CIDOB • Barcelona Centre for International Affairs

ISSN: 2013-4428

notes internacionals CIDOB

63

NOVEMBER 2012

TO BAIL OUT OR NOT? Germany, "Madame No" and the Euro Crisis

Eckart Woertz, CIDOB Senior Research Fellow Associate

Four years into the Eurozone crisis two things become increasingly clear: Simple austerity measures do not work and German support for bailouts in the Eurozone is key. If political consensus in Germany for such bailouts wanes, the Eurozone will break up, if austerity measures in southern member countries continue unabated, economic deterioration and political resistance will lead to a breakup as well. Single countries will be forced to exit the Eurozone and ensuing contagion effects might become uncontrollable. This leaves the Eurozone and possibly the whole project of European unification in a serious dilemma as Germany and its public opinion predicate bailouts to no small extent on a continuation of austerity measures. The political consensus for bailouts could be further eroded in 2013 by expected weaknesses in Germany's model of export led growth as China and other emerging markets face a cooling of their economies.

Four years into the Eurozone crisis two things become increasingly clear: Simple austerity measures do not work and German support for bailouts in the Eurozone is key. If political consensus in Germany for such bailouts wanes, the Eurozone will break up, if austerity measures in southern member countries continue unabated, economic deterioration and political resistance will lead to a breakup as well.

Redressing imbalances within the Eurozone and restoring growth perspectives in its south is essential for a survival of the Eurozone. During the first decade of its existence up to the global financial crisis in 2008, Germany and the Netherlands amassed increasing current account surpluses, while the rest of the Eurozone mostly did the opposite.

The question of bailouts has shifted from the if to the how. Southern partners in the EU ask for more than the steps the Merkel government has taken, like Eurobonds. Germany on the other hand is anxious to avoid a transfer union without political controls and it wants to avoid liability of German taxpayers for legacy problems of southern banking systems.

Due to a higher multiplier effect of state spending, declines in spending are overcompensated by declines in GDP. Austerity can mean pain without gain. At the same time stimulus is impeded by unsustainably high debt levels. It is increasingly acknowledged that deficit reduction needs to be stretched out in time and certain levels of spending maintained, especially in areas that are crucial for growth like investments or research.

The costs of a Eurozone breakup would be astronomical and would also affect Germany and other net payer states. Yet a continuation is only conceivable with increased economic convergence and some form of fiscal union for which considerable political resistance exists.

How the Good Times Stopped Rolling

Redressing imbalances within the Eurozone and restoring growth perspectives is essential for a survival of the Eurozone. During the first decade of its existence up to the global financial crisis in 2008, Germany and the Netherlands amassed increasing current account surpluses, while the rest of the Eurozone mostly did the opposite. Even countries like France, Italy and Ireland that still had slight surpluses at the beginning of that decade went into deficit later (see Tables). They consumed more than they produced and financed the gap by foreign capital inflows. The result was growing foreign indebtedness and an erosion of their net foreign asset position.

This was not a problem as long as borrowing was easy. The advent of the euro eliminated the exchange rate risk. Implicit market assumptions about intra-European guarantees led to a decline in in-

terest rates in countries with weaker productivity. It is difficult to imagine today, but a few years ago risk premiums had virtually vanished and Greek government bonds more or less paid the same interest as German ones. If at all, the debtor nations grew faster. Sure, demand was credit fuelled and outpaced productivity growth, but who cared as long as the times were good? It were Germany and France that faced Excessive Deficit Procedures by the European Commission in 2002/03 for violating the fiscal deficit criteria of the Stability and Growth Pact, as their budget deficits soared beyond 3 percent of GDP. At the same time, Ireland had a surplus and Spain was soon to follow by achieving a budget surplus in the three years before 2008.

The problems became apparent once financing conditions deteriorated. Tax income disappeared that had relied on economic activity that was based on asset bubbles. The fiscal balances weakened as governments were forced to bailout banks, pay for unemployment benefits and stimulus packages. In the meantime, the current account deficits of the debtor nations have diminished. On the surface, the imbalances, the "original sin" of the Euro, have been redressed, but this is little solace as it did not happen because of increased exports and competitiveness but rather as a result of demand compression in the wake of recession and austerity measures. It is another symptom of the crisis, not an indication of its solution. Spain and Greece have unemployment rates of 25 percent now. This is depression, not recession level and hardly acceptable in the long run.

