

## **Chapter 6**

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### **Russia: Ukraine Crisis Destabilizing Russia's Geopolitical Position**



The crisis in Ukraine continues to unfold in the wake of the election of President Petro Poroshenko in May 2014, and the situation in the eastern regions of Ukraine, where the Ukrainian military and the pro-Russian separatist forces confront, remains unstable in spite of the ceasefire agreement signed on September 5. Relations between Russia and the Western nations, which have deteriorated due to the Ukraine crisis, appear unlikely to improve anytime soon. The annexation of Crimea by the Russian Federation in response to the Ukraine crisis led to a temporary resurgence in President Vladimir Putin's approval rating, which had been on the decline, but political problems caused by the crisis have cast a long shadow over the Russian economy. Fears of the effects of economic sanctions imposed on Russia by the European Union and the United States have caused a stagnation in business activity, and the government in Moscow is being forced to steer a difficult economic and fiscal course constrained by the need to foresee and deal with such sanctions.

As relations with the European Union (EU) and the United States worsen, Russia is pushing forward with economic integration with neighboring countries. It set up the Eurasian Economic Union (EAEU) with Belarus and Kazakhstan, and took steps to reinforce a strategic partnership with China. Russia continues to strengthen its military cooperation with Belarus and the countries of Central Asia within the framework of the Collective Security Treaty Organization (CSTO).

Turning to Russia's external energy policy, the country has been engaged in tough bargaining with its major export market of Europe over the supply of gas via Ukraine; meanwhile it has signed, in May 2014, an agreement with China on the supply of gas via a major pipeline, an issue that had been under negotiation for a long time. Exports of energy are also expanding to other markets in East Asia, and the importance of this part of the world within Russia's overall energy foreign policy is growing.

Regarding Russia's military policy, in a continuation of the trend in 2013, President Putin ordered snap combat-readiness inspections of a wide range of Russian troops. In the Eastern Military District, snap inspections were held on September 11–18, 2014, and large-scale maneuvers were held under the name Vostok-2014 on September 19–25. These maneuvers included movements of airborne troops straddling different military districts and involving the projection of force into distant theaters such as islands off the coast of Russia's Far East, and in the Arctic.

In the face of the Ukraine crisis, the Federal Assembly of Russia gave President Putin the authority to employ the military, and he consistently applied pressure on Ukraine through snap inspections and mobilization of troop units. It has been pointed out that in August 2014 Russian troops entered Ukraine to provide support to local pro-Russian separatist forces. In the face of a decline in the supply of military materiel from Ukraine, Russia has taken steps to raise the percentage of defense equipment produced within Russia itself.

## **1. Russia Faces Pressure to Respond Effectively to Ukraine Crisis**

### **(1) Situation in Eastern and Southern Ukraine Remains Unstable**

Since becoming an independent state following the dissolution of the Soviet Union in December 1991, Ukraine has struggled in its foreign policy to maintain a balance between the United States and the EU on the one hand and Russia on the other. From the geopolitical perspective, Ukraine shares borders to the west with Poland, Slovakia, Hungary, and Romania, all of whom are members both of the EU and of NATO, while to the east it borders Russia. The country thus occupies a very strategically important position. It is against this background that the administration of President Victor Yanukovych—widely viewed as pro-Russian—came to power in 2010.

In April 2010 the Yanukovych administration and the Russian government signed the Kharkiv Pact, under which the Russian lease on naval facilities in Sevastopol in Crimea (for use by Russia's Black Sea Fleet) was extended to 2042. Meanwhile, the Ukrainian government continued to negotiate with the EU for an association agreement, and preparations were completed in March 2012. In November 2013 preparations were completed for the signing of an agreement with the heads of the EU nations in Vilnius, Lithuania.<sup>1)</sup> However, just before this could take place, the Yanukovych administration announced a decision to postpone the signing, and this was a major cause of the deterioration in the political situation in the Ukraine that has continued to this day.

This decision is believed to have been motivated by two major factors.<sup>2)</sup> The first is economic pressure exerted by Russia on Ukraine to dissuade the government in Kiev from signing the association agreement, and the inability of the EU to take adequate fiscal steps to alleviate the economic pressure on Ukraine. The

second factor consisted in the fact that the Yanukovych administration became gradually but increasingly uneasy about the probable negative impact on the Ukrainian economy (over the short term at the least) of the Free Trade Area Agreement that was included in the overall association agreement with the EU. In particular, some analysts pinpoint the influence on the Yanukovych administration's decision exerted by the managements of companies in Eastern Ukraine—where the Yanukovych administration had its main support base—who harbored distrust toward the free trade agreement.<sup>3)</sup> At the end of 2013, as a reward for postponing the conclusion of the association agreement with the EU, Russia offered to cut the price of natural gas supplied to Ukraine by 33 percent and to purchase 15 billion dollars worth of Ukrainian government bonds.

The obstruction of Ukraine's move toward closer ties with the EU sparked a backlash from pro-Western elements among the Ukrainian public, and from February 2014 antigovernment protests became increasingly frequent and violent, particularly in the capital city of Kiev.<sup>4)</sup> In an attempt to quell the political crisis, on February 21 President Yanukovych held talks with representatives of the opposition groups, the EU, and Russia, leading to the signing of the "Agreement on Settlement of the Political Crisis in Ukraine." This agreement entailed bringing forward the presidential election to the end of 2014, and building a government composed of a coalition between government and antigovernment factions that would be able to regain public trust. However the implementation of this agreement was rejected by radical antigovernment groups such as the Right Sector, who called for the resignation of President Yanukovych. Amid this chaotic situation, the Yanukovych administration collapsed, and on February 21 an interim government was formed by the forces that had been rejecting the implementation of the aforesaid agreement. This interim government then proceeded to strongly criticize the opposition, including the Communist Party and the Party of Regions (President Yanukovych's party) and to pass legislation that infringed the rights of Russian-speaking citizens. These moves were fiercely opposed by many people in the eastern and southern regions of Ukraine, where there is a high percentage of Russian-speaking residents (including both Ukrainian citizens of Russian ethnicity as well as residents of Russian origin who are not Ukrainian citizens).

The Ukrainian presidential election held on May 25, 2014 resulted in the election to the post of president of Petro Poroshenko, a former minister of economic development and trade, who won 54.7 percent of the vote. Poroshenko's

candidacy had been supported by pro-European parties. Poroshenko was inaugurated as president on June 7, and in his inaugural address he stated that he intended to pursue an association agreement between Ukraine and the EU. Regarding internal policy, he announced the intention to work toward a ceasefire agreement with armed separatist groups, and recognized the language rights of Russian speakers in an

attempt to halt the ongoing destabilization of the eastern and southern regions of Ukraine.<sup>5)</sup> This policy move is an indication of the two main issues with which the new Ukrainian administration was and is faced: how to improve relations with the EU and the United States, and how to reestablish the Ukrainian central government's authority in the country's eastern and southern regions, where Russian influence is strong. On June 27, Poroshenko signed the economic part of the Ukraine-European Union Association Agreement, thereby fulfilling the policy promise made on June 7, but this exacerbated Russia's fears. With respect to the signing of this agreement, Russian Foreign Minister Sergey Lavrov criticized both the EU and Ukraine, characterizing the agreement as an attempt by the EU to unilaterally secure an economic advantage, and pointing out that Ukraine's fulfillment of its responsibilities under the agreement would be in conflict with its existing duties as a member of the Commonwealth of Independent States (CIS).<sup>6)</sup>

In the field of domestic political issues, the Poroshenko administration initially followed a hard-line policy, pushing forward with a "counterterrorism" strategy against the pro-Russian rebels operating in Luhansk and Donetsk provinces (collectively known as the Donbass), whom they labeled terrorists. Russia responded by providing even greater support to the separatists, and from August onward the government's antiseparatist strategy became bogged down. The Poroshenko administration then effected a policy switch involving granting greater autonomy to Luhansk and Donetsk provinces.<sup>7)</sup> On September 5, representatives of the Ukraine government and of the various groups opposing it, including the Russian Federation, signed the Minsk Protocol, an agreement to halt

the war in the Donbass region that also granted special local government status to certain districts in the two provinces. A law to this effect was passed on September 16 as a follow-up to the Minsk Protocol.<sup>8)</sup>

This law legislated guarantees of the free use of the Russian language in the two Ukrainian provinces (oblasts) of Luhansk and Donetsk, where pro-Russian forces had proclaimed *de facto* independent states (respectively, the Donetsk People's Republic and the Lugansk People's Republic). Moreover, while this law employs the phrase "local autonomy at the district level," representing a concession by the Ukrainian government by granting special self-government status, not to the provinces of Luhansk and Donetsk, but to individual administrative units at a lower level, it does not recognize the existence of the two self-proclaimed "people's republics," which indicates Kiev's refusal to allow expanded autonomy for the two provinces.<sup>9)</sup> However, the cabinet headed by Prime Minister Arseniy Yatsenyuk of Ukraine opposed the granting of expanded autonomy to the regions where a high percentage of the population was Russophone, on the grounds that this would tend to lead to the partition of Ukraine. Because of this, President Poroshenko himself took the initiative in drafting this legislation. Subsequently, the president also proposed as a condition for implementation of this law that Russian troops must withdraw from Ukrainian territory.<sup>10)</sup> Amid this confusion, President Poroshenko withdrew the legislation in November 2014, and the situation in eastern and southeastern Ukraine remains unstable.

## **(2) Russia's Approach to the Ukraine Crisis**

As the Russian government regards Ukraine as being within its sphere of influence,<sup>11)</sup> it took a serious view of the political revolution that occurred in that country in 2014. As a result of the fall of the Yanukovych administration, which was seen to be broadly pro-Russian, the influence of pro-Western groups within Ukraine grew stronger. In Moscow's view, there was a danger that Ukrainian foreign policy would show a bias toward the EU and the United States, and that Ukrainian membership of NATO would become a real and imminent possibility, or at least that military cooperation between Ukraine and NATO would increase and that this would present a military threat to Russia.<sup>12)</sup> Specific fears harbored by the Russian establishment regarding such a development fall broadly into two categories. First, that the continued existence of Russia's Black Sea Fleet (whose home base was the Crimean port of Sevastopol) might become impossible. This

would greatly expand NATO's military power in the Black Sea, and Russia would thus face an increased military threat on its southern flank. Second, they feared that elements of NATO military infrastructure might be transferred to Ukrainian soil. In particular, if missile defense systems (whose deployment is being advanced by the United States) were to be deployed within Ukraine, this would seriously compromise the effectiveness of Russia's nuclear deterrent<sup>13)</sup>.

In the face of these threats, Russia moved to assert its sovereignty over the Crimean Peninsula and reinforce its influence in the Ukrainian provinces of Donetsk and Luhansk, where local pro-Russian groups were increasingly moving toward autonomy. President Putin called for the extension of Russian jurisdiction to these two provinces, employing in his speeches and statements the term "Novorossiya" (New Russia)—thus evoking the Russian Empire under the Tsars—as well as the phrase "the federalization of Ukraine." This approach by Putin was aimed at countering Ukraine's perceived moves toward closer alignment with the EU and the United States by giving the two easternmost Ukrainian provinces a greater voice in domestic policy-making.<sup>14)</sup> In an election held on October 26, however, parties seen to be pro-Western won a majority of seats in the Ukrainian Parliament (the Verkhovna Rada), and the country began to follow a pro-Western foreign policy.

