

Beyond the Sanctions: Russia, the West, and Ukraine

Clifford G. Gaddy and Barry W. Ickes¹

I. Introduction

As successive rounds of sanctions on Russia are being announced, the most important question is how effective will they be. But the discussion is typically framed in terms of assessing not the *effectiveness* of the sanctions but the *impact*. There's a big difference between the two. An analysis of impact can tell us how much damage sanctions can do to the Russian economy, what the cost will be in terms of reduced trade, foreign investment, credit flows, technology transfer, GDP growth, incomes, and so on. These analyses, however, cannot tell us how likely the sanctions are to cause Russia to change its behavior — that is, how effective they will be.

Impact tells us how much pain we can cause. Effectiveness depends also on how well the adversary can cope with the pain. How able and willing are Russians to endure the hardship and sacrifice we can impose? To answer that question, we need to understand, first, the peculiarities of the Russian economy and past Russian experience with economic hardship, and second, Russians' motivations for the behavior we want to change.

The last point is crucial. It is a fallacy to assume that Russia will respond to sanctions the same way that we would. We cannot simply project our own preferences onto Russians.² (If Russians had our preference structure, they would not have annexed Crimea in the first place.) Our sanctions will be costly to Russia; there is no disputing that. The country will have to spend resources to adjust. If the primary goal of Putin and Russian decision makers were to maximize Russian economic welfare, then the inefficiency that might be caused by import substitution or a cutoff from the world economy would, at some point, become unacceptable. But if the motivation is defense of vital national interests and survival, Russia — like any state — will resort to import substitution and even more radical sorts of interventions to defend itself.

II. The Missing Quadrant

To understand the motivations for Russia's current behavior in Ukraine, we need to step back. The events playing out now are bigger than Ukraine (even though, as we explain below, Ukraine is important to Russia). The roots of the present conflict lie in a fundamental flaw in the way the West viewed Russia's possible futures after the end of the Cold War. We can explain using a simple scheme. Imagine a matrix with two columns representing a strong Russia and a weak Russia, and

¹ Senior Fellow, The Brookings Institution and Professor of Economics, The Pennsylvania State University, respectively.

² The new round of sanctions announced on April 28, for example, seems based on the perception that Putin cares more about his personal wealth than Russian national security. This view is also consistent with the discussion in Peter Baker, "Sanctions Revive Search for Secret Putin Fortune," *New York Times*, April 27, 2014, http://www.nytimes.com/2014/04/27/world/sanctions-revive-search-for-secret-putin-fortune.html?_r=0.

two rows, representing a good Russia and a bad Russia. This leaves four possible outcomes. However, and this is the crucial point, from the vantage point of the early 1990s, only three of them were foreseeable.

In the early 1990s one could imagine that Russia could reform and succeed. It would accept the Washington consensus for economic reform and develop its democracy. This would result in a strong Russia that was positively inclined toward the West (that is, “good”). Another possibility was that Russia could continue to pursue democratic reforms but fail at economic reform. It would thus remain weak but still be “good.” Finally, Russia might reject reforms altogether. It would not always be friendly to the West, but without Western-style reforms it would remain weak and unable to act on any hostile intentions it might have. From the vantage point of the immediate post-cold war period these, then, were the potential outcomes (Table 1.)

	Strong Russia	Weak Russia
Good Russia	Possible: Very low probability	Possible: High probability
Bad Russia		Possible: Low probability

Table 1. The Missing Quadrant

But note that there was one quadrant that is missing. What could not be imagined was the fourth alternative: a “strong, bad” Russia. Hence, no probability was attached to that outcome.

All this would have been rather academic except that the assumptions of this matrix were taken as the basis for the entire post-Cold War order. With the collapse of the USSR and the end of the Warsaw Pact, the United States took the lead in establishing a new post-Cold War order in Europe. The rallying cry was “a Europe whole and free.” The Iron Curtain separating West and East would be torn down, and the former Soviet republics and satellite nations of Eastern Europe would be transformed into Western-style market democracies as quickly as possible. As such, they could be incorporated into the new international order under the United States.

Providing incentives for these countries to undertake the painful reforms necessary to make this new order happen required a big carrot. The carrot was membership in the premier Western clubs, the European Union and NATO. The promise of NATO membership was the key. No matter how much lip service the eastern Europeans paid to the virtues of free markets, democracy, civil society, and so on, they took on the burdens of reform for one main reason: to earn a guarantee of protection against their age-old enemy, Russia.

At the time, and for years after, this appeared to be a successful tactic for the United States. Had we not offered the incentive of NATO membership, it is likely that many, if not most, of the eastern European countries would not have made nearly enough of the sacrifices needed for successful reform. Only the shared perception of the Russia threat could create domestic peace long enough to reform.

