PLAN B: MONETARY POLICY

Policy of the National Bank of Ukraine and Its Impact on Financial Stability and Economic Situation: Criticisms, Alternatives, and Prospects

According to the Constitution of Ukraine, the main function of the NBU is to ensure the stability of the Ukrainian currency. In addition, it should promote financial stability, to include the stability of the banking system, as well as contribute to sustainable economic growth and support the economic policy of the Cabinet of Ministers of Ukraine. Since Russia's invasion, the NBU has been successfully performing its primary function, given the extremely difficult conditions and challenges it faced. This is a result of both current decisions and the quality of the banking system's preparation in previous years. However, over the past year, there have been decisions in the NBU's policy which have had a negative impact on budget execution, which threatens financial stability on foreign economic activity and lending, slowing the pace of economic recovery.

This paper analyzes the impact of the NBU's policy on the above areas.

The main instruments used by the NBU to achieve its main objectives are the discount rate and the national currency exchange rate. Before the war, the national currency exchange rate was formed based on supply and demand in the foreign exchange market. However, given the significant exchange rate risks,

until 3 October 2023 — was in effect → fixed rate — **36,5686 UAH/$**

a fixed rate of 36.5686 UAH to 1 USD was in effect until 3 October 2023, in order to balance the foreign exchange market and maintain the economy's resilience in the face of war. After that date, the NBU decided to switch to a regime of managed exchange rate flexibility.

Матеріал створений ГО «Мережа захисту національних інтересів «АНТС» в рамках Програми сприяння громадській активності «Долучайся!», що фінансується Агентством США з міжнародного розвитку (USAID) та здійснюється Pact в Україні. Зміст матеріалу є винятковою відповідальністю Pact та його партнерів і не обов'язково відображає погляди Агентства США з міжнародного розвитку (USAID) або уряду США.

The discount rate is a base indicator, being the basis for calculations of many important indicators that directly affect macroeconomic stability and business activity, including the setting of lending rates by commercial banks. This determines the availability or inaccessibility of loans to households and businesses and the ability to borrow.

A high discount rate helps fight inflation if there is demand inflation, as it reduces consumers' access to lending and accordingly pushes importers and producers to reduce prices of their products. However, when a country is experiencing supply-side inflation, this policy has minimal impact on inflation. While the war rages on, all elements of our cost price have increased: imported components, energy, logistics, attracting employees, some of whom went abroad and others were drafted into the army, wages were increased, and risks from war also increased. This in turn increases the cost of production and services for manufacturers, and forces them to raise prices. It makes no sense to fight the nature of inflation with a high discount rate.

According to the baseline scenario developed by the NBU,

by the end of 2025 will slow → **TO 5,8%**

2026 and return → **TO THE 5,0%**

YEARLY

At the same time, the NBU promises to maintain an active presence in the foreign exchange market and smooth out excessive exchange rate fluctuations under the regime of managed exchange rate flexibility. This scenario is based on the assumption that high security risks will decline starting from 2025. If security risks persist longer, this will have a negative impact on business and consumer sentiment, exchange rate, and inflation expectations, the NBU governor adds. This will also increase pressure on public finances and deepen problems in the labor market.

The NBU's optimistic calculations are based on the assumption that the level of international aid will remain at its 2023 level, as well as on an underestimated consumer price index. If these two components change, the economic reality will be different. The NBU cites possible additional budget expenditures to support defense, respond to terrorist attacks, and other threats to the economic and financial systems, or a significant quasi-fiscal deficit, particularly in the energy sector, as risks to the economic and financial systems.

In addition, the NBU cites risks such as significant damage to port and energy infrastructure that will limit exports, continued partial blocking of borders with certain EU countries for freight transportation, which will limit exports and increase imports, and deepening negative migration trends. The NBU did not disclose a negative scenario in which international financial aid would stop flowing, as it hopes that it will continue. However, they promise to respond as problems arise.

However, a pessimistic scenario of economic development is also possible, given a potential significant reduction or absence of financial assistance from international partners. The rhetoric that there will definitely be international support is reminiscent of the rhetoric of 2022 prior to the invasion, when Ukraine had neither prepared nor allowed for such a scenario[1].

The policy of the National Bank of Ukraine has been the subject of discussion and criticism due to a number of decisions that have affected the financial and economic situation in the country. In particular, the NBU's discount rate has caused outrage among the business community and experts because of its high level, being reflected in high interest rates on loans and bonds. Some of the NBU's decisions, such as bond purchases and foreign exchange market interventions, have also been criticized for their impact on the financial market and public finances. High interest rates on loans reduces demand for loans and investments, affecting business growth and development. In addition, higher interest rates on domestic government bonds has put an additional burden on the budget due to overpayments on debt obligations. However, it is important to note that the NBU is operating in a challenging economic environment and must balance various aspects, such as inflation, lending, the hryvnia's stability, and financial stability.

[1] NBU: Ukraine's Economy Has Adapted To The War
https://www.dw.com/uk/prognoz-nbu-ekonomicne-zrostanna-v-ukraini-trivatime-popri-vijnu/a-68095377

Analysis of the National Bank of Ukraine's policy and its impact on the financial and economic situation:

1. The accounting rate of the NBU

in 2023 from 25% reduced → to 15%

although remained significantly higher than the inflation rate (Figure 1)

The high discount rate of the National Bank of Ukraine (NBU) is a sign of restraint on lending and economic development. This has had a negative impact on the government bonds market, as the high discount rate, and consequently the high rate on deposit certificates, makes it unattractive for commercial banks to invest in government bonds. This effectively forces the Ministry of Finance to keep the interest rate on government bonds high, well above the inflation rate. The financial burden on the state budget is thereby increased and leads to significant overpayments.