In response to the Ukraine crisis, on March 1, 2014 the Federation Council, the Upper House of the Federal Assembly of Russia, agreed to the use of the Russian military by President Putin to protect Russian citizens living in Ukraine, Ukrainian citizens of Russian ethnicity, and Russian troops stationed on Ukrainian territory in accordance with international treaties.<sup>15)</sup> In response to this, armed groups believed to have been Russian troops were deployed across the Crimean Peninsula, and a referendum was held on whether Crimea should declare independence from Ukraine and be annexed by the Russian Federation. These proposals were supported by an overwhelming majority of the public (over 95 percent of votes counted). The demographics of Crimea break down into 59 percent of Russian ethnicity and 24 percent of Ukrainian ethnicity, with various other groups making up the difference.<sup>16)</sup> The origins of the issue of whether Crimea should or should not return to Russian control can be traced back to the Soviet era. Until 1954 Crimea was a constituent part of the Russian Soviet Federative Socialist Republic (RSFSR) under the name of the Crimean Autonomous Soviet Socialist Republic, but in that year it was transferred at the initiative of Communist Party First Secretary Nikita



Khrushchev to the control of the Ukrainian Soviet Socialist Republic in commemoration of the 300th anniversary of the union of Ukraine with Russia.

These events form part of the background against which Russia regards the Crimean Peninsula as a region of special interest. However, the single most crucial factor in Russia's annexation of this region is surely the strategic importance that the Russian leadership places on the Crimea. President Putin has stated that Crimea is an extremely important factor for the stability of the entire region; that Russia must ensure that this strategic area is firmly controlled; and that this can only be achieved by asserting Russian sovereignty over the peninsula.<sup>17)</sup> In support of Russia's claims regarding Crimea, Putin has also cast doubt on the legality of the legislation by means of which the aforesaid 1954 decision to transfer Crimea to Ukraine was made. For example, it has been pointed out that, according to the constitution of the RSFSR, the resolution regarding the transfer of Crimea to the jurisdiction of Ukraine—which was adopted by the Presidium of the Supreme Soviet of the RSFSR on February 5, 1954—exceeded the authority of the Supreme Soviet of the RSFSR and of the Presidium.<sup>18)</sup> Immediately following the dissolution of the Soviet Union, this issue became a domestic problem for the Russian Federation, and on May 21, 1992, the Supreme Soviet of the RSFSR adopted a resolution to the effect that the resolution of February 5, 1954, was legally invalid on the twin grounds that it was in violation of the Russian constitution and that the correct legal procedures were not followed.<sup>19)</sup> President Putin's actions demonstrate his belief that the transfer of sovereignty over Crimea from the RSFSR to Ukraine was illegal.<sup>20)</sup>

As a result of the referendum on whether Crimea should join Russia, on March 18 President Putin and representatives of the separatist government of Crimea signed a treaty of accession of the Republic of Crimea and the city of Sevastopol into the Russian Federation. This treaty was ratified by the Federal Assembly of Russia on March 21.<sup>21)</sup>

### **(3) Impact of Ukraine Crisis on Russian Internal Politics**

The annexation by Russia of the Republic of Crimea and the city of Sevastopol led to a recovery in President Putin's approval rating. A public opinion poll conducted in July 2014 by Levada-Center found that the president's approval rating had risen to 86 percent, the second-highest level since the 88 percent recorded at the time of the Russo-Georgian War of 2008.<sup>22)</sup> Putin thus seems to

have been successful over the short term in dealing with the Ukraine crisis, and his administration appears stable. Over the long term, however, he will undoubtedly be faced with difficult problems, and may therefore not be able to maintain such high approval ratings.

The first likely problem involves the rise of Russian nationalistic feelings, which have been whipped up by Putin's government. Growing nationalism may cause Russia to adopt a hard-line foreign policy, leading to a deterioration in relations with other countries and multinational organizations. This outcome is particularly probable in the case of the other former Soviet republics, which Moscow views as being within its sphere of influence. In other words, just as the upper house (the Federation Council) of the Federal Assembly of Russia granted Putin the authority to use military force in protecting the rights and freedoms of Russian citizens and Russophone Ukrainian citizens through the annexation of Crimea, it is possible that Russia will in the future again forcefully assert its right to protect Russian citizens and other persons of Russian ethnicity residing in other former Soviet republics.

Ethnically Russian residents of Ukraine and other former Soviet republics have close historical, cultural and economic ties with Russia, who regard them as compatriots. Because of this, the authorities have asserted their duty to protect such Russophone populations from political oppression. Regions containing such Russophone populations—which Moscow has assumed a responsibility to protect—do not coincide with the territory of the Russian Federation, and the government is being increasingly called upon to take steps—including military action—in defense of national interests.<sup>23)</sup>

The second problem concerns the negative economic fallout from the Ukraine crisis, which seems likely to exert a long-term destabilizing effect on the Putin administration. At the end of July 2014, the EU imposed a raft of sanctions against Russia over a wide range of fields, including finance, oil drilling, and arms exports. In early August Russia responded by banning the import of certain food items from the countries imposing these sanctions.<sup>24)</sup> As of July 2014, direct foreign investment in Russia had fallen by 60 percent from the previous year's level, and some sources claimed that the extent of capital flight from Russia had grown to roughly twice that in 2013.

The third problem revolves around the effect of the Ukraine crisis on the ongoing reorganization of Russia's administrative structure. Against the

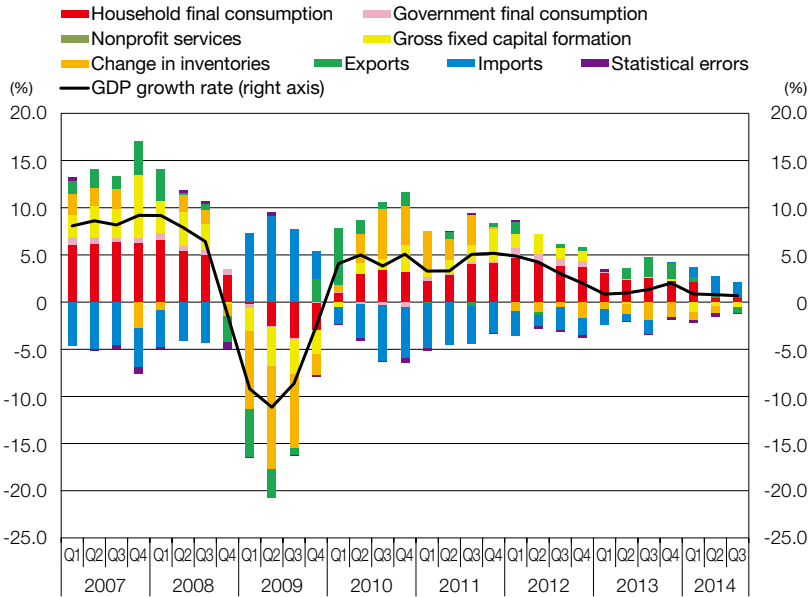
background of a series of such reorganizations, it appears that the Putin government believes that its stability rests on its ability to effectively address various policy issues that have come to the fore as a result of the Ukraine crisis. The annexation of Crimea led to the creation of a new government department—the Ministry of Crimean Affairs—dedicated to addressing issues attendant on the incorporation of the region into Russia<sup>25)</sup>. This was based on the concept that separate administrative bodies need to be established to deal specifically with economic and social issues for each region of the country. This concept had already led to the creation of the Ministry of Development of the Far East in May 2012 and the Ministry of North Caucasian Affairs in May 2014. In line with this policy of creating separate ministries for different regions, the Ministry of Regional Development was dissolved in September 2014.

The Ukraine crisis has also been a significant factor behind the reorganization of administrative bodies responsible for overseeing Russia's defense industry and weapons procurement. In September 2014 President Putin took the decision to upgrade the Military Industry Committee, which had been under the direct control of the government, to the status of a standing committee under the direct control of the president. This decision was announced at a conference held to examine problems attendant on the changeover from the existing State Weapons Program for 2011–2020 to a new State Weapons Program for 2016–2025, and is believed to have been motivated by a desire to more effectively pursue policies relating to Russia's defense industry.<sup>26)</sup> At the conference, Putin hinted that the Ukraine crisis was one of the factors lying behind the decision. Specifically, he stated that NATO members were aggravating the situation in Ukraine and exploiting it to strengthen NATO.<sup>27)</sup> In the same month of September, the Federal Agency for Defense Orders and the Federal Agency for Procurement of Weapons, Special Military Machinery and Materials, and Supplies were both scrapped, and the Ministry of Defense took over all responsibility for the procurement of military equipment.<sup>28)</sup>

#### **(4) Ukraine Crisis Causing Further Slowdown in Russian Economic Growth**

The Russian government's start-of-the-year economic growth forecast for 2014 was 2.5 percent,<sup>29)</sup> but the actual growth rate came to only 0.6 percent.<sup>30)</sup> Not only has the hoped-for recovery from the mere 1.3 percent growth in 2013 failed to materialize, the economy actually seems to be on the verge of a recession. This

**Figure 6.1. Russian quarterly GDP growth rates, y-o-y  
(breakdown by contribution ratios of principal factors)**



Source: Compiled from statistics issued by the Russian Federal State Statistics Service.

growth slowdown also sharply diverges from the forecasts made by international financial institutions such as the IMF, which predicted growth of over 2 percent.

Russian economic growth fell well short of the start-of-year forecast in 2013, too. The principal factors behind this were: a deterioration in the current account and serious capital outflows—both resulting from a prolonged economic downturn in Europe, which is Russia's main export market—leading to downward pressure on the Ruble; lack of progress in the structural reforms required to ensure sustainable economic development; weak business confidence caused by shrinking profit margins against the backdrop of a failure to raise productivity; and a stagnation in private investment. In addition, in 2013 private consumption, which was the main driver of Russian economic growth, grew by only half the amount in 2012, due to lower growth in real wages. In short, the Russian economy entered 2014 amid a situation of sluggish investment and decelerating private consumption resulting from the downward pressure on the Ruble caused by the factors listed above.

Meanwhile, the reason that economic growth for 2014 had initially been forecast at over 2 percent was the expectation of a recovery in domestic investment accompanying the recovery of the global economy, particularly in Europe and emerging economies. In fact, however, the prolongation of the Eurozone debt crisis caused economic stagnation in Eurozone member states, and as this economic bloc exerts a powerful influence over the Russian economy, business sentiments in Russia failed to rebound, and growth continued to slow. This already dismal economic situation was exacerbated by market volatility and policy uncertainty stemming from geopolitical tensions caused by the Ukraine crisis.

Specifically, against the background of policy uncertainty, sharp fluctuations were seen in Russia's stock market and foreign exchange market, and the impact of this was exacerbated by the imposition of sanctions on Russia by the EU and the United States, leading to a more rapid capital outflow from Russia. This, in turn, led to sluggish consumption and stagnant investment activity. Meanwhile, the Ruble depreciation caused the value of imports to follow a downward trend, and it was against this backdrop that the first raft of sanctions was imposed in March. Domestic production in Russia rose slowly to compensate for the drop in imports (as part of Moscow's import substitution policy), leading to a slight rise in private consumption. Consequently, economic growth for the first half of 2014 barely managed to register positive figures. Despite this, and against the background of policy uncertainty and the imposition of still tougher sanctions, the outflow of capital failed to dry up. The Ruble therefore continued to depreciate, and core inflation accelerated. The household debt burden grew, the growth of real wages was restricted, and private consumption peaked out.

