SECTION 12. MICRO AND MACRO ECONOMY

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12.1 Macroeconomic policy of Ukraine in the conditions of war

The Ukrainian economy suffered greatly as a result of Russian aggression. Even in the third month of the war, there are no official estimates of the impact of military actions on industry, retail trade, agriculture, etc. in the public domain. The war with Russia is turning into a protracted struggle of attrition. And in order to win this war, it is critically important for us to hold the economic front – not only today, but for as long as the Armed Forces of Ukraine will need to expel the enemy from our land.

The aggressor's blitzkrieg was unsuccessful - albeit with significant losses, but Ukraine repulsed the enemy with dignity both on the battlefield and on the financial front. In the first months of the war, the actions of the authorities were aimed at preventing the economy from falling into the abyss. And despite all the challenges of the war, we successfully passed this stage.

However, the war is dragging on, and this makes it necessary to reformat the priorities of the state's economic policy for a long game. In practice, this means the optimal distribution of available resources to support the defense capability of the country and population, as well as creating conditions for the generation of these resources by business.

The main tool in this exercise is the country's fiscal policy and budget.

Since the beginning of the full-scale war, the budget deficit has logically expanded significantly and, according to the results of the year, may reach 25% of GDP (if international grants are deducted from budget revenues). Over the past 20 years, a higher level of deficit was observed in the world only a few times - in Iraq in 2004, in Eritrea for several years in a row, in Ireland in 2010, in Libya in 2014-16, in Venezuela in 2018. Deficits of this scale cannot be financed in a normal way and they are evidence of extraordinary problems of state finances and miscalculations in economic policy.

In Ukraine, after years of balanced fiscal policy, reforms in the monetary and financial sphere, such a huge deficit is a consequence of the war and its impact both on the drop in budget revenues and on large-scale expenditures for defense and support of the population and business. However, this does not remove the task of finding an optimal solution to this problem in order to avoid the collapse of the public finance system and to adequately finance critical expenditures to ensure the country's defense capability.

Unfortunately, despite all the efforts of the Ukrainian authorities and our partners to attract foreign military and financial resources, this international support is only enough to partially finance the budget deficit.

What to do with the rest? Is a key issue for macroeconomic policy. There are several options [624]:

Use stocks of the past. That is, accumulated international reserves.This occurs when central bank issuance to finance government needs creates additional demand for the currency through the purchase of imports or foreign currency assets, but this demand is sterilized by the central bank's sale of currency to avoid devaluation. In Ukraine, the reserves were definitely not unlimited on the eve of the war - at the beginning of the year, they were 31 billion US dollars. And in 7 months, they decreased by 8.5 billion US dollars. This source will not be enough for a long time, in addition, it is always necessary to have an intact supply of reserves in case of worst-case scenarios. Even more, a rapid decrease in reserves will lead to additional demand for currency and accelerate a full-fledged balance of payments crisis.

Borrow from the future. That is, due to involvement in the domestic market. For this, it is necessary to increase the rates for DSLB, which will shift the burden of financing the budget deficit to the post-war times.

Transparently redistribute the resources that the economy is currently able to generate to the most priority areas. That is, to reduce the budget deficit in a controlled manner by reducing non-priority expenditures and raising taxes, which will have the least negative effect on the recovery of economic activity and, accordingly, the ability of the economy to generate resources in the future [625].

To continue the emission and at the same time to rob citizens due to the devaluation of their savings and income in hryvnia. That is, due to the emission of money by the National Bank, which leads to the devaluation of the hryvnia due to devaluation and inflation. For a while, this can be resisted by spending reserves (see option 1), but not for long.

At first glance, the latter method seems to be the easiest solution, at least in the short term from the point of view of its perception by society. After all, emission financing by the central bank imposes a hidden "inflation tax" on society, which may even allow reducing the budget deficit to acceptable levels if budget expenditures are "frozen" and nominal incomes increase due to inflation.

