

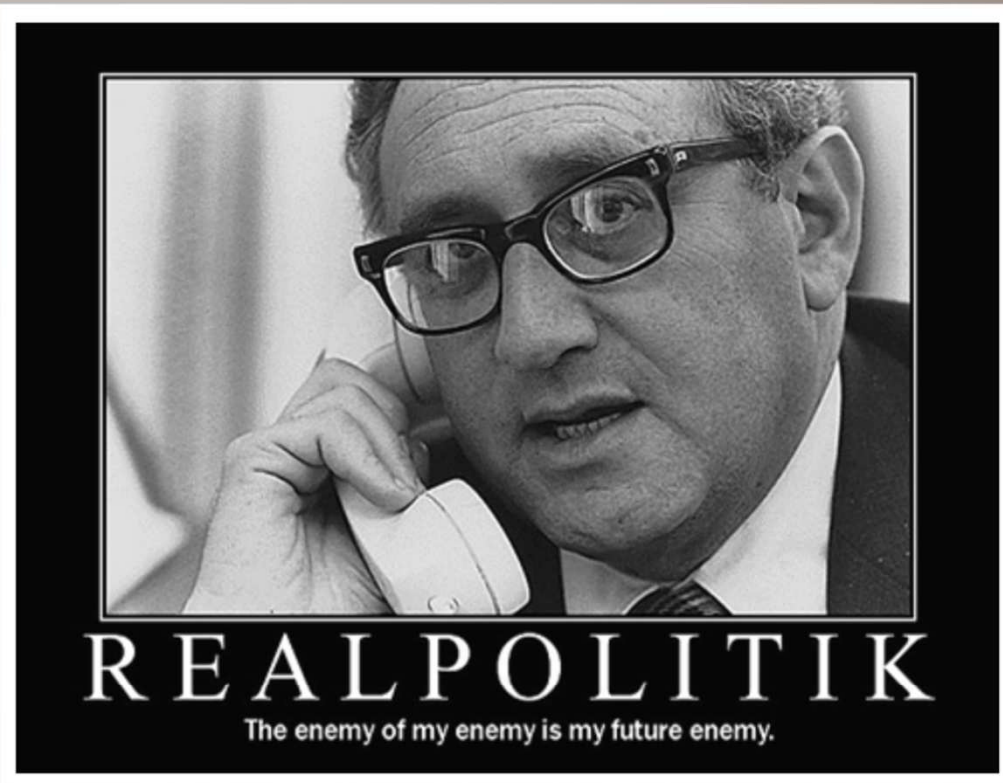
ANDBANK RESEARCH

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Realpolitik and Financial Markets

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Many are those who have felt (and still feel) a chill when seeing the events in Ukraine. At the end of the day, the facts of Crimea represent the most serious event since the Cuban Missile crisis and, without a doubt, the most serious episode of the post Soviet era.

Having said this, there are actually more reasons to stay calm rather than nervous. Let me explain.

This episode is being considered by the political experts as a “textbook example of realpolitik”, and this is definitely not bad. The realpolitik is nothing but a discipline that advocates for the advance in the interests of a country according to the circumstances of their environment. And, although Realpolitik does not follow ethical, or moral principles, it shares aspects of its approach with those of the philosophical realism and pragmatism.

Remember that Otto von Bismarck created the concept of Realpolitik to refer to the method through which to achieve a balancing power between the European forces. And just because balance meant peace. At that time, and now.

It has only been a period in the 20th century where Realpolitik was abandoned. It was during the first decade of the century... and this led to the WW I, and thus, to the WW II.

Admittedly, the absence of tensions is more comforting, although sometimes is misleading and leads to disaster. Therefore, Why not to welcome the Realpolitik in Crimea?

