OBSERVATION

TD Economics

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THE TRILLION DOLLAR PIE

At this stage, low level, telegraphed economic sanctions on Russia seem likely to keep the majority of uncertainty and losses contained to Russia. However, Russia retaliating with sanctions of their own has not yet been as clearly telegraphed to markets and would see an impact. Military conflict would obviously be the worst outcome for markets. There was a military incursion of Russian forces across the border into Ukraine on Saturday, but they reportedly pulled mostly back while maintaining control of a natural gas distribution plant. Alternatively, Secretary of State John Kerry and Russian Foreign Minister Sergey Lavrov did reportedly reach an agreement on the phone on Sunday to discuss how to move forward and while Russian proposals so far may not be acceptable, they do seem to suggest they are less inclined to further militarily creep, so we cannot fully rule out a more peaceable and market friendly outcome. But we cannot rule out an intermediate and less favourable scenario either, according to which Ukraine slowly slips into a civil war, as the east of the country may want to follow Crimea's footsteps after setting the precedent.

In particular, we look at how further sanctions may develop and try to quantify the initial linkages and exposures. So while the EU is the most important trade and financial partner for Russia, its member states do not have that strong an incentive to act as hard liners as they would harm their own national interests. However, Germany, the UK and France seem better positioned to impose sanctions than it is commonly believed. And recent inertia may soon turn into more resolute action if Russia refuses to de-escalate tensions. On the contrary, the US has a significant financial weight, and may be willing to let Russia feel this capability to implement sanctions.

So, while the biggest threat of sanctions comes from the US and a few EU countries, the trigger is likely to be further escalation of Russia's presence in the Ukraine. In the absence of any relevant development on this front, we believe the EU will let things linger on and allow only long-term consequences to do the job. This justifies a timid return of risk appetite that we may have seen on Monday. EMEA assets could benefit the most, but any long position should be opportunistically implemented, and positions squared rapidly in case of negative developments. USD/RUB, the long-term uptrend remains in place (strengthened by progressive isolation of Russia), but the

The Weekend Vote

On Monday March 17, the Crimean parliament formally declared independence from Ukraine and asked to join the Russian Federation. The decision comes as a direct consequence of the referendum held the day before, which resulted in a vote that overwhelmingly backed secession. According to the Crimean electoral office, the turnout has been as high as 83%, with nearly 97% voting to leave Ukraine.

In spite of the announcement that the opposition would boycott the referendum, these plebiscitary figures raise legitimate suspicions on the validity and fairness of the vote. In fact, some 58% of people in Crimea are ethnic Russians, with the rest made up of by Ukrainians and Tatars. Assuming that this breakdown is equally represented among age groups with voting rights, the final outcome shows that more than 80% of the population with the right to vote has supported annexation to Russia. In other words, the vote highlights that not only has the entire Russian-speaking community voted 'yes,' but the referendum has also received the backing of Ukrainians and Tatars in excess of 20% of the total population. While this is not impossible, it is definitely unlikely and stands in stark contrast with polls as of early-March showing that only 40% of Crimeans supported separation from Ukraine.

Besides its fairness, the EU and US continue to repeat that the vote is illegal under the constitution of Ukraine and international law, and have called a first round of sanctions on Russian and Ukrainian individuals. Ukraine's interim administration labelled the referendum as a 'circus,' while Russia reiterated that they will respect the will of Crimean people. And this now suggests that Russia will soon take formal steps to annex the peninsula.

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negative RUB momentum has for now faded as the pair fell below key supports at 36.5650, 36.4820 and 36.4545. We see the opportunity for a tactical extension of the positive RUB momentum, although we remain fundamentally negative.

A three-step approach to sanctions

The EU and US administrations will have to deal with a set of uncertain conditions. First of all, is Russia's move limited to Crimea or rather the first step of a broader expansion into eastern Ukraine? Does Russia want to destabilize Ukraine to take control of its eastern territories, because they feel threatened by a NATO expansion to the east or want to sit at the negotiation table from a stronger position? And, with whom does Russia want to negotiate? Is Russia's interest in Ukraine based on geostrategic and military considerations only, or does it involve commercial aims given the large gas reserves identified in east Ukraine?

