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THE ECONOMIC CONSEQUENCES OF PEACE IN UKRAINE

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Summary

How Russia's invasion of Ukraine will end is still an open question. However, most conceivable scenarios raise similar questions about how Europe should manage the peace. The easy part is investing in Ukraine. This will also confer a substantial boost upon the European economy as a whole, strengthen its defense industry, and enhance global food security.

The intricate part is how to deal with Russia and its allies. This paper analyzes various strategies, taking Keynes' famous "Economic Consequences of the Peace" from 1919 as a starting point. While Germany after the First and Second World Wars converted to a democracy, Russia is likely to remain a fascist and corrupt state, which requires strategies quite different from those advocated by Keynes after the First World War, and partially implemented after the Second World War.

Eight insights emerge from the analysis:

1. Winning the economic and technological competition remains paramount for the West as long as aggressive dictatorships threaten Europe and democracies at large. That means that sanctions need to be upheld and in some respects even sharpened.
2. While sanctions are not very effective, they do weaken authoritarian governments, and the cost to the West is small even if they were to lead to extensive decoupling between the West and the East.
3. Even the small cost to the West following sustained sanctions may be offset by three benefits: they can accelerate climate transition, they confer growth stimulants upon poorer countries that today rely on aid from the West, and they help to de-risk supply chains.
4. The EU should expedite damage claims against Russia using Russian central bank holdings as collateral. If Ukraine were coerced into accepting a peace deal with Russia and relinquished its damage claims, the EU should pursue such claims anyway as compensation for costs of the war incurred by EU countries. Essentially this could mean holding on to Russian central bank reserves forever, if Russia continues to refuse to pay reparations.
5. Sanctions can be targeted better. There is no advantage in prohibiting the export of luxury consumer goods to Russia, but loopholes for goods with military or industrial use should be closed. Russia's shadow fleet can be curtailed with relatively simple measures. Movement of Russian capital, experts and entrepreneurs out of Russia should not be impeded but controlled more carefully.
6. Regardless of immigration from Russia, the West needs better vetting and measures to minimize infiltration by criminals, for example by building on recent reforms concerning "unexplained wealth".
7. Ukraine and other Eastern countries can strengthen the EU considerably, but that requires important reforms of EU-institutions and the European Monetary Union.
8. Technological competition can be won mainly by strengthening the West's own capacity. In fact, Europe can potentially double its rate of economic growth over the coming decade by embracing growth reforms.

The end of the war

The war could end in various conceivable ways. Russia is scraping the bottom of its stockpiles of tanks and cannons. Ukraine is recurrently threatened by dwindling support from the US and even some European countries. In combination with a rapidly shifting technological landscape, one cannot exclude the possibility that one side or the other will gain a decisive advantage. More likely however is either a protracted war, perhaps even reverting to the low intensity conflict witnessed after the initial Russian invasion 2014-2022; or some kind of deal or ceasefire eventually agreed upon.

These various scenarios have dramatically different implications for Ukraine, but they also share common features that serve as a starting point for thinking about economic development and policy after the bombing ceases. First, Ukraine will remain a democracy, eager to join the European community. Second, important parts of Ukraine's economy have survived, such as grain exports, and others are world-leading, such as drone technology. Third, Russia will remain a repressive dictatorship with imperial ambitions. Fourth, Russia's relations have become more tightly knit with Iran, North Korea and China, with whom it will share technology and arms development. This is likely to continue even if Putin dies or is ousted. Given the degree of corruption and pervasiveness of criminal groupings in Russia, it appears unlikely that the country would revert to a democracy even without Putin.

These four common threads have significant implications for economic policy, which differ fundamentally from the reasoning that may have applied after the First and Second World Wars.

Earlier warnings of counterproductive peace policies

John Maynard Keynes published *The Economic Consequences of the Peace* in 1919 and it became an immediate success. In this book, he presents his arguments for a much less onerous treaty, not out of generosity for German civilians but for the sake of the economic well-being of all of Europe and beyond.

At the heart of the book are two profound criticisms of the Treaty of Versailles and its associated treaties. First, Europe could not prosper without an equitable, effective and integrated economic system, which was impossible under the economic terms of the treaty. Second, the Allies breached critical principles to which they had committed in the earlier Armistice agreement regarding reparations, territorial adjustments, and evenhandedness in economic matters.

The French prime minister Clemenceau took the view that European wars should be regarded as recurrent events. European history would remain a perpetual prize-fight, of which France had won one round, but certainly not the last. Therefore, Germany should be weakened as much as possible.

One of the most serious charges Keynes levelled against the Versailles treaty is that it failed to include provisions for the economic rehabilitation of Europe, and did nothing to promote good neighbors, nothing to stabilize the new states of Europe, did nothing to sort out the disordered finances of France and Italy, and finally did nothing to reclaim Russia or to solidify solidarity amongst the Allies themselves.

