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A Shaky Equilibrium in Ukraine

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Since the publication of our Ukraine crisis briefing memo in late January, the most significant development was the signing of the February 12 Minsk-II cease-fire agreement by Russian president Vladimir Putin, Ukrainian president Petro Poroshenko, German chancellor Angela Merkel, and French president François Hollande. The Minsk-II deal called for each side to abide by a bilateral cease-fire monitored by the Organization for Security and Cooperation in Europe (OSCE), withdraw heavy weaponry from the line of contact, and remove all foreign armed groups, weapons, and mercenaries from the territory of Ukraine. Minsk-II also addressed broader political concerns, committing Kyiv to a political dialogue with the separatist-held regions in Donetsk and Luhansk *oblasts* (in particular on the issue of local elections) and a broader constitutional reform within Ukraine by the end of the year, which would address the issues of decentralization and special status for the separatist-held areas. While there have been numerous reported violations from both sides, for now the cease-fire continues to hold.

International observers, including those in the U.S. government, have expressed concern that the pro-Russian separatists, with support from the regular Russian military, are using the lull to build up capabilities for a renewed offensive, perhaps in the direction of the Black Sea port of Mariupol, which is the most important piece of real estate between rebel-held positions in eastern Ukraine and the Russian-occupied Crimean Peninsula. Another possibility is for the rebels and their Russian backers to turn their sights on Russian-speaking areas of eastern Ukraine that have so far remained loyal to Kyiv, namely the cities of Dnipropetrovsk and/or Kharkiv with their surrounding *oblasts*.

The Minsk-II agreement allowed the rebel side to consolidate the gains made during the winter. It also represents probably the maximum level of concessions the rebels will be able to get from this, or any, Ukrainian government that has not suffered a crushing military defeat, one the rebels would be unable to achieve without the open participation of Russian military forces. Such direct Russian intervention would nonetheless be fraught with peril for Moscow as well, given the probable Western response. Russia appears likely to pursue this course of action only if it judges that abiding by the Minsk-II agreement is not allowing it to attain even its minimum objectives of keeping Ukraine weak, divided, and isolated from the West.

From discussions in Moscow with officials and experts earlier this month, we are now cautiously optimistic about the chances for the Minsk-II agreement to hold. For one, a major offensive on Mariupol, a city of 500,000, would be militarily very challenging for the insurgents and cause tremendous collateral damage, which would in turn galvanize Western support for deeper sanctions and military assistance to the Ukrainian government.

A renewed rebel offensive toward Mariupol or elsewhere would signify the total breakdown of Minsk-II and, with it, much of what remains of cooperation between Russia and the West. There would be no Minsk-III agreement. Both the United States and the European Union would impose tougher economic sanctions, and the Obama administration would likely capitulate to pressure to begin providing lethal military assistance to Kyiv, a prospect that played at least some role in Moscow's willingness to accept the Minsk-II agreement in the first place. The dangers of major escalation of the conflict would increase, the impact on the Russian economy would be greater, and any chance of near-term normalization of Moscow's ties with Europe and the United States would be shattered. In sum, by authorizing a renewed offensive, Russia would be courting serious risk for highly uncertain reward.

One major risk Russia faces is continued deterioration of the economy. The Russian economy appears to have at least stabilized after the panic in currency and financial markets at the end of 2014, but the challenges remain steep. Russia is now in deep recession, with a likely economic contraction of up to 5 percent in 2015. Despite this negative growth, annual inflation has more than doubled to 16.9 percent and continues rising. High interest rates have failed to stem inflation, but they have crimped lending and contributed to the economic slowdown. At the same time, Western lending has declined because of sanctions and the perception of greater political and economic risk. Without access to Western financial markets, more Russian companies are being forced to deleverage. While this deleveraging will be painful in the short term, ultimately it could leave them with stronger balance sheets, though several firms will need state support to pay down their debts.

The devaluation of the ruble since the start of the crisis in Ukraine meanwhile helps in maintaining budget balance and lowers Russian manufacturing and production costs, even in the oil and gas sectors. Altogether the ruble has appreciated by 16.63 percent since the beginning of the year, and Russian stock indices have also recovered more than 10 percent the currency is still down from around 30 rubles to the dollar before the crisis to around 52 to the dollar today. Although Russia has burned through more than $150 billion in foreign exchange in little more than one year since the annexation of Crimea (much of it in a futile bid to prop up the ruble in 2014), and is now left with less than $360 billion, concerted government policy to conserve reserves has significantly slowed the rate of decline. Despite the recession and higher inflation, today there is a greater sense that the Russian economy can endure this situation for at least two years.