A high discount rate makes bonds less attractive to investors, as they can find more profitable alternatives for their capital. This leads to a deterioration in the volume of domestic government bonds sold and an increase in their servicing costs.

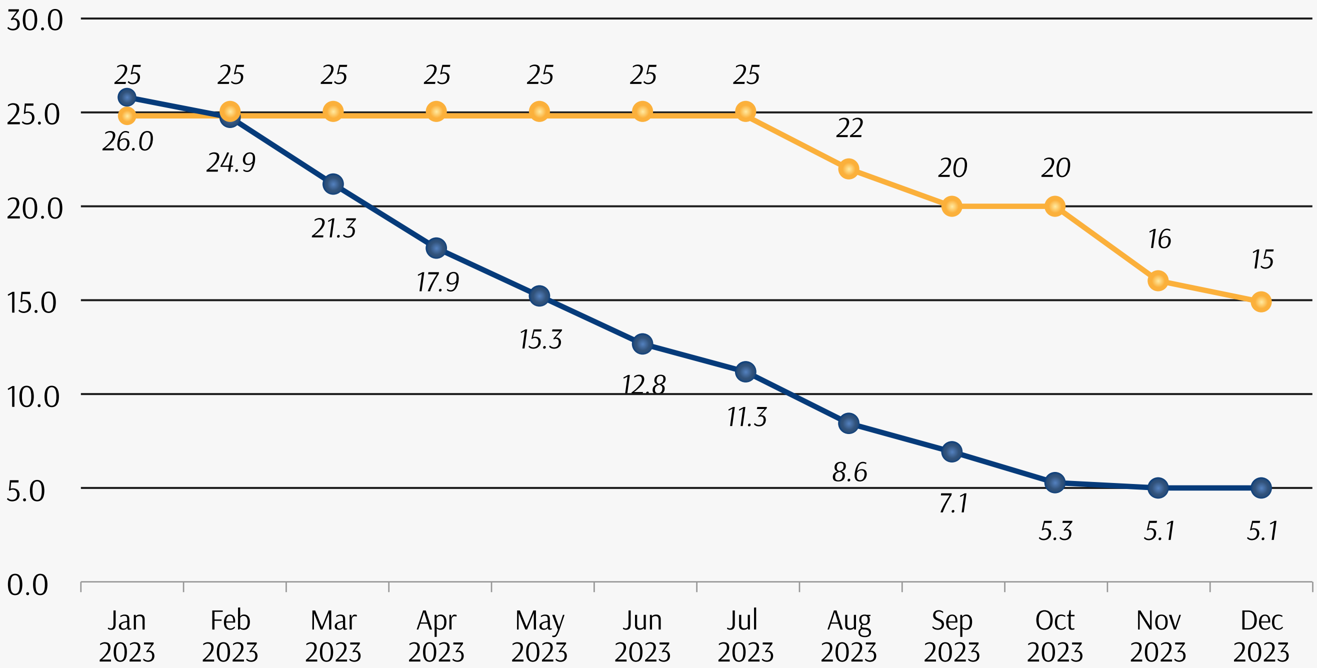

Figure 1. *Inflation and discount rate for 2023*[2]

[2] Presentation for the press briefing on monetary policy https://bank.gov.ua/admin_uploads/article/Key_messages_on_monetary_decision_pr_2024-01_ua.pdf?v=7

According to the NBU Depository, in the first two months of 2024, the Government of Ukraine raised UAH 34,845.2 million, USD 477.3 million, and EUR 514.2 million from the placement of domestic government bonds at auctions. During this period, UAH 10,189.4 million, USD 548.5 million, and EUR 555.5 million were allocated for repayment of domestic government debt securities. In January-February 2024, the Ministry of Finance's borrowings on the domestic debt market exceeded the repayments on domestic government bonds by UAH 20,118.1 million in equivalent, and by UAH 796.4 million in equivalent specifically in February. The rollover of investments in domestic government bonds (the ratio of the nominal value of securities sold at auctions to those redeemed in accordance with the terms of their issue) in January-February amounted to 118% in all currencies at the current official exchange rate.

IN TOTAL,

from the beginning of the full-scale invasion until 29 February 2024, the government raised

Figure 2,3

589 020,9 mln. UAH,
6 094,6 mln. $ USD,
2 227,3 mln. EUR

for repayment of domestic government bonds.

439 561,3 mln. UAH,
6 684,2 mln. $ USD,
1 806,1 mln. EUR

The NBU allowed banks to cover up to 50% of their total required reserves with benchmark government bonds from a list determined by the NBU and gradually expanded the list. The NBU has allowed non-residents to transfer funds abroad received from the payment of interest on domestic government bonds after 1 April 2023, provided that they comply with the minimum continuous period of holding the bonds before receiving the interest. For its part, the government offers rates on domestic government bonds at market levels. In February 2024, the maximum yield on domestic government bonds placed at auctions was 18.50% per annum in hryvnias, 4.66% per annum in US dollars, and 3.25% per annum in euros. An active domestic debt market is important for ensuring macrofinancial stability. On one hand, this is a safeguard against monetary financing of the budget deficit, and on the other hand, it is an important tool for improving the maturity of funds in the banking system, minimizing risks to the foreign exchange market and price stability[3].

