

*February 10, 2014*

## **The Return of Germany**

In last week's report, we discussed the situation in Ukraine. We commented on how the EU really doesn't want to be responsible for Ukraine, it simply wants to increase Russia's costs in controlling Ukraine. However, Germany has been surprisingly vocal about defending Ukraine which is a bit of a surprise. After all, Germany has little direct interest in Ukraine and is dependent on Russia for energy, so it seems that the Merkel government is being rather aggressive in defending a peripheral concern.

However, when examined in a broader context, Germany's stance with Ukraine makes more sense. Essentially, it appears that Germany has decided to expand its influence beyond economics to include military and political power. Germany is, in our opinion, returning to its previous pivotal role in Europe and perhaps beyond. This decision appears to be driven by changes in U.S. policy and the need to defend the EU. The evolving changes in Germany's foreign and defense policies have significant ramifications for Europe, but impact other regions as well.

In this report, we begin with a short recap of the "German problem" and how the U.S. resolved this issue after WWII. However, as U.S. policy appears to be changing, power vacuums appear to be developing in several parts of the world, including Europe. It is into the vacuum that Germany is beginning to change its policies. From this point, we

will discuss how German policy will likely change and why this adjustment will offer both comfort and concern to Europe. As always, we will conclude with potential market ramifications.

### **The German Problem**

Modern Germany sits in the center of Europe. It has few natural barriers, meaning it is nearly perfect for commerce and impossible to defend. The country was formed in the wake of the Franco-Prussian War of 1870. Germany was formed by Prussian leaders coalescing other independent regions in the area that formally were part of the Holy Roman Empire. The decision to create a nation was due in part to prevent another military power from conquering the various principalities as Napoleon did and to take full advantage of the industrial revolution.

In short order, Germany became a rival for Britain, France and Russia. Henry Kissinger described Germany as "too big for Europe but too small for the world." Given its favorable geography and industrious population, Germany became an industrial powerhouse; by the onset of WWI, the German economy had surpassed Britain's. However, due to the lack of natural defenses, Germany feared it was vulnerable to attack. To act as a deterrent, Germany built a large military and allied with Italy and the Austro-Hungarian Empire. Unfortunately, the decision to militarize raised fears of German power, leading France, Russia and Britain to expand their militaries as well, creating something of an arms race in the period leading up to 1914.

The rise of Germany made the European continent geopolitically unstable. A series of unfortunate events and diplomatic missteps led to WWI. Germany lost that war after the U.S. made a late entry on the side of the Allies; America's entry ended the stalemate and insured victory for France and Britain. Unfortunately, the Wilson administration was not able to sway the peace process. France led the effort to punish Germany through the Versailles Treaty, in part as revenge for the 1870 Franco-Prussian War and in part to prevent Germany from recovering to major power status. John Maynard Keynes's analysis of the treaty, *The Economic Consequences of the Peace*, correctly forecasted that the treaty was not harsh enough to prevent Germany's recovery to major power status but was onerous enough to make Germany resentful of the treaty. Keynes was spot-on; the Versailles Treaty did undermine Germany's economy and led to a hyperinflation that gave rise to the Nazi Party. However, the treaty did not cripple Germany enough to prevent its recovery.

After WWI, the U.S. retreated into isolationism. American leaders wanted to avoid the turmoil in Europe. The onset of the Great Depression led to increased isolation as Americans tried to deal with the consequences of the economic carnage brought by the collapse of credit. Britain, who had been the global superpower, was fading with no other nation able to step into the breach. Germany, taking advantage of the void, began a massive rearmament program under Nazi leadership. The German problem returned to Europe.

After the carnage of WWII, the U.S. decided to shoulder the burden of global leadership. The general consensus among the political leadership was that America's retreat to isolationism after WWI was partially

responsible for the rise of Nazi Germany and WWII.

### **America's Solution to the German Problem**

The U.S. solution to the German problem was to demilitarize the country and take over its foreign policy. Although the Truman administration did not plan to permanently divide Germany after the war, the act of partitioning the country into U.S., French, British and Soviet zones led to actual divisions because the Soviets would not allow their region, which became East Germany, to join the democratic West Germany. West Germany would no longer have to worry about its national security as the U.S., through NATO, took over this role.<sup>1</sup>

Since 1945, Germany has operated a pacifist foreign policy. It generally has avoided joining most NATO and U.S.-led military operations. Public opposition to military activities has been strong until recently. Germany has been a major source of funding for EU transfer programs, providing money to allow less developed European nations to join the EU.

German unification raised fears in Europe of a German resurgence. This is partly why France would not approve unification until Germany agreed to give up the D-mark and support the creation of the euro. France wanted to tie Germany closer to the EU to constrain its power. From 1990 into the 2008 Financial Crisis, most Europeans would have been generally comfortable with Germany's place in Europe. However, since 2008, Germany has become more assertive. Recent events seem to signal a significant change in German policy and behavior.