The Allies paid no attention to these issues, being preoccupied with reparations and crushing the economic life of their enemy. Based on these failures, Keynes predicted the causes of high inflation and economic stagnation in Postwar Europe:

> "Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. ... Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on

> the side of destruction, and does it in a manner which not one man in a million is able to diagnose."[1]

He explicitly pointed out the relationship between governments printing money and inflation:

> "In Germany the total expenditure of the Empire, the Federal States, and the Communes in 1919–20 is estimated at 25 milliards of marks, of which not above 10 milliards are covered by previously existing taxation. This is without allowing anything for the payment of the indemnity. In Russia, Poland, Hungary, or Austria such a thing as a budget cannot be seriously considered to exist at all. … Thus, the menace of inflationism described above is not merely a product of the war, of which peace begins the cure. It is a continuing phenomenon of which the end is not yet in sight."[2]

Given that Keynes was writing in 1919, his prediction that the next war would begin in twenty years had an uncanny accuracy. Some years later Adolf Hitler was to write *Mein Kampf*. The German people were humiliated, and their faith in democracy – which was fragile to begin with – was almost totally destroyed. The Allies should perhaps have either totally dismembered Germany or else have made a sincere effort to make a fair and just peace with her and bring her into the family of nations as a full partner.

Yet a prerequisite for Keynes' prescience was that Germany did in fact give democracy a chance. Awareness of imminent defeat sparked a revolution, the abdication of Kaiser Wilhelm II and the proclamation of the Weimar Republic on 9 November 1918. In its initial years, grave problems beset the Republic, such as hyperinflation, just as Keynes had foreseen. By 1924, a great deal of monetary and political stability was restored, and the Republic enjoyed better economic growth and significant cultural flourishing, social progress, and gradual improvement in foreign relations. Yet large swathes of the middle class had lost their savings.

This came to a head during the Great Depression, which crushed Germany's tenuous progress; high unemployment and subsequent social and political unrest led to the collapse of Chancellor Hermann Müller's grand coalition. From March 1930 onwards, President Paul von Hindenburg used emergency powers to back a succession of chancellors. On 30 January 1933, Hindenburg appointed Adolf Hitler as Chancellor to head a coalition government even though Hitler's Nazi party only held two out of ten cabinet seats. Yet Hitler managed to get the Reichstag to pass the Fire decree and the Enabling Act. Hitler promptly used these powers to thwart constitutional governance and suspend civil liberties, which brought about the swift collapse of democracy and eventually a new world war.

Keynes' argument eventually informed the policies of the Western Allies after the Second World War. Initially the focus was on ceding territory to the Allies, deporting Germans from these territories and attempting to convert Germany into an agricultural nation, allowing only light industry. Many factories were dismantled as part of reparations agreements or were simply destroyed.

By mid-1947, however, the success of denazification and the onset of the Cold War prompted a reconsideration of policy. The Germans were now seen as potential allies in the emerging conflict, and it was becoming evident that Europe's economic recovery depended on the reactivation of German industry. The Marshall Plan was initiated to support Western Europe, including Germany. By 1950, the UK and France followed the American lead, and stopped dismantling German heavy industry. The country's economic recovery under the newly formed democratic government was swift and effective, once it was permitted.

Toward the end of the Second World War, Swedish economist Gunnar Myrdal wrote a book titled *Varning för fredsoptimism* (Beware of Peace Optimism) in 1944. There he warned that the war would be followed by an international depression, mainly due to conflicts between the US and Britain, and between these two and the Soviet Union.[3] While this book did not attract nearly as much attention

1 Keynes, J.M. (1919). The Economic Consequences of the Peace. (1 ed.). London: Macmillan & Co, p. 220.
2 Ibid, p. 232.
3 Myrdal, G. (1944). Varning för fredsoptimism. Albert Bonniers förlag, Stockholm.

as Keynes', it propelled Myrdal into the chairmanship of a Swedish post-war economic commission that proposed far-reaching public initiatives to promote growth. During a brief tenure as Minister of Trade, he also advocated for export credits to the Soviet Union as a means of mitigating the risks of the conflict he anticipated. Most importantly, however, his prediction of an international depression failed to materialize. As we will see further below, a Western decoupling from Russia hardly affected Western economies then and will not do so now either.

The easy part – investing in Ukraine

Investing in Ukraine is not only a humanitarian obligation. Crucially, it serves to show that a people who choose to ally with the democratic Western hemisphere relatively quickly achieve a much higher standard of living than those that remain under the Russian empire. Moreover, such investment should not be viewed as a cost, since a prosperous Ukraine with a skilled workforce trading with the West contributes to economic growth in Western Europe as well. Countries that join the EU have subsequently grown at a fast pace, in particular Eastern European countries.[4] This growth effect can be expected to be even larger in Ukraine because rebuilding is generally more profitable than trying to kick off growth in regions with structural impediments.

In fact, the growth stimulus to Europe would act as a fulcrum for humanitarian and geostrategic aims. Following Russia's invasion in 2022, foreign direct investment dropped from $6.5 billion in 2021 to just $570 million in 2022, according to the Vienna Institute for International Economic Studies. But as peace is negotiated many Western firms will be eager to invest in Ukraine to make use of labor at competitive rates and to secure markets. In some sectors, such as military hardware, Western firms will invest also to gain access to technological leading-edge competence.

