

*October 11, 2021*

## **AUKUS**

On September 15, the leaders of the U.S., U.K., and Australia [announced a new security relationship](#) which includes a nuclear submarine arrangement with Australia. Although it will likely take a couple of decades before Australia will have its own indigenous nuclear propulsion vessels, the treaty means that the U.S. and U.K. will likely begin sharing nuclear technology and other weapons systems.

The announcement not only marked the beginning of a new security relationship in Asia for the U.S. and U.K., but it also marked the end of another one, a \$60 billion defense arrangement that France had with Canberra. France had previously agreed to provide Australia with diesel/battery submarines, but this new deal scuttled the French arrangement. The French were incensed; [ambassadors were recalled](#), and European governments denounced the new arrangement.

It is not a huge surprise that the French were upset, but the degree of the reaction seemed strong given the violation. Diesel submarines pale in comparison to the capabilities of nuclear propulsion. The former is only useful in coastal protection. They need to resurface to use the diesel engines to recharge batteries; during this period, they are vulnerable to attack. They also require regular refueling. Nuclear submarines don't need to resurface and can extend their patrol range significantly compared to a diesel-powered vessel. When the deal was made in 2016, diesel subs may

have been adequate for the risks Australia perceived. That is no longer the case. So, it should have come as no surprise that Australia would consider an upgrade. Although France has nuclear propulsion technology, it is not as effective as American technology.

The U.S. decision to create this new security arrangement, Australia's acceptance, the U.K. decision to join, and the reaction of France all reflect an [evolving geopolitical situation in Asia](#). In this report, we will discuss why the three nations decided to create a new pact. From there, we will offer a short geopolitical analysis of Europe, followed by an examination of the French and European reactions. We will close with market ramifications.

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There are two factors that led to this new security arrangement. First, in the U.S., there has been a nearly universal acknowledgement among the foreign policy establishment that China is never going to become a democratic-liberal<sup>1</sup> nation, no matter how advanced its economic development. Consequently, China is now seen as a great power adversary. Second, Australia has realized that China has become hostile to its interests and thus it needs upgraded military deterrence to counter China's belligerence. When Australia entered the arrangement with France in 2016, the former's relationship with China was still friendly. China was a significant consumer of Australian exports and there

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<sup>1</sup> Liberal in the classical sense—a rules-based society that focuses on individual, as opposed to collective, rights.

was still some hope of Beijing’s eventual liberalization. There was no obvious need for Australian power projection; the U.S. Navy continued to protect sea lanes, so vessels designed for coastal protection were more than adequate.

Accordingly, [Canberra has now concluded that it is facing a serious threat from Beijing and has a greater need to project power.](#)

Although France could work with Australia to make nuclear submarines, the U.S. offer is more attractive. The U.S. has the best technology, so joining the U.S. and U.K., which also shares American technology, means Australia would be able to boost its defense posture. And, of course, [this gives the U.S. a stronger relationship with Australia](#), bolstering its posture in the region. Although France does have modern defense technology, it isn’t necessarily cutting edge and Paris won’t give Australia the ability to project power in the same way the alliance with Washington and Westminster will offer. France has a small footprint in the Pacific, nothing in comparison to the U.S. presence.

Of course, there is the matter of breaking up with France. Australia’s plan to purchase submarines was a point of pride for Paris. [Being “fired” without consultation was a deep disappointment for France](#), and the French reacted aggressively to the snub. [Ambassadors to the U.S. and Australia were recalled.](#) Terms like “stab in the back” emerged from the Macron administration.

