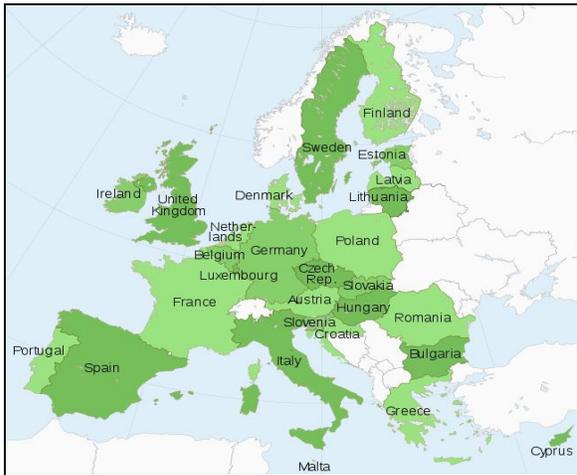


*April 3, 2017*

## **The EU at 60: Part I**

On March 25<sup>th</sup>, European Union (EU) leaders from 27 nations gathered in Rome to celebrate the 60<sup>th</sup> anniversary of the founding of the organization. Although the EU currently consists of 28 members, the U.K. was absent due to its recent decision to leave the EU.

On that day in 1957, France, West Germany, Italy, Belgium, Luxembourg and the Netherlands signed the Treaty of Rome, creating the European Economic Community (EEC), which eventually became the EU. Over time, new members joined the group. This map shows the current members.<sup>1</sup>



(Source: EU)

<sup>1</sup> For the next two years, the U.K. will remain a member. PM May did submit an Article 50 letter on March 29 which begins the two-year process of exiting the EU. It is possible that this deadline could be extended depending on negotiations. Britain is the first nation to exit the EU.

It should be noted that this wasn't the first attempt at a supranational European body. France proposed the European Defense Community to be comprised of the six original EU members. However, the French failed to ratify the treaty. In 1951, West Germany and France built the European Coal and Steel Community which included the other four founding nations of the later EU and it became a forerunner of the EU. In 1957, the same six nations agreed to cooperate on nuclear power. Still, the EEC is considered the original source of what evolved into the EU.

The primary goal of the EU was to prevent another world war from being fought on European soil. That goal, at least so far, has been successful. The key to meeting this goal was to solve the "German problem." That issue continues to evolve.

In Part I of this report, we will discuss the German problem and how NATO and the EU were developed in response to resolving that problem. In Part II, we will examine the post-Cold War expansion of the EU, including a discussion of the creation of the euro and the Eurozone. With this background, we will analyze the impact of the 2008 Financial Crisis and the difficulties the EU has faced in dealing with the problems it caused. There will be an analysis of immigration and European security as well. We will look at several proposals being floated in the wake of Brexit about reforming the EU and, as always, conclude with potential market effects.

### The German Problem

Until the early 1800s, what is now Germany was a region of small principalities. These small states created a buffer zone between France and Russia and was thus considered useful by both. Napoleon shattered that notion by marching through the region on his way to Moscow. Although the French leader was ultimately defeated, his invasion sparked nationalism in Prussia that led to the creation of the German state in 1871, led by Prussian leaders. The creation of the German nation was aided by the Franco-Prussian War of 1870-71, which encouraged the southern principalities to join Prussia to create Germany.

Germany's central location in Europe coupled with few physical barriers to the free movement of people and goods helped Germany become an economic powerhouse. At the same time, the German military was acutely aware that it could not withstand a simultaneous attack from France and Russia. Thus, Germany's military doctrine focused on eliminating one competitor first, usually France, and turning on the remaining nation. It also meant that if France and Russia were aligned, it would be forced to act pre-emptively because it could not allow these two powers to choose their time to start a war.

For the most part, France and Russia welcomed Germany's economic expansion. It offered investment opportunities and gave them another source of goods and services, reducing their economic dependence on Britain. However, they also feared Germany's rise because that same economic expansion made the country a formidable military power.

In 1907, in response to Germany's rise, France, Russia and the U.K. signed the Triple Entente. Although Germany

responded with its own treaty with the Austro-Hungarian Empire and Italy, this treaty was really no match for the Triple Entente. As long as Russia and France were allied against Germany, the country was in great peril.

In the first half of the 20<sup>th</sup> century, Germany attempted to militarily deal with this threat twice. In 1914, it invaded France but was unable to defeat the French forces. WWI became a two-front war that was extremely costly to Germany. Although the Germans were able to remove Russia from the conflict in 1917,<sup>2</sup> Berlin was unable to offset the impact of America's entry into WWI. On November 11, 1918, WWI came to an end.