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<sup>1</sup> Although not part of this report, the U.S. essentially resolved the Japan problem in a similar fashion.

### **The Return of Germany**

There have been two critical developments that have led to a gradual change in German foreign policy. The first was the Eurozone crisis. When the Eurozone periphery economies began to suffer in 2010, Germany, being the largest economy in the Eurozone, was forced to lead the bailout. The Merkel government began working with the IMF and the ECB (the “troika”) to build a bailout package. Similar programs were created for Spain, Portugal and Ireland as well. Eventually, Cyprus also needed support and there have been fears that Italy will also require a bailout.

For most of the postwar era, Germany provided funding for EU projects and it appears that the Eurozone periphery expected generous treatment. Instead, they faced an IMF austerity program and a Germany unwilling to provide unqualified support. German voters have been persistently opposed to bailouts, viewing the problems in the periphery nations as self-inflicted. At the same time, there have been rather vitriolic media attacks on Germany within the bailout nations.<sup>2</sup>

It did appear, at least for a while, that the Eurozone was doomed to fail. The troika forced periphery nations into austerity programs that led to catastrophic economic contractions and rising unemployment. Germany refused to support the creation of Eurobonds that would share sovereignty for Eurozone government borrowing. And, the Merkel government generally opposed ECB emergency measures to curtail market volatility and raise inflation. Conditions deteriorated to the point where it seemed that the most rational action the troubled

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<sup>2</sup> <http://www.zingarate.com/network/berlino/la-merkel-e-come-hitler-per-multi-media-internazionali.html>

nations in the Eurozone should take was exiting the single currency.

However, over time, Germany has softened its position. Although it still opposes bailouts and Eurobonds, the Merkel administration has also made it clear that it supports the Eurozone and the EU, and does not want it to dissolve. Germany has gradually eased conditions for bailouts and has become less vocal in opposing supportive measures from the ECB.

We believe Germany has decided that the EU is too important to fail. Germany needs the captured export market that the EU offers and the depressed currency that the euro provides. The return of the D-mark would bring a very strong currency that would depress its export competitiveness. That doesn't mean Germany won't force financial and fiscal discipline on wayward members, but it won't push these members out of the EU and risk the end of the union.

The second factor that has changed Germany's position is the accumulating evidence that the U.S. is reducing its global superpower role. Since the fall of the Soviet Union, the U.S. has been searching to redefine its role. President Clinton argued the U.S. was the “indispensable nation” but his actions on foreign policy were mostly geared toward expanding the U.S. economy through globalization. He seemed to pay little regard to creating a world system and establishing America's role in that system. President Bush was consumed with Islamic terrorism after the 9/11 attacks. Bush focused on defending the U.S. from future attacks and tried to prevent such attacks by using military force to address failed states. Unfortunately, his ousting of Saddam Hussein in Iraq led to a power vacuum in the region that is still affecting the area to this day. However, other than acting against

terrorism and perceived national threats (“axis of evil” nations—Iran, Iraq and North Korea) with military action or sanctions, a sustainable policy that described America’s role never emerged. In Wilsonian fashion, Bush wanted to rid the world of evil but that task is simply too large for any single government no matter how powerful.

President Obama entered office with promises to end the wars in Afghanistan and Iraq. For the most part, he managed to do both. He has also been aggressive in pursuing terrorists through Special Operations and drone attacks. Although there seems to be a lack of focus, at times, on foreign policy, we have noted that the administration does seem to be quietly pursuing a policy of offshore rebalancing. Such a policy means the superpower refrains from being directly involved in the world beyond keeping the sea lanes secure and keeping rival regional powers “balanced” (hence the name). As we noted in a previous report (see WGR, 1/27/2014, [The TTIP and the TPP](#)), the administration is negotiating trade deals that would effectively establish the global trading regime going forward according to U.S. dictates. The “pivot” to Asia and negotiations with Iran could be considered steps in establishing this new policy regime.

At the same time, it isn’t obvious the president considers this policy change as critical. The day after his State of the Union address where Obama asked for “fast track” authority (critical legislation for trade agreements), Senate Majority Leader Harry Reid (D-NV) indicated that this legislation would not be on the agenda this year. Although Democrats have become increasingly adverse to trade deals since the Cold War ended and supporting these trade proposals would be difficult in an election year, for a leading figure in the president’s

own party to almost immediately dismiss an important legislative agenda sends a powerful message to trade negotiators in other countries that the U.S. may not be able to complete these deals.

From Germany’s perspective, uncertainty about the TTIP (the European trade treaty proposal) is simply adding to evidence that the U.S. is withdrawing from its post-WWII European commitments. Although the administration can point to the installation of land-based missile interceptors in Poland and missile defense ships in Spain, these cannot offset the fact that American military personnel headcount in Europe has declined by 70% and the number of installations is down over 80% since the end of the Cold War.

