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The German Problem

Since unification, Germany has been steadily becoming a “normal” country instead of being divided and dominated by the Soviet Union and the United States. As it develops independent foreign and economic policies, Germany is upsetting traditional alliances and forcing other nations to deal with its resurgence. In this report, we will describe the geopolitical issues and history that define Germany, its reemergence after the end of the Cold War and how these policies may realign the country's orientation. As always, conclude with a discussion of the potential market effects.

The Geopolitics and History of Germany

Until 1871, Germany was a region of fragmented powers, remnants of small kingdoms, duchies and principalities that were part of the Holy Roman Empire. Because the region was divided, it was vulnerable to manipulation by surrounding nations. To the southeast, Austria, a predominantly Catholic nation, tried to control Bavaria, an area of similar religious leanings. The French persistently intruded on the Rhineland. Russia sat to the east, where it partially controlled Poland. Prussia, the Protestant portion of the German region, spent much of the first half of the 19th century trying to build a nation and counteract outside influences.

In 1866, in a six-week war, Prussia defeated the Hapsburgs who controlled Austria. In

the 1870-71 Franco-Prussian war, Prussia led a coalition of German states to defeat France. These two wars led to the creation of Germany. Russia could have interfered, but viewed the rise of Germany as the creation of a buffer state that would protect the Czarist nation from Austria, and more importantly, France. Thus, Russia acquiesced to the rise of Germany.

The rise of Germany caused a major geopolitical restructuring of Europe. Germany developed into a large, economically vibrant nation. Over time, German economic growth outstripped that of both Britain and France; by the onset of WWI, Germany had the world's second largest economy (after the U.S.) and was the largest in Europe. Germany was building a “blue water” navy to compete with Britain. It was also acquiring colonies and was increasing its exports. From 1871 into the new century, Germany's expansion was raising concerns among the European governments that were uncomfortable with its growing power.

Germany's geopolitical problem was essentially that it lacked major natural barriers to invasion, making it vulnerable to attack from France, Austria or Russia. In addition, the British Navy could still block German ports despite its growing naval power. Because of the robust German economy, none of these powers could defeat Germany alone. However, if allied against Germany, they would likely win. German leaders assumed that, eventually, European powers would collaborate and attack. Thus, German war planning centered on preventing simultaneous attacks and, if that

was impossible, how to fight a two front war. Due to Germany's perceived vulnerability, the German High Command leaned towards preemptive strikes.

Germany's war planning was devised by Count Alfred von Schlieffen. The Schlieffen Plan envisioned a rapid invasion across the Netherlands, Luxembourg and Belgium (violating their neutrality), and swinging across northern France. The plan was designed to rapidly defeat the French Army. Schlieffen assumed Russia would attack, but due to its poor rail network, he assumed the mobilization would be slow. Thus, the goal was to defeat France before Russia was ready to attack Germany. This would allow Germany to shift its forces to the eastern front to repel the Russian Army, who the Germans greatly feared.

The Schlieffen Plan, with modifications, was employed in WWI. The French Army was able to stop the German Army at the First Battle of the Marne and the war devolved into the long stalemate of trench warfare. In fact, the Russian Army proved to be a much lesser threat and so Germany mostly fought a single front war anyway.

In WWII, instead of trying to fight on two fronts, Germany shocked Europe by signing the Molotov–Ribbentrop Pact, which was a non-aggression treaty with the Soviets. The treaty was totally unexpected because the Nazis severely persecuted communists in Germany. The treaty would allow Germany to focus its war efforts on Western Europe. In addition, Germany and the Soviet Union secretly planned to divide Central Europe into spheres of influence. History suggests

that Stalin believed that Germany would become bogged down in France and after Hitler's armies exhausted themselves, the Red Army would be able to sweep into Europe with little resistance. Instead, military leaders discovered the missing element of the Schlieffen Plan—air power. By combining rapidly moving armored forces with air strikes, the German army was able to overthrow French forces rapidly. Hitler then violated the Molotov–Ribbentrop Pact and ended up fighting a war of attrition against the Soviets.

After the war, European, Soviet and American leaders worked to address the German geopolitical problem. The solution was for Germany to be occupied by France, Britain, the Soviet Union and the United States. The West German economy recovered from the war, while East Germany languished (although it was considered the “jewel” of communist economies). In this period, Germany was mostly unable to conduct an independent foreign policy; instead, it followed the dictates of NATO. West Germany was on the front lines during the Cold War. The U.S. stationed troops and placed tactical nuclear weapons in Germany to protect against a Soviet invasion. To some extent, both East and West Germany were in greater danger than during the previous two world wars.

Until unification, most of Germany's economic policy was subsumed into the European Union. However, the Bundesbank did become the dominant central bank for Europe and the D-mark became the *de facto* reserve currency for the continent.

The New Germany

The fall of the Soviet Union and German unification ended the post war “occupation” period. In the nearly 20 years since the fall of the Berlin Wall, Germany has steadily come into its own. Although Germany lost its beloved D-mark for the euro, Bundesbank officials were able to put a firm anti-inflation bias into the European Central Bank’s policies. The German Army has begun to take shape. During the occupation, the German Army was primarily a local defense force, precluded from projecting power. Now, the German Army has troops stationed from the Balkans to Afghanistan.

Germany is also crafting its own foreign policy. And, this policy is, in some cases, diverging from the interests of the United States, Central Europe and France. The key to understanding Germany’s emerging foreign policy is observing its history, which we capsulated above. Overall, Germany still faces the same vulnerabilities now that it faced in 1871. It wants to ensure that it won’t be trapped between France and Russia.

