

Russian Expansion: A Challenge and Opportunity for the Emerging Authoritarian Regime in Ukraine

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The year 2010 marked a swift rapprochement between new Ukrainian authorities, headed by President Viktor Yanukovych, and the Russian tandem of Prime Minister Vladimir Putin and President Dmitry Medvedev. The Kremlin and its loyal conglomerates managed to convert their growing political influence into a number of strategic agreements in Ukrainian energy, industrial, and financial sectors. However, these achievements did not meet early Russian expectations regarding possible Ukrainian concessions, while Ukraine's new ruling elites were surprised and disappointed with the Russian government's neglect of reciprocity and parity in economic and international affairs. As a result, both countries took a tactical timeout to reconsider their relationship. Although it is premature to say that a new crisis is evolving between Ukraine and Russia, there is clear evidence of a crisis in trust between the Ukrainian and Russian leadership.

The Kremlin's "All-Business" Approach

After Yanukovych won the February 2010 presidential election, the Kremlin began a diplomatic and economic expansion in Ukraine that took advantage of Yanukovych's pro-Russian rhetoric and the huge losses of Ukrainian business groups from high gas prices and economic contraction.

In early May 2010, the Russian version of *Newsweek* published a leaked document from the Russian Ministry of Foreign Affairs titled "Program on the efficient and systemic employment of external capacities to promote the long-term development of the Russian Federation."^{*} The document, prepared in February 2010, acknowledged the "crucial role of the Black Sea Fleet" for Russian security, the "huge industrial and scientific capacity of Ukraine [and its] modern defense industry" and recommended

^{*} It was available online in May 2010 here: <http://www.runewsweek.ru/country/34184/>, but access was later restricted. The document can be viewed here: Программа эффективного использования на системной основе внешнеполитических факторов в целях долгосрочного развития Российской Федерации: <http://www.flot2017.com/file/show/none/24253>.

integrating them “without establishing technological dependence for Russian industries.” This latter point could only mean the acquisition of Ukrainian enterprises in the aerospace, transportation, and energy sectors. The document also advised pushing Kyiv to establish a gas transportation consortium in order to control the gas transportation system, a goal considered strategically important for Russia. It recommended limiting Ukraine’s access to Caspian energy resources, increasing dependence on Russian fuel supplies for Ukrainian nuclear power stations, and supporting private companies in their bid to control large industrial enterprises in Ukraine.

Subsequent events demonstrated the logic of this plan. After tough negotiations with the Kremlin over reducing the price of gas, Yanukovych decided to make a geo-strategic concession. He signed an agreement with Medvedev in Kharkiv in April 2010, whereby Moscow agreed to decrease the price of natural gas sold to Ukraine by approximately one-third (by \$100 per 1000 cubic meters of gas) in exchange for leasing the Russian naval base in Sevastopol for an additional 25 years (after the present agreement expires in 2017) and for 5-year terms thereafter.

At the same time, the cost savings to Ukraine automatically converted into sovereign debt to the Russian government. According to the agreement, Ukraine’s debt is to be written off by 2042, and it will constitute a part of the payment for Russia’s lease of the naval base. If any future Ukrainian government decides to cancel the agreement, it will thus have to repay Russia billions of dollars. Moreover, the agreement establishes a permanent formula for the price of gas that was not reviewed as Yanukovych had requested, which means that the deduction is regulated by unilateral decision of the Russian government and its size can be unilaterally changed, a lever that the Kremlin uses to control Ukraine’s heavy industry and export dynamics.

The Kharkiv agreements were based on the assumption that the Ukrainian government, dependent on the interests of oligarchs whose companies are the main contractors of Russian gas, would not reform the energy and industrial sector to reduce dependency on gas.

In April, after the Kharkiv agreements, Putin presented Yanukovych with a number of integrationist projects, starting with a merger between Naftogaz and Gazprom to embark on joint ventures in nuclear energy, mining, aerospace, and shipbuilding. In every case, Ukrainian assets were to become part of Russian corporations, while Ukrainian authorities would receive minority shares in the merged companies. For instance, after a merger of Naftogaz and Gazprom, the Ukrainian government was to reportedly end up with 3 percent of Gazprom’s shares. Putin also raised the possibility of Ukraine joining the Customs Union or even the Collective Security Treaty Organization (CSTO).

Besides gas, the most successful sphere for Russian expansion was Ukraine’s banking sector. The Russian VTB group became the top lender to the Ukrainian government, providing it and state-owned companies with more than \$3 billion in short- and medium-term loans. In case of a hypothetical default, these loans would be

used to force the Ukrainian government to cede control over strategic state assets in the gas sector.