Western negotiators will have to unravel these complicated matters before coming to a decision of whether they should impose additional sanctions on Russia and define the nature and timing of these measures. The one thing diplomacy is aware (and wary) of is that the Kremlin will retaliate tit-for-tat. So, sanctions will have to be calibrated accurately unless the US and especially the EU accept to pay the economic price of a hard line. But, Russia has to also make its own calculations. A soft or hard invasion of east Ukraine would unite the rest of the country into an anti-Russia alliance and most likely lead NATO to settle in west Ukraine. Also, many sanctions may not be implementable or convenient for the EU and US at this stage, but there could still be long-term consequences for Russia in terms of business, GDP growth and economic stability of the country. At risk is Russia's increasing isolation and growing gap to the rest of the EM world.

Likely leveraging on these aspects, German Chancellor Angela Merkel suggested last week a three-step approach to imposing sanctions on Russia. Measures would be upped in their intensity and scope depending on Russia's decision to

The Week Ahead—A Roadmap to Geopolitical Instability

The result comes as a surprise to no one and the important issue now is what next? The risk here is that the immediate uncertainty may linger through Friday as we work through Western sanctions, potential Russian reprisals, the decision of what Russia will do with this Crimean referendum, whether other Ukrainian cities and regions try to follow suit, and whether the regional conflict escalates.

Late Monday, President Putin signed an order recognizing Crimea as a sovereign state. He will address a joint session of Parliament on Tuesday, though it is possible any official absorption of Crimea will wait until the end of the week when the Duma is scheduled to debate, though the formal act may happen earlier that expected. The EU and US have already announced a first round of sanctions on Putin's closest advisers and top Russian policymakers. These involve travel bans and asset freezes on Russian and Ukrainian individuals (21 identified by the EU, 7 by the US). Among those affected, Dimitri Rogozin (Russia's Deputy Prime Minister), Valentina Matviyenko (the Head the Russian Federation Council), Sergey Aksyonov (Crimea's new pro-Russian PM), and Vladimir Konstantinov (speaker of the Crimean parliament). In addition to this, the US—that is not targeting companies or other entities at this stage—also targets any individual or entity that operates in the Russian arms industry.

Western sanctions have been well telegraphed and seem unlikely to disturb markets massively if they continue to be limited. The EU has so far adopted an even softer approach, whereby the full list of names has not been disclosed but this is reportedly excluding Putin's immediate circle. Comments from US and European officials over the weekend do not suggest they are prepared to deliver anything significantly stronger at this stage, and prefer to let lingering uncertainty and selective sanctions hurt Russia over time.

But US leaders have talked about sanctions "in the coming days," so it is not clear whether and when to expect more, with Friday perhaps the most early likely date. The fact that Russian forces have reportedly given Ukrainian military personnel in Crimea safe passage into Ukraine through Friday suggests they see the end of the week as the critical date. European Commission Vice President Rehn is expected to announce the terms of financial assistance for Ukraine on Wednesday (11:00am GMT), while the EU Leaders Summit on Thursday and Friday could be a more official venue to announce details of sanctions against Russia, which is also the target for the IMF to complete their negotiations for a Standby Arrangement with Ukraine. There will also be further intrigue on how tensions may spill over into other regions as the second round of nuclear negotiations with Iran are scheduled to resume in Vienna on Monday and Tuesday, with Russia one of the key participants.

Accounting for the Trillion Dollar Exposure

$445bn—Russian trade with EU and US: Russia's annual trade (exports plus imports) with the rest of the world is worth $844bn, $418bn of which is with the EU (50% of total). Russian exports to the EU add up to $283bn (54% of total exports) —with energy and minerals making up almost half of that — while European countries import approximately $134bn (42% of Russian imports). In comparison, the US imports only $11.2bn a year (2.1% of total Russian exports) and exports $16.5bn (5.2% of Russian imports).

