Weekly Geopolitical Report

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Imperial Germany

Last week, we analyzed the Greek/Eurozone negotiations using game theory as an explanatory tool. In this report, we will review the basic geopolitics of Europe, the political response and the evolution of the Eurozone. Using this background, we will examine Germany's actions in the most recent Greek crisis. As always, we will conclude with market ramifications.

The Geopolitics of Europe
To understand Europe, geography matters.

(Source: Maps of the World)

This is a physical map of Europe. Moving from north to south, the key features are:

The Baltic Sea: This body of water separates the Nordic states from the continent. Separation allowed this region to develop independently from the rest of Europe and, much of the time, protected the Nordic states from southern powers. At the same time, there was enough proximity to allow both Nordic and continental powers the opportunity to interfere in each region.

The British Isles: These islands are close enough that the British can influence the continent but offer enough isolation to allow various British governments the opportunity to avoid deep continental entanglements. During the period of British hegemony, it acted as a balancing power for Europe, becoming involved just enough to prevent any single power from dominating the continent. At the same time, it should be noted that no outside power has successfully invaded the British Isles since 1066.

The Southern Mountains: The Alps, Pyrenees and the Carpathian Mountains act to isolate southern Europe from the rest of continental Europe. Although not an impenetrable barrier, invasions over these mountains have proven to be difficult. Switzerland's famous neutrality is mostly due to the fact that to conquer the country, one must conduct military operations in the mountains.

The Northern Plains: From the foothills of the Pyrenees to the Ural Mountains, there is a clear corridor that is mostly flat with only rivers acting as barriers. On the one hand, nations across these plains enjoy the agricultural and transportation benefits of the landscape. Militarily, however, this corridor is very hard to defend.

Now, let's examine the political map.

(Source: Maps of the World)

The key political feature of Europe is Germany, which sits in the middle of the continent. Most of the country is on the aforementioned Northern Plain, which means that Germany has the potential to be an economic powerhouse due to its central location. At the same time, it is in a very vulnerable position because it has no natural geographic barriers for defense. Although other nations share similar vulnerabilities—the Benelux, Poland, Belarus, Ukraine and Russia—these nations don't have the same central location as Germany. In other words, these other states also lack natural defenses but, because they lack the economic benefit of being centrally located on the continent, they are less attractive candidates for military aggression.

Due to the Industrial Revolution and the early harnessing of fossil fuels in manufacturing and transportation, the nations of Europe were able to become the most economically powerful on earth from the early 1800s into 1945. However, due to the aforementioned geography, no state was able to dominate Europe. This did not stop the Europeans from fighting each other to establish dominance. Europe was the site of numerous wars over the years. One could argue that one of the great tragedies of humankind is that Europeans were not able to unify the continent, and this inability fostered two world wars.

Modern Europe

After WWII, Germany was separated into four parts; each was operated by one of the allied powers. Although this arrangement was initially thought to be temporary, it became clear in short order that the Soviets were not going to allow free elections in their zone. Consequently, Germany was divided into East and West and became "ground zero" for the Cold War. By being divided, it was no longer a threat to European security.

Over the postwar period, two trends emerged. First, the U.S. steadily took responsibility for Europe's security. Over time, European nations, using the protective umbrella of NATO, were able to scale back their defense spending. After the loss of most colonies, Europe's need and ability to project power globally became less critical.[1] Thus, Europe shifted its government spending to domestic social needs and deployed "soft power" to maintain relevance on the world stage.

The second trend to emerge was the creation of inter-European groups to steadily unify the continent, at least economically. In the early 1950s, the French proposed a European Steel and Coal Union. This program was designed to create a common

[1] The seminal event that shifted this narrative was the 1956 Suez Crisis. In this event, the U.K. and France, along with Israel, used military force to take control of the Suez Canal. Although the military operation was successful in its aim, the Eisenhower administration forced the parties to withdraw and return the canal to Egypt. The U.S. would no longer tolerate European imperialism. Essentially, this crisis clearly indicated the end of the European colonial period. Within the next decade, most European colonies became independent.

market between France and Germany; at its inception, it included these two countries along with Italy and the Benelux nations. The group steadily evolved, adding members and affecting more of Europe's economy. Over time, this expanded into the European Community, the European Union, and now, to the Eurozone.

