Longview Point of View: Outlook for Ukraine and Russia
September 15, 2014

As the West and Russia engage in a sanctions war, the conflict in Ukraine goes unresolved. But, the situation could calm in the coming months. We present a view on paths forward.

Key drivers

• The West is driven by idealism, leading it to take the moral high ground and ratchet up sanctions as the conflict in Ukraine has intensified. But Ukraine is not a core interest.

• Russia is fighting for what its leadership perceives to be a core national interest: having a neutral neighbor in Ukraine. Sanctions won’t convince Moscow to change course.

• In the coming months, this costly stand-off likely will settle into a “frozen conflict” with some level of autonomy for eastern Ukraine. Sanctions gradually will be dialed back.

Signposts to watch, questions to ask

• Truce. Kiev has little option but to sue for peace. Does the ceasefire hold? Does Moscow give the rebels in Ukraine latitude to keep the situation unsettled? How far does Russia push into Ukrainian territory before it halts its advance?

• Frozen conflict. Russia is highly incentivized to keep meddling to maintain leverage over Kiev. Does Kiev have the will to strike a grand bargain with the Kremlin over control? How long does the EU stay engaged and focused on a resolution?

• Getting back to business. Western firms are keen to get back to business as soon as possible. But the Russian economy has taken a hit and trust on both sides has eroded. Russia will not quickly revert to trend unless Moscow takes some bold steps to reform.

The situation in Russia

Western sanctions have had a significant impact on Russia’s economy.

• The ruble is down 16% YTD and this has pushed up inflation (7.6% in August). The Russian Central Bank pegged 1H14 capital flight at about $75 billion—substantially more than in all of 2013. It has raised interest rates three times in 2014 (to 8%) to stem capital flight and contain inflation.

• Russian corporates depend on foreign capital for about half of their borrowing needs. An estimated $157 billion is coming due before the end of 2014, but capital-raising in the West has been all but frozen since the crisis began. The Russian government has said it and (it hopes) Asian and Middle Eastern lenders will come to the rescue. Rosneft, for example, has appealed to the Russian government for a soft loan of $40 billion.

• All of these factors are hurting consumer sentiment—an important driver of growth over the past decade. For illustration, car sales in Russia plummeted 17 percent in 1H14.

In recognition of this situation, the IMF has twice downgraded its 2014 Russia growth outlook to 0.2%. The Russian government is forecasting 0.5% growth.
The sanctions, however, are not having the intended impact on policy. With Russian troops and heavy weaponry now in eastern Ukraine, we believe that this escalation signals Moscow’s intent to assert control for the long term. Unlike in Crimea, Russian historical claims and boundaries in eastern Ukraine are not clear. At this point, it’s not obvious what territory or assets President Putin seeks to control, but fears of a new Russian empire likely are overblown.

At a minimum, Putin seeks to hold hostage Ukraine’s economic recovery, keep Kiev off-balance, and foreclose the possibility of Ukraine joining NATO or the EU. Accordingly, we do not foresee a return to the military or political status quo ante. Restoring once-deep economic and cultural ties between Russia and Ukraine will be slow and difficult as well.

The position of the West

While the West has taken the high moral ground, it has not backed up its sentiment with decisive support on the ground. At their summit in Wales, the NATO allies sent a clear message: They will not be coming to Ukraine’s rescue. Rather, they focused on defending front-line member nations through the formation of a rapid deployment force. Poroshenko’s disappointment was palpable: The meeting curtailed Kiev’s strategic flexibility and likely contributed to the president’s motivation to seek a ceasefire.

The Kremlin’s unpredictable behavior, the ruse of Russian non-involvement, and the Kremlin’s scorching information warfare campaign have eroded trust in the West in Putin and his willingness to follow-up on his commitments. While sanctions have jolted the Western business community, interest in the Russian market persists and East-West business relationships remain intact.

Scenarios for Ukraine

Ukrainian military setbacks, rising casualties, a moribund economy, and the absence of Western support, will make many Ukrainians weary of sustained warfare. Moreover, autumn is in the air and they soon will be turning on the heat, and for this, they need Russian gas. We see several possible outcomes for Ukraine, most of which are grim, in the near term.

