Confluence
INVESTMENT MANAGEMENT

Weekly
Geopolitical Report

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Thirty Years Since the Fall of the Berlin Wall: A Retrospective, Part II

(Due to the Thanksgiving holiday, the next report will be published on Dec. 2.)

In Part I of this report, we presented the first two of four ideas about the post-Cold War era and how well they fared. This week, we will cover the remaining two ideas and conclude with market ramifications.

Idea #3: The German Problem

Modern Germany sits in the center of Europe. It has few natural barriers, meaning it is nearly perfect for commerce and impossible to defend. The country was formed in the wake of the Franco-Prussian War of 1870. Germany was fashioned by Prussian leaders coalescing other independent regions in the area that were formerly part of the Holy Roman Empire. The decision to create a nation was due, in part, to prevent another military power from conquering the various principalities as Napoleon did and to take full advantage of the industrial revolution.

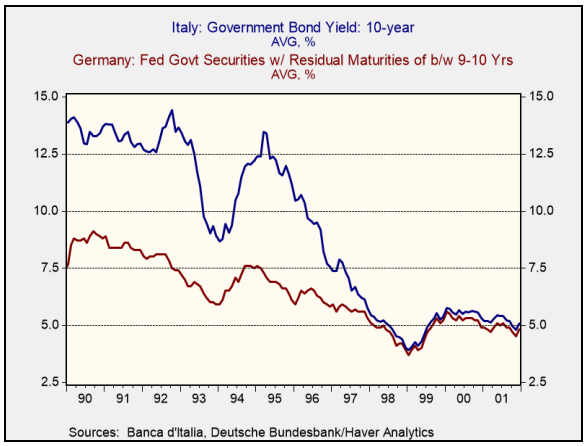
In short order, Germany became a rival for Britain, France and Russia. Henry Kissinger described Germany as "too big for Europe but too small for the world." Given its favorable geography and industrious population, Germany became an industrial powerhouse; by the onset of WWI, the German economy had surpassed Britain's. However, due to the lack of natural defenses, Germany constantly feared invasion from its neighbors.

The rise of Germany made the European continent geopolitically unstable. This instability became the fount of two world wars. At the end of WWII, the U.S. essentially took over the defense of Europe. This relieved the continental powers from the need to spend on their own defense and allowed them to no longer fear Germany. Part of the resolution after WWII was, of course, the division of Germany. A divided and demilitarized Germany was no longer a military threat to its neighbors.

With the collapse of East Germany, there was a natural desire from West Germany to unify the country. There was a good deal of reluctance to this action within Europe. Prime Minister Margaret Thatcher opposed the reunification of Germany on fears that the German problem would return and destabilize Europe. The U.S. supported reunification and the power of America ensured that unification would occur. But, European worries about Germany's power led the French to propose the creation of the euro in order to weaken the power of the Deutsche mark. The French concluded that forcing Germany to give up its precious currency would bind the country to the EU and undermine its power.

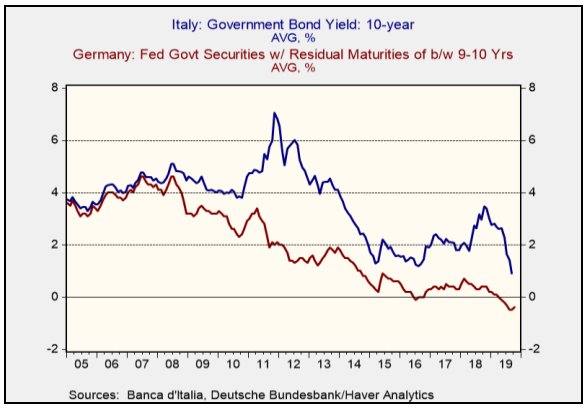
Initially, this decision appeared to have the desired result. Although the single currency didn't become operative until 1999, the original 13 Eurozone nations saw economic and financial convergence; effectively, the

Eurozone was able to borrow at German rates.



