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MONETARY POLICY DURING THE WAR AND POST-WAR PERIODS: FOREIGN EXPERIENCE AND UKRAINIAN PRACTICE
МОНЕТАРНА ПОЛІТИКА У ВОЄННИЙ ТА ПОВОЄННИЙ ПЕРІОДИ: ЗАРУБІЖНИЙ ДОСВІД ТА УКРАЇНСЬКА ПРАКТИКА

Summary. *The article is devoted to the study of the monetary policy experiences of other countries that have undergone military conflicts during the active phase of the war and post-war periods, consider current steps of the National Bank of Ukraine (NBU), and to provide recommendations to the NBU on the effectiveness of decisions and actions in the monetary policy domain. Firstly, we studied the examples of foreign countries that had faced armed conflicts in the past. It was discovered that during wartime, monetary policy objectives shift to address the unique challenges of a military economy, where government spending increases, and the state plays a larger role. Historical examples from World War II demonstrate how central banks employed monetary policy tools, such as purchasing government securities and imposing credit controls, to manage war-related economic challenges. Examples from Israel and Croatia illustrate that many countries have successfully recovered from wartime crises through independent monetary policy, fiscal consolidation, and market financing.*

The current monetary policy in Ukraine was considered. To combat inflation and protect hryvnia assets, the NBU implemented an active interest rate policy, raised required reserve ratios for banks, and kept a high key policy rate of 25%. Although inflation has been stabilizing, and NBU started to decrease key policy rate starting from July 2023, there are still potential risks. As for October 27, 2023, the key policy rate was set at 16%. At the same time, the expected trajectory of inflation limit the scope for softening the interest rate policy next year. It was determined that under these conditions, the trust of households and businesses in the NBU and the regulator's constant communication with society *are extremely important. Collaboration with media, educational institutions, and banks, as well as developing their application, can further enhance communication and financial literacy efforts.*

***Key words:** monetary policy, NBU, official exchange rate, key policy rate, inflation targeting, monetary instruments.*

***Анотація.** Статтю присвячено вивченню досвіду монетарної політики інших країн, які пережили військові конфлікти в активну фазу війни та післявоєнний період, розгляду поточних кроків Національного банку України та наданню подальших рекомендацій. Так, було досліджено приклади зарубіжних країн, які в минулому стикалися зі збройними конфліктами. Було виявлено, що під час війни цілі монетарної політики змінюються для вирішення актуальних проблем військової економіки, де державні витрати збільшуються, а державне регулювання відіграє вирішальну роль. Історичні приклади Другої світової війни демонструють, як центральні банки використовували монетарні інструменти, такі як купівля державних цінних паперів і запровадження кредитного контролю, щоб впоратися з економічними проблемами, пов'язаними з війною. Приклади з Ізраїлю та Хорватії показують, що багато країн успішно вийшли з воєнних криз завдяки незалежній монетарній політиці, фіскальній консолідації та ринковому фінансуванню.*

Розглянуто поточну монетарну політику в Україні. Для боротьби з інфляцією та захисту гривневих активів НБУ проводив активну процентну політику, підвищував нормативи обов'язкових резервів для банків і підтримував високу облікову ставку на рівні 25%. Визначено, що хоча інфляція стабілізувалася, а НБУ почав знижувати облікову ставку з липня 2023 року, все ще існують потенційні ризики. Станом на 27 жовтня 2023 року облікова ставка встановлена на рівні 16%. Водночас очікувана траєкторія інфляції обмежує можливості для пом'якшення процентної *політики наступного року. Обґрунтовано, що за цих умов надзвичайно важливою є довіра населення та бізнесу до НБУ та постійна комунікація регулятора із суспільством. Співпраця із засобами масової інформації, освітніми установами та банками, а також розробка їхніх програм може ще більше посилити комунікаційну та фінансову грамотність.*

Ключові слова: *монетарна політика, НБУ, офіційний обмінний курс, облікова ставка, таргетування інфляції, монетарні інструменти.*

Statement of the problem. Numerous countries have the objective of preserving the value of their national currencies by maintaining low and stable inflation rates over the medium term, and the National bank of Ukraine (NBU) shares this aim. The negative consequences of inflationary pressure include reduced income and savings for economic agents, higher production costs, increased loan costs, and servicing expenses, among others. As a response, the NBU introduced de facto inflation targeting in 2016 to ensure the stability of the monetary unit. The monetary policy has been gradually reducing inflation rates to achieve the medium-term inflation target of 5% with a permissible deviation of 1%. The Russian invasion of Ukraine had a significant impact on the country's monetary policy framework. Firstly, the exchange rate of the Ukrainian hryvnia to the US dollar was fixed, and the most effective tools for maintaining macro-financial stability became Foreign exchange (FX) interventions and capital controls [8]. During the initial months of the full-scale war, market-based monetary instruments lost their significance in the functioning of the money and foreign exchange markets due to the strong psychological shock. Consequently, the policy rate became a complementary tool, and the inflation-targeting regime underwent significant modifications.

