

2.4. Recommendations for enhancing monetary policy interventions to achieve macroeconomic stability in Ukraine over the medium term

Monetary policy constitutes a pivotal instrument of economic governance, enabling the regulation of inflation levels, ensuring the stability of the financial system, and supporting sustainable economic growth. However, the implementation of monetary policy amidst macroeconomic instability presents unique characteristics and poses a complex task for central banks and other state authorities. A notable challenge is that macroeconomic instability diminishes the effectiveness of monetary policy. For instance, in a recessionary context, increasing the discount rate does not yield the anticipated effect of reducing inflation and diminishing investment activity. Furthermore, a higher policy key rate can augment the risk of insolvency for households and businesses.

Military conflicts represent one of the most serious threats to a country's economic stability and development. In the context of the Russo-Ukrainian War, conducting monetary policy becomes a considerably more complicated task, as risks and challenges are significantly heightened. One of the primary issues is the escalation of inflation, as military actions lead to restricted access to resources and a decrease in production volumes, resulting in rising prices for goods and services. Consequently, additional economic difficulties emerge, including reduced demand and a downturn in economic activity. Another problem is the reduced efficacy of monetary policy during wartime, particularly as the state's fiscal deficit limits the government's ability to conduct currency interventions in financial markets. In the Ukrainian context, maintaining the temporarily fixed exchange rate by the National Bank of Ukraine (NBU) is feasible only through financial support from the IMF and other partners. Moreover, the uncertainty and instability in wartime conditions diminish the effectiveness of communication between the central bank and the market, weakening the impact of monetary transmission.

The primary risks associated with conducting monetary policy under macroeconomic instability are linked to changes in fundamental economic factors, such as increased budget deficits, low investment inflows, production decline, and

rising unemployment. In such conditions, challenges for monetary policy escalate, and the influence of monetary instruments on the real sector and prices may be limited. The key risks can be categorized into four groups: financial, economic, political, and inflationary (Figure 2.11).



Figure 2.11. Key risks associated with the conduct of monetary policy in conditions of macroeconomic instability

Source: developed by authors based on [21, 58, 60, 61]

In contemporary conditions, economic and inflationary risks are the most significant, as the former are associated with a reduction in production volumes, increasing unemployment, and a general economic downturn, while the latter signify threats of uncontrollable inflation rates by the central bank. Furthermore, averting risks related to the disruption of the country's financial system stability is a crucial component of overall macroeconomic equilibrium in the market. Complications in clients' access to their bank accounts, carrying out transactions for payments, transfers, and receiving funds block economic activity, and also cause panic moods and inflated inflationary-devaluation expectations among economic agents. Political

risks are associated with reputational losses of the state, particularly the decline of credit and investment ratings.

The realization of each of these risks leads to a series of negative consequences, complicating monetary and state regulation in general. In this context, there arises the need to develop a risk map for conducting monetary policy under conditions of macroeconomic instability, especially considering the current military-crisis conditions. Table 2.6 presents the developed risk map. The main destabilizing factors, considering the Russo-Ukrainian war, are identified as changes in the volumes of financing from the IMF, the EU, the USA, and other countries providing assistance to Ukraine to cover the budget deficit and support financial stability, the prolonged duration of military actions as a factor deepening crisis phenomena due to further destruction of infrastructure, as well as a global recession that will slow down the recovery of the national economy after the war.

Testing scenarios related to changes in financial assistance based on a simulation model involves changing two main factors - the main means in the economy and the volumes of international reserves. A reduction in financial support from partner countries will most significantly affect the exchange rate of the hryvnia to the dollar (devaluation of more than 10%), as the inflows, particularly from the IMF, are directed at ensuring financial stability. In case of reduced financing, devaluation expectations of the population and business will grow, moreover, financial support is important from the point of view of facilitating economic recovery and growth in the context of the major reconstruction after the victory over Russian invaders. Due to the effect of transferring exchange rate volatility to inflation, internal prices will also rise with less international aid than Ukraine needs, accordingly, the discount rate will increase in order to return the consumer price index to the target range, and GDP risks continuing to shrink due to insufficient resources for increasing production to pre-war volumes. The reverse situation, namely - more significant financial support from the EU, the USA, and other countries will instead facilitate the implementation of a softer monetary policy, strengthening the exchange rate, and increasing economic activity.

