Monetary policy in times of war: the case of Ukraine

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Since the beginning of the Russian invasion, the National Bank of Ukraine (NBU) has contributed to the resilience of the Ukrainian economy by using a variety of instruments to support the war effort and respond to financial imbalances. This blog post analyses this contemporary example of a central bank in wartime from the perspective of the notion of monetary policy autonomy.

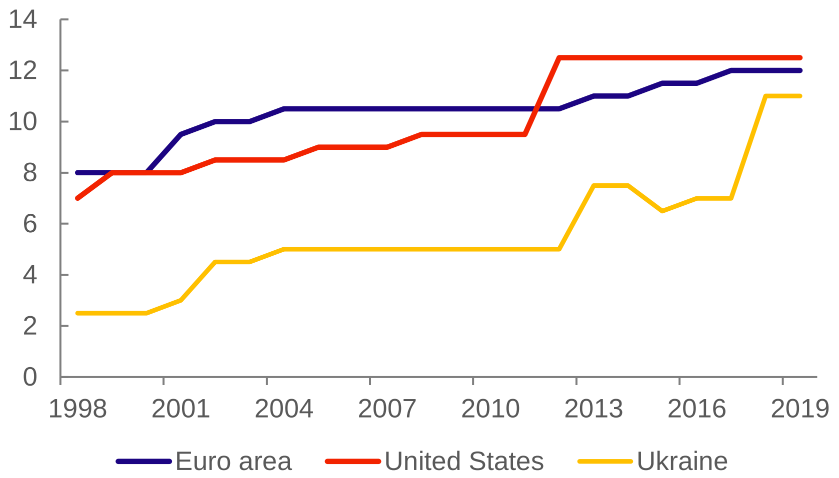
The Ukrainian central bank's wartime actions have historical precedents

Historically, central banks have had to be called upon in times of war, either to contribute to the solvency of states (Poast, 2015; Pamfili and Chambley, 2017), or later to ensure the liquidity of the banking system (Margairaz, 2019).

Since the introduction of inflation-targeting regimes in the 1990s and the increasing internationalisation of economies, the actions of central banks in wartime have come to be seen through a new lens, as they must maintain both the internal and the external autonomy of monetary policy (Mundell, 1960). This is the case of the NBU, which, thanks to the reforms undertaken from 2014, has gained this dual autonomy, thereby bringing its monetary policy framework closer to those of advanced economies: adoption of a floating exchange rate regime, inflation targeting, improvement in the degree of independence according to the Romelli index (2022), and greater transparency in the conduct of monetary policy (see Chart 1).

The NBU's actions since the Russian invasion therefore differ from past examples of central banks in wartime. This blog post looks at how the NBU was able to preserve its dual autonomy while supporting the war effort.

Chart 1. The NBU, a modern central bank (transparency index)



Source: Dincer, Eichengreen and Geraats (2022).
Note: The transparency index, which ranges from 0 to 15, reflects the transparency of monetary policy decisions, as well as political, economic, procedural and operational dimensions.

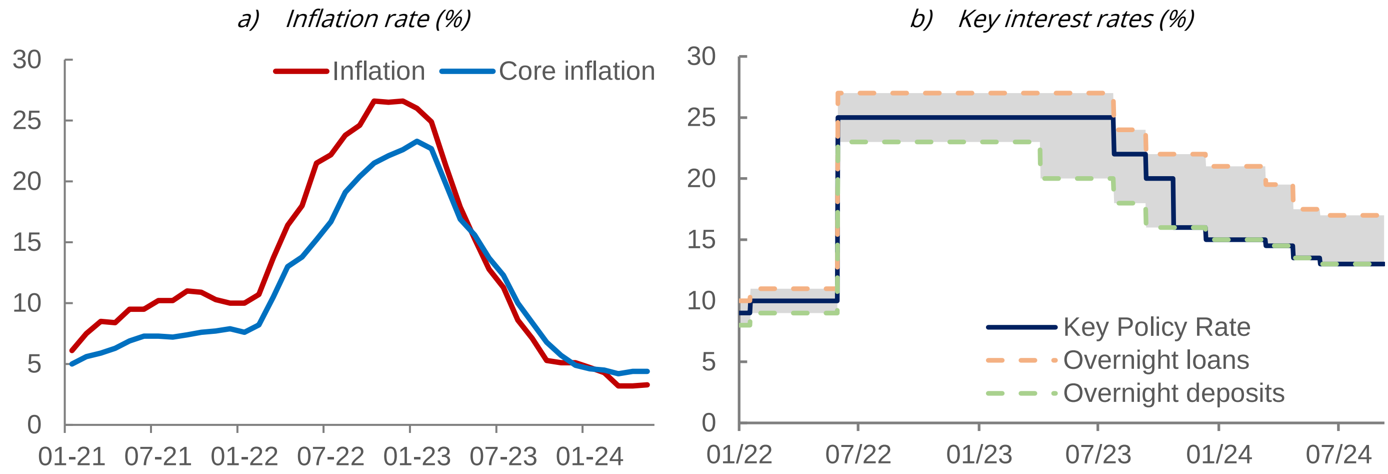
Regulating monetary financing to regain domestic monetary autonomy

Financing a war can result in a situation of fiscal dominance whereby the monetary authority deviates from its price stability objective to ensure the sustainability of public debt (Barthélémy et al., 2021). Studies of countries in the aftermath of war or conflict reveal a substantial risk of hyperinflation in the event of continued recourse to monetary financing (Antipa, 2023).