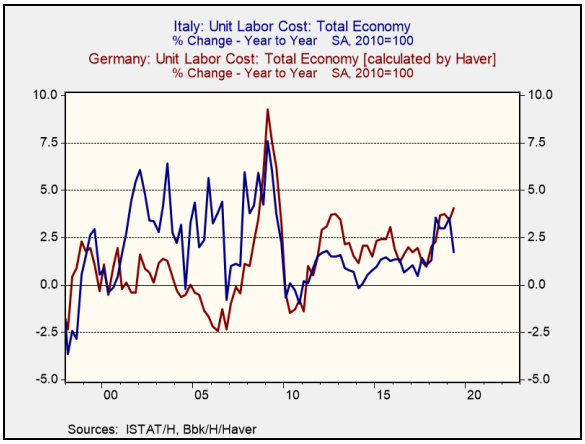
This chart shows German and Italian 10-year sovereign bond yields. In February 1992, at the onset of the Maastricht Treaty, which set up the process for the creation of the Eurozone, the spread between the two rates was just over 470 bps. By 1999, the yields had converged. The financial markets assumed that Germany was unofficially underwriting the credit risk of the Eurozone.

Of course, the 2008 Financial Crisis and the subsequent European Financial Crisis proved that Germany was not going to underwrite the credit risk of the Eurozone.



As the financial crises evolved, financial markets rapidly realized that credit risk within the Eurozone was not identical across countries and began to price the perceived risk accordingly. This pricing increased German financial power within the Eurozone as Germany had become the benchmark yield within the single currency bloc.

The other factor that developed was based on the Hartz reforms, a series of labor market reforms in Germany which began in 2002. The reforms removed a number of labor market protections and lowered German unit labor costs.[1]



This chart shows unit labor costs of Italy and Germany since the onset of the Eurozone. From 2002 into the 2008 Financial Crisis, Italian unit labor costs grew much faster than German labor costs. Similar patterns can be seen with Eurozone nations. As German competitiveness improved relative to its neighbors, Germany's external account swung into surplus at the expense of other Eurozone nations.

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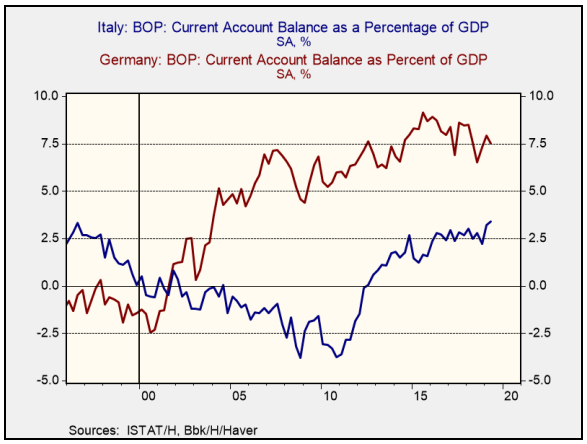
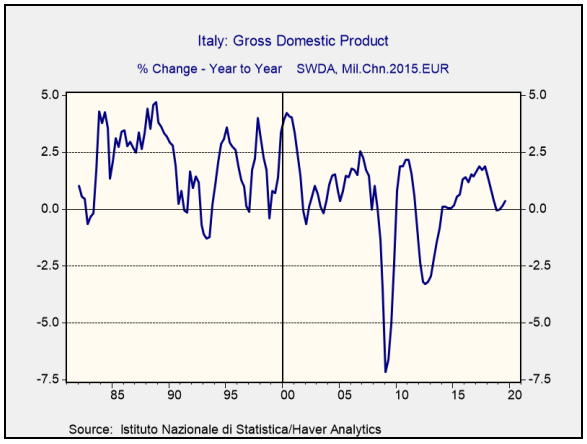
[1] Labor costs adjusted for productivity.

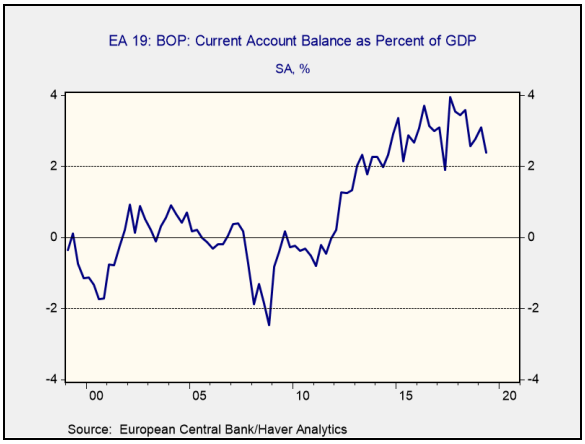


Shortly after the creation of the Eurozone, Germany's current account as a percentage of GDP began to rise sharply; note that Italy's moved in the opposite direction until the financial crisis. Even more interesting is that before the Eurozone was established, Italy was running a current account surplus while Germany had a deficit. After the financial crisis, Italy began running current account surpluses but only because its growth fell precipitously.



