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Global Growth at Risk as Ukraine Adds to Known Unknowns

By Rich Miller, Shobhana Chandra and Simon Kennedy - Mar 28, 2014

Known unknowns are multiplying in a new threat to global economic expansion.

While economists Mohamed El-Erian of Allianz SE, Allen Sinai of Decision Economics Inc. and Morgan Stanley's Joachim Fels see growth speeding up this year, mounting geopolitical strains in Ukraine and elsewhere are prompting them to turn more guarded about the outlook.

"There is a significant tail risk that's growing for the world economy," said Sinai, chief executive officer of the New York-based consultant. He sees a 10 percent chance of a global recession triggered by escalating tensions between Russia and the U.S. and Europe over Ukraine.

The crisis in Crimea isn't the only concern financial markets must grapple with. On the lengthy list of what former U.S. Defense Secretary Donald Rumsfeld dubbed "known unknowns" are elections in some emerging markets starting with Turkey on March 30, the Syrian civil war and negotiations over Iran's nuclear program, which could be complicated by the U.S.-Russia standoff in eastern Europe.

Global investors are on the alert. The share of cash in their portfolios is the highest since July 2012, according to a March 7-13 survey by Bank of America Merrill Lynch of 241 fund managers who oversee $636 billion in assets.

Falling Stocks

U.S. stocks fell the past two days, erasing gains that sent the Standard & Poor's 500 Index to within three points of a record, on worries the situation in Ukraine may escalate after President Barack Obama said the international order is being tested.

Businesses also are becoming concerned. Seventy percent of 1,403 corporate executives polled by consultants McKinsey & Co. this month cited geopolitical tensions as a risk to global growth in the next year, up from 27 percent in December.

"Heaven knows, there's a lot of geopolitical events out there that may be, God forbid, that we'd get into some sort of war and some sort of large intervention event," Andrew Liveris, chief executive officer of Dow Chemical Co. (DOW), told analysts on a March 19 conference call. Midland, Michigan-based Dow is the largest U.S. chemical maker.

Central bankers and finance ministers will debate the potential economic fallout in Washington April 11-13 at spring meetings of the International Monetary Fund and World Bank.

Growth Forecast

El-Erian, chief economic adviser to Munich-based Allianz, said in an e-mail he is sticking with his prediction that worldwide growth will pick up this year. What's changed is a greater chance there won't be any acceleration, he said.

Fels and his team at New York-based Morgan Stanley agree, saying in a March 16 report that the risks to their forecast of 3.4 percent growth this year "are generally tilting to the downside." The world economy expanded 3 percent in 2013.

Those risks are centered on developing nations. The Morgan Stanley economists cited "volatility" from elections as a reason for cutting their forecast for emerging-market growth this year to 4.7 percent from 5 percent.

The biggest worry is Ukraine. Obama warned Russia on March 25 it would face the consequences of tougher sanctions if it encroaches further into the country. The U.S. and European Union already have frozen assets of Russian and Crimean officials in retaliation for Moscow's move.

Consolidated Control

Russia has consolidated control over Crimea and is maintaining forces along the border with Ukraine in what Obama said "appears to be an effort of intimidation." The confrontation between the two countries is the most serious since the Soviet Union collapsed more than two decades ago.

"It raises an unknown," said Russ Koesterich, chief investment strategist at New York-based BlackRock Inc., which manages $4.3 trillion in assets. "This may be a longer-term issue that doesn't significantly resolve itself in the next two to three months."

Russia today dismissed as "counter-productive" a United Nations resolution on its takeover of Crimea, while the IMF moved forward with a bailout to help Ukraine avoid insolvency.

Any ripple effects from the stand-off probably will hit Europe the hardest, according to Citigroup Inc. economists. European Union countries rely on Russia for 20 percent of their energy consumption, and their trade exposure to Ukraine and Russia has almost tripled in the past decade. Germany, the region's biggest economy, has strong links with neighbors in the east that have even closer ties with

Russia.

