

Martial law in Ukraine: business will resume as usual

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 Strategy / Economy / Politics

Ukraine is back on global radars after Russia's latest act of military aggression this weekend, this time against Ukrainian navy ships in the Black Sea that prompted the government to impose martial law in selected regions. In our view, the measures were excessive and not necessary, in turn prompting a disproportionately negative market reaction to them.

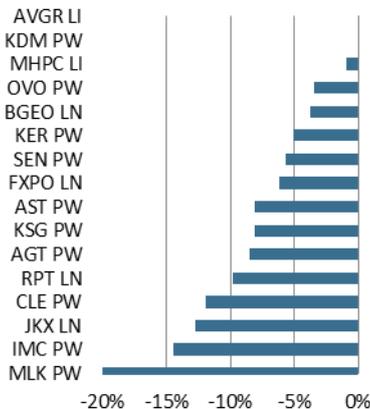
The measures introduced by the government will, at minimum, demonstrate Ukraine's institutional and physical readiness to withstand a possible campaign of Russian military aggression, thereby diminishing the risk of it occurring at all.

Amid the turbulence, the IMF and World Bank offered support for Ukraine by reaffirming that martial law is not an impediment for their plans to lend over USD 2 bln in financing by the end of 2018. The World Bank has already scheduled a respective board meeting for Dec. 18, while the IMF managing director expects the fund's board meeting will be scheduled after Dec. 10.

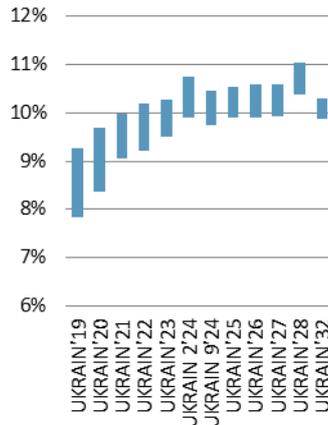
Among the possible economic benefits of the situation for Ukraine is a long-term solution to Russia currently preventing the free flow of goods to and from Ukrainian ports in the Azov Sea, to the benefit of steelmaker Metinvest.

Market reaction: prices and YTM changes, Nov. 28 vs. Nov. 23

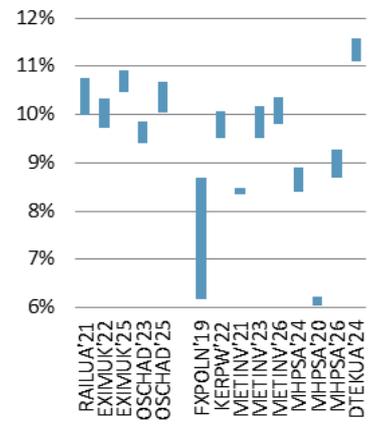
International stock price chg



Sovereign Eurobonds YTM*



Corporate Eurobonds YTM*



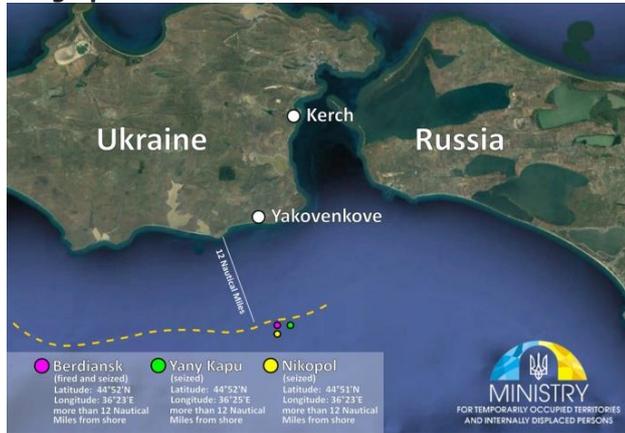
* Lower bound represents YTM on Nov. 23, upper on Nov. 28
 Source: Bloomberg

What happened: Russians shot at Ukrainian military ships

On Nov. 25, Russia border patrol ships detained three Ukrainian navy ships in the Black Sea as they approached the Kerch Strait on their way to the port of Mariupol. In the attempt to stop them, the Russian forces rammed one of the ships, used fire and injured six sailors, reportedly. The Ukrainian side declared that this was the first explicit act of aggression against the Ukrainian military committed by the Russian military since the war began in 2014.

This was the second attempt of the Ukrainian Navy to cross the Kerch Strait after the successful passing of two ships in October. However, this time the Russian side decided not to allow for anymore exceptions. We had expected a violent incident to occur eventually in Ukraine's maritime zone with Russian law enforcement authorities behaving increasingly aggressively in recent months, particularly those headed for Ukrainian ports.

