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Russia, Ukraine, and U.S. Policy Options: A Briefing Memo

Jeffrey Mankoff and Andrew Kuchins

Ukraine's crisis has continued escalating since former president Viktor Yanukovich announced his decision to cancel the planned signing of an association agreement with the European Union in November 2013. Over the subsequent 15 months, what began as a debate over a relatively arcane trade deal descended into revolution, a Russian invasion, and a civil war in eastern Ukraine. Despite wholesale political change in Ukraine, repeated diplomatic initiatives, and billions of dollars in foreign assistance, the crisis shows no signs of ending. The effects of the crisis have also rippled across Europe, and across the Atlantic. Relations between the United States and its European allies on the one hand and Russia on the other have plummeted to levels not seen since the Cold War.

Russia too has suffered badly from the crisis. Sanctions, coupled with a precipitous decline in oil prices over the past several months, and poor economic policy have combined to plunge the Russian economy into stagflation, even as Russia's military intervention in Ukraine has left Moscow isolated internationally. In all likelihood, Moscow miscalculated the galvanizing effect its actions would have on the West, along with the ability of the United States and European Union to maintain a unified front on sanctions even in the face of continued economic weakness in Europe. Professional economists and the business community have urged President Vladimir Putin to reach a negotiated end to the crisis, but Putin has systematically excluded these voices from decisionmaking, relying on an ever-shrinking circle of security service veterans. While Putin has enjoyed a huge boost in his approval ratings since the initial Russian push into Crimea in February 2014, the economic crisis and a growing unwillingness to hear bad news have made Kremlin policymaking increasingly erratic, injecting a high degree of uncertainty into Russia's future development.

Russia

Russia is facing its own economic and political crisis, which is intimately linked to the conflict in Ukraine, but at the same time also reflects the fundamental weaknesses of Russia's own economy, including the failure of Putin's Kremlin to reduce dependence on natural resource exports during his tenure in power. Russia's economic problems began even before the United States and European Union imposed sanctions in response to the February 2014 annexation of Crimea. For now, the most likely course for Russia is continued economic decline, with the main uncertainty centered on the effects that the economic crisis will have on both Russian actions in Ukraine and on domestic stability.

Russia's economic troubles are likely to continue because they have more to do with structural weaknesses than sanctions or the conflict in Ukraine. Capital flight from Russia was already around \$61 billion in 2013, and more than \$48 billion just in the first quarter of 2014 (the total figure for 2014 ended up being around \$151 billion). This capital outflow reflected investors' concerns that the business climate in Russia was deteriorating and Russian politics becoming more unpredictable. With the state's share of the economy expanding rapidly since Putin's return to the Kremlin in 2012, private investment has been increasingly crowded out, while inefficient state monopolies have failed to invest efficiently in new production and have become a drain on the state budget and reserves. Meanwhile, the arrest of oligarch Vladimir Yevtushenkov in September 2014 and subsequent nationalization of his Bashneft oil company, despite Yevtushenkov's efforts to stay out of politics, sent shockwaves through the business community.

On top of these structural challenges, the collapse of oil prices during the second half of 2014 was extremely damaging for the Russian economy. The Russian government derives more than 50 percent of its budget from oil revenues, and under the three-year budget passed in 2014, Russia needs oil prices around \$100 per barrel for its budget to balance. If oil averages \$50 per barrel in 2015, the Russian Finance Ministry estimates that budget revenues will fall by \$45 billion.

Lower oil prices have also placed substantial pressure on the ruble, which has fallen from around 29 to the dollar in early 2014 to around 67 to the dollar in late January 2015—with tremendous volatility since mid-December especially. This currency collapse has dramatically raised the price of imports and suppressed demand, contributing to the overall economic slowdown. The Kremlin spent \$76 billion from its reserves to prop up the ruble in 2014 and an additional \$1.3 billion in January 2015. Russia's stock of foreign reserves, built up over a decade on the back of high oil prices, plunged from about \$500 billion at the start of 2014 to \$388.5 billion at the end of the year and has continued falling into early 2015.

