

MACROCOSM

Crimea Doesn't Pay

Tuesday, March 11, 2014

Donald Luskin with research input from **Lorcan Roche Kelly**

Europe might appease Russia -- is it just too expensive to fight a sanctions-war?

Last week's panic over the Crimea crisis has subsided, but the matter remains a threat. We still think Russia is playing a weak hand (see "[Crimea River](#)" March 4, 2014), but it is playing it strongly. *So the end-state may involve significant appeasement from the West. So far the US is the only nation to have imposed even modest economic sanctions -- while Europe, at ground zero of the crisis, has done nothing. While this is repugnant to us as friends of liberty, we think it may nevertheless be a bullish outcome for global markets and the global economy.*

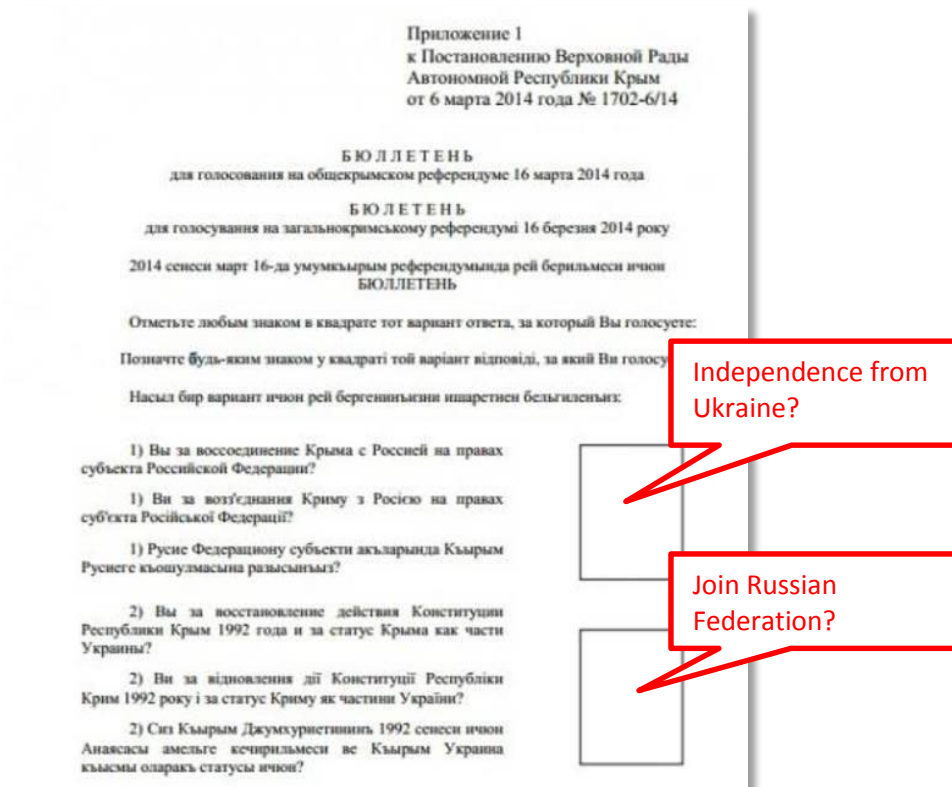
- The next date with destiny is Sunday, March 16, on which the

Update to strategic view

EUROPE MACRO, EMERGING MARKETS MACRO, EMERGING MARKETS STOCKS, FX: Russia stands to lose the most from a trade sanctions war -- but so far Europe appears to be unwilling to lose anything. Only the US has imposed any sanctions. Crimea has set an independence referendum for Sunday, which will put Europe to the test. We can't rule out a supine response, permitting Russia to absorb Crimea as Europe permitted Turkey to absorb the north half of Cyprus in 1975. While repugnant morally, such appeasement would be a good economic outcome. No matter who backs down -- as long as someone does -- it would lift global markets, demonstrating again their robustness to threats of contagion. The biggest beneficiary would be Russian equities and the ruble, rebounding from fears that the Russian economy might have been crushed by sanctions.