> The advent of the euro eliminated the exchange rate risk. Implicit market assumptions about intra-European guarantees led to a decline in interest rates in countries with weaker productivity.

German Views of Austerity

The economics textbook prescription to fight the fiscal crisis has been austerity. It has been largely shared by German politicians. Germany increased its competitiveness in the 2000s by reducing relative unit costs of labor via wage moderation in the framework of Gerhard Schröder's Agenda 2010 policy. It did not see a housing bubble, increased its retirement age to 67 and has a relatively high savings rate. A widespread opinion has been that if Germany was to pay for bailouts then only if the others did their homework. The country's most read tabloid *Bild* has been filled with stories about Italian early retirement excesses or tax evading Greek millionaires. How much of this is misleading allegation and how much contains a kernel of truth is secondary, bailout payments for other Eurozone countries have been a tough sell for German politicians.

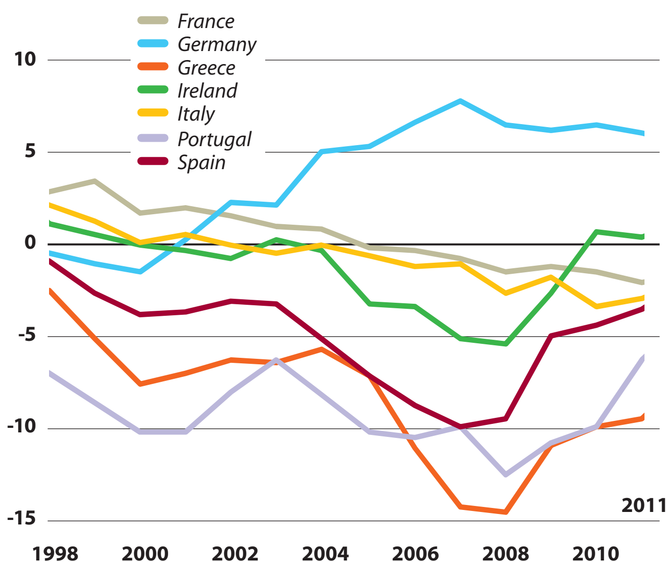
Some of them, like the chairman of the Christian Social Union (CSU) Horst Seehofer or the chairman of the Liberal Democrats (FDP) Philipp Rösler, both members of the ruling coalition, have used opposition against further payments and insistence on strict conditionality to raise their profile. As a peculiarity of the German party system the CSU only runs for elections in Bavaria, while its sister party, the Christian Democratic Union (CDU) of Chancellor Angela Merkel covers the other federal states. Seehofer is anxious to mobilize his conservative base as he faces regional elections in fall 2013 in Bavaria, which is proud of its cultural traditions and relative economic prosperity. Similarly, Rösler's FDP has seen a fall from grace in opinion polls and is struggling with the 5 percent hurdle to enter parliaments. He is desperate to detract internal critics and gain more profile with the FDP's core constituency of small business owners, lawyers and doctors. In opinion polls in September 2012, 54 percent of Germans were against increased transfers of competencies to the EU level and 42 percent welcomed a Greek exit of the monetary union.

Critics have pointed to the no-bailout clause in the European Stability and Growth Pact (SGP) of 1997 and the lack of a European fiscal union that could provide clear mechanisms of accountability and sanctioning in case of a violation of deficit criteria. Eurobonds or bond purchases by the European Central Bank (ECB) are discarded for similar reasons, they would open the way for a transfer union without reciprocal political rights and obligations. In reality, crucial decisions about allocation of resources would be undertaken without any democratic legitimatization by the parliament. The German Supreme Court pointed out the importance of democratic legitimization in his verdict in September 2012 that paved the way for the European Stability Mechanism (ESM) and the European Fiscal Compact (EFC) that the German Bundestag had greenlighted before. The ESM allows the ECB to purchase bonds of distressed EU countries to bring down interest rates and the EFC envisages steps towards a fiscal union and a stricter enforcement of the SGP, whose deficit criteria have been violated repeatedly even before 2008, not least by Germany itself.

