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Article

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FACTORS OF MONETARY AND CREDIT POLICY: WORLD AND UKRAINE IN THE CONDITIONS OF MILITARY AGGRESSION

Starting with the global pandemic crisis, whose consequences included the disruption of logistics chains and the suspension in a number of economic sectors, the world economy is experiencing increasingly large losses. Full-scale Russian aggression against Ukraine and the imposition of sanctions against the Russian Federation by many countries have made the global economy even more unstable and problematic. Macroeconomic problems are accumulating in the world, which will be a long term trend.

The article deals with Ukraine's domestic financial and monetary sphere since the beginning of Russian aggression in 2014 and in the context of the post-pandemic global crisis. In the first months of the war, Ukraine – being a small open commodity based economy – managed to maintain the stability of money circulation and prevented panic in the financial markets, in contrast to 1998, 2008 and 2014.

The full-scale war continued the economic crisis initiated by the COVID-19 pandemic. The interaction of the two crises deepens imbalances in both the global and Ukrainian economic and financial systems. As manifestations of the crisis, the article examines the disrupted supply chains of goods and raw materials, and the negative impact on the companies' solvency due to reduced demand. On the other hand, with their financial injections, the governments prevent the rapid bankruptcy of unviable firms in order to preserve employment, which exposes the economy to new risks.

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The article outlines expected developments in Ukraine’s financial system due to long war and the ensuing macroeconomic losses and uncertainty. Recommendations are given on urgent measures to support the banking sector in order to increase its liquidity and solvency under the conditions shaped in 2022.

The authors note that in the fight against inflation, it is necessary to take into account the increased energy prices, the disrupted logistics chains for commodity producers, the decreased export revenue, and the increased prices for critical imported goods. Anti-inflationary measures under such conditions could lead to stagnation and phase out domestic production.

Keywords*: monetary policy, exchange rate policy, economic reforms*

The full-scale war unleashed by Russia against Ukraine in 2022 has led to dramatic changes in the security doctrine in world politics. Ukraine, which is at the epicenter of these changes, is facing existential challenges. Therefore, financial sector professionals in Ukraine will have to reassess their approaches to monetary and fiscal policy, which is being implemented in the context of macroeconomic uncertainty in the country, which is at war. The government needs to meet the needs of the army and defense first and foremost, and other needs related to social problems in society, as the acute shortage of resources, the curtailment of production, and the breakdown of logistics chains all aggravate these problems.

In an environment of ongoing hostilities, the development of economic processes cannot be predicted, and the monetary authorities face the problem of choosing between bad and very bad scenarios. This policy needs to be analyzed in order to make further informed decisions and apply possible optimal actions to reconcile economic and monetary policy in times of war.

The purpose of the article is to identify the main contradictions in Ukraine's monetary policy that arose during the COVID-19 pandemic and martial law, and to develop recommendations on possible actions by regulators to overcome them and improve the effectiveness of monetary support for the economy in the context of Russia's full-scale war against Ukraine.

In their recent publications, leading Western economists and scholars pay much attention to defining the nature of recent economic crises and the effectiveness of central bank policies to overcome them. Numerous publications by such scholars as R. Baldwin, V. Mauro [1], Ch. Riley [2], V. Papava [3], J. Boon [4], J. Stiglitz [5, 6], J. Sachs [7], D. Rodrik [8], J. Pride [9], D. Marin [10], C. Roach [11], K. Rogov [12], M. Spence [13] are devoted to this very topic.

While in 2020-2021, the world's leading experts were focused on studying the unpredictable consequences of the large-scale COVID-19 pandemic [14], which in turn triggered a new round of the global economic crisis that began in 2008 [1], in 2022, with the onset of a large-scale Russian military aggression against Ukraine and the imposition of unprecedented sanctions against the aggressor country, the global economy faced new challenges. They include the largest energy crisis in 50 years and a crisis of food shortages in world markets. In order to stop the rapid spread of the COVID-19 pandemic, governments of leading countries chose to limit direct human contact, which in turn had certain economic consequences, such as the suspension of a number of economic sectors [2, 15] and the loss of logistical economic ties. The full-scale war unleashed by Russia against Ukraine's military alliance in February 2022 will have consequences in the form of increased investment in the global arms production system, and will also stimulate the search for ways to overcome the energy and food shortages.