$170bn—Russian Deposits in Foreign Banks: Sanctions may span from trade to capital flows, involving the freezing of Russian deposits with foreign banks (approximately $170bn). Some of these will be accounted for by the selective personal sanctions, while the risk is that Russian depositors would move to offset losses her by retaliating against their liabilities owed to the banks.

$221bn—Claims of EU/US Banks on Russians: The exposure of BIS reporting foreign banks to the Russian public and private sector totals $242bn, of which $184bn is from European banks—who are the most exposed to retaliatory lack of payment by some Russian borrowers. US banks, on the other hand, have a smaller $37bn exposure.

$180bn—Other Potential Financial Exposures of EU/US Banks: We can add to these figures other potential exposures such as derivatives, CDS (mostly from American banks), and credit guarantees, that total another $180bn.

Trade flows between Russia and the rest of the world (Dec 2013 data, 12-month rolling)

Russia's:	EU	EU breakdown: Germany	Netherlands	Italy	France	Poland	Finland	UK	Other EU	Turkey	China	Japan	US	Ukraine	Other
(USD billions)															
Total Trade	417.5	74.9	76.0	53.9	22.2	27.9	18.7	24.6	119.3	32.8	88.8	33.2	27.7	39.6	204.6
Exports to	283.2	37.0	70.1	39.3	9.2	19.6	13.3	16.4	78.2	25.5	35.6	19.6	11.2	23.8	127.4
Imports from	134.3	37.9	5.8	14.6	13.0	8.3	5.4	8.1	41.1	7.3	53.2	13.6	16.5	15.8	77.2
(% of total)															
Total Trade	49.4	8.9	9.0	6.4	2.6	3.3	2.2	2.9	14.1	3.9	10.5	3.9	3.3	4.7	24.2
Exports to	53.8	7.0	13.3	7.5	1.7	3.7	2.5	3.1	14.9	4.8	6.8	3.7	2.1	4.5	24.2
Imports from	42.2	11.9	1.8	4.6	4.1	2.6	1.7	2.6	12.9	2.3	16.7	4.3	5.2	5.0	24.3

Source: Haver, TD Securities

Foreign Claims of Banks on Russia (2013Q3, USD billions, Residency Basis)

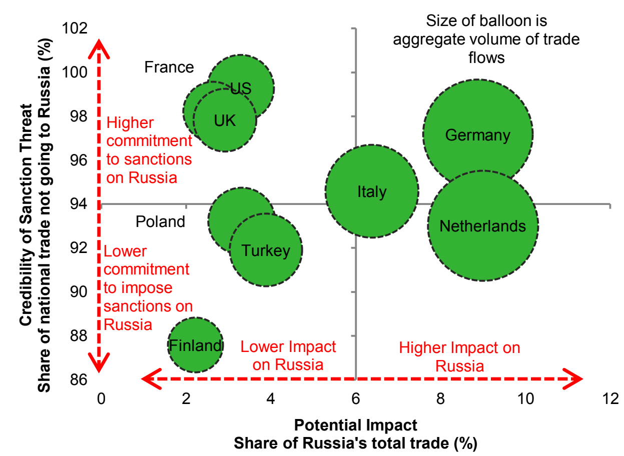
	Claims by BIS Reporting Banks in:	European Banks															By Maturity			
		Total	German	French	Italian	Dutch	Spanish	UK	Swedish	Swiss	Other	US	Japan	Canada	Turkey	India	<1Y	1Y-2Y	>2Y	n.a.
Foreign claims on Russia	**242.0**	**184.2**	**23.7**	**50.9**	**28.6**	**17.6**	**1.0**	**19.1**	**14.0**	**6.8**	**22.6**	**36.7**	**16.3**	**1.0**	**0.4**	**0.8**	**81**	**24**	**80**	**14**
Public Sector	29.3		2.4	3.3	1.4		0.0	8.3		1.1		7.1	3.3		0.0					
Banks	56.6		11.5	5.5	2.1		0.4	5.0		2.3		9.5	3.5		0.2					
Non-Bank Private	155.2		9.8	42.1	25.1		0.6	5.9		3.0		20.1	9.5		0.3					
Unallocated	0.9		0.0	0.0	0.0		0.0	0.0		0.3		20.1	0.0		0.0					
Other potential exposures	**180.2**		**3.9**	**12.5**	**5.7**		**0.2**	**42.1**		**2.7**		**92.9**	**2.3**		**0.0**					
Derivatives	4.1		0.4	1.3	0.0		0.0	0.7		0.3		1.2	0.1		0.0					
Guarantees extended	152.7		1.6	6.2	5.0		0.1	39.3		0.2		89.7	1.3		0.0					
Credit commitments	23.3		1.9	5.1	0.8		0.1	2.1		2.2		2.1	1.0		0.0					
Russian deposits with foreign banks	**170.5**																			
o/w: Russian non-banks	34.0																			
Russian loans from foreign banks	**159.2**																			
o/w: Russian non-banks	86.0																			
o/w: Short-term	75.3																			
Foreign claims (% of assets)			1.0	2.1	5.1	1.5	0.2	0.4	3.0	0.7		1.3	0.5	0.2	1.5	3.0				
MEMORANDUM																				
Foreign claims on Ukraine	24.7	23.3	1.0		5.8		0.0	0.2	0.1	0.7		1.2	0.2		0.0	0.0				