The most severe impact of these developments was felt in the field of investment. For a number of years, structural problems in the Russian economy had prevented improvements in productivity, and profit margins had consequently been narrowing. On top of this, in 2014 the growth of consumption slowed down, and the combined effect of policy uncertainty and economic sanctions introduced a further element of unpredictability in the country's economic prospects, leading to a slump in investment. Most notably, the economic sanctions targeting the financial sector restricted access to external capital markets, and even companies operating in sectors where growth was expected were forced to delay or scale back their investment programs.

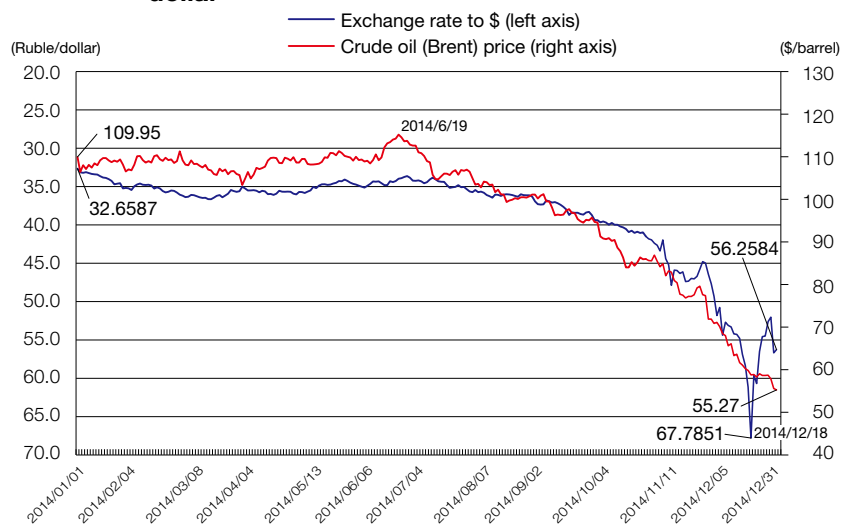
## **(5) Russia Seen Facing Difficult Choices in Economic and Fiscal Policy**

Sanctions imposed by the EU and the United States as a result of Russia's involvement in the Ukraine crisis fall into two broad categories: sanctions imposed on specific individuals, organizations, and corporations judged to have had a hand in creating or aggravating the situation in Ukraine, and sanctions targeted at entire sectors of Russian economic activity, such as the financial, military, and energy sectors. Since coming into force in March 2014, the scope of sanctions in the former category has been gradually expanded, while the severity of those in the second category, which came into force in July, has also been reinforced in a stepwise manner.<sup>31)</sup> It is this second category of sanctions that presents the Russian government with particularly thorny problems.

Sanctions targeting the Russian financial sector made it difficult for the principal Russian state-owned banks to procure funds on financial markets in the EU and the United States. In July, easily-settled bank borrowings with a maturity of less than ninety days were excused from application of sanctions, but in September sanctions were strengthened, with the applicable maturity period being reduced to less than thirty days. Ahead of the imposition of sanctions in March 2014, the Bank of Russia (the country's central bank), which had been under pressure from inflation, hiked the key interest rate from 5.5 percent to 7 percent as an emergency response to a sharp depreciation of the Ruble. At the same time, in response to exchange rate volatility, the central bank raised the amount of cumulative foreign exchange interventions—aimed at stabilizing the forex market—from \$350 million to \$1.5 billion. Subsequently, the Bank of Russia key rate was also raised to 8 percent in July, in spite of which the Ruble continued to depreciate, inflation pressures failed to ease off, and the central bank was forced to conduct large-scale foreign exchange interventions to slow down Ruble depreciation.

For the Russian government, an even more serious problem than the stagnation of investment activity caused by depreciation of the Ruble was the fear that it would push inflation up. This would depress consumer spending, which had until that point barely managed to shore up the economy. It was against the backdrop of such fears that in the latter half of 2014 global oil prices fell sharply, making it more difficult for Russia—which is a major oil producer—to apply the brakes to the Ruble depreciation. On November 5 the Bank of Russia raised the key interest rate to 9.5 percent, and announced on November 10 that a floating exchange rate

**Figure 6.2. International crude oil prices and exchange rates to the dollar**

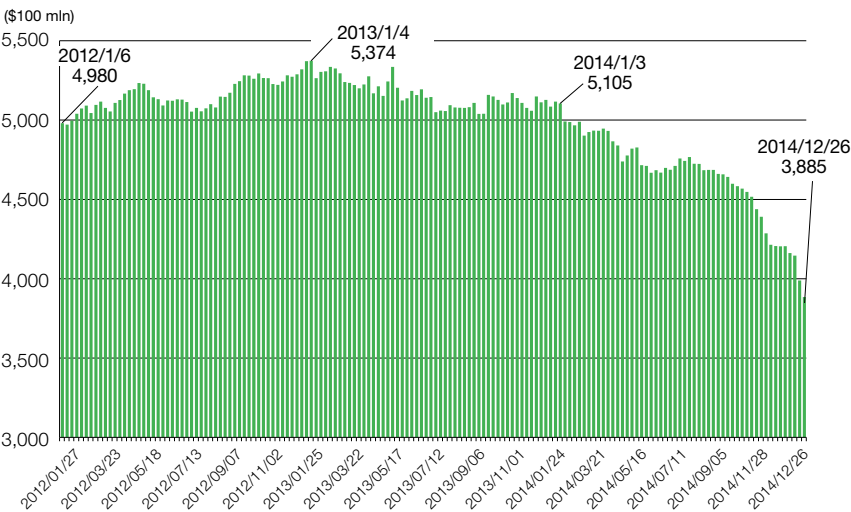


Source: Compiled from data released by the Bank of Russia.

system would be introduced.<sup>32)</sup> The principal factor behind this decision was the fact that the system traditionally employed, in which an allowable fluctuation range was set, and currency interventions were implemented when the exchange rate exceeded these limits, made the Ruble particularly susceptible to speculative trading. It was recognized that this system—far from helping to stabilize the Ruble exchange rate—was now acting as an obstacle to stabilization.<sup>33)</sup>

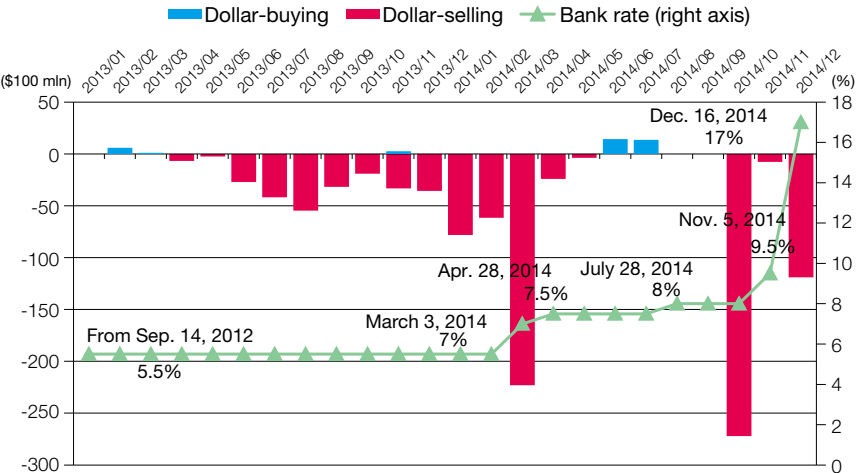
Following this move, however, oil prices continued to fall, and on November 27, OPEC decided not to implement production cuts at its 166th meeting of the conference in Vienna. In reaction to this, oil prices plunged steeply, taking the sharp Ruble depreciation in tandem. On December 12 the Bank of Russia raised the key rate to 10.5 percent, in spite of which the Ruble continued to depreciate. On the 16th, the central bank hiked the key rate to 17 percent and simultaneously conducted a large-scale market intervention.<sup>34)</sup> Thus, the Russian financial authorities' room for maneuver in terms of monetary policy aimed at countering the significant depreciation of the Ruble was rapidly constrained by the imposition of sanctions and the fall in global oil prices, against the background of the structural problems from which the Russian economy suffers.

**Figure 6.3.1. Russia’s rapidly narrowing financial policy options**  
—International reserves—



Source: Compiled from figures released by the Bank of Russia.

**Figure 6.3.2. Financial policy measures**  
—Foreign exchange intervention on monthly basis (US\$) and bank rates—



Source: Compiled from figures released by the Bank of Russia.



Sanctions targeting Russia's military sector not only restricted the ability of corporations in the defense industry to raise funds, but also banned the export of dual-use goods and technologies (i.e. those with both civilian and military uses) for military end users.<sup>35)</sup> The Russian government is committed to the establishment of an innovation-led modern economy by acquiring cutting-edge technologies for dual-use equipment both here and abroad in order to raise the overall level of the country's military technology, and it was predicted that these sanctions would constitute a severe blow from the twin standpoints of financing and imports of technologies. In order to cushion the impact of the sanctions, in addition to the reform of the military technology development system on which the Russian government embarked in 2012,<sup>36)</sup> various steps were taken to strengthen the system for implementation of the military industrial policy. One such step was the transfer in September of the Military-Industrial Commission of the Russian Federation, which had up to then been under the control of the government, to the direct control of the president.<sup>37)</sup>

Sanctions targeting Russia's energy sector have limited the ability of major energy companies to raise funds. In addition, they have also prevented the conclusion of new contracts for the export to Russia of technologies or services needed by Russia to develop its deep-water and Arctic oil resources or to develop shale oil resources. For the energy sector, which is seeing decreasing production capacity at existing oil and gas fields, these new development possibilities are an indispensable means of maintaining and hopefully increasing total production volume. For this reason, restrictions on the ability of energy companies to raise funds or import new technologies are expected to have a long-term adverse effect on the Russian economy as a whole, which is heavily dependent on exports of natural resources. Consequently, ahead of the anticipated additional sanctions—at the St. Petersburg International Economic Forum held in May 2014 and Global Oil Conference held in June, among other occasions—the Russian government focused efforts on obtaining confirmation of the implementation of existing contracts with European and American major energy companies, and on seeking strengthened cooperation.