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Crimea independence referendum ballot



Приложение 1
к Постановлению Верховной Рады
Автономной Республики Крым
от 6 марта 2014 года № 1702-6/14

БЮЛЛЕТЕНЬ
для голосования на общекрымском референдуме 16 марта 2014 года

БЮЛЛЕТЕНЬ
для голосования на загалнокрымському референдумі 16 березня 2014 року

2014 сенеси март 16-да умумкрым референдумында рей берильмеси ичюн
БЮЛЛЕТЕНЬ

Отметьте любым знаком в квадрате тот вариант ответа, за который Вы голосуете:
 Позначте будь-яким знаком у квадраті той варіант відповіді, за який Ви голосує:
 Насыл бир вариант ичюн рей береншынгына ишаретнен белгыленгыт:

1) Вы за воссоединение Крыма с Россией на правах субъекта Российской Федерации?
 1) Ви за воз'єднання Криму з Росією на правах суб'єкта Російської Федерації?
 1) Русие Федерациону субъекти акъларында Къырым Русиеге къошулмасына разысынмыз?

2) Вы за восстановление действия Конституции Республики Крым 1992 года и за статус Крыма как части Украины?
 2) Ви за відновлення дії Конституції Республіки Крим 1992 року і за статус Криму як частини України?
 2) Сиз Къырым Джумхуристивиниъ 1992 сенеси ичюн Анавасы амельге кечирильмеси ве Къырым Украина къысмы оларакъ статусы ичюн?

Independence from Ukraine?

Join Russian Federation?

Source: Kyiv Post, TrendMacro calculations

Crimean parliament has [scheduled a referendum](#) on Crimean independence.

- This is the second critical referendum in recent memory that Europe has had to face -- the other in 2011, on Greece leaving the euro currency (see ["On the Greek Referendum Surprise"](#) November 1, 2011).
- Europe took a very hard line then, ultimately quashing the referendum and replacing Greece's government with an ECB-approved technocracy (see ["Papandemonium!"](#) November 3, 2011). But the stakes then were truly existential -- the fate of the euro currency was at risk, which in turn put the global banking system at risk. *What's really at risk now for Europe if the Crimean referendum proceeds, and Crimea votes to join Russia?*
- Ukraine's government has [called the Crimean referendum "an illegitimate decision."](#) Even the *referendum ballot itself* seems illegitimate, as it does not include any way for voters to express their wish to keep the *status quo* (please see the previous page). *But why is any of that really important to Europe?*
- To be sure, two European nations would be obligated by treaty to act against Russia -- somehow. The UK and France (along with the US and China) are signatories to [the 1994 Budapest Memorandum](#), pledging to guarantee Ukraine's sovereignty after it handed over all of its nuclear weapons -- it held the third largest stockpile in the world -- to Russia.
- Yesterday, UK Prime Minister David Cameron [threatened asset freezes and travel bans](#) if Russia treats a Crimean referendum "yes" vote as legitimate, and said German Chancellor Angela Merkel was on board). And yesterday the [European Commission announced](#) a delay in relaxing anti-trust restrictions against Gazprom which would have increased the flow of Russian natural gas into Europe. But so far... that's it.