But what was not recognized was that this was a tactic based on a false assumption in the United States, namely the assumption that this perceived “Russia threat” was not real and never would be. Russia, we assumed, would remain more or less as it emerged from the Cold War, a backward, weak economy that would try, but most likely not be able, to follow the course of its neighbors to the West and grow to become a strong market democracy. It would therefore slide further and further into weakness. A few optimists held to a fading hope that Russia might some day succeed in reform. No matter which way it went, Russia would not seriously threaten any country allied with the United States. It would either be “good” (if it reformed) or weak (if it didn’t). Neither of those Russias was a threat. The Russia that would be a threat — a strong, bad Russia — was unimaginable. This was precisely the “missing quadrant.”

III. The Insurance Scheme

When a particular bad outcome is unimaginable, there is little cost to selling insurance against this possibility. (Or, to use a different analogy, it is like selling a put option that is far out of the money — you claim the premium income, but nobody ever exercises the option.) In the minds of Russia’s neighbors who feared a resurgent Russia, the need for insurance was real, and they were eager to purchase the insurance. (For them, there was no missing quadrant!) For the U.S., which was convinced that Russia could only be either weak or good, it made sense to sell insurance. Promises of admission to NATO, even to Ukraine and Georgia, or to put missiles in Poland were perceived as low-cost since the insurance contracts — that is, the commitment to protect the new NATO members against a serious Russian attack — would never be exercised. After all, that scenario assumed a Russia that was strong and bad, and that was impossible.

Now suppose that you are Vladimir Putin and you see the U.S. selling this insurance to all your neighbors. You do not have to be a genius to see the implications. One important consequence of any insurance is moral hazard. The insured party takes greater risks because it has insurance to fall back on. This clearly makes the international system more fragile. The United States is issuing all of these contingent liabilities, and if you are Putin, you need to indicate to the U.S. the cost of this. When repeated verbal protests do not suffice, the message has to be delivered in stronger fashion. Hence, the Georgia conflict of August 2008. Regardless of who started it, the conflict demonstrated with utmost clarity the cost of those insurance policies that the U.S. had been selling. In the period between August 1998 and August 2008 the unimaginable occurred. Russia became strong, but “bad.” It became strong again without “becoming like us.”

How exactly did that happen? The answer is oil. No one’s scenarios in the 1990s included one with a world oil price of \$50 a barrel, much less \$100-plus. And this is not just no one in the community of Russia analysts; not even the oil analysts thought that way. Since no one could imagine \$100 a barrel oil, no one thought of what kind of Russia we would have with \$100 a barrel oil. That was like asking, what kind of Russia would we have if Martians took over the Kremlin? It was outside the realm of possibility.

But this also means that what had looked like a nearly riskless strategy for re-ordering a post-Cold War world and for assigning Russia a place in it turns out to have been a very risky one indeed. It was a gamble, and a gamble that failed. We built institutions on a fictitious foundation. We sold insurance policies like out of the money put options with no belief that the bubble would ever end. There was no push back for many years. We did get the benefit of that premium income — the U.S. could act freely. Russia, and Yeltsin, had to comply. They were too weak to resist from the very

beginning, and the weakness only grew over time. Between 1991 and 1999, Russia's dollar GDP as a share of world GDP dropped by over 70 percent. In the two years from 1997 to 1999 alone, it collapsed by 50 percent. Meanwhile, the Russian government incurred close to USD 30 billion in new debt from 1996 to 1999.

IV. The Bill Comes Due

Beneath the veneer of compliance and submission to the new world order, however, actual Russian attitudes about what was happening were very different. Again, as long as Russia was weak, what the Russians really thought did not matter. Once Russia's capabilities later changed, those attitudes would be fateful. Nationalists and communists, of course, became even more deeply resentful of the U.S. as the end of the 1990s approached. But even pro-Western liberals were affected. Anatoly Chubais, the leading liberal reformer in Moscow working with the U.S., stated publicly already in 1997 that NATO enlargement was undercutting all attempts to reform Russia and bring it close to the West. The policy might bring short-term gain for the U.S., but it was bound to create a political backlash inside the country. It was a "major mistake," he said.³ The international order was thus analogous to a financial bubble. Chubais was simply warning that Western policy was creating a balloon payment that would come due in the future.

There was an attempt to rationalize what was going on to avoid recognition that Russia's compliance was just Russian weakness. Proponents of NATO expansion were convinced that this policy was designed to stabilize democracy in the newly emerging countries, not as a military threat to Russia. Why then would Russia think any differently, regardless of what those in Poland or the Baltics thought? And the argument that Russia could only become strong economically by reforming its economy along the lines of the Washington consensus was widely accepted. These perceptions rationalized away the potential risks inherent in our strategy. One is reminded of the arguments by Federal Reserve head Alan Greenspan in the lead-up to the housing bubble burst that financial innovation would make the system safer and that no financial institutions would take excessive risk that would cause bankruptcy. Just like expectations that housing prices would continue to rise, or could not fall, such stories justify the bubble.

