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No, the West's energy imports don't finance Putin's war

The claim that Europe's payments for Russian energy exports are financing the destruction of Ukraine is wrong. Here's why

Russian President Vladimir Putin's decision to launch a large-scale invasion of Ukraine has thrown down immense challenges to the West – and has led to soul-searching as to the appropriate military, diplomatic and, not least, economic countermeasures.

In this situation, it's vital that relevant policies are based on a sound economic analysis. Unfortunately, this is often not the case. Some claim that the Russian state is about to go bankrupt. The collapse in the value of the rouble is made out to be more important than it really is. And social media is abuzz with the claim that the West's payments for Russian energy exports are financing the destruction of Ukraine.

This has culminated in a large number of prominent personalities in Germany calling for a complete EU energy-import stop – 'no more of our money for Putin's war!' – while claiming that 'our money' is supporting the rouble. While the sentiment is understandable in the face of the horrors of the war, it is based on a number of serious misconceptions.

Getting the economics straight

Let's start with the basics. It is important to distinguish between transactions that are conducted in roubles and those in foreign exchange, euros for example. A related but not identical distinction is between goods that are currently, or could relatively quickly, be produced in Russia or close allies and those it has to import from 'hostile' countries. The rouble is a currency that the Russian central bank issues itself. The government can raise taxes, issue bonds, or 'print' the money, as Western central banks have done with quantitative easing. Therefore, rouble-based transactions cannot – the first misconception – 'bankrupt' the Russian state. It might well default on foreign-currency bonds, but that is a different matter.

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The supply of foreign currency, on the other hand, is limited basically to past and current exports of goods in excess of imports, factored in or previously converted into foreign currency and generating, respectively, a stock and a flow of foreign exchange.

In the press, one can often read that the war is costing Putin X million dollars or euros a day, while Europe is transferring Y million dollars or euros to purchase, mostly, energy. This implies: stop buying the energy and you stop financing the war. But the former is actually an estimated amount of military spending in roubles that has been recalculated, at an assumed exchange rate, in dollars or euros. The Russian government pays its servicemen and women, its contractors and suppliers in roubles.

The domestic costs of war

What higher military spending does do is reduce the scope for civilian production and consumption through some mix – depending on how it is financed – of inflation and lower post-tax incomes. More guns, less butter. This is the classic dilemma of a country at war. But it is not directly linked to the issue of foreign exchange. Russia very obviously has a surfeit of fuel, it is not dependent on foreign mercenaries, and it deploys overwhelmingly domestically produced military hardware, of which it certainly has substantial undeployed reserves. The caveat is that some military goods or components may need to be imported and this would normally require foreign currency. However, this is hardly an issue in the short run. And even here, the idea of an inflow of foreign currency being necessary to finance the Russian military is wrong-headed for a different reason.

Russia has a sizeable reserves from past export surpluses, estimated at some $630bn. Yet the existing sanctions on the central bank – an unprecedented step amounting to a confiscation of financial assets – mean that this nest-egg cannot easily be run down to purchase imports. Yet this shows that the sanctions already imposed in revulsion at Russia's war of aggression, and the resulting inability or unwillingness of key partners to trade with it, is the key issue, and *not* the flow of foreign exchange from ongoing exports. Similarly, the considerable attention given to the collapse in the *external* value of the rouble, is misplaced: the exchange rate is not that relevant when trade is blocked for other reasons and convertibility is restricted. The Russian central bank does not need revenue from current net exports to prop it up.

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Existing sanctions sharply restrict the financing of imports from those countries that won't accept payment in roubles. Russian consumers and producers will have much greater difficulty accessing final and intermediate goods imported from abroad. This will directly hit living standards, especially of the middle and upper classes. Over time, this will cause serious problems for Russian industry to the extent that it cannot acquire inputs for production from alternative foreign or domestic sources. It won't have a direct effect on the war machine, but will generate general economic misery in Russia and possibly provoke popular or elite opposition to Putin. How the masses or the oligarchs react when their access to hi-end consumer goods or their profits are restricted, and whether it may help the autocrat circle the wagons around his regime is however an open question. Many experts are sceptical.

The West doesn't finance Putin's war

A critical determinant of the economic impact on Russia, alongside its ability to substitute domestic production for imports, is the willingness of China, India, and some smaller countries to engage in trade with Russia out of political expediency or economic necessity. It is noteworthy that, pre-crisis, China and Belarus were the first and third largest source of Russian imports. Some of these countries might insist on payment in dollars, in which case a stop to current inflows to Russia will weaken its position. However, if the political will is there, goods trade seen as mutually beneficial will not fail to materialise because of a lack of suitable unit of account. If necessary, a shared spreadsheet in the respective national treasuries would do the job.

What is certain is that policy-makers need to take decisions based on a sound appreciation of economic realities.

Ultimately the decision on economic sanctions, including the proposed total import stop, is part of a larger 'game' of threat and counter-threat, escalation – and possible de-escalation – that cuts across all areas, including military ones. Assessing the consequences of a given course of action is extremely hard. The West must stand with Ukraine, but the best way to do so, to force or persuade Putin to call off the war, is not self-

evident.

What is certain though is that policy-makers need to take decisions based on a sound appreciation of economic realities. Western energy purchases do not – in a meaningful sense – finance Putin's war. Russia is suffering economically from sanctions. But its government will not go bankrupt without further foreign currency inflows. The costs to Europe of an immediate halt to energy imports will be substantial – and require additional sourcing from other unpleasant regimes, not least Saudi-Arabia which is pursuing a war of its own with horrendous loss of life. The shift to alternative, and especially renewable sources must in any case be undertaken at warp speed.

May policy-makers find a way that ends the loss of life, permits Ukrainians a life in safety and dignity, and limits the economic fallout as quickly as possible.



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