There seems no doubt that it was this kind of forward-looking stance on energy adopted by the Russian government that formed the backdrop against which a contract was signed in May 2014 between the Russian gas monopoly Gazprom and the Chinese counterpart. This contract, for the supply of gas to China by pipeline, was the end product of many years of hard-fought negotiations over price conditions. Among Russia's leading companies in the energy sector, which

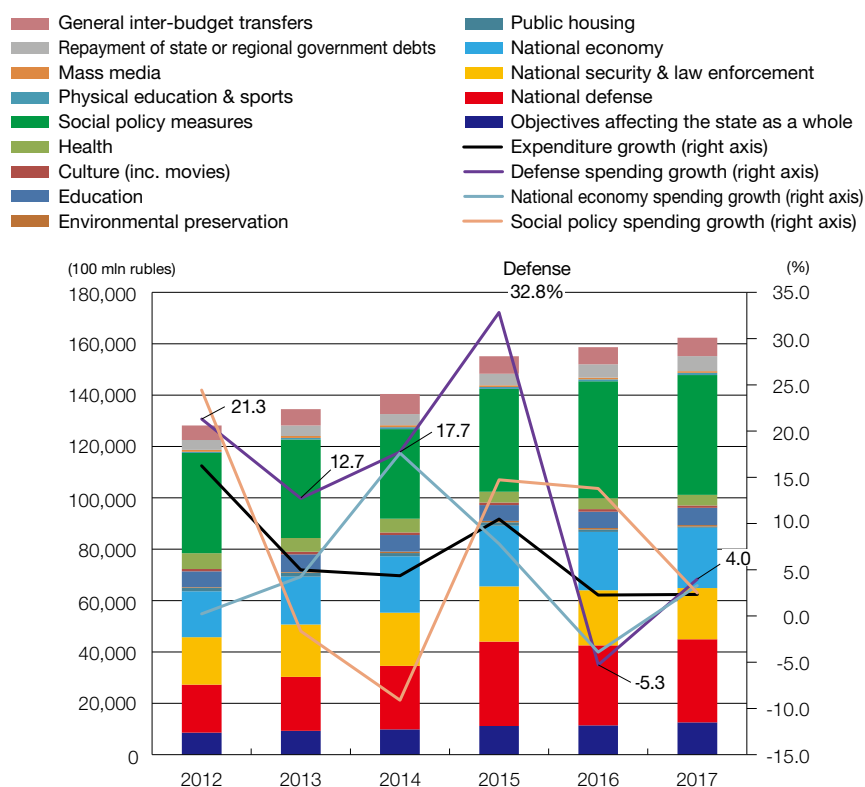
faced great difficulties in procuring funds, Gazprom was initially exempt from the application of sanctions. However, with regard to the issue of nonpayment for gas received by Ukraine, which was one of the major factors behind the Ukraine crisis, the Russian government initially adopted a hard-line stance, but during the latter half of 2014 it began to follow a policy of seeking to hammer out a compromise on this issue with the aim of collecting its outstanding claims and securing stable exports to Europe. In addition, Russia's largest oil company, Rosneft, requested the government to disburse money from the National Wealth Fund to finance large-scale projects such as expanded exports to China and development of oil fields in the Arctic and on the island of Sakhalin.

The Russian government's management of public finances is predicated on its own economic growth forecasts, but it has recently been forced to revise these forecasts downward on multiple occasions. In May 2014 the Ministry of Economic Development announced that the economy's growth for the year would fall well short of the initial forecast of 2.5 percent, at a mere 0.5 percent growth. This downward revision was based on the observations that: capital outflows were proceeding unchecked, causing negative year-on-year growth in investment; and the rate of inflation had risen to 6 percent from the start-of-year 4.8 percent, pushing down the growth of real wages from 3.1 percent to 1.4 percent, leading to sluggish consumption. As a consequence, the ministry recommended that government expenditures be increased. Following this, after repeated consultations between the Ministry of Economic Development and the Ministry of Finance—which took a cautious stance on increasing expenditures in consideration of the need to maintain market confidence—in July the Finance Ministry revealed a three-year draft federal budget (covering the period 2015-2017) featuring a prime focus on budget-balancing. Under this draft, the scale of expenditure for 2015 would fall below the amount stipulated in the three-year budget bill that was passed in December 2013.<sup>38)</sup>

Nevertheless, when various statistics began to appear in August, it was seen that inflation was rising faster than forecast, and with real wages stagnating it was feared that consumption would slow still further. In response, the finance ministry was forced to redraft the budget with a focus on economic stimulation measures. As a result, planned expenditure for 2015 not only exceeds the finance ministry's initial budget draft, but also exceeds the level stipulated in 2013, at 15,513.1 billion rubles, or a year-on-year increase of 10.5 percent.<sup>39)</sup> This year-on-year growth is well above the 4.4 percent figure budgeted for 2014. Broken

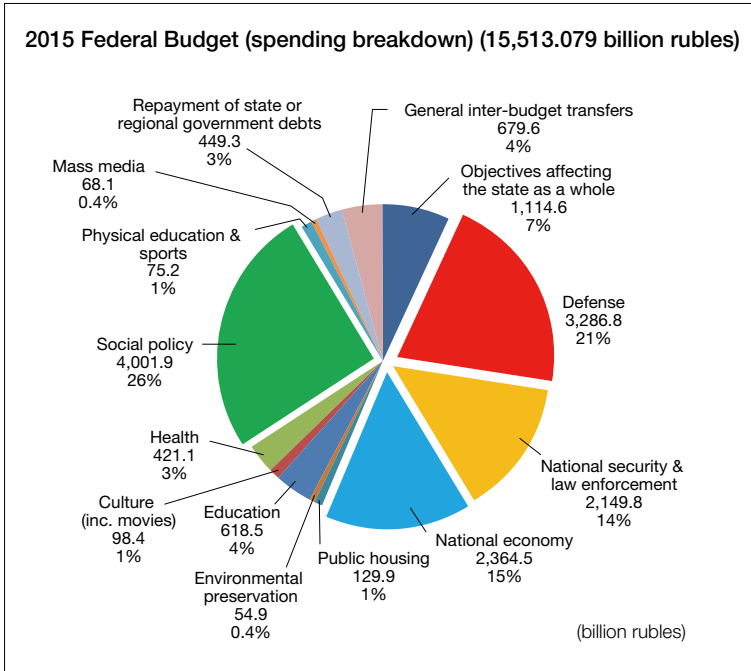
down into broad expenditure categories, budget expenditure on national economy, social policy, and defense was increased, while spending on education, sports, and health was reduced. From the apportionment of expenditures in this budget, it can be deduced that the Russian government was attempting to address economic problems that had recently come to the fore. Among these, the growth in expenditure on national defense is particularly marked. The growth in defense spending was notably sharp in 2012, at 21.2 percent over the previous year (17.7 percent in 2014), but the defense spending budgeted for 2015 exceeds even this, by a wide margin, up 32.8 percent year on year, at 3,286.8 billion rubles. This accounts for 21.2 percent of the total budget of the Russian Federation for 2015 (compared with 17.6 percent in 2014), or 4.2

**Figure 6.4. The federal budget of the Russian Federation**



Source: Compiled from explanatory materials released by the State Duma for each year.

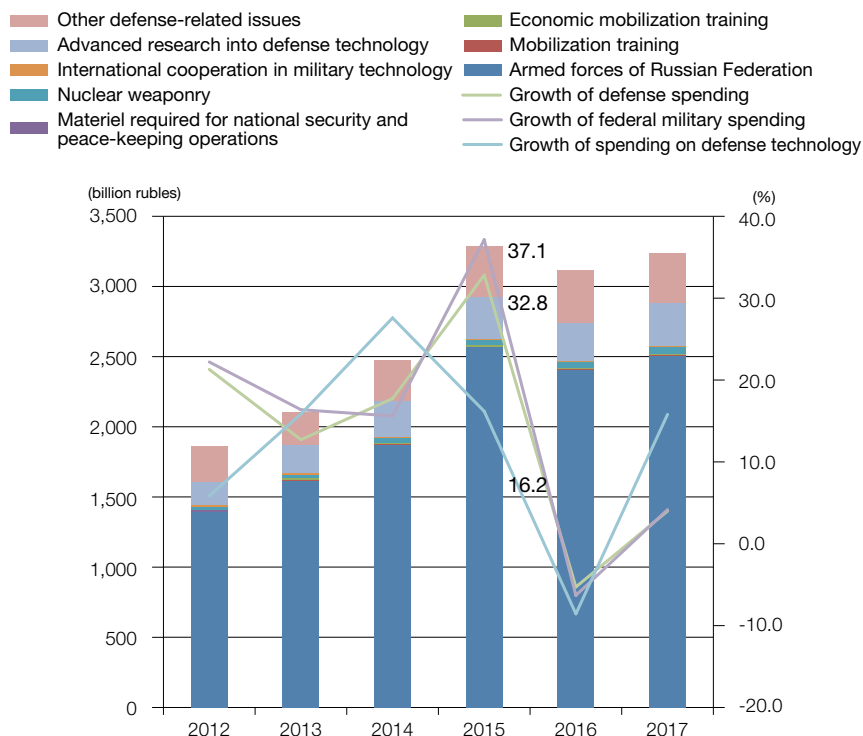
**Figure 6.5. Breakdown of Russian federal budget for 2015**



Source: Compiled from explanatory materials released by the State Duma for each year.

percent of Russia's GDP (3.4 percent in 2014).

Although details of the breakdown of defense spending in the 2015 budget are unavailable, the single largest expenditure item—the defense budget appropriation for the Russian Armed Forces—is up by 37.1 percent over the previous year, for a year-on-year increase of 696.6 billion rubles. In addition, notable other increases include a boost in spending of 16.2 percent (40.8 billion rubles) on research and development in the field of defense technology, and an increase in spending on “other national defense issues” (correspond to discretionary reserve) of 23.9 percent (69.8 billion rubles).<sup>40)</sup> With respect to this, at the end of November 2014, following the passage of the government's budget draft by the Federal Assembly of Russia, a series of meetings were held on the issue of reinforcing the country's military capabilities. At these meetings, President Putin placed emphasis on the

**Figure 6.6. Russian spending on national defense**

Source: Compiled from explanatory materials released by the State Duma for each year.

following points: (1) the necessity, amid a rapidly changing security environment, of continuing to strengthen Russia's military capabilities through structural reform; (2) the importance of sticking with the target of modernization of 70 percent or more of all military equipment by 2020; (3) the need to reinforce the domestic system for production of alternatives to imported military equipment; and (4) the need to modernize the defense industry so that it is capable of efficiently developing and manufacturing state-of-the-art equipment. Putin also stressed the need to take special care to prevent the deterioration of the economy from impacting the defense industry.<sup>41)</sup> Despite the difficult economic circumstances, it seems Russia found itself needing to make haste to provide the country's armed forces with the equipment they require by strengthening the foundations of the defense industry through increased defense expenditure.