To overcome the pandemic crisis in 2019-2021, most governments of leading countries used the measures similar to those that they had used to overcome the 2008 crisis. But the current crisis has a different economic nature. The large-scale financial injections ("helicopter money") that were made during the current crisis, along with rising consumer inflation, lay the groundwork for new local crises in financial markets.

The rise in inflation in almost all developed countries in 2021 and 2022 showed that it is not possible to use the experience of the global financial crisis of 2007-2009 to fully mitigate the effects of subsequent economic crises, as the former was a typical economic crisis, while the latter are atypical in nature [3]. Nevertheless, in 2020 and 2021, governments applied the same anti-crisis measures (reducing social burden on the population and providing financial support to businesses), which were actively used during the 2008-2009 crisis.

In 2019-2021, to overcome the effects of the pandemic crisis, governments mainly used monetary and fiscal instruments to support households and companies. In particular, the financial support for businesses included tax breaks for firms, deferred repayment of bank debts, budget subsidies, etc. In other words, companies were provided with the kind of assistance that would mitigate the problem of losing their solvency. In the pre-crisis period, the instruments of rehabilitation and withdrawal of insolvent companies from the market were used. Such actions were the main measures taken in developed market economies to prevent the development of systemic economic crises.

When analyzing the measures introduced by the monetary authorities to address the problem of high inflation, it is necessary to understand its main causes. In particular, it is necessary to find out whether we are dealing with an increase in demand or a decrease in supply, and whether a combination of these two factors is possible [8]. Only by determining the true cause of this inflation can we choose the right methods to combat this negative phenomenon [5].

Many world-renowned scientists state the opposite trends, the world is facing a combination of rising demand and falling supply, with the latter dominating. Some growth in demand was driven by direct government spending for socially vulnerable citizens and support for corporate businesses affected by the COVID-19 pandemic.

Nevertheless, according to a number of world famous scholars, the fall in supply played a slightly larger role in the increase in inflation. The reason for this is the collapse of global supply chains caused by the blocking of certain sectors of the economy to limit the spread of the virus. Until mid-2021, there was a misconception about short-term supply bottlenecks [9], but in autumn 2021, it became clear that we are facing a virtual collapse of the global production system.

Today inflation in many countries (especially in Europe) was driven by the war in Ukraine, Russia's blockade of Black Sea ports, and the expansion of sanctions against Russia for unleashing the war, which further increased the scale of supply chain disruption.

The disruption of global supply chains caused by the pandemic [10] had a significant impact on the deterioration of the global economy. It is clear that the de-globalization of various sectors of the economy as a result of global quarantine and war caused the disruption of supply chains for goods and components or slowed down their internal dynamics [16]. Disruptions in global supply chains distort global technological production cycles, leading to lower production levels and labor productivity. It has become clear that businesses need to invest heavily in new production facilities in the jurisdictions that were previously considered unfavorable in terms of tax regimes.

The inflation caused by the economic crisis of the COVID-19 pandemic and the war is mainly an underproduction inflation. And Russia's blockade of grain supply to the world markets might not only cause an increase in food and energy prices, but also lead to famine in a number of countries in Africa and Asia. This raises the question of whether central banks can solve the supply chain problem. Obviously not, as central banks do not have any tools to increase output by upgrading old or creating new global supply chains. In other words, the supply chain problem is not instrumental and cannot be solved by central bank instruments.

The essence of the central banks' mistake was that they did not understand the economic cause of the high inflation of 2020-2021 and considered it a macroeconomic problem [11]. In reality, as noted, the problems in supply chains are obvious. Perceiving inflation as a macroeconomic problem, central banks started raising interest rates to limit demand. But in doing so, they made credit more expensive, which would further negatively affect production and, as a result, constrain supply. Unfortunately, by making such an unjustified decision on interest rates, central banks increased the possible level of "zombifying" the economy that was already suffering from the disruption of production chains [12].