However, this option has a number of very negative, even catastrophic long-term effects:

- *First, inflation is persistent*. There are a number of theories that explain the persistence of inflation - from the impact of the increase in the cost of some goods on the cost of others to the importance of inflationary expectations, which in themselves can fuel inflationary processes. If expectations are raised, then in order to stop them, very tough measures must be taken, which will cause even more damage to the economy and can significantly slow down economic recovery, or worse, deepen and prolong recessionary processes.
- *Secondly*, inflation deepens social injustice, because it primarily affects the least well-off sections of the population. Owners of assets (real estate, currency) suffer less from inflation because the value of these assets also increases. And the recipients of pensions and salaries are in a losing position, because the payments are fixed. After all, for the same money, you can buy fewer goods and services.
- *Third*, inflation can easily lead to a vicious circle of rising nominal social standards, devaluation and a new wave of inflation.As a result, the so-called spiral of inflation-devaluation-salaries is formed, which was very typical for Latin American countries before, and led to permanent financial crises. By the way, the breaking of this vicious circle in countries such as Chile, Colombia, Brazil, and Mexico became a significant impetus for a significant improvement in macroeconomic management and

rapid economic growth. Why should we repeat the negative experience and not use the correct recipes for macroeconomic stabilization before the onset of the crisis?

Such a vicious circle can easily be the result of politicians trying to overcome the negative effects of inflation on the population by raising social standards. As a result, in order to pay indexed salaries and pensions, more emission will be required. Therefore, payments will depreciate even faster than they will be increased. And this is the loss of social stability, the second front inside the warring country.

- *Fourth,* the loss of confidence in the national currency, the restoration of which will take years, or even decades, and only under the conditions of normalization of economic policy. Under conditions of high inflation, money first loses its function as a means of savings (saved in currency), then its function as a means of measuring value (prices are set in more stable conventional units, currency, etc.). At the last stage, money no longer functions as a means of exchange. Markets and shops begin to accept foreign currency or switch to barter. Normal redistribution of resources becomes impossible - the economy declines.
- *Fifth*, the collapse of financial stability and loss of control over economic processes. The banking system steadfastly withstood the challenges of the first months of the war. However, significant devaluation, outflow of liquidity, loss of confidence are inevitable attributes of issuance in significant volumes. When the economy turns to barter or foreign currency and, to a large extent, to the shadow, the state generally loses the leverage to accumulate and redistribute resources, because control over the financial system is lost. Which, accordingly, will no longer be able to be a support for victory in the war.Therefore, the general conclusion is that macroeconomic correction due to inflation can only be on a very limited scale. After all, the reverse option will lead to a drop in the incomes of broad sections of the population below the poverty threshold, destabilization of the financial system, and eventually - to the loss of the country's defense capability.

We must clearly realize that even the current 22,2 % consumer inflation per year is a significant reduction, almost by 1/4, of the real disposable income of citizens. At the same time, in order to prevent a greater loss of income due to inflation, we were forced to spend a significant part of our reserves and significantly increase the interest rate.

Our basic (programmatic) macroeconomic scenario predicts that inflation will exceed 30 % this year, next year it will be around 20 %, and only in 2024 it will decrease to a single-digit level. That is, in these 3 years, the purchasing power of the hryvnia will decrease by almost half.

And even to implement such a scenario, we still need to make a lot of effort (otherwise the results can be much worse). It provides for the following emission schedule: the National Bank will buy up to UAH 30 billion per month by the end of this year, which corresponds to the total amount of UAH 400 billion agreed with the government, in 2023 the volume of the issue will be halved, and in 2024 it will stop in general [626].

And for this, decisive measures to reduce the budget deficit are needed. No matter how unpopular they may seem, their conscious and controlled application is the most effective option for adapting the economy to a war of attrition and providing the basis for victory.Therefore, the authorities need to take responsibility and make unpopular decisions, honestly explaining to society the need for appropriate steps.

And it is very important not to procrastinate with this, because the greater imbalances accumulate, the more difficult and painful future decisions will be.