## **2. Russia Seeking to Move Forward with Eurasian Union Concept, and to Strengthen Ties with East Asia**

### **(1) Moving Forward with Eurasian Union Concept**

Amid deteriorating relations with the EU and the United States over the Ukrainian issue, Russia has become more active in strengthening its diplomatic ties with other former members of the Soviet Union that are within what Russia regards as its unique sphere of influence. These moves are part of an effort to realize the Eurasian Union concept put forward by President Putin, involving the economic integration of countries of the CIS. In October 2011, Putin had already announced that he would stand as a candidate in elections for his third term as president, and had been campaigning for this so-called “Eurasian integration” as one of the most important issues Russia needed to address in the foreign policy field.<sup>42)</sup> The eruption of the Ukraine crisis then spurred Russia to move with still greater speed to realize this concept. In March 2014 Putin stated that in his opinion, the actions taken by the EU and the United States with respect to Ukraine were aimed at opposing Russia and the Eurasian Union concept.<sup>43)</sup>

On May 29, 2014, at the Supreme Eurasian Economic Council, a conference held in the Kazakhstan capital of Astana, the heads of Russia, Belarus, and Kazakhstan signed a treaty on the Eurasian Economic Union. Accordingly, the union came into existence on January 1, 2015.<sup>44)</sup> This treaty binds the three signatories more tightly together in the economic sphere, and consists primarily of guarantees of free trade, unrestricted financial cooperation, and free movement and

operation of goods, services, capital, and labor.<sup>45)</sup> President Putin has asserted that the treaty fully respects the sovereignty of all three signatory nations, and has praised it for making possible close coordination among the three governments in economic matters. The future of the Eurasian Economic Union, as envisaged in the treaty, involves a stepwise evolution entailing: (1) the

creation of a single pharmaceuticals market from January 1, 2016; (2) the creation over the period up to 2019 of a common electric power market; and (3) the creation by 2025 of a single framework for coordination of financial policy and a shared macroeconomic system, encompassing agreements on antitrust measures, foreign exchange, and fiscal policies. It also contains provisions for the establishment of common markets for oil and gas.<sup>46)</sup>

Some observers, however, have cast doubt on the viability of plans to strengthen cooperation among the three countries over the long term. To establish common markets in various fields, it will be necessary to standardize the differing customs rates and systems across the three separate markets to enable the free movement of goods within the union. This will not be easy, say the observers.<sup>47)</sup> It has also been pointed out that the motives of the three governments for strengthening economic integration may not necessarily be identical. In the background to Russia's move towards integration lies the desire to expand membership of the union so as to expand Russia's sphere of influence in opposition to what it sees as encroachment by the countries of the West, but the other two governments are wary of this concept. The economy of Belarus is heavily dependent on Russia—notably for the supply of energy—and this dependence has reduced the country's foreign policy options and acted as an obstacle to expanded relations with the European Union.

Voices within Belarus have questioned whether so-called Eurasian economic integration would, in fact, be beneficial to the country.<sup>48)</sup> Kazakhstan, on the other hand, was first to propose the concept of a Eurasian economic bloc in 1994, and the government places importance on the union, but this does not mean that the idea of moves led by Russia to strengthen integration enjoy wholehearted support. In January 2014 Kazakhstan released a conceptual framework for the country's foreign policy in the period 2014-2020 in which it was stressed that diversification of Kazakhstan's economy was an important factor in upholding the national interest, and that it was vital to emphasize economic cooperation with a wide range of nation states.<sup>49)</sup> In fact, at the Davos Forum, during talks on January 22, 2014, with President Jose Manuel Barroso, president of the European Union Commission, President Nursultan Nazarbayev stressed that it was a matter of urgency for Kazakhstan to sign a partnership and cooperation agreement with the EU.<sup>50)</sup>

For Russia's part, with respect to military strategy, the centerpiece of the Eurasian integration concept is the opportunity it affords to continue reinforcing

military collaboration under the Collective Security Treaty Organization (CSTO) framework. At a meeting of CSTO defense ministers held in Moscow in June 2014, the issue of strengthened military cooperation was discussed, with an eye to the situation in Ukraine. At this meeting, as a way of reinforcing collaboration among the various CSTO military organizations, the participants examined issues involving mutual support by CSTO members in the event of an increase in the severity of external threats, and approval was given for operational deployment plans for all military units within the CSTO framework.<sup>51)</sup>

## **(2) Russia Seeking to Strengthen Ties with Nations of East Asia**

The confrontation with the EU and the United States over the Ukraine crisis has left Russia feeling increasingly isolated in the sphere of diplomacy, and this has increased the importance of China as a partner in this respect. President Putin has long since been consistently looking for ways to improve ties with the countries of East Asia, in view of his commitment to placing a strong focus on developing the economy of the Russian Far East,<sup>52)</sup> and the Ukraine crisis has therefore injected further urgency into Russia's drive to establish stronger relations with East Asian countries.

On May 20-21, 2014 President Putin paid an official visit to China in an attempt to demonstrate the closeness of relations between the two countries.<sup>53)</sup> One major success achieved by this visit in the economic field was the signing of a long-term contract between Gazprom and the China National Petroleum Corporation (CNPC) for the supply of natural gas to China via pipeline. On the occasion of the visit by Putin, the two sides signed over forty memoranda and other agreements on economic cooperation.

Meanwhile, coinciding with Putin's recent summit meeting with Chinese President Xi Jinping, the Russian and Chinese navies conducted a joint exercise under the name Maritime Cooperation 2014, and both leaders attended the commencement ceremony for these exercises. This was a significant event in terms of demonstrating the close relationship that has developed between the Russian and Chinese armed forces against the background of the virtual freezing of military cooperation arrangements between Russia and the West.<sup>54)</sup>

Putin also attended a meeting of the Conference on Interaction and Confidence Building Measures in Asia (CICA), scheduled to coincide with the Russo-Chinese summit meeting. This meeting took up for discussion the issue of expanding



cooperation between CICA and a variety of international organizations, and Putin proposed that possible closer liaison between CICA and the Shanghai Cooperation Organization (SCO) be examined.<sup>55)</sup> This kind of proposed liaison is seen as means of expanding the scope of activity of the SCO in reaction to the worsening of relations between Russia and the West.

In November 2014 Minister of Defense Sergei Shoigu paid an official visit to China and held a series of meetings with Chinese Minister of Defense Chang Wanquan, General Xu Qiliang (vice chairman of the Central Military Commission of the CPC), and other top officials. Minister Shoigu came away from these meetings convinced that—in consideration of the current international situation, which is showing a tendency to become increasingly complex—the strengthening of Russia’s strategic partnership with China would make an important contribution to the maintenance of peace and stability in the whole Eurasian region. In a statement made at that time Shoigu stressed the importance of further developing collaborative relationships with China in the fields of military operations and technology.<sup>56)</sup>

However, the Russo-Chinese strategic partnership is not necessarily turning out the way the Russians had hoped for, and certain limits can be seen to the degree to which these two countries are able to come together. For instance, China has not come out as a clear supporter of the Russian side in the Ukraine crisis. While the government in Beijing opposes the imposition of sanctions by the EU and the United States on Russia, it cannot help but be alarmed by Russia’s annexation of Crimea and its actions within Ukrainian territory.<sup>57)</sup>

On March 27, 2014, when Ukraine put a resolution before the General Assembly of the United Nations criticizing Russia’s annexation of Crimea and supporting the territorial integrity of Ukraine, China abstained from voting. This reflects Beijing’s ambivalent stance on this issue. China and Russia also have their own individual stances on the so-called Eurasian integration concept. While Russia’s views have been described above, China is also taking an active stance on Central Asia, and has put forward the idea of the “New Silk Road.” China’s attempt to expand its influence into an area that Russia regards as part of its sphere of influence may well lead to a serious clash between the national interests of these two countries sometime in the future.<sup>58)</sup>

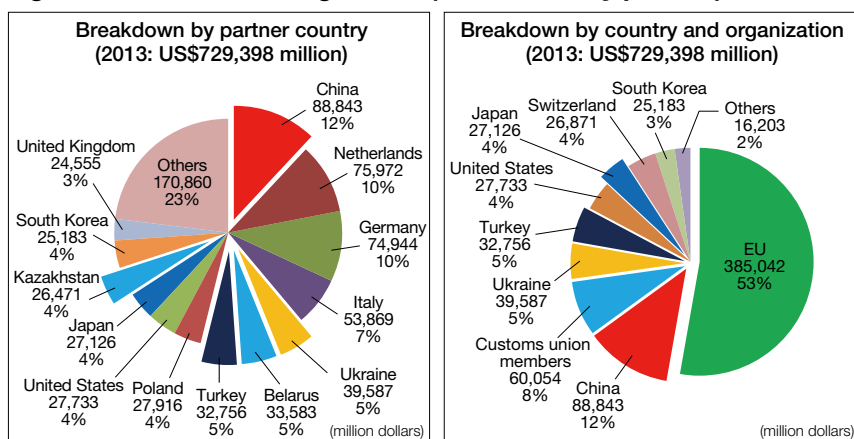
### **(3) The Ukraine Crisis and Russia’s External Energy Policy**

The Russian government is committed to overseeing a transformation of the

structure of the Russian economy from one overly dependent on exports of natural resources to one that is more diversified and capable of realizing sustainable growth. To this end, it has been pursuing a policy of modernization driven by innovation, and has for many years been drawing up the federal budget in such a way as to gradually decrease the percentage of the Russian Federation's total revenues accounted for by oil and gas. To date, however, it has failed to reach its targets. In fact, oil and gas accounted for as much as 50 percent of total government revenues in 2013, and this rose to 52 percent in 2014 despite a start-of-the-year forecast of 48 percent. Moreover, as economic growth has slowed down still further in reaction to the Ukraine situation, the government has been forced to draw up an initial budget for 2015 that assumes a revenue dependence on oil and gas of over 50 percent.

On the other hand, the government was able to introduce economic and fiscal policy measures to support the economy, which was hit hard by the Ukraine crisis, only because it possessed a financial buffer in the form of the Reserve Fund and the National Wealth Fund—which had been built by the injection of revenues from oil and gas exports—as well as a foreign currency reserve that had similarly been increased when Russia was enjoying an economic boom period.<sup>59)</sup> In other words, the Russian government's ability to secure stable revenues into the future—based on the adequate establishment and management of an export-focused energy policy—is just as crucial to maintaining the wealth and vigor of the state as the modernization of the economy, if not more so.

Against this background, in February 2014 the Ministry of Energy released its Energy Strategy of Russia up to 2035,<sup>60)</sup> which is an update of the Energy Strategy of Russia up to 2030, published in November 2009.<sup>61)</sup> Whereas the 2009 strategy set a target for the year 2030 of raising exports of energy to countries in the Asia-Pacific region to 26–27 percent of total energy exports, with a subsidiary target of expanding exports of natural gas to 19–20 percent, the new 2014 strategy has ratcheted up these figures to 34 percent and 31 percent, respectively, for achievement by 2035. This represents a sharp increase in exports to the Asia-Pacific region. At the same time, both of these strategies aim to increase exports to European markets for the time being—based on forecasts of demand in that market—and to maintain the attained volume of exports over the medium-to-long term, indicating the authorities' determination to work to continue a stable relationship with the European consuming countries.