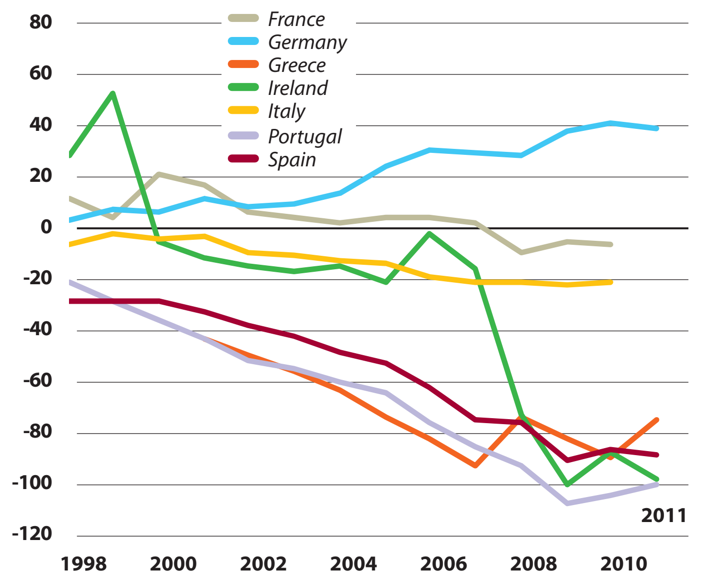
German central bankers are aghast at the expansionist role of the ECB and would like to see strict adherence to its mandate of price stability. Employment creation, which is a second mandate of the American Fed, should remain the responsibility of fiscal policies that ensure competitiveness in their view. The former President of the German Bundesbank Axel Weber who was a likely candidate for the ECB Presidency resigned in 2011 in disagreement over initial ECB bond purchases and so did Jürgen Stark, the German chief economist of the ECB. Rumor had it that the current Bundesbank President Jens Weidmann also pondered resignation in 2012 for the same reasons. He has publicly opposed the expansionist course of the ECB under Mario Draghi. No doubt, some in Germany feel that the ECB has been hijacked by Euromed countries and see its independence undermined.

Yet, the breathtaking expansion of the Eurozone crisis works on a different schedule than political debates and even skeptics agree that there need to be emergency measures. Financial markets have not given politicians the time to ponder

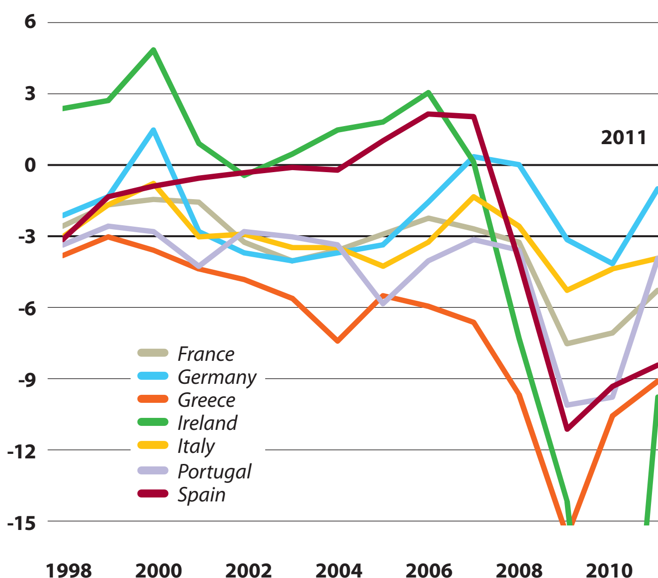
Current Account Balance (percent of GDP)



