The Economic Rationale for Oil and Gas Embargo on Putin's Regime

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Stopping purchases of Russian oil and gas is likely to be the fastest way to stop Putin's war in Ukraine. It is also the most economically efficient one.

We are economists and for the purposes of this article, we do not put forward moral arguments against Europe's decision to continue paying Russia for its oil and gas, while Vladimir Putin uses these funds for his brutal war in Ukraine. Not being German citizens, we cannot call on the German government to make choices that involve short-term costs for German voters. However, as economists doing research in political economy and international economics and experts on the Russian economy, we can confidently argue that a European embargo on Russian oil and gas is the right *economic* decision and the fastest way to stop Putin's ability to finance his war in Europe.

Yes, this embargo is costly. But its costs are manageable. Leading German economists estimate the cost of the German embargo in the range of 0.5 to 3% of GDP or roughly 120-1200€ per capita, the equivalent of a moderate recession and below the economic costs of COVID. The Nobel prize winner Paul Krugman agrees that these costs are manageable. Two other studies consider a European embargo; one estimates that stopping purchases of Russian fuels would decrease Europeans' real incomes by less than 1%, the other one suggests that fully switching off Russian gas would reduce the euro area GDP by 2%. The German government has ample fiscal resources to make German consumers whole by subsidizing the higher expenditures for energy from alternative sources and to offset negative effects on production and the labor market - as it did during the COVID recession. As the winter is over and there is less need for gas in heating, this is an ideal moment to substitute gas consumption and store as much natural gas as possible for the next winter. If the embargo is started now, the Western economies can adjust quickly, and finally rid themselves of the dependency on Russian fossil fuels, eliminating Europe's vulnerability to economic blackmail by Putin. The analysis by Bruegel, a Brussels-based think tank, suggests that Europe can manage next winter without Russian gas and face only temporary disruptions from an outright ban on Russian oil and gas.

What is more important, is that not imposing the embargo has much larger costs. Putin's war in Ukraine is first and foremost a human tragedy. But it is also an economic disaster for Europe. Europe faces the worst refugee crisis since World War II; the number of refugees has already exceeded 3 million and continues to grow. The Euro area economy is projected to be in recession in the second quarter of 2022. Its post-COVID recovery is substantially slowed down: e.g. Goldman Sachs has already downgraded 2022 growth forecast from 3.9 to 2.5 percent. To put things in perspective, Russia accounts for only 3% of German imports, and the war in Europe disrupts production chains and processes (so far mostly) in Eastern Europe that account for a much larger share of European trade. Crucially, the return to status quo is not in the choice set. Prolonging this crisis will result in much higher economic costs. Thus, ending Putin's war is not just a humanitarian, but also an economic imperative.

Aren’t existing sanctions sufficient to stop Putin? Since the war started, the West demonstrated unprecedented resolve and unity, and has indeed introduced sweeping sanctions which have crippled the Russian economy. The Ruble has lost 40% of its value. The Russian stock market ceased to exist. Russian sovereign debt is trading at 20 cents per dollar. Russia’s Central Bank raised its inflation forecast for 2022 from 5.5 to 20 percent per year. The GDP fall is expected to be the worst one in Russia’s thirty year post-Soviet history. Western companies have exited Russia en masse. Most importantly, the West has sanctioned the Russian Central Bank and its vast reserves, freezing a large portion of the 630-billion-dollar war chest, one of the key pillars of the economic “fortress Russia”.

However, while the sanctions eliminated the accumulated stock of Russia’s petrodollars, the flow is still coming in mightily at over 500M euros per day from deliveries to the European Union. At the current oil prices, Russia is likely to solve its fiscal and balance of payments problems. Oil and gas revenues are the backbone of the Russian budget. In 2021, at considerably lower oil prices, direct oil and gas taxes accounted for 40% of the Russian budget, with substantial indirect contributions from corporate profit tax, personal income tax and VAT. The Russian budget is balanced at $44 dollars per barrel. If oil and gas revenues keep coming in, Russia will run a fiscal surplus.