The macro-economic investment climate is fairly encouraging, considering the circumstances. Inflation has fallen to moderate levels during 2024. The economy is growing again. The budget deficit has been funded without issuing a single hryvnia's worth of monetary financing, and international reserves are at sufficient levels. To ensure this continues, international aid will be necessary for several more years. A large part of this year's deficit (some USD 38 billion) will be very difficult to cover without financial aid from abroad. Yet the sums involved, roughly 30 billion dollars per year, amount to a small fraction of allies' public expenditures.

In addition, many European countries and the EU will provide funds for infrastructure and environmental projects that make a big difference in Ukraine without being much of a burden on EU countries. Approximately one-third of the EU's regional funds is allocated to cohesion policy, with the European Regional Development Fund (ERDF) accounting for the largest portion at 55 percent. However, the extensive empirical literature on the effects of the EU's regional policy overall is rather discouraging. Some studies find positive but small effects. Many find no effects or even negative ones. Yet for the type of support that Ukraine would receive, empirical results are much more hopeful. Two studies are particularly thorough and interesting because they investigate the characteristics of projects that had the best effect on the economic development of regions. The first study concludes that infrastructure investments seem to have worked best.[5] A later study first estimates regional growth that cannot be explained by background factors and then examines how much of this "unexplained" growth can be attributed to EU projects with different characteristics.[6] The conclusions are, in short, that only Cohesion Funds (CF) seem to have positive effects. These funds largely finance infrastructure in countries with less than half of the EU's average GDP.[7]

4 See for example Campos, N. F., F. Coricelli and L. Moretti. (2014). "Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union Using the Synthetic Counterfactuals Method."; European Commission (2018). The Impact of EU Membership on Economic Growth, summarizes the literature.
5 Bachtler et al., (2017). EU cohesion policy - Reassessing performance and direction, Routledge, London, United Kingdom.
6 European Parliament (2019). Effectiveness of cohesion policy: learning from the project characteristics that produce the best results. Policy Department D for Budgetary Affairs Directorate General for Internal Policies of the Union PE 636.469.
7 They also find that projects managed by local administrations have worse effects. Local influence should instead be combined with external project management.

Infrastructure projects are in many ways easier to evaluate than other projects. It is straightforward to ascertain whether a treatment plant has been built and whether it functions. Thus, the bureaucracy surrounding "performance review" can be significantly simplified. The EU's regional policy should probably focus exclusively on what the Cohesion Fund currently addresses: infrastructure projects for transport and environmental purposes in the EU's poorer countries. In the case of Ukraine some infrastructure will also be aimed at sustaining Ukraine's defense and deterrence posture.

Two other questions could be larger stumbling blocks. One is that, once Ukraine edges closer to EU-membership, the question of agricultural subsidies would loom larger. Ukraine would, as a member, swallow a huge swathe of EU's subsidies that would have to be withdrawn from other countries. That could threaten accession. In the best of cases, however, the EU would reform and reduce its agricultural subsidies even before Ukraine joins. In that case Ukraine would have helped the EU to reform one of its lingering sores.

Another question is how to handle the estimated $300 billion in frozen Russian Central Bank (RCB) assets. Of this total, only about $5 billion is held in the United States, while the largest portion is managed by Euroclear, a central securities depository located in Brussels, Belgium. As more countries support the decision to allocate these frozen assets for reparations, this move would gain greater legitimacy within the international community and under international law.

One of the major breakthroughs in this regard occurred in the US Congress with the adoption of the 21st-Century Peace Through Strength Act. This act stipulated a political "yes" to such a seizure, yet avoids the practical "when". The bill does not provide for an immediate confiscation of Russian assets but rather confirms the authority of the US president to do so.

The earlier International Emergency Economic Powers Act (IEEPA) was utilized to confiscate assets of a state violating international law. For example, in 1992, after Iraq invaded Kuwait, President George H.W. Bush froze Iraqi assets and then transferred them to the Federal Reserve Bank of New York; eventually the money was sent to the UN Compensation Commission, to compensate the victims of Iraqi aggression.

The adoption of the 21st-Century Peace Through Strength Act is intended to eliminate any uncertainties regarding the US president's authority to seize, confiscate, transfer, or invest Russian aggressor state assets. However, a different US administration might choose not to exercise these powers or might retreat from them if it brokered a peace deal with Ukraine.

This would place the EU in a challenging position, having to decide whether to take unilateral action. Analyses by several international law experts[8], as well as by the EU itself, have concluded that this could be done in accordance with international law.[9] Under customary international law, a state bears responsibility for its internationally wrongful acts, which in turn gives rise to a reciprocal duty to provide reparation. In its aggression against Ukraine, Russia has acted in violation of its international obligations, including those arising from the United Nations (UN) Charter. This has been recognized by the UN General Assembly on several occasions.

However, states are immune from the enforcement jurisdiction of domestic courts, which means that measures of constraint may not be taken against their property (including central bank assets) unless the state has consented to the measure, or one of the limited exceptions applies. This rule has been confirmed by the International Court of Justice and included in international agreements. This immunity may be overcome in several ways, of which the two most realistic appear to be:

1. Placing a windfall tax on frozen Russian state assets, which the EU agreed upon and has started paying out to Ukraine.