[3] Since the beginning of 2024, the government has raised more than UAH 74 billion in equivalent from the sale of domestic government bonds at auctions, and more than UAH 892 billion in equivalent during martial law https://bank.gov.ua/ua/news/all/z-pochatku-2024-roku-uryad-zaluchiv-vid-prodaju-ovdp-na-auktsionah-ponad-74-mlrd-grn-v-ekvivalenti-a-zagalom-uprodovj-voyennogo-stanu--ponad-892-mlrd-grn-v-ekvivalenti

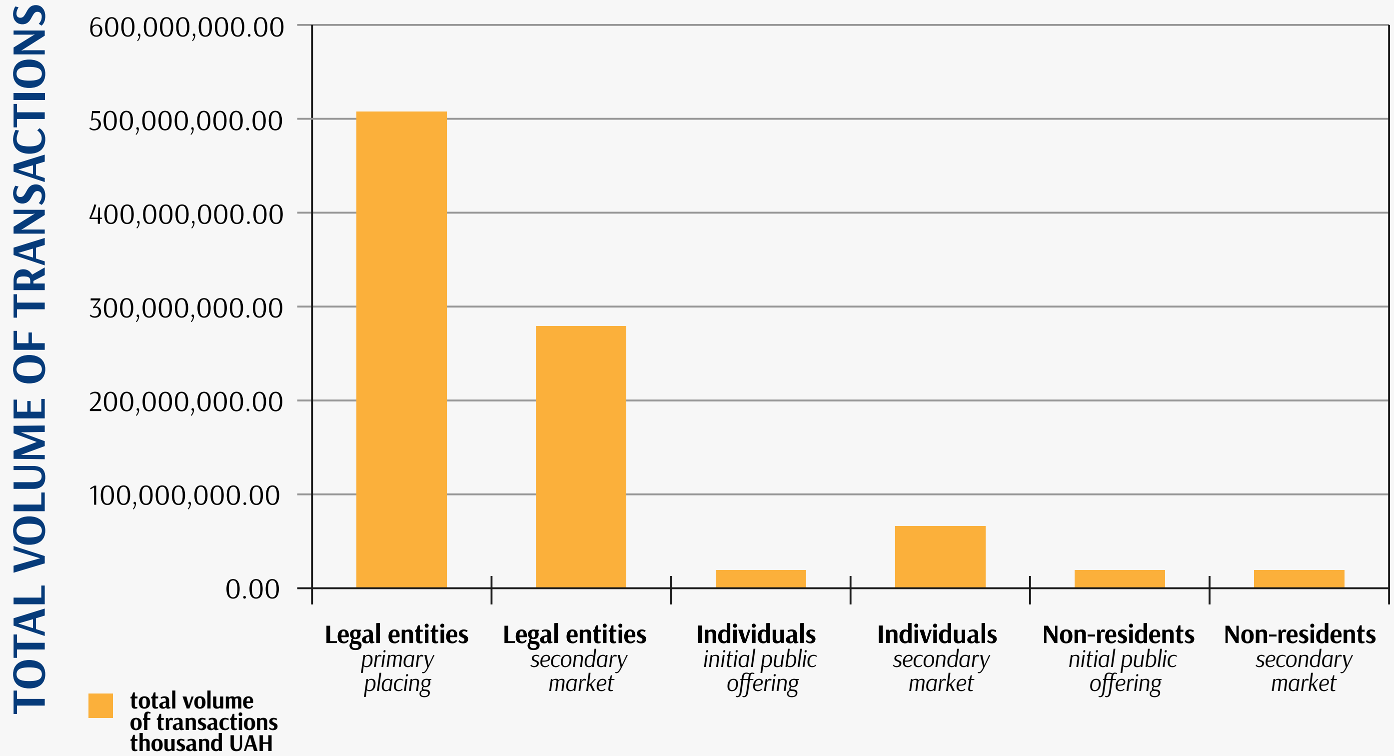

Figure 2. *Total volume of military government bond purchases for 24 February 2022 - 29 February 2024* [4]