Source: BIS, OECD, World Bank, IMF, TD Securities
Note: The above statistics include only the exposure of BIS banks, and excludes exposures of non-banks such as insurance companies, hedge funds, etc. Guarantees extended, in part, include the gross, notional value of CDS contracts sold by BIS reporting banks sold to Russian counterparties.

annex Crimea, extend control in the region and continue acting as a destabilizing force, or further expand into Ukraine. Given the limited information we have at the time of writing, measures can be summarized as:

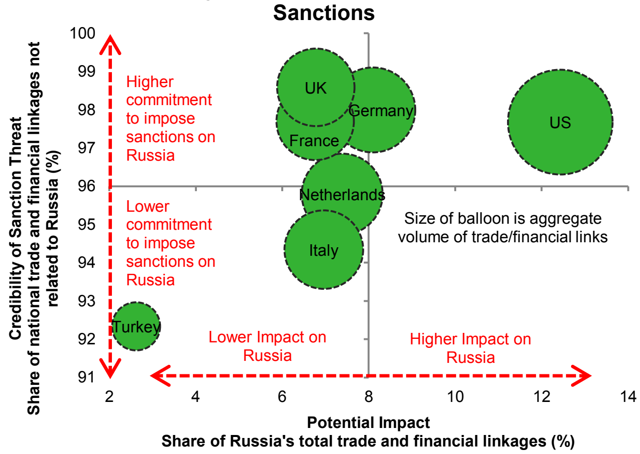
1. **Selective visa bans and asset freezes** on Russian and/or Ukrainian citizens who contributed to destabilizing Ukraine's democratic and constitutional rule. This is already hitting people within Putin's inner circle, and could be extended to politicians, high-rank state bureaucrats or business people. Effects will not be immediate, but they may bite on personal interests of people influential to the Kremlin. The risk is that the West imposes sanctions on people they will have to negotiate with, de facto breaking an important negotiation channel or leaving Western authorities with no option but to backtrack at a later stage.
2. **Economic sanctions:** This would entail a broader impact than the prior type of sanctions, with an extension to companies and entities that are not individuals. There could be limitations on the capability of Western governments to push forward the agenda of economic cooperation and integration with Russia. Permanent suspension of negotiations on light-visa agreement between the EU and Russia, expulsion from the G8, rejection from the OECD, or imposition of additional tax and duties on select Russian exports. Trade and capital bans of selected Russian industries, such as arms or strategic technology sectors, or on Russian firms and individuals that conduct commercial activity with other countries affected by international sanctions (for example, Syria, Iran, North Korea). Once again, consequences would be more visible in the long-term, with Russia's isolation causing business frustration and loss of opportunities. On the other hand, Moscow could make exports from the EU and US more difficult and, given the volume of trade flows, measures would self-inflict more pain to the EU than the US.
3. **Trade restrictions:** Likely only in the case of further invasion of Ukraine from Russia, Western nations could impose broader restrictions in trade and capital flows with Russia. However, the damage would be almost symmetric between Europe and Russia. The EU is far from being energy self-sufficient like the US is aiming to be soon. Energy exports from Russia cannot be halted unless they are replaced. But this won't happen in the short term. Alternative supplies have to be identified first, legislative changes may be required

1. Credibility vs. Impact of Trade Sanctions



Source: Haver, TD Securities.