Geographical visualization of the Nov. 25 attack



Source: Ukraine's Ministry for Temporary Occupied Territories

The government's response: initiation of martial law

As its response to Russia's open act of aggression, Ukraine's top power brokers decided on the early morning of Nov. 26 on the need to introduce martial law in Ukraine for 60 days, aiming to:

- 1) **Mobilize** all of Ukraine's armed forces, as a logical response to a foreign attack. In this way, demonstrate the Ukrainian army's readiness to possible aggression from Russia's side, thus diminishing its likelihood.
- 2) **Draw the world's attention** to Russia's latest aggression. Introducing martial law demonstrated that Ukraine's authorities are serious about the threat.

But, in our view, all this was secondary to President Petro Poroshenko's primary aims from the conflict. They are:

- 3) **Reintroducing into the public consciousness** Russia's ongoing hybrid war of aggression against Ukraine, with it having largely left the public discussion because it has been occurring at a low-level in Donbas (with only a few casualties per week) with **the public having become accustomed to the war's persistence**. In this way, the president could be aiming to mobilize his pro-Western electorate and boost his poll ratings, which have been weak all year.
- 4) Using martial law to **postpone presidential elections** that were expected for March 31, 2019. If martial law had been imposed for 60 days, it would have delayed the elections, which would have had to be explicitly scheduled at least 100 days in advance. And there would have been no opportunity to schedule elections under martial law.

Parliament's response: no martial law – no power usurpation

The president's decree imposing martial law must be approved by parliament within 24 hours, according to legislation. And parliament wasn't as eager to exercise that option.

Understanding the implications of martial law for her comfortable lead in the polls and her overall prospects of being elected president, Yulia Tymoshenko (as well as several other presidential rivals) blocked the parliamentary tribune on Nov. 26 to prevent its approval.

As a result, the risk emerged that martial law wouldn't be introduced at all, which would have discredited Poroshenko not only before the civilized world (which had already condemned Russia for the naval aggression), but also before the Ukrainian people, which would have **all but destroyed his re-election prospects**.

Therefore, Poroshenko had no choice but to find compromise with parliament.

The compromise: limited martial law, presidential election date reaffirmed

As a result of political negotiations throughout Nov. 26, parliament and the president agreed to approve a limited version of martial law, as well as measures to ensure that presidential elections would be held in March and likely second round runoff in April:

- 1) Martial law is to be introduced only in ten of Ukraine's regions (out of 25 in total) that are bordering Ukraine's maritime coastline, Russia and the Transnistria region of Moldova controlled by Russia.
- 2) Martial law is to be introduced for 30 days as of Nov. 28 in order to not affect the official start of the presidential election campaign, which is supposed to occur 90 days before the date of elections, or Dec. 31.
- 3) Parliament voted to schedule explicitly presidential elections for March 31, 2019, thereby virtually ensuring they will occur as planned, regardless of what happens otherwise.

All in all, Poroshenko was not able to fully meet any of his domestic political goals from the incident near the Kerch Strait. His initial scope of martial law was unnecessary, which also hints that even partial martial law could be excessive. But, at least it allowed him to save face internationally and muster the latest wave of global support, particularly from the U.S.

Ukraine: map of martial law introduction



What does martial law mean?

Martial law does not mean that any military actions will necessarily happen in the regions where it is introduced. But this regime allows for mobilizing economic resources for military needs in the event of expanded Russian military aggression. In turn, better preparedness of these regions, in and of itself, reduces the probability of a Russian invasion (however low it might) due to the high potential costs that Russia would incur.

Also, the legislation:

- Provides for increased measures to guard strategically important sites.
- Allows for limiting the activities of political parties, banning any public meetings, introducing curfews, travel restrictions on citizens, and regular document checks.

- Among risks to the economy, the martial law legislation allows the government to:
 - Enlist non-military employees to military service, if necessary.
 - Use the capacities of private firms for military purposes and even confiscate assets in extreme cases.

At the same time, we expect that no one will dare to introduce such measures unless there is a real threat of expanded military aggression or invasion. The most we see happening is the recruitment of citizens for security functions, as well as the use of road construction equipment and farming machinery (which is mostly idle now) for building barriers.

All in all, we see the following consequences of martial law being imposed on Ukraine's economy:

- **No doomsday for Ukrainian business**

Among the biggest risks is a delay in signing and executing international contracts from the side of foreigners, who might be intimidated after these events. The delay or cancellation of some international investment projects to Ukraine is also highly likely. At the same time, we see no risks for contracts between Ukrainian residents.