All such rationalizations are useless once the bubble bursts and the bill comes due. The problem is that the bill is now far overdue. The bigger the bill gets, the nastier the bill collector has to be. The unpleasant bill collector, of course, is Vladimir Putin. And he is not going to go away until we pay the bill. (Sanctions are our attempt to move on without really paying the bill. We hope that sanctions will deter Putin without recognizing that he is just collecting a bill long postponed.)

As a member of the Yeltsin team, Putin observed at close hand how Yeltsin was compelled to accommodate NATO expansion because Russia was weak. There were ample opportunities for Putin to witness Russia's humiliation through the words and deeds of the West in the three years he spent as a somewhat junior member of the Yeltsin team in Moscow between August 1996 and August 1999, but surely one episode that must have left a lasting impression came in June 1999. On

³ "Frankly, the politicians who support this decision [to enlarge NATO] believe that Russia is a country that should be put aside, a country that should not be included in the civilized world—ever. That is a major mistake." "Russia and the 'Threat' of NATO" (interview with Anatoly Chubais, *Time*, February 17, 1997, p. 40, reported in James M. Goldgeier and Michael McFaul, *Power and Purpose: U.S. Policy toward Russia After the Cold War*, Brookings, 2003, p. 184.

March 12, 1999, all Russia's hopes of avoiding NATO's eastward expansion had been dispelled, when the Czech Republic, Hungary, and Poland were formally admitted. Less than two weeks later, March 24, NATO started its bombing of Yugoslavia, also that against vehement Russian protests. When the bombing stopped on June 10, Russia insisted on having a say in the deployment of KFOR peacekeeping troops in Kosovo. When its demand was refused, Russia unilaterally sent troops into Kosovo and seized the military airport at Pristina. NATO pressured Hungary, the new NATO member, and Bulgaria and Romania, hoping to soon join NATO, to deny Russia the airspace it needed to resupply the units in Pristina.⁴ A couple of phone calls was enough to force Russia to back down.

Kosovo was a watershed in U.S.-Russia relations. Any lingering pretense about Russia having a say in the post-Cold War order was removed.⁵ Even more important in retrospect was that Kosovo marked the first attempt by Vladimir Putin personally to reassert Russia's interests against the West. Five days after NATO began its bombing, Putin had been appointed secretary of Russia's security council.⁶

Putin concluded that Russia had to be strong to resist in the future. In Putin's view the Russian state must never again surrender its autonomy to foreign interests. But it is notable that he began by focusing not on military strength but rather on reducing economic — specifically, financial — vulnerability. The state must have the financial reserves to withstand any future crisis. This is why financial stability was a priority.

The first step of Putin's strategy was to reduce dependence on foreign creditors. In the beginning of 2000 Russia had only \$8.5 billion in foreign currency reserves, while the government's external debt was \$133 billion. For Putin, paying off the debt was an imperative if he was to achieve his stated goal of restoring Russia's status as a sovereign nation. This was the lesson from the end of the Soviet Union. For all the underlying weaknesses of the Soviet economy, the USSR did not collapse because it had been defeated militarily. It collapsed because it lost real political sovereignty as a result of losing all financial autonomy. Once it had become dependent on loans from first Western banks and then Western governments simply in order to import enough food to prevent starvation, it no longer could claim to control its own political destiny.

Putin changed that. By the end of 2007 he had reduced the government's foreign debt to 37 billion dollars. But more important, he had along the way paid off Russia's entire debt to the International Monetary Fund (IMF) three and a half years ahead of schedule, as well as its debt to the Western governments in the so-called Paris Club.

Russia then began using oil and gas revenues to create a sovereign wealth fund and build up the foreign exchange reserves. The currency reserves reached a total of nearly \$600 billion in mid-2008, third-largest in the world. And with a substantial amount of those funds held in the form of U.S. government securities, Russia was a leading financier of the U.S. current account deficit. It was a dramatic reversal of fortune over the course of a decade.

⁴ Goldgeier and McFaul, p. 262.

⁵ Goldgeier and McFaul, p. 265: Kosovo "had important implications for U.S.-Russian relations. NATO's campaign to convince Moscow that it was no longer a military organization designed to protect others against Russia but rather a political organization eager to take account of Russia's interests now fell on deaf ears."

⁶ Putin had been a member of the security council since July 1998, by virtue of his position as head of the FSB. He remained head of the FSB until August 16, when he was appointed prime minister.

V. Can Sanctions Produce a Compliant Russia?

There are many reasons to doubt that Western countries will be able to unite behind truly strong sanctions. Strong sanctions will cause real pain to Western countries, and after years of recession and accumulated economic challenges, there is little appetite for more pain. The global economy is still fragile, especially Europe. Awareness of this fact alone is probably going to deter strong sanctions. But let us assume they are implemented. What happens? There are two points to consider. First, how resistant is the Russian economy to the effects of the sanctions? Second, how will they be perceived politically by Russian decision makers?