2. Justifying any breach of Russia's immunity as a third-party countermeasure. This would require showing that the proposed confiscation would be temporary and reversible, and that the confiscation would be for the purpose

8 For example, Mills, M., T. Poston and O. A. Hathaway (2024). How to make Russia pay to rebuild Ukraine. *Just Security*.
9 European Parliament (2024). Legal options for confiscation of Russian state assets to support the reconstruction of Ukraine. EPRS.

of inducing compliance with an international obligation. This could justify confiscation of RCB assets as third-party countermeasures with a conditional element, for example that RCB assets are given as a loan to Ukraine, repayable in principle if and when Russia complies with the obligation to make full reparation.

This paper makes the argument that the EU should pursue third-party countermeasures even if Ukraine were coerced into a peace deal where it relinquishes reparation demands. In that case, the EU should demand reparations based on the costs caused by Russian cyber and hybrid warfare in Europe as well as costs for supporting Ukraine.

In sum, Ukraine can expect fast economic growth and rebuilding without great cost to Europe, and even if access to Russian Central Bank funds is not available. Still, Europe should insist on proceeding with making these funds available, even if the US were to make concessions to Russia.

Should Europe maintain pressure on Russia after a peace deal?

Regardless of how the war ends, the EU should think of ways to sustain its strategic autonomy and effective leadership in "bad weather" situations – that is, if/when strong and united support of Ukraine or other victims is endangered.

Generally, Western and Ukrainian interests will align, but there could be differences. For example, if under duress Ukraine negotiated an agreement that left Russian forces in place in Crimea or other parts of Ukraine, the West or the EU should take a firmer position toward Russia than that agreed on by Ukraine. In particular, if the US forces a deal on Ukraine, Europe should refuse to ease or lift its extraordinary sanctions so long as any Russian forces remain in Ukraine.

To some, the issue of reparations might be contentious with reference to Keynes' argument. The economies of aggressors in wars have often recovered well when those countries have transitioned to more open and humane governments and cooperated more with the international system. But repressive countries facing economic constraints, such as Iran did with sanctions throughout 2015, have suffered high unemployment, inflation, and economic decline. Similarly, Russia's slow growth, combined with underinvestment and the potential burden of paying reparations, could degrade living standards for Russians. Would this make Russians more receptive to populist or authoritarian rule?

The problem with applying Keynes' argument to the case of Russia is that Russia already is a brutal dictatorship. Some would argue that economic decline might tighten Putin's stranglehold on Russia even more. But the empirical literature on how sanctions affect autocrats' hold on power gives conflicting results.[10] Therefore, predictions on how sanctions might affect Russia's internal politics should be set aside.

Instead, an argument of greater importance is that Europe is already under the threat of invasion from Russia and in fact a direct victim of unconventional warfare by Russia. This justifies measures that erode Russia's capabilities. The empirical literature is much clearer on the effects of sanctions in this respect.

For example, one extensive study by Neuenkirch and Neumeier (2015) investigates the impact of economic sanctions. They find significant results that imply that the imposition of UN sanctions has an average effect of decreasing the target state's annual GDP per capita growth rate by more than 2 percentage points per year, although the negative effect diminishes over time and becomes insignificant after 10 years. At an aggregate level, the imposition of UN sanctions is associated with a drop in the target's GDP per capita of 25.5 percent. In contrast, isolated American sanctions are found to have smaller effects on GDP growth and to be of shorter duration than UN sanctions. Specifically, the effect of American sanctions accounts for a total decline in GDP per capita of 13.4 percent.[11]

In June, the EU adopted its 14th sanctions package, which included measures targeting liquefied natural gas

10 von Soest, C. and M. Wahman (2014). The Underestimated Effect of Democratic Sanctions. *E-International Relations*.
11 Neuenkirch, M. and Neumeier, F. (2015). The impact of UN and US economic sanctions on GDP growth. *European Journal of Political Economy*, (40): pp.110– 125.

and Russia's shadow fleet, responsible for transporting sanctioned Russian oil globally. Vladimir Putin and his authoritarian regime are peddling the false narrative that the Russian economy is strong, and that its war machine is unharmed by Western sanctions.

On the contrary, there are many signs that the Russian war economy is deteriorating. Russian GDP may or may not be growing. Apart from downright manipulation of statistics, the economy is increasingly geared towards the war industry, the value of which is registered by more or less arbitrarily set prices for military hardware. Other goods and services are in short supply, with the weaker ruble also increasing import prices. Export bans on petrol and sugar have been introduced to secure domestic supply. Strict capital controls have been put in place to prevent the exodus of private funds from the country and keep the ruble from free-falling. Even so, there are still reports of billions of US dollars being transferred out of the country.

Despite the Russian Central Bank's efforts to fight inflation with interest rates at 18 percent (and mortgage rates way above 20 percent), consumers may have lost 20 to 30 percent of their purchasing power. The short-term overheating of the economy, fuelled by heavy investments in the war industry and very limited access to technology, will likely hinder productivity gains and result in stagnation of the private sector and therefore even more rampant inflation and increasing pressure on Russian households.

To finance the war, the Russian government has tapped into the liquid assets of Russia's National Wealth Fund, which is being depleted. Between 2022 and 2023, Russian export revenues decreased by around a third, based on information from the Russian customs service.