There were a number of currents behind the second trend. For France, the goal was to use this steady expansion of European unity to both project influence and contain Germany. The individual states of Europe were dwarfed by the U.S. and the Soviet Union, and were threatened by the rapidly growing nations in Asia. By banding together, the EU could project more power; the continent, as a single economic unit, was the largest in the world. By hitching itself to Germany, France could use the former's powerful economy as a platform for global power projection.

At the same time, Germany, chastened by the horrors of WWII, accepted the role of junior partner. It allowed France to set its foreign policy and direct European spending. In practical terms, Germany acted as a fiscal transfer agent to other European Community members.

Europe was never to become the United States. Nationalism ran too deep; individual nations were not prepared to give up their sovereignty. European leaders instead tried using peace and economic prosperity to craft closer relations with each other. Ensuring that another world war did not originate from Europe was a major part of this drive for unification.

And yet, the EU unification process rests on strategic ambiguity. Unification and the preservation of individual state sovereignty are incompatible goals. The EU has been able to make progress on steady unification by focusing on economic issues. However, since the creation of the Eurozone and the removal of immigration restrictions, along with the ever increasing bureaucratic rules emanating from Brussels, state sovereignty is steadily being undermined. The rise of populist movements across Europe are a reaction to the dissonant objectives of steady unification and the preservation of state sovereignty.[2]

When the Berlin Wall fell and German unification occurred, the German problem returned. Initially, U.K. PM Thatcher opposed unification, referring to WWII. France was cool to the idea as well. To make the unification more palatable, Germany agreed to give up its beloved Deutsche mark for a currency of Europe, the euro. France believed that this move would make Germany more integrated into Europe and less likely to dominate it.

Events since 2010 suggest that France probably made a mistake. Instead of the Eurozone acting to limit German influence, Germany has now come to dominate the Eurozone. In the various debt crises since 2010, it is becoming clear that Germany is steadily establishing its economic model on the rest of the Eurozone. It is pressing for market-based economies with modest government intervention and balanced budgets. This model, which emerged from Germany's post-WWII recovery, is now being held out as the model for all of Europe.[3]

In the initial stages of creating the Eurozone and the single currency, Germany did not want to set a precedent that nations could borrow to unsafe levels and rely on the

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[2] See WGR, 1/12/2015, European Populism.
[3] See WGR, 10/27/2014, The Echo of *Wirtschaftswunder*.

savings and credit ratings of northern European nations for relief. To prevent this from occurring, a myriad of rules were established in the Maastricht Treaty, which created the Eurozone. Financial markets concluded (incorrectly, in hindsight) that the presence of these rules meant that credit risk across the Eurozone was universal; in other words, Italian and German sovereign debt carried the same credit risk. This perception led to clearly inappropriate lending and borrowing behavior that led to debt crises across the Eurozone. The latest Greek crisis is the most recent iteration of re-establishing the notion of diverse credit risk among members of the Eurozone.

Recent Events

In January, Syriza, a leftist coalition of parties, took power in Greece. It immediately set out to rewrite the austerity measures that Germany and the rest of the EU had put on the Greek economy. The Greek government believed that the Eurozone leadership (read: Germany) would never actually force expulsion of a nation out of the Eurozone. It also believed that the popular will of the Greek people, expressed in the election of the Syriza coalition on an anti-austerity platform, would require the EU to offer Greece debt relief.

The initial response from the EU was to stall. The Tsipras administration did not seem to understand that time was its enemy. The steady decline in banking system deposits was threatening the financial stability of Greece. When the ECB refused to expand the level of emergency funding to the Greek banking system, the banking system faced a crisis. In reaction, capital controls were implemented, but the critical Greek mistake was deciding to hold a referendum on the EU's bailout proposal. The vote strongly rejected the EU conditions of support, which included more austerity.