The solution to the current supply chain problem depends entirely on the proper functioning of the global economy, which should be built on the basis of the updated context of globalization in the post-pandemic period [13]. Given the principle of economic efficiency, the creation of new global supply chains should take into account the risks associated not only with COVID-19 pandemic, but also with the possible emergence of new global threats. It is possible that part of the production will be transferred to countries and regions where production costs will increase significantly. As a result, solving the supply chain problem will lead to a new rise in inflation, which economists call cost-push inflation.

Cost-push inflation is another cause of underproduction inflation. In 2022, this crisis will be exacerbated by the problems of reduced supplies of commodity food products to global markets. It turns out that in a newly established supply chain, an inflation caused by high costs may emerge. In other words, one of the causes of inflation, namely, underproduction, is replaced by another. The main economic theme of the post-pandemic world should be economic growth, supply expansion, and increased productivity [17], which is impossible if central banks apply a high price for national money, in other words, high refinancing rates.

In Ukraine, inflationary pressures on the economy were evident even before the military aggression in 2022. In 2021 and early 2022, inflation in Ukraine increased in the consumer sector and, especially, in the producer sector due to the rise in the cost of imported raw materials and components. The inflation rate in the consumer market declared by the NBU in its "The basic principles of monetary policy for 2022 and for medium-term perspective" [18] was not achieved in the pre-war period. One of the main levers of inflationary pressure was the rise in prices for critical imports, which in not properly controlled by the monetary authorities.

During the 2019-2021 pandemic, the central banks of leading countries began stimulating their economies using monetary instruments, and governments introduced fiscal stimuli, which increased the money supply in their markets. The global inflationary surge was also due to the surge in energy prices that occurred in the second half of 2021 as economies emerged from the crisis. In addition, inflationary pressures were caused by the Russian Federation's behavior on European energy market, including the blockade of trade in the Black Sea region.

Before the full-scale invasion, the NBU's monetary policy had trends similar to those of global central banks. In 2021, in accordance with "The basic principles of monetary policy for 2021 and for medium-term perspective", the National Bank of Ukraine pursued a moderate, rigidly conservative policy, influencing the money price in the domestic market by raising the key policy rate from 6% to 9% and to 10% in February 2012. This decision in the pre-war period was aimed at offsetting the impact of additional inflationary risks, improving inflationary expectations, and ensuring a steady decline in inflation to the 5% target +/-1% in the medium term.

In 2021, inflationary processes in Ukraine were contained by the strengthening of the national currency due to increased agricultural exports, which led to an improvement in the current account. Inflationary risks were contained by the NBU through its policy of strengthening the hryvnia exchange rate in 2021 in the range of 3.5 to 6.9%. The NBU's flexible exchange rate policy, together with its inflation targeting policy, kept prices for imported goods and energy down and kept inflation in the consumer market within the

10% range year on year. However, it had a negative impact on economic growth and exporters' profits.

Since the outbreak of hostilities in 2022, the NBU made a number of decisions that were possible only under martial law. Taking into account the previous mistakes, the NBU managed to maintain the exchange rate, stopped panic in the exchange market, and limited the withdrawal of funds from the banking system. In other words, the NBU's decisions to impose restrictions on the exchange market were timely and successful. In particular, on 24 February 2022, the NBU adopted Resolution No. 18, which imposed the following restrictions in an expedited manner:

- suspending the foreign exchange market, except for the sale of foreign currency to customers;
- fixing the exchange rate as of the date of adoption of the resolution;
- restricting cash withdrawals;
- prohibiting cash withdrawals from customer accounts, etc.

In the first months of the full-scale war, the NBU kept the key policy rate at 10% and fixed the exchange rate. The NBU also decided to finance the budget deficit and military expenditures directly, through the purchase of military bonds via the NBU. Such actions can be considered justified, as under martial law, the NBU is the only institution able to cover the cash gaps that the Ministry of Finance faces when financing the budget deficit.