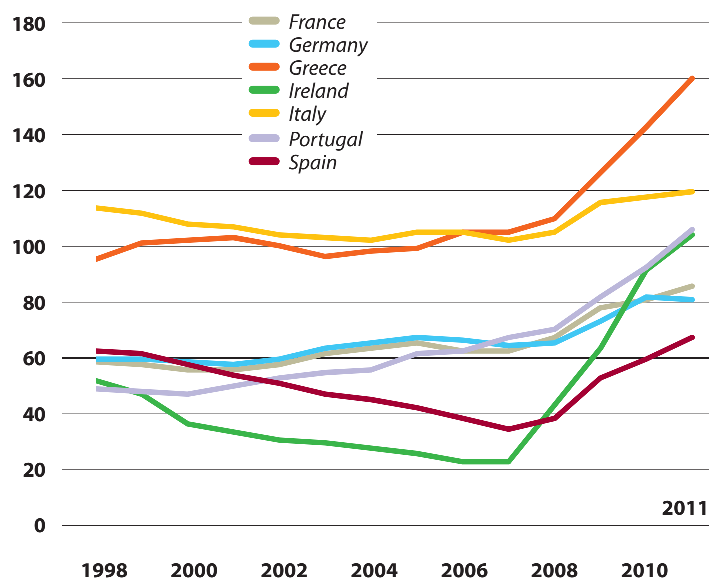
Net Foreign Asset Position (percent of GDP)



General Govenment Balance (percent of GDP)



General Govenment Debt (percent of GDP)



Source: International Monetary Fund (IMF), *Euro Area Imbalances*. Annex to Umbrella Report for G-20 Mutual Assessment Process, Washington D. C., 2012

long-term political solutions and they had to bow to their logic. Starting with the Greek bailout package at the beginning of 2010 the no-bailout clause of the SGP has been effectively violated. German politicians have recognized this reality. The former chancellors Helmut Schmidt and Helmut Kohl, whose voices carry weight as elder statesmen, have given passionate pleas for Eurozone bailouts and argued that they are a necessary price to be paid for a continuation of the European project which has managed to overcome a legacy of conflict and war on the continent. The opposition parties of the Social Democrats (SPD), the Greens and the Left are more inclined than the ruling coalition to advocate robust state interventions. The marginalized Left furthermore stresses that bailouts should not be directed towards banks but accrue directly to affected companies and individuals, and should go together with a thorough regulation of investment banking and financial markets.

Chancellor Angela Merkel has been given the nickname “Madame No” and she might upset other Eurozone countries by driving a hard bargain during negotiations, but she is a moderate voice within the ruling coalition. It also needs to be noted that Germany has not seen the rise of a right-wing populist party like other European countries. Overall, Ms. Merkel has followed a pragmatic course and has been successful in reining in conservative members of her coalition. Initially she

was reluctant to bail out Greece and to establish a permanent rescue fund. She also was against buying government bonds with bailout money in the secondary market, but eventually she conceded to the crushing realities of a spiraling crisis. "If the Euro fails, Europe fails. It cannot fail and it will not fail," she said in a speech in the German Bundestag in 2011.

The necessity of some form of bailout is largely accepted now. The question has shifted from the if to the how. Southern partners in the EU ask for more than the steps the Merkel government has taken. They want Eurobonds that are backed by all member countries, an extended timeline for weak economies to meet deficit-reduction targets, direct lending to Spanish banks and a bank union that would include a Europe-wide deposit insurance. Germany on the other hand is anxious to avoid a transfer union without political controls and it wants to avoid liability of German taxpayers for legacy problems of southern banking systems. It ties its financial commitment to greater political integration in Europe to ensure the shared responsibilities and accountabilities of a fiscal union and joint bank supervision.

Critics have pointed to the no-bailout clause in the European Stability and Growth Pact (SGP) of 1997 and the lack of a European fiscal union that could provide clear mechanisms of accountability and sanctioning in case of a violation of deficit criteria

Why Austerity Does not Work

When I was a kid, I once told my grandfather that I wanted to be a millionaire. He walked to a cigar box with old paper money, gave me a million Reichsmark note, and said with a smirk: "Here, you are one." The hyperinflation of 1923 is an indelible part of the German collective memory. People had to carry banknotes by the billions in wheelbarrows in order to buy a simple loaf of bread. The collapse of the banking system in the wake of the bankruptcy of the Austrian Creditanstalt and Heinrich Brüning's deflation policy of the 1930's that aggravated the Great Depression and paved the way for the rise of Nazi dictatorship loom less large. Yet the more immediate threat in the Eurozone right now is deflation and not inflation and the austerity measures threaten to ignite an economic downward spiral in southern Eurozone countries that would also affect Germany.

