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MACROCOSM

No Pain, No Ukraine

Tuesday, April 15, 2014

Donald Luskin with research input from Lorcan Roche Kelly

Almost a war now, but no escalating sanctions. Why would Europe suffer for a failed state?

The stakes in Ukraine have gone way up -- with its provisional government sending troops into its eastern Donetsk region to confront armed separatists alleged to be operating at Russia's behest, potentially provoking an invasion by Russian forces massed at the Ukraine/Russia border.

- These events are horrific, and the imagination can extrapolate them into worst-case military scenarios that deserve at least some weight in our appraisal of risk in the global economy.
- We think the feasible worst-case is a war of strong trade sanctions, depriving Russia and Europe of mutual trade. That would hit both sides hard -- Russia, because if derives 12.3% of GDP from exports to Europe, and Europe because it sources a significant share of its natural gas from Russia.
- These economic realities constrain both sides within a range of action calculated to maximize their objectives subject to avoiding that risk -- what diplomats in Europe are calling the "grey zone."
- At this point Russia may already have achieved much of its maximal objective, even without invading Ukraine's eastern regions. The separatist violence -- and the specter of nearby Russian troops -- has already forced Ukraine to express willingness to hold a national referendum on regional autonomy.
- And this recent escalation has been insufficient to move Europe -- or the United States, for that matter -- to escalate sanctions.
- Even an outright invasion of Ukraine's eastern regions may not be sufficient to trigger worst-case trade outcomes. While Europe needs to not appear entirely indifferent to Russian aggression, it recognizes that Ukraine is essentially a failed state that has been in some version of civil war on and off throughout its post-Soviet life. Why, really, should Europe suffer any costs over the matter (see "Crimea Doesn't Pay" March 11, 2014)?
- *So we continue to believe that even if Russia pries Ukraine apart and its eastern sectors join Russia informally or even formally, once the outrage has subsided, the actual economic repercussions that markets will have to consider will be inconsequential.*

Indeed, over time, this crisis will more likely end up being a positive for the

Update to strategic view

EUROPE MACRO, EMERGING MARKETS MACRO: Ukraine is attacking armed separatists in Donetsk, potentially provoking an invasion by Russian forces massed at the border, and a cut-off of natural gas. Russia has already achieved a large measure of its political objectives here, as the provisional Ukrainian government has agreed to a national referendum on regional independence, so overt interventions that would trigger ruinous sanctions are less necessary. But Europe is not likely to respond strongly even to the worst Russian provocations -- it has little at stake in Ukraine, which it sees rightly as a failed state. Longer term, though, this affair is a wake-up call on energy security. If it motivates Europe to exploit its vast shale gas reserves -- comparable in scale to those of the US -- it would be a pro-growth catalyst for Europe, and a boon to the global economy through lower world energy prices.

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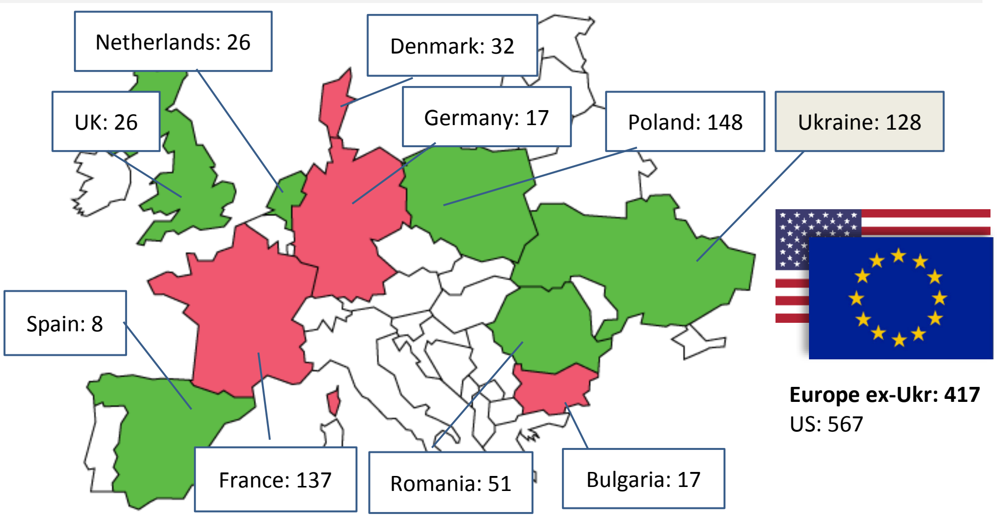
global economy, because it will concentrate Europe's will on achieving energy independence through more domestic exploration and extraction.

- For Europe, it's not just that it is an energy hostage to Russian natural gas. It is a hostage to Ukraine, too, because Gazprom pipelines supplying Europe cross Ukrainian territory. Since Ukraine became an independent nation in 1990, Russia has [repeatedly stopped gas transmissions to Ukraine] because of pricing and payment disputes -- [as it is threatening now], more for political reasons. In several of those past cases, Ukraine siphoned off gas from pipelines supplying Europe, triggering shortages in Europe even though it was not Russia's intent to cause them.
- Europe has a solution close at hand: it is endowed with significant reserves of shale gas. In fact, Europe's shale gas reserves, conservatively estimated, and excluding Ukraine, are almost equal to those of the US (please see the chart below).
- Obviously, this resource could be tapped using the horizontal drilling and staged fracking techniques that have proved so effective in the US.
- Start-up fracking operations have already begun in Poland, the nation with Europe's largest shale gas endowment. Fracking is presently banned in France, the nation with the second largest endowment (as fate would have it, France's major shale basin is right underneath Paris).

Europe's shale gas Technically recoverable, trillion cubic feet
Fracking permitted **Fracking banned**



Source: Energy Information Administration, TrendMacro calculations

- Longer term -- and it will take years for this to play out -- this would be a salutary development not just for Europe but for the global economy. Because energy is a global market, introducing new supplies *anywhere* effectively introduces them *everywhere*. So Europe is already benefiting, via lower world prices, from new US supplies. In the future, Europe may well return the favor -- at the same time as it solves a critical security issue with Russia.

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Bottom line

Ukraine is attacking armed separatists in Donetsk, potentially provoking an invasion by Russian forces massed at the border, and a cut-off of natural gas. Russia has already achieved a large measure of its political objectives here, as the provisional Ukrainian government has agreed to a national referendum on regional independence, so overt interventions that would trigger ruinous sanctions are less necessary. But Europe is not likely to respond strongly even to the worst Russian provocations -- it has little at stake in Ukraine, which it sees rightly as a failed state. Longer term, though, this affair is a wake-up call on energy security. If it motivates Europe to exploit its vast shale gas reserves -- comparable in scale to those of the US -- it would be a pro-growth catalyst for Europe, and a boon to the global economy through lower world energy prices.