Formulation of the purpose. The research aims to analyze the monetary policy experiences of other countries that have undergone military conflicts during the active phase of the war and post-war periods, and to consider current steps of the National Bank of Ukraine.

Research results. During a crisis, the objectives of a monetary policy shift to address the unique challenges presented by a military economy. In such an economy, government expenditure rises, and the state's role in the economy becomes more prominent. Furthermore, economic decisions are dominated by security concerns, and the economic multiplier effect is limited due to the destruction caused by war [4].

If we look at the Federal Reserve System of the U.S. when World War II outbroke, the challenges for dealing with a considerable surge in the federal deficit due to increased war expenditures occurred even though the Treasury depended more on taxes than it did during World War I and even with the rise in tax revenue due to the significant growth in industrial production [11].

To promote stable financial markets and reduce interest rates on financing large deficits, the FRS controlled government bond prices and established a maximum yield. The FRS`s commitment to maintaining low yields resulted in the purchase of a significant volume of government securities, producing a substantial expansion of the Federal Reserve System's balance sheet and the monetary base (by 149% from August 1939 to August 1948). Moreover, the outbreak of war in Europe led to an acceleration of gold inflows as Britain and other allies paid for domestically produced war materials and supplies by shipping gold to the United States [12]. This, along with another contributing factor, resulted in a strong expansion of the monetary base and the money supply. As a result, inflation rose significantly during the war despite price and wage controls, and consumer credit controls were imposed to curb inflation.

For many years, reserve requirements were an important part of US monetary policy, but since the Treasury-Federal Reserve accord, more emphasis was placed on open market operations. Selective credit controls, except on stock exchange securities, were not a permanent part of monetary control. However, the

US did not face the same reconstruction or payment difficulties as other countries, and its simple monetary policy techniques combined with budget surpluses facilitated steady economic growth and high employment. Although there had been no direct controls for most postwar years, the US experienced moderate price increases compared to other countries [10].

If we look deeper into the foreign experience of countries who took part in World War II, Belgium was one of those that the fastest returned to economic liberalism by using monetary policy, which was consistent with the country's prevalent liberal philosophy. Belgium undertook a monetary purge in October 1944 to reduce the money supply by blocking part of the currency and bank deposits. Besides, the banking system's liquidity was attacked to avoid excessive expansion of bank credit. Banks were required to keep 50 to 65% of their demand deposits as cash or government securities, and this provision has remained in force with minor modifications. The use of the discount rate technique began in January 1945 when the rate was lowered from 2 to 1.5% to promote the revival of production and the replenishment of stocks. The rate was gradually raised as the economy recovered and lowered during an economic recession in 1949 [10]. The central bank also set up a system of certified bank acceptances for imports and exports, which had been developed considerably and become the basis for charging different discount rates for different types of bank paper.

Analyzing the Netherlands and its experience with monetary policy after World War II, the country faced latent inflation with a money supply four times larger than in 1938, and wholesale prices 80% higher than prewar levels in May 1945. The government tried to tackle the problem in September 1945 by withdrawing and blocking all currency and deposit money. The idea was to gradually deblock old accounts to provide means of payments for current contributions to production. However, the deblocking of old money and assets together with the creation of new money led to the re-emergence of latent inflation in the early postwar years. Control over bank credit was exercised, with banks not allowed to give credit to anyone still holding blocked accounts. The discount rate remained at the 1941 level of 2,5%, and banks were not subject to reserve requirements. The mainstay of credit control was direct quantitative control. By 1949, the ratio of the money supply to national income had been restored to the 1938 level, and the excess money supply had been worked off with the help of rising prices and import surpluses [10].

Looking back at Germany after World War II, Germany demonstrated economic achievements since the currency reform of 1948, attributing them to a combination of monetary policy and generous U.S. assistance. Employment in industries has increased by over 20% and industrial production has more than doubled since then, while real wages have increased along with productivity. Germany achieved a small balance of payments surplus and a commanding cumulative surplus with EPU by 1952. Despite a remaining unemployment rate of 1.1 million people, the country's progress should be judged against the backdrop of a rise in employment and real wages and the influx of millions of refugees from Eastern Germany.

