



BULLETIN

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The Annexation of Crimea: A Challenge for Russia to Balance the Books

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The annexation of Crimea will require significant financial investment from Russia, which must implement changes in, for example, social security, education and health care systems on the peninsula. The expenditures will not be balanced by benefits such as savings connected with stationing the Black Sea Fleet (BSF) and navigation through the Strait of Kerch, or access to the Crimean marine shelf. Moreover, these costs will be a significant burden for the Russian budget during the coming economic crisis.

The annexation of Crimea means that Russia must not only secure the stable functioning of the physical infrastructure of the peninsula (especially regarding water and electricity supplies, which were previously ensured by Ukraine), but also incorporate it as a new entity of the Russian Federation, in the financial, social, infrastructure, administrative and legal systems. In 2014, the Republic of Crimea will receive RUB 44.8 billion (about \$1.3 billion) from the Russian federal budget, and Sevastopol will get RUB 10.6 billion (about \$305 million). The programme to develop this region until 2020 will cost an estimated RUB 1 trillion (nearly \$29 billion), of which 95% will come from the central budget. The scale of the necessary changes is so great that the Russian authorities have decided to set up a Ministry of Crimea, on the model of the Ministry of Development of the Russian Far East.

Social and Financial Issues. The annexation of Crimea necessitates increased social spending, including pensions. Social benefits for the local population will rise gradually, and the system will be brought into line with the Russian system on 1 July. In 2014 alone, it will cost Russia more than \$800 million. Moreover, the salaries of 140,000 public sector employees in Crimea will be increased. Russia will have to finance education reform (changing school programmes) on the peninsula. In addition, a new university, which will receive federal status (there are currently only nine such universities in Russia), is planned for Simferopol.

A major problem is also connected with functioning of the banking system. Ukrainian and Western banks were closed, while Russian ones have delayed opening their offices for fear of Western and Ukrainian sanctions. The result is that the inhabitants of Crimea not only have problems accessing their savings (assessed at about \$2.4 billion), but also with paying bills (such as taxes and rents).

In particular, it will also be important to ensure the normal functioning of tourism (most tourists in Crimea were Ukrainians), which is one of the most important branches of the Crimean economy. As a part of their aid to the region, Russian authorities decided to subsidise summer holidays for children (allocating \$50 million for this) and necessary infrastructure renovations related to this. Moreover, they launched a campaign to encourage Russians to holiday in Crimea.

The Military. In the coming years, Russia is also planning large-scale investment in the Black Sea Fleet, for which RUB 86 billion (\$2.5 billion) has been set aside up to 2020. The money will be spent on the development of bases, establishing new elements of the air defence system, creation of a new unit of marines, and purchase of submarines. In 2014, BSF will be equipped with two ships—the Kilo-class submarine *Novorossiysk* and the Talwar-class frigate *Admiral Grigorovich* (their entry into service was initially planned for 2015). By the end of 2016 this formation should receive six additional 636.3 submarines and six 11356 frigates.

Another financial challenge will be guaranteeing social security (wages, housing, and medical expenses) for about 8,000 former Ukrainian soldiers, who remained in Crimea and decided to serve in the Russian army.

At the same time, however, the Russian budget will save about \$100 million per year on fees previously paid to Ukraine for the stationing of the fleet in Sevastopol. An additional benefit is the opportunity to equip this fleet with new vessels, which will increase Russia's military presence in the Black Sea. This is all the more important as Russia previously only had the right to exchange "like for like," had an obligation to inform Ukraine of changes, and was required to maintain a fleet size according to the 1997 level (388 units, of which 14 were diesel-powered submarines).