'Negative Impulse'

"A major crisis in Russia could impart a substantial negative impulse to the euro-area growth," Citigroup's Ebrahim Rahbari and colleagues said in a March 25 report.

Investors in the euro and European stock markets aren't paying enough attention to the dangers, said Bill O'Grady, chief market strategist at St. Louis-based Confluence Investment Management LLC, which oversees more than $2 billion in assets. The euro is little changed against the dollar since the start of the year, and the Stoxx 600 share index is up about 1 percent.

While the U.S. economy is less exposed than Europe to the fallout from the Crimea crisis, American companies with investments in Russia -- including General Electric Co. (GE) and Boeing Co. (BA) -- still could suffer if tensions escalate. Almost 100 chief executive officers with the Business Roundtable discussed their concerns last week in a Washington meeting with Defense Secretary Chuck Hagel.

Fragile Five

Among developing economies, elections are slated in each of the so-called fragile five countries: Brazil, India, Indonesia, Turkey and South Africa. They earned that moniker in 2013 after their markets swooned when Federal Reserve policy makers first began talking about scaling back their bond-buying program.

The geopolitical risk from the Ukraine crisis, "coupled with domestic uncertainty, is going to create a difficult period ahead for many of the emerging markets" in the run-up to their elections, said Eswar Prasad, a senior fellow at the Brookings Institution in Washington and a former IMF economist.

Countries with big current-account deficits may find it harder to attract foreign capital as investors unnerved by the crisis in Crimea "pull back to safety," he said.

In Turkey, local elections on March 30 are seen as a referendum on Prime Minister Recep Tayyip Erdogan, who is ensnared in a graft scandal and faces public anger after the death this month of a teenager hurt by police in anti-government protests last year.

Market Pressure

"There's more uncertainty about how exactly this will play out in the months ahead," said Charles Collyns, chief economist for the Institute of International Finance in Washington and a former U.S. Treasury official. "That concern has been reflected in the market pressure on Turkey in recent months."

While share prices have risen this week, the Borsa Istanbul 100 Index is still down 10 percent in the past six months.

Investors are betting on a better outcome in India, where voters go to the polls starting April 7. Foreigners have bought $8.8 billion of local shares and bonds this year, the highest among eight Asian markets tracked by Bloomberg. Prospects of a growth-galvanizing new government have helped push the S&P BSE Sensex index of shares to a record high on March 27 and driven up the rupee.

The confrontation between the U.S. and Russia over Crimea also is raising questions about what's ahead for the already volatile Middle East. In the Syrian civil war, Russia is backing President Bashar al-Assad, who Obama repeatedly has said needs to step down.

Nuclear Talks

The clash also may affect the Iran nuclear talks. Russia's delegate, Deputy Foreign Minister Sergei Ryabkov, said his country is prepared to use the negotiations as part of "retaliatory measures" against the U.S. and Europe, according to comments reported by the Interfax news agency this month.

The talks are aimed at reaching a final accord to limit the scope of Iran's nuclear program in return for lifting sanctions against the Islamic republic. Iran has said it has no intention of building a nuclear bomb. The U.S. and Israel have warned they're ready to use military force to prevent it from doing so.

Taken individually, the geopolitical shocks buffeting financial markets have been small, El-Erian said. In aggregate though, they are encompassing a more substantial part of the global economy and may be building toward a tipping point.

Nariman Behravesh, chief economist for IHS Inc. in Lexington, Massachusetts, said the outlook for stronger growth worldwide this year is pegged to the U.S. and Europe doing better and emerging economies "at least not getting worse." The projected improvement is helping to keep markets "calmer" than they perhaps would be otherwise, he said.

His hope is the Ukraine crisis will have a limited spillover, though "the risks are more to the downside," Behravesh said. "There are now more unknowables in some sense. The uncertainty has gotten bigger."

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