

## Special Report on Ukraine Crisis

### A New Cold War?

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### The Collapse of the Soviet Empire

Fears of a new Cold War have been vastly overblown. The Cold War, which lasted from the end of WW II to the fall of the Berlin Wall in 1989, featured two formidable military alliances engaged in a titanic struggle between capitalism and communism. Even though Western powers held a significant technological edge on the military front, the Soviet Union and the Warsaw Pact had numerical superiority in ground troops, tanks and combat aircraft – thereby creating “equilibrium of terror.”

As the eastern European satellite countries moved out of the Soviet orbit, and former Soviet republics became independent, Russian military power collapsed, and a U.S.-dominated unipolar world emerged. Today, Russia is no match for NATO, and would be incapable of sustaining a military confrontation with Western powers. Meanwhile, the economic and geopolitical rise of China poses a growing threat to resource-rich and sparsely-populated eastern Russia, and a tenacious Islamist terrorist movement poses serious security challenges to the Russian state.

## The Soviet Union and the Warsaw Pact in 1986: a Credible Power

1986	WEST		EAST		
	U.S.	TOTAL NATO	TOTAL EAST	WARSAW PACT	SOVIET UNION
Population	241 million	<b>642 million</b>	<b>393 million</b>	114 million	280 million
Armed forces	2.1 million	<b>5.5 million</b>	<b>6.4 million</b>	1.2 million	5.1 million
Reserves	1.7 million	<b>7.4 million</b>	<b>8.3 million</b>	2 million	6.3 million
Tanks	14,300	<b>32,700</b>	<b>69,000</b>	14,500	54,500
Combat aircraft	7,200	<b>11,100</b>	<b>11,300</b>	2,300	11,400
Nuclear weapons	23,317	<b>24,094*</b>	<b>45,000</b>	0	45,000

\*Includes 777 from Britain and France      Note: Estimated totals may not add up due to rounding.

Source: The International Institute for Strategic Studies & *The Washington Post*, March 2014

## Russia in 2014: A Declining Regional Power in Europe

2014	U.S.	TOTAL NATO	RUSSIA
Population	317 million	<b>917 million</b>	<b>142.5 million</b>
Armed forces	1.5 million	<b>3.6 million</b>	<b>800,000</b>
Reserves	840,000	<b>2.4 million</b>	<b>2 million</b>
Tanks	2,300	<b>7,500</b>	<b>2,750</b>
Combat aircraft	3,500	<b>5,900</b>	<b>1,571</b>
Nuclear weapons	5,000	<b>5,325*</b>	<b>12,000</b>

\*Includes 325 from Britain and France

Source: The International Institute for Strategic Studies & *The Washington Post*, March 2014

## Russia: Economic Stagnation and Weak Fundamentals

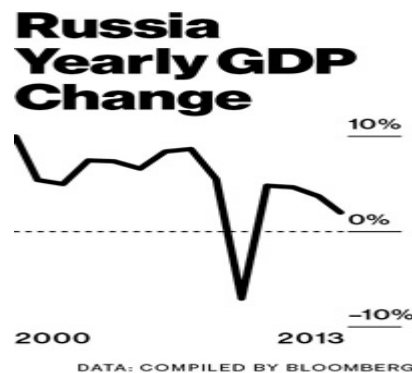
Economic stagnation was a major cause of the collapse of the Soviet Union. The decade which followed was marked by economic chaos and hardship for the Russian people. Western promises to Gorbachev and Yeltsin to help smooth the transition towards capitalism were largely unkept.

From 2000 to 2010, as a result of freed private enterprise, spare capacity from the Soviet era and unprecedented oil exports (and prices), GDP grew at a 7% average annual pace. While the decade witnessed meaningful increases in disposable income and living standards, and helped usher in a period of political stability, the economic growth was

largely artificial, and mostly unsustainable. Few investments were made in factories, equipment and new technologies (including the oil and gas sector). The education and healthcare systems were also allowed to deteriorate. As a result of its inefficient industrial structure, Russia cannot compete with the developed economies, where productivity is higher, or the emerging economies, which have lower wages and manufacturing costs.

Within the state apparatus, high levels of cronyism and corruption, bureaucratic inefficiencies, bloated salaries for officials and the continued dominance of public corporations, mostly notably in the natural resource, banking, media and infrastructure sectors, have provided additional obstacles to economic growth.