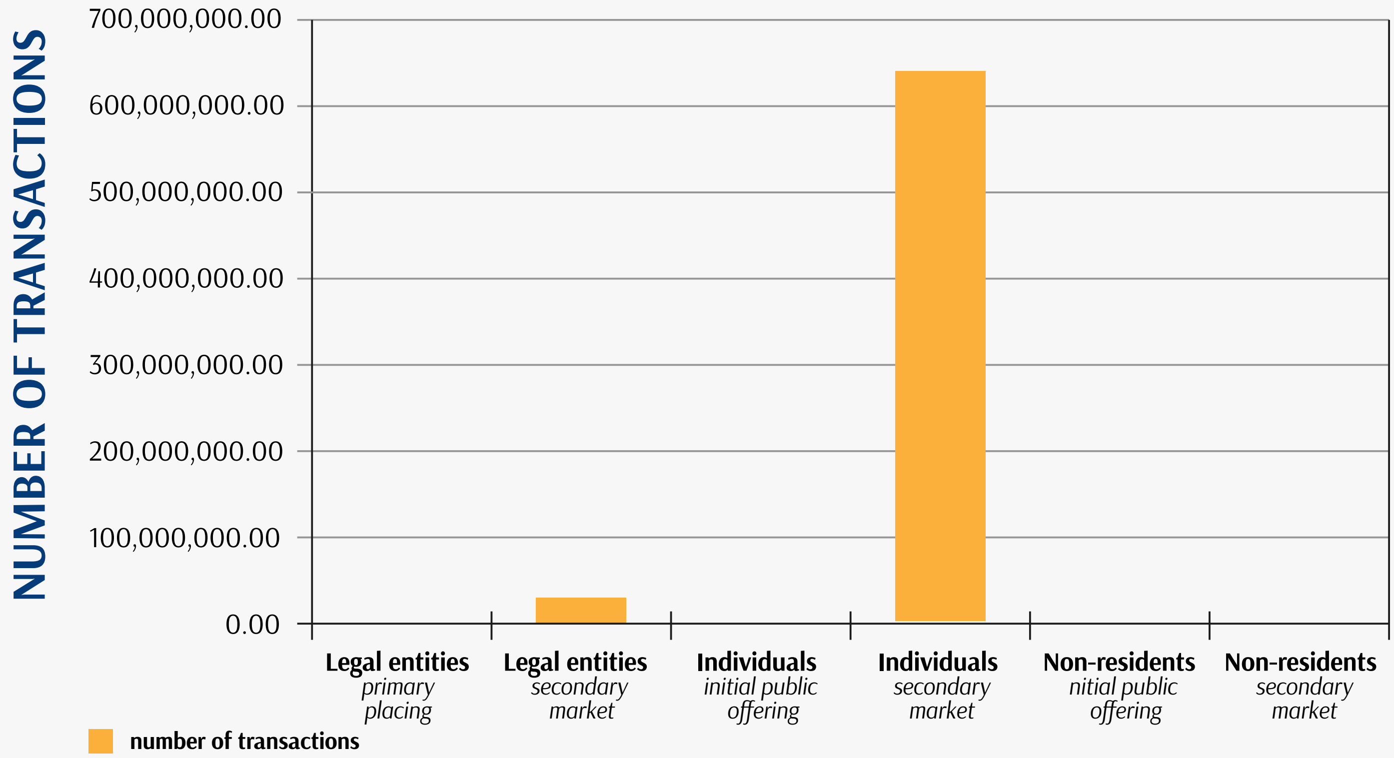

Figure 3. *Number of transactions for military government bond purchases for 24 February 2022 - 29 February 2024* [4]

[4] Since the beginning of 2024, the government has raised more than UAH 74 billion in equivalent from the sale of domestic government bonds at auctions, and more than UAH 892 billion in equivalent during martial law https://bank.gov.ua/ua/news/all/z-pochatku-2024-roku-uryad-zaluchiv-vid-prodaju-ovdp-na-auktsionah-ponad-74-mlrd-grn-v-ekvivalenti-a-zagalom-uprodovj-voyennogo-stanu--ponad-892-mlrd-grn-v-ekvivalenti

As before, the largest volume of these securities is concentrated in primary dealer banks.

The second largest portfolio is the portfolio of military bonds held by Ukrainian citizens and businesses.

As of 1 March 2024, this amounted to:

01

51 886,9 mln. UAH / or **29,2%** of the total amount of purchased UAH-denominated military government bonds

(as of **1 February – UAH 45,684.1 million,** or **28.6%**);

02

1 187,3 mln. USD / or **51,6%** of the total volume of military bonds denominated in USD

(as of **1 February – USD 1,119.2 million,** or **53.8%**);

03

106,2 mln EUR / or **17,5%** of the total volume of Euro-denominated domestic government bonds

(as **of 1 February – EUR 108.4 million, or 17.1%**)

As of 1 March 2024, the total portfolio of military bonds held by individuals and legal entities amounted to UAH 101.4 billion in equivalent, compared to UAH 43.4 billion in equivalent as of 1 March 2023, an increase of almost 2.3 times. As of 1 March 2024, the amount of military domestic government bonds held by non-residents amounted to UAH 15,862.3 million, USD 24.2 million, and EUR 0.1 million, having more than doubled over the year (compared to 1 March 2023). In February 2024, the Ministry of Finance redeemed military government bonds worth almost EUR 304.0 million [4].

[4] Since the beginning of 2024, the government has raised more than UAH 74 billion in equivalent from the sale of domestic government bonds at auctions, and more than UAH 892 billion in equivalent during martial law https://bank.gov.ua/ua/news/all/z-pochatku-2024-roku-uryad-zaluchiv-vid-prodaju-ovdp-na-auktsionah-ponad-74-mlrd-grn-v-ekvivalenti-a-zagalom-uprodovj-voyennogo-stanu--ponad-892-mlrd-grn-v-ekvivalenti

2. The 5-7-9 program provides compensation to companies that obtain loans at the NBU's discount rate.

> *However, the high discount rate makes participation in this programme less attractive for businesses due to high interest rates on loans. This also leads to overpayment of compensation by the Ministry of Finance of Ukraine.*

In the context of total war, business support has become critical, given that taxes dependent on business activity are the main source of financing defence expenditures in the state budget. Ukraine's international partners have pointed to the need to increase the share of domestic financing and reduce dependence on external revenues for the needs of recovery and further economic growth. One of the most well-known business support **tools is the «5-7-9» government programme.**

During the wartime period of 2022–2023, the government programme «**Affordable Loans 5-7-9%»** played an unprecedentedly important role in debt financing for enterprises amid a slowdown in bank lending on market terms *(Figure 4)*.

