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The New German Problem

When times are tough, you discover who your real friends are, just ask the European Union. From 1860 to 1945, Germany struggled to keep the peace with its neighbors. Commodity-deprived and lacking natural barriers, Germany has sought to impose its will throughout Europe to protect itself from being invaded or cut off from mineral resources. The European Union (EU) and the Northern Atlantic Treaty Organization (NATO) were eventually set up to mitigate this problem, but Germany's unusual size and export needs created other issues.

Germany's integration into the EU was designed to ensure that German interests were aligned with the West. However, things didn't necessarily turn out that way. A decade ago, during the European debt crisis, the Germans lambasted southern European countries for being unable to repay the money they had loaned them. Germany built the Gazprom 2 pipeline with Russia against the wishes of the U.S., and its decision to sell a major port to China has drawn the ire of France. In short, Germany never truly committed itself to the European project.

The war in Ukraine has made Germany's ambivalence unpalatable to its Western allies as the group gears up to take on a rising China and an aggressive Russia. Although it appears that Germany is attempting to maintain its neutrality, it isn't clear whether this is possible, given the

country's size and influence. This report begins with a discussion on Germany's conflicting loyalties, reviewing the country's attempts to manage its relationships with its Western allies as well as China and Russia. Next, we consider how Germany has adapted to the changing geopolitical landscape, and we conclude with market ramifications.

Old Habits Die Hard

"The West over the rest" has never been a mantra that Germany championed. Although it preferred to have friendly ties with its European neighbors, it never wanted to be bound to them. In February 1885, Germany spearheaded an agreement that avoided a continental war over African resources, only to spark a conflict that led to a European war 30 years later. Its volatile relationship with Europe is related to its geography and industrial base.

Germany sits at the center of Europe both in terms of location and influence. Established in the wake of the Franco-Prussian War of 1870, modern Germany was created by gathering independent regions formerly part of the Holy Roman Empire. Its central location on the continent and manufacturing prowess meant that Germany had to ensure access to trade routes and resources. World Wars I and II were fought largely due to Germany's fears of isolation. However, the creation of the EU and NATO mitigated a majority of the country's concerns.

Although austerity prevented the German economy from keeping pace with the rest of Europe in the first 10 years of the 20th century, it was able to surpass its peers for

most of the final 10 years. After integrating its economy into Europe and basically outsourcing its defense to the U.S., Germany focused its attention on expanding its economy. By joining the EU and then substituting the weak euro for the strong Deutsche Mark, Germany was able to make its exports more competitive abroad. Meanwhile, the lack of military spending made it easier for the government to maintain fiscal stability.



The security assurances provided by the West allowed Germany to expand its reach outside of Europe. China and Russia were crucial to the expansion of Germany's industrial base as Russia provided the needed resources, while China's growing population provided the export market. In 2020, Russia [provided Germany with more than half of its natural gas and a third of its oil](#). Meanwhile, China is Germany's second biggest trade partner after the U.S.

Zeitenwende

If it wasn't clear before 2022, Russia's invasion of Ukraine made it obvious: Germany's relationships with China and Russia were incompatible with its ties to the EU and U.S., and something needed to change. Germany has tried to mitigate these tensions by acting as a neutral party, but its dependence on Western countries has made

this strategy difficult to manage. As a result, the country finds itself in a quagmire.

At the start of the invasion, the Western allies were unsure if Germany would commit to the cause. When Chancellor Olaf Scholz succeeded Angela Merkel, [it was assumed that his administration would continue her policies](#), which generally favored Moscow. It is widely believed in Germany that the country's [policy of rapprochement, known as ostpolitik](#), led to the fall of the Berlin wall. Before the invasion, [Scholz traveled to Ukraine and Russia to calm tensions](#) between the two countries. Additionally, he ruled out the possibility of Germany sending weapons to Ukraine and was ambiguous about his country's response to the invasion.

However, Russia's invasion forced Scholz to commit to a side. When Russian President Vladimir Putin made his intentions clear, Scholz instructed his economic ministry [to withdraw a binding opinion that the Nord Stream 2 pipeline](#) did not threaten its energy security and, therefore, the certification process could not move forward. For years, German politicians had hailed the pipeline as crucial to the country's future as it moves away from nuclear power. The pipeline would have allowed Russia to transfer natural gas to Germany without traveling through Poland and Ukraine. Scholz's decision meant that Moscow would need to rely on pipelines in Ukraine if it wanted to continue to send natural gas to Europe.