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**Recommended
Reading**

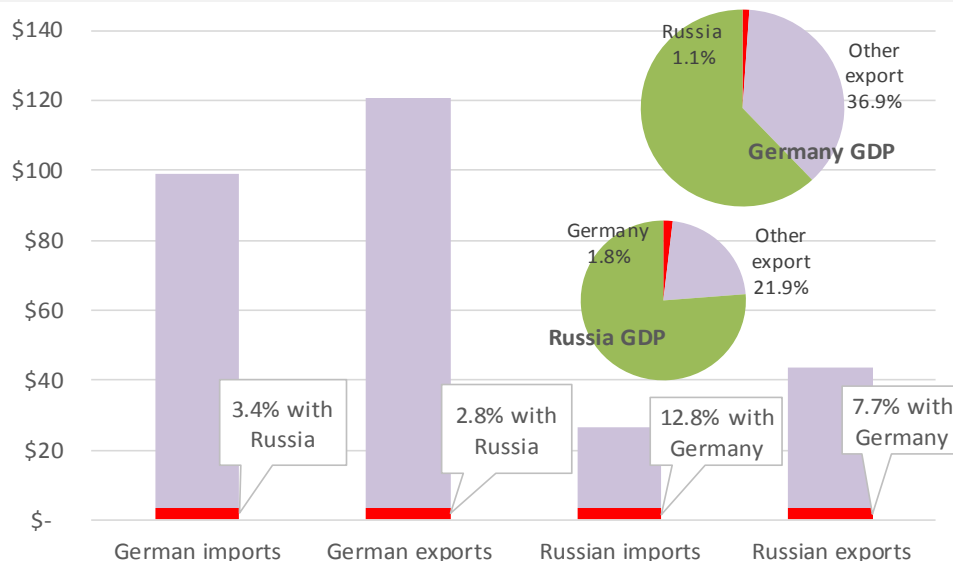
 [Why Europe Wobbles Before Russia's Challenge](#)
John Vinocur
Wall Street Journal
March 4, 2014

 [Obamacare: The Uninsured Are Not Signing Up Because the Dogs Don't Like It](#)
Robert Laszewski
Health Care Policy and Marketplace Review
March 6, 2014

 = suggested by clients.

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Germany and Russia, cross-trade dynamics



Source: Various, TrendMacro calculations

- Europe is unlikely to speak strongly with one voice on serious sanctions.
- Is Finland -- infamous for boycotting bail-outs during the euro area's debt crisis -- going to approve strong trade restrictions considering that it gets 100% of its natural gas from Russia?
- And how about Germany? Yes, Russia could be at risk of losing 1.2% of GDP from a German boycott of its exports -- while Germany would only be at risk on 0.7% of GDP (please see the chart on the previous page). That was the message of global stock markets last week, when Russia's took the most damage of all in the heat of the crisis, and has recovered the least (again, see "[Crimea River](#)").
- *But why should Germany want to lose anything at all to rescue from Russia a region that has been controlled by Russia for all but 20 of the last 231 years?*
- Former German Chancellor Helmut Schröder is publically [arguing that the original sin here is Europe's](#), having fomented the present crisis by offering Ukraine an "either/or" association with Europe at the expense of Russia. He is now advocating a broader view in which Europe simultaneously offers formal trade "associations" with both Ukraine and Russia.
- Yes, Schröder is non-executive chair of [a gas pipeline joint venture](#) that includes Russia's Gazprom -- and has been involved in putting together trade deals for Russia, including the 2011 sale by France of two [Mistral-class amphibious assault ships](#).
- But that doesn't make his views on this wrong, or mean they don't have authentic resonance for Germany. Schröder is arguing, at least to some extent, from legitimate economic convictions about the pro-growth effects of trade. Remember, he is the author of the "Agenda 2010" supply-side policies that transformed Germany a decade ago into the developed world's most dynamic economy and an export powerhouse (see "[Europe's Supply-Side Revolution](#)" February 17, 2012).

Don't think Europe couldn't live with a Crimea controlled by Russia. Ever eager to avoid a shooting war -- and ill-equipped to wage one anyway -- Europe already has a template for compromising in situations like this one: the nation of Cyprus.