Although financial markets in Russia have tumbled, the fallout from Ukraine crisis for Russia's economy might well be less severe than many fear

- **Although admittedly, the crisis in Ukraine can only add to the headwinds facing Russia, experts on this topic think that he fears of a recession miss the point.**
- **Structural problems meant that Russia's economy was already stagnating before the crisis in Ukraine (some GDP Trackers suggests that output grew by just 0.8% y/y in January). Against this backdrop, a recession at some point over the course of this year would not be particularly remarkable.**
- **What's more, while the impact of the crisis on Russia's financial markets has clearly been substantial, several factors suggest that the immediate fallout for the economy could in fact be less severe than many fear.**
 1. **Concerns about the potential economic cost to Russia of any sanctions by the West may be overdone.** If and when any sanctions are placed on Russia, they are likely to be targeted on key officials rather than on the wider economy. Europe is too dependent on Russian energy to countenance full-blown trade restrictions.
 2. **While capital flight has accelerated over the past few days, Russia has amassed nearly \$500bn in foreign exchange reserves over the past decade.** As such, it has a substantial buffer with which to withstand a period of capital outflows, with Fx reserves representing more than 7 times the public external debt.
 3. **Public debt is too low** (15% of GDP), and **oil price is too high** (Brent > \$110pb) allowing the government to balance the budget (already in a **very good shape: -1% fiscal deficit**).
 4. In the Balance of Payments, although slowly weakening, **the Current Account is in surplus** (+1.5% of GDP). Even more, this reduction in the external surplus can be considered as "normal" for an economy whose per capita GDP has grown from US\$9.000 in 2009 to 15.000 in 2013.
 5. **The economy is operating at full employment**

According to expert sources in this topic, here are the only possible outcomes and the probabilities assigned

| | Possible Outcomes | Probability | Rationale |
|---|--|-------------|---|
| 1 | Putin withdraws troops from Crimea | 0% | It would mean the end of Putin's presidency. The Russian public, not to mention the military and security apparatus, believe unanimously that Crimea belongs to Russia, since it was only administratively transferred to Ukraine (almost by accident) in 1954. In fact, many Russians would think that most of Ukraine belongs to them (the very name of the country in Russian means "at the border", and not "beyond the border". The idea that Putin will respond to Western economic sanctions by giving up his newly gained territory is pure wishful thinking. |
| 2 | NATO military attack on Russia forces | 0% | The West will not engage in a war for Ukraine. The reasons are (1) The opposition will hardly hold together after the elections, since the interim government comprises groups from across the political spectrum. (2) With a weak parliament the required reforms will not pass and the EU will not provide an effective anchor for change. (3) Ukrainian economy can not withhold the period of political transition due to an external debt financing of \$80bn a year mostly in the corporate sector. |
| 3 | The West and the new Ukrainian government accept the loss of Crimea | 80% | Far from being a strategic blunder, Putin's decision to back himself into this corner is actually perceived by experts as a "textbook example of realpolitik". Putin has created a situation where the West's only alternative to acquiescing in the Russian takeover of Crimea is all-out war. The alternative for Crimea is to retaliate against Russian speakers in Ukraine, offering Putin a pretext for invasion and precipitating an all-out civil war. The balance of probabilities in such situations is usually tilted towards a peaceful solution. In this case, Western acquiescence in the Russian annexation of Crimea and the recognition of the new government of Ukraine by Moscow. |
| 4 | The Western-backed Ukrainian government will fight back | 20% | The country would descend into a Yugoslav-style civil war. The alternative of a full-scale war, while far less probable according to the experts, would have much greater impact |

Probabilities are determined by Andbank according to the arguments of some expert sources: Neal Shearing (Cap.Economics), Anatole Kaletsky (Gavekal)

The market implications of the central scenario

- Looking back through history at comparable episodes of severe geopolitical confrontation, investors have usually done well to wait for the conflict to reach some kind of climax before putting on more risk.
- In the 1962 Cuban Missile Crisis, the S&P fell -6.5% between the date when the confrontation started (October 16) and the worst day of the crisis (October 23), when President Kennedy issued his nuclear ultimatum to Nikita Khrushchev. The market steadied then but rebound four days later, when it became clear that a peaceful solution would be reached. It went on to gain 30% in the next six months.
- In the 1991 Gulf War, it was not until the bombing of Baghdad actually started (and a quick victory looked certain) that equities bounced back, gaining 25% by the summer.
- **Therefore, whenever there is a perception that a “peaceful resolution” of the conflict seems certain (as we think will be the case, with Russia prevailing), you can expect the financial assets to bounce back (specially those most affected by the confrontation. In this case, EM assets, Russian assets, etc.)**

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