Sanctions have played a role in Russia's economic difficulties but are not the key factor. Energy sanctions prohibit Western financial institutions from providing long-term loans to Russian energy majors and prohibit the export of technology for new production in deep water, Arctic offshore, or shale projects. Though Moscow has sought financing and technology from other sources, above all China, it remains unable to compensate, and sustained sanctions would seriously limit Russia's ability to maintain—much less expand—oil production for the foreseeable future. Financial sanctions meanwhile have increasingly cut Russia off from global financial flows. Russian banks unable to roll over their loans on international markets have turned to the government for bailouts, forcing the Kremlin to dig deeper into its reserves to keep the banks afloat. These financing difficulties, along with a plummeting currency and high inflation are further damaging Russia's investment climate; in late January 2015, ratings agency Standard & Poor's downgraded Russian sovereign debt to junk status. With the combination of structural impediments, lower oil prices, and sanctions, the World Bank estimates that Russia's economy will now contract by around 2.9 percent in 2015. This is a very conservative estimate,

as in December the Russian Finance Ministry estimated a 4.7 percent contraction in 2015, assuming oil averaged \$60 per barrel. Some economists have forecasted the contraction for 2015 to be close to double digits.

Russia faces a range of unpleasant possibilities in the near to mid-term future. The worst-case scenario likely involves a spiraling economic crisis, coupled with deepening social and political unrest at home fed by an increasingly bloody stalemate in Ukraine. A serious recession, high inflation, large layoffs, and growing political repression could begin to wear away the popularity that Putin's aggressive actions in Ukraine have won. Worsening economic conditions could galvanize more coordinated opposition, no longer confined to the urban middle class that formed the core of antigovernment protests in 2011–2012. Discontent from within the elite, especially the economic elite that Putin has marginalized over the past year, could intersect with a growing protest movement to create the prospect of a real challenge to Putin's rule for the first time since the early 2000s, with the 2016 Duma elections and 2018 presidential elections the most likely inflection points for change.

The best-case scenario for Russia is hardly ideal but would at least see the country ride out its economic difficulties without exacerbating social tensions. A partial rebound of oil prices could limit the damage to Russia's economy without the Kremlin changing its policy in Ukraine. At the same time, the impact of sanctions could diminish if tensions within Europe (see below) prevent Brussels from maintaining the full panoply of sanctions when they come up for renewal this spring and summer. Failure to maintain transatlantic unity on the sanctions issue could give the Kremlin additional space to play the United States and the Europeans off one another. In such an environment, the West would face a diminished capacity to assist Ukraine, and Russia could consolidate its hold on Donetsk and Luhansk, while potentially expanding its reach into neighboring regions en route to implementing some version of its strategy to recreate the Tsarist-era region of Novorossiia in southern and eastern Ukraine (as well as parts of Moldova), which Putin announced along with the annexation of Crimea. Riding out the sanctions and achieving his strategic objectives in Ukraine would provide a fillip for Putin, who would be able to depict himself as the leader who not only overcame Russia's 1990s-era weakness, but restored Russia to its rightful status as a great power in the face of opposition from the West. Riding this wave of popularity, Putin could coast to reelection in 2018 without any cohesive opposition emerging.

Impact on Other U.S. Security Interests

The crisis in and around Ukraine matters because it touches on a wide range of major security interests for both the United States and its allies. Apart from the impact on the bilateral U.S.-Russian relationship, the crisis affects European security in manifold ways, from NATO's future orientation to the cohesiveness of the European Union and arms control. As Russia is a major player across a range of geographic and substantive ("functional") priorities for the United

States, the effects of the crisis extend far beyond Europe as well. Russia, for instance, could be an important player in U.S. efforts to end, or at least contain, the Syrian conflict and the resultant spread of the so-called Islamic State (IS). It also plays a key role in international efforts to prevent Iran from developing nuclear weapons and in stabilizing Afghanistan and Central Asia following the drawdown of coalition forces. While the United States has been reluctant to see Russia as a major player in the Asia-Pacific region, the sanctions have led Russia to deepen its already robust engagement with China and give new momentum to its own Asia “pivot” strategy. The challenge for the United States is to achieve its objectives in and around Ukraine, while minimizing the impact on its ability to cooperate with Russia across the whole range of issues where U.S. and Russian priorities intersect.