Table 2.6. Risk map for conducting monetary policy in conditions of macroeconomic destabilization and military actions

Destabilizing factors	Direction of change (deviation)	Monetary and macroeconomic indicators																			
		Consumer price index, %				Key rate, p.p.				GDP, in million hrn				The level of the shadow economy,				Exchange rate. UAH/USD			
		+10%	+5%	-5%	-10%	+10%	+5%	-5%	-10%	+10%	+5%	-5%	-10%	+10%	+5%	-5%	-10%	+10%	+5%	-5%	-10%
Changes in the amount of financing from the IMF, the EU and others	-10%	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
	+10%	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
Longer duration of the war	+ 1 p.	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
	+ 2 p.	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
Recession of the world economy	-10%	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
	-5%	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
Low probability of scenario implementation										High probability of scenario implementation											

Source: developed by authors

The continuation of active hostilities in Ukraine, widespread attacks on energy facilities, and further damage to infrastructure will lead to risks of GDP loss and deterioration of macroeconomic indicators. The destruction of logistical routes leads to an increase in prices for goods and services, and, as a result, to the implementation of a restrictive monetary policy. Furthermore, businesses are either going bankrupt or moving their operations underground in order to stay afloat in the market while minimizing costs, which increases the level of shadow economy in Ukraine. Each additional month, quarter, or year of the Russo-Ukrainian war exacerbates the crisis phenomena in Ukraine, slows down the recovery of economic activity, and intensifies the migration of skilled labor abroad. A longer duration of the war, according to the analysis of destabilizing factors, significantly affects macroeconomic and monetary indicators, with each of them worsening by 10% or more when testing scenarios that

predict high unemployment, deepening GDP gap, decline in exports, and increase in foreign debt.

In addition to internal problems associated with the attack by Russian aggressors and insufficient funding to cover the country's current needs, there are significant risks of destabilization due to a possible global recession. The scenario is based on changes in indicators such as the weighted consumer price index of Ukraine's trade partner countries, the weighted average exchange rate of the Polish zloty and the German mark to the US dollar, and the real neutral rate of the US. The global economic slowdown will primarily negatively affect monetary indicators, necessitating the implementation of an expansionist monetary policy to support economic growth. For Ukraine, as an exporting country, prices for products abroad are critically important, as they determine the volume of revenue received. Accordingly, the balance between demand and supply (created by the sale of foreign currency earnings by exporters) in the foreign exchange market is a driving factor in forming the exchange rate of the hryvnia to the dollar. In case of a significant decrease in prices for Ukrainian export goods (grains, oilseeds, metallurgy, etc.), there are significant risks of devaluation of the national currency by more than 10%. Devaluation of the hryvnia will lead to the exacerbation of internal problems in the country, in particular provoking price increases due to higher import costs and slowing down production growth due to unfavorable market conditions.

Based on the developed risk map, significant effects of destabilizing factors on monetary and macroeconomic indicators have been identified, in particular, delay or reduction of financial aid from partner countries, global recession, and a longer Russo-Ukrainian war lead to a deterioration of the analyzed indicators by more than 10%. The realization of risks mostly necessitates the implementation of a stringent monetary policy to curb price increases. At the same time, under the conditions of positive factors, particularly sufficient financial support from the EU, the USA, the IMF, and others, the chances of returning to economic growth with relative price stability increase. The risk map of monetary policy implementation under macroeconomic instability is convenient for identifying the most negative development scenarios, as well as choosing favorable ones. A thorough understanding

of the consequences of the realization of various risks will allow for well-informed management decisions regarding the application of relevant combinations of monetary instruments in a particular situation.

The sensitivity analysis of macroeconomic and monetary indicators to the realization of risks caused by both economic destabilization and military actions on Ukrainian territory revealed the need to develop an approximate scheme of measures aimed at post-war recovery and enhancing the effectiveness of monetary transmission. Achieving the goal, namely the quickest possible return to economic growth after victory, is impossible without the implementation of prompt monetary and institutional measures. Monetary regulation is carried out by the National Bank of Ukraine, while institutional regulation is the prerogative of the government, parliament, local authorities, the National Securities and Stock Market Commission, etc. A generalized scheme of monetary and institutional measures for conducting effective monetary policy during and after the war is presented in Figure 2.12.

