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.

Sanctions against Russia ignore the real politik of the markets

The crisis in Ukraine, which started around last November, has intensified and exacerbated tensions between Russia and NATO to a degree unknown since the pre-Gorbachev Soviet Union.On September 30, The European Union decided to renew and add new sanctions against Russia, claiming that the peace plan in Ukraine has not yet been respected. Brussels had hinted that it would consider revoking the sanctions had there been progress by September 30 toward a ceasefire. The EU will continue to "closely monitor developments on the ground," but failed to issue another deadline. Should the EU consider the 'situation on the ground' to have stabilized, it will consider amending or revoking the sanctions, in whole or in part. The EU, in effect, is looking for any possible excuse to scrap the sanctions as even the most critical EU member states were reluctant to enforce sanctions while others continue to demand a softer approach toward Moscow.

Russia, meanwhile, has taken the first steps to comply with the EU demands, agreeing to a ceasefire with Ukraine, even as it has enforced its own, ongoing, retaliatory embargo against a number of European agriculture-food sector products. The

ceasefire is holding tenuously but there is great uncertainty and fear because Ukraine aspires to join NATO and the European Union within the next six years. There is very little chance Russia would allow this to happen without its own retaliation, especially about the issue of NATO membership. The Russian Foreign Ministry has been controversially referring to Ukraine's 'restive east' as Novorossiya, the territory that once consisted of what in today's terms would be Odessa, Mykolaiv, Kirovograd, Dnepropetrovsk, Kherson, Zaporizhya, Donetsk, and Luhansk.

The EU's sanctions Russia concern companies operating in the energy, finance and defense sectors, including the oil giant Rosneft and the weapons manufacturer Kalashnikov. The EU has also imposed assets freeze and a ban on granting visas to travel to a number of officials and business personalities considered to have close ties to President Vladimir Putin and pro-Russian rebels in eastern Ukraine and in Crimea, annexed to Russia. NATO military command said that while the first phase of the ceasefire saw a significant withdrawal of Russian forces in Ukraine, there are still hundreds of troops, including special forces, in Ukraine. The conflict between pro-Russia rebels and Kiev's own troops has now claimed more than 3,000 lives.

The crisis worsened last July 18, when (still unconfirmed) pro-Russia rebels accidentally shot down a Malaysian Airlines Boeing 777 airliner, (Flight MH-17) sparking a slew of allegations against Russia and its reckless arming of the rebels. Evidence suggesting that the rebels had Russian 'Buk' surface to air missiles, which were deployed against Ukrainian fighter jets and helicopters, amounted to a "massive escalation" of the crisis said Jonathan Eyal, director of the UK's Royal United Services Institute. It should be noted that while Flight MH-17 served as the premise to bolster Western resolve against Putin, the Ukrainian government holds the actual technical fault because it failed to shut down its

airspace at a time of aerial warfare. In fact, the families of that flight's German victims plan to sue the government of Ukraine, rather than Russia's, in accordance with that failure.

The international response was to boost sanctions against Russia that had been rather tepid until that point. However, the US State Department, and the neo-conservatives that still have influence there, primarily one Ms. Victoria Nuland, the US Assistant Secretary of State in charge of Europe and Eurasian Affairs, played a rather important role in fomenting the crisis. Nuland was secretly filmed as she addressed Ukrainian business and political leaders at a Washington meeting that the United States had spent "USD$ 5 billion to develop Ukrainian Democratic Institutions". Nuland was evidently rather involved, then also in the successful coup (and it was a coup, regardless of one's feelings about the previous Ukrainian leadership) against the democratically elected, but pro-Russian President Viktor Yanukovych. Indeed, the situation in Ukraine is not at all as clear as the Western media and diplomacy hawks have presented it; that is, one where Russia is bullying a 'democratic' neighbor, trying to improve its fortune by looking toward alliances with the 'West' rather than staying 'East'. Many commentators have ignored the huge role played by the United States and its allies in prompting the Ukrainian crisis in the first place, ignoring, in the process, the very real risk of it escalating into a more wide reaching war.

