact be forced to take this cost-cutting approach because new debt ceiling limits will soon apply. Under these rules, the federal government's new borrowing is limited to 0.35 percent of GDP, which is currently about €9 billion. The instrument inspires hope that the trend to incur more and more new debt can finally be stopped. It is "the only correct approach," says entrepreneur Goebel.

Far More Difficult to Generate Growth

But there are also exceptions to the law. The government can loosen the debt brake during economic downturns, as well as in the case of natural disasters. What is also missing is a clause stipulating that surpluses in good years be used to pay off old debts -- and not for tax cuts.

But a consolidation of finances is certainly possible, as Italy, Spain and Belgium demonstrated in the late 1990s. These countries managed to substantially reduce their debt levels. Spain, for example, trimmed its debt from 67 to 36 percent of the country's economic output within 10 years. Of course, this sort of turnaround was also made possible by the fact that Spain's economy proved to be so dynamic at the time.

Growth is undoubtedly the best way to get out of the debt trap. After World War II, the American economy grew at a faster rate than the national debt. As a result, the debt ratio was automatically reduced.

Nowadays, however, an aging and shrinking population makes it far more difficult to increase economic output. This means that slow-growing countries like Japan or Germany can hardly serve as the reliable borrowers of tomorrow. Rising economies like China, India, Indonesia, the Philippines or Vietnam offer more security. Ironically, for the rating agencies, it is the shaky candidates of the past that could very well be the most reliable economies of the future.

In the West, on the other hand, it is now the state that must increasingly assume the role of growth engine. To do so, it borrows money and tries to reduce government debt with the additional value added. Kurt Biedenkopf (CDU), the former governor of the eastern German state of Saxony, describes this as a fatal process in which the government takes on new debt to finance growth in order to pay off old debt.

The Power of the Purse

Biedenkopf recently proposed a concept with which he argues the debt burden could be paid off within a generation. Under the concept, all liabilities would be transferred to a foundation, dubbed the "German Financial Agency," to which a portion of tax revenue would be allocated in order to slowly reduce the debt, thereby bypassing the parliament. But it is questionable whether the members of that parliament would readily agree to be deprived of the power of the purse.

A plan unveiled by the German Council of Economic Experts in November seems more realistic. The council proposes establishing a fund that would assume all the debts of euro member states that exceed the Maastricht ceiling of 60 percent of economic output. Under this plan, the total debt of about €2.5 trillion would be paid off within 20 to 25 years, partly through tax surcharges.

Whatever approach the Western world uses to combat its debt crisis -- be it austerity measures, taxes, inflation or, what is most likely, a mixture of the three -- solving this problem will shape the lives and work activities of a generation.

"If history is a model, we can expect to see many years of debt repayment," the McKinsey management consulting firm predicts in a study. In other words, the debt avalanche is inevitable, and the only question is whether countries can protect themselves in time.

It is not as much a question of putting a stop to speculators or penalizing rating agencies. Such skirmishes are merely a distraction from the responsibility that politicians bear when they constantly incur new debt to service old debt. But it is also the responsibility that voters bear for rewarding such behavior, and that the banks bear for being so consistently dependent on the government to bail them out whenever they gamble away their money.

Secretly, they all know that a Ponzi scheme has never turned out well.

Translated from the German by Christopher Sultan

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