Prior to joining the Eurozone in 2000, Italy's real GDP growth averged 2.0% per year; since joining the Eurozone, its growth has fallen to 0.4%.

The crux of the German problem is that its neighbors feared domination by their bigger neighbor. Although Germany doesn't dominate the continent militarily, it clearly does economically. The reason Italy and other nations in the Eurozone were able to fend off German domination before the advent of the Eurozone was through currency depreciation. A steadily falling currency relative to the D-mark allowed these nations to maintain their competitiveness. But, after joining the single currency bloc, depreciation was no longer available. Since the financial crisis, Germany has been effectively turning the entire Eurozone into a reflection of itself.



Before the financial crisis, the Eurozone, on average, had balanced trade. Since then, it has run persistent surpluses.

The fears that a unified Germany would dominate Europe have generally been realized despite efforts to prevent it. So far, this domination is economic. Germany's ability to force its will on Greece is an example of its economic power. The issue of German dominance may become worse if the U.S. withdraws its security support and Germany rearms.

Idea #4: The Problem of Hubris

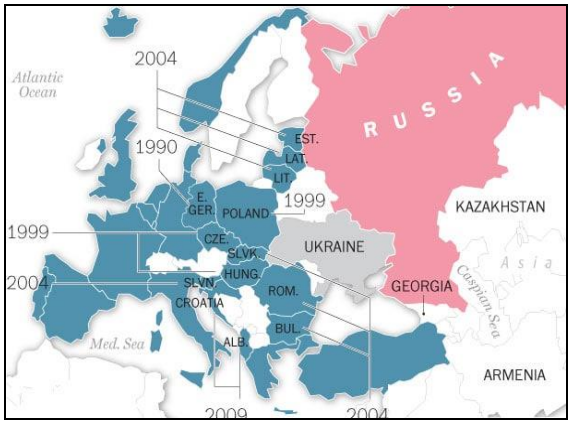
The triumphalism, which set in after the Cold War ended, encouraged the West to engage in actions that increased the risk of reaction and undermined the rules-based order that the leaders professed. Here are some of the actions that emerged:

The expansion of NATO. From the perspectives of Western Europe and the U.S., the expansion of NATO was a benign act. The former Warsaw Pact nations, anxious to separate themselves from the former Soviet Union, pressed for NATO membership. Assuming Russia was no longer a military threat, the NATO members obliged. Unfortunately, expanding NATO meant the treaty organization was now required to defend nations on the border with Russia.

This is NATO (in blue) in 1989.

(Source: *Washington Post*)

This is NATO now.



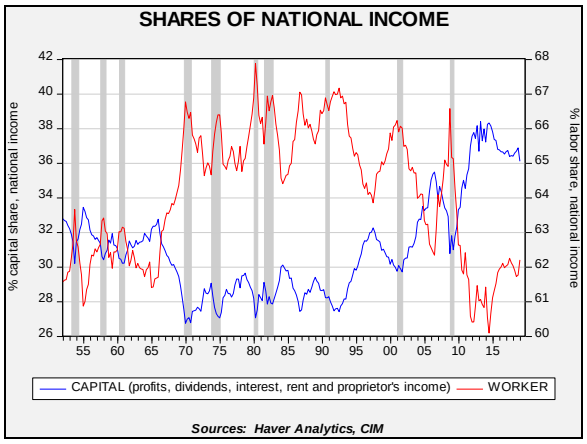
(Source: *Washington Post*)

As Russia recovered, especially under Vladimir Putin, it viewed the NATO expansion as hostile. Now, the credibility of NATO is under threat; would the other members really go to war to protect the Baltic States? If NATO decided not to, Russia would suggest that the treaty organization is a "paper tiger" and increase pressure on the nations in Eastern Europe. Given Russia's history, it was reasonable to believe that, at some point, it would follow its usual pattern of expanding its influence westward. It's perfectly fine for the West to press against that expansion but it's reckless to promise to defend nations if the will to do so may not exist.