Over time, the fixing of the hryvnia exchange rate led to the accumulation of other negative phenomena, such as the gap in the difference in currency prices between the cash and non-cash markets. The NBU returned to the practice of a "positive interest rate" and in June 2022 sharply increased the key policy rate to 25% (see Figure 1). In making this decision, the NBU was guided by the logic of changing monetary approaches to economic management and returning to market instruments.

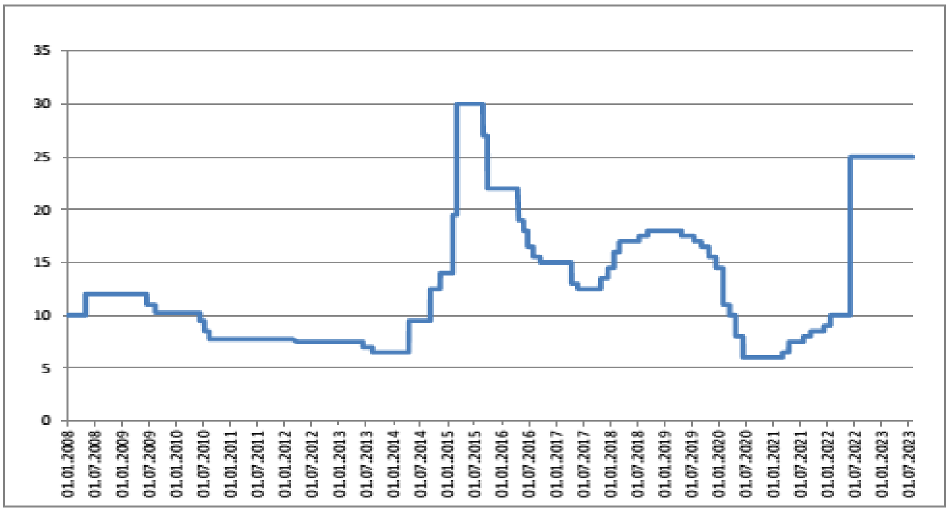

Fig. 1. Dynamics of the NBU key policy rate in 2000-2022, *%.*
Source: according to NBU data (www.bank.gov.ua).

The increase in the key policy rate was preceded by the following developments: inflation rising to 21.5% in May (year-on-year), a deterioration in the term structure of deposits, increased price pressure, and increased demand in the exchange market. The NBU's decision to increase the key policy rate along with the adjustment of the official exchange rate was intended to level the playing field and ensure macro-financial stability. This decision made it possible to keep the exchange rate within the band without significant spikes and to stabilize inflation within the forecast range.

In the context of the ongoing war, Ukraine's macroeconomic situation will deteriorate, taking into account that inflation in March-May 2022 rose to 16.4%, up from 10% in January, and in September inflation rose to 21.8%. According to the NBU's forecasts, inflation will be around 30% in 2022. In early summer, businesses in relatively calm regions started to recover and the logistics of export and import flows began to improve. One should note the positive impact of the timely decision on the situation of state guarantees for bank deposits and changes in the NBU's requirements for calculating provisions for active operations.

It should be noted that the sharp increase in the key policy rate in June to 25% has both supporters and critics. The main argument of the critics of such a hike in the key policy rate is that the economy is losing access to credit. The banking system is curtailing lending programs to protect depositors' funds in the wake of the war. It should be noted that institutionally in 2022, the financial system of Ukraine withstood the first shock, ensured uninterrupted cash flow in both the banking and public sectors, and the monetary authorities managed to prevent panic in the money market through their decisions. This is evidenced by the behavior of legal entities and individuals in the financial markets.

The current level of the key policy rate is lower than in 2015 or the early 2000s. The NBU, despite a flurry of criticism that such a policy would lead to a suspension of credit processes and negatively affect lending, argues that this decision will not have such consequences for lending. The NBU believes that commercial banks do not risk increasing their loan portfolios under martial law. The banking system provides loans mainly under state guarantees and government compensation, and such programs are mainly available to state-owned banks. The government's recent domestic government bonds offered at low rates were mainly bought by the NBU (see Figure 2), which means that the budget is directly subsidized with money issues, which directly increases inflationary risks.