The Treaty of Versailles, which dictated the terms of peace, was poorly constructed. The terms were quite harsh for Germany but not harsh enough to prevent its eventual recovery.<sup>3</sup> The German Problem emerged again in the 1930s and led to WWII. This time, Germany was able to defeat France and turned its attention to the Soviet Union. However, as Napoleon had learned nearly a century and a half before, it's hard to defeat the Russian winter. Soviet forces, through strategic retreat, winter weather and well timed counter-attacks, were able to turn back the German military and hold ground until the U.S. and the West were able to invade Western Europe, eventually ending WWII.

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<sup>2</sup> For details on German diplomatic actions to push Russia out of the war, see WGR, 3/27/17, [It's Tsar, Not Comrade](#).

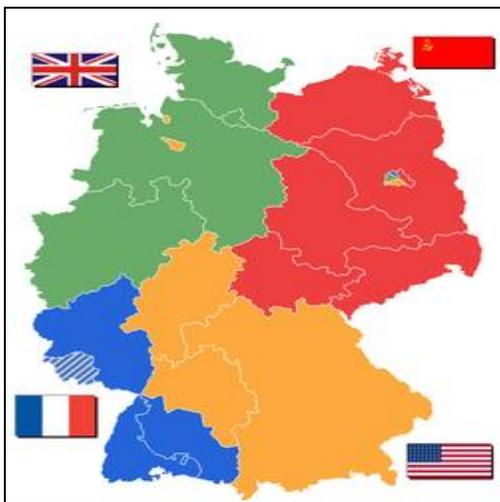
<sup>3</sup> Probably the best critique of the treaty came from John Maynard Keynes. See: <http://oll.libertyfund.org/titles/keynes-the-economic-consequences-of-the-peace>.

Essentially, the successful resolution of the German Problem is about being able to harness Germany's economic dynamism and avoid German domination. The first half of the 20<sup>th</sup> century for Europe is a history of the failures to resolve this issue. Germany needs to feel safe from Russia and France; at the same time, those two nations want to avoid being under German control.

### The Postwar Response

After the devastation of two world wars, European leaders were determined to avoid a third. For this to be accomplished, Germany had to be protected from the Soviets and France. At the same time, recovery from the wars wasn't possible without economic recovery in Germany.

There were essentially three responses to resolving the German problem. The first was to divide the country. After the war, the allies divided Germany into four zones.



(Source: Wikipedia Commons)

Berlin itself was also divided into four zones. The Potsdam Treaty, which created this situation, was thought to be temporary; eventually, Germany would become sovereign again and unify. However, it became apparent that Stalin was not going to allow democratic practices in the Soviet

zone, which could have ousted the communists through the ballot box. France also opposed allowing Germany to unify and had to be coaxed into doing so by the U.S. and Britain. Consequently, Germany divided into East and West Germany; the Soviets controlled the former and the West controlled the latter.

Second, to ensure the defense of Europe against Soviet aggression and discourage the rearmament of Europe, the U.S. created the North Atlantic Treaty Organization (NATO) in April 1949. Although members were required to spend 2% of their GDP on defense, the U.S. mostly ignored this rule. This decision did increase America's defense burden but U.S. policymakers were uncomfortable with European rearmament, fearing nationalism would rekindle new militarism. In addition, American policymakers wanted to ensure that communism would be contained and didn't necessarily trust the Europeans to be consistent on this issue. Thus, the U.S. effectively demilitarized Western Europe by taking over its defense.<sup>4</sup>

The third response was the creation of the EU. One of its predecessors, the European Coal and Steel Community, was designed to closely entwine the French and West German economies together. However, the founders of the EU had a greater goal; essentially, they wanted to allow for the free movement of people, goods, services and

<sup>4</sup> This policy became abundantly clear during the Suez Crisis in 1956. France, the U.K. and Israel invaded Egypt to retake control of the Suez Canal. President Eisenhower forced all three parties to stand down, fearing a broader war in the Middle East. In addition, the U.S. wanted to dismantle Europe's colonial empires and American actions were consistent with that goal. The Crisis made it clear that Europe could not have an independent defense policy, thus removing the need to project power globally.

capital. The hope was that a deeper economic union would overcome the European nationalism that had been an element of the prior major wars.

Not only was the EU a customs union and a free trade zone, but the union created supranational bodies to unify policy. The EU bureaucracy was built in Brussels that was independent of national governments and it regulated significant parts of the European economy and social life. The bureaucracy includes the European Court of Justice, removing a major part of national sovereignty. The concept, known as functionalism, was designed to steadily transfer state prerogatives to supranational bodies. These bureaucracies were technocratic in nature and supposedly non-ideological. The expansion of this faceless bureaucracy became increasingly unpopular in Europe. To some extent, governments in

Europe used Brussels to force neo-liberal reforms on their citizens and then blamed the EU for being “forced” to make unpopular changes.

Still, as the Cold War was nearing an end by the late 1980s, the EU, NATO and a divided Germany had fulfilled their promise; another world war had not occurred in Europe, or anywhere else for that matter.

Next week, we will conclude this report, taking up German unification and the end of the Cold War. A discussion of European security and immigration will be included. We will cover market ramifications in that report 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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