History gives no encouragement that economic hardship can force Russia to back down. Russia can survive difficult situations. Coping and survival are part of Russian history and the Russian national identity. We do not need to go back to dramatic events like the Siege of Leningrad in World War II to understand this. The experience of the so-called virtual economy of the 1990s shows that no matter how weak and backward Russia's economy may be by conventional indicators, its households and enterprises can endure significant dislocation thanks to bottom-up, informal mechanisms of mutual help and self-survival.⁷ This can be repeated. The virtual economy itself preserved an economic structure that is inefficient but also highly robust to negative shocks. Much is made of the alleged weakness of today's Russian economy.⁸ But inefficiency and lack of competitiveness in the global economy — features of the Russian economy we ourselves have described repeatedly and in detail⁹ — are not the same as fragility. Indeed, many of the features of the Russian economy that account for its inefficiency are also its strengths in terms of robustness to shocks.¹⁰

From a strictly economic point of view, what then would sanctions have to do to accomplish the goal of changing Russian behavior? For a starting point in that analysis, we can turn again to the matrix of good-bad, strong-weak Russias. To force Russia to abandon its opposition to the post-Cold War order would require re-creating the weak and compliant Russia of the 1990s, the Russia that was forced to accept the international order imposed by the West after the Cold War. In other words, strong sanctions would have to move Russia from the “missing quadrant” to the weak/bad quadrant. It is clear to us that no feasible actions by the West today can produce that Russia. We can explain why in terms of the concepts of rent and rent management — the keys to understanding the entire Russian economic system.

Russia's fortunes have always been dependent on the volume of resource rent it has available and how that rent is deployed throughout the economy and society. In modern Russia, that means rent from oil and gas. The flow of resource rent to Russia in the late 1980s and the 1990s dwindled to historic lows. That — combined with the collapse of the heavily integrated market of the Soviet Union — was what caused Russia's weakness. Rent flows today are incomparably greater than in the 1990s. To reduce rent flows to the 1990s level would require a drop in the world oil price to \$15 a barrel.

⁷ See Clifford G. Gaddy and Barry W. Ickes, *Russia's Virtual Economy*, Brookings, 2002.

⁸ For instance, Nicholas Eberstadt, “Putin's hollowed-out homeland,” *The Wall Street Journal*, May 7, 2014.

⁹ Most recently in Clifford G. Gaddy and Barry W. Ickes, *Bear Traps on Russia's Road to Modernization*, Routledge, 2013.

¹⁰ One is tempted to describe Russia as the cockroach of economies — primitive and inelegant in many respects but possessing a remarkable ability to survive in the most adverse and varying conditions. Perhaps a more appropriate metaphor is Russia's own Kalashnikov automatic rifle — low-tech and cheap but almost indestructible.

Even this is not the end of the story. The system for distribution of rents in the 1990s was weak and decentralized. As indicated above, that chaotic and bottom-up system did ensure the survival of the economy, but little more. Key strategic sectors, especially those vital for state power, were greatly disadvantaged. The situation today is different. Putin has put in place a strong, centralized system of rent management that permits him to channel the rents to groups and sectors of the economy he deems most important. A top priority for him is defense industry and the security apparatus. In an environment of a Russia under siege, his control will be tighter than ever. That control extends especially to the oligarchs, who play a key role in distributing the rents. Most important of all, Putin has already achieved his main goal for reducing the kind of vulnerability that brought down the Soviet Union in the Cold War: he has made sure Russia has no debt to foreign governments or supranational institutions.

Of course Russians would not want to repeat the experience of the 1990s. But no one is talking of sanctions that could reduce Russian GDP by 40 percent or cut oil prices by \$90 a barrel. The shock will not be at the 1990s level of severity. Moreover, notice that sanctions that affect Russia's status as an energy exporter will *raise* oil prices.

Sanctions that cut oil exports would do real damage. But consider how unrealistic such a move is. References to the precedent of sanctions against Iran, often made, are not relevant for the Russian case. Russia exports much more than Iran did prior to heavy sanctions. Iran was exporting a bit more than 2.5 million barrels per day (mbd) before heavy sanctions were imposed. Russia's net exports are over 7 mbd. When the Soviet Union collapsed and Russian oil production fell by 5 mbd, OPEC production expanded to offset the loss. There is no spare capacity now to absorb such a shock. How will the world economy replace 7.2 mbd? Prices will have to rise significantly to balance supply and demand, perhaps by as much as \$80 per barrel.¹¹ And this calculation ignores any impact of a cutoff of Russian gas. (Of course, such a shock would no doubt cause a severe recession that would cut oil demand, thereby reducing the pressure on prices. But it is not much of an argument to say we can absorb the oil price shock that sanctions will impose by creating a global recession to absorb the cut in supply.)

These are only some of the economic considerations that militate against the effectiveness of sanctions. To that must be added the political dimension: Russians are motivated by a threat to national survival to withstand any level of hardship. It is in this political dimension that sanctions may be most counterproductive. If Putin has acted because he perceived that NATO and the West were encircling Russia, and we impose sanctions on Russia in response to its actions, then this will confirm for Putin that his perception is correct. Our imposition of sanctions only reinforces all of Putin's preconceived beliefs about our hostile intentions.