December 2023

40%

Thus, as of December 2023, about 40% of the net UAH loan portfolio of Ukrainian banks was made up of loans at preferential rates under the Programme, and according to the head of the Entrepreneurship Development Fund, 90% of new business loans during the full-scale war were provided under the Programme.

With the start of the full-scale invasion, the Programme underwent significant changes for a second time: the list of recipients was significantly expanded (including large companies), and new lending areas were added to support businesses in the context of military operations. Firstly, the opportunities to support agricultural producers to finance sowing operations were expanded and a separate programme area was introduced to support sowing operations; secondly, loans to overcome the consequences of total war, including the recovery of production capacity (classified as "anti-war purposes" in the Business Development Fund (BDF), which administers the Programme), became a separate funding area. **In addition, the Programme was expanded to include retail chains in 2022, and energy companies in 2023.** In fact, the Small Business Support Programme has become a means of lending to a wide range of businesses.

AFFORDABLE LOANS 5-7-9%

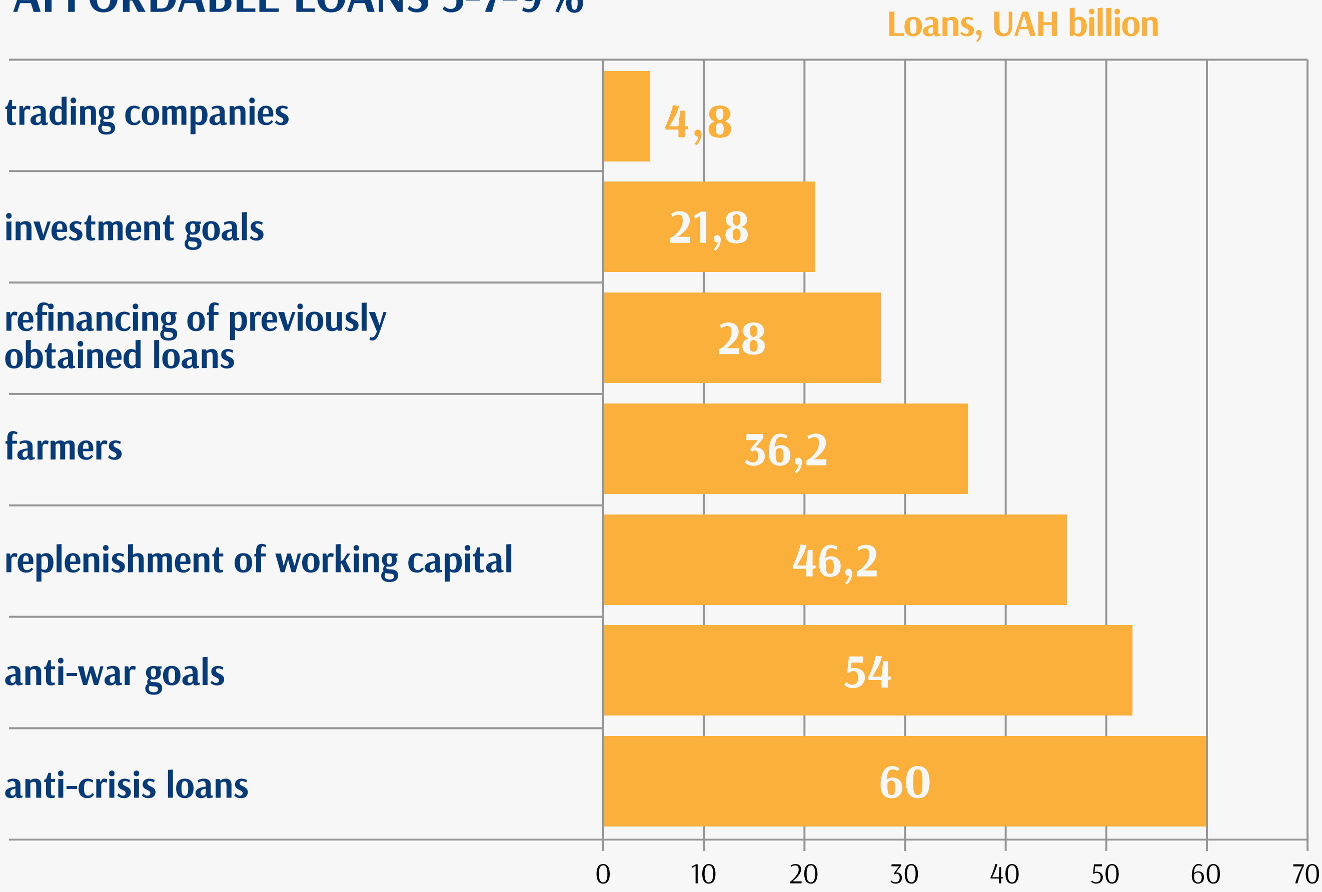

Figure 4. Loans provided under the «5-7-9» Government Programme for 2020-2023 [5]

Both during COVID-19 and the full-scale war, changes to the programme were made under critical time pressure and without a thorough analysis of the pros and cons. This led to imbalances that were discussed post factum by experts from the National Bank, the Ministry of Finance, and the banking community. These include sectoral and regional imbalances in the distribution of soft loans, cases of lending to unreliable companies, and an increase in non-performing loans under the programme (NPLs) from 1% to 7% from 2022 - 10 months of 2023. In March 2023, the NBU and the government amended the programme to increase interest rates (in particular for working capital loans), refusals to refinance previously issued loans to overcome the effects of the COVID crisis, etc. At the same time, the range of lending targets was expanded to include businesses operating in the de-occupied and frontline areas, and in the fall, an emphasis was added on supporting recycling and energy efficiency projects.