In sum, the current difficulties are generally manageable, but another major external shock, such as a renewed collapse of oil prices or imposition of much harsher sanctions, may deeply destabilize Russian markets and create more near-term social and political challenges. Again, this leaves us with very cautious optimism that Russian authorities will find it in their interests to maintain the current shaky equilibrium on the battlefield in Ukraine.

On the Ukrainian side, the incentives to pursue peace rather than war became clear in late August 2014 when the Russians escalated their indirect and direct military support for the insurgents, resulting in a major military defeat for Ukrainian government forces around the town of Ilovaisk. This defeat, combined with the absence of anything more than rhetorical support for Kyiv coming out of the September NATO summit in Wales, provided clear proof that Ukrainian forces could not resolve the conflict with the rebels militarily. Meanwhile, the near catastrophic condition of the Ukrainian economy, exacerbated by increased expenditures to support the war, also pushed Kyiv to take a more accommodating stance. Poroshenko consequently agreed to scale back the "antiterrorist operation" (ATO) and seek a negotiated settlement, leading to the first Minsk agreement (Minsk-I) in September. That agreement failed to hold, however, and the rebels pushed to secure a more defensible perimeter, culminating in the capture of the major rail hub of Debaltseve in February 2015, just before the Minsk-II agreement came into effect.

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As bad as these military setbacks have been, Ukraine's greatest challenges are economic. On March 11, the IMF approved a $17.5 billion Extended Fund Facility Program to help Ukraine meet its short-term financial commitments, while providing a window of opportunity to tackle its deeper structural problems. The first disbursement of $5 billion was transferred on March 13, half of which immediately went to replenish the Central Bank's foreign reserves, which had fallen to less than $6 billion. The IMF will carry out quarterly reviews to monitor how Ukraine is proceeding in the implementation of the reform program it agreed to as a condition of the loan package, including extremely sensitive issues such as energy price reform and anticorruption measures. Another condition for the release of further funds is that Minsk-II is viewed as holding. Given the importance of the IMF package for staving off economic collapse, not to mention the inability to defeat the rebels militarily, Kyiv too has a strong incentive to keep the cease-fire in place.

Though both Moscow and Kyiv would be best served by maintaining Minsk-II, plenty of potential spoilers exist. One, there are military operatives on the ground not fully subject to the will of either Kyiv or Moscow. These include nationalist militia on the Ukrainian government side and various armed formations connected with the so-called people's republics on the rebel side. Not all of these groups view peace as useful for their personal and institutional interests.

More worrisome are questions about the balance of power within the Kremlin itself. Despite a well-maintained façade of unity within the Russian elite, the conflict in Ukraine and the resultant tensions with the West have created new uncertainty in Moscow. The murder of oppositionist Boris Nemtsov in late February was a red flag in this regard. It appears quite unlikely that Putin himself would order the murder of such a high-profile but politically marginal figure, particularly just outside the walls of the Kremlin. Russian press reports point to a behind-the-scenes struggle involving various factions of the security services, as well as forces loyal to Chechen leader Ramzan Kadyrov. Putin's 11-day disappearance from public view just after the Nemtsov murder heightened concern among Russian political and economic elites that Russia's "managed democracy" was becoming less and less manageable. This political uncertainty raises the likelihood of hardline forces in the Kremlin using the Ukraine conflict as a means of advancing their own political interests (as Putin used the conflict in Chechnya to facilitate his own rise to power in 1999–2000), as well as of Moscow simply losing control over the rebel groups in eastern Ukraine.

Assuming the Minsk-II agreement holds into the summer, the unity of the West on sanctioning the Russian economy will be tested. The tougher European sanctions are due to expire in July, although EU leaders made clear recently that the duration of sanctions will be directly tied to the implementation of the Minsk agreement, which is slated to run until the end of 2015. Even so, maintaining consensus will be difficult absent renewed provocations, particularly given Russian efforts to peel off individual European governments (notably Cyprus, Greece, and Hungary) through offers of financial assistance ahead of the EU June summit, when a vote on extending sanctions will be taken. The Japanese government, meanwhile, remains very keen to reengage with Russia for broader strategic and economic reasons and hopes Putin will participate in a summit meeting with Prime Minister Shinzo Abe in the fall. The Obama administration though shows little inclination to remove sanctions or to more clearly define when this might happen, assuming Minsk-II continues to hold.

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Russia's smartest move, then, would be to avoid any aggressive maneuvers that could reinvigorate the consensus for sanctions, while allowing Ukraine's own political and economic weaknesses to undermine support for Poroshenko and for further integration with the West. At the same time, Ukraine remains extremely vulnerable and dependent on the goodwill (and cash) of the West to maintain stability. Cooler heads in both Moscow and Kyiv should favor keeping Minsk-II alive. Unfortunately though, leaders on all sides have shown a proclivity for recklessness at different points throughout the crisis.

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