

Global Political Insights

Alert: Plane Crash to Inflamm Geopolitical Tensions, Potentially Accelerating Further Sanctions on Russia

- **The downing of Malaysian Airlines passenger jet MH-17 over eastern Ukrainian airspace on July 18, coming only hours after the announcement of new US and EU sanctions against Russia over its alleged support for Ukrainian separatist activity, has significantly escalated the tensions surrounding the Russia-Ukraine crisis.**
- **Will Markets Continue to Shrug Off Geopolitical Risks?** The incident also heightens the already elevated geopolitical risk temperature, higher than it has been in some years and likely to remain so given intensifying prospects for further conflict in Gaza and the ISIS occupation of Iraq. Taken together, these developments will test market resolve to continue to shrug off geopolitical developments.
- **White House Signaling No Willingness to Intervene:** Outside military intervention in the Ukraine conflict remains a low probability, a position confirmed by President Barack Obama in a press conference by the White House on Friday. Previous instances of passenger airlines downed under similar circumstances, such as Korean Air Lines 007 shot down over Sakhalin in 1983 and Iran Air 655 in 1988, did not trigger military action. Instead, the trajectories following these crashes suggest that a hardening of tensions and worsening of trade relations is the more likely outcome. But the incident will nevertheless trigger a range of concrete negative effects with implications for regional markets and the economic outlook as well as relations between the West and Russia, now at their most strained since the Cold War.
- **Level 3 Sanctions More Likely to Happen, and Sooner:** We have increased our probability of the likelihood and timing of Level 3 (broad-based sectoral) sanctions, possibly as early as September. The incident will also likely narrow the divide between the US and EU positions on sanctions, following earlier resistance by Italy and other EU member states, which underscored diverging views within the EU. New sanctions against Russia would potentially prompt retaliatory measures from Moscow, which has thus far shown restraint.
- **A Further Blow to the Russian Economy:** The newly imposed sanctions by the US and EU will make for a more challenging backdrop to the Russian economy, creating additional risks to growth. As a result, we have downgraded our 2014 GDP forecast from 1.0% to 0.7% (1.3% in 2013). We maintain our 2.3% 2015 GDP forecast.

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- **Importantly, we still maintain a more positive view on macroeconomic performance than the consensus and Russian government.** Our more sanguine view has always been based on the belief that the market has been embedding an inordinately large risk premium to assessing economic performance. And indeed, after the very large first-quarter contraction in fixed investment (-4.9% YoY), which has been the key GDP component suffering from the geopolitical tension, incoming data has been pointing to a significant moderation in the pace of decline, with fixed investment declining by 1.6% YoY in 2Q and actually emerging into a positive territory in June (0.5% YoY) for the first time in the year. We now anticipate that the new more severe sanctions may somewhat reverse this positive momentum in fixed investment, thus forcing us to trim our 2014 GDP forecast. However, given that preliminary data suggests that 1H GDP already grew at a stronger-than-expected 1.0%, we anticipate that full-year GDP performance at 0.7 percent will still be higher than the consensus view and government view of 0.5 percent.
- **Military Operations in Ukraine and Geopolitical Risk Likely to Continue:** Moscow, Kiev and Washington have traded accusations about responsibility for the crash, which remains unclear. Although evidence remains in short supply in the aftermath of the incident, and UN calls for an investigation according to international civil aviation guidelines have not yet been acted upon, US statements (President Obama) have blamed Ukrainian separatists for the incident, and accused Russia of supporting their efforts, suggesting tensions will remain high. We do not expect the Ukrainian government to cease its military operations in the East, suggesting further incidents are possible.

Appendix A-1

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