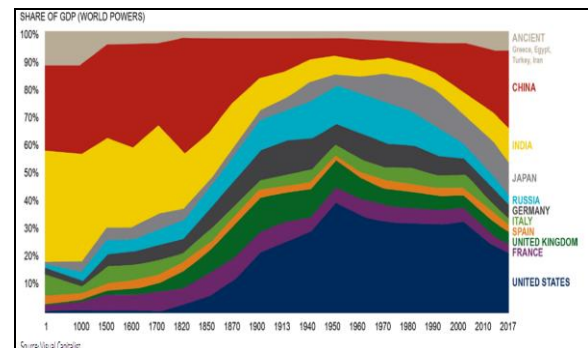
Is the French reaction justified? Simply put, Australia’s security situation changed significantly over the five years from when the initial agreement was struck. [Nations don’t have friends, they have interests.](#) France would not have been able to provide the level of defense support that the U.S. could make available. America is a Pacific

power; France has some island holdings in the area but cannot project power in the same manner as Washington. Given the threat escalation that has developed with a more aggressive China, Canberra has every reason to bolster its defense posture. AUKUS is a suitable vehicle for this bolstering.

### What’s Behind the European Reaction?

As noted above, [France reacted harshly](#) to the snub, but it [wasn’t the only negative reaction from the EU](#). [Germany](#) and others criticized the U.S., Australia, and Britain. American disregard for French and EU interests in the 2016 submarine deal made it abundantly clear how little European “feelings” mean to Washington. Why would the U.S. behave in this fashion?

Let’s look at the history. From around 1500, Europe became increasingly dominant.



(Source: Angus Maddison)

This chart shows the shares of world GDP. Starting around 1500, when European nations began their colonialization period, the share of GDP steadily rose. The onset of the industrial revolution accelerated the rise of Europe, although by the 20<sup>th</sup> century, the expansion of the United States had begun to compete for Europe’s economic dominance. Two world wars effectively ended European dominance, and the rise of Asia during the postwar period has weakened the European position.

Why did Europe lose its preeminent position? The heart of the issue is the geography of Europe.



(Source: Freeworldmaps.net)

The geography of Europe made it impossible for a single power to dominate the continent. Southern Europe was isolated by a series of mountain ranges, including the Pyrenees, Alps, and Carpathians. The Baltic Sea separated Scandinavia. Britain loomed off the coast. The North European Plain offered nearly unimpeded access from Spain to the Ural Mountains.

This meant that if a single power were to dominate continental Europe, it first had to overcome the mountain ranges. If a power managed that feat, it had to conduct amphibious operations to capture Scandinavia and the British Isles. The Roman Empire came closest to lasting domination, but even the extent of its empire excluded most of Germany and Eastern Europe and half of the British Isles; the empire had no control over Scandinavia. Throughout history, no power was able to completely dominate the European continent, but that wasn't due to a lack of effort. However, a clear pattern emerged; continental powers were unable to successfully invade Britain, meaning that the British were consistently able to thwart efforts to control the region. Nevertheless,

Britain was never strong enough to invade the continent and hold significant territory. Scandinavian powers did invade northern Europe but didn't extend their power very far. The Spanish Empire controlled significant parts of Europe, but Britain's defeat of the Spanish Armada prevented Spain from extending its rule further. Russia extended its empire into present-day Eastern Europe but failed to move further west. Napoleon dominated central Europe but failed to control Britain. In general, European powers fought numerous wars and empires expanded and contracted, but no power was able to fully unify and dominate the continent. It should be noted that while the European powers jostled for control of the continent, they were controlling much of the world through massive colonial holdings. The lack of European dominance did not stop them from expanding power outside of Europe.

When Germany emerged as a nation in 1871, European stability was severely challenged. Germany sits in the middle of the North European Plain with no natural defenses. Invaders from the east and west didn't need to overcome large bodies of water or mountain ranges. Being on the plain facilitated Germany's industrialization, but the position of vulnerability caused Germany to foster an aggressive foreign and military policy. The two world wars in the first half of the 20<sup>th</sup> century are evidence of the underlying instability of Europe.

The United States emerged as the dominant power in the aftermath of these two world wars. To ensure that a third one wouldn't emerge from Europe, the U.S. effectively provided European security. Germany no longer needed to fear its neighbors and other nations in Europe no longer needed to fear Germany or other European nations. With the U.S. providing European security under

the auspices of NATO, European nations began a steady process of economic and political integration. The European Coal and Steel pact eventually evolved into the current European Union. The creation of the euro and the Eurozone was a major step in the development of European unity.