1. **Frozen conflict (60% probability)** The current ceasefire takes hold, but grievances aren’t resolved. Under the banner of restoring law-and-order, Moscow maintains *de facto* control, creating a “militarized demilitarized zone” akin to what evolved in Transnistria (Moldova) in 1992 and in South Ossetia and Abkhazia (Georgia) in 2008. The region’s indeterminate status renders it a black-market backwater that is rewarding for friends of the Kremlin while the population relies on Moscow’s financial support. The situation generates long-term economic and political uncertainty for Kiev.

2. **Quebec (20%)** Kiev and the West are hoping for a negotiated resolution. This would include Kiev agreeing to give regions with a large Russian population significant economic, political, and cultural autonomy—akin to what Quebec achieved in the 1970s. While Russia has advocated for this solution, the Kremlin probably would continue to stir antagonisms in Ukraine and Poroshenko would have difficulty governing an unruly confederation. Moreover, Ukraine would have to raise massive funds for rebuilding and cease efforts to align with NATO and the EU—a policy direction Kiev committed to after the recent revolution and presidential elections.
3. **Crimea 2.0 (10%)** After gaining *de facto* military control with the help of Moscow, the locals vote again for independence and transferring contested territory to the Russian Federation. Moscow takes *de jure* control and initiates a large-scale rebuilding program akin to its efforts in Chechnya and Crimea. Friends of the Kremlin benefit tremendously from government largesse, but recovery and integration go slowly and the whole project proves to be very costly for Moscow. The West, in pique, extends sanctions.

4. **Cauterization (10%)** After coming to power in 1918, the Bolsheviks ended Russia’s disastrous involvement in World War I by negotiating a harsh peace with Germany that sacrificed Russia’s western lands. President Poroshenko could take this well-known page from the region’s history and do the same. Such a move would be very costly politically for Poroshenko, as many Ukrainians (dubbed the Party of War) still want their leadership to take a firm position against Moscow.

Once the military conflict on the ground eases, European and American policymakers are likely to turn their attention to other pressing matters, such as the Middle East, thus increasing the likelihood that eastern Ukraine defaults to a frozen conflict. Ultimately, the message being sent by the West to Kiev is that Ukraine needs to find a way to co-exist and trade with its imposing neighbor, just as Finland did after World War II.

**Outlook for business**

Russia remains an attractive long-term business bet, given the country’s energy and natural resource endowments, its large consumer class,. Russia wants Western technology and know-how, financial services, and consumer goods. While the Kremlin is trying to execute a pivot to Asia, Russia’s natural trading partners largely are in the West.

In the near-term, nerves will remain raw: The US and EU significantly ratcheted up sanctions on September 12, and Russia will retaliate with countermeasures. But, we expect Ukraine will need to sue for peace soon and European policymakers will start to dial back sanctions once they see signs of a credible truce. For reference, it took about two years for cross-border business activity with China to normalize after the 1989 Tiananmen Square crackdown and we believe this timeframe fits the case in Russia as well.

Even when sanctions are lifted, Russia is unlikely to recover quickly.

- Growth in the Russian economy slowed over the past several years thanks to waning global energy prices; a challenging regulatory environment; an aging infrastructure and technology base; cutbacks in government spending; and growing consumer indebtedness. Oil prices look set to continue their downward drift, and a ruble rebound would hurt Russia’s competitiveness.

- Geopolitics has diverted Russian policymakers’ attention from necessary policy reforms to tackle the country’s woes and attract FDI. If anything, Russia’s economy will be managed more tightly by the Kremlin and its anti-Western cronies in the coming years.

- For many Western business leaders and investors, Russia has never been a must-have market. Their heightened risk perceptions won’t be unwound quickly, especially in an era when they are looking at emerging markets with more skeptical eyes.

In July, the IMF forecasted that Russian economy would grow 1% in 2015. This looks optimistic, the longer the conflict and sanctions continue.