France pursued an active monetary policy since World War II but faced unique economic challenges including persistent budget deficits, political instability, and social tensions. To combat inflation, France implemented an elaborate system of quantitative and qualitative controls over credit. However, as inflationary pressures continue to be generated, massive wage and price increases become inevitable. French monetary policy was characterized by periodic attempts to patch up loopholes in existing credit controls while acknowledging the need to raise the lid on credit in response to inflation [10].

After World War II the United Kingdom's monetary policy changes represent a more complete return to monetary orthodoxy compared to other countries. The new monetary policy relied on controlling bank liquidity to restrict the availability of bank credit, without using statutory reserve requirements or keeping interest rates low. The fear of increasing the cost of government debt had been set aside for a flexible monetary policy. Besides, short-term government paper interest rates increased to encourage banks to hold short-term government investments. Qualitative credit controls were used along with indirect pressure on banks during refinancing operations.

It is common and effective to peg the exchange rate at the start of military activities to stabilize macro-financial conditions. For instance, in 2008, the Georgian central bank stabilized the foreign exchange market by fixing the lari to the USD during the summer and autumn months. However, to achieve this, they had to devalue the domestic currency by 16% and stabilize the exchange rate at a new level through foreign exchange market intervention [6]. Similarly, Israel used various forms of pegging the shekel with varying degrees of success since 1985 but only introduced a floating exchange rate in June 2005 [9]. However, keeping the exchange rate fixed for an extended period can result in accumulating macroeconomic imbalances, as the effect of stabilizing the exchange rate diminishes over time. This fact is exemplified by the negative experiences of Libya (2016-2020) and Lebanon (in 2020) [1]. It is also worth noting that foreign exchange crises can occur even in peacetime if the exchange rate remains fixed for too long, as was the case in Chile, Mexico, and Thailand.

It is important to consider the link between war financing and monetary policy. War can be financed through various means, including tax increases, borrowing from domestic and foreign markets, receiving financial aid from other countries, and borrowing from the banking system. However, when central banks finance a large portion of the budget deficit, it often results in hyperinflation, high levels of dollarization, and, in some cases, the loss of monetary sovereignty. This was demonstrated after the First World War in countries such as Germany (where inflation reached 29,500% month-over-month in October 1923), Austria (which experienced 129% month-over-month inflation in August 1922), Poland (with 275% month-over-month inflation in October 1923), and others. Similar experiences occurred after the Second World War in Japan, Hungary, and again in Germany and Austria. South Korea also experienced high inflation during the Korean War (213% year-over-year in 1951), and Israel experienced a surge in inflation after the Lebanon War (480% year-over-year in November 1984) [3].

To recover from wartime crises, many countries have found success in abandoning monetization and adopting a more independent monetary policy, fiscal consolidation, and market financing. Two examples of successful programs were implemented in Israel and Croatia. Israel's program, for instance, significantly reduced annual inflation from 480% to 18% in the mid-1980s through a combination of fiscal consolidation (such as subsidies reduction, new tax introduction, and limiting civil servants), tight monetary policy, and structural reforms [2]. Similarly, Croatia introduced a comparable program in 1993 after annual inflation surpassed 1000%, implementing measures such as tight monetary policy, fiscal adjustments (such as increasing tax revenue and reducing state budget expenditures), and structural reforms (such as accelerating privatization and demonopolizing the economy) [7]. Both countries limited the central bank's financing of the government and, with the collaboration of the government and central bank, successfully controlled inflation and stabilized inflationary expectations.

International experience on monetary policy tools in the post-war period is considered in Table 1.

Next step is to consider the peculiarities of monetary policy during the war in the example of Ukraine. Based on the information provided above, Ukraine followed a similar path to other countries when the NBU chose to peg the exchange rate of hryvnia to USD during the onset of the invasion. This move was made by the regulator to maintain stability in economic agents' expectations and thereby ensure macro-financial stability during the war. In addition, the fixed exchange rate played a vital role in controlling inflation [8].