2. Credibility vs. Impact of Trade and Financial Sanctions



Source: Haver, BIS, OECD, WorldBank, IMF, TD Securities.

(for example to allow nat gas exports from the US, or exploit the shale gas reserves that also have been found in numerous EU countries), and infrastructures have to be built (regasification units across Europe and connecting pipelines). In the end, costs will be higher for European companies, which may be conducive to lower international competitiveness and a likely deterioration of Europe's trade balances. Moscow knows that this route is not an easy one and will require time for implementation, so the Kremlin may be tempted to ignore it or try and capitalize on short-term factors to hedge greater long-term risks. Given the deep financial interlinks between the EU and Russia, and difficulties in anticipating all the consequences, financial sanctions are probably the hardest to pursue and would be left as the option of last resort (see page 3 for details on trade and capital exposure of world countries to Russia).

Anticipating sanctions: What is feasible and what is not

The box on page 3 demonstrates that if we aggregate the major linkages, it totals a huge pie worth at least a trillion dollars. Even this figure underestimates the potential exposure as it excludes assets held outright by Russians abroad as well as Western assets held outright in Russia. Against these figures, it is very reasonable to expect a cautious approach from authorities when imposing sanctions.

In this respect, Russia is giving leeway to the EU and US to act first, knowing that the EU is more exposed to trade and financial links with Russia, and therefore less keen to take radical measures, while the US has more room to manoeuvre, but the effectiveness of their sanctions would be softer.

To understand the likelihood of further sanctions, we have analysed their potential impact on Russia's economy and the resolve of Western administrations to push through with them. The two previous graphs highlight trade flows (chart 1 shows that the EU is significantly more exposed) and financial linkages (chart 2 compounds both dimensions, showing that the US has a higher impact, but the EU as a whole remains a larger partner for Russia). 'Potential impact' is measured as the share of Russia's total trade flows and financial links, while 'credibility of sanction threat' is the share of national trade and financial linkages not related to Russia.

So while the EU is the most important trade and financial partner for Russia (in particular, Germany, Netherlands, Italy, the UK and France), EU members do not have that strong an incentive to act as hard liners as they would harm their own national interests. However, Germany, the UK and France seem better positioned to impose sanctions than it is commonly believed. On the contrary, the US has fairly small exposure on the trade side — which makes a threat credible but not effective on this front — but has significantly higher financial impact, and the threat is supported by the capability to implement sanctions.

In conclusion, the biggest threat of sanctions for Russia comes from the US and individual EU countries. To trigger measures hitting trade and financial flows, though, the current situation must escalate further, with Russia perhaps aiming at taking control of the rest of east Ukraine. On the contrary, if the situation remains as it is, we believe the EU will let things linger on and allow only long-term consequences to do the job.

Finding opportunities

Markets unwound a fair bit of risk aversion in the aftermath of the weekend's referendum. With the exception of Turkey, Eastern Europe has performed decently in the FX, equity and fixed income space. Russian stocks even rallied 3.8% since Friday's close. But uncertainty remains elevated and this has a cost. Conciliatory tones can quickly turn into more radical decisions, but not all resolutions can be adopted by the contenders. Therefore, the situation seems set to be frozen until Russia makes the next move.

Until then, we may see a timid return of risk appetite and EMEA assets benefit the most, but any long position should be opportunistically implemented, and positions squared rapidly in case of negative developments. Concerning USD/RUB, the long-term uptrend remains in place (strengthened by progressive isolation of Russia), but the negative RUB momentum has for now faded as the pair fell below key supports at 36.5650, 36.4820 and 36.4545. We see the opportunity for a tactical extension of the positive RUB momentum, although we remain fundamentally negative.