The crisis has actually been rather less about Russian aggression in Ukraine than a Western attempt to lure Ukraine into NATO and the European Union, while weakening the political future of Russia's President Putin. Victoria Nuland's previously mentioned meeting proves that Washington invested many US tax payers' dollars to finance Kiev's Maidan public protests and the coup against President Yanukovych, who had been democratically elected. Russia sees NATO's creeping

into Eastern Europe as a challenge to Russia, which had been assured of its continued influence – free of NATO troops – in a formal agreement signed by Presidents Mikhail Gorbachev and the George H. Bush at the time of German reunification in 1990. NATO, meanwhile, has announced it will build five new bases in Eastern Europe last August. This cannot but deepen tensions between the Kremlin and the West. Meanwhile, Ukraine has gained nothing since its new 'democracy' started. Kiev needed, says the IMF, some USD$ 35 billion in aid last May; the IMF has revised that amount to USD$ 55 billion, while economist Desmond Lachman says it now needs "closer to USD$ 100 billion". Moscow has not done so, but it could shut off supplies of its gas to Ukraine as winter approaches. The fact is that the most democratic solution would be to allow a referendum in the pro-Russian Ukrainian provinces to vote whether to stay in Ukraine or join Russia.

Many of the opinions heard so far, enforced by sanctions and materialized through the deceptive use of campaigns costing billions of dollars, have come from people living far beyond the borders of Russia or Ukraine. Meanwhile the sanctions continue; are they effective? The last package of sanctions Treasury USA and the EU takes aim at Russian banks, the energy industry and the military. Sberbank, the largest bank in Russia, will not have to Western long-term capital (that is any loan lasting over 30 days). The USA and the EU want to cease the development of exploration projects in Siberia and the Russian Arctic, preventing the West's oil majors from selling equipment and technology for deepwater shale gas projects. Exxon and Shell, therefore, can no longer do business – building pipelines for instance – with such energy sector giants as Gazprom, Gazprom Neft, Lukoil, Rosneft and Surgutneftegaz.

The United States Secretary of the Treasury, David Cohen, has insisted that the sanctions package "isolate" Russia further from the global financial system. Interestingly, nationalist

Russian shareholders have seen to it that the shares of the companies on the list of sanctions go up rather than down while the shares of the oil majors in the United States have gone down! Oh, and because Russia has been isolated from Western capital, Russia will simply not be importing goods and services both from the USA and the EU – finding alternatives through its BRICS (Brazil Russia, India, China, South Africa) partners and beyond. Moscow is simply dealing in local currencies with its other business partners and this could hurt the West and its currencies in the long term, because other developing countries might start to do the same.

Russia may sell its energy resource in any currency except USD and EUR while importing clothes, technology, hi-tech electronics, computers, agricultural goods and raw materials it needs from Asia and South America. There are serious doubts, moreover, as to how long the EU member states, in absence of a shared energy policy, will last without Russian gas even if they manage to secure alternative supplies from other countries (Azerbaijan, Qatar, Libya?). The West is still banned by another set of, rather counterproductive, sanctions against Iran, which means that it cannot import oil or gas from there to meet the Russian shortfall. The markets are less 'irrational' than they are motivated by profit and profit is based in reality. The current intentional politics practiced by the West against Russia express very little 'reality 'and much ideology. Russia has a huge surplus of foreign capital – and can protect itself from the economic storm. The EU is still in austerity mode and failing to recover; even Germany, the Union's strongest economy, is hurting with recent growth rates noted at -0.2%. Markets respond to realpolitik and the economic wars launched by Washington and Brussels against Moscow will hurt the markets of the former rather than the latter.