At present, its relations with France are stable; however, President Sarkozy’s improved relations with the U.S. and U.K. are a significant shift from previous French governments. Thus, this change must be managed. However, a much bigger worry is the emergence of Russia.

After the fall of the Soviet Union, Russia lost most of its “buffer states.” The Eastern Bloc changed its alignment with the West and the emergence of the Central Asian

states means that Russia cannot necessarily count on their economic and political support. Since taking control of the Russian government in the late 1999, Vladimir Putin has worked to regain influence in Russia’s “near abroad” (although no longer president, we believe Putin is still ostensibly in control of Russia).

To this end, Russia has used its energy resources to coerce its neighbors into Russia’s orbit. After the Orange Revolution in Ukraine, Russia has cut off natural gas supplies on numerous occasions to extract policy changes from the Ukrainian government. These supply disruptions have cut natural gas flows to Europe, which have upset European leaders. As we discussed last week, there are proposals designed to try and weaken Russia’s grip on natural gas supplies to Europe.

In addition, Russia moved troops into disputed regions of Georgia last August. This move shocked the West and led to widespread condemnation. However, no power sent troops to protect Georgia, although the U.S. moved a couple of warships into the Black Sea as a warning.

Russia’s policy of expanding its influence runs counter to U.S. policy which prefers to weaken this influence. The U.S. has supported NATO membership for the Baltic States, Ukraine and Georgia. This is seen by Russia as a direct threat.

For Germany, the feelings are mixed. To a great extent, it appears both Germany and Russia feel slighted by U.S. policy actions over the past 20 years. Both the Clinton and

Bush administrations acted as if Russia didn't really matter in making strategic decisions and it appeared both administrations didn't take into account the fact that Germany was unified and not as beholden to the U.S. and NATO. A couple of examples illustrate this perception. After 9/11, Russia, in its view, "graciously" allowed the Bush administration to use former Soviet airbases in Central Asia to conduct operations in Afghanistan. Russia expected the use of these bases to be temporary. However, the war in Iraq made it clear that the Afghan War was in a holding pattern and the bases would be used indefinitely. The second example occurred with the bankruptcy of General Motors. Germany expected the U.S. to support General Motors European subsidiary, OPEL. The Obama administration made it very clear that wasn't going to happen, and Magna International became the lead bidder, supported by a Russian bank.

Germany and Russia have been steadily improving relations. The former German president, Gerhard Schröder, championed the Nord Stream natural gas pipeline, which will ship natural gas directly from Russia to Germany. The German government has been divided on supporting the Nabucco pipeline, which Russia opposes.

Germany has also made it clear that it doesn't support the further expansion of NATO. Based on Germany's history, this makes perfect sense. If NATO is going to defend Ukraine and Georgia from Russian attack, it will likely require a massive increase in military spending. Since the U.S. already spends a significant amount on

defense, it will logically fall to the Europeans to defend these new members. And, Germany, being the largest economy in the Eurozone, would be forced to fund the bulk of the buildup. From Germany's perspective, it makes little sense to threaten Russia, who supplies 40% of Germany's natural gas imports.

The reality for Germany is that Russia is a more proximate military threat. At the same time, Russia has become an important economic partner; Russia is Germany's largest foreign supplier of natural gas and Germany is Russia's largest trading partner. It seems likely that Russia and Germany will remain friendly, which means that Germany will conduct relations with Russia that run counter to the desires of the United States.

This "cozy" foreign policy between German and Russia will tend to raise fears in Central Europe. Over the past 120 years, Germany and Russia have tried to dominate this region. Germany subjugated this area between the world wars through its export policies. That's why many of these states aligned themselves with the Nazis. And Russia controlled the region after World War II. The Central European states have been very open to U.S. overtures. Poland has lobbied to have a ballistic missile defense installation on its soil, much to the chagrin of Russia. These nations fear that Germany will not support their efforts to fend off Russian attempts to dominate them. The recent German decision to not support a financial bailout for Central European banks has added to these fears.

Finally, Germany has been reticent to support fiscal expansion. Germany is an exporting nation; from its perspective, global stimulus does more for its economy than domestic stimulus. However, Germany's stance has angered the U.S. and U.K., who view Germany as "free riding" on the stimulus of others. Germany has also supported global financial market regulation, which would tend to weaken the financial dominance of New York and London.

Ramifications

The end of the Cold War initially ushered in a "unipolar moment" for the United States. The U.S. was the world's undisputed superpower; President Clinton described America as the "indispensible nation." However, two wars and a financial crisis have changed the perception of the United States. More nations are preparing for a multipolar world. And, it appears Germany is one of them. In effect, Germany is shaping an independent foreign policy to suit its geopolitical conditions. And, this policy will, at times, diverge from U.S. interests.

In terms of market impact, there are two immediate concerns. First, Germany will continue to avoid fiscal stimulus which will weaken European and global growth. As the U.S. recovers, imports from Europe will likely increase, supporting European growth and the expense of the U.S. In other words, U.S. fiscal stimulus will be helping employ Europeans. This will increase protectionist pressures. Second, Germany's anti-inflation stance will tend to boost the euro which may act to undermine sentiment for the dollar. Both of these potential outcomes are worrisome and would tend to weaken equity markets and support commodity markets as protectionist concerns increase resource hoarding.

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