Not surprisingly, the GDP faltered in recent years, falling from 3.4% in 2012 to 1.3% in 2013. For 2014, growth is expected to stagnate, and the current confrontation over Ukraine could push Russia into a recession. In the first three months of 2014, capital outflows reached \$70 billion, up from \$63 billion for the whole of 2013. Perhaps Russia's greatest vulnerability going forward is its extreme dependence on oil and gas – which account for 75% of all exports and 50% of budget revenues. In 2005, a balanced budget required an oil price of \$20 per barrel. Today, the equilibrium point is at \$110 per barrel. For Russia, using natural gas or oil as geopolitical weapons is very much a double-edged sword.



Date: April 2014

At the internal political level, the repression of opposition groups, the absence of a free media and independent judiciary, growing demands for decentralization and a faltering economy have weighed on President Putin's popularity. While events in Ukraine have allowed Putin's popularity to reach a new high recently, the spike could prove ephemeral and fragile.

Russia also faces a daunting demographic challenge. The labour force has been shrinking since 2009. One million people have been retiring every year, and pension payouts have grown at an average of 25% a year within the last five years, creating a medium-term threat to the federal budget. In 2000, the fertility rate dropped to a low of 1.2. It recently rebounded to 1.7, still well below the replacement level.

## The World According to Russia: Betrayal and Paranoia

Most Russians believe that the collapse of the Soviet Union has exacerbated their geopolitical and economic decline, and that the United States and Western Europe used the fall of the USSR as an opportunity to convince former Soviet satellite countries in Eastern Europe and some former Soviet republics (including Latvia, Estonia and Lithuania) to join NATO and build up military forces on its periphery. They also believe that the West continues to actively undermine pro-Russian regimes, including Ukraine, Moldova and Georgia. President Putin, finally, is convinced that the ultimate goal of Western efforts is to provoke regime change in Russia itself.

Combined with the meteoric rise of China to the east, it should come as no surprise that Russia has become a paranoid, fearful and frustrated power, and that it has been an easy prey for President Putin’s nationalist revival.

## Why is Russia Paranoid?



Importantly, the nostalgia for the former Soviet Union runs deep and extends to many former Soviet republics. According to a Gallup poll taken in 2013, residents of 11 out of 15 former Soviet republics perceived the 1991 breakup of the Soviet Union as “harmful” rather than “beneficial” to their home country. Only Turkmenistan, Kazakhstan, Georgia and Azerbaijan though it was “beneficial.” In Russia, 55% thought it was “harmful” (vs. 19% “beneficial”) and in Ukraine, the numbers were 55% and 23%, respectively.



In order to counterbalance the influence of the EU and protect its periphery, Russia has created a customs union which will be called the Eurasian Economic Community starting next year, representing only 3% of global GDP, compared with 25% for the EU. Current members include Belarus, Armenia and Kazakhstan. Thus far, the EU has rejected the possibility of a country joining both the Customs Union and the EU. The economic crisis in the eurozone coupled with significant economic ties to Russia will deter a number of European countries, including Serbia and Slovakia, from joining the EU.

## Ukraine: A Deeply Divided Country on Russia’s Security Perimeter and the Risks of Escalation

From the Russian perspective, the geostrategic importance of Ukraine cannot be overestimated. It is one of the key “buffer countries” – along with Belarus – which separates Russia from Europe. The prospect of Ukraine leaving the Russian orbit and joining the EU, and particularly NATO, is perceived as inimical to Russia’s national interests. NATO troops and missiles on the security perimeter are no more acceptable than Russian missiles were for the United States during the Cuban missile crisis in 1962. It therefore should come as no surprise that Russia will continue to put substantial efforts in preventing the emergence of a pro-Western Ukraine.

Contrary to what some analysts have argued, Ukraine is deeply divided along largely overlapping political and ethnic lines. An important percentage of the population is Russian and concentrated in the east of the country. This includes the regions of Donetsk and Luhansk, which are currently witnessing the strongest opposition to the new government in Kiev. Many ethnic Russians reject the legitimacy of the interim government in Kiev, claiming it came to power as a result of a Western-instigated coup.



Source: *The Washington Post*, Jan. 30, 2014

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In a poll conducted in February 2014 (see map below), when asked if they would prefer to join the EU or the Russian-led Customs Union, an overwhelming majority of the population from the east and south of the country favoured the Custom Union, whereas a large majority in the centre and west opted for the EU.