Yet another erroneous notion is the idea of the efficacy of so-called targeted sanctions. The fear of

¹¹ A back of the envelope calculation would be an 80% increase in the price of oil. Russian exports are about 8% of world production. So world supply would contract by 8%. The change in price would then be $\frac{\Delta 8\%}{\epsilon_s - \epsilon_d}$,

where ϵ_s is elasticity of supply and ϵ_d elasticity of demand. Presuming that the elasticity of oil supply in the short run is 0.05 and that the demand elasticity is -0.05, then we have $\frac{\Delta 8\%}{.1} = \Delta 80\%$. See, for example,

Smith, James L., "World Oil: Market or Mayhem," *Journal of Economic Perspectives*, vol. 23, 3, Summer 2009: 145-164.

consequences for the global economy has prevented the West from imposing draconian sanctions. Hence we opted for measures directed specifically at Putin's so-called crony oligarchs. The idea behind these targeted sanctions is that by altering the incentives of those around Putin, we can force them to convince him to change his policies. This theory, however, ignores the nature of political power in Putin's system. That power rests on a deal between Putin and the oligarchs. The essence of this deal is mutual obligations: Putin protects the oligarchs' property rights; they refrain from questioning his strategic policies.¹²

VI. The Ukraine Burden

Almost forgotten in the discussions of the conflict between Russia and the West is what happens to Ukraine. The West's view, of course, is that it is defending Ukraine against Russia. From Russia's standpoint, Ukraine is a front in a war being waged by the West against Russia. Its actions against Ukraine are intended as a message that the West must cease trying to pull Ukraine into its sphere and out of Russia's. The West can no longer attempt to use Ukraine as a staging ground for operations against Russia. Russia views sanctions as a yet another weapon in the West's war. Cognizant of the overwhelming dominance of its adversaries in terms of economic size and strength (the combined GDP of Russia's NATO and EU adversaries is roughly 20 times that of Russia), Russia has opted not to engage in tit-for-tat responses to Western sanctions but rather resort to "asymmetric" measures. One obvious target is Ukraine itself: if the Western coalition says they are defending Ukraine, let them pay a cost there.

It is clear to most observers that the West would not be able to defend Ukraine economically from a hostile Russia. Perhaps less evident is that the West by itself could not guarantee Ukraine's survival in the absence of Russia's active opposition. Russia today supports the Ukrainian economy to the tune of at least \$5 billion, perhaps as much as \$10 billion each year.

It is not just gas that constitutes the subsidies Russia provides Ukraine, though this gets the most attention. The main subsidies are hidden, in the form of production orders to Ukrainian heavy manufacturing enterprises. This part of Ukrainian industry depends almost entirely on demand from Russia. The southern and eastern oblasts of Ukraine are dominated by Soviet-era dinosaur enterprises similar to Russia's. They all had been built in Soviet times as part of a single, integrated energy-abundant economy. They could be sustained only thanks to the rents from Soviet (overwhelmingly Russian) oil and gas. Russian subsidies continue to maintain the structure in the post-Soviet era. Because most of these subsidies are informal, they do not appear in official statistics. (Even Putin does not refer to these subsidies, because the extent of rent sharing within even the Russian economy is a taboo subject.)

A good example of how Russian resource rent is shared with Ukraine is Ukraine's railroad equipment manufacturing sector. The Ukrainian railroad locomotive and rolling stock producers have been an integral part of the Soviet/Russian rent-distribution chain since the Soviet era. They were built and sustained with Russian oil and gas rents. Virtually all of their export shipments go to Russia. The series of charts below (Figures 1-3) illustrate the close relationship between Russia's oil and gas rents and demand for the output of both Russian and Ukrainian producers. Figure 1 shows that Russian demand for Ukrainian rail cars is highly correlated with Russian domestic demand.

¹² We discuss the nature of this mechanism more fully in "Putin's Protection Racket," *From Soviet Plans to Russian Reality*, Iikka Korhonen and Laura Solanko, editors, Helsinki: WSOYpro Oy. 2011.

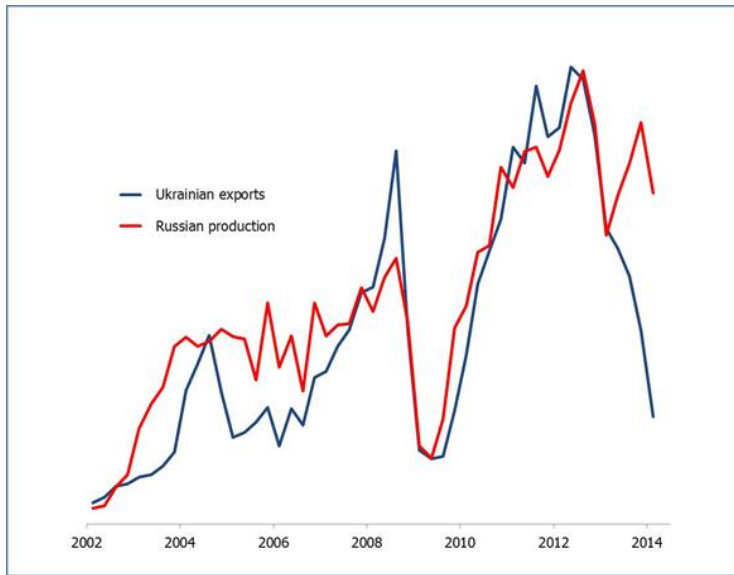


Figure 1. Trends in production of railroad rolling stock in Russia and exports of railroad rolling stock from Ukraine to Russia, 2002-2014