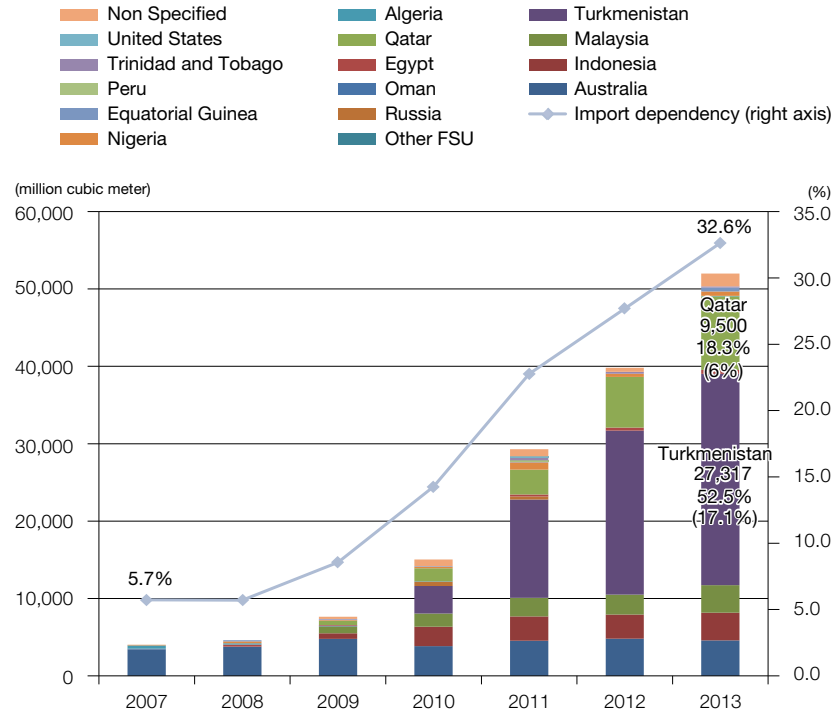
**Figure 6.7. Russian foreign trade (breakdown by partner)**

Source: Compiled from statistics issued by the Russian Federal State Statistics Service.

Turning to Russia's strategic maneuverings toward the Asia-Pacific regional markets, during President Putin's visit to China in May 2014, he and President Xi attended the signing ceremony of a contract between Gazprom and China National Petroleum Corporation (CNPC) to supply gas by pipeline to China. Under this contract—the culmination of many years of negotiations<sup>62</sup>)—Gazprom will begin supplying gas in 2018, and undertakes to supply 38 billion cubic meters of gas annually for 30 years at a price totaling \$400 billion. The signing of the contract opens up the way to the full-scale development of promising gas fields in Eastern Siberia. Following on from this, at the Russo-Chinese summit held in conjunction with the APEC summit in November 2014, an agreement was reached on the supply of 30 billion cubic meters of natural gas (produced at gas fields in Western Siberia) per annum to the Xinjiang Uyghur Autonomous Region in northwest China, and a Framework Agreement on this was signed between representatives of Gazprom and CNPC in the presence of presidents President Putin and President Xi.<sup>63</sup>) Also at that summit meeting, a Framework Agreement was signed between Rosneft and CNPC under which CNPC would acquire a 10 percent capital stake in a massive oilfield development project being undertaken by Rosneft in Eastern Siberia.<sup>64</sup>) In this way, Russia and China are building even stronger cooperative ties in the field of energy.

China and Russia are also reinforcing ties in nonenergy areas. In October 2014,

**Figure 6.8. Origins of natural gas to China**

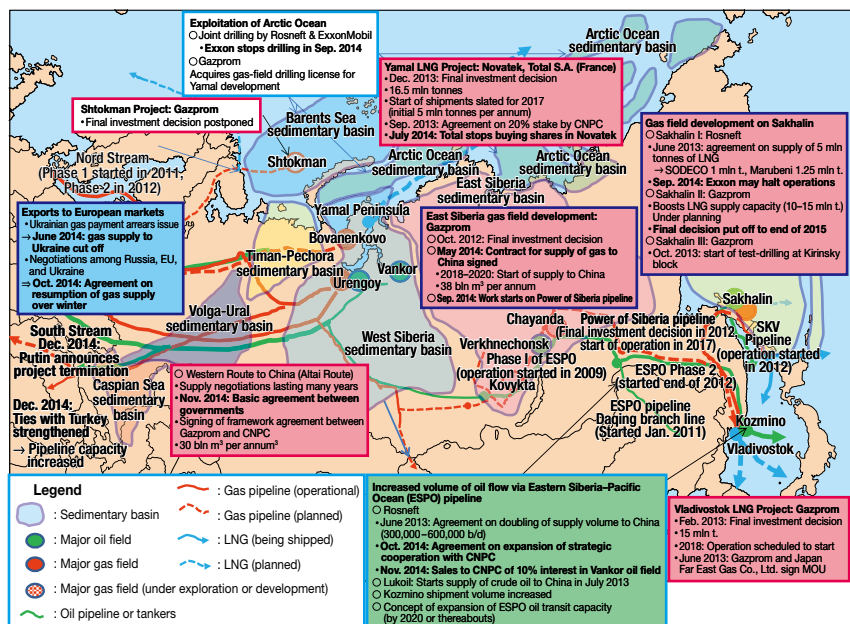


Sources: Compiled from figures released by the IEA.

when Chinese premier Li Keqiang visited Moscow, he held talks with the Russian government on strengthening economic cooperation, and the Central Bank of the Russian Federation and the People’s Bank of China signed a National Currency Swap Agreement. This was followed, at the Russo-Chinese summit in November, by an agreement to expand bilateral trade denominated in Chinese renminbi. Economic cooperation between Russia and China is thus becoming increasingly extensive, and encompasses the financial sphere.

Meanwhile, on the European front, at a meeting of the European Council (a summit meeting of the heads of state of the EU member nations) held on October 24, 2014, an energy strategy for the period up to 2030 was adopted at long last.<sup>65</sup> This strategy document calls for measures to alleviate the risk of disruption of energy supplies by upgrading energy-related infrastructure and rationalizing

Figure 6.9. Russia's energy policy



Sources: Compiled from various sources.

energy markets within the EU, while simultaneously taking steps to strengthen its energy price bargaining power.<sup>66</sup> While this was going on, three-way talks were held between Russia, the EU, and Ukraine on resuming the supply of gas from Russia to Ukraine, which had been stopped in June 2014. The result of these negotiations was that Ukraine would make the payments for which it was in arrears (at a discounted price), and that Russia would supply gas to Ukraine over the winter period (up to the end of March 2015) on condition that Ukraine paid for each month in advance.<sup>67</sup> The EU pledged support for Ukraine, in cooperation with the IMF and other international financial institutions.<sup>68</sup>

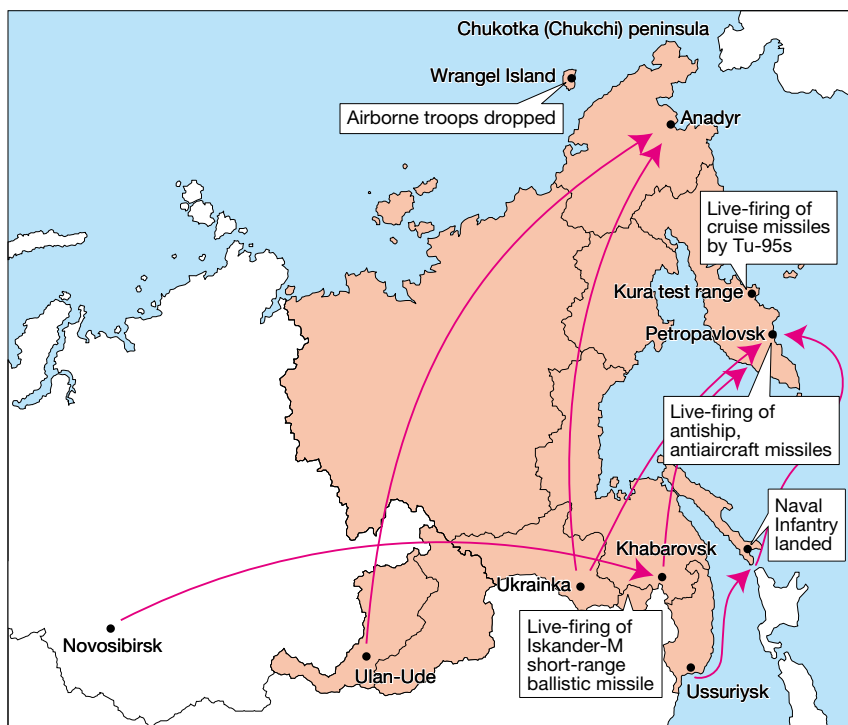
### **3. Russian Military Continues Reform and Accelerates Operational Maneuvers**

#### **(1) Military Exercises Display Operational Readiness and Strategic Focus on Arctic and Far East**

During the military reforms conducted over the past few years, Russia has pursued the operational integration of its four Military Districts, reorganized its ground forces and reformed their chains of command—centered on the brigade as the basic command unit—promoted the supply of state-of-the-art military equipment to front-line units and the training of troops in their use, and conducted a series of large- and small-scale military exercises to ensure that the units involved possess adequate combat-readiness and mobility. A large number of snap inspections were carried out in 2013 to test the armed forces' combat readiness, and this pattern was repeated in 2014. In March 2014 the Federal Assembly authorized the president to order military operations to deal with the Ukraine crisis, making it possible to mobilize troops with a focus on Ukraine and regions of Russia close to the Ukraine border, and a number of combat-readiness inspections were conducted. In 2014, strategic-class exercises at the Military District level, which have been carried out once every four years, consisted of the Vostok-2014 exercises held in the Far East. While large-scale maneuvers had been anticipated, no details were released until the starting date of the exercises on September 19.

The Russian authorities have continued to conduct increasingly intense military activities in the Arctic region. In March 2014 a parachute drop was carried out involving 350 airborne troops, as well as patrols by four Tupolev Tu-95MS bombers as part of moves to reinforce Russian military response capabilities in the Arctic,<sup>69)</sup> and landing drills were also conducted in April.<sup>70)</sup> In August, units of Naval Infantry (marines) under the command of the Pacific Fleet staged the Russian military's first-ever landing on Wrangel Island in the Arctic Ocean. Then, in October the military announced a plan to establish a radar site in the Arctic,<sup>71)</sup> and in December the Northern joint strategic command was established in the region, with control over the Northern Fleet among other units being transferred to this center.<sup>72)</sup> This is Russia's fifth joint strategic command following the existing four associated with the country's four Military Districts, and this move indicates that the Arctic region is now positioned as a military "front" of equal importance to those associated with the other military districts.

**Figure 6.10. Combat-readiness inspections (Sep.11–18) and Vostok-2014 exercises (Sep. 19–25) in the Eastern Military District**



Sources: Compiled from various reports, including from Russian Ministry of Defence and RIA Novosti.

A series of exercises were held in August and September 2014 in Russia's Eastern Military District, including the drills in the Arctic described above. Combat-readiness inspections were conducted from September 11 to 18,<sup>73)</sup> and the Vostok-2014 strategic maneuvers were held from September 19 to 25. All of these were ordered by President Putin, but he did not pay an inspection visit to the drill sites. The location of the sites ranged from exercise grounds in the southern part of the Russian landmass to the Arctic Ocean between the North Pole and the Chukotka Peninsula, as well as areas contiguous to the Sea of Okhotsk. In all these maneuvers, the Russian military made use of operational capabilities inherited from the Soviet era. They were aimed at reinforcing the armed forces' mobility and enhancing their ability to defend outlying territories.