The International Monetary Fund (IMF) has pointed out in October that the multiplier effect of state spending seems to be higher than in earlier models of forecasting agencies. Where it used to be 0.5 and every saved budget euro would have led to a decline in GDP of 50 cents only, the IMF now assumes a multiplier between 0.9 and 1.7.[1] That means that every euro that is saved in the budget is mostly overcompensated by a greater decline in GDP. Austerity means pain without gain in such a situation at least in the short run. Reduced budget deficits lead to an increased indebtedness compared to GDP. Governments are in danger of saving their countries to death. This has now been a common occurrence in Greece where the debt ratio has grown from 110 percent at the beginning of the crisis to 170 percent today. All at a time when the government decreased spending. Italy, Spain and even the Netherlands seem to embark on a similar path. Nowhere else this becomes clearer than in Spain, where the real problem is not public but private debt. In addition to slack private demand, the state is cutting back and is sending the economy into a tailspin. Its debt ratio has grown from 60 percent before the crisis to a projected 90 percent in 2013.

Whether it is *The Economist*, the *Financial Times*, Nobel Laureate Paul Krugman or investor legend George Soros, they have all argued that the virtues of austerity on which the Germans are so proud of are in fact vices that might lead to a second Great Depression. Given slack demand, Krugman has chided Germans for barking up the wrong tree with their inflation fears. Fiscal expansion, lose monetary policies and higher inflation rates could help to stir economic activity and reduce debt burdens, he argues. In a similar vein the chief economist of the IMF, Olivier Blanchard, has suggested in 2010 to increase inflation targets from 2 percent to 4 percent. Adjustment should not only come from the southern countries, but also by the Germans. They should spend more and thus reduce their current account surplus. The German Minister of Finance Wolfgang Schäuble acknowledegd this part of the problem when saying that there is room for higher wages in Germany to help a European adjustment process.

George Soros has called for an urgently needed recapitalization of European banks and Eurobonds to ease refinancing costs for troubled countries. They would be backed by all member countries and would represent a joint liability by stronger countries for economic policies in weaker ones. For this reason, Ms. Merkel has said that there would be no Eurobonds "as long as I live." Yet she might need to reconsider this stance as well as her earlier opposition against bailout programs. The respective Ministries of Finance would presumably administer Eurobonds and any decision about them would entail allocation of voting rights. The one country one vote system of the ECB is an unlikely formula of success, given the crucial role of stronger economies and their credit ratings to make Eurobonds a viable tool. A distribution of voting rights according to capital contribution like at the IMF could make the idea more palatable to German officials.

In light of the abysmal record of austerity programs and growing political instability in southern member states, the IMF now acknowledges that deficit reduction needs to be stretched out in time and certain levels of spending main-

1. International Monetary Fund (IMF), *World Economic Outlook. Coping with High Debt and Sluggish Growth*, Washington D. C., October 2012.

tained, especially in areas that are crucial for growth like investments or research. After frantic state activity in the form of stimulus and nationalizations in the immediate aftermath of the global financial crisis of 2008 there was an equally frantic withdrawal into austerity after the costs for the public hand appeared on balance sheets. Now the pendulum seems to swing back tacitly into the opposite direction as the need for continued stimulus becomes apparent. A manic-depressive appears stable in comparison. After they had to abandon neo-liberal orthodoxy hastily in 2008, economists are without clear conviction or narrative. They merely react and give ex-post justifications for the contradicting emergency measures of the day. One cannot escape the feeling of a deep structural crisis of capitalism. Marx seems to have a field day, right at a time when nobody is talking about him anymore.