To cover future deficits, Russia will have to use monetary financing, adding more fuel to inflation, and further depleting the Russian cash reserves. If Putin stays on this path, the long-term damage to the Russian economy will be significant. The Russian economy will not "collapse". But in combination with the mismanagement and corruption that pervade the Russian economy, its ability to replace weapons systems will be further impaired. Europe has a strong interest in contributing to further erosion of Russian capability even after a peace deal for Ukraine.

The long run consequences of decoupling the East from the West

Maintaining sanctions while Russia aligns itself more closely with Iran, North Korea and China can eventually lead to various degrees of decoupling between these countries and the West. Yet this risk is worth taking and would not cost the West much, according to extensive simulations.

For example, Wache et al. (2024) find that China and Russia stand to incur greater losses from decoupling from the West than vice versa.[12] Their calculation assumes that imposing tariffs on all trade flows in a broad decoupling scenario would lead to a substantial decrease in international trade between the two blocs. In terms of real income, Russia and China stand to lose relatively more than the West, partly explained by the fact that Russia and China would "lose access" to a larger share of the world economy than vice versa.

Further, the cost to the West is partially offset by trade diversion. For instance, if a French company encounters challenges in accessing its Chinese supplier, it might opt to procure intermediate inputs from a neutral source such as Brazil or Morocco. This has three advantages. First, the West currently supports growth in developing countries that may become better able to support themselves. Second, this might also confer a security benefit as lower unemployment and better prospects assay risks of political instability and democratic deterioration. Third, Western firms and governments might face lower costs for securing their supply lines if they rely less on dominant China and diversify their sources globally.

In another simulation, Felbermayr, Mahlkow and Sandkamp (2022) use a computable general equilibrium model of international trade to investigate the impact of different sanctioning and decoupling scenarios on trade and welfare.[13] The model quantifies the effects of changes in

12 Wache et al., (2024). Geopolitical decoupling and integration scenarios of global trade. CPB, The Netherlands.

13 Felbermayr, G.J., H. Mahlkow and A. Sandkamp. (2022). Cutting through the Value Chain: The Long-Run Effects of Decoupling the East from the West. Economic Policy Brief 41. April, vol. 6. CESIFO.

bilateral trade barriers on 65 sectors in 141 countries, covering 98 percent of economic activity worldwide, based on detailed input-output linkages, making it especially suitable to analyze a decoupling from Russia in the energy sector.

A decoupling between "East" and "West" would reduce real income in all countries involved. In the most extreme scenario, the US and its allies would experience a permanent drop in income of 1.3 percent, while the BRIC countries would see their income fall by 3.9 percent on average. Regarding the current conflict between Russia and the West, reciprocal decoupling would reduce Russian income by 9.7 percent, while the West would only suffer losses averaging 0.2 percent. Thus, increasing the scope of economic sanctions comes at relatively low costs for the West on average, in particular in the long run. Nevertheless, the short-run impacts of such sanctions, such as in the energy sector, are not only likely to be more severe but also surrounded by a large degree of uncertainty. This makes a gradual stepping up of sanctions a reasonable strategy.

Some of the effects noted in the simulations are already playing out. For example, many developing countries will likely adopt a gradual distancing from Russia, often without stating this in public. For example, India imports Russian oil at a discount, but aims to eventually convert to renewables. It encourages Russian investment in munition manufacturing in India, since it has a lot of Russian weaponry that requires secure supply lines but is also buying more new weaponry from France and other suppliers, partly because the war in Ukraine has revealed significant shortcomings in Russian weapons.

Further, India and other countries benefit from Chinese stagnation, not just by attracting simple manufacturing. China used to breed many unicorns. Between 2016 and 2018 the country created at least as many as America and three times more than the rest of the world. But so far this year China has produced only half as many new billion-dollar startups as America. The total number in 2024 is likely to be less than one-third of the 2021 figure, when China produced a record 109 unicorns. A global slowdown in startup activity is only partly to blame. The original boom depended on American investment funds, often staffed by executives with Chinese roots. Seven in every ten Chinese unicorns have foreign, mainly American, backing. A single firm, HongShan, had a hand in 96 of 369 Chinese unicorns, according to KPMG, an accountancy firm. HongShan was part of Sequoia Capital, a renowned Silicon Valley venture capital firm, until it spun off in 2023 as tensions rose between China and America.

Attracting Silicon Valley cash and expertise is much harder now. American funds investing in China face greater scrutiny and policy uncertainty. For example, draft rules published on June 21st by the Treasury Department ban some investments in Chinese artificial intelligence, expanding America's security net to include outbound capital flows. Reflecting these risks, this year foreign investors are on track to fund fewer Chinese startups than in any of the past ten years. Instead, countries like India appear more attractive.

Decoupling energy a boost for the climate

Decoupling Europe from Russian gas also accelerates climate conversion. In 2024 Ukraine stopped gas delivery to Hungary, at least temporarily. In the short run much of the gas delivery to Europe has been replaced by imported LNG. At the same time, existing nuclear power stations have been refurbished, and the installation of solar energy and smarter grids has accelerated. Planning new nuclear power stations and offshore wind projects has also gained momentum.