From the moment of the Russian invasion and the introduction of martial law, the NBU's activities were totally subordinated to military objectives. The NBU financed as much as half of the public deficit in the first half of 2022. Its key rates were kept unchanged for the first few months (see Chart 2), as it considered that it was no longer useful to adjust rates during the acute phase of the conflict. To support the banking sector, the NBU opted to create an unlimited collateral-free refinancing facility with a renewable maturity of one year, with a rate corresponding to the overnight lending facility rate +100 bp.

However, as a sign of the NBU's attachment to its independence and to the transparency of its monetary policy, it immediately stressed the temporary nature of these measures. An official announcement has been made for each purchase of a war bond on the primary market.

Chart 2 NBU's target and conventional monetary policy instrument



Source: NBU

Although real GDP stabilised as from Q3 2022 after the sharp fall in activity in Q1-Q2, domestic financial imbalances worsened. Inflationary pressures began to materialise in the summer of 2022 before reaching a peak in October 2022 (+26.6% y/y), forcing the NBU to take aggressive measures to address the imbalances generated by the war and the monetary financing of the public deficit (see Table 1). At the start of 2023, the challenge was to reduce excess bank liquidity in order to improve the transmission of monetary policy. To achieve this, the NBU introduced liquidity-absorbing measures that required banks to pay higher interest on customer deposits, while at the same time putting an end to monetary financing of the public deficit with the technical support of the IMF (economic surveillance programme).

Table 1. Measures taken by the NBU between June 2022 and March 2023

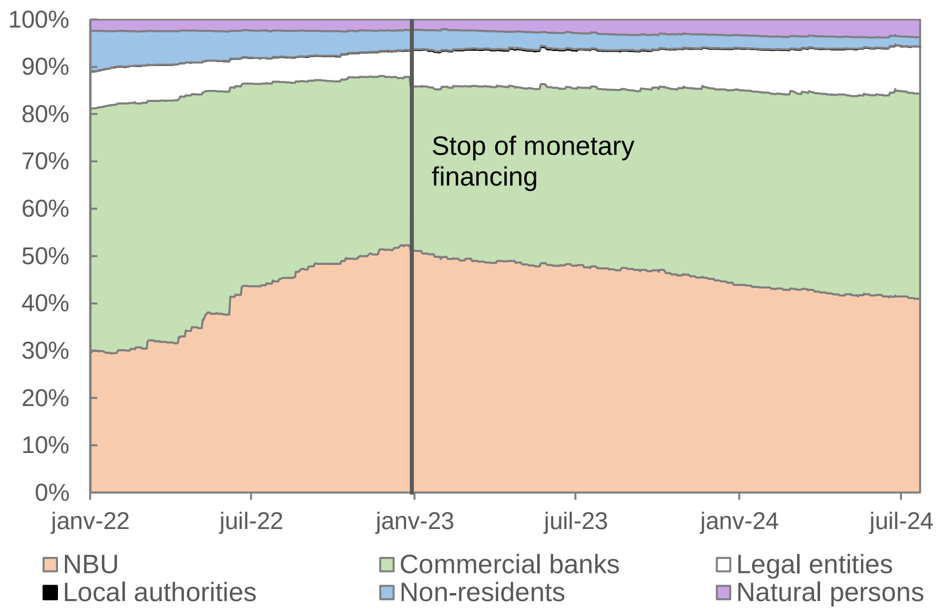
Date	Measure
Jun. 2022	Increase in the main refinancing rate from 10% to 25%
Jul. 2022	25% currency devaluation, new exchange rate of 36.57 UAH/USD
Nov. 2022	Suspension of unsecured refinancing operations

Oct. 2022	Introduction of a new instrument to protect the savings of Ukrainian households against exchange rate risk
Dec. 2022	Increase in minimum reserve requirements
Jan. 2023	Stopping monetary financing of the public deficit
Mar. 2023	Introduction of a 3-month deposit certificate with the central bank, with a 25% interest rate. Lowering of overnight deposit certificate rate to 20%

Source: NBU

As of Q2 2023, the NBU diversified its sources of financing for the budget deficit. On 17 March 2023, the IMF approved Ukraine's first wartime structural adjustment programme. It provides financial assistance of USD 15.6 billion over a four-year period. The programme acts as a catalyst for international financial aid. At the same time, disinflation is helping to drive up real interest rates, making hryvnia-denominated assets, including government bonds, more attractive. Ukrainian banks and savers are gradually standing in for the NBU as holders of government bonds (see Chart 3).

Chart 3. Holdings of Ukrainian sovereign bonds (%)



Source: NBU
Note: The scope of the analysis excludes bilateral loans granted by international donors to help Ukraine.

