

## Russian roulette

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Headlines around Russia and their heightened military presence on the Ukrainian border have been increasingly newsworthy lately. This uncertainty has led to questions around the geopolitical environment and its potential implications. The following outlines the background and context of these rising tensions and the risks it poses for the economy and markets.

### What is happening?

In recent weeks Russia has amassed heavy equipment and troops along its border with Ukraine, sparking concerns over a potential Russian invasion. Diplomatic talks between the U.S. and Russia to diffuse the risk of more intense military action are underway, though there are clear divisions between the concessions that both sides are willing to undertake. From Russia's standpoint, it is concerned about the influence NATO and the west have over the countries that border Russia. Meanwhile, the U.S. and NATO do not want to stand by as Russia attempts to redefine its borders to reclaim some of the territories previously under its control as part of the Soviet Union.

In recent days, Russia has also moved military troops to Belarus to perform joint military exercises. While these were planned back in December, the amassing of additional troops on Ukraine's northern border has given rise to fears that it is preparing to invade.

### Background

NATO was established as an alliance in 1949 in order to develop collective peace across a region that had been torn apart by WWII, and establish protection against the Soviet Union. After the collapse of the Soviet Union, an agreement was signed between Russia and NATO allies that outlined guidelines for building a relationship based on peace and security. Years of confrontation and escalating tensions during the Cold War made this agreement, entitled the "Founding Act on Mutual Relations, Cooperation and Security," central for the two adversaries in establishing trust and fostering cooperation.

However, Moscow has long argued that implicit in the act was a side agreement that NATO would not expand its membership to the nations that surround Russia. More specifically, it has taken offense to the build-up of U.S. military bases in places that were formerly part of the Soviet Union. Since the collapse, 15 countries have joined NATO. The fact that Poland, Romania and other countries that encircle Russia have aligned with the west is concerning to Russia, and viewed as a threat.

This is not the first time Russia has taken military action against a neighbouring country. In 2008 it was involved in a five-day war with Georgia while the country was on the verge of joining NATO. Then, in 2014, it invaded Crimea, an area of Ukraine that contains a strategically important naval port as well as a large Russian population. The invasion was essentially to establish a buffer between Russia and the NATO alliance.

## Why now?

There are a few theories surrounding why Russia may be moving towards action:

- Putin may be testing Biden, checking his willingness and ability to unify governments in response to threats of Russian action.
- Strategically, Russia suspects that many NATO countries may not want to step in and defend Ukraine, creating an opportunity to foster division within NATO.
- More countries from the former Soviet Union have shown a desire to join NATO. While far from official entrance into the alliance, Russia wants to avoid losing its influence over these former Soviet states.
- Putin's popularity rises when he puts Russia on a military footing.

Timing-wise, the weather may also be playing a factor. The ground between Russia and Ukraine is riddled with mud flats. In order to roll heavy artillery across the border, it must be frozen, which only occurs for about a month or so in mid-winter. If it doesn't act soon, Russia must wait another year or attempt an invasion without its heavy equipment.

## What does Russia want?

Russia has made its intentions fairly clear. It wants to push back on what it sees as a tightening noose that the west has established around Russia's borders. Their demands include:

- Banning the countries that encircle Russia from ever joining NATO, limiting its reach.
- All NATO military troops and weapons removed from former Russian states, as well as a halt to any military exercises in the regions.
- Removal of all U.S. nuclear weapons from Europe.

Behind all of this is the intention of bringing NATO back to the table to rewrite the agreements that were established after the fall of the Soviet Union. This would put Russia into a position where it has a level of protection against the west and can expand its sphere of influence.

## What measures might the U.S. and NATO under take?

There are three main tactics NATO can use to respond to military action without physically stepping in to defend Ukraine:

- It can cut off access to SWIFT, the system that connects banks and allows for international payments and transfers. In essence, this would prevent Russia's financial institutions from dealing with European and U.S. banks. This act would be incredibly disruptive for Russia's economy and currency, including severely impacting Russia's oil and gas operations.
- Additional debilitating sanctions can be introduced in the form of cutting off access to semiconductors and microcomponents as well as the patents for components, making it difficult to develop additional artillery. It could also prevent access to industrial and consumer goods shipped from NATO countries. This could have wide-reaching impacts on businesses and consumers all across Russia.
- NATO could provide weaponry to Ukraine, enabling them to amass a stronger response without the need for NATO troops to get involved.

Essentially, the goal would be to make the threat of these sanctions painful enough to prevent Russia from moving on any plans for an invasion. Alternatively, it could concede to some of the lesser Russian demands, allowing Russia to back down while still saving face.

## How might it play out?

Escalating tensions have essentially pulled the two regions into a game of chicken. Russia is pushing the U.S. and NATO to see how far it can go, while the U.S. is considering its options to show Russia it won't stand idly by as the country attempts to redraw its borders.

At this time, indications suggest Putin is poised to move in on Ukraine, though whether it is merely a tactic to apply political pressure is in question. Indeed, a recent cyber attack on the area suggests it is trying to emphasize how

easily it can disrupt Ukraine through its power grids. Russia could also threaten to disrupt the flow of energy and natural gas to Europe, intensifying the ongoing shortages already being experienced.

The worst-case scenario would be a direct military conflict between the U.S. and Russia, though this is unlikely.

Perhaps the unintended consequence of all this is the risk that Russia pushes too far, leaving surrounding areas less supportive of the Russian regime and more westward inclined.

### **What are the potential implications?**

Given the degree of sanctions that the U.S. and NATO may enact, an invasion of any kind could temporarily be disruptive for Russia and Ukraine's economies. Markets have begun to price in some additional risk of a Ukrainian sovereign default, while long-dated bond yields for the region have risen.

Should fears about disrupted energy flows be realized, there may also be considerable short-term implications for Europe; however, this risk seems limited. Energy flows were not interrupted during the prior Russian invasion of Ukraine. While Europe would be hurt, the damage would be no less significant for the Russian economy in the form of lost revenues. Finally, disrupting energy flows could actually have a long-term devastating impact for Russia, in the sense that it could force Europe to accelerate its transition away from European natural gas.

As a result, while the conflict represents a clear geopolitical risk, it does not yet merit central billing in our economic or financial market forecasts for 2022. As we saw in 2014 when Russia invaded Crimea, the threat of sanctions are high, but they rarely have a large or lasting impact on markets or economies. Keep in mind that Russia invading Ukraine doesn't mean it's out to capture the entire country. Instead, this could be an incremental attempt to consolidate power in eastern Ukraine. This is a fairly likely scenario.

### **Conclusion**

Escalating tensions are likely to continue making headline news over the coming weeks; however it need not come to blows. Gauging the probabilities around how the next few weeks might play out is complex. While some sanctions are possible, a large-scale invasion and the threat of multi-regional involvement appears less likely at this time. It's worth remembering that geopolitical risks like these often crop up suddenly, but also tend to resolve themselves relatively quickly.

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