The Presidential election in 2010 which brought former President Yanukovich to power also demonstrated deep political divisions among Ukrainians. In this light, it is simplistic to view the current tensions in the eastern regions of Donetsk, Luhansk and Kharkiv as principally the actions of paid Russian agitators. The divisions in the country are real, the concerns in the eastern region are legitimate and a political compromise is necessary. All indications are that eastern Ukrainians are prepared to accept a solution that would include a more federal structure of government, additional decentralization and protections for the Russian language, rather than outright separation and annexation with Russia. A Ukrainian military offensive and harsh repression of protesters in the east would almost certainly lead to a violent confrontation and backlash from the local population, and could draw in the Russian army.

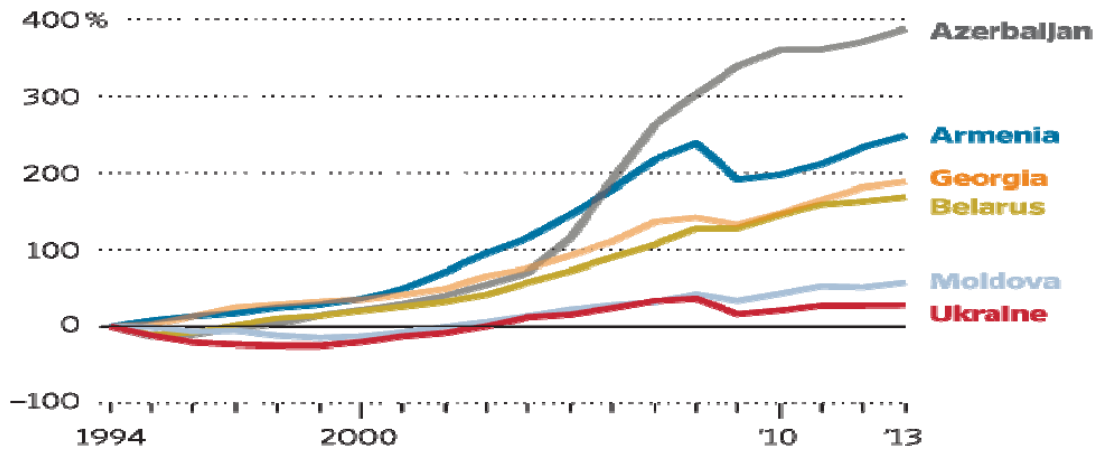
An invasion of eastern Ukraine, however, would present high risk for Russia. Contrary to Crimea, a significant part of the population would resist the invasion, potentially leading to a civil war in the region, and military confrontation with the Ukraine army. Debilitating economic sanctions would follow, along with a trade war inflicting damage to Russia and its trading partners.

In our view, Russia is convinced that time is on its side, and that Ukraine will be unable to achieve socio-political stability and economic growth without its active support. It is also convinced that a military intervention would provoke a powerful anti-Russian backlash among a majority of Ukrainians. Finally, Russia does not believe that the United States and the E.U are prepared to devote the massive financial resources required to stabilize Ukraine for the long term.

## Weak and Dependant Economy Underlines Ukraine's Vulnerability

While the immediate trigger to the overthrow of Yanukovich was his refusal to sign a trade deal with the EU, the "revolution" in February 2014 was fuelled by a weak economy, and a corrupt and authoritarian government. GDP per capita (\$7,000 in 2013 PPP terms) remains stuck at the 1989 level when the Soviet Union collapsed.

### CHANGE IN GDP SINCE 1994



Source: *The Wall Street Journal*, March 2014

A quarter of the population lives under the poverty line. In recent years, Ukraine has been hit by plunging global demand for its exports of steel and capital goods, including industrial machinery, and its GDP growth has remained stagnant (0.2% in 2012 and 0.4% in 2013). It is estimated that 50% of activity is generated by the shadow economy and much of its industrial sector is globally uncompetitive. High debt levels - much of which is denominated in foreign currencies - have become unsustainable as a result of the sharp devaluation of the currency, and the inability of successive governments to implement reforms and stem corruption.

The Ukrainian economy is largely dependant on its immediate neighbours. Sixty percent of its exports go to the former Soviet Republics, including 30% to Russia. The country has also relied heavily on deeply discounted natural gas prices from Russia, and has provided massive subsidies to Ukrainian consumers – who currently pay only 20% of the wholesale price of natural gas. In December 2013, President Putin and Yanukovich agreed to a \$15 billion aid package from Russia in the form of loans and lower gas prices. The aid was later withdrawn and replaced by an IMF assistance package of some \$14-\$18 billion on March 17. Ukraine has an urgent need for further financial assistance. About \$60 billion in private and public sector debt is coming due in the next 12 months (mostly in foreign currencies). The government only has \$12 billion in foreign currency reserves.