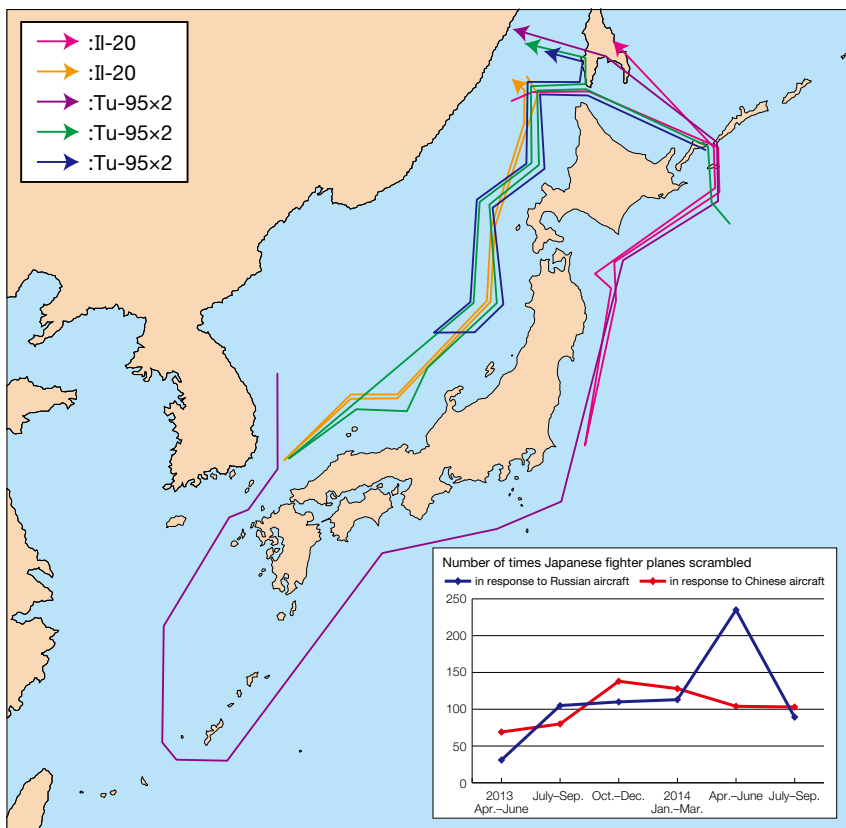
The combat-readiness inspections that commenced on September 11 involved the mobilization of 100,000 troops in operational maneuvers necessitating the movement of units over distances up to a maximum of 1,000 kilometers or so within the Eastern Military District. Units taking part were the 5th, 29th, 35th, and 36th armies, the 3rd air force and air defense battalions, and the Russian Navy's Pacific Fleet. The maneuvers also involved the use of twenty transport planes including An-124s and Il-76s, which transported materiel from locations outside the Far East, such as Ivanovo and Ulyanovsk. In addition, fighter planes including MiG-31s, Su-24Ms, Su-35Ss, and Su-30SMs flew roughly 4,000 kilometers from their bases in the Central Military District to take part in these exercises. Finally, Tu-142 and Il-38 antisubmarine patrol aircraft, among others, flew missions over the Sea of Japan and the Sea of Okhotsk, while airborne troops moved into Sakhalin and Anadyr.<sup>74)</sup>

On September 23, Defense Minister Sergei Shoigu, who was visiting the Kamchatka Peninsula, reported via a television conference hookup to President Putin—who was on board a ship—regarding the progress of the Vostok-2014 maneuvers. Describing the results of snap inspections, Shoigu was critical of the degree of readiness of the units involved, and stated that it was because of the implementation of these inspections that the military were able to commence the Vostok-2014 exercises in an organized manner. The maneuvers involved the participation of roughly 155,000 servicemen and women, as well as 8,000 major pieces of equipment including fighter planes and ships. He stated that fourteen exercise grounds had been used, of which he specifically mentioned those located on the island of Sakhalin as well as in the Kamchatka and Chukotka (Chukchi) peninsulas and the southern part of Primorsky Krai. Notable weapons systems tested in these exercises included 9K729 Iskander short-range missiles, Tu-95MS bombers, MiG-31 fighters, and surface-to-air missiles including the S-300 and the Pantsir-S1.

Landings were staged on Wrangel Island by the 83rd Airborne Brigade and the 155th Brigade of Marines (Naval Infantry) of the Pacific Fleet.<sup>75)</sup> Operations on the Chukotka Peninsula involved the movement of 200 officers and MiG-31 and Su-25 fighters from the Transbaikal region, as well as two warships from the Pacific Fleet.<sup>76)</sup> The *Varyag* (a guided missile cruiser of the Pacific Fleet) and other surface vessels as well as submarines attacked mock targets with missiles. Targets were also attacked by coastal units with S-300 surface-to-air missiles, and



**Figure 6.11. Flight paths of Russian aircraft in vicinity of Japan during April 11–19, 2014**



Sources: Compiled from information released by Joint Staff Office on April 14 and 15, 2014.

by naval warplanes.<sup>77)</sup> The Kamchatka maneuvers were also observed by military officials from over thirty countries, ranging from China and North Korea to Malaysia, Venezuela, Peru, Zimbabwe, and Angola.<sup>78)</sup> No large-scale military maneuvers in inland areas of Russia were reported, and the focus of this latest round of exercises was clearly on testing the ability of the armed forces to effectively deploy against long-range targets in the Arctic, as well as remote marine areas south of Kamchatka.

Regions in which the Russian military exercises were conducted include those in which Japan has particular interest. For example, exercises were conducted on

August 12–15 on the islands of Etorofu and Kunashiri in the disputed Northern Territories, evoking protests from the Japanese government via diplomatic channels. These involved the participation of troops not garrisoned on the islands, including five helicopters, and were clearly intended to test troop unit mobility.<sup>79)</sup> In March and April of the same year, exercises that involved bombers and submarine patrol aircraft following courses circling Japan showed remarkable frequency, for example in the seven days from April 13–19. When Japanese officials pointed out the singular nature of these flights, Deputy Defense Minister Anatoly Antonov denied any irregularity, and expressed the wish that the Japanese side would take this opportunity to “normalize” its stance toward Russia<sup>80)</sup>. At around the same time, four Tu-95MS bombers flew over the Arctic Sea<sup>81)</sup>. In August Russian planes were reported to have repeatedly violated the airspace of Finland. The Russian military is continuing to use such patrols to train its pilots and other personnel to ever-higher levels, and is placing emphasis on the Arctic region. In addition, it is thought that Russia’s intent may be to use these patrols to exert political pressure on neighboring countries.

As the crisis in Ukraine gathered pace, NATO froze plans for joint maneuvers with Russian forces, but Russia continued to carry out maneuvers with a number of Asian countries. These included the “Peace Mission 2014” conducted under the umbrella of the SCO as part of a series of exercises conducted each year, and rapid reaction force exercises with other members of the CSTO in August. In October the fifteenth joint search and rescue exercises were carried out off the coast of Vladivostok with Japan’s Maritime Self-Defense Force.

Then, in May the “Maritime Cooperation 2014” Russo-Chinese exercises were held off the Chinese coast near Shanghai. As stated above, President Xi Jinping and President Vladimir Putin both attended the commencement ceremony for these exercises. Taking part on the Russian side were seven surface vessels of the Pacific Fleet—including the missile cruiser *Varyag* and the large-scale amphibious landing craft *Admiral Nevelskoy*—which passed through Tsushima Strait (the strait between Japan and Korea, also known as the Korea Strait) to meet up in the vicinity of Shanghai. On the Chinese side were the destroyer *Zhengzhou* and two submarines. A joint Russo-Chinese chain of command was established, and the vessels of the two navies sailed together for four days, including two days of actual maneuvers. These exercises—which covered such matters as antipiracy, air defense, and sea rescue—are believed to have been successful in fostering mutual

trust, but maneuvers involving submarines (in which the Chinese side are thought to have been particularly interested) did not incorporate anything notably sophisticated. On the occasion of his visit to China in November, Defense Minister Shoigu announced plans for the conduct of joint naval exercises in both the Mediterranean Sea and the East China Sea.<sup>82)</sup>

## **(2) Military Involvement in the Ukraine Crisis**

Russia's military involvement in the Ukraine crisis is covert and complex in nature, and reveals a number of patterns. Unlike the events that unfolded during the Russo-Georgian War of August 2008, when Russia denounced Georgian military actions and then counterattacked and invaded Georgian territory, in 2014—while asserting both at home and abroad the legitimacy of intervention by its armed forces—this time Russia refused to officially acknowledge that it had taken military action. It is clear to most third-party observers, however, that Russia intervened by taking both direct and indirect military action on Ukrainian soil.

Officials of NATO and other organizations have described the way in which Russia has intervened militarily in Ukraine as “hybrid warfare,” and analysts are currently studying this new form of military activity, which has rung a number of alarm bells in the West. Statements by certain Russian military officials have hinted at the development of such new types of warfare. For instance, according to the February 2013 edition of the *Defense Industry Courier*, a weekly magazine, at a military research meeting in January 2013, Chief of the General Staff Valery Gerasimov suggested that it was necessary to conduct academic studies into new forms of warfare. Gerasimov said that in this modern age war can no longer be conducted solely by traditional military means. He cited the case of Libya, where he thought the United States achieved its aims by nonmilitary methods, through support for antigovernment forces, and argued that Russia, too, must respond to the needs of the times by pursuing academic studies into new methods of achieving its objectives.<sup>83)</sup>

In the revised edition of its Military Doctrine, released in December 2014<sup>84)</sup> the Russian military signaled a recognition that the Western powers were utilizing political methods to exert their influence on Russia's neighbors, and that this constitutes a problem for Russia. In comparison with the edition of the doctrine published in February 2010, the revised edition adopts basically the same framework of concepts. NATO issues remain within the category of “military

danger,” not of “military threat.” The use of nuclear weapons is not ruled out even in reaction to an attack employing conventional, nonnuclear weapons, if that attack is seen as a threat to the very existence of the state. The Ukraine crisis does not seem to have effected any major change in the Russian military posture shown in the Military Doctrine. As in the past, the Russian authorities continue to hold to the view that the country’s military may be employed outside Russia’s borders to protect Russian-speaking minorities. In the revised military doctrine, however, examples of what the Russians view as “military dangers” include the establishment of governments in countries neighboring Russia that pursue policies contrary to Russia’s national interest, and the distribution within Russian borders of propaganda aimed at sapping the will of Russians to defend their motherland. The same mindset is reflected in the criticism of the West seen over the past several years, as well as in the attacks directed against the change of government in Kiev. This kind of attitude toward security issues on the part of the leadership can be cited as one of the factors behind Russia’s harsh responses to the Ukraine crisis.

