

## Emerging Markets Illustrated - Flash – 3/4/14

*“Move along. Nothing to see here, folks.”* - Common phrase used by the **NYPD**, usually after a traffic accident.

### Conclusions:

- There will be no war in **Ukraine** or over Ukraine. The crisis is past.
- **Russia** will maintain “significant control” over **Crimea** and possibly to a lesser extent over eastern Ukraine as well.
- Western Ukraine (including **Kiev** and land west of the **Dnieper River**) will become a weak state and buffer zone between the competing ideologies of Russian statism and European liberalism.
- Russia has much to gain from this (territory as well as influence at home and abroad) and very little to lose.
- Ukraine is not a member of **NATO** and NATO has no defense obligations to the country.
- Russia is still a member of the **UN Security Council** and will veto any UN action (China would also use its veto).
- Global market impact is close to zero.



With “America’s top diplomat,” **John Kerry** visiting Kiev today, I thought it useful to examine the crisis in Ukraine with as little western bias as possible. The facts have not been clearly represented in the media and the probabilities of us having already passed the climax of the crisis are, in my view, quite high.

The media and select politicians have been presenting Russia’s “invasion” of Ukraine, a “sovereign nation,” as blatant and unprovoked aggression pitting “*a vast nuclear power against a state equal in size*”

to France.” This is not so and markets, I feel, have over reacted considerably to admittedly fast-moving events on the ground.

### **(The) Ukraine**

Ukraine is a big place almost the size of **France** in area and boasts a restless population of 45 million souls. As almost one in five people in Ukraine consider themselves Russian, it is important to look at a little history to see how we have come to the situation facing us today.

One thousand years ago the area we now know as “Ukraine” was the largest and most powerful state in Europe but it has only been recognized as an independent country since the collapse of the **Soviet Union** in 1991. From the Middle Ages onward much of the country was controlled by **Poland** and **Lithuania** – especially the western half. Cleaved in two distinct parts by Europe’s fourth longest river, the Dnieper, which runs from the north of the country and empties into the **Black Sea** in the south, the western half of Ukraine has tight historical and cultural ties with Europe. Some of this has to do with religion. The Poles and Lithuanians introduced a form of Roman Catholicism (the Uniate Church) to the land west of the Dnieper which they controlled for centuries. Known also as the “Eastern Catholic Church,” it competes with traditional Eastern Orthodoxy, which to this day remains the predominant religious force in the eastern half of the country.



### **In 1654 Russia came knocking on the door**

In order to drive the Poles out, the Cossacks of Ukraine turned to Russia for help and signed the **Treaty of Pereyaslav**. This treaty formed a military and political alliance between the two countries whose influence continues to this day. (Pereyaslav is an ancient city near Kiev and the birthplace of **Sholem Aleichem**, who wrote stories about **Tevye the Dairyman** upon which the musical **Fiddler on the Roof** is based).

The western half of Ukraine remained a part of Poland until the invasion of Poland by **Nazi** and Soviet troops in World War Two, who then divided up that country. The Crimean Peninsula comes into the picture next as it was “transferred” to Ukraine from Russia in 1954 by **Nikita Krushchev** to celebrate the 300<sup>th</sup> anniversary of the Treaty of Pereyaslav. When you are an absolute communist ruler you can do things like that.



### **Lips and teeth (and eyebrows)**

Russia has viewed Ukraine as an integral part of the country for generations. The two countries are, in Soviet parlance, *“As close as lips and teeth.”* Indeed, between 5-7 million Ukrainians fought in the **Soviet Army** during **World War Two**. After the war, which devastated Ukraine, during the 1946-1950 Five Year Plan, Soviet Russia devoted 20% of its budget to rebuilding the country. Many Soviet elite came from Ukraine - **Leonid Brezhnev**, who ousted Krushchev and ruled the **USSR** from 1964 until his death in 1982, was born to a Russian family in Ukraine. (Even Krushchev himself was born within spitting distance of the Ukrainian border and formerly governed the area during the reign of **Stalin**).