In Ukraine, conversion is being forced to go even faster. Wind and solar farms are being built because they are strategically resilient. It only takes one missile to destroy a coal-fired power station, but 50 missiles to destroy the same capacity in a wind farm. The potential for wind and solar is vast. Hospitals and public buildings are being quickly equipped with solar panels that cover at least part of their energy needs. One analysis finds that one percent of

Ukraine's land could easily supply the wind and solar energy that Ukraine needs.[14]

The challenge is that these energy sources do not always provide electricity reliably. Better connections to other countries would help, but these are bottlenecks, as are ways of storing electricity. Thus, for heating and large-scale industries, other solutions are needed. Small businesses have diesel generators. Medium-sized factories have invested in gas turbines and can even sell their extra supply to the national grid. Local municipalities, desperate to provide the critical services of heating and water-pumping this winter, are decentralizing power generation, installing mini-power plants in the form of modern, efficient gas turbines that have a capacity of anything from 5 to 70 megawatts. These mini-power plants can be installed locally, but before the coming winter, not enough will be ready to address the nationwide structural power deficit. Ukraine extracts about 20 billion cubic meters of fossil gas each year, and since 2022 this has almost met demand. Ukraine has been estimated to possess natural gas reserves of over 670 billion cubic meters and in 2018 was among the top countries with proved reserves of natural gas.

The bottlenecks in building decentralized power are not just technical. Ukraine enforces low electricity tariffs for households, which cap electricity prices for consumers below the cost to produce it. This has limited the ability of energy companies to reinvest in upgrading infrastructure. Since the full-scale invasion began, Ukraine has already increased the tariff twice due to rising electricity prices and the government's inability to sustain its substantial subsidies amid financial constraints.

The current standard price for households remains about one-third of the EU average. However, raising electricity prices further is politically challenging during a war that has driven many Ukrainians into poverty. In the aftermath of peace and during an economic recovery, economic incentives could be better tailored to support energy transition efforts.

All this means that part of the cost of decoupling energy supply from Russia is one that Europe and Ukraine would eventually have incurred anyway as a part of climate conversion.

Smarter sanctions and reparation claims

The cost of decoupling from Russia and even China can be diminished further by honing sanctions and targeting them better. In some respects, sanctions should be strengthened. Additional measures can be implemented to deter China from facilitating the circumvention of sanctions. In strategically important sectors like energy, finance and technology, loopholes can be closed. Harvard's Craig Kennedy, for example, proposes a low-risk strategy to curtail Russia's shadow fleet, the second-hand, often dilapidated ships that Russia bought to avoid Western sanctions.[15] Half of Russia's daily oil exports are shipped through the Baltic Sea where they routinely transit the territorial waters of EU member states, and roughly half of those cargoes are carried by the shadow fleet. These ships pose three threats: they present a heightened risk of oil spills, owing to the poor condition of the aging fleet; they likely violate international shipping law by not complying with mandatory oil spill insurance requirements; and they enhance Russia's ability to fund its war of aggression against Ukraine by circumventing price-cap sanctions.

Kennedy proposes a program requesting all tankers operating in the Baltic verify the adequacy of their spill liability insurance by undertaking basic financial disclosures. Disclosures are standard financial documents already routinely provided by 95 percent of the global tanker fleet and would be in line with guidelines provided by the International Maritime Organization (IMO). The verification program would be administered by European Union Baltic states in coordination with the US Treasury's Office of Foreign Assets Control (OFAC). The second part of the mechanism consists of a deterrent threat aimed at dissuading noncompliant or underinsured tankers from continuing to operate

14 Teske, S. and S. Miyake. (2023). Ukraine: Mapping the energy opportunities – Solar and wind energy assessment. The University of Technology Sydney. Institute for Sustainable Futures.

15 Kennedy, C. (2024). Making the Baltic a "shadow-free" zone: A proposal to reduce Moscow's shadow fleet with minimal risk of litigation, escalation or market disruption. Harvard.

in the Baltic. Any ship declared noncompliant would be subject to OFAC and other coalition enforcement agencies' blocking orders, which have been highly effective. Essentially, any actor engaging with the ship would become unable to transact in dollars through Western banks.

Not all sanctions should be sharpened. After a peace deal, some sanctions could be relaxed that primarily improve outcomes for the West while being neutral or negative for Russia. For example, lifting Western sanctions on exports of consumer goods to Russia could accelerate Russia's capital outflow without enhancing its ability to wage war. Exports of Italian handbags or German cars to Russia would likely remain marginal and would hardly make Russia more aggressive. Instead, greater efforts can be made to close loopholes for exports that have military use. Currently, there are so many banned goods that it is practically impossible to track them all. Only in recent months have steps been taken toward improving oversight. Export controls developed by the West during the Cold War could be a useful model. The effectiveness of this system successfully limited technological progress in Eastern Bloc states. Using the same approach now—banning not only dual-use technologies, but technologies and goods that boost workforce productivity—would make stricter control easier, as well as increasing Russia's capital outflows and lowering productivity.

Another example is that the Kremlin's struggle to reduce capital outflow has been aided by Western restrictions on the withdrawal of personal funds from Russia. While there is no direct ban on such withdrawals, Western bank compliance departments prefer not to get involved. The West has still not worked out clear rules for the withdrawal of private funds, even though these would complicate the Kremlin's efforts to ensure financial stability.