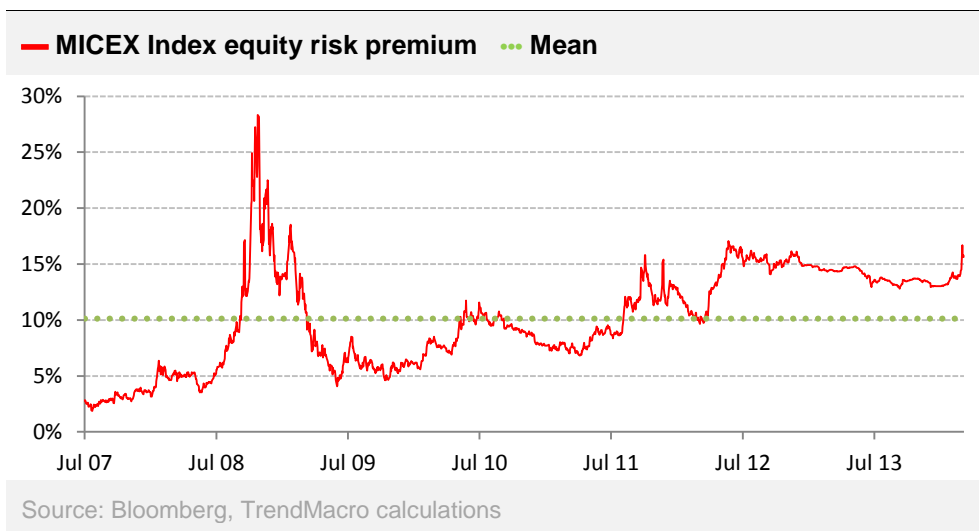
- In 1974, Cyprus was invaded by Turkey following a Greek-led *coup*. In 1975 the island was separated between north and south, with the south being recognized almost universally as the Republic of Cyprus. Only Turkey recognizes the north as a nation -- the rest of the world regards it officially as Turkish-occupied territory of the Republic of Cyprus.
- This has remained a stable situation for almost four decades.
- Cyprus was [admitted to the European Union](#) in 2004, with the EU pretending that the Republic was the entire island -- but "suspending" EU legislation in the occupied north. Ten years later, the wall in the official United Nations buffer zone between north and south has been torn down, and significant cultural and commercial

relations flow across what has become an increasingly imaginary line.

- Using Cyprus as a template, Crimea could declare itself independent, or part of Russia, and only be officially recognized as such by Russia, with the rest of the world calling it "occupied Crimea."
- And then everyone moves on.

However disgusted we may be privately about the immorality of this kind of *geo-realpolitik*, in naked economic terms it's a good outcome. The global economy would be harmed by fully isolating Russia economically -- it doesn't matter that Russia itself would be harmed the most.

- *Whether this plays out by Russia backing off or by Europe's appeasing Russia, we think the implications are positive for global equities -- and we caution clients to not be blinded to this by disappointment if the West's response turns out to be cowardly.*
- When this crisis fully passes -- no matter who backs down, just so long as *someone* does -- it will stand as yet another successful test of the global economy's robustness to financial contagion (see ["2013: The Year of Living Not Dangerously"](#) December 31, 2013). This will facilitate the next leg down in equity risk premia -- with a move higher in global stock markets and global bond yields (see ["Regime Change for Equities"](#) November 26, 2013).
- Ironically, the Russian equity market may be the biggest beneficiary. It is now tied with China for the richest equity risk premium in the world (please see the chart below, and ["Data Insights: Global Equity Risk Premia"](#) March 20, 2014).



- China has offered a rich equity risk premium for a long time -- and is arguably a value-trap. But Russia got there just the right way to create a tactical asset allocation opportunity -- by experiencing a sudden large decline, driven by a threat that has a good chance of being reversed.
- The equity risk premium model is "in-country," which means it is entirely a local currency analysis. This makes Russian equities all

the more attractive in USD terms, as any reversal in stocks ought to be accompanied by strengthening of the ruble -- half its sharp losses at the worst of the crisis have already been reversed.

- What's more, that currency strength could lead to lower Russian bonds yields. Typically when equity risk premia mean-revert, it is a joint process of *higher* stock prices and *higher* bonds yields. With *lower* bond yields, as we would expect in this case, the potential gains for stocks can be all the greater for any given move lower in the risk premium.

Bottom line

Russia stands to lose the most from a trade sanctions war -- but so far Europe appears to be unwilling to lose anything. Only the US has imposed any sanctions. Crimea has set an independence referendum for Sunday, which will put Europe to the test. We can't rule out a supine response, permitting Russia to absorb Crimea as Europe permitted Turkey to absorb the north half of Cyprus in 1975. While repugnant morally, such appeasement would be a good economic outcome. No matter who backs down -- as long as someone does -- it would lift global markets, demonstrating again their robustness to threats of contagion. The biggest beneficiary would be Russian equities and the ruble, rebounding from fears that the Russian economy might have been crushed by sanctions. ▶