Europe's debt crisis is hardly an outlier. America is excessively indebted with a debt ratio of 107 percent and a budget deficit of 8.7 percent. It is facing a "fiscal cliff": A deeply divided Congress has stipulated that tax increases and spending cuts swing into action automatically by January 1, unless a last minute compromise on raising the permissible debt ceiling of the US is found. Japan has the highest public debt ratio in the world with 237 percent. Finally, the UK has somehow miraculously escaped scrutiny and still maintains a AAA rating, even though its financials look as bad or worse than the ones of Spain, which is one notch away from junk status with a BBB- rating. Apart from the fact that the UK can print its own money if push comes to shove and has a history of non-default and stable institutions one cannot help the feeling that London's pivotal role for global finance and superior Anglo-Saxon salesmanship have played a role as well in the decision of the rating agencies.

Would End of Austerity Mean End of the Euro?

What if stimulus does not work better than austerity? The Keynesian advocates seem to be blithely unaware of the high debt levels that have been reached and seem to overestimate room for maneuver. Kenneth S. Rogoff of Harvard University and Carmen Reinhart of the Peterson Institute have argued in their seminal book on the history of financial crises that government debts above 90 percent of GDP reduce economic growth by about one percent and decisively compromise the ability of a country to grow itself out of its debt problem.[2] Greece, Italy, Ireland, and Portugal are beyond that level and will be joined by Spain in 2013. Germany itself is above 80 percent and way beyond the SGP criteria of 60 percent. It does not exactly practice what it preaches. When Ms. Merkel warned not to overestimate Germany's capacity to provide bailout funds, she was not just bluffing to avoid payment.

Advocates of German led bailouts in the Eurozone, including partial debt mutualisation, argue with the catastrophic consequences that a breakup of the Eurozone would have and the benefits that have accrued to Germany because of its existence. A confidential study by the German Ministry of Finance has warned of an epic 10 percent reduction of the German GDP in such a case and a jump of unemployment from less than 3 million to 5 million people. Given these costs, many regard bailouts as the lesser evil.

Hans-Werner Sinn, the vocal President of the Ifo Institute in Munich and an opponent to bailouts, has pointed to another more complicated problem: There are huge liabilities that have accrued on the balance sheet of the ECB in the form of the so called Target II balances. As the interbank markets of southern member countries have broken down, their commercial banks had to resort increasingly to the ECB for their daily liquidity operations. In contrast, the interbank markets in northern countries returned to normal. The amassed liabilities are at 1 billion Euro and would materialize in case of a Eurozone breakup or a bankruptcy of a member state. This would make such a step a costly if not impossible option for Germany because the Bundesbank would be one of the main creditors. Sinn argues that the Target II balances should be secured with collateral like gold or mortgage bonds (Pfandbriefe) in the future, not unlike the collateral that Finland stipulated as a precondition for its contribution to bailouts of Greece.[3]

German central bankers are aghast at the expansionist role of the ECB and would like to see strict adherence to its mandate of price stability

Over 40 percent of Germany's GDP are exports. The Eurozone has undoubtedly benefitted its growth model. Yet its current account surpluses are not simply a mirror image of the deficits in the south. It has traditionally exported a lot to the US and Asia has become an important market for its capital goods and cars. Mercedes sells almost as many cars in China as in Germany. While manufacturing industries in the southern member states like textiles have suffered from China's competition, the German economy with its different structure has benefitted from its rise.

Mutual interests are not as clear-cut and the benefits of the Eurozone have come with considerable liabilities. Some argue therefore that the Euro is not the solution, but the problem that could tear Europe apart instead of uniting it. This has been the argument of Thilo Sarrazin, a former member of the board of the German Bundesbank who wrote a controversial bestseller about migration in Germany in 2010 and followed up with a book about the euro in 2012.[4] The euro

2. Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different. Eight Centuries of Financial Folly* (Princeton and Oxford: Princeton University Press, 2009).