However, economic unification has not led to political unification. There are elements of political unification, such as the steady expansion of EU regulations and the recent [issuance of a Eurobond](#), which are further evidence of European unity. However, national interests still dominate.

This history brings us to the issue of U.S. and European security policy. The U.S. has provided security to Europe because Washington concluded that the Europeans, left to their own devices, would remain a threat to global security. European nations, to a greater or lesser extent, maintain some ability to project power. France and the U.K. arguably have the most potent militaries in the region. But given Europe's lack of ability to project power, the cost to the EU is that the U.S. has little obligation to take European concerns into account when making security decisions.

The snub to France is [not, by any means, the first time something like this has occurred](#). The 1956 Suez Crisis put to rest the idea that Europe could engage in foreign adventures without U.S. approval. President Nixon ended Bretton Woods unilaterally. The U.S. based nuclear missiles in Europe despite local opposition. President Reagan offered only lukewarm support for the U.K. retaking of the Falkland Islands. President Bush moved into Iraq over European objections, and President Biden left Afghanistan without fully consulting European allies.

The reaction from French officials was extreme. As we noted above, the security situation for Australia has become perilous in the face of Chinese expansionism and the need for stronger allies is obvious. But the U.S. could have handled it better; the way Washington dealt with the situation [suggests French or European concerns were simply not a high priority](#). There are [already actions being taken to diffuse the situation](#). Although we would expect tempers to cool, the damage done from this event will linger.

For Europeans, this event, along with those cited earlier, is another reminder of how they no longer dominate the world. Had it not been for the particular geography of Europe, it is possible that a single European power that dominated the continent would also be the global hegemon. Nevertheless, persistent conflict that was never able to resolve into a single government has led to the current scenario. Adding to tensions was the fact that [three English-speaking nations created this security relationship](#); although the notion of an [Anglo-Saxon view of the world](#) isn't common in English-speaking nations, it is a point of contention in France.

### Going Forward

Perhaps the most telling issue this event highlights is that the [U.S. focus has now shifted to China and Asia](#). [French President Macron has been arguing that Europe can no longer rely on the U.S. for protection](#). Although we [still think America will support NATO](#), it is also clear that Asia is a higher priority. Therefore, [European powers should bear greater responsibility for their own defense](#). However, if the U.S. allows Europe to rearm, the frozen conflicts in Europe that led to two world wars could easily reemerge. The apparent European unity that has developed since the end of WWII may simply be an artifact of the security provided by the U.S. In the absence

of American dominance, European unity could dissolve as well. If so, the conflicts of the previous centuries could return. That is the potential risk of America's policy focus on Asia. [There are arguments for Europe to avoid rearming](#), but if the U.S. is reducing its military support in the region, then the Europeans will need some ability to project power to not only protect themselves but to give the semblance of power projection.

Another issue for the Europeans is that [it may not be in their best interests to side with the U.S. against China](#). Germany has deep economic ties to China and will be loath to make a hard break with Beijing. Although European leaders are concerned about China's influence, Europe does not face as direct of a threat from China compared to nations on the Pacific. China will likely use this snub of the French to weaken U.S. ties to Europe and to express [China's own anger at the arrangement](#).

### **Ramifications**

European rearmament should benefit defense companies. It remains to be seen if U.S. or European defense industries would enjoy the greatest benefit, but overall, they should see increased business activity.

If the slow withdrawal of American security becomes a reality, holding the Eurozone together may become a challenge. The euro has managed to survive various challenges, including the PIIGS debt crisis in 2011-13. However, rearmament and power projection may cause strain that would encourage the reintroduction of national currencies. Most war efforts lead to debt expansion which the current structure of the Eurozone would discourage. Concerns over the structure of the Eurozone would increase market volatility for European assets, in particular, but would likely affect other markets as well.

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*This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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