

The consequences of the annexation of Crimea

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On 16 March, an illegal referendum was held on the territory of the Autonomous Republic of Crimea and the separate municipality of Sevastopol, in which 96.8% of voters opted to join the Russian Federation as its subjects, with a turnout of 83.1%. The results of the referendum, during which significant abuses occurred, have no meaning. They only provide a 'fig leaf' for the decision Russia had already taken to separate Crimea from Ukraine. 18 March saw Moscow proclaiming the annexation of Crimea (both the Republic and Sevastopol) to the Russian Federation as two of its entities. This decision has not been recognised by Kyiv.

For Ukraine, the loss of Crimea – in addition to its geopolitical and military importance, as well as its impact on the internal political scene (more on which in subsequent analyses) – is associated with the economic consequences resulting from the loss of state property located on the peninsula, including in the energy and mining sectors, as well as the port infrastructure, which is significant for Ukrainian exporters.

For the Russian authorities, the takeover of Crimea is a propaganda success for domestic consumption, but it is associated with significant costs on the international political scene (Russia has acquired the image of a dangerous and unpredictable state), as well as financially (one preliminary estimate puts the total cost of annexation at \$82 billion).

The secession of Crimea also confronts the new authorities on the peninsula with a number of serious problems related to the need to establish a new relationship with Ukraine, on which the region is profoundly dependent (such as deliveries of raw materials and supplies, the transport and tourism sectors, the need to rebuild the financial system, etc.).

The problem of demarcation

The *de facto* land border between Ukraine and Crimea (Russia) will be the existing border between the Autonomous Republic of Crimea and the Kherson region of Ukraine, a total of around 20 km. Russia may attempt to grab part of the Arabat Spit belonging to the Kherson region (on Crimea's eastern shore) in order to control the gas pipeline compressor station there which supplies Crimea.

The previous negotiations on delimiting the waters of the Azov Sea are no longer relevant, as the starting points for such a division have now changed fundamentally. Moreover, it will be necessary to demarcate the waters and the continental shelf west of Crimea, where valuable fisheries, oil and natural gas are found; and to determine the courses of the shipping routes to the ports of Odessa, Belgorod, Nikolayev and Kherson. Kyiv will not want

to hold any talks on these matters, because to do so would be an acknowledgement of the territorial changes.

In all likelihood, the Ukrainian government will instead insist on speeding up the demarcation of the Ukrainian/Russian land border beyond Crimea (work on this has been ongoing for several years, and should now be resumed after the winter break), although Moscow will almost certainly sabotage them. Until there is a political solution, passport and customs checkpoints on the *de facto* Crimean border are unlikely to be built.

Crimea's dependence on Ukraine

Crimea is dependent on supplies from Ukraine of water, for agricultural and industrial products (75-80%), and electricity (80-85%). Supplies of natural gas are probably only important for certain industrial plants; Crimea extracts a significant amount of this material itself, and is able to meet the vast majority of the needs from its own territory (currently over 80%).

Kyiv is unlikely to interrupt the supply of these raw materials to Crimea, above all because that would mean a *de facto* abandonment of its sovereign rights over the peninsula (the formalities connected with continuing supplies will probably be governed by a law on the status of the occupied territories prepared in Kyiv), and also because Russia could treat such a move as a *casus belli* and use force to take over the hydroelectric power plant in Nova Kakhovka in the Kherson region (the Kakhov Bay is also a water source for Crimea).

If Kyiv (or both parties) close the land border between the peninsula and the rest of Ukraine (i.e. the two railway lines, two major and two minor roads), the only way to supply Crimea would be the Kerch ferry. As this is inadequate for the purpose (a bridge over the Strait of Kerch could not be built in the space of a few months), this would cause not only serious supply difficulties, but would also contribute to the collapse of the tourism industry (the much longer rail route would be an additional disincentive for tourists from Moscow, etc.).

Consequences for Crimea

The major problems are linked to the separation of Crimea's budget from Ukraine, and of the Crimean financial system from that of Ukraine. In 2013, two-thirds of the Crimean budget was based on transfers from the central budget (80% in the case of Sevastopol).

These disturbances have affected the banking sector in Crimea, where local branches of banks operate whose head offices are in Kyiv. The Crimean authorities are putting the Russian rouble into circulation, which will force banks to adapt to a new situation (the transitional period is to last until 2016). However, even before the referendum, the Crimean authorities had introduced severe limits on withdrawals from savings accounts denominated in Ukrainian hryvnia.

Another particularly important issue for the residents of the peninsula is the uncertain income from tourism. Russia's militarisation of the peninsula could, especially in the short term, result in the collapse of proceeds from tourism, and strike especially hard at the small and medium businesses on Crimea's southern coast. Approximately 70% of tourists coming to Crimea were from Ukraine, who in the current environment will probably not come any

more.

There will also be problems with issuing new ownership and property documents, as Ukraine has blocked access to the central registry for Crimean sites, and the Crimean autonomous government did not make its own records.