### **No Polish jokes, please**

Post 1991 independence has not been kind to Ukraine. GDP plunged for 10 straight years after independence from the Soviets Union. Rife with lawlessness, corruption and violence the country has been a large source of immigration. Much as Polish jokes faded into obscurity with the courageous rise of Lech Walesa and the Solidarity movement, with independence the English-speaking world has dropped the “the” when referring to Ukraine or even Crimea. We reserve the definite article now just for “the” Sudan, a stigma from which Ukrainians must be glad to have redeemed themselves.

# UKRAINE



## Center of White Slave Trade

Formerly a Muslim slave-trading khanate, Crimea itself is a peninsula at the bottom of Ukraine whose history has seen it ruled by just about everyone. With a population of just 2 mn, it still remains an autonomous republic within the Ukraine and is governed by the Constitution of Crimea. Almost 60% of the population are ethnic Russians – *it is the most Russian part of Ukraine* and, as is well known, is the home of **Sevastopol**, the naval base for Russia's **Black Sea Fleet**. Just 24% of inhabitants are ethnic Ukrainians and about 12% are Tartars, a Muslim minority which Stalin deported wholesale in 1944 to Central Asia as punishment for collaboration with the **Nazis**. Since Ukrainian independence, they have been returning and make up the second largest minority after Ukrainians.

From a geopolitical standpoint, Putin has made the smart move as the political benefits of his recent actions outweigh the potential economic costs. He has had his nose bloodied twice in Ukraine, first with the **Orange Revolution** in 2004 when voters gave a resounding thumbs down to Russia's preferred candidate for presidency – *Viktor Yanukovich* - and then recently again with the same guy being run out of the country. Putin realizes the western half of Ukraine yearns for a place in Europe and that makes them the enemy of Russia. The eastern half of the country is different and its sympathies clearly lie with Russia, as has been demonstrated in the last two elections. This is especially evident in Crimea where the Yanukovich party won most of the votes in the 2007 Ukrainian parliamentary elections and again in the 2010 Crimean parliamentary elections. In fact, without Crimea, Yanukovich would not have won office at all.

## The end game

To permanently cement Crimea into the bosom of Mother Russia, Putin will likely encourage elections - in accordance with western demands that "*a people have the right to choose their own future.*" If such an election were held today, it is quite likely the majority of people in Crimea – most of whom are

Russian and have voted pro-Russian candidates in the past – would vote to maintain some sort of “autonomy” under the protective umbrella of Russia rather than go with a wild and recklessly divided Ukraine whose experiment with independence thus far has been excruciating for most.

It is clear concrete options available to Europe and the US to stay Putin’s paw are limited at best. Howling bombast, supplied by Mr. Kerry et al, will fill newspapers and some sanctions will be applied but with little impact to Russia’s economy. Oil and natural gas comprise 60% + of Russia’s exports, helping the country maintain a \$15-20 bn monthly trade surplus and they will have little trouble finding willing buyers despite sanctions. If the ruble continues to weaken due to the threat of sanctions it will make those exports even more valuable than they are today.

### **Putin speaks**

In his first interview on the crisis, conducted this morning, Putin had the following to say:

- *“We are not going to go to war with Ukrainian people.”*
- *“We are not considering a possibility of annexing Crimea. It is up to local people to decide.”*
- *“We perceive that we’ll not be forced to do anything in Eastern Ukraine.”*

Taking Mr. Putin at his word, it appears he is publicly trying to “de-escalate” the situation. He has Crimea and will exert significant control over much of Ukraine indirectly in the future: the arrival of Russians is like a carpet stain, easy to occur but very difficult to remove.

There is little to be gained and much to be lost by continuing the aggression of Russia’s military in Ukraine. While political passions always have the potential to surprise, the probabilities indicate the crisis is past and markets will move on from here.

Cheers.

**Derek Hillen, CAIA**

Mirae Asset Securities