At the end of February 2014, marines from the Black Sea Fleet (but without insignia) took control of all airports and other major military bases on the Crimean Peninsula, and during this period movements were reported of a number of military vehicles belonging to the Black Sea Fleet in areas outside the navy base at Sevastopol. Thereafter, a number of military units belonging to Russia’s Southern Military District moved into Crimea and occupied important transportation hubs. While this was going on, the Crimean parliament voted to replace its prime minister, and call a referendum on Crimea’s status. The referendum delivered a majority for the pro-Russian vote, and a treaty of accession of Crimea and Sevastopol to the Russian Federation was signed by Russia and the separatist government. During all this process, the Ukrainian armed forces offered almost no resistance, and there was virtually no confrontation between the two sides. The objective of Russian military action during this phase was to silence the Ukrainian side, and the separation of Crimea from Ukraine was achieved by making use of the dislike of the majority of the Crimean population for the Ukrainian government, and their desire to secede from Ukraine. In a televised public address on April 17, President Putin remarked that Russian servicemen had backed the Crimean self-defense forces in order to ensure the safe conduct of the Crimean referendum in the face of threats from Ukrainian nationalists.<sup>85)</sup>

The relationship that has existed since April 2014 between Russia and the

armed separatist groups in Eastern Ukraine remains unclear. In a Russian defense ministry meeting on April 24, Minister of Defense Sergei Shoigu denounced attacks on Russian-speaking residents of Ukraine carried out by Ukrainian nationalists, and pointed to an overall deterioration in Russia's security environment, against the backdrop of NATO holding military exercises in Poland and the Baltic republics. On the same day, Shoigu announced the commencement of maneuvers to be held on the border with Ukraine, involving troops under the command of Russia's Southern and Western military districts.<sup>86)</sup> Then, in a telephone conversation on April 28 with then US Secretary of Defense Chuck Hagel, Shoigu stated that Russia had no intention of invading Ukraine.<sup>87)</sup> In this way, at the start of the Ukraine conflict, Russia put its forces on alert and ready to move at a moment's notice, thereby implying to observers both at home and abroad that intervention was a possibility. On the other hand, authorization for the use of military force, which had been given to Putin by the upper house of the Federal Assembly, and which constituted the legal grounds for intervention under Russian law, was annulled. The Russian authorities appear not to have possessed overall command or control of the armed separatists in Ukraine. In addition, the Russian government is believed to have decided to limit intervention in Ukraine to destabilizing its internal situation by indirect means, in view of the likely cost of a direct clash with the Ukrainian armed forces, as well as the cost of occupation of the country's territory.

The month of August saw clear evidence of direct Russian military intervention in Ukraine. On August 12 a convoy of Russian trucks on a humanitarian aid mission crossed into Ukrainian territory without permission from the government in Kiev, and on August 20 Ukrainian troops captured Russian troops and took possession of their military equipment. From these troops' personal effects, it was determined that they belonged to Russia's 76th Airborne Brigade. On August 26, President Putin claimed that the troops had crossed the border accidentally. On August 28 NATO published satellite photographs which it claims showed Russian military units crossing the area around the city of Krasnodon on their way to Luhansk.<sup>88)</sup> Through these means, it appears that the Russian military entered Ukraine in support of armed separatist groups and alleviated some of the pressure that the Ukraine armed forces were bringing to bear on these groups. Thus, while Russia has refused to officially admit involvement in provision of organizational support, weapons and other materiel and fuel to the separatist groups, as well as

supervision of drilling, the conduct of special operations, and the incursion of regular forces across the border, the authorities have consistently justified the taking of military action.

### **(3) Military Equipment Production and its Reliance on Ukraine**

As described above, Russia's defense budget was increased from 2,471 billion rubles in 2014 to 3,286.8 billion rubles in 2015, which is slightly above the amount planned in the State Weapons program approved at the end of 2010. Despite the eruption of the Ukraine crisis, the authorities evidently feel that the state's revenues will maintain their predicted level over the short term, and have therefore budgeted for the amount of weapons procurement and military maneuvers originally planned.

To realize the government's targets for modernization of military equipment, tests were carried out in the fields of strategic nuclear weapons and in other weaponry for both the navy and the air force. Units to which such new weapons were assigned were made to participate in exercises prior to their full deployment, and the delivery of a number of new weapon systems was registered. Additionally, even prior to actual official deployment, these new systems were introduced during maneuvers and subjected to repeated testing in field conditions. It can be inferred from this that the military authorities wished to deploy these weapons in the field as soon as possible. Hereunder, we will first examine developments in the field of nuclear missiles.

Russia continues to invest time and effort in upgrading its strategic missile arsenal, with test-firing in preparation for actual deployment being conducted on a continuous basis. Following the deployment in 2013 of the Borei-class nuclear-powered ballistic missile submarines Yury Dolgoruky (with the Northern Fleet) and Alexander Nevsky (with the Pacific Fleet), in December 2014 a third Borei-class submarine, the Vladimir Monomakh, was handed over to the navy.<sup>89)</sup> Test launchings of Bulava submarine-launched ballistic missiles (SLBMs) were conducted for the first time on the Vladimir Monomakh in October 2014, and these test-firings successfully hit their targets. In the field of ICBMs, too, Yars, and Topol missiles have been employed in military exercises, tested, and handed over to the armed forces.<sup>90)</sup> On July 10 a strategic rocket unit stationed in Irkutsk was subjected to a snap inspection. It is said that the RS-26 Rubezh missile—a state-of-the-art ICBM that underwent many reported test launchings in 2012 and

2013—is deployed with this unit.<sup>91)</sup>

Regarding test-launchings of the RS-26 Rubezh, it has been reported to hit targets at distances of over 5,500 kilometers, but launchings conducted in October 2012 and June 2013 involved hitting targets at a distance of around 2,000 kilometers,<sup>92)</sup> and since 2012 the United States government has been voicing concerns that these missile launchings may be in violation of the Intermediate-Range Nuclear Forces Treaty (INF) signed in 1987 between the United States and the Soviet Union.<sup>93)</sup> This treaty prohibits ground-launched cruise missiles (GLCMs) and ground-launched ballistic missiles (GLBMs) with ranges between 500 and 5,500 kilometers. Of these two, the Rubezh would be classified as a GLBM. The R-500 missile, which has recently undergone repeated test-launchings from Iskander-K cruise missile systems, is believed to actually have a considerably long range, and sources have indicated that this missile, too, may be in violation of the INF<sup>94)</sup>. In a report on compliance with the terms of disarmament treaties (a de facto annual report) released in July 2014 by the United States Department of State, Russia was described as being in violation of the GLCM provisions of the INF, but the report did not specify the suspected violations, and no mention was made of GLBMs.

One of the areas of military equipment provision on which the Russian government places particular emphasis is its nuclear capability. The government has recently been making efforts to upgrade its strategic nuclear missile arsenal, which is an area where Russia had been lagging behind the United States. The Russians maintain that the United States' development of a missile defense system will at some point in the future impair Russia's offensive capabilities, and that it damages the strategic parity between the two military superpowers. To that end, it insists that the development of missiles such as the above-described Rubezh is necessary in order to secure a sufficient offensive capability even under that hypothetical future scenario. The Russian authorities have also insisted on numerous occasions that the INF is unfair because only the United States and Russia are bound by it, and these criticisms are believed to be motivated by fear of a strategic missile imbalance between Russia and China. Russia is thought to be bolstering its long-range missile arsenal while simultaneously preparing missiles that can be used in shorter ranges.

Turning to conventional weaponry, production and delivery of new weapon systems had been falling behind schedule until very recently, but have now

returned to normal, and further progress was seen in 2014. The MiG-35S jet fighter is currently in the pre-production stage, and the government has signed a contract with manufacturer Mikoyan for sixteen more MiG-29SMTs—the version already in use by the armed forces—which are scheduled for deployment by 2016.<sup>95)</sup> Su-30SM and Su-35S fighters, among others, are also being delivered and deployed. Ilyushin Aviation Complex has already signed a contract for delivery of 39 Il-476 transport aircraft at a cost of 140 billion rubles, and test flights are currently being conducted from the airfield attached to the company's Aviastar plant at Ulyanovsk. S-400 surface-to-air missiles are also being manufactured and delivered.<sup>96)</sup>

Russia continues to place a high priority on the export of weapons. At a meeting of the Committee for Cooperation with Foreign States in Military Technology held in April 2014, President Putin revealed that the value of Russia's arms exports in 2013 had risen by three percent over the previous year, to \$15.7 billion. In addition to countries with which Russia has long had a relationship of cooperation in the military sphere—including the other former members of the Soviet Union, India, Venezuela, Algeria, China, and Vietnam—Putin stated that Russia was also entering new markets in Latin America and elsewhere.<sup>97)</sup> Regarding the above-mentioned weapons systems, notably the Il-476 and Su-35S aircraft and the S-400 missiles, Russia was negotiating contracts with China. While some framework agreements had already been announced by the Russian authorities in the period up to the start of 2014, no official comments were released subsequently regarding agreements on detailed conditions. In a change of policy, the Chinese military is seeking to adopt leading-edge conventional weapons systems that the Russians are still in the process of deploying in their own armed forces. In such cases, even following the signing of a contract, China would have to wait a while for delivery. For the Russians' part, they harbor a strong distrust of the Chinese side, based on past experience in cases where China had made unauthorized use of technology acquired from Russia. They are thus expected to be very cautious about concluding contracts.

The Ukraine crisis has had an impact on Russia's relationship with other countries in the field of the procurement of military materiel. Two notable examples of this are France and, of course, Ukraine itself. Russia had been scheduled to take delivery from France of the first of two Mistral-class amphibious assault ships, which Russia said would be deployed as part of its Pacific Fleet, but immediately ahead of a NATO summit in September, French President François Hollande



**Table 6.1. Major developments in Russian arms exports in 2014**

Export markets	Details
India	Delivery of components for local assembly of Su-30MKI fighter planes (as per 2012 contract). Assembly and overhaul of Su-30MKIs carried out by Hindustan Aeronautics Limited. Manufacture of Su-30MKIs equipped with BrahMos missiles jointly produced by Russia and India.
Pakistan	Negotiations on sale of Mi-35 attack helicopters Direct delivery of RD-93 jet fighter engines planned.
China	Negotiations on sale of S-400 surface-to-air missiles, Su-35 fighters, and Lada-class submarines (framework agreed).
Algeria	Contract for sale of 42 Mi-28N attack helicopters, 6 Mi-26T2 transport helicopters, etc. (totaling \$2.7 bn); contract for sale of 2 improved Kilo-class submarines (Project 636).
Vietnam	Delivery of 2 improved Kilo-class submarines (Project 636) out of total of 6 vessels agreed under 2009 contract (roughly \$2 bn); construction of 3rd submarine completed.
Brazil	Delivery of 12 Mi-35M helicopters; talks held on sale of Pantsir-S surface-to-air missile systems.
Iraq	Mi-28 helicopters and Pantsir-S surface-to-air missile systems delivered.

Sources: Compiled from various media reports.

announced that the ship would not be delivered. France announced that conditions were “not right” for delivery, and that further examination of the issue would be made in October. However, an indefinite hold has been placed on the delivery.

Meanwhile, the Ukrainian government has put a ban on exports to Russia by the state-owned company Ukroboronprom. Motor Sich, located in the city of Zaporizhia in southeastern Ukraine, had been manufacturing engines for Russia’s Mi-24 helicopters. The Yuzhinoe plant located in the Ukrainian city of Dnipropetrovsk, which had been manufacturing the engines for the Russian ICBM R-36M2 Voevoda, has stopped supplying the engines, bringing work on completion of the missiles within Russia to a halt. The Russian side is believed to fear that the supply of missile-related technology from Ukraine will be restricted.<sup>98)</sup> Russian sources insist that there will not be a severe impact from this, as Russia possesses the necessary know-how to make the same missile components, but production plans will undoubtedly be thrown into disarray, as volume will lag behind for some time to come. While Crimea, which has been newly incorporated into Russia, possesses marine industry companies such as More, the producer of Zubr-class air-cushioned landing craft, their business situation is currently poor, and their early integration into the Russian industrial system will present problems.

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