3. Hans-Werner Sinn, *Die Target-Falle. Gefahren für unser Geld und unsere Kinder* [The Target Trap. Threats to our Money and our Children] (Munich: Carl Hanser 2012).
4. Thilo Sarrazin, *Europa braucht den Euro nicht: Wie uns politisches Wunschdenken in die Krise geführt hat* [Europe does not need the Euro: How Political Wishful-Thinking has led us into the Crisis] (Munich: DVA, 2012).

has been conceived on political grounds as a boost for European unification, disregarding lack of economic convergence the argument goes. It does not constitute an optimal currency area as one of its intellectual fathers Nobel Laureate Robert Mundell would have had it. It does not do justice to the different productivity levels of countries and deprives them of important policy tools. Countries with lower productivity do not have the possibility to devalue their currencies to improve competitiveness, leaving the price mechanism as the only adjustment tool. Yet prices tend to be downward sticky, especially in labor markets. The Euro has thus allowed the lack of convergence to go out of hand via deindustrialization and credit fueled booms in non-tradables in southern member countries. Now it condemns them to painful and potentially harmful austerity, while exposing the richer member states to unmanageable and politically sensitive liabilities. As countries with lower productivity enter a debt trap, bailouts become a steady feature instead of a one-off event. They create resentment in donor and recipient countries alike, exemplified in preposterous Third Reich comparisons at anti-austerity manifestations.

There are good arguments to keep the Eurozone together, which would be only possible with partial debt mutualization, a growth agenda in the southern countries, and a speedy realization of bank recapitalization, a bank union with common deposit insurance and a fiscal union. It would also require improvements of governance. Italy has set a mark when sentencing former Prime Minister Silvio Berlusconi for tax fraud who had publicly condoned tax evasion while still in office. The German opposition parties of SPD and the Greens have demanded that funds to Cyprus should only be released if it improves its management of money laundering procedures. A report by the German secret service BND warned in November that a bailout of the country's banks would mainly benefit Russian oligarchs, who have parked large sums of black money on the island. Greece austerity has so far mainly concentrated on the weakest of society while leaving the vested interests of clientele networks untouched. Instead of going after tax evaders, the state is prosecuting journalists who report about them. According to a survey by the international network of public accounting firms BDO, Greece is now deemed a less attractive business destination than war torn Syria and only slightly ahead of Iraq and Iran. This is hardly promising for attracting investments and can make bailouts a futile exercise in throwing good money after bad money.

Overall, Ms. Merkel has followed a pragmatic course and has been successful in reining in conservative members of her coalition

Proponents of partial exits of Eurozone countries do not deny that the costs would be huge, but think that it would be the preferable evil. After a painful adjustment period countries like Greece could regain competitiveness and would be better off than within the Eurozone. However, the tremendous costs and contagion effects that could push other countries over the cliff are underestimated. Servicing of euro legacy debts would become difficult if not impossible for governments and private sector entities after a devaluation. The ensuing defaults would make the collapse of Lehman Brothers look like a walk in the park. Furthermore, devaluations might not work their magic in southern countries that have relatively small sectors of manufacturing and tradables. Their export revenues might not appreciably increase because of devaluations while the costs for necessary imports ranging from Chinese computers to Arab oil and Russian wheat would skyrocket.

Future Scenarios

The costs of a Eurozone breakup would be astronomical, putting growth perspectives in all member countries in peril for years to come. It would lead to a global recession if not depression. Political unrest and disintegration would become a distinct possibility. Other achievements of European integration like freedom of travel and free trade might fall prey to populist politics. In an increasingly multipolar world that is characterized by assertive emerging markets like China, India and Brazil, individual European countries would find it difficult to amass the necessary weight to play an international role. Even larger states like Germany or France would not escape marginalization.

Still, many regard the Greek situation as manageable after a debt forgiveness scheme, which the Troika of European Commission, ECB and IMF has proposed. Bankers like former Deutsche Bank chief Joseph Ackerman have somehow disingenuously endorsed such a scheme after they have managed to hand over much of their exposure to the public sector. The German government opposes such a step, as it would need to tell its constituency that billions of recent fund releases have not been repayable loans but in fact transfers with nothing to show for.