In July 2023, during the review of the current IMF programme, one of the structural beacons was the development of a new strategy for the 5-7-9 Programme with a return to the SME focus. The implementation of this structural beacon was scheduled for the end of September 2023, but it was not fulfilled, and following the second revision of the Programme, the deadline was postponed to the end of March 2024.

[5] Since the beginning of 2023, businesses have received affordable loans amounting to UAH 95 billion https://www.me.gov.ua/News/Detail?lang=uk-UA&id=ce07fca7-a1a7-43e7-959e-b37289b82ec7&title=95-MlrdGrn

Thus, returning the programme's focus is important for maintaining macroeconomic stability in Ukraine.

The programme is complemented by the possibility of providing loans under portfolio guarantees, the volume of which as of **mid-February 2024** exceeded **UAH 105 billion for 33.2 thousand agreements.** As of **1 February 2024, the volume of guaranteed loans serviced amounted to UAH 67.2 billion**, of which almost **70%** were **granted under the 5-7-9% Programme.**

The important role of the Programme for business and the economy as a whole is emphasized by the rapid growth of the share of loans issued under the 5-7-9% programme in the net UAH corporate portfolio – from 5% in 2020 to 18% in 2021, 26% in 2022, and up to 40% in 2023. Two-thirds of the volume of loan agreements signed under the Programme (67.4%) falls on the period of martial law in Ukraine, from 24 February 2022 to 5 February 2024. Thus, the growth of the loan portfolio under the «Affordable Loans 5-7-9%» programme is mainly due to the change in the programme design in the context of the war.

The amount of budgetary funding for the programme has increased significantly[6]:

2024 was allocated → **18 billion UAH**

2023 was allocated → **16 billion UAH**

2022 was allocated → **7 billion UAH**

2020 – 2021 was allocated → **2 billion UAH**

[6] The Government Programme for Business Support "Affordable Loans 5-7-9%": In Search of Optimal Design https://www.ukrinform.ua/rubric-economy/3836803-derzavna-programa-pidtrimki-biznesu-dostupni-krediti-579-u-posukah-optimalnogo-dizajnu.html

For about five months now, banks have not been receiving money from the government to compensate for preferential rates under the 5-7-9 programme. This debt amounted to UAH 7 billion at the beginning of the year. As a result, the programme has come close to a critical point: under the “5-7-9” terms, if a debt is 181 days overdue (about six months), banks have the right to demand that borrowers pay the difference in interest that the government has not compensated. In early February, the government postponed this risk by extending the deadline to nine months. However, this does not solve the major problem of the 5-7-9 design: the state cannot pay for everyone. Therefore, the Ministry of Finance and the Ministry of Economy are preparing their own vision of reformatting the affordable loan programme, says Pervin Dadashova, director of the NBU’s Financial Stability Department[7].

3. The NBU’s foreign exchange interventions

during the period of the managed flexible exchange rate were inconsistent, and instead of mitigating exchange rate fluctuations, actually led to manual exchange rate formation (Figure 5). This has created instability in the foreign exchange market and negatively impacted the predictability of exchange rate fluctuations, thereby negatively affecting foreign trade.