Clash of Interests

However, Russia's further encroachment into the Ukrainian economy following Yanukovych's election has been much slower than expected. The Ukrainian government made a number of proposals to secure the interests of loyal business groups. Russian businesses were asked to invest in the construction of new nuclear power plants and hydroelectric stations and to allow access to supplies of natural gas from Central Asia via Russian territory. As for the potential merger of Naftogaz and Gazprom, the Yanukovych administration suggested that the new joint venture include both Ukraine's gas transportation system and Russia's rich gas deposits. Gazprom was also asked to give legally binding guarantees of fixed oil and gas transit volumes. A joint aerospace venture promised to secure large contracts from Russia's armed forces, as well as to benefit from contracts between Russia and large Asian markets such as India and China.

Yanukovych made several statements that showed he was not going to surrender to Russia's economic expansion. In December 2010, he openly rejected Ukrainian membership in the Customs Union. He also called the Russian gas pipeline project South Stream "a form of pressure" against Ukraine in gas negotiations.

Ukrainian and Russian oligarchs clashed in several privatization cases. In 2010, the richest man in Ukraine and sponsor of Yanukovych, Rinat Akhmetov, attempted to stop the sale of Zaporizhstal (a large steel plant) to Russian investors supported by Russian state bank Vneshekonombank, the advisory board of which is chaired by Putin. He wanted to buy it himself but failed. Akhmetov had to agree to compensation to drop his claims. At the same time, he won over Russian businesses, which wanted to buy the Ilyich steel plant in Mariupol, Ukraine.

The Russian industrial group Transmashholding suffered from a suspension in the privatization of Luhanskteplovoz, a Ukrainian train producer and the largest in the CIS. The Transmashholding interest in Luhanskteplovoz has a long history. The company participated in the latter's privatization auction, but its participation was overruled by a court decision at the request of the previous government. In 2009, Yanukovych representatives announced that they would find a solution. In early 2011, Ukrainian authorities signed an agreement with Transmashholding – once the Russian company relinquished its claims on the Ukrainian government to pay fines for breaking the deal.

As well, newly-drafted conditions for privatizing the state telecommunication company, Ukrtelekom, contained restrictions against the participation of foreign companies. This was despite the fact that a major Russian company, Sistema, already the second largest player in the Ukrainian telecommunications market, expressed interest in buying it.

Finally, a private dealer of the Russian nuclear fuel company TVEL, a subsidiary of the state-owned Rosenergoatom, managed to secure a deal with the Ukrainian

Energoatom regarding long-term supplies and the removal of processed nuclear fuel to Russian territory. However, the deal did not allow Russia to remain a monopolist supplier, thus keeping intact an agreement between Energoatom and the U.S. company Westinghouse, which in 2011 will begin its own deliveries of nuclear fuel to Ukrainian power stations.

At the same time, where Yanukovych is personally interested in the involvement of Russian companies, their achievements are more impressive. For instance, in 2010 Naftogaz had to return to RosUkrEnergo, a joint venture between Gazprom and Yanukovych sponsor Dmitri Firtash, 12 billion cubic meters (bcm) of gas that it had bought at lower prices in 2008-2009 (compared with the higher gas prices of 2010). After negotiations with Lukoil owner Vahit Alekperov during the 2011 Davos summit, Yanukovych also ordered the establishment of a joint venture between Ukrainian state energy company Chornomornaftogaz and Russia's Lukoil to develop Black Sea oilfields.

Symbolic Concessions

One area in which Yanukovych has made significant concessions to Russia is in the humanitarian sphere. The situation is complicated by the Yanukovych administration's belief that "national identity issues" can be handled administratively and easily manipulated. In fact, his policy has further polarized the country. During an April 2010 visit to the Council of Europe, Yanukovych rejected the view that Ukraine's 1933 Great Famine was genocide, thereby aligning himself to Russia's position. Minister of Education Dmytro Tabachnyk (known for his pro-Russian views) has also called for revisiting the way in which school textbooks address the Ukrainian national liberation movement of World War II and a return to more unfavorable Soviet interpretations.

In contrast to all his predecessors, Yanukovych has also given clear preference to that part of the Ukrainian Orthodox Church that is under the jurisdiction of the Moscow Patriarchate. Tellingly, he accepted the blessing of Russian Patriarch Kirill I, in Kyiv, even prior to his inauguration at the Ukrainian parliament.

Nonetheless, contrary to his electoral promises, Yanukovych declared early on that Ukrainian would remain Ukraine's sole state language. Still, his Party of Regions submitted a draft law on languages that would upgrade Russian to the status of a regional language throughout most of Ukrainian territory, something that would be a significant blow to the Ukrainian language. For the time being, Yanukovych's administration appears to have understood the explosive potential of this law and has refrained from pushing it forward.

In July 2010, the Ukrainian parliament also adopted a new law on the fundamentals of Ukraine's foreign and domestic policy, which excluded NATO membership (a goal former president Leonid Kuchma proclaimed back in 2003) and declared a new "non-alignment" policy for Ukraine (though it also highlighted European Union membership as a continued priority). At the same time, this meant that the law did not mention anything about CIS integrationist projects, including the Customs Union and the CSTO. Finally, Yanukovych ultimately rejected the idea of

recognizing Abkhazia and South Ossetia after toying with it during the presidential election cycle.