The most fundamental U.S. interests affected by the Ukraine crisis center on European security. Russia’s intervention in Ukraine marks the first large-scale, cross-border use of force in Europe since the Cold War and the first effort to conquer territory in Europe by force since World War II. The invasion of Ukrainian territory, as well as Putin’s invocation of Russia’s right to protect ethnic Russians, Russian speakers, and “compatriots [*sootchestvenniki*]” abroad threatens the foundations of a post–Cold War European order based on principles of state sovereignty, territorial inviolability, and nonuse of force to resolve international disputes. With Russia now increasingly identified as a threat in much of Europe, efforts to sustain and extend the series of agreements underpinning European security since the end of the Cold War are also imperiled. Both a follow-up to the 2010 New START agreement (which cut the U.S. and Russian nuclear arsenals) and efforts to update the Conventional Forces in Europe (CFE) Treaty now appear dead, while Russia is challenging the 1987 Intermediate Nuclear Forces (INF) Treaty.

After a period in which the United States was seeking to reduce its involvement in European security to focus on the Asia-Pacific, the emergence of a revisionist Russia has forced a renewed focus on Europe, including the rotational deployment of additional U.S./NATO forces to frontline states like Poland and the Baltic states, and NATO’s decision at the 2014 Wales summit to refocus on its core competency of ensuring members’ security. A major challenge is that Russian revisionism appears much more threatening to newer NATO members in Eastern Europe than to Western European states that enjoy strong economic relations with Russia and do not see a direct threat from Moscow.

While Ukraine is neither a member of NATO nor a U.S. ally, the United States (along with Russia and Great Britain) committed to provide security assurances to Ukraine in exchange for Kyiv giving up its inherited nuclear weapons in the 1994 Budapest memorandum. Washington’s response to the crisis therefore also has implications for the credibility of its commitments elsewhere, even if its obligations to Ukraine fall far short of the treaty commitments it has to NATO allies. Washington’s Asian allies, especially Japan, are watching events in Ukraine closely, fearing that Russia’s actions could provide a template for Chinese revisionist ambitions in Asia.

Indeed, Russia has at times raised the specter of an axis with China to contain the expansion of U.S. influence. While closer Sino-Russian relations can pose some difficulties for the United States (e.g., increased Russian assistance in China's military modernization), prospects for a true alliance are slim given prevailing mistrust and competing ambitions in much of their shared neighborhood.

The crisis also has implications for U.S. efforts to engage Russia in addressing common security challenges such as the rise of IS in Syria/Iraq, halting Iran's nuclear program, the postwar stabilization of Afghanistan and Central Asia, and the U.S. "pivot" to Asia. The United States has sought to wall off the confrontation in Ukraine from efforts to continue cooperation with Moscow in these other areas. Russia, meanwhile, has at times threatened to revert to a policy of linkage, cutting cooperation for instance on the Iranian nuclear issue should the conflict with Washington in Europe escalate. A desire to ensure Russian support for U.S. priorities elsewhere in the world is part of the reason Washington has been reluctant to engage in a more direct confrontation, for instance by providing weapons systems to Ukraine.

U.S.-Russian Relations

Over the past year, U.S.-Russian relations have plummeted to levels not seen since the Cold War, though the relationship was already facing difficulties before the crisis in Ukraine started. Relations began going off the rails around 2011–2012, both because of Russia's shifting domestic landscape and because the agenda of the Obama administration's "reset" policy appeared to have run its course. In September 2011, Medvedev and then–prime minister Putin announced that they would be shifting places, with Putin returning to the Kremlin the following year. Falsified parliamentary elections in late 2011 saw the emergence of a major anti-Putin protest movement in Moscow and other major cities. Similar protests surrounded the presidential elections in May 2012 that solemnized Putin's return to the presidency. With much of the urban middle class increasingly hostile, Putin not only cracked down on dissent, but also began deliberately invoking nationalist, religious, and populist themes to appeal to the "silent majority" of Russians lacking ties to the West. Part of this crackdown included new restrictions on foreign nongovernmental organizations and rhetorical hostility to lesbians and gays that bred mounting revulsion in the West. Tellingly, Obama and most other Western leaders boycotted the opening of the Sochi Olympics in early 2014 in large part over Russia's elevation of homophobia to official ideology. This ideological turn was accompanied by a renewed emphasis on "Eurasia," rather than Europe or the West as the focal point of Russian energies.