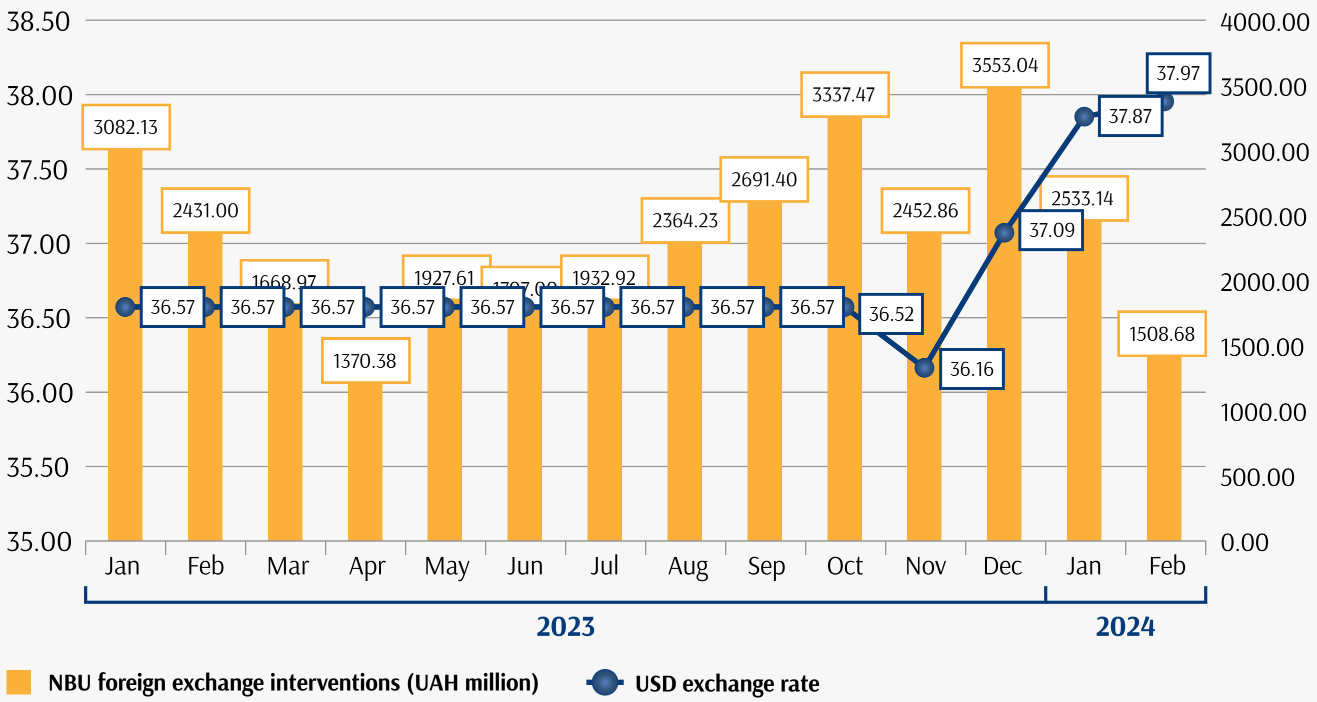

Figure 5. *Official UAH exchange rate and NBU currency interventions for 2023-2024*[8]

[7] Affordable loans in the debt trap. The state owes banks billions of hryvnias in compensation under the 5-7-9 programme. How it can now be changed https://forbes.ua/money/5-7-9-u-borgoviy-pasttsi-derzhava-vinna-bankam-milyardi-griven-kompensatsii-za-derzhprogramoyu-dostupnikh-kreditiv-yak-ii-teper-mozhut-zminiti-15022024-19213

[8] Official UAH exchange rate against foreign currencies https://bank.gov.ua/ua/markets/exchangerate-chart

The NBU is optimizing a number of currency restrictions to prevent unproductive capital outflows to protect Ukraine's international reserves and maintain foreign exchange market stability.

Thus, on 21 February 2024, changes in a number of areas came into effect.

To make payments in foreign currency, a business must first use its existing foreign currency, and then, if necessary, purchase it on the Ukrainian foreign exchange market. Businesses can also engage in swap transactions for the purchase and sale of foreign currency if the first part of the transaction involves the bank purchasing foreign currency from the client. To ensure that such transactions are not used to circumvent the current currency restrictions, the NBU is clarifying the conditions for companies to purchase foreign currency.

Thus, starting from 21 February 2024, when purchasing foreign currency by businesses, banks take into account not only the **funds in foreign currency placed on the client's** current and deposit accounts, but also **information on the client's outstanding foreign exchange transactions** with banks on swap terms, under which the first part of the transaction (the sale of foreign currency by the client to the bank) was carried out.

To this end, on the date of purchase of foreign currency, legal entities will have to provide the bank with information on the foreign currency sold by them under the first part of foreign exchange transactions on swap terms (currency, transaction term) under outstanding agreements with banks. This information will be provided additionally, along with information on available funds in foreign currency on current and deposit accounts.

Currently, banks may complete currency supervision of residents' compliance with the deadlines for settlements under export transactions after crediting the resident's current account with a bank with funds received from a non-resident for goods, if these funds were transferred from abroad. In order to encourage the return of foreign currency earnings from the export of goods to Ukraine, the NBU is clarifying the specifics of currency supervision by banks.

Starting from **21 February 2024**, banks will be able to complete **currency supervision** of the relevant transactions **only if the funds** from a non-resident are received in **foreign currency.** That said, transfers in UAH will not be grounds for termination of currency supervision by the bank.[9]

[9] NBU clarifies a number of currency restrictions
https://bank.gov.ua/ua/news/all/natsionalniy-bank-utochniv-nizku-valyutnih-obmejen

4. Changes in customs payments are caused by a number of factor,

such as changes in tariff policy, trade agreements, and changes in foreign trade volumes, but the undervalued exchange rate results in significantly lower payments. This affects the balance of the payment system and the country's foreign economic performance.

Based on the results of customs clearance of foreign economic transactions with goods carried out by Ukrainian businesses and citizens, **in February 2024**, the customs authorities **transferred UAH 39.8 billion** of customs and other payments to the state budget, which are controlled by the State Customs Service of Ukraine.

In comparison **to February 2023** revenues *(Figure 6)*, the amount of taxes transferred to the state treasury from the taxation of foreign economic activity i**ncreased by UAH 6.4 billion**. In total, since the **beginning of 2024, more than UAH 87.1 billion of customs payments have been transferred to the state treasury**.