The NBU's monetary policy under martial law differs significantly compared to the classic regime of inflation targeting. Under such conditions, the main goal of monetary policy becomes not only ensuring price stability but also ensuring the stability of the financial system and the economy in general. In particular, during the war, the risk of financial instability increases, not least due to rising inflation and currency instability.

Under such circumstances, the National Bank must ensure the stability of the banking system and reduce risks associated with the increase in insolvent banks. Additionally, the monetary policy of the central bank during the period of war should maintain the stimulation of the economy and enterprise activity, increase the bank loans amount.

During martial law, it is also essential to ensure the effectiveness of institutional control and supervision over financial institutions to mitigate risks of corruption and dishonest activities in the banking system.

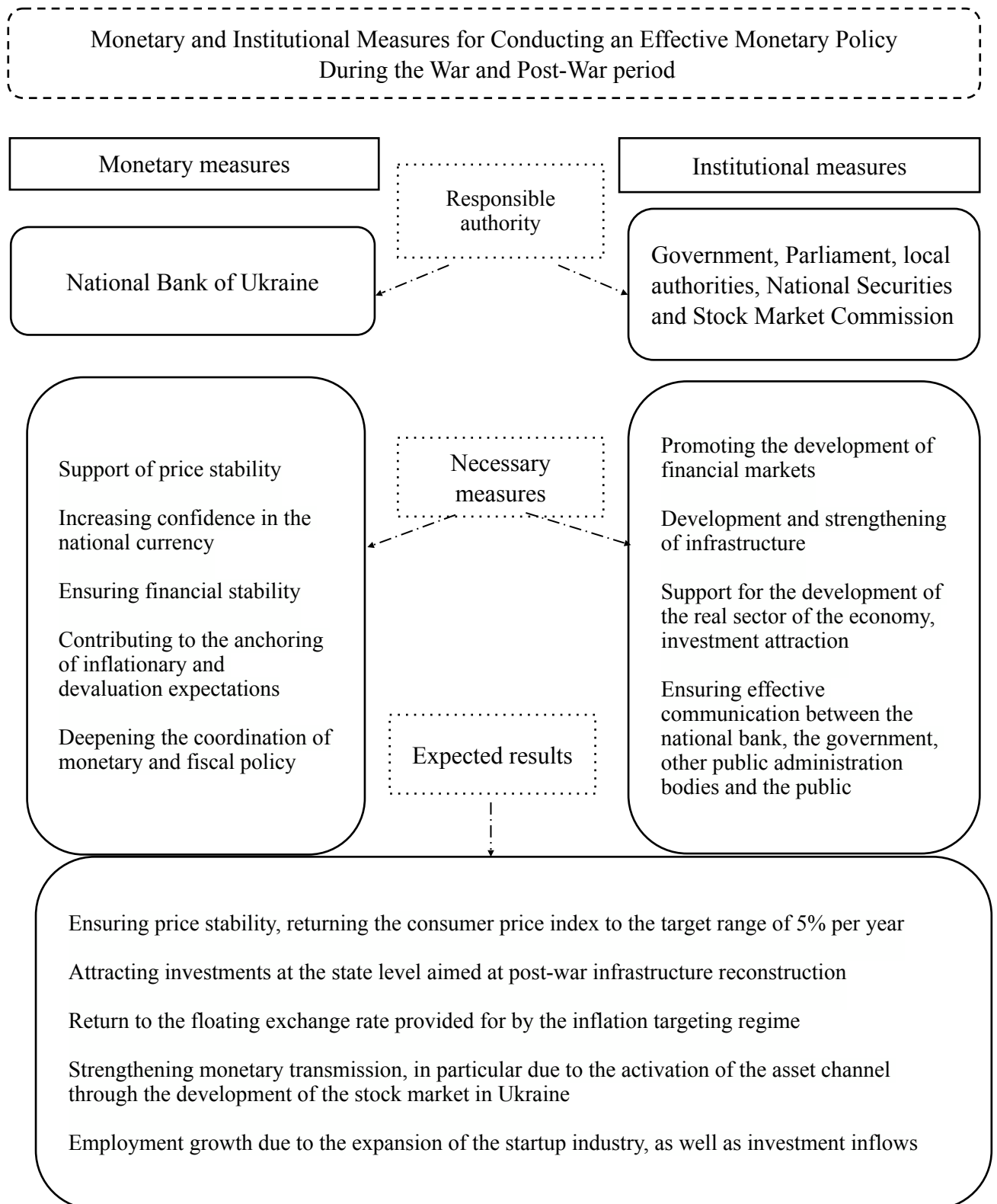


Figure 2.12. Conceptual scheme of monetary and institutional measures to stabilize the macroeconomic situation

Source: developed by the authors

In response to the specific needs of the economy following the onset of the Russian invasion, the Board of the National Bank of Ukraine approved the "Main Principles of Monetary and Credit Policy during the Period of Martial Law" in Ukraine [62]. Implementing monetary policy in the format of inflation targeting is untimely, as the efficacy and efficiency of the monetary transmission mechanism channels are significantly reduced due to administrative restrictions on capital and foreign exchange movements. Consequently, the NBU cannot fully rely on the discount rate as the primary tool of monetary policy affecting the cost of money in the economy and is compelled to apply administrative measures to curb price growth. However, the central bank is committed to ensuring the functioning of the payment system and avoiding losses for financial institutions under martial law. It was also determined that in case of emergencies threatening the country's financial stability, the central bank has the right to impose temporary restrictions on foreign currency and other financial operations. Additionally, the NBU increased liquidity for banks operating in temporarily occupied territories and reduced loan repayment terms. Overall, the NBU's primary approach is to ensure the stability of the financial system under martial law and minimize adverse effects on the country's economy. Even providing support to the state budget by purchasing government-issued securities on the primary market is permissible. Each of these measures aims to preserve price and financial stability and mitigate GDP losses in the face of widespread infrastructure destruction. In time, after Ukraine's victory over the Russian invaders and the lifting of martial law, the NBU commits to returning to the fundamental postulates of inflation targeting with a floating exchange rate and no government fiscal dominance [62].

