Ukrainian economic woes and Eurozone fears could lead to negotiated solution with Russia

The economy in Ukraine is collapsing and inflation has reached 17%. Its currency, the Hryvnia, has suffered the worst performance of the year, losing 48% against the US Dollar, in the world and, unless foreign aid arrives promptly, a default is expected. Ukraine's civil has had tragic effects on the economy and expectations of GDP having fallen 7.5% in 2014 are optimistic, while the central Bank expects even worse performance in 2015. In order to avoid a sovereign default, the European Union estimates that Kiev would need a USD$ 15 billion injection and Prime Minister Arseniy Yatsenyuk has already found it very difficult to obtain even a fraction of that as he considers the holding of a donors' conference. In this scenario, the International Monetary Fund has already allocated a USD$ 17 billion rescue package. What is especially troubling is that, despite the desperate financial condition, the government has forecast an increase in military spending of 5.2% and a cut in social spending to ease the burden on the state budget, while the imports "non-essential" duties will be doubled to 10%. Ukraine's dire economic situation plays into a complex geopolitical scenario that contains the seeds of a thaw in relations between itself and Russia and Russia with the West.

In recent weeks it has also learned that Ukraine has almost completely dried up its gold reserves from March to today, demonstrating the seriousness of the financial and currency crisis. Gold reserves in Ukraine are at the lowest levels since August of 2005, a decrease of 45% in 8 months. In contrast, while Ukraine has almost wiped out its gold reserves, Russia has continued to buy back, coming to 1,187.5 tons in November. Since 2005, Moscow has tripled its gold reserves, bringing them to the highest levels since 1993, suggesting that central banks, beyond Western Europe and North America, still have appetite for the shiny metal. Therefore, as hard as the situation may be for Russia, facing international sanctions and de-facto isolation from the West, Ukraine's financial situation is far worse. Indeed, the new government, which replaced the one led by former President Yanukovich a year ago in a US and European Union supported coup, Ukraine has proven unable to control and stabilize the internal political and economic situation, while becoming a virtual tool of foreign geopolitical interests and machinations. The good news is that, given its precarious financial condition, Ukraine will be forced to reach some kind of negotiated settlement with Russia in 2015 rather than risking default and the spreading of the conflict. Russia shares this interest because, the pursuit of a more intense military option is out of the question – apart from the cost, it would risk inviting additional encroachment from NATO powers. Surely, Russia will be in recession, but it should be able to avoid a default despite a predicted 4% drop in GDP for 2015.

President Putin said that Russia's economy will adjust gradually to the new level of oil prices. Therefore, while Russians can continue to expect bad economic conditions in 2015, a recovery should start in 2016; neither Ukraine or Russia stand to gain militarily or politically from a perpetuation of the war while the European Union will be overly preoccupied with 'Euro' exits to continue sustaining Ukraine. European investors – and voters – are weary of the volatility and increased risk resulting from a very possible Greek exit from the Eurozone: a 'Grexit' as some have called it. Doubtless, Greece represents a very small part of the Eurozone economy but even the departure of a small economy from the Euro would generate several problems from the ‘mathematical’ standpoint in the short term. The prospect of a Greek exit is a kind of ‘black hole’ of risk, because no one has ever come out from the Euro, and no one has ever suggested the release of the Eurozone economy. This uncertainty creates market volatility, a self-feeding mechanism that will inevitably force the European Central Bank to intervene to calm the markets. This possibility will reduce the appetite for foreign adventurism in the EU, leaving Ukraine more isolated. Russia, in turn, will fare better later in 2015 because the low oil prices that have so fiercely targeted its resource economy are unsustainable in the long term, despite recent Saudi rhetoric.

The price of oil is too low for OPEC, which will surely cut production in order to cause prices to rebound to at least USD$ 70-80 per barrel – it seems to be a fairly realistic number in the medium term. Therefore, Russia will be in a stronger position than Ukraine, which will be left with the ultimate responsibility to find a solution, even if it means leaving a part of itself to Russia. The conditions point to such a solution to emerge before the end of 2015 but, in geopolitics, there are many uncertainties and it could take longer. The more optimistic timeline for a solution is backed by the fact that France has already stated that it would stop sanctions against Russia in view of a continued diplomatic effort aimed at easing dialogue between Kiev and Moscow. Last December 6, France’s President Hollande held a surprise meeting with Putin in Moscow upon returning to Paris from a trip to Kazakhstan. Many other EU powers are eager to lift sanctions as well and it will not be difficult to convince the EU as a whole to suspend or ease sanctions in order not to cripple Russia in return for the intensification of negotiations with Kiev. On January 15, there will be a big test in this direction as the French, Russian and Ukrainian will shake hands to create a compromise to restore peace. That solution, which should be satisfactory to the White House (if not a Republican interventionist Congress), will likely see a deal whereby Russia will stop supporting pro-Russian Ukrainian separatists in exchange for full recognition of Russia’s ownership of the Crimean peninsula plus any eventual reparations (in the form of gas supplies?). And then the ice between Russia and the West will break.

The Ukrainian crisis will not bring down world markets

Rising tensions in Ukraine – as well as Thailand and Venezuela – have put pressure on emerging market indices; however, overall market performance, despite the escalation of violence in Kiev and other major cities such as Lvov, should not be affected. While the crisis has reawakened the never quite resolved ‘cold war’ between East and West, in this case Russia on one side and the EU and USA on the other, the stakes are too high for any one of these three parties to take on the kind of geopolitical or military action that would allow tensions to spill outside of Ukraine’s borders.