In addition to breaking its previous policy with respect to Russia, Germany has also decided to re-militarize. Days after suspending Nord Stream 2, Scholz promised to raise his country's defense spending to 2% of GDP from just [1.3% in 2021](#). The push to increase military expenditures comes as the country recognizes Russia as a national security threat. In addition to the new spending, Germany reversed its decision regarding not sending weapons to Ukraine.

Although it ultimately succumbed to pressure to get tough with Russia, Germany has never felt comfortable with its complete alignment with the West. Since the war in Ukraine began, Germany has tried to dial back some of its actions. In December, the country stated that it would not be able [to meet its 2% defense spending for at least another two years](#). A few weeks later, Germany partially backtracked on its [promise to send German-made tanks to Ukraine](#). Its lack of commitment to the West may be an effort to ensure a path toward normalization with Russia in the future.

No Plan B

German leaders used to believe that enhancing trade ties could replace the need for a strong military; however, the conflict in Ukraine has disproven this thesis. Germany now confronts the fact that it has friends on both sides of the conflict and choosing one will be difficult. On the one side, it relies on the U.S. and Europe for security, while on the other, it depends on Russia and China for commodities and market expansion. As a result, the war has thrown German foreign policy into disarray.

Since the end of the Cold War, Germany has been reluctant to spend resources on its military. Despite its involvement in NATO, Germany has starved its military of funding. Its armed forces, known as the Bundeswehr, are undermanned, insufficiently trained, and poorly equipped. A 2015 report showed German troops [using broomsticks instead of machine guns during military exercises](#). To make matters worse, increasing numbers of German [soldiers have left the army since Russia started its invasion](#). The German military's lack of readiness means that the country is largely helpless and defenseless without the backing of the West.

Meanwhile, foreign trade is also an issue. Germany's export-promotion economic model has made it a powerhouse in trade. As a result, the country is reluctant to close itself off from China, the world's second-largest consumer market. In November, Scholz traveled to Beijing to meet with Chinese leaders [to discuss the deepening of trade ties](#). The visit drew the ire of his European and American counterparts, who view China as abetting Russia's invasion of Ukraine. Germany's insistence on keeping ties with China shows its reluctance to choose between trade and security.

Germany is stuck between a rock and a hard place. It does not want to abandon Russia and China because it would prefer not to depend solely on the West for its trade and security, but it also aims to minimize the investment in its military. As a result, Germany is forced to use strategic ambiguity as it tries to find neutral ground between the two contentious sides. Although both sides are being patient with Germany for the time being, it is clear that it will be forced to choose a side soon.

The New Germany

Former Secretary of State Henry Kissinger once quipped that Germany is “too big for Europe and too small for the world,” meaning that although it wants to influence the world, it lacks the economic size and military capacity to do so effectively. As the world moves away from globalization and toward broad geopolitical and economic blocs, Germany may not get all it wants by sticking with the evolving U.S.-led bloc, which is where we consider it to be at the moment. Instead, there is a chance that Germany may attempt to form a new bloc over the next decade. This new bloc would contain mostly EU countries and would likely be closely aligned with the U.S.-led bloc. The German-led bloc might offer countries more flexibility than they would have under the U.S.-led bloc. For example, the German-led nations could participate in

U.S.-led attempts to go after smaller autocratic countries but remain neutral in U.S.-led conflicts with bigger countries where they have economic interests. Although this would create some friction between the two sides, it likely wouldn't necessarily lead to a complete severance of ties.

Additionally, a German-led bloc should rouse European nationalism. As the bloc relies less on the U.S., its countries could forge closer ties with each other and embrace protectionist policies such as a tax on non-EU made vehicles. This may even lead to a “buy-EU” agenda in which governments promote purchasing goods from other European countries. If we are correct, a German-led bloc could promote European champions in industries where the continent lags the U.S., such as tech and defense. These dynamics would further support our expectations for a period in which the world faces higher costs, higher inflation, and rising interest rates. We continue to believe that this environment would be negative for the U.S. dollar but positive for European stocks. Likewise, we expect it would be negative for bonds but positive for commodities.

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