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Germany: The Reluctant Superpower

Two recent articles caught our attention. First, the *New York Times* discussed growing worries in Germany about a post-American Europe,¹ given the potential withdrawal of the U.S. from the superpower role. Second, an op-ed in *Der Spiegel* went so far as to suggest that Germany should become the world leader of an anti-Trump coalition.²

These reports are indicative of the rapidly changing views on how the U.S. manages its superpower role. The fact that Germans are considering their options in response to American foreign policy is a significant development.

In this report, we will start with the background of American foreign policy post-WWII to the present. This will set the stage for why Germany feels compelled to adjust its foreign policy. From there, we will reflect on how Europe and the rest of the world could react to a hegemonic Germany. As always, we will conclude with potential market ramifications.

¹<https://www.nytimes.com/2017/02/06/world/europe/germany-prepares-for-turbulence-in-the-trump-era.html>

² <http://www.spiegel.de/international/world/a-1133177.html>

U.S. Post-War Foreign Policy³

As WWII came to an end, the Roosevelt administration concluded that if it didn't stay involved in the world, eventually the U.S. would be drawn into another world war. Thus, the decision was made to accept the superpower role.

The decision was quite controversial. The U.S. is fortunate to be surrounded by two unthreatening states and bodies of water. Because it faces no immediate threats, the U.S. can choose isolationism. Many other nations can't make that choice. Because it doesn't face nearby geopolitical dangers, the U.S. is, at least geographically, almost a perfect superpower. The U.S. doesn't have to expend significant resources defending its borders. This characteristic can allow it to avoid the superpower role as well.

America's primary superpower worry after the war was dealing with communism. George Kennan shaped the U.S. response to Soviet communism with the "long telegram"⁴ in 1946. In this missive, he suggested that capitalism and democracy were superior systems and that communism could be defeated by containment and time. This became the way the U.S. dealt with its most critical geopolitical imperative after the war.

However, communism wasn't the only important geopolitical issue. There were

³ For a deeper look at this issue, see WGR, 10/3/2016, [American Foreign Policy: A Review, Part I](#); and WGR, 10/10/2016, [American Foreign Policy: A Review, Part II](#).

⁴<http://nsarchive.gwu.edu/coldwar/documents/episode-1/kennan.htm>

three regions of the world that needed to be managed. Europe had been the focal point of two world wars. The continent had not been able to cope with the emergence of Germany. The country, set on the northern European plain, had no natural defenses. Thus, it always faced the threat of invasion from either Russia or France. This same lack of natural barriers was destined to make Germany an international powerhouse. It was easy to move goods around the newly formed nation and to export them. In fact, Germany even had ocean access through the Baltic Sea.

As the German economy rapidly grew from its founding in 1870 into the early part of the 20th century, the country was becoming a threat to the established order. A series of unfortunate mistakes, including treaty obligations, inappropriate belligerence and the poor estimation of the costs of war, led Europe to stumble into WWI. The Treaty of Versailles virtually guaranteed that Germany would be humiliated but not crippled, and this led to the rise of the Third Reich and WWII.

After the war in Europe ended in 1945, the peace treaty left Germany divided. Although the allies didn't necessarily intend to keep the country in this state, the inability to work with Stalin on integrating the Soviet eastern sector into the rest of Germany led to the Cold War and the creation of East and West Germany.

It had become apparent that the best way to prevent another world war from originating in Europe was to manage the "German problem." To accomplish that goal, the U.S. effectively demilitarized Germany (and, to a greater extent, Europe) by creating the North American Treaty Organization (NATO). Essentially, the U.S. took over security for Europe, paid for by American taxpayers.

Germany no longer feared invasion by its neighbors because such acts would trigger war with the U.S.

The other two global "hotspots," the Far East and the Middle East, were also pacified by heavy American involvement. Japan and China had been geopolitical rivals for centuries. The U.S., as with NATO, took over Japan's defense which assured China that it would not have to worry about defending against Japanese aggression.

In the Middle East, the U.S. honored the colonial borders even though these frontiers didn't always create functional states. Colonies were formed for the benefit of the colonialists, which meant that borders were created with little regard for ethnic, religious or tribal divisions. Often the colonial powers would put minority groups in control which forced them to rely on the European nation in order to remain in power. Once these nations became independent, they tended to devolve into authoritarian regimes because it was the best way for the minority ethnic, tribal or religious group to stay in power. Although the situation was far from ideal, the U.S. supported these regimes for stability and to deny the Soviets access to the region.

The other key element of American hegemony was to establish the dollar as the world's reserve currency. At Bretton Woods in 1944, the U.S. and its allies created a modified gold/dollar standard for what was to become the Free World. From 1944 to 1971, dollar holders could swap their greenbacks for gold at \$35 per ounce. Nixon closed the gold window in 1971 but the dollar has remained the reserve currency.

Robert Tiffin, a European economist, forecast that the U.S. would eventually face a currency crisis because of the reserve

status of the dollar. When a national currency is the reserve currency of the world, nations will want to acquire this currency to conduct trade. This means the reserve currency nation must run persistent current account (trade) deficits to ensure global liquidity. However, the wider the deficit becomes, the less faith foreigners will have in the stability of that currency. Known as the “Tiffin Dilemma,” the thesis suggests that no nation can be the reserve currency indefinitely.

Until the late 1960s, America’s relative size in the global economy meant it could provide the reserve currency without serious strain. However, by the late 1960s, Europe had recovered from the war and was holding large dollar balances. To prevent European nations from draining U.S. gold reserves, Nixon ended the ability of dollar holders to swap their dollars for gold.