At the same time, if we analyze the economic impact of such a 2.5-fold increase in the key policy rate, its effect on the economy remains small. Analyzing the economic and monetary consequences of this decision, Bohdan Danylyshyn states that "monetary transmission through each of the channels was weak, due to both the factors of traditionally low intermediary activity of banks and non-market factors caused by the war" [19]. Over the past four months, there was no significant increase in deposit rates for both individuals and legal entities, which in turn prevented banks from increasing their deposit portfolios. Bank consumer lending and business lending both declined.

Since the beginning of the year, the structure of trading on Ukrainian stock exchanges continued to be dominated by debt instruments, with the portfolio of domestic government bonds in the banking system growing (see Figure 2), and rates on new issues of domestic government bonds not significantly dependent on the key policy rate, as the increase in public debt due to rising military spending leaves no other financing channels than the issue of bonds during war.

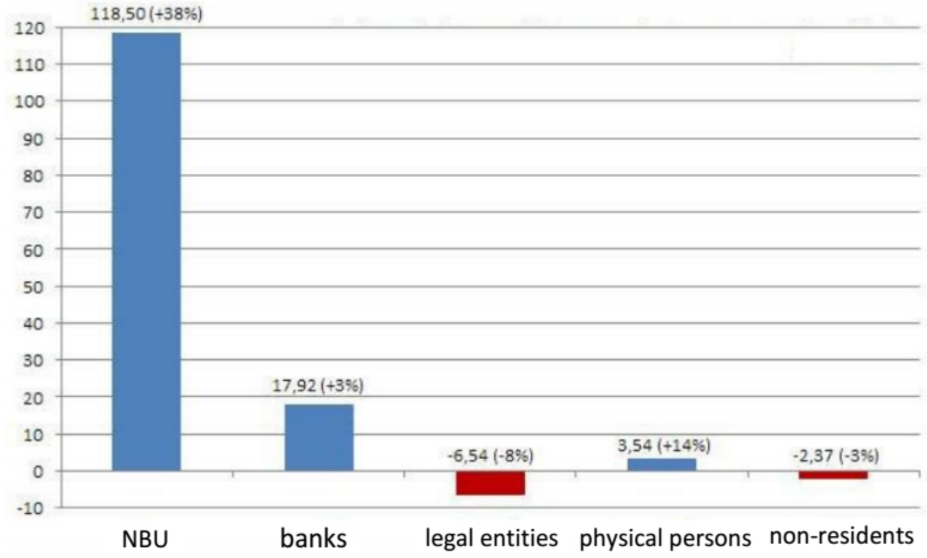

Figure 2. Growth of the domestic government bonds portfolio in the period from 24.02.2022 to 03.06.2022, *billion UAH*

Source: according to NBU data (www.bank.gov.ua).

The Ukrainian expert community continues to debate the use of monetary policy instruments by the National Bank of Ukraine during the current armed conflict with unpredictable macroeconomic factors. The triad of monetary base growth, key policy rate management, and hryvnia exchange rate management includes many variables that cannot be modelled during the period of active hostilities and complete dependence on funding sources. The NBU's move in February to the fixed official exchange rate of 29.25 UAH/USD with restrictions on the foreign exchange market did not cause any serious controversy.

In May, individuals withdrew only -1.3% of their hryvnia deposits from the banking system, while since the beginning of the year, hryvnia account balances increased by +UAH 12.9% billion. It is clear that the structure of individuals' funds is deteriorating - almost UAH 20 billion was transferred from term accounts to current accounts. In foreign currency, individuals withdrew USD 940 million (-11.9%) and EUR 92 million (-5.6%) from the banking system at the beginning of the year. Taking into account the number of refugees (estimated at almost 7.5 million) who went abroad during this period and the number of internally displaced persons, which is much higher, it can be said that the banking system managed to maintain public confidence during the acute phase[3]. As for retail lending, the portfolio decreased by only UAH 1.2 billion (-0.56%) since the beginning of the year. This shows a positive trend, given the challenging times and the government's decision to introduce a loan repayment holiday.