Russian domestic demand for railway cars in turn depends on the flow of oil and gas rents to Russia. (Figure 2.)

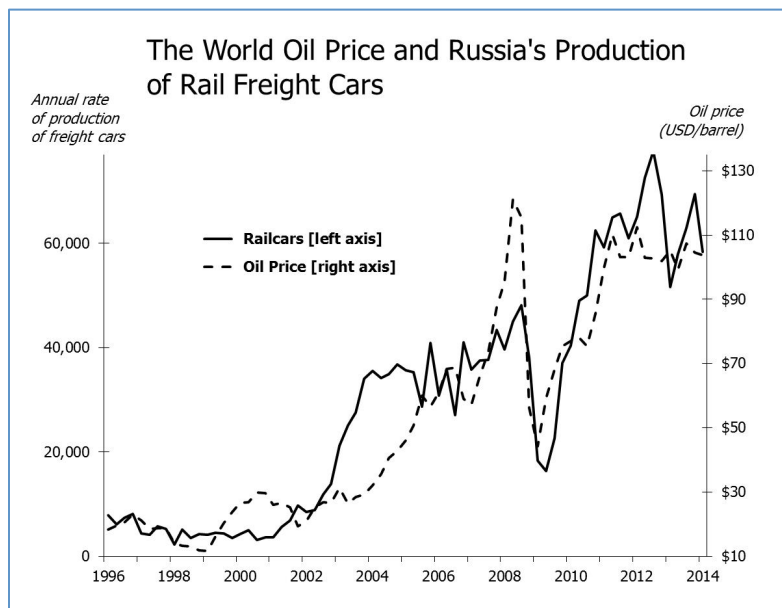


Figure 2. The world oil price and Russia's production of rail freight cars

That rent flow is driven by the world price, which Russia obviously cannot determine. Hence, the fact that Ukrainian production looks exactly like Russian production demonstrates how tied together this sector is between the two countries. It is one integrated sector in the Russian rent chain distribution system. This part of Ukrainian heavy industry was being treated by the Russians on an equal basis with their own manufacturing sector. That is, until the second quarter of 2013. At that point, the Russians stopped ordering Ukrainian railcars and locomotives. They cut off the Ukrainian sector from the rents. Rents did not decline, but orders collapsed. Figure 3 (where the oil price is a proxy for Russian rents) makes the point.

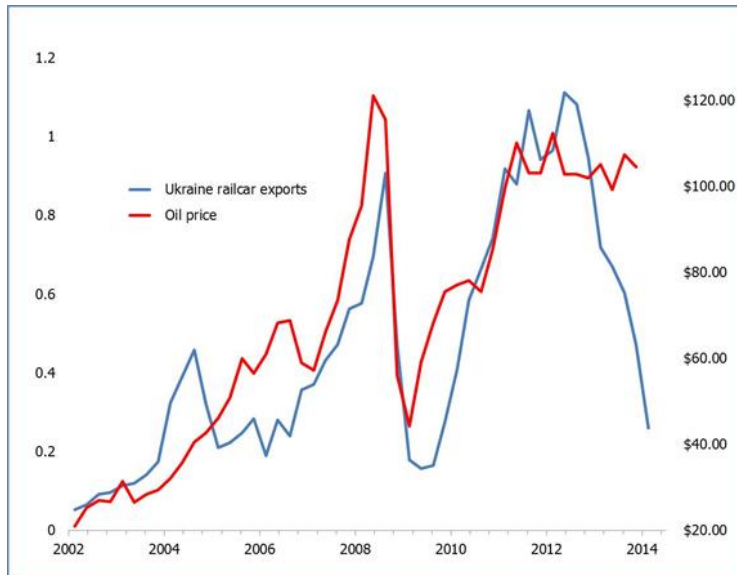


Figure 3. The world oil price and Ukraine's exports of rail freight cars

Two points are worth noting. First, the loss to Ukraine is very large. The decline of exports of railroad rolling stock to Russia between the peak in 2012 and the present represents a loss of more than three billion dollars. These plants are now effectively shut down. There are also knock-on effects to the metals producers, mining, and power sectors. At the same time, the rolling stock producers are only part of the huge Ukrainian dinosaur manufacturing sector that is supported by Russian orders. The Ukrainian portion of the Soviet defense industrial complex was about one-fourth the size of the Russian share. But it was much more highly concentrated geographically. Approximately 96 percent of Ukraine's defense industry employment was in four cities: Kiev, Kharkov, Dnepropetrovsk, and Nikolayev. One out of every four people in the labor force in those cities worked in defense plants.