At the same time, the outbreak of the Arab Spring increased geopolitical tensions between Washington and Moscow. The United States initially saw the uprisings as a positive step toward the Middle East's democratization, while Russia worried that they augured chaos and the expansion of militant Islamism. A major clash over Libya was averted when Moscow surprisingly abstained on the UN Security Council vote authorizing intervention against the

forces of Muammar el-Qaddafi. Yet the expansion of the U.S.-backed mission in Libya, Qaddafi's ugly end, and Libya's subsequent collapse into anarchy bred increased resentment in Moscow. Having gone along in Libya, Moscow was determined to hold the line in Syria, a strategically more significant country where Russia maintained a naval facility and had longstanding ties to the government of Bashar al-Assad. The United States blamed Russia for propping up Assad and enabling his increasingly bloody attacks against civilians (including those using chemical weapons), while Russia blamed the United States for pursuing an undifferentiated policy of regime change, drawing links to its interventions in Yugoslavia in the 1990s and Iraq in 2003, as well as the post-Soviet "colored revolutions."

The narrative of U.S. support for regime change has become increasingly accepted in Russia. As bilateral ties have worsened, more and more Russians have become convinced that regime change in Russia itself is the unstated objective of U.S. policy. Russian officials, including Foreign Minister Sergey Lavrov, have openly stated that they see the U.S. and European sanctions regime as aimed at fomenting discontent leading to Putin's eventual ouster.

Resentment at Washington's proclivity for military intervention and regime change, coupled with the perpetuation of a NATO-centric European security order from which Russia remains systematically excluded have bred hostility to the United States among the upper echelons of the Russian elite that goes beyond disagreements about specific issues. Russia's intervention in Ukraine is thus about serving notice that Moscow is unwilling to accept Western diktat, especially in its own neighborhood, and that Russia sees itself as lying outside the West, as part of a separate Eurasian civilizational and geopolitical bloc. As long as Russia defines itself in opposition to the West and conceives of the relationship in essentially confrontational terms, any more than limited cooperation is unlikely.

For the short to medium term, then, prospects for U.S.-Russian relations are dim. Not only has the Obama administration essentially written off Putin and Russia, but Russia itself sees less and less need for cooperation with the United States today. Once the immediate crisis passes though, it is likely both states will have an interest in finding a stable *modus vivendi* that allows Russia to address its economic challenges and the United States to secure Russian support for its security objectives in the Middle East and Asia-Pacific. Whatever the new framework for relations is, it is likely to look quite different from what prevailed for the past two decades.

EU-Russia Relations

EU-Russia relations have also suffered over the course of the Ukraine crisis, but the picture is complicated by some EU member states' (especially in Western Europe) extensive economic ties with Russia. For now, Brussels has been willing to march in lockstep with Washington on sanctions, but mounting economic difficulties across the continent will make it more difficult for the European Union to maintain a unified front over the coming year.

For many years, Russia viewed the European Union as an essentially benign alternative to NATO and raised few objections to EU expansion and development. That comparative indulgence ended as the European Union began to push into Russia's post-Soviet neighborhood with the so-called Eastern Partnership (EaP) beginning in 2009. The EaP proposed offering the six states of post-Soviet Eastern Europe and the South Caucasus (Armenia, Belarus, Azerbaijan, Georgia, Moldova, Ukraine) a path to association agreements, complete with Deep and Comprehensive Free Trade Agreements (DCFTAs) that would see signatories implement a substantial proportion of the European Union's own rules and regulations, with serious implications for the inherited post-Soviet political cultures that serve as a primary vehicle for Russian influence. The DCFTAs would also likely reorient trade from the EaP states away from Russia and toward Europe. The prospect that Ukraine would sign this association agreement led Moscow to ratchet up the pressure on former president Viktor Yanukovich, whose clumsy decision to suspend the agreement led to the protests that ultimately ousted him and prompted the Russian intervention in Ukraine.

Europe remains divided over Russia, with several Western European governments and corporations (not to mention the range of populist and Far Right parties such as Britain's UKIP, France's National Front, Hungary's Jobbik, the Swedish Democrats, and others who receive direct Russian support) seeking an end to sanctions and a restoration of trade and investment ties. Most of the Eastern European states with a history of Russian imperial domination have been much more supportive of sanctions. The most important player in this drama remains Chancellor Angela Merkel of Germany who, despite the protests of many German industrialists, has called for maintaining sanctions until Russia complies with its obligations in Ukraine. Indeed, Putin has gone a long way to undo much of the historical German-Russian rapprochement whose roots predate the end of the Cold War. With the EU sanctions up for renewal in the spring and summer of 2015, the intra-EU politicking is liable to increase, as are Russian efforts to pick off individual EU countries like Hungary or a Syriza-led Greece in order to prevent consensus.