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The upcoming Presidential election on May 25 is likely to bring to power a pro-Western government. The new government will be facing formidable challenges. It will need to make unpopular decisions on subsidies, tariffs and social programs (some of which are mandated by the IMF). The cooperation of the powerful oligarchs – 50 of whom control half of the country’s GDP – is also essential for stability. Most importantly, the government will need to heal the divisions and restore national unity by creating a truly representative government. All of this comes at a time when the annexation of Crimea has given rise to anti-Russian nationalism, and where Russian ethnic minorities feel threatened by events unfolding in the country.

**In the aftermath of the election, Ukraine will remain highly vulnerable to Russian efforts to destabilize its government and economy, including trade sanctions, energy supplies and funding of opposition groups.**

## **The End Game: Towards a Negotiated Settlement?**

**Tensions in Ukraine and in the rest of the Russian periphery can be expected to continue for the foreseeable future. The fear that the annexation of Crimea is the first step in a Russian political and military offensive to take over other regions in Ukraine or in the former Soviet Republics is overblown.** Beyond the Cold War nostalgia, media frenzy and desire of the militaries in Western and Eastern Europe to revitalize NATO and boost defence spending, there are few reasons to believe that the world is on the verge of a major military confrontation or a new Cold War on multiple fronts.

The annexation of Crimea is above all a testimony to Russia’s weakness. Crimea is the weakest link in Ukraine, which required a low-risk, low-cost action to protect Russian military and trade interests on the Black Sea (Sevastopol), and its credibility in the region. Crimea is also unique: it has special status as an autonomous region in Ukraine; it has had deep historical and political ties with Russia since 1783; in a controversial decision, it was “gifted” by former President Khrushchev to Ukraine in 1954; it is inhabited by a large majority of ethnic Russians (60% of a population of two million); Russian soldiers were already on the ground on a permanent basis; the local economy is highly dependent on Russian military installations, and, most importantly, an overwhelming majority of Crimeans favoured annexation to Russia.

There has been much speculation that Russia would seek to pull back in its orbit other former Soviet Republics. This appears highly unlikely. The Baltics are often mentioned because Estonia and Latvia’s population are 25% ethnic Russian. Aside from the fact they are members of NATO, Russian attempts to stir discontent among minorities or undermine trading relationships (particularly in the energy sector) would almost certainly backfire, and alienate the overwhelming majority of their populations. While pushing for the rights of ethnic Russians in former republics could prove disruptive, it poses no systemic threat to the countries involved.



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A negotiated settlement on the future of Ukraine will take time to achieve, and uncertainty will continue to affect Russian markets, the ruble and foreign companies operating in Russia. An eventual compromise will require the “military neutrality” (i.e., no membership in NATO) of Ukraine, and economic relations with both the EU and Russia (a status which some have called “Finlandization”). A more decentralized federal system of government in Ukraine, which would empower the regions dominated by ethnic Russians, and perhaps impede the full integration of Ukraine into the EU is also likely. Clearly, a negotiated solution is in the best interests of the West, Russia and Ukraine itself.

An escalation of sanctions and trade embargos would be highly detrimental to Russia and the EU, whose trade relations have increased markedly in the last decade. Europeans, particularly the Germans, have shown little interest in applying sanctions that would hurt their economies and could eventually impact the availability and price of natural gas coming from Russia. Similarly, the Russians - whose economy is weak and vulnerable - will be reluctant to jeopardize natural gas revenues from Europe and their credibility as a reliable long-term supplier. Cutting off supplies to Europe (which gets 33% of its natural gas from Russia) would ultimately prove self-destructive. The loss of Western FDI would also inflict severe damage to the Russian economy.

**Russia will, of course, continue to attempt to destabilize Ukraine in the hopes of deterring its former Republic from becoming a close ally of the West. A further military incursion appears unlikely, however. Over the years, Russian actions in Georgia and Moldova have achieved only modest results, and along with the annexation of Crimea, herald the decline of an empire rather than a Russian resurgence. Overall, while the risks of miscalculation should never be underestimated, the path of least resistance remains a negotiated settlement of the crisis.**

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