Since the dollar began floating in 1971, there hasn’t been a serious challenge to the greenback’s reserve role. No other nation has been willing to maintain open trade to ensure adequate global liquidity or has deep enough financial markets to give reserve holders vehicles to invest in while they hold their dollar assets.

Foreign nations realized with the U.S. providing the global reserve currency, the best path to development was export promotion. This entailed suppressing domestic consumption, boosting saving, building an industrial base with the saving and exporting the excess to the U.S. Germany, Japan, South Korea, Taiwan and China all used this development model to become developed economies.

The U.S. political class has had to manage these foreign policy goals while simultaneously conducting domestic policy.

From 1945 until 1978, domestic policy was designed to create high paying, low skilled jobs. Industry concentration was allowed and high marginal tax rates discouraged entrepreneurship and market disruption, while technology was restrained by concentrated industries and regulation. This led to steadily rising inflation which was addressed by a reversal of domestic policy in the late 1970s to globalization and deregulation. Although inflation did decline, the cost to society was a steady rise in inequality. Households tried to maintain their lifestyles in a stagnant wage environment by expanding debt, but that avenue for lifestyle maintenance ended with the 2008 Financial Crisis.

The U.S. was willing to make these sacrifices in order to win the Cold War and avoid WWII. With the fall of the Berlin Wall and the collapse of the Soviet Union, American policy efforts were vindicated. However, the costs to the U.S. were considerable. The U.S. had to develop a large standing military. The government ballooned in size, in part to supply the aforementioned global public goods of security and the reserve currency; it’s impossible to be a small government superpower. The American economy was also affected. Creating a broad middle class fostered inflation, while combating inflation led to income inequality and household debt.

Part of the recently observed rise of populism is due to hegemony fatigue. U.S. citizens are tired of being global “first responders” and having to maintain peace in regions prone to war. The fatigue is reasonable. Although the U.S. has reaped tremendous benefits from being the global hegemon (cheap imports, no WWII), we have played this role for so long that all we are aware of is the costs; the benefits are no longer obvious. In addition, there is a

reasonable concern that the costs and benefits of hegemony are not equally shared. For U.S. households that can operate in a globalized and deregulated economy (usually through education and, in many cases, through being born into the “protected classes”⁵), the past 39 years have been rather good. If one struggles to compete, the last 39 years have been difficult.

However, ending America’s hegemonic role will have costs. Germany’s talk of preparing for the end of Pax Americana means that the “German problem” is returning to Europe. Given the last century’s history, this is a deeply unsettling thought.

Germany’s Situation

Germany fully adapted to U.S. hegemony. First, it accepted U.S. geopolitical dominance and no longer had to cope with this issue. The U.S. solved the problem by relieving Germany from its own defense. Second, it took full advantage of the dollar’s reserve role to become a major exporting power; Germany’s current account surplus at 8.5% of GDP is one of the highest in the world. Exports represent 45.6% of GDP.

However, there is growing evidence that this postwar situation is unwinding. As we noted in an earlier report,⁶ the U.S. stabilized the Middle East by maintaining the existing borders. President Bush’s ouster of Saddam Hussein weakened the territorial integrity of Iraq. President Obama’s decision to pull the U.S. military out of Iraq and his reluctance to intervene in Syria has created a condition where neither Iraq nor Syria are able to control their established borders.

⁵ <https://www.wsj.com/articles/trump-and-the-rise-of-the-unprotected-1456448550>

⁶ Op. cit., [American Foreign Policy: A Review, Part I](#)

When President Trump intimates that the U.S. is no longer comfortable with Japan and Europe “free riding” the American security umbrella, he makes a case that resonates with many Americans. However, if the U.S. does unthaw these potential conflict zones, it is reasonable to assume that European and Asian nations will take steps to protect themselves in ways that may not fit U.S. interests.⁷ For example, if Germany decides to form a non-aggression pact with Russia, it could lead to the creation of spheres of influence in Eastern Europe, dividing the area between these two powers. Having Germany, in particular, or Europe, in general, paying more for their defense isn’t unreasonable until one realizes that this also gives them the freedom to enforce their own interests, which don’t necessarily align with ours.

If the U.S. changes how it manages the reserve currency role and undermines export promotion as a development model, the German economy will be in deep trouble. Germany is already being criticized for its economic and financial dominance within the EU. If it rebuilds its military, as U.S. behavior seems to be supporting, the rest of Europe will likely oppose this action. However, if the Germans feel vulnerable, both militarily and economically, it would be unreasonable to expect that they won’t respond to that fear. If Germany fears that it can no longer rely on the U.S. for defense and absorption of its excess capacity via exports, rebuilding the military using this export capacity is a reasonable outcome.

Ramifications

If the U.S. does reduce its military support of Europe and establishes trade barriers to lessen the dollar’s reserve currency role,

⁷ This is one of the key flaws in the foreign policy of “offshore rebalancing.” See WGR, 11/5/2012, [The Foreign Policy Choice](#).

then Germany is at risk to economic weakness and security vulnerability. How Germany responds will be key to the impact on financial markets. A surge in German defense spending would support European and U.S. defense equities. If the Eurozone devolves from its current form, a likely outcome would either be a return to the Deutsche mark or a concentrated Eurozone of northern European nations. In either case, the resulting currency would likely appreciate strongly from current levels, hurting German exports. On the other hand, currency investors could benefit; the problem is it's almost impossible to determine whether the current euro would

become the northern European euro or if the D-mark would re-emerge! Still, this is an area that bears watching.

Given how deeply Germany has invested in the economic and security structure the U.S. built after WWII, it is reasonable to assume that the country would suffer in the adjustment process toward independence. Europe would likely suffer as well. We view this situation as an unpriced risk in European financial assets that could weigh on their values in the coming years.

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