Potash prices have stabilized and looking up

The gloomy clouds that cast shadows over the global potash market last summer after the breakup of the Russian/Belarusian BPC cartel have not collided and the stormy forecasts have changed for far more agreeable forecasts. The conflict between Russian and Belarusian potash producers threatened to flood the market with quantity, undoing the oil like cartel pricing system that has worked so effectively in the past decade. The reasons for the disintegration of BPC turned out to be more complex, extending far beyond potash into bilateral Russo-Belarusian relations. Close ties between the new president of Ukraine, Petro Poroshenko, and Belarus's President Alexander Lukashenko, have not discouraged talks to revive the BPC cartel. In April, Lukashenko is believed to have held very "constructive" talks with new Uralkali co-owner Dmitry Mazepin about bringing back the Belarus Potash Company, or BPC, joint venture. Such a development would certainly help to boost potash prices to at least 2012 levels. The main obstacles are no longer political or diplomatic (the BPC breakup was a full scale diplomatic incident); simply, Uralkali wants to ensure that its shareholders get the best possible deal while moving the new BPC headquarters from Minsk in Belarus to Switzerland.

The potential for sanctions to be applied to Russian potash, meanwhile, remains even if so far, its importance to the European Union suggests this resource will be kept out of geopolitics for the time being. The EU issued a list of critical raw materials last week: phosphate (though more generally meaning mineral fertilizers) was one of the six. Uralkali, therefore, will experience only minor if any impact

at all from Western sanctions against Russia. Its main focus is on the so called BRICS nations (Brazil, Russia, China, India, South Africa) where potash demand has been growing fastest.

Recent pricing statistics have only confirmed the bullish climate for potash. The average per ton FOB price per ton for potash at the Vancouver port, which was still 459 dollars in 2012 dropped to 379 dollars average last year largely due to the BPC related conflict. The predicted market flood did not occur, even if volume surplus exists and the average for 2014 is expected to hover around USD$ 300/ton (though mostly on the higher end of that plateau considering that both the CANPOTEX and former BPC partners signed contracts with China and India at above USD$ 300. The potash market is expected to remain in substantial surplus over the next five years according to Australian bank Macquarie, which predicts Canadian producers will increase production from the 15.88 million tons of 2013 to 17.42 tons in 2014. Russia and Belarus should also increase their supply in 2014.

Canada, Russia and Belarus hold three of them 90 % of global potash reserves. Canada alone accounts for 46% of proved reserves and probable reserves of 33% also according to Macquarie. The lower prices, however, have discouraged major projects, which will benefit the current majors and any junior potash company close to reaching production stage such as IC Potash (TSX: ICP | OTCQX: ICPTF) or Allana Potash (TSX: AAA | OTCQX: ALLRF). The three majors Potash Corp, Uralkali and Belaruskali, will simply expand existing mines. Chinese demand is expected to rise in the next few years, rapidly absorbing the predicted surplus.

Agriculture is the driving force behind potash demand and its consumption is linked to the needs of agriculture and varies with changes in agricultural prices. Potash helps increase crop yields, improve plant quality, reduce water needs and accelerate their growth. Lower agricultural commodity prices

tend to reduce fertilizer demand; not surprisingly, demand or use of potash increases when its price drops. This period of ‘cheap potash’ will serve to get more farmers around the world using potash; the results will then convince them to continue using potash even after prices inevitably rise again. China, Brazil and the United States (on average using some 10 million tons each) use more than half of the 62 million tons of potash that Macquarie expects will be consumed in 2018. While, it makes the biggest ‘splash’ in determining price, China is only the third largest potash importer (6.1 Mt in 2014, 6.9 Mt in 2018).

The main importer is Brazil, while the main consumer is the United States, which imports as well as produces potash. Potash demand is rising fastest in such other major Asian countries as India, Indonesia and Malaysia – the latter two being driven by the large potash amounts needed to stimulate the cultivation of palms for palm oil (used in a number of applications and as a biofuel). Finally, the potash scenario in the near future may be summarized as one that will be marked by a slower growth of supply and improving demand, which will lead to a price recovery in the next few years.