Spain's much larger economy and its ailing real estate and banking sectors are now regarded as a bigger problem than Greece by many in the investment community because of the humungous size of its private sector debt – 235 percent of GDP. The Rajoy government is reluctant to ask for funds of the ESM that would go beyond the 100 billion euro facility that was readied in June for the recapitalization of its banks. It fears loss of sovereignty to European institutions. Yet financial markets regard such a second bailout program as necessary. Negotiations with the Troika are currently ongoing and outcomes are expected for November/ December this year. However, even partial mutualization of the large Spanish private sector debt would be politically difficult to sell in Germany and other net payer countries. Spain and Italy are too big to fail, but also too big to bail. Developments in these two countries will be a crucial test. The Euro crisis is currently less acute after the German Supreme Court has greenlighted the ESM in September and the ECB has extended its support, but it is far from over.

Success of bailouts is not assured and strong incentives exist for an exit by northern countries. Finland, which has seen the rise of the populist party of the True Fins and has demanded

collateral for its aid to Greece, has already hinted at the possibility of its exit. Its banking sector is less exposed to Mediterranean credit risk and its trade more oriented towards non-Euro countries in Scandinavia and Eastern Europe. Thus, it might come to the conclusion that the costs of Eurozone membership outweigh its benefits. The Netherlands, another net payer of the EU, has also seen increasing unease with European transfer payments and the rise of Geert Wilder's populist Freedom Party. On the left, the Socialist Party under Emile Roemer also performed well in recent elections with an agenda against further European integration.

Germany is torn between fear of action and inaction alike. This leads to fence sitting. In the short run, Germany even benefits from the euro crisis because it can refinance itself at very low costs: As investors have fled to the perceived safety of German government bonds they have been willing to pay low or even negative interest rates. A weaker euro also keeps Germany's exports competitive. Yet, if Germany is serious about a Eurozone rescue it will need to tell its constituency that a spade is a spade. The rescue will be expensive and it will include debt mutualization, but it will be a small price to pay for avoiding the alternative scenario of disintegration. Southern member countries in turn will need to swallow bitter pills as well. They will need to agree to a fiscal union and the relinquished sovereignty that comes with it. It will not be a Europe that is based on unanimity and one country one vote, but on the principles of one (wo)man one vote and quick decisions by simple majorities. Close cooperation between Germany and France will be key like during any major European unification step before, but considerable divergences exist. In a fiscal union it would not be conceivable for example that the German retirement age is 67, while France has lowered its own to 60 after corresponding promises of François Hollande in his election campaign.

The more immediate threat in the Eurozone right now is deflation and not inflation and the austerity measures threaten to ignite an economic downward spiral in southern Eurozone countries that would also affect Germany

If economic deterioration and insurmountable political differences about a fiscal union made cohesion of the Eurozone impossible, it would be important to have contingency plans for an orderly breakup. This would not need to be a return to the former national currencies. Hans-Olaf Henkel, a former president of the Federation of German Industries (BDI) has suggested to split up the Eurozone into a northern bloc under German leadership and a southern bloc under French leadership. One can debate Henkel's inclusion of Ireland in the northern bloc and the exclusion of France, but in principle, the northern bloc would form a stronger currency given its higher productivity, while the rest-Euro would become a softer currency and would allow the southern countries to gain competitiveness via devaluation. It also would not put them into the dilemma of serving legacy Euro debts with a devalued currency, as legally they would keep the Euro. The northern countries on the other hand could presumably stomach the appreciation of their new currency more easily. Serving then devalued Euro debts would not be an issue for them and some reduction of their exports would be even desirable as far as they have large current account surpluses. At the same time, the European Union and its many achievements would be preserved.

How all these scenarios play out is impossible to predict. Germany will hold federal elections in October 2013 right at a time when its economy shows signs of slowing. Capital goods exports are hit by reduced growth in China. The Ifo business climate index has fallen from nearly 110 in April to 100 in October and factory orders in August were down by 5.2 percent on a yearly basis. It looks like 2013 is going to be a tough year for the German economy and political support for bailout payments and European integration might be negatively affected. At the same time, patience wears thin with austerity measures in southern member countries as long as they fail to deliver a light of hope at the end of the tunnel. No doubt, 2013 will be a fateful year for the Eurozone.