At the end of the first half of 2022, the balances of both legal entities and individuals in the banking system began to increase, indicating that business recovered in the first half of the year, despite the constant missile attacks on the country's infrastructure and the blockade of Black Sea ports. The business recovery was driven in no small part by the introduction of government lending support programs. According to balance sheet data, the loan portfolio of legal entities increased by UAH 43.8 billion in national currency since the beginning of the year, while in foreign currency, the business reduced credit currency risks and repaid USD 1.0 billion and EUR 304 million. At the same time, the banking system's losses for the period up to July 2022 cannot be called catastrophic, because, given the UAH 77.9 billion of profits in 2021, banks still have a liquidity reserve to support money circulation.

It should be noted that this was mainly due to the activities of state-owned banks and the government's support through interest rate compensation programs. In this sense, the large share of state-owned banks in the structure of the banking system was positive. However, the banking system faced issues that require close attention and resolution: the problem of servicing clients' credit debts (the banking system showed losses of UAH 4.7 billion in the first half of 2022 (as of 1 June 2022), mainly due to the allocation of profits to reserves. However, due to Privatbank's profit of UAH 22.9 billion as of 01.12.2022, the total profit of the banking system was UAH 19.4 billion UAH. Among the factors behind the above figures are the following:

- the NBU's increase in the discount rate created a problem for banks in servicing contracts based on floating rate terms;

- the issue of resolving in the legal framework the repayment of loans by borrowers who lost their fixed and/or working capital or collateral as a result of military aggression.

To compensate for the damage caused to Ukraine's banking system by the full-scale war waged by the Russian Federation, the government urgently needs to establish either a bank of lost assets or a financial company to manage lost assets during the war and in the post-war period. This company should *buy back* lost assets from banks at public expense (with the requirement that the funds be spent on lending to restore the economy). The purchase of the lost assets should be notarized in accordance with the current legislation. Via such a company, a qualified and documented accounting of assets lost by the banking system during the war could be performed, which can be used as

[3] This should also take into account the liquidation of banks with Russian state capital in Ukraine, which had a negative impact on this dynamics. With the onset of Russian aggression, the NBU revoked the licences of two banks with Russian state capital.

evidence in international courts. The institution should submit its claims to compensate for the costs through reparations that the aggressor country must pay after the decisions of international courts.

The lost assets can be recovered from the frozen resources of the Russian Federation in the future, so the government will support not only banks but also domestic demand with the future reparations resource.

Shifting from a flexible exchange rate policy to a fixed exchange rate at the beginning of the war was a justified decision, which, in particular, kept the foreign exchange market stable. However, fixing the official exchange rate inevitably leads to the money market splitting into segments where speculative rents can be extracted. In effect, there is a gap in exchange rate levels between the cash and non-cash markets, which encourages exporters to withhold foreign exchange earnings until the last or look for offsetting schemes. This increases demand pressure on the exchange market and forces the NBU to sell foreign currency from its reserves.

In the current environment, the Ukrainian government needs to face a number of mutually exclusive challenges. With production and import flows falling and inflationary pressures on supply, the domestic market needs to be supplied with goods, which is impossible under the pressure of high tax rates. Covering the budget deficit by issuing national money via the National Bank of Ukraine inevitably leads to demand-pull inflation and depreciation of national money. State support of commodity producers in order to save jobs also provides an opportunity to prolong the stagnation of insolvent firms, which ultimately leads to increased losses, non-repayment of loans to banks, and "zombification" of the banking system [17]. All of this is tied to the need to protect the territorial integrity of the state in the context of an exorbitant increase in military spending, which is unpredictable in time and volume.

Conclusions

In 2022, the pandemic economic crisis was compounded by the military crisis in Ukraine. As a financial market regulator and lender of last resort to the banking system, the NBU has to make decisions in the face of macroeconomic uncertainty. The effectiveness of these decisions is assessed by the behavior of economic agents. In the first four months of the war, the banking system managed to keep the quality of money circulation in the country at an appropriate level. An operational analysis of the behavior of the main money market segments showed the following.