A major variable is the state of the European economy. Europe's continued struggles, including the likelihood of a recession in Germany this year, mean that leaders and publics will be increasingly sensitive to arguments that sanctions are contributing to their hardships at home. A full-blown crisis in Europe, for instance if the new Greek government oversees Athens' departure from the euro, could accelerate the pressure to lift EU sanctions. A very serious concern for Europe comes from its banks' exposure to Russia and the danger of contagion from an economic meltdown in Russia. An important element of U.S. policy must consequently be to ensure transatlantic unity on sanctions and on policy toward Russia and Ukraine more generally.

U.S. Policy Responses

The challenge for U.S. policy is to simultaneously frustrate Russia's revisionist ambitions while keeping the door open for renewed engagement and cooperation down the road. The United States is rightly unwilling to fight a war with Russia over Ukraine, but it should also do more to both assist Ukraine in resisting Russian aggression and reassure its European (and non-European) allies that its security commitments remain robust. At the same time, the United States needs to keep channels to Moscow open to seek a negotiated end to the conflict in Ukraine, but also to lay the foundation for reengagement once the immediate crisis burns out.

The sanctions are, at this point, an entrenched part of the U.S. response and cannot be lifted without concrete steps by Moscow to respect Ukraine's sovereignty and end Russian involvement in the conflict. The Minsk Protocol, negotiated under the auspices of the Organization for Security and Cooperation in Europe (OSCE) in September 2014 and signed by representatives of Russia, Ukraine, the separatists, and the OSCE, remains the best framework for a negotiated solution that would include the gradual lifting of sanctions. Unfortunately, Russia's renewed assault toward Mariupol and the failure of the so-called Normandy format talks (representatives from France, Germany, Russia, and Ukraine) in late January seem to indicate that Russia remains for now unwilling to accept a settlement on the basis of the Minsk Protocol. While the sanctions have succeeded in the stated objective of imposing costs on Russia, they have failed to end Russian support for the Ukrainian separatists; if anything, Moscow appears to be doubling down on its support for the rebels in recent weeks.

Yet the United States and its allies have a strong interest in not only stopping the violence in Ukraine, but also in nipping Russia's revisionist turn in the bud by ensuring that Russia is unable to achieve its objectives at an acceptable cost. The critical piece of this approach is ensuring that Ukraine does not become a failed state: providing the financial and political support to consolidate Ukraine's political transition while increasing Ukraine's capacity to fight the rebels and their Russian backers. The most important step would be providing sufficient financial assistance to prevent a Ukrainian default (likely to be at least \$15 billion) and to sustain political support for the current Ukrainian leadership to push through necessary reforms.

While providing lethal military assistance to Ukraine remains highly controversial, we believe that such assistance, potentially provided covertly to blunt the effects of Russian escalation dominance, can allow the Ukrainians to dramatically escalate the human and material costs to Russia of continued intervention. Given the Kremlin's concerns about political support for a war, a credible U.S./allied commitment to bolster the Ukrainian military while tightening sanctions will help signal to Moscow that it risks a political and military catastrophe should it continue to eschew negotiations.

Even as it works to bring the conflict in Ukraine to an end through continued pressure, the United States needs to ensure that it keeps lines of communication to Moscow open, both as part of the overall diplomatic process on Ukraine and to lay the foundation for more substantive engagement in the future. One of the more pernicious aspects of the crisis on U.S.-Russian relations has been the suspension of existing channels ranging from the Bilateral Presidential Commission to regular military-to-military engagements. Given this closing of communications and the overarching need to find a solution to the Ukraine crisis, establishing a high-level back channel to the Kremlin should be a top priority right now. At the same time, unofficial engagement, including at the Track 2 level, should be expanded to discuss the parameters for renewed U.S.-Russian engagement once the immediate crisis has ended.

Jeffrey Mankoff is a fellow and deputy director of the Russia and Eurasia Program at the Center for Strategic and International Studies (CSIS) in Washington, D.C. Andrew Kuchins is a senior fellow and director of the CSIS Russia and Eurasia Program.

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