- **Increased cost of international borrowing by Ukraine as a consequence of panic on the fixed income markets**

The yield to maturity of Ukraine's 10Y sovereign Eurobond increased to 11.1% as of today, from 10.4% on Friday.

- **No interruption of official lending to Ukraine**

The IMF reported it has no reasons to stop its lending to Ukraine as a result of martial law being imposed, and its managing director stated she expect the board meeting to consider new loan tranche for Ukraine (around USD 1.5 bln) will occur after Dec. 10. The World Bank has recently scheduled for Dec. 18 a board meeting to decide on providing Ukraine USD 0.8 bln financing.

- **Limited negative psychological effect on currency market, banking system**

So far this week, the Ukrainian currency lost 1.6% vs. the U.S. dollar (and lost 0.5% since November's start). The move is usual for the last two months of a calendar year in Ukraine (the hryvnia lost 4.3% in Nov-Dec. 2017). In the retail segment, the Ukrainian currency was much more volatile with significant widening of spreads to the fortune of currency dealers. The situation is being stabilized there, but it points to the nervousness of households, which also might have resulted in unusually high withdrawals of bank deposits these days.

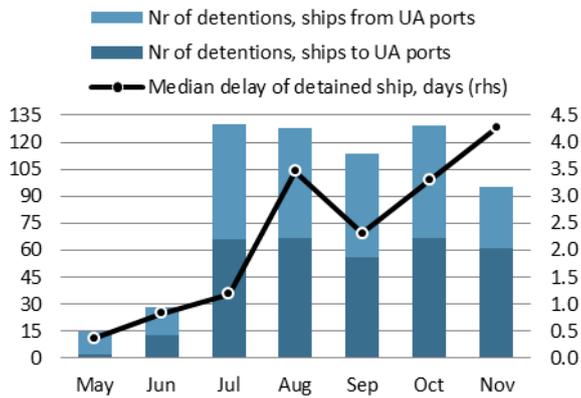
So far, the statistics indicate minimal panic. Individuals' accounts in banks decreased "less than two percent" since last Friday, according to the central bank's deputy head, which also includes an effect of "Black Friday" shopping on the weekend. In any way, some panic withdrawal should have been present, which resulted in some shrunken liquidity of the banking system and slowing down of lending activity. But the effect is unlikely to be significant or long-lasting.

Among the potential benefits of martial law, we see:

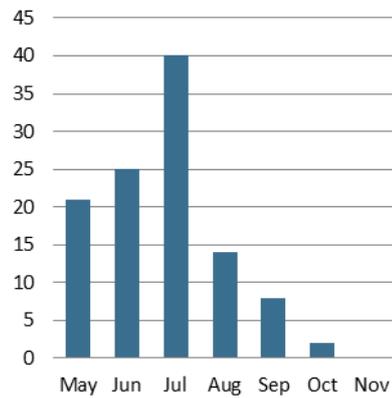
- **Opportunity to resolve the Azov Sea crisis**

Since May 2018, Russian law enforcement authorities have become increasingly aggressive against commercial ships traveling to Ukraine's main Azov Sea ports of Mariupol and Berdiansk. The aggression is reflected in the increased rates of detention for the inspection of ships crossing the Kerch Strait into the Azov Sea, which has led to stoppages ranging from five hours to ten days, according to statistics of the blackseanews.net website. In turn, this increases the costs of servicing Ukraine's Azov ports, where Metinvest delivers most of its steel goods for export. All the recent attention drawn to Russia's aggressive actions in the Azov Sea may lead to enough international pressure for Russia to back down eventually.

Detention of ships near Kerch Strait servicing Ukrainian Azov ports since May 17



Detention of ships in Azov Sea since May 17*



* Most delays were between 2 and 4 hours
 Source: www.blackseanews.net, Concorde Capital calculations

- **Reduced likelihood of Russia's expanded aggression or invasion**

We don't view the threat of Russian expanded military aggression or invasion these days to be more than 25% likely. Yet if it happens, Ukraine's preventive measures under martial law will work to significantly reduce this threat. Taking lessons from Russia's aggression against Georgia in 2008, Ukraine's military commanders have shown they are careful enough not to succumb to Russian provocations, which has enabled Ukraine to enjoy diplomatic backing from all the Western world. At the same time, Ukraine's readiness for aggression means that any hostile move by the Russians will cost a lot.

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