If the West were somehow able to wrest full control of Ukraine from Russia, it would be up to the United States, the other NATO nations, and the EU to assume Russia's role here as well. The IMF, of course, would never countenance supporting these dinosaurs the way the Russians have. But if

Russia does wash its hands — even with no cutoff of gas — then there is a huge cost to be borne by the economy of Eastern Ukraine. Presumably someone has to absorb that cost.¹³

The only known parallel for the amount of transfer needed is the case of German reunification. The transfer amounted to \$2.76 trillion over twenty years. If Ukraine has per capita income equal to 1/10th of Germany's, then a minimum estimate is \$276 billion to buy off the east (if the population size of Eastern Ukraine was the same as East Germany; actually it is larger, so this is an underestimate). It is unthinkable that the West would pay this amount. We did not do it with Russia when it would have been much cheaper and could have significantly helped produce the good/strong Russia that was hoped for — that is why the dinosaurs survived.

Notice that Russia, by contrast, can survive the cutoff of Ukrainian industry. The Soviet Union provided provided for dual sources for virtually every component needed for its defense industry. For every producer located in Ukraine, there was an actual or potential twin far off to the east in the Urals and beyond. Russia could just implement more import substitution.¹⁴ This is economically inefficient, but it is what every country does for national survival. In the case of substituting for imports from Ukraine, the chief beneficiaries would be the very defense enterprises and other heavy equipment manufacturers in Russia which Putin has already declared to be a priority as recipients of rent.

The key point here is that there can be no prosperous Ukraine without a benign Russia. Ukraine's hypothetical futures can be plotted on a line extending from left to right (or think of these as west to east). At the far left of the line (the western end) is a flourishing Ukraine fully integrated into the EU and NATO and completely free of Russian control. At the opposite end is a Ukraine that is thoroughly under Russian control, either fully or partially incorporated into the Russian Federation. In between are variants of a neutral, highly federalized but territorially intact Ukrainian state that avoids all action that can be perceived by the Russians as threatening. What is important is to recognize that each of these outcomes for Ukraine depends on a particular kind of Russia that maps into the matrix. This is the "Russia condition" for each Ukrainian scenario. Schematically, it looks as shown in Table 2, below.

Note that these are only hypothetical, not necessarily realistic, outcomes. The outcome labeled "Ukraine as Poland" — that is, a NATO-affiliated Ukraine — is shaded, because it is impossible. The "Russia condition" for that scenario cannot be met. This fact leads to a further conclusion: although the "Ukraine as Poland" option is unfeasible, adopting that option as the goal of Western policy would not merely fail in its objective; it would have the consequence of ruling out the middle outcome and guaranteeing the least favorable one, "Malaya Rossiya."¹⁵

¹³ We are not arguing that closing dinosaur enterprises in Ukraine would be bad for economic reform and progress. We are pointing out the cost implied by such policies, which must be important for political calculations.

¹⁴ This is apparently happening as we write. See Putin's meeting on implementation of the defense order, May 14, 2014.

¹⁵ This is a crucial point. The attempt to choose "Ukraine as Poland" option actually collapses the choice set in table 2, leaving only the "Malaya Rossiya" option as feasible.

Ukraine as Poland		Ukraine as Finland		Ukraine as “Malaya Rossiya”	
Hard-core NATO	“Soft” NATO: NATO with limits	True Finlandization: a neutral, intact, Ukraine whose sovereignty is respected by both Russia and the West	Pseudo-Finlandization: a nominally neutral Ukraine under predominantly Russian control	Southeast Ukraine annexed, rump Ukraine under de facto Russian control	All of Ukraine fully annexed by Russia
Precondition: Russia is either (1) reduced to weakness of 1990s, or (2) completely reformed. I.e., Russia is in NW, NE, or SE quadrant.		Precondition: Russia accepts Western assurances of Ukraine’s non-NATO status. The West and Ukraine refrain from any actions to provoke Russia.		Precondition: Russia remains STRONG+BAD (SW quadrant). Russia provoked by NATO actions and/or massive attacks on Russian-speakers inside Ukraine. Russia intervenes militarily.	
NOT AN OPTION BECAUSE IT SUFFERS FROM THE MISSING QUADRANT FALLACY		DESIRED OUTCOME FOR RUSSIA, ACCEPTABLE TO WEST		POSSIBLE OUTCOME, NOT GOOD FOR EITHER RUSSIA OR WEST BUT FORCED BY EVENTS	

Table 2. Hypothetical Ukrainian outcomes

VII. Beyond the Confrontation

There is no doubt that the West can take actions that harm the Russian economy. We can weaken Russian state finances and make Russian citizens poorer. Neither effect will cause Putin to back down. Putin is not going to be deterred from aggressive behavior by economic weakness, whether caused by the global economy, his own policy, or sanctions. Russia can weather all those. And even though the economy can become smaller and poorer, Russia will still have its financial independence and freedom of action.