The West should likely consider opening its doors to Russian programmers, scientists, engineers, and other professionals. This move would benefit the economies of Europe and the United States while representing a loss for the Russian economy. In a modern economy, a brain drain can be as impactful as capital outflow.

In Russia, many entrepreneurs are under Western sanctions for their success in building businesses that today de facto support the Russian war effort in one way or another. There is little doubt that many of these Russian entrepreneurs would be happy to stop supporting the Kremlin and leave Russia, taking their experience—and capital—with them. But the West has not established a mechanism by which they can change sides in exchange for sanction relief. Such a mechanism could tempt defectors, buttress the legality of sanctions, and drive a wedge into the artificial unity of power and capital in modern Russia. Easing the movement of Russian experts and entrepreneurs into the West, however, would require better vetting and measures that filter out criminals.

Protection against criminal infiltration

Over the past years the West has at long last become more alert to criminal infiltration and money laundering from Russia, apart from the more familiar espionage. Bank regulation has been tightened considerably. Western banks will now usually refuse to undertake with customers who shuffle unexplained wealth.

Yet the discrepancy between amounts stolen and funneled to the West or given as bribes and actual recoveries indicates that the tools that governments have at their disposal are not yet yielding the desired results. Legal action to recover assets is often unsuccessful when it fails to establish that a property is derived from a given offense, as required by criminal as well as civil confiscation. This link can be difficult to establish when there is no money trail leading from the jurisdiction harmed by corruption to the one in which the ill-gotten gains are laundered.

For example, a government official may receive bribes in foreign bank accounts held by shell companies and invested in real estate. When there is no detailed information about a specific corrupt transaction, opening an investigation into the origin of the property may be legally challenging; moreover, obtaining evidence to support criminal, or even civil, confiscation may require years of complex cross-border investigations without guarantee of success.

Several countries have in recent years introduced the unexplained wealth order (UWO) as a tool to improve recoveries of the proceeds of crime—particularly kleptocracy, the fruits of corruption by government officials. While it is too early to draw any definite conclusions as to its effectiveness in curbing corruption, the UWO contains novel ideas that are worth examining in more depth.

UWOs oblige persons suspected of corruption or other serious crimes to explain the origin of their wealth and discrepancies between their legitimate sources of income and the value of their assets. UWOs are a civil, not criminal action and can be an invaluable tool in asset recovery cases in which cross-border identification and tracking of criminal and corrupt assets is a challenge for relevant investigative agencies and prosecutors.

In March 2022, the British government expedited the passage of the Economic Crime (Transparency and Enforcement) Act 2022 in response to the Russian invasion of Ukraine. This Act reformed the UWO regime, broadening the scope of its powers and enhancing operational confidence in their use.

An enforcement agency can apply to the High Court for a UWO where there are reasonable grounds for suspecting that a respondent holds property; and either that their known sources of lawfully obtained income would have been insufficient to obtain the property in question, or that the property was obtained through unlawful conduct. The UWO requires the respondent to explain their interest in property, how they came to obtain it and any other information required by the order. UWOs may be served on Politically Exposed Persons and persons reasonably suspected of involvement in, or of being connected with persons involved in, serious crime. While this law has been passed, Britain has not, so far, allocated commensurate resources to its enforcement.

These and other tools will and should become more important tools for Western institutions. In many cases they can be targeted better to vet those against which they are directed while easing the regulatory burden for other customers.

Better EU growth policies

Much discussion has centered on economic policies that harm the Russian economy. However, an even more crucial and productive approach is to focus on promoting growth in Europe. A recent report for the Stockholm Free World Forum shows that EU economic growth could actually be boosted by ten percentage points more than normal over a ten-year period.[16] This increase corresponds to five times what EU countries spend on defense and would therefore cover climate transition, welfare technology, and a substantial defense investment.

Research has shown that improvements in various economic freedom indices causally increase growth and income for all income groups. If EU countries implemented reforms that move them from the average (where, for example, Germany is) to a better level of economic freedom like that of Ireland or Denmark, it would be enough to create at least ten years of super-growth.

Are there realistic conditions for such a shift in EU countries' growth? The history of the EU's growth packages is not entirely encouraging. More comprehensive reforms are needed than those sketched out, for example, in the Enrico Letta report published during the summer of 2024. The urgent situation, however, makes the reforms more politically realistic. Moreover, empirical evidence shows that voters normally reward governments that take bold reform initiatives.

These reforms must largely be carried out by the individual countries, all of which face their own political challenges. But at the EU level, levers can be created. Sweden, for example, was forced to open up a number of monopolies to competition in connection with its membership. Here we propose several new levers that together can boost the EU´s GDP by 10 percent above and beyond what normal growth would yield.

1. Prepare a Plan B against vetoes from individual countries sliding towards undemocratic or corrupt governance. Create separate "Action Funds" when extraordinary needs arise controlled by participating countries, which then, by simple majority, decide which conditions to impose on countries receiving money and the types of projects funded. Conditions could include rule of law and necessary growth reforms.