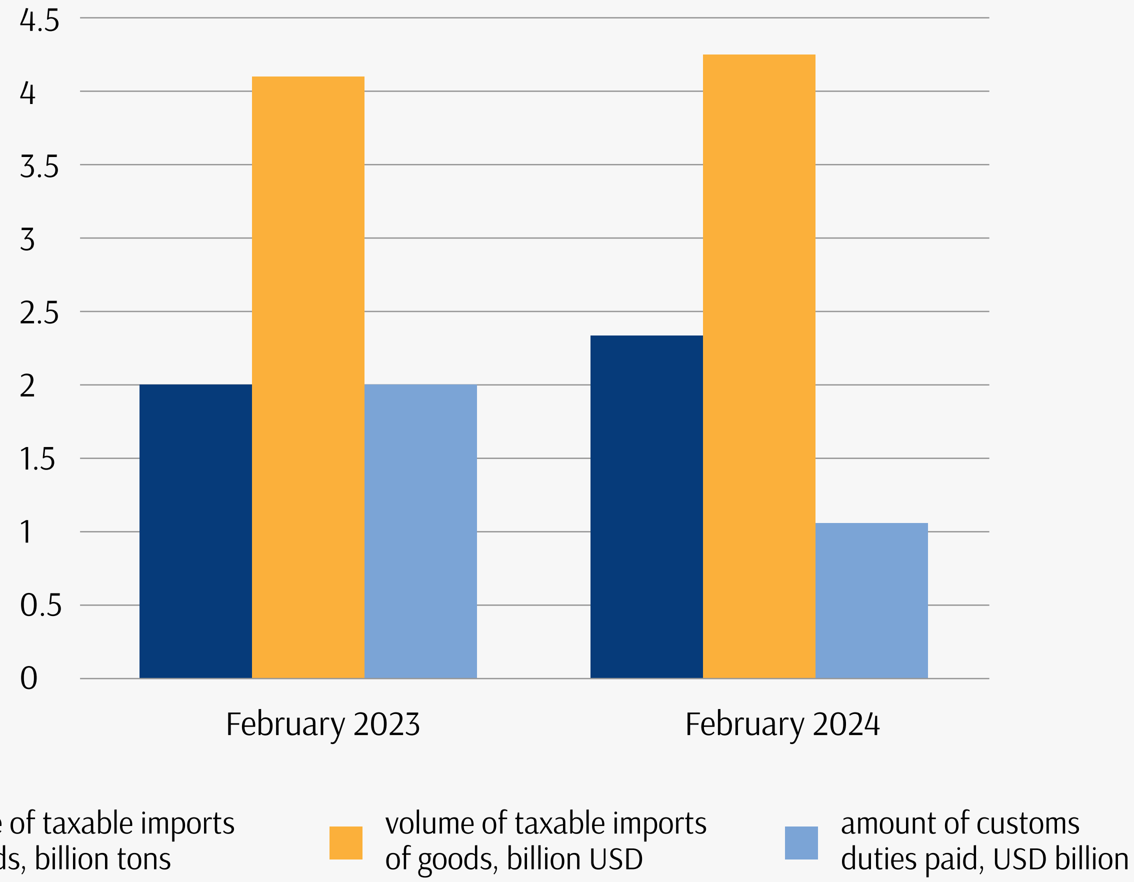

Figure 6 *Dynamics of taxable imports of goods and customs duties paid in February 2023–2024.*[10]

[10] Customs revenues to the State Treasury in 2024 show significant growth https://customs.gov.ua/news/zagalne-20/post/nadkhodzhennia-mitnikh-platezhiv-do-derzhbiudzhetu-v-2024-rotsi-demonstruiut-suttieve-zrostannia-1513

Among the main **budget-forming goods**, a significant increase in **customs revenues in February 2024**, compared to February 2023, **was recorded for imports of:**[1]

OIL PRODUCTS
(gasoline, diesel fuel)
3 635 mln UAH

PASSENGER CARS
1 381 mln UAH

COAL
339 mln UAH

TRUCKS
218 mln UAH

MEDICINAL PRODUCTS
192 млн грн

FERTILIZERS
with 2–3 nutrients N, P, K
142 mln UAH

FERROALLOYS
120 mln UAH

CONSOLES, PANELS, AND SWITCHBOARDS
110 mln UAH

COKE AND SEMI-COKE;
retort coal
109 mln UAH

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[11] Customs revenues to the State Treasury in 2024 show significant growth
https://customs.gov.ua/news/zagalne-20/post/nadkhodzhennia-mitnikh-platezhiv-do-derzhbiudzhetu-v-2024-rotsi-demonstruiut-suttieve-zrostannia-1513

Overall, the NBU's high discount rate and other policy measures could have a complex impact on Ukraine's financial stability and economic development, including overpayments and other financial burdens on the government and businesses. A high discount rate serves as a tool to curb inflation and stabilize the financial market, although it can also burden the business environment through high interest rates on loans. The NBU's current monetary and financial policies require careful analysis and possible adjustments to ensure a balance between containing inflation, supporting economic development, and promoting financial stability. It is necessary to consider alternative mechanisms and optimization methods that might ensure the efficiency and sustainability of Ukraine's economy in this difficult global situation.

One alternative might be to cut the NBU's discount rate, which would help lower interest rates on loans to businesses and consumers. This can stimulate greater demand for loans, promoting business development and economic growth. The NBU may consider introducing more flexible monetary policy tools, such as targeting the money supply or using other instruments to stimulate lending and investment. Initiating additional financial programmes or support instruments for enterprises that were more attractive and effective. In addition, it is important to consider opportunities to cooperate with international financial organizations and develop international partnerships to attract investment and support economic development. Consideration of these alternative mechanisms and their implementation could help balance the NBU's policy and contribute to the stability and development of the Ukrainian economy.