

RELEASE IN FULL**CONFIDENTIAL**

August 8, 2012

For: Hillary

From: Sid

Re: Euro fear and loathing: Aftermath of the August 2, 2012 European Central Bank (ECB) meeting/future plans

SOURCE: Sources with access to the highest levels of the Governments and institutions discussed below. This includes political parties and regional intelligence and security services.

1. In early August, 2012 German Minister of Finance Wolfgang Schaeuble and Chancellor Angela Merkel are closely watching what they fear will be increasing social and political unrest in Greece, Spain, and Italy as the Euro-zone economic crisis continues and the various governments attempt to deal with their sovereign debts, slow growth, and increasing unemployment. Schaeuble also advised his staff to expect anti-German statements from politicians in these troubled countries, supported by press coverage. His greatest concern is the possibility of these statements leading to hostile actions against German citizens and interests in Southern Europe. Following discussions with Schaeuble, Merkel has ordered German Embassies and the Stations of the Federal Intelligence Service (Bundesnachrichtendienst—BND) to collect intelligence associated with these threats and the entire, complicated economic situation, particularly in Greece, Spain, and Italy.

2. (Source Comment: A particularly sensitive source added that during late July 2012, BND President Gerhard Schindler, and Vice President General Norbert Steir informed Merkel and Schaeuble that the BND Operations Center (Abteilung GL) received reporting that media outlets owned by former Italian Prime Minister Silvio Berlusconi intended to begin attacking German government policy toward the Euro-zone in August 2012, calling the Merkel administration, among other names, the “Fourth Reich.” The Chancellor was particularly angered by this reporting. According to Schaeuble, personal attacks of this type make it difficult for his staff to withstand the calls for increasingly nationalistic policies from certain officers of the Chancellery. Officials of Merkel’s ruling Christian Democratic Union/Christian Social

Union/Federal Democratic Party (CDU/CSU/FDP) have also learned that the opposition Social Democrat Party (SDP) plans during the 2012 national election campaign to accuse Merkel of mismanaging fiscal and monetary policy, setting the stage for increased inflation and unemployment inside of Germany.)

3. At the same time, after reviewing the results of the August 2, 2012 European Central Bank (ECB) meeting, and his late July discussion with United States Secretary of the Treasury Timothy Geithner, the German Minister of Finance told his senior staff members that they must be prepared to deal with the crisis in the Euro-zone with little hope of effective action in the foreseeable future from the ECB, the Eurogroup, or the European Union (EU) itself. According to an extremely sensitive source, Schaeuble is convinced that the seventeen (17) nations of the Euro-zone are incapable of making the hard choices needed to address the current economic crisis and can be expected to rely on symbolic moves and positive public statements to manage the situation. The Minister noted that this conclusion became clear to him from the results of the late June EU meeting in Brussels, as well as the August 2 ECB conference. In both cases the parties involved agreed on broad statements and limited action, when, in Schaeuble's opinion, they must address the serious structural and institutional weaknesses in the Eurogroup, and the EU in general. Schaeuble is now preparing for the September 3 finance ministers meetings, where he believes that actions regarding Spanish and Italian Bonds will be hotly debated. This session will be followed closely by the next ECB meeting on September 6, where Draghi will again be under pressure to take some action.

4. This individual added that, as these meetings approach, Schaeuble now believes that needed reforms will not take place until the members of the Euro-zone are faced with real disaster, including the collapse of the Euro, serious increases in unemployment, and multiple bank failures. Schaeuble and Merkel are equally frustrated by what they view as the failure of France, Spain, and Italy to consider seriously the possibility that German internal politics make it impossible for the Berlin government to accept broader growth/relief packages for troubled economies, without real EU structural reforms. Schaeuble believes that both Geithner and ECB President Mario Draghi now realize that with national elections scheduled for 2013 German voters will insist that the Merkel administration press the other members of the Euro-zone to accept responsibility for their situations before supporting substantial relief packages. For his part, Schaeuble now has no doubt that the levels of growth in the U.S. and Chinese economies will not increase at rates capable of encouraging European growth until at least 2014.

5. Accordingly, in the opinion of this particular source, Schaeuble and his advisors continue to approach the crisis on a day by day basis, reacting to political and economic problems as they develop. While they are not confident that progress can be made on the Euro-zone crisis, they will also look for indications that the French government of President Francois Hollande and its allies in the Eurogroup are prepared to make the compromises on structural reform that will allow the German government to support a comprehensive relief program for the problematic economies in Southern Europe. At the same time Schaeuble will work closely with

Draghi and Eurozone President Jean-Claude Juncker, the Prime Minister of Luxembourg, both of whom discreetly support his position in this matter. Like Schaeuble, Draghi and Juncker are concerned that conservative political appointees in the German Chancellery Economic Section (Wirtschaftliche Abteilung – WA) will press Merkel to become increasingly vocal in expressing her frustration with the other members of the Euro-zone as the 2013 German elections approach. Schaeuble believes this increasingly nationalist position will become appealing to Merkel if she fears losing control of the Bundestag in 2013.

6. (Source Comment: In the opinion of a very sensitive source, Schaeuble's staff is preparing to deal with the negative reaction they believe will develop when the world financial markets realize that optimistic public statements made by officials of the ECB and the Euro-zone states do not reflect the reality of the current situation. According to this individual, Schaeuble is particularly frustrated with Italian Prime Minister Mario Monti in this regard. He has also advised Draghi to avoid repeating his actions in July, first making seemingly optimistic statements about the Euro, followed by his cautious actions at the August 2 ECB meeting. Schaeuble believes that, while Germany must have a clear straightforward position supporting the Euro, they must prepare for the possibility that the Currency Union may change in makeup and structure as Greece, Spain, and other troubled states are faced with the prospect of having to leave or modify their relationships with the Eurogroup.)

7. Schaeuble added that on September 3, if he can persuade the other Euro-zone finance minister to support idea of structural reform in tangible terms, he can persuade Merkel to go along with the idea of using the European Stability Mechanism (ESM) to purchase sovereign bonds. In the opinion of this individual, Schaeuble believes that by the time the German Constitutional Court (GCC) rules on the legality of German participation in the ESM in mid-September the crises in Spain and Italy will have reached serious stages, where action must be taken. That said his greatest challenge will come if no compromise can be reached on language regarding structural changes to the Euro-zone. In that case Schaeuble states that the Merkel government will be hard pressed support the ECB program.

8. According a sensitive source, Schaeuble's advisors feel that the actual function of the ECB, maintaining price stability, has faded into the background during the crisis. Under German influence, the ECB has taken its duty of combating inflation seriously; however, pressure is growing on the mid- and long-term policy decisions which could complicate this position. The German officials, both in the Ministry of Finance and the Chancellery fear that the greater the quantity of questionable sovereign bonds on the books, the higher the potential losses. Schaeuble and his advisors believe that even worse is the potential damage to the bank's reputation; in a worst case situation the ECB could become subordinate to finance ministers in crisis-stricken countries. Schaeuble added that in Italy such a situation was the norm for decades and the result was chronic inflation. He is warning Draghi to guard against accepting a repeat of history. In the short term, it might bring relief in the debt crisis, but in the long term it will create an even greater crisis involving inflation and high levels of unemployment.