The Search for a New Balance

The most important goal of Yanukovych's foreign policy, according to presidential aide and director of the National Institute for Strategic Studies Andriy Yermolayev, is to acquire from external powers legally binding guarantees of Ukrainian sovereignty (a legacy of the 1994 Budapest Memorandum that committed Russia, the United States, and Great Britain to such) and to use all opportunities in contemporary global markets to modernize the country. The key element of this strategy is to restore confidence in Ukraine among external powers and to participate in geopolitical projects that do not contradict Russian interests and enable the country to increase its standing.

In the latter half of 2010, therefore, the presidential administration attempted to intensify contacts and to improve relations with Poland, Germany, France, Great Britain, and the EU. The aim was to establish personal and trustworthy relations with their leaders and institutions and persuade them that under Yanukovych Ukraine had successfully stabilized relations with Russia while continuing to pursue European integration.

Yanukovych's foreign policy might yet evolve from its initial pro-Russian overtures into a new edition of the "multivector" policy pursued by Kuchma. However, such a policy could be undermined if Ukraine's ruling elites fail to follow European requirements concerning democracy and rule of law, as happened with the Kuchma regime in the early 2000s. At the end of 2010, the European Parliament expressed serious concerns about democracy in Ukraine, and EU officials warned of setbacks to plans to establish a deep and comprehensive free trade area (DCFTA) with Ukraine and a visa liberalization regime.

Nonetheless, negotiations on these issues continue and both sides stress that it is realistic to conclude an agreement on DCFTA by the end of 2011. Moscow also declared that if Ukraine joins the Customs Union it will receive enhanced economic preferences. However, the Customs Union and DCFTA are not compatible, so Yanukovych declared that cooperation with the Customs Union would be limited to the formula "3+1" (that is, without acquiring membership status in the Customs Union).

Possible Outcomes

The further development of Ukrainian-Russian relations depends on how Yanukovych's team is able to react to emerging political and economic challenges. Ukraine's sovereign debt currently amounts to more than 40 percent of GDP, with much of it short-term, and no restructuring of the country's economy, core industries, or social infrastructure is taking place. Tepid global recovery and suppressed domestic demand leave little space for a substantial improvement of economic and social conditions, which at least was possible from 2000 to 2008.

Meanwhile, the "honeymoon" between Yanukovych and his supporters – let alone with other parts of society – has ended. Implementation of unpopular reforms

may demand, in the government's view, further restrictions of civil liberties, especially freedom of expression. In this context, Yanukovych's position toward Russia may serve to mobilize supporters inside Ukraine or to win the sympathies of former moderate opposition followers, as with Kuchma back in 1999. Speculating on how Yanukovych will deal with Russian expansion, it is necessary to consider the following three scenarios for Ukraine's future economic and political development.

1. A second wave of economic recession + growing authoritarianism. In this scenario, Russia will face a difficult dilemma: either to use its vast but still limited resources to build "safety nets" for Ukraine's ruling elites or to leave the country's "bailout" to the IMF and the West and, consequently, risk that its new gains in Ukraine will be lost or "forgotten." If Russia is hit hard by a second wave of recession that complicates its own domestic affairs, its attitude to Ukraine, in our opinion, will be shaped by the nature of the regime in Kyiv. If it is authoritarian, but weakened by economic recession, the Ukrainian president will be seen as a natural ally and a satellite worth saving. Russia's "rescue package" could include economic concessions from Ukraine and its membership in the CSTO. On the other hand, if Yanukovych decides to ease his grasp on power and address European concerns about democracy in order to obtain Western aid, Moscow will use Ukraine's debts to make Kyiv keep the promises it gave in 2010-11.

2. Economic revival + growing authoritarianism. Favorable external conditions will help Yanukovych smooth away the negative social impact of reform, while Ukrainian oligarchs will be more resolute in protecting their interests against Russian competitors. At the same time, Russia can help limit a sluggish recovery through its setting of gas prices and limiting Ukrainian exports. The biggest risk for Russia is that economic development combined with repression in Ukraine can create new opportunities for a pro-European opposition and the conclusion of power-sharing deals between opposition forces and oligarchs formally loyal to Yanukovych but interested in getting closer to the EU.

3. Economic stagnation + political stalemate. A failure of proclaimed reforms and poor economic performance will result in growing demand for permanent external aid and relatively cheap long-term loans. At the same time, growing disapproval of the state could push the Yanukovych team to exploit polarizing policies to divide and manipulate society. As a result, a weakened economy and state could give Russia a chance to spur Ukraine's reintegration into significant Russian integrationist projects. Another possibility, however, is that Yanukovych will be forced to distance himself from Russia, if Moscow demands too much and alienates not only the Ukrainian opposition but also power groups surrounding the Ukrainian president.