There is certainly a risk that the Ukraine crisis might escalate into large-scale economic warfare (or military confrontation), but at this point the likelihood seems small. If rationality — which still appears to guide leaders on both sides — prevails, it will push the parties towards a solution something like the middle options in Table 2, above. In any case, the crisis will end at some point. What then? We can offer several general answers.

First, the direct effects of sanctions on Russia, though possibly severe, will be temporary. Economic growth is likely to turn negative and the economy may go into recession. Notice, however, that economic growth was already slowing before this confrontation began, and the roots of this slowdown stem from the plateauing of oil prices.¹⁶ Although many observers in Russia had been obsessed with the need for a new “growth model,” sanctions may provide an excuse for a worsening economy and slow the search for reform. This would be worse for economic performance, but probably good for Putin politically.

Nonetheless, it is important to recognize that Russia will rebound after the confrontation, as it always does after a crisis. In general we can expect fast post-conflict growth. Indeed, the deeper the

¹⁶ We discuss the causes of the slowdown in Russian growth in “Russia’s Growth Crisis,” *Milken Institute Review*, forthcoming.

drop, the faster the rebound growth. What level of income Russia attains in the short term is a different matter. Depending on how long the confrontation lasts, it will take longer for Russia to regain its current prosperity level once the conflict is over.

Also — although this depends on whether the confrontation between Russia and the West ends through some sort of cooperative efforts and thus a modicum of trust — Russia has the potential to rapidly bring back foreign investors who may have been frightened away or deterred from entering Russia during the conflict. The great magnet is, as always, its resource sector. Examples from recent and more remote Russian history tell us that Russia's natural wealth will always attract foreign investors, almost irrespective of how they were treated in the past.¹⁷ Investment will flow because the potential upside in Russia is huge and comparable alternatives elsewhere in the world are few. Thanks to oil, Russia does not need costly reforms to attract capital. And thanks also to the oil, it has rich consumers. Once sanctions are lifted, the postponed consumer demand that might result from a sanction-induced recession will be unleashed and help accelerate the rebound. Both domestic retail and imports will benefit.

None of this, however, should cause us to ignore some very serious concerns about Russia's future that this crisis raises. The real worry is that a prolonged confrontation with the West, even without direct conflict, will make the prospects for Russia's evolution as a modern society more remote.

Putin himself began the pullback from modernization in 2012 with his launching of political war on Russia's creative class and his "mobilization economy" programs designed to shift resources to the most inefficient parts of the economy — defense industries and remote regions in the eastern part of the country.¹⁸ The Ukraine conflict intensifies both the political and economic trajectories that Putin had begun and therefore moves him further away from modernization.

The tendency towards import substitution was already underway before the Ukraine crisis. Heavy sanctions by the West will accelerate the movement in this direction. Even more important, the sanctions may cause an especially damaging qualitative shift in the nature of import substitution. Previously, import substitution was a policy limited to core manufacturing sectors, the "old economy." Russia's so-called new economy was to a large extent allowed to continue its integration into and dependence on the global marketplace. Now the process of important substitution will reach beyond the manufacturing sector to sectors that were previously integrated with the modern economy, such as banking. This is what will happen, for example, if Russia creates its own credit card payments system to replace the system previously developed by Visa and MasterCard, now banned by U.S. sanctions.

These tendencies to import substitution in the relatively modern sectors will be especially costly. When Russian dinosaur manufacturing plants take over market share from Ukrainian dinosaurs, the cost is minimal. When modern foreign companies are ousted in favor of Russian ones, the loss is much bigger. Companies in Russia's "new economy," whether foreign-owned or Russian, were driven by the forces of international competition. Their replacements will be directly under Putin's control. This is a general conclusion: more import substitution and more reliance on rent

¹⁷ We refer to this as the "Lena Goldfields" principle. Lena Goldfields was a British-owned mining company that was appropriated by the Bolsheviks after the 1917 revolution and then sold back in the mid-1920s to the very same investor group — who, despite their previous ill-treatment, could not resist the lure of a monopoly on the Russian gold sector — only to again be appropriated by Stalin a few years later.

¹⁸ For the war on the creative class, see the final chapter of Gaddy and Ickes, *Bear Traps*.

distribution to cover the excess cost of such activities mean that more of the economy will be dominated by Putin's rent management system.

Sanctions thus lead to greater control by Putin over the economy. They also reinforce his political power. They rally the public around Putin. Indeed, it is hard to see how sanctions do anything but weaken the liberals as a political force in Russia. This means that our current approach of dealing with Russia by sanctions and isolation will not only fail to accomplish its immediate goal of stopping Putin in Ukraine, but it will also be counterproductive to the more important, long-term objective of Russia's evolution as a normal, modern, globally integrated country. With the approach we now have, not only do we lose the battle. We make it harder to win the war.