1. Households did not lose confidence in the national banking system, and hryvnia deposits of individuals were growing since the beginning of the year. The NBU's actions helped prevent panic, which was typical of previous economic crises in 1998, 2008, and 2014, when the economic crisis was compounded by the financial crisis.

2. Despite the uncertainty of the situation at the frontline, in May-June 2022, business began to revive, with an increase in bank customer current account balances and an increase in the bank loan portfolio. It should be noted that this was mainly due to the

activities of banks with state capital and support to compensate the borrowers' interest payments through government programs.

3. The banking system continues to be liquid, has withstood a powerful blow, and, despite current losses, maintains a proper level not only of cash turnover in the domestic market but also of the flow of funds on credit cards issued by Ukrainian banks abroad.

4. In the fight against inflation, regulators need to be careful about the instruments they use, as demand-pull inflation increases the risks of cost inflation due to rising energy prices, disruption of commodity producers' supply chains, lower export revenues, and higher prices for critical imports. The use of instruments to counteract demand-pull inflation in the face of rising cost inflation may lead to economic stagnation and a curtailment of domestic production.

5. Consideration should be given to establishing an institution at the level of the Cabinet of Ministers of Ukraine that would buy back lost assets from banks, with the requirement that the banks use the obtained funds to lend the economic recovery. This could be a bank of lost assets or a financial company for managing lost assets during the war. The lost assets could be recovered in the future from the frozen resources of the Russian Federation, so the government would support not only banks but also domestic demand with the future reparations resource.

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ЧИННИКИ ГРОШОВО-КРЕДИТНОЇ ПОЛІТИКИ: СВІТ ТА УКРАЇНА В УМОВАХ ВОЄННОЇ АГРЕСІЇ

Починаючи із загальносвітової пандемічної кризи, наслідками якої стали розрив логістичних ланцюжків та призупинення роботи ряду секторів економіки, світова економіка зазнає дедалі більших втрат. Повномасштабна російська агресія проти України та уведення багатьма країнами санкцій проти РФ перетворили глобальну економіку на ще більш нестабільну та проблемну. У світі накопичуються макроекономічні проблеми, які спостерігатимуться у довгостроковому вимірі.

У статті розглянуто вітчизняну фінансово-грошову сферу від початку російської агресії проти України у 2014 р. та на тлі постпандемічної світової кризи COVID-19. У перші місяці війни Україна – з малою відкритою сировинною економікою – утримала стабільність грошового обігу та не допустила паніки на фінансових ринках, на противагу 1998, 2008 та 2014 рокам.

Повномасштабна війна продовжила економічну кризу, до якої призвела епідемія COVID-19. Взаємовплив цих кризових обставин поглиблює дисбаланси у економічній та фінансовій системах як світу, так і у вітчизняних. Як прояви кризи у статті розглядаються процеси розриву ланцюгів постачання товарів і сировини, негативний вплив на платоспроможність підприємств за рахунок зменшення попиту, з іншого ж боку – уряди фінансовими вливаннями запобігають швидкому банкрутству нежиттєздатних фірм задля збереження зайнятості – й наражають економіки на нові види ризику.

Окреслено очікуваний перебіг процесів у вітчизняній фінансовій системі за тривалого продовження війни та відповідних макроекономічних втрат і невизначеності. Наведено рекомендації щодо заходів, яких необхідно терміново вжити задля підтримки

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банківського сектора з метою підвищення його ліквідності та платоспроможності в умовах, що склалися у 2022 р.

Відзначено, що у боротьбі з інфляцією потрібно зважати на факт зростання цін на енергоносії, розрив логістичних ланцюгів товаровиробників, зменшення експортної виручки, збільшення цін на товари критичного імпорту. Антиінфляційні заходи в таких умовах можуть призвести до економічної стагнації та згортання внутрішнього виробництва.

Ключові слова: *грошово-кредитна політика, валютно-курсова політика, економічні реформи*