Of course, ideally, the necessary, albeit painful and difficult, steps should be taken in advance - before the situation turns from threatening to a full-fledged crisis scenario.

We do not outline specific recommendations here. We have repeatedly voiced our position regarding possible steps in our previous publications. However, we realize that the Ministry of Finance, the Government in general, the Parliament have much more expertise in finding optimal ways to manage the reduction of the budget deficit.

Buffers accumulated in the past (international reserves) and resource mobilization of post-war generations can help mitigate the financial burden of these steps for the current generation. The first resource is limited, and a significant part of it has already been used.

In the case of the second resource source, we are talking about attracting financing through the placement of DSLB on market terms. We understand that this will increase the government's expenditure on servicing the national debt in the long run. In addition, this path will somewhat narrow the possibilities for recovery, because more taxes paid by Ukrainians and budget revenues from other sources will have to be directed not to post-war recovery, but to debt payments.

But:

a) this process can be controlled and the yield curve can be built so as not to create debt peaks, to equalize the debt burden on future generations;

b) bond buyers in the future will have more resources that they can use for investments or consumption;

c) another way will be much worse.In addition, the issue is not a salvation for the government, because when the NBU buys DSLB, the government pays interest on them.

If we do not raise rates now and do not attract more in the market, then the negative effects of emission financing and inflation described above will be significantly higher. If the country plunges into the chaos of uncontrolled emission, devaluation and inflation, collapse of the financial system, loss of defense capability, then future generations will have to pull the country out of this abyss much more difficult and longer.

Moreover, it is not only about strengthening the «monetary transmission», i.e. increasing the effects of the increase in the NBU discount rate on the yield of government securities, which was an almost automatic process in the pre-war period. Currently, the increase in rates for DSLB is an opportunity for people to protect their savings and income in hryvnia from rapid depreciation, to avoid poverty.

Therefore, the mechanism of internal debt raising should be significantly strengthened, although it should also be controlled. However, even if the servicing cost of hryvnia government bonds approaches the current level of the discount rate, it will still remain below the expected average growth rate of nominal GDP over the next two years. And therefore, from this side, the threats to debt stability due to the development of the «financial pyramid» (or "Ponzi game" in macroeconomic terms) are minimal. On the other hand, taking into account the fact that the share of state and guaranteed debt in foreign currency exceeds 60 %, the uncontrolled devaluation of the hryvnia is a much greater threat to debt sustainability.

It would seem that the conclusion regarding the need to significantly limit emission financing and the inflationary tax on society (due to a controlled reduction of the budget deficit and an increase in its market financing) is obvious. Why do countries so often fall into the trap of hyperinflation? Let's recall the examples of interwar Germany, Hungary, Serbia, Croatia, Israel, Venezuela, other Latin American countries and Ukraine itself in the 90s.

The answer lies in the formal division of powers between the government, which is responsible for implementing the state budget, and the central bank.

In Ukraine, as in many other countries, responsibility for the stability of the national currency, i.e. inflation, is legally assigned to the central bank. But the instrument of influencing it is in the hands of the government. After all, it is the government that determines the level of the budget deficit and the sources of its coverage by its decisions.In the conditions of war, the NBU is forced to cover the gap in the government's financial needs with its emission, essentially being "hostage" to the effects of the war on the budget and the reaction of the fiscal authorities.

Currently, emissions are ventilators for the seriously ill patient that is our economy. Not to finance the budget deficit - to face the collapse of public finances, when spending on defense, social support and pensions will stop.

I dream of the patient recovering and being able to breathe on his full chest without artificial support. This will not happen by itself, decisive steps are needed to improve our budgetary and monetary sphere.

Now the NBU agrees to use this «artificial respiration apparatus» – temporary and limited emission financing.