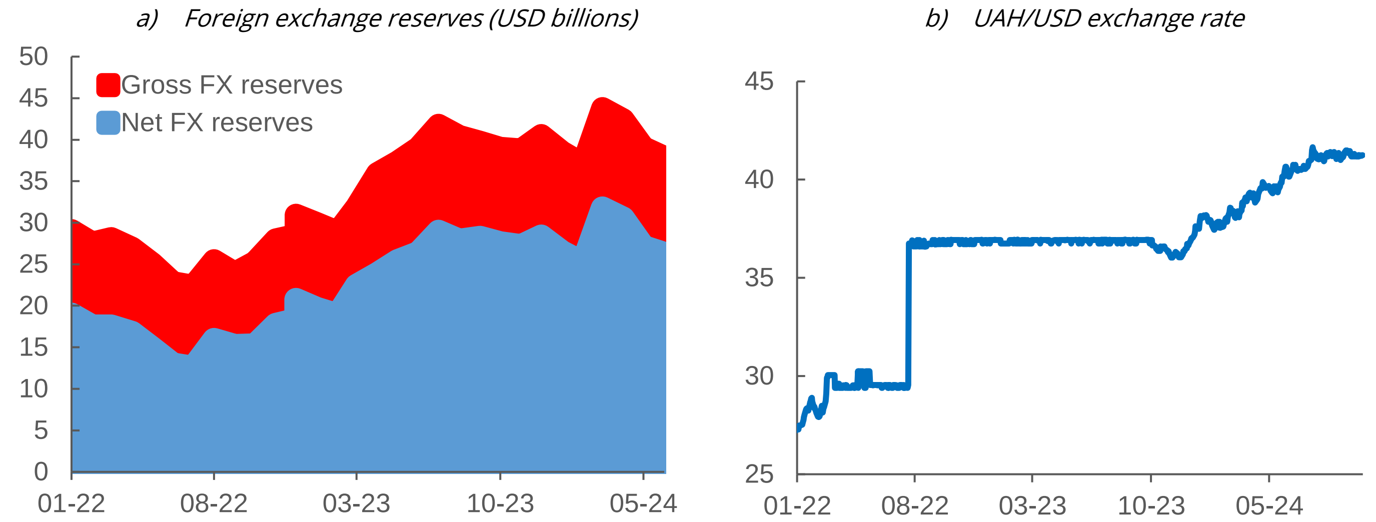
In this context, the NBU could ease its monetary policy by lowering its key rates, including the deposit certificate rate, without jeopardising its objective of fighting inflation. In October 2023, the NBU made the overnight deposit certificate rate its main key rate (transition from a "corridor" regime to a "floor" regime) in order to restore the main key rate's role as a monetary policy tool - an essential feature of an inflation-targeting regime.

Preserving external monetary autonomy, the new objective of central banks during times of war

Externally, the measures implemented by the NBU since the Russian invasion initially constitute a monetary policy reversal in the Mundellian trilemma (1960). In order to maintain the external autonomy of monetary policy (i.e. vis-à-vis the rest of the world), the NBU temporarily adopted a fixed exchange rate with the dollar (29.25 UAH/USD) at the expense of introducing capital controls. In concrete terms, cash withdrawals were capped, the foreign exchange market was suspended and a moratorium on cross-border currency payments was introduced. These choices aimed to preserve the autonomy of monetary policy while underpinning the value of the hryvnia.

The domestic imbalances generated by the monetary financing of the public deficit are having external repercussions in the form of the emergence of a parallel foreign exchange market, which could eventually lead to the dollarisation of the Ukrainian economy. Despite the gradual lifting of certain foreign exchange controls, the gap between the parallel exchange rate and the official exchange rate widened to 28% in July 2022. The restriction on monetary financing introduced in the second half of the year and the gradual increase in international aid were not enough to stem the decline in international foreign exchange reserves, which reached a low in summer 2022.

Chart 4. Foreign exchange reserves and value of the hryvnia



Source: NBU

However, the devaluation of the hryvnia in July 2022, in conjunction with other measures to tighten monetary policy (see Table 1), made it possible to bring back the official exchange rate more into line with the fundamentals of the Ukrainian economy. At the same time, the NBU gradually lifted its capital account restrictions, before opting in October 2023 for an exchange rate regime known as a managed float, leading to a depreciation of the hryvnia (see Chart 4b).

Monetary autonomy successfully preserved

The NBU has played a key role in the resilience and stability of the Ukrainian economy. Even during the most acute phase of the conflict, the NBU assured citizens and investors of its determination to return to an inflation-targeting regime as soon as possible. Testifying to the effectiveness of this policy, inflation slowed to 3.3% in May 2024, and should converge towards the medium-term target in 2025, although there is still a great deal of uncertainty surrounding this forecast.

In addition to the decisions taken by the authorities, this success can be ascribed to the resilience of the Ukrainian external sector. By supporting foreign exchange reserves (see Chart 4a), international aid (USD 38 billion in 2023) has played a decisive role in the gradual return to the inflation-targeting regime in force before the invasion. Similarly, the continuation of exports via the new Black Sea corridor has had a positive impact on the trade balance. The actions of a modern central bank in times of war therefore cannot be analysed without close consideration of the country's external position.