It is obvious that PM Tsipras miscalculated Germany's reaction. The Greek leader thought the referendum would improve his bargaining position in talks. Instead, the EU, again spearheaded by Germany, came to negotiations with even harsher measures and made it abundantly clear that if Greece didn't comply then it would be pushed out of the Eurozone. Included in the package was a €50 bn account that would be funded by sales of Greek state assets that would be controlled by the EU to ensure debt repayment and reinvestment of the proceeds in the Greek economy under EU supervision.

Tsipras and his leadership didn't expect this response and were wholly unprepared for it. In the Greek government's defense, Germany crossed several "red lines" that Greece was assuming would not be crossed.

Imperial Germany

Germany needs the Eurozone more than the reverse. Germany is an exporting power. Having a large free trade zone that uses a single currency offers it two benefits. First, the euro will never be as strong as the D-mark because of the inclusion of lesser economies. Thus, the euro will always give Germany a weaker currency and boost its exports. Second, the free trade zone with the single currency means that its neighbors, who absorb most of Germany's exports, cannot protect their economies through devaluation. Seeing this situation break up would not be in Germany's interest.

At the same time, as noted earlier, Germany has no interest in mutualizing the debt of the Eurozone. It does not want to give the profligate members of the Eurozone access to German savings and good credit. Accordingly, to promote cautious borrowing behavior in the rest of Europe, it has not offered broad debt relief.

Another key issue is Germany's past. As noted earlier, the French wanted to create the Eurozone in response to fears of German domination. No nation is more aware of the dangers of hegemony than Germany. It has been reluctant to project power and has been much more comfortable working within the constraints and rules of the EU.

However, the Greek referendum was an inflection point. The decision to hold the vote meant that Tsipras was trying to use Greek sovereignty to impel Germany into actions that it felt undermined German sovereignty. ***Germany reacted by demanding harsh measures that will either force Greek capitulation of sovereignty or exit from the Eurozone.***

This action came despite opposition from France. Essentially, Germany ignored French objections, which is a major change in postwar history. Germany has mostly been the junior partner in the German/French axis. That situation has probably ended. It appears to us that this is the most aggressive projection of power by Germany since the end of WWII. Germany is not only demanding austerity from Greece, but it is demanding political submission as well.

Ramifications

The implications for the EU of Germany's actions are striking. The strategic ambiguity that allowed for steady unification and the preservation of state sovereignty has been broken. From this point forward, the risk to defying German demands could be expulsion from the Eurozone. The cost of staying in the Eurozone is the potential loss of sovereignty to Germany.

This event is the opening of a new chapter in European history. The rise of populism in Europe will be fanned by Germany's actions in Greece. At the same time, it would probably be a mistake to underestimate the power and commitment of the EU establishment. From the establishment's perspective, the individual nation states have been subsumed by the EU.

How will this situation change the EU? For nations that held persistently weak legacy currencies, mostly on the Eurozone periphery, leaving the Eurozone is very risky. Although austerity hurts, the electorate will probably not want to return to the days of weaker currencies and inflation. The fact that the Greeks want austerity relief but overwhelmingly support remaining in the Eurozone suggests that, given the choice of returning to a legacy currency or living under German domination, they will choose the latter.

Perhaps the bigger issue is how the rest of the world will react to German regional hegemony. Germany has structured its economy to run trade surpluses. If Germany gets its way in the Eurozone, it will recreate the German economy across the entire Eurozone, an economic bloc larger than the U.S. economy. It is important to remember that the world cannot run a trade surplus; if one nation runs a surplus, some other nation must run deficits. If Germany insists on creating conditions that lead to persistent Eurozone trade surpluses, it is hard to see how the rest of the world will tolerate absorbing Eurozone exports and supporting European economic growth at the expense of their own. Trade frictions will almost certainly rise and the euro could become an impossibly strong currency. Although neither outcome is imminent, a hegemonic Germany will lead to such conditions in the long run. Europe has managed to be peaceful for seven decades; perhaps the most unsettling development is that a resurgent Germany puts that streak at risk.

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Confluence Investment Management LLC

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