President Obama has warned Ukraine’s pro-Russian government of US retaliation, but until now, his administration has limited itself to issuing sanctions against certain officials close to Ukrainian President Viktor Yanukovich. Similarly, it is equally improbable, in the background of the Russian Olympic stage in Sochi and the effort that the Games represent in Russian President Vladimir Putin’s strategy to raise Moscow’s international standing, that Russia would send in troops to help Yanukovich in the style of Budapest 1956, Prague 1968 or Tbilisi 2008. One of the reasons is that, inasmuch as some of the western media has been trying to frame the crisis as one pitting western Ukrainians against more Russian speaking southern and eastern ones, distaste for Yanukovich cuts across any such ethnic lines, given that his pre-crisis approval rating was about 11%. It would be difficult for Putin to justify an invasion of Ukraine or Latvia (as in the last days of the Soviet Union under Gorbachev) by claiming the need to defend ethnic Russians.

The Ukrainian predicament has limited its market effect to the dollar / ruble (USDRUB) exchange rate that has touched a new five year high. Clearly, the turmoil in Kiev has highlighted the Russian economy and currency's exposure to potential financial losses in case of a new pro-Western government – or in case of a pro-EU shift by Yanukovich. The head of the RCB (Russian Federation's Central Bank), Elvira Nabiulina, has geared monetary policy to control the Ruble's fluctuation bands against the Euro and the US Dollar to prevent a massive use of foreign exchange reserves to defend the currency. However, even there, Russia has large reserves of Dollars and Euros and is therefore less fragile than other emerging countries in difficulty. In other words, Russia can sustain an extended crisis in its backyard even if Ukraine cannot.

At least 25 people were killed on Wednesday and many more on Thursday – reports suggest over 100 dead – in clashes between police and anti-government protesters in Kiev. Ukrainian dollar denominated bonds have hit free fall while and the Hryvnia, the local currency, has lost 10% of its value since the start of 2014. The Hungarian economy, which is an important economic thoroughfare for Ukrainian imports and exports, has also suffered. Russia, as Ukrainian President Viktor Yanukovych's main ally, has agreed to pay USD$ 2 billion out of a total USD$ 15 billion package to provide some oxygen to the highly indebted Ukrainian economy. However, the market weakness has not spilled beyond the financial centers in Central and Eastern Europe or other emerging markets. What will happen if Ukraine edges closer to the unthinkable: Civil War? In a dispassionate analysis, and as coldhearted as it may sound, the world economy and global markets should not experience much more turmoil than this.

Ukraine’s economy is not very significant in the world context and its average level of foreign direct investment has also generally stood at the level of a small to medium emerging economy, not much more than other former East Bloc states and far lower than India, China or ASEAN states. Even if Ukraine were to default on its debts, it would cause a minor headache to foreign investors and lenders, but hardly enough to warrant a migraine or a full out financial crisis. Kiev is not New York, nor is it London or Berlin. Therefore, the global financial order would remain largely intact even in the event of the worst case scenario of a civil war in Ukraine. There is a precedent to support this, the Balkan wars of the 1990s as bloody and horrific as they were from a humanitarian point of view had very little or no financial implications whatsoever. Indeed, the 1990’s were also the years when the stock markets grew at their highest rates in Europe.

Ukraine is a bit like Syria in this sense. Syria is now entering the third year of a brutal civil war that has already cost an estimated 140,000 lives. However, Syria, as strategically important as it is in the region, lacks the kind of resource concentrations that would scare world markets. It has some oil and some phosphate, but so do its more stable neighbors, who are not even producing at peak capacity. Even Turkey, which has a non-resource based economy, has continued to thrive despite the Syrian spillover of refugees and tensions with its Kurdish minority. Of course, should the Russians be inspired by their Ukrainian counterparts, leading to street demonstrations against Putin’s government, and then the world economic picture might be a little gloomier. For now, apart from some picturesque protest from Russia’s punk band ‘Pussy Riot’, there is little to suggest that youth mobilized through Twitter or Facebook will be occupying Red Square any time soon.

The crisis in Ukraine essentially started last November when the European Union, in an effort to build closer ties to Ukraine, offered Kiev a very attractive aid and trade package. Russia, under Putin’s nationalist leadership, offered Yanukovich an even stronger incentive to refuse the EU’s offer. Putin drastically reduced the price that Ukraine would have to pay to import Russian gas, reducing the money it owes the Russian oil and gas giant, Gazprom, while and ensuring an aid package to keep the Ukrainian economy afloat. The EU did not make a counter-offer, leaving Yanukovich bound to Putin and the Kremlin. Therefore, there is a clear limit to how far the EU – or the United States for that matter – will go to wrestle Ukraine away from Moscow’s influence. Nobody is going to raise the confrontation with Putin in an already difficult cooperation context and especially as the White House needs good ties with Russia in order to conclude its much more strategic negotiations with Iran and Syria. Neither Russia nor the West is an innocent bystander to Ukraine’s drama.

So far, the markets have not been affected beyond some limited turbulence; in the long term, however, the standoff between the United States and Europe, on the one hand, and Russia on the other, will have reignited Cold War echoes in relationships. The fate of Ukraine is in the middle of Putin’s plan to rebuild Russian influence in the international arena. Its Customs Union with Belarus and Kazakhstan requires Ukraine’s participation. For this reason, Russia offered everything possible to persuade President Yanukovych to scrap the agreement with the EU. That said, it should be noted that Putin will just as easily scrap his ties to Yanukovich, should a better candidate to lead Ukraine – even one more favorable to the demonstrators’ demands – come forward. Putin’s concern is to safeguard Russian interests not to defend Yanukovich.