In the face of these changes, Germany is signaling an important change in policy. German President Horst Kohler, in a 2010 interview to German public radio, suggested that a nation of Germany’s size and reliance on foreign trade had to be prepared to deploy its military if these interests were threatened. The comments sparked a public outcry and Kohler resigned. A little over a year ago, the *New York Times* reported that German Defense Minister Thomas de Maiziere suggested that Germany could no longer rely on others to guarantee its security. The public response was a few protestors that passed out fliers at the Brandenburg Gate. Over the past few months, there has been a virtual chorus of German officials who have been suggesting Germany needs a more “muscular” foreign policy. For example, German President Joachim Gauck indicated in a recent speech that Germany’s Nazi and Communist pasts were no excuse for ducking international responsibilities. Germany’s defense and foreign ministers have made similar comments recently. Noticeable in her

absence, Chancellor Merkel has not commented on this issue. However, given her preternatural caution, she is likely waiting to measure the reaction to the aforementioned officials' comments before making her own.

What are Germany's goals? First, Germany wants to defend the EU from all threats, not just economic ones. Germany is coping with an increasingly aggressive Russia that is trying to threaten nations in Eastern and Central Europe. The Merkel administration has concluded that the U.S. cannot be relied upon to militarily defend these nations and thus Germany may be required to build an EU response to Russian aggression. Second, Germany intends to maintain its role as a major global exporter. This will require Germany to maintain the EU in its present form and perhaps expand the group further. Such expansion will likely require more than just economic power. Third, for the EU to have any relevance in a world where the U.S. is reducing its global "footprint," Europe will need to project military power. Germany will need to be part of that equation.

Can Germany become a military power? Although Germany's military is rather small, its arms industry is rather large (though it should be noted it is no longer a conscription force, which should improve its professionalism). Its defense spending is 2.7% of the world's share and the industry employs 80k workers. It is also the world's third largest arms exporter over the 2001-12 period, after the U.S. and Russia. Germany's rearmament under Hitler showed that a nation with a strong industrial base and a well-educated population can build a world-class military rather quickly.

### **The Significance of Germany's Return**

Given that Germany was a major protagonist in three European wars from 1870 to 1939, it would be reasonable to expect some serious concern about Germany's apparent change in policy. Thus far, European comments opposing Germany have mostly come from nations who have been forced to adopt austerity as the cost of bailout. In fact, Polish officials have been calling for a more robust German policy for some time. However, assuming Germany does rearm, and given the threat from Russia it seems as though Merkel will be inclined to do so, we can expect some degree of concern to be raised in short order.

For best results, Germany should couch its remilitarization in EU terms; in other words, this isn't being done for Germany as much as it is being done for Europe. Still, given Germany's role in two world wars, it seems unlikely that there won't be some worries about a German military that matters.

It is important to note that this adjustment is occurring due to changes in how America exercises its superpower role. The lack of an overarching policy theme makes it appear that the U.S. is starting a steady march to isolationism. And even if the U.S. is moving toward offshore rebalancing, such a policy requires the development of regional powers that offset potential threats. In Europe, if Russia is the threat, then Germany is potentially the most potent adversary.

It appears that we are seeing the German problem reappear after being resolved 69 years ago. The potential ramifications are quite significant. A powerful Germany could become a threat to its neighbors and may not cooperate with the U.S. in maintaining global peace. On the other hand, the U.S. probably cannot afford the

status quo and Germany is clearly not the same country it was in 1930. Still, if our analysis is correct, a more assertive Germany is a significant geopolitical change that would not have occurred without a perceived change in American policy.

### **Ramifications**

In a recent report (see WGR, 1/13/2014, [The Great Man or the Great Wave](#)), we examined one of the great historical debates, namely whether history is shaped by great movements (waves) or great people. In general, we lean toward the “Great Wave” side of the argument which suggests that America’s steady withdrawal from the world is really part of a broader trend. American society saw the need to make superpower sacrifices in the face of the Communist threat but now that Communism is no longer relevant, Americans are simply less inclined to continue those commitments. If this is the next wave, it probably doesn’t matter who occupies the White House in 2016.

For Germany to consider the path it seems to be taking, it apparently has concluded that

the U.S. will not revert back to its Cold War stance of protecting Europe. If Germany does make this change, there will be costs in terms of “geopolitical capital.” For example, it will need to convince Greece that an economically powerful Germany with a formidable military isn’t a serious threat if Greece decides to default on its financial obligations to the Eurozone.

For investors, it is important to note that significant changes in the global environment are underway. These changes can also affect how markets relate to each other, how currencies react, etc. Former patterns may no longer hold. Although it is too early to tell exactly how these changes will affect markets, we feel confident that relationships and correlations will likely adjust and as they do, investors will need to adapt.

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