The treatment of Russia. Western economists went to Russia and recommended "shock treatment," which meant rapid privatization, elimination of social safety nets and a swift shift to free markets, which left the Russian economy in shambles. Workers were given shares in the state-owned companies where they worked, and these shares were bought far below their value by oligarchs who used control of these former state entities to become wealthy. Economic growth collapsed. Life expectancy fell, which almost never occurs outside of war. Eventually, Russia defaulted on its debt in the late 1990s. The turmoil led to the rise of Vladimir Putin.

The capitalists no longer needed to prove that capitalism was better than communism. During the Cold War, capitalist and communist societies were locked in a public relations battle to show which system was better for their citizens. Overwhelmingly, it became apparent that life was generally better under capitalism. There were more goods and services and citizens of capitalist nations enjoyed more freedoms. However, once the threat of communism faded, the owners of capital no longer had to prove their system was better; as Francis Fukuyama stated, the contest was over and capitalism had won. In response,

the capitalists started taking on a greater share of the spoils.



This chart shows the shares of U.S. national income that flow to capital and labor. Although the majority of income flows to labor, in every business cycle since 1990 labor has seen its share shrink while capital has increased its share. This issue has become politically explosive; it is arguable that one element of this trend is the fall of communism.

Being inconsistent on implementing the rule of law in foreign affairs weakened the moral authority of the West. The U.S., as global hegemon, would restrict its own freedom of action if it conducted policy under the boundaries of the Washington Consensus. However, at times, the U.S. presses other nations not to do things because they are contrary to U.S. interests. The U.S. conducted a bombing campaign against Serbia in 1999 without U.N. approval. The U.S. invaded Iraq in 2003, again without U.N. approval. Although the U.S., as global hegemon, has the power to engage in military actions without U.N. approval, acting in this way appears capricious to other nations and can encourage them to behave in a similar fashion. Thus, the Russian invasions of Georgia, eastern Ukraine and Crimea were done without U.N. approval as well.

The end of the Cold War ousted the Hamiltonians and inserted the Wilsonians. Using Mead's archetypes, foreign policy is framed by four important American leaders—Hamilton, Jackson, Jefferson and Wilson. Hamiltonians would be considered "realists" in the common description. Foreign policy figures such as Henry Kissinger, Zbigniew Brzezinski and Brent Scowcroft were considered strong examples of this archetype. During the Cold War, the Hamiltonians tended to dominate but, shortly after the Soviet Union collapsed, Wilsonians began to take over the foreign policy apparatus. The "duty to protect" doctrine became ascendant, which wanted to base foreign policy on protecting peoples under pressure from governments or other groups. Wilsonians project an aspirational view of America, one that spreads its message around the world for the greater good. Such a policy does not necessarily lead to stability. President Obama's support of the Arab Spring was a case in point; in order to maintain order, a Hamiltonian would have supported the autocrats under pressure from protestors. A Wilsonian observing the Arab Spring would have seen aspirational democrats wanting to create a new societal order, whereas a Hamiltonian would have seen chaos.

Hamiltonians are necessary when a nation is confronting an existential threat; Wilsonians are more likely to gain power when no such threat is perceived. The problem is that Wilsonians can support movements that may lead to instability and the duty to protect can involve the military in civil conflicts with no discernable exit. To some extent, the wars in Iraq and Afghanistan have developed into such conflicts.

Ramifications

To some extent, a reflection report doesn't lend itself to obvious market effects.

However, there are a few lessons to be taken from this analysis. First, it's important to understand all the elements of a victory. Overestimating a cause can lead one to do more of it when it's possible the win had other factors that supported or enhanced the winner's actions. A bit of humility goes a long way. Second, a victory is great but the win itself creates a new set of problems. The victory may still be worth it, but one should never assume that all will be perfect in the aftermath.

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Confluence Investment Management LLC

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