The EU risks a very frosty winter as tensions in Ukraine rise

Oil prices rose again in Asia because of the crisis in Ukraine, where fighting between government forces with pro-Russian rebels have left dozens dead in the east, which is a key transit route for gas. A barrel of ‘sweet light crude’

(WTI) for July delivery gained 7 cents to reach USD$ 104.18 a barrel while the Brent price hit USD$ 110.3. The increases were prompted by the tensions in Donetsk following the results of Sunday's presidential election, won by candy magnate Petro Poroshenko. Donetsk is the bastion of Ukraine's pro-Russian population, resulting in dozens of dead combatants on both side and two civilians between Monday and Tuesday. Poroshenko has dismissed plans to visit Moscow to discuss the standoff with President Vladimir Putin, who, in turn called for an end to the government forces' 'punitive' operation in the East.

The situation in Ukraine has added to the oil and gas risk resulting from recent developments in Libya, where there is a high risk of a resumption of fighting on a large scale. The oil and gas markets are reacting to concerns that a prolonged civil war in Ukraine, a transit country for Russian gas exported to Europe, disrupting exports and causing a surge in energy prices. The crisis in Ukraine has served as a reminder of the extent to which the European Union, where many of its member States are struggling to recover from recession, relies on Russian gas for survival: over 50 % of needs.

Today, the European Commission, therefore, presented a new strategy for energy security, aimed at diversifying sources of external energy supply, modernizing the energy infrastructure and stimulating savings in energy consumption. Of these, however, diversification will be the main target. The EU plans to accelerate the diversification of external energy suppliers, especially for gas. Russia supplies 39% of the gas consumed in the EU, Norway 33% and the remaining 22% is imported 22 from North Africa (Algeria and Libya – which is wrought with its own supply risks. The EU could seek new supply routes, for example in the basin of the Caspian Sea, through the extension of the Southern Gas Corridor, the development of Mediterranean gas hub and more LNG supply sources.

The EU also plans to strengthen its energy independence

through renewable energy and fossil fuels. Energy efficiency should be strengthened. However, the EU has little time and it must find short term as well as long term solutions. In the short term, the EU will have to carry out comprehensive risk assessments ahead of next winter in order to anticipate and provide mechanisms for relief, given that the scale of the tensions in Ukraine and Libya are more likely to intensify than to resolve. The EU may consider such options as increasing gas stocks this summer, reduce demand through the use of alternative fuels (a return to coal or nuclear in Germany…?), or releasing some of the current emergency stocks.

The energy risk emanating from Ukraine to Western Europe is high. Should, Russia shut off the gas taps to Europe, due to its concerns in Ukraine – especially concerns that Ukraine will be offered a fast track into NATO – almost the whole of the EU, except the Iberian Peninsula and the South of France (which is supplied from Algeria), would be affected in a direct way. Europe risks a very frosty winter 2014-2015, especially South-Eastern Europe where over 60-80% of gas supplies are Russian. Former Soviet Republics or Warsaw pact members – and current NATO and EU members – such as Poland and Romania may need to compensate as much as an 80% supply disruption.

Adding ‘fuel to the fire’, Gazprom President Alexei Miller has insinuated that China and other Asian countries are willing to pay a higher price for Russian liquefied natural gas, meaning that Europeans will have to adapt if they want to keep their LNG terminals full. Gazprom plans to squeeze every possible dollar out of the crisis in Ukraine, which has been exacerbated by Sunday’s elections – despite the defeat of the extreme right. Miller suggested that the significant differences in tariffs gas between Europe and the Asian markets has resulted in a shift of gas originally destined for EU export to be shifted toward the Asian market. Miller’s statements were delivered in a delicate geopolitical context;

however, his warnings have some ‘bite’ because Gazprom and China’s CNPC have just signed a thirty year LNG supply deal that will surely herald a competition for Russian gas between China and the EU, which will ultimately have an impact on gas supplies in Europe. The suggestion, from the White House, that the US will be able to compensate for the loss of Russian gas remains rather fanciful, which further strengthens Moscow’s stance.