At the same time, at a certain stage, the negative effects of monetization begin to threaten the stability of money, defense capability, and monetary sovereignty of the country. Moreover, if such support is used for too long or in too significant amounts, addiction occurs, and the patient (country) can no longer do without artificial ventilation and loses the ability to breathe independently (that is, manage the budget in a controlled manner without emission support). Despite the unpopularity of such complex decisions, it is now more important than ever that the government takes political responsibility and finds opportunities to reduce the budget deficit and minimize emission financing of the deficit. Only unification, common understanding of the necessary, albeit difficult steps, cohesion and joint responsibility of all branches of government in the face of an external enemy can ensure our victory on this front.

On June 1, 2022, the CASE Ukraine Center for Socio-Economic Research held a discussion on the topic «Macroeconomic situation in the conditions of war: what are the prospects?». It was attended by Olena Bilan, Chief Economist of Dragon Capital, and Oleksandr Parashchii, Head of Analytical Department of Concorde Capital, moderated by Executive Director of CASE Ukraine, Dmytro Boyarchuk [627].

Main theses:

✓ The fall in GDP is now estimated at -35%, exports have fallen critically from 13 million tons since the beginning of the invasion to 2 million tons today.

✓ According to UN statistics, 6.8 million people left Ukraine, 2.2 million people returned, 4.6 million people (10% of the population) emigrated, consumption potential decreased by at least 12–15%.

✓ The National Bank imposes restrictions on the interbank market, the less regulated retail market. The exchange rate is at a fixed level, the general economic policy is aimed at preserving macroeconomic stability and preventing the exchange rate from rising to the level of UAH 40/$.

✓ The structure of the balance of payments has changed, trade credits show -4.5 billion dollars. USA, more than the export of all goods in 2 months.

✓ Risks of danger caused the emigration of capital. Ukrainian businessmen are trying to geographically diversify their businesses abroad. Recovery for business is the most pressing issue.

✓ International partners are ready to provide more than 30 billion dollars. USA for additional military expenses, humanitarian support, payment of salaries and pensions.

✓ It is important to create investment pools ready to invest in Ukraine without high profits, but with the possibility of new or vacated niches.The country has a unique chance not just to reproduce the old, but to modernize, transform the economy, make it more efficient and productive.

The government roughly outlined the consequences of the invasion at the level of a 30-50% drop in GDP. Is it possible to assess the situation more accurately today?

Estimates are very difficult to make without access to classified data. The State Statistics Service currently does not publish any statistics, except for price and foreign trade statistics. All these indicators now suggest that the economy is not recovering from the initial shock. According to the estimates of the National Bank, at the beginning of the war, the economy shrank by 50%, that is, we lost half of our production. However, later recovery began, the fall in GDP decreased, in March it was -45%, in April -40%, in May we can talk about -35%. Now the main question is what will happen next, whether we will be able to grow and recover, even if military operations and the threat of air attacks continue. The Ukrainian economy has a sufficiently large margin of safety, the recovery will continue. The opportunity to export is critical for Ukraine. If before the war they exported up to 13 million tons per month, now it is about 2 million tons. Perhaps we will be able to expand the capacity to 5-6-7 million tons, but this will still be half of the pre-war volume. This significantly affects the economy and the possibility of resuming production.

Experts suggest several policy measures to address these challenges [628]:

1) fixing the exchange rate was the right thing to do at the beginning of the war, when the economy was hit particularly hard and it was critical to control expectations to avoid panic. However, with each subsequent day of the war, the exchange rate moves away from economic realities, which accumulates imbalances.

2) the Ministry of Finance should work to generate more revenue and control spending. Yes, the restoration of customs duties and VAT on imports was an obvious step.

3) although few people like currency restrictions, in a critical situation their use can be justified. Indeed, since the role of prices in the allocation of resources is limited in times of war, quantitative restrictions can be used to direct resources to basic needs.

4) the government should redouble its efforts to attract more resources on a bilateral basis.

In general, it must be remembered that in a war of attrition, the economic front is critical to victories on the battlefield. Macroeconomic stability is an essential condition for the economy.