In addition to formal sanctions, Russian oil revenues have been recently disrupted by the private sector’s voluntary boycott of Russian oil. It is hard to estimate the decline in the volumes of Russia’s oil exports, but Russian oil is trading at an unprecedented discount of $30 per barrel. The private sector’s de facto embargo does create a major problem for Putin. But, first, this embargo is not complete, there are still Western traders who handle Russian oil. Second, this disruption may be temporary – until Russia manages to reorient oil exports to new routes. The lack of a formal European embargo thus provides a light at the end of the tunnel for Putin. As he can hope for a medium term resolution to his oil revenue problem, he has an incentive to continue the war.

The foreign cash Putin receives from Russian natural resources is now used, and will be used further, to continue the war in Europe. The sanctions on the financial sector, including the incomplete ban from SWIFT, provide only a partial obstacle as there are a variety of work-arounds, including never bringing foreign cash inside Russia and using it on international black and gray markets. Oil and gas revenues will be used to hire mercenaries from third countries and procure essential components for Russian military systems which are not domestically produced. Furthermore, Putin will attempt to use these revenues to wreck chaos and create division in Europe to improve his bargaining position. The sanctions and secondary sanctions that are in place to prevent this are inherently leaky, and this is why limiting the financial resources of Putin’s military machine is of the essence.

It is true that Putin pays his military and policemen in rubles rather than in euros. But without the natural resource export incomes, the Russian budget will be in deficit. So Putin will either have to cut soldiers and officers’ salaries or resort to printing money. Inflation is already very high, at

2 percent per week, and the export embargo will accelerate it considerably. The depletion of foreign currency revenues together with accelerating inflation will undermine Putin's ability to support the purchasing power of salaries of policemen, bureaucrats and propagandists who are the key pillars of his oppressive regime at home, making further foreign military aggression inviable.

Is an embargo futile as Putin will sell gas and oil to China? A complete substitution towards China and other countries is impossible given the constraints of the transportation infrastructure and the size of the European market, which accounts for half of oil exports and three quarters of gas exports from Russia. However, more importantly, the embargo on Russia oil is the ultimate statement of resolve and unity from the West, which will make it much easier to bring China onboard – another crucial part of the containment and isolation strategy. In contrast, it would be much more difficult for the United States to impose secondary sanctions on countries trading with Russia, if European allies keep importing Russian energy resources.

Indisputably, an embargo will also hurt ordinary Russians, whether they support Putin's war in Ukraine or not. In a nondemocratic regime, the burden of the sanctions which target Putin and his friends will be at least partially borne by the public, as this already happened after 2014. As long as Putin is in charge, he will continue to reorient Russia's fiscal resources to benefit his friends and reinforce the loyalty of his repression and propaganda apparatus; this will of course happen at the cost of lower incomes for ordinary Russians. But this does not mean that not imposing sanctions will help them. Rebuilding the Russian economy requires stopping the war. Putin has shown his ultimate disregard towards human life. He wants to continue this war which is devastating for both Ukraine and Russia, with tens of thousands lives lost and the welfare of over hundred million people destroyed. On March 16, in a meeting on economic (!) issues, he literally said that he is seeking a "final solution" in Ukraine. The only way to stop Putin is to deprive him of financial resources to continue this war. It is also crucial to emphasize that the embargo is in place until Russia can provide credible assurances of no further aggression in Ukraine or elsewhere.

Not implementing embargo now will prolong the war in Ukraine, which already has very high economic costs for Europe. In addition, the short-term economic arguments fail to capture the possible costs from further escalation of the war which threatens to involve more countries in Europe with potentially catastrophic consequences. Thus, embargo is the economic imperative which will deprive Putin of financial resources to continue the war. Any other policy option will in all likelihood be vastly more costly and dangerous.