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Update on Ukraine & Russia

Background

The current crisis in Ukraine can be traced back to last year when the now ousted former President Viktor Yanukovych sparked mass protests by deciding not to sign a trade deal with the EU in favour of a Russian bailout. Ukraine has significant financing needs this year (estimates range from $15 to $30 billion) and Yanukovych decided to accept Russia's financial assistance rather than foster closer economic and financial ties with Europe.

After the breakdown of a negotiated truce between protestors and Yanukovych, who is now in exile in Russia, an interim unity government led by Arseniy Yatsenyuk came to power with the promise of full democratic elections in May. In practice, this interim government is in great part controlled by former Ukrainian Prime Minister Yulia Tymoshenko, who was recently released from jail.

Ukraine has been attracting a lot of interest given its geographic and geopolitical importance both to Russia, which has strong political, military and economic interests in the region, and to the West, where its large population and proximity to Western Europe make it a key strategic partner.

Recent Developments

The Ukraine crisis escalated significantly on March 1 following President Vladimir Putin's move to gain parliamentary approval for the deployment of troops in Ukraine. There are current estimates of 6,000 Russian troops on the ground in Crimea controlling the airports and main ports, with a further 150,000 on high alert near Ukraine's border.

Russia's threat to annex Crimea is seen as Putin's direct response to Yanukovych's removal and to the emergence of a new pro-European interim government, which includes several nationalist politicians who were involved in the recent protests. Russia has defended its actions by arguing that the uprising in Ukraine is effectively a coup, and that it is justified in protecting its interests and those of the majority Russian-speaking citizens living in Crimea. In a further blow to the new Ukrainian government, the head of Ukraine's navy appeared alongside Crimea's self-declared pro-Russian leader to announce he was defecting to Russia.

In response to this show of Russia's military aggression, G7 leaders and NATO have united in condemning Russia's actions and have threatened a robust response including the possible use of sanctions unless Russia withdraws its forces. Response to Russia's military aggression from Ukraine's new government has been swift; it is preparing for a full mobilisation of troops with the defence ministry calling up reservists for training as well as increasing security at strategic locations.

Potential Scenarios

- **Crimea is annexed.** Russia could prevail quickly in a military conflict and annex Crimea. Putin has taken a calculated gamble that the West will do anything to avoid an all-out war and that the benefits of fighting for Crimea (which many Russian citizens and the majority Russian speaking population believe belongs to them, and which is also home to Russia's Black Sea fleet) outweigh the impact of economic and political sanctions. In this scenario the rest of Ukraine stabilises as pro-Europeans are supported by EU/IMF/US guarantees. Political posturing continues but the EU is ultimately reluctant to be too severe given its energy dependence on Russia and trade links.

- **Civil war.** The Ukrainian government (possibly backed by the West) fights back and the region descends into a civil war (that could draw in NATO and with it the US and Poland). This is the worst-case scenario and would clearly have very significant negative geopolitical and economic implications. It is hard to see Russia wanting this as it would destabilise its southern border, but, if events get out of control and Crimea and Eastern Ukraine decide to secede from Ukraine then it is difficult to see any other course. This would pose a major dilemma for Putin against a background of strong nationalist fervour at home. Would Putin back the separatists? How would the EU/US respond? This would be very destabilising for other parts of Eastern Europe, in particular Poland. What would happen to other nations with large Russian minorities?

- **Negotiated solution.** Russia makes its point, and negotiates a solution with the West that protects Russia's interests in Ukraine but also honours Ukraine's borders. Russian troops withdraw and strict sanctions are avoided. This ultimately comes down to how much the West and Ukraine are willing to compromise on Crimea to satisfy Russia's interests. A deal between EU/US and Russia regarding spheres of influence and bailout funding would be reached.

Market Implications for Ukraine and Russia

Ukraine

The West and the IMF have pledged support to Ukraine's new government (subject to the usual criteria being fulfilled) and it seems likely that a combined EU/IMF deal would help avert a default scenario. On March 4, the US announced that it is giving Ukraine a $1 billion loan guarantee to help mitigate the effects of reduced energy subsidies from Russia. Ukraine's growth would be negatively impacted under more severe scenarios, in particular through potential gas shortages and disruptions to grain exports. In trying to defend its currency (the hryvnia) in response to weak growth and recent outflows, the Ukranian central bank has depleted foreign exchange reserves from $30 billion at the beginning of 2012 to $12 billion currently. The current account deficit stands at 9% of GDP. Year-to-date (YTD), the currency has fallen 15% and yields on USD-denominated bonds have fluctuated between 8.5% and 11.3% (currently 10.3%).

Russia

Russia arguably has the most to lose from this escalation in tensions with Ukraine. Russia has been successful in opening up its local debt markets and trying to improve its standing among international investors. Russian corporates are very active in international capital markets and a conflict with the West would make issuance extremely difficult and put further pressure on capital outflows. The Russian ruble has already been under significant pressure YTD, depreciating almost 10% versus the EUR/USD basket, prompting the central bank to respond by hiking rates by 150 basis points (bps) to 7%. This is clearly unhelpful at a time when growth has already weakened significantly. The local bond market has been under pressure with local yields rising around 100 bps over the last month (current yield on 10-year bonds is approximately 8.9%). External sovereign debt currently trades at around 220 bps over US Treasuries, 60 bps wider than recent lows, but at similar levels to where Russia issued in late 3Q13. Similarly, the Russian stock market has been very weak, falling by over 10% YTD.

Broader Implications

Gas Supply

Ukraine hosts a network of Soviet-era pipelines that carry over half of Russia's gas exports to the EU. Gazprom, Russia's state-owned gas company, supplies around 30% of Europe's gas needs. Last year Russia agreed to supply Ukraine with gas at a subsidised rate but this deal expires this month. Gazprom is now threatening to end natural gas discounts for Ukraine unless it is paid $1.55 billion owed for fuel from last year. Ukraine is currently estimated to have four to five months of gas storage. So far, gas shipments to Ukraine and the rest of Europe have not been disrupted. Russia has previously used threats over gas supply to strongarm Ukraine and has cut off supplies twice since 2006 over payment disputes.

Grain Supplies

Ukraine is by some estimates the world's second largest grain exporter, and these exports could be choked off if Crimea's strategic port of Sevastopol is cut off, as most of Ukraine's grain is exported by ship from its ports. Grain makes up for 24% of Ukraine's exports and accounts for more than 5% of GDP.

European Growth and Markets

A serious and prolonged conflict would have a negative impact on sentiment and growth in Europe, in particular on Ukraine's main trading partners and its neighbours such as Poland. There is the possibility of permanently higher risk premium for Russian and other Eastern European assets.

Conclusion

In summary, the current crisis is quite volatile and financial markets continue to react to the rapidly evolving developments in Ukraine. Western Asset is monitoring the situation carefully and will provide updates as necessary going forward.