Securing Energy and Water Supplies and Transport Development. The vast majority (approximately 80%) of the electricity consumed in Crimea previously came from Ukrainian power plants. Therefore, since the change of territorial affiliation, unrecognised by Kyiv, this region has been subject to suspended power supply (Ukraine reduced power in March). For this reason, Russia will have to pay for the creation of gas power plant networks, in order to secure energy supplies in the peninsula. One option is to build three gas power plants with a total capacity of 1,320 MW, to which gas will be delivered through the pipeline beneath the Black Sea (this would, at the same time, be a branch of the South Stream pipeline). The cost of such an investment is estimated at RUB 5–6 billion (about \$170 million). The second option assumes that energy for Crimea will be delivered via high-voltage lines of Taman (Krasnodar Krai). However, the peninsula will not receive full coverage until January 2016 at the earliest.

Of particular importance will be providing fresh water, used primarily by agriculture, and all the more so as, so far, 85% of the water consumed in Crimea came from the Dnieper River and was supplied by the North Crimean channel. In April, Ukraine cut off this supplies (though talks about restoration are currently underway), which caused serious problems for Crimean farmers (local authorities have already announced a net loss regarding the rice harvest). Among projects which could replace the North Crimean channel, the most probable are construction of an aqueduct from Kuban, or a sea water desalination plant. There are also plans to reconstruct the deep wells system that may become a significant source of drinking water for the region. Russia will have to pay local farmers around \$144 million this year alone, for losses resulting from water shortages. And the Russian authorities will have to continue paying such compensation for the next few years, because it will take about five years to build the necessary infrastructure to provide fresh water to the peninsula.

Investment in the transport network will be also needed. In 2014, Russia will spend RUB 7 billion (\$200 million) to subsidise flights to Crimea, overhaul the airport in Simferopol, and reconstruct the road-rail ferry from the Kerch peninsula. In the coming years, spending on rail services will also increase, as Russian Railways will take over the rail infrastructure of Crimea from 2015. Subsidies from the central budget will also be used for bus transport. Repairs and construction of new roads are also planned, primarily on the Simferopol–Alushta–Yalta and Kerch–Feodosia routes. Building a bridge across the Kerch Strait will be a particular challenge, which could cost up to RUB 200 billion (\$5.7 billion) and take at least three years. At the same time, however, Russia will save about \$15 million a year on fees for transit through the strait, and the use of Crimea's port infrastructure.

Benefits. The annexation of Crimea will not only free Russia from fees that it used to pay for Baltic Fleet stationing in Sevastopol and transit through the Kerch Strait. It also gives Russia the opportunity to take control of about 2,000 local enterprises (in 2012, the gross regional product amounted to \$4.5 billion). What is more, Russia has gained access to the shelf of the Black Sea and Azov Sea, from which gas is extracted (about 1.6 billion cubic meters in 2013), and crude oil recovery is planned. According to "Naftohaz" data, the peninsula may yield an estimated 48 billion cubic metres of gas and 3 million tonnes of crude oil.

The annexation of Crimea resulted in a significant increase in popularity for President Putin and the party United Russia. In May, the Russian president enjoyed the support of almost 86% of Russians (an increase of 25% since January), and the popularity of United Russia reached 60.4%, reaching its historical maximum (according to the Levada Centre). Russian authorities can use such high support to introduce reforms, especially those limiting civil rights such as the right to peaceful assembly.

Conclusions. Despite the high costs that Russia will have to pay in the coming years due to the annexation of Crimea, full normalisation of the peninsula's functioning will not be possible in sooner than three years. However, this process could take even longer due to economic crisis, the outflow of foreign capital, possible Western economic sanctions, and boycotts of Crimean enterprises. Moreover, during this time, Russia will have to start difficult talks with Ukraine about water and electricity supplies.

Also, Russian society, despite the current euphoria after the annexation of Crimea, may over time become less willing to bear such high costs, especially if Russia's economic condition deteriorates. Thus, the profit and loss account will be based, to a large extent, on the economic consequences of the peninsula's annexation. If the economic crisis is not strong and long-lasting, the annexation of Crimea will strengthen the position of the Russian authorities both domestically and regionally. If, however, it is severe, and results in Russia's isolation in the international arena (to which Western sanctions may contribute), it could weaken the position of this country in the region, and may bring about its withdrawal from the integration processes in the post-Soviet area, due to the inability of the Russian government to finance this project.