We should also expect pressure to be put on the Crimean Tatars, primarily to force them voluntarily to leave the land they occupy. If this is not associated with the legalisation of owning at least those properties on which residential buildings have already been established, the Crimean Tatar community's opposition to the new government will be strengthened, accelerating their radicalisation.

The economic consequences for Ukraine

From an economic point of view, the effect of losing Crimea on the Ukrainian economy as a whole will have limited macroeconomic consequences (Crimea's part in the country's GDP was 3.6% in 2013), although it could seriously affect selected sectors of the economy. This may to a large extent be caused by the Crimean state taking over Ukrainian property located on the peninsula. The loss of local energy and mining assets will be particularly expensive, above all the company Chornomornaftohaz. This is one of three state-owned mining companies owned by NAK Naftogaz Ukraina, and was one of the fastest increasing gas producers in recent years (in 2013 it increased its production to 1.65 bcm, which in the short term could fully meet the peninsula's demand, estimated at between 1.7 and 2 bcm). Nevertheless, Ukraine's loss of Chornomornaftohaz's production does not have to fundamentally change its gas balance (with the exception of gas consumption on the peninsula); however, the considerable efforts made in recent years to develop the company (including the purchase of two new drilling platforms) will represent a big loss.

The loss of Crimea is also associated with a reduction in size of Ukraine's exclusive economic zone on the Black and Azov Seas. It practically negates the possibility of Ukraine implementing projects to extract hydrocarbons from the Black Sea shelf which it had planned jointly with Western companies. For example, in late 2013 Kyiv had signed an agreement with ENI and EdF to extract natural gas from the continental shelf in the Kerch Strait; and on 19 March, the British Shell company (which had been a participant in the Ukrainian partner consortium) withdrew from negotiations to sign a contract to divide up production on a project to extract hydrocarbons from the Skifski shelf in the Black Sea.

It is also not clear how the annexation of Crimea will affect the implementation of the Ukrainian-Russian agreement from 2010 known as 'Fleet for gas' (in exchange for extending the lease of the Russian Black Sea Fleet in Ukrainian Crimea, Ukraine received a 30% discount in the price of gas imported from Russia). Moscow could use the new situation to put pressure on Kyiv, although in recent years Russia did not fully exploit all the possible options for doing so under the two parties' existing agreements.

It is almost certain that there will be significant changes in the ownership of private companies operating in Crimea. We may expect a rapid expansion of Russian business, and not just those associated with the current local authorities. In this context, there is uncertainty about the future status of the Crimean assets which currently belong to big Ukrainian business. Rinat Akhmetov, Dmytro Firtash and Andriy Klyuyev, among others, have

businesses in Crimea. Although the Crimean authorities have so far tried to insist that they will not attempt to take over private businesses, in the case of local energy, for example, there are signs of the possible nationalisation of all electricity generation facilities (due to a lack of capacity). One of the private tycoons is Andriy Klyuyev, who in recent years has invested a great deal in solar energy. Many Ukrainian businessmen have estates in Crimea, and they also lease thousands of acres of beaches on the south coast.

The costs and financial benefits for Russia

The annexation of the peninsula entails a number of costs for the Russian Federation. For Crimea, the urgent problem is how to finance the huge local budget deficit, estimated at \$1 billion. According to preliminary announcements, Russian economic aid for Crimea is expected to amount to at least \$2.2 billion annually. This sum does not cover the expectations (aroused during the referendum campaign) that after the peninsula joins the Russian Federation, pay and pensions in the public sector will rise to Russian levels (salaries in Russia are on average more than two and a half times higher than in Crimea). Subsequent costs will be incurred by adapting the apparatus of state and the economy of the peninsula to Russian requirements, especially the transition to the Russian rouble and the Russian financial and legal systems. Moreover, investments are needed in the peninsula's infrastructure. Government officials estimate the need for Russian investment in the transport and tourism sectors at \$4-5 billion. Just to ensure effective communication with Russia, it will be necessary to build a bridge across the Kerch Strait. The Russian transport minister Maksim Sokolov estimates the cost of such an investment at a minimum of \$1.4 billion. For Crimea to become independent of the electricity and gas supplies from Ukraine, Moscow will have to bear the costs constructing a power connection through the Kerch Strait, as well as a pipeline (initially there is talk of building a branch of the South Stream pipeline, or even re-routing the whole project to run through Crimea). According to the late deputy finance minister Alexander Pochinok, the annexation of Crimea could cost Russia a total of up to \$82 billion.

Apart from the need for direct financial outlays, Russia's annexation of Crimea generates administrative and organisational problems. They will need to create a border infrastructure and ensure the defence of the borders; as well as the demarcation of new borders, including maritime borders, and the division of territorial waters to regulate access to and ownership of the shelf. Settling these issues will be more difficult as Ukraine, which should be a party to most of the agreements, does not recognise the annexation of Crimea, and will not want to hold talks to resolve these issues.