16 Fölster, S. (2024). Så kan EU få 10 år av supertillväxt. Stockholm Free World Forum. Stockholm.

2. A uniform regulatory framework across the EU has led to a dramatic simplification for cross-border businesses. But many countries, like Sweden, have not only over-implemented EU directives but created even larger, entirely homemade regulatory labyrinths. The EU should implement regulation-removal levers based on the model established by the "Net Zero Industry Act" for green investments. This binding EU regulation drastically simplifies the permit process for all "net-zero" industries. Similar down-sizing of regulation should be implemented for all activities. Countries should introduce simplified permit processes through single national authorities to which applications can be submitted digitally. This authority would then be responsible for all coordination with other agencies and the process should normally take no more than one year.
3. At least eight countries risk falling into a Russian sphere of interest if they do not see a viable path to EU membership. These eight countries have shaky macroeconomic policies and are sadly lacking in terms of rule of law and measures against corruption. Only the ECB can then be the new sheriff in town. Its leverage is so strong that even Greek socialists and Italian nationalists had to toe the line. It is desirable for the ECB to be strengthened by Sweden joining the euro, and for Sweden to have a voice in the process. It could even become a welcome form of insurance for Sweden. Swedish banks have much larger lending to the private sector than banks in other EU countries. And the Swedish central bank's mistakes now require an injection of about 80 billion kronor after ill-considered bond purchases. A slew of recent studies also confirm that the introduction of the euro has raised growth. Although Sweden has had better growth than euro countries on average, this is solely due to the reforms implemented in the aftermath of the crisis in the early 1990s. Many euro countries like Spain, Portugal, or Greece were forced to implement similar reforms only ten years ago. Now they grow better than Sweden.
4. Only the segment of the EU's regional policy that mainly finances infrastructure in poorer EU countries shows proven results according to evaluations. The rest should be scrapped. Innovation should more often be financed with payment for proven results: Europe's universities have grown into bureaucratic colossi with weak innovation capabilities. The successful early development of American digital giants, on the other hand, went hand-in-hand with a major shift in American innovation policy, which started paying for technological leaps and results. The EU should encourage countries to do the same.
5. Countries that take on higher defense expenditures than required by NATO should be able to make some deductions from the EU fee. This could be financed by streamlining regional support as described above. The EU can promote joint purchases of defense equipment developed by countries that have the best capability. In the long run, for example, Ukraine could become one of the most competent suppliers of some equipment.
6. Growth reforms are in no way in conflict with sharper climate policies. Countries with greater economic freedom also have much more effective climate policies. The EU has introduced the world's most effective climate measure in the form of the emissions trading system. Parallel to this system, the EU wants to patch and mend with a whole series of overlapping directives, which partly conflict with each other, and partly create greater emissions in other parts of the world. The EU should instead follow the academic literature and expedite directives for the economic mechanisms around carbon capture and storage and agreements on how these should be accounted for. Agricultural subsidies, through CAP, account for 40 percent of EU expenditure. This year's farmers' demonstrations were against the introduction of a more complex and arbitrary control apparatus at the farm level. Instead, CAP should be simplified and focus on rewarding desired outcomes. Subsidies should be converted into a reverse carbon tax for BECSS (BioEnergy Carbon Capture and Storage). Thus, farmers would be paid for production by selling biomass to an energy company that manages carbon storage. Through these mechanisms, it would be very easy to verify the result.

How well EU countries develop will be crucial for how the world values democratic and rule-of-law governance.

The most important questions for Western post-peace economic policy is therefore to create powerful levers for growth reforms in democracies.

Conclusion

Keynes' analysis, although prescient in 1919, does not apply after an armistice or peace after the Russian invasion of Ukraine. The central difference is that Russia is not likely to revert to democracy as Germany did in the aftermath of the two World Wars. Even if Putin were ousted and formal democratization were reinstated, pervasive corruption, criminal organizations, and influence of the FSB make it highly unlikely that something akin to Marshall aid could succeed. In fact, much of the goodwill and investment from the West in the 1990s dwindled as it encountered widespread corruption.

There are other considerations as well. One is the risk of criminal infiltration into the West if sanctions are relaxed indiscriminately. Another is that there is no point in easing Russian export of fossil energy that needs to be phased out anyway. A third is that Russia would still remain an aggressor with troops in Georgia, Moldavia, Armenia and other places. A fourth is that Russia would also likely continue its close cooperation with Iran, Syria, North Korea and China.

In light of these considerations and the earlier analysis, several key recommendations emerge. Regardless of which scenario eventually materializes, the EU should withstand the temptation to agree to let up on sanctions toward Russia. The exception would be a few sanctions that can be relaxed in a way that would actually erode Russian capabilities for aggression. For example, export restrictions to Russia could be eased for anything that has no military use and instead better targeted to close loopholes where it matters.

Further, the EU should more forcefully pursue enforcement of safety rules on Russia's shadow fleet, and should also keep Russian assets waiting for Russian agreement to settle damages, not just in Ukraine but in the rest of Europe as well.

Investing in Ukraine and integrating it into the EU will be the easiest part of the agenda. Much harder, but possible and crucial, would be a European growth agenda that delivers growth, resources for military and environmental challenges, and a showcase for the value of democracy. Our calculations show that such super-growth is quite possible, hindered only by political ossification.

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