Equally important is the implementation of institutional measures aimed at effective conduct of monetary and state policy to ensure macroeconomic stability. In the case of Ukraine, a key task is the development of financial markets, which play a significant role in determining interest rates and credit conditions, impacting the size of investments, expenses of enterprises and citizens, and overall economic development of the country. The development of financial markets includes creating effective financial instruments like stocks, bonds, derivatives, etc., which allow

attracting more capital and creating favorable conditions for business in Ukraine. Additionally, the creation of financial instruments will reduce the risk to investors and enable the raising of funds for long-term investments in Ukraine. Directions for the development of financial markets include the evolution of the banking system, securities market, stock market, insurance market, pension market, and derivatives market. Successful development of financial markets in Ukraine can increase the effectiveness of monetary policy and positively impact the development of the real sector of the economy.

As mentioned in previous sections, trust and dialogue with the regulator play a significant role in forming inflationary expectations. Therefore, communication by the NBU with various target audiences is essential for stabilizing these processes. Considering that the regulator uses its official website as the primary communication channel, most information presented there is mainly of interest to the academic community for working with statistical data and reviewing reports for scientific research, as well as stakeholders in public policy. However, ordinary citizens and users of financial services who are not directly involved in monetary policy get news related to the current actions of the NBU from external sources, including the media. Hence, the regulator should focus on alternative communication channels most used by Ukrainian citizens, where the current macroeconomic situation in the country can be explained in a simplified and interactive format. The NBU can collaborate with banks in Ukraine, which have online applications, and agree to duplicate information posted on the NBU website in the news section, but in a simplified format understandable to the citizens. Communication by the NBU's Head and his constant presence in various media, social networks, and conducting press conferences for reporting on the regulator's work and conveying decisions to the public is essential. Such a strategy by the NBU is necessary to consolidate expectations and increase trust in the regulator. Thus, the NBU's communication policy is a fundamental element of macroeconomic management and stability, contributing to ensuring transparency, predictability, and effectiveness of monetary policy.