In addition to the costs, however, the annexation of Crimea could also bring Russia some financial benefits. Among them we should first mention the cost of the Black Sea Fleet. So far, Ukraine had been paying Moscow \$97 million a year to station the Fleet on the peninsula (\$30 million of which remained in Crimea's budget). In accordance with the existing agreement, as of 2017 this amount was to have risen to \$100 million. The takeover of Crimea not only eliminates the need to pay these fees, but Russia gains an opportunity to modernise the Fleet in any way it sees fit, which so far had been limited by the Russian-Ukrainian agreement which only provided for the possibility of renovating the equipment that was already there. Russia intends to take over the Ukrainian ships which were in

Crimea, as well as the entire Ukrainian military infrastructure and ports. By gaining control over Crimea, Russia will reduce the cost of the passage of ships through the Kerch-Yenikal Canal. According to the Russian Ministry of Transport, the Russian Federation has paid about \$15 million annually to the Ukrainian budget. Russia and Crimea will also take over the peninsula's entire infrastructure, along with the property of the Ukrainian state.

The consequences of Crimea's secession on Ukrainian domestic politics

The effective loss of Crimea will be one of the main themes of Ukrainian political debate in the coming months, including the beginning of the presidential campaign, and will be an important element in preparations for the autumn parliamentary elections (unless further developments force Kyiv to declare a state of emergency or martial law, making it impossible to hold those elections).

Crimea and Sevastopol have 13 single-member seats in the *Verkhovna Rada* (parliament) of Ukraine. The MPs elected to them will retain seats unless they themselves abandon them. Their eventual departure would weaken the pro-Russian camp in parliament. Since elections in the Crimean districts cannot be held in the current situation, they will probably not be held; the loss of up to 13 MPs will not threaten the parliamentary quorum.

If any of the deputies elected in proportional seats resign, this will not affect the functioning of parliament, because their places will automatically be filled by successive candidates from the appropriate party lists.

The Ukrainian presidential elections scheduled for May 25 will not take place in Crimea (although electoral commissions for the 13 constituencies in the peninsula will presumably be set up). This will not be relevant to the elections' validity, although support for a possible pro-Russian candidate will be significantly reduced, as it will for the Communist Party of Ukraine.

Everything points to the fact that in the parliamentary elections, which will probably take place in the autumn of 2014, a purely proportional electoral law will apply, so the failure to hold elections in the 13 constituencies of Crimea will not matter. A problem will arise if regional (i.e. open) lists are introduced, since in this case the mandates allocated to Crimea will be vacant. This will be probably a strong argument for staying with national lists.

The debate over the *de facto* loss of Crimea, its causes and consequences, will likely push arguments about the future development of the Ukrainian state into the background, and any attempt to come to terms with this *fait accompli* will be criticised very severely by representatives of the Maidan. Crimea's status will also be a problem during discussions on a new constitution for Ukraine, as it will be impossible to retain the existing laws concerning Crimean autonomy; it is possible that Crimea will become the dominant theme, casting into shadow matters which are much more important for the future of the state.

Political consequences for Russia

There is no doubt that the absorption of Crimea is a huge domestic propaganda success, and has translated into real support for Vladimir Putin among both the general public and the elite. The annexation is a response to the imperial sentiments which still flourish in

Russia and the myth, sustained over years, of the unity of the so-called Russian world (*russskiy mir*). This was well illustrated by the reaction to Crimea's incorporation from Sergei Naryshkin, chairman of the State Duma, who said that this was a happy moment in the history of Russia, which for the first time since the collapse of the USSR has not lost territory, but gained it.

On the other hand, the question is how long the current euphoria of most of Russian society summoned by the annexation of Crimea will last, taking into account the costs Russia will incur in connection with the annexation. Resources for Crimea have come largely from the National Welfare Fund, which also subsidises the Russian Pension Fund. In turn, the Pension Fund, which has been suffering from constant deficit, will now cover residents of Crimea. Direct and indirect costs connected with the annexation will also come from the regional budgets. The finance minister Anton Siluanov announced on 18 March that the first payment for Crimea will come from the budget of the Krasnodar *krai* which borders the peninsula.

From the Russian point of view, the Kremlin has strengthened its geopolitical position by the annexation of Crimea, and positioned Russia as a country ready to actively defend the implementation of its interests in the international arena, and able to bear the costs of such actions. In fact, it seems that these activities will reinforce the West's image of Russia as an unpredictable and dangerous country, which does not necessarily mean their acknowledgement of Russia's regional ambitions. Moreover, it appears that the annexation of Crimea will strengthen the concerns of leaders of post-Soviet states about Russia, and could increase their tendency to seek opportunities to reduce their dependence on Moscow by efforts to strengthen their cooperation with alternative international partners. However, the options for the region's countries are limited. The fear of Russian expansionism will adversely affect the Eurasian integration process.