Table 1

The monetary policy tools of the countries in the post-war period

Country, Year	Monetary policy of Central Bank
The Unites States of America, 1946-1953	• The preferential discount rate was abolished, marking the first move towards flexible interest rates. • The discontinuation of the buying offer on Treasury bills in July 1947 led to an increase in the rates on new issues of Treasury bills and certificates, which narrowed the spread between short-term and long-term interest rates and affected the money market rates. • The legal maximum requirements for central reserve city banks were increased to avoid a situation of bank credit`s excessive expansion. This step reduced potential bank credit expansion by about 12 bln USD. • Temporary controls were imposed on consumer credits to curb speculative purchases of securities made with borrowed money.
The United Kingdom, 1945-1953	• The interest rates on short- and long-term government security rates were decreased to sell Treasury Bills held by government agencies to banks and purchase long-term securities from the public with the proceeds of the Treasury Bill sales (Ultra-cheap-money policy). • Qualitative control over bank credit was introduced, consisting mainly of instructions sent out to banks by the Bank of England regarding the priorities to be given to different uses in granting bank advances. • A substantial outflow of reserves, primarily due to the UK's balance of payments situation, occurred in 1951 amounting to $1.5 billion over six months. To stop this drain, the key policy rate was raised several times step-by-step, the peg on the Treasury Bill rate was removed, and the direct or qualitative controls were further intensified.
Germany, 1948-1953	• Change from the old Reichs mark to a new Deutsche Mark. The conversion rate of RM 10 to DM 1 was used to convert most monetary claims under the currency reform, which also declared the entire internal debt of the old Reich worthless, resulting in a reduction in the money supply and liquid assets in the economy. • The minimum reserve requirements and the key policy rate were raised to restrict bank credit in 1948 and 1950. • Imports were made harder to finance by requiring a 50% cash deposit at the central bank for import permit grants or extensions. As a result, the balance of payments position improved.

France, 1945-1953	• The discount rate was raised significantly (from 1,625% to 3,5%) together with the rate on advances against securities (from 2,75% to 4,5%). These moving-ups resulted in the cost of borrowing from banks and made government bonds more appealing. In early 1950s, the discount rate was lowered to 2,5% to ease the restrictions on loans. • The direct credit controls were initiated to give the power for the National Credit Council to grant authority to provide banks with instructions or recommendations on the types of loan they should promote or discourage. • The regulations on mandatory reserves were also updated (during 1945-1950 every month, in 1951 – on daily basis) and increased.
Israel, 1985	• The Bank of Israel increased the reserve requirements and the real discount rate to restrict the growth of deregulated banking lending. • The minimum term for dollar-indexed deposits was raised to one year. • The new central bank law was introduced, prohibiting borrowing from the BoI to finance the budget deficit. • The tradability of government bonds was improved. • The exchange rate was devaluated, partially unified for importers and exporters, and the rate was fixed to the USD at NIS 1,5 per dollar.
Croatia, 1995-2000	• The Stabilisation Programme included the establishment of nominal exchange rate targeting framework as a crucial component. • The emergence of numerous new banks due to financial liberalization and low requirements has led to intense competition for deposits, resulting in the establishment of attractive deposit rates. • To prevent appreciation, the monetary policy facilitated capital inflows by buying foreign currency. • The excess liquidity was sterilized mainly through reserve requirement, but the CNB also issued voluntary and obligatory bills in kuna with high interest rates, which succeeded in lowering money market interest rates.

Source: compiled from [1-3; 5-6; 9-12]

FX interventions have become the main monetary policy instrument in Ukraine during the war. By imposing FX restrictions and intervening in the interbank market to cover the remaining FX deficit, the NBU was able to fix the exchange rate. Also, certain restrictions were imposed on some FX transactions and capital movements. In such a way, NBU has wanted to prevent nonproductive capital outflows, thereby limiting foreign exchange demand.

At the same time, in the first several months of the full-scale invasion, the regulator decided to postpone its decisions regarding the key policy rate and left it unchanged at 10% till the beginning of June 2022, when the Board of the NBU raised the key policy rate to 25% [8].

At the beginning of the extensive Russian aggression, the NBU chose not to make any significant decisions regarding the key policy rate. The reasoning behind this decision was the immense psychological pressure caused by the full-scale invasion. As a result, altering the key policy rate was unlikely to have a positive impact on stabilizing expectations and encouraging the retention of hryvnia assets, particularly in support of the fixed exchange rate. Instead, the NBU focused its monetary policy efforts primarily on guaranteeing the uninterrupted functioning of the banking system and payments within the economy.

The situation with inflation was worsening, as it was accelerating from February to May (from 10,7% to 18% respectively) due to the disruption of production and logistics [8]. Moreover, the persistently high global energy prices exerted significant inflationary pressure on consumer inflation, both directly and indirectly, through increased production costs. Furthermore, global inflation rates also recorded high values, exceeding 8% in the United States and euro area countries, which was further fueling the rise of domestic prices. Despite the gradual economic recovery, the upward inflation trend was expected to persist in the upcoming months. This may have worsened inflation expectations, leading depositors to convert their hryvnia savings into foreign currency. To mitigate these negative effects, the NBU returned to an active interest rate policy.

The NBU's governing board has opted to maintain the key policy rate at 25% per year for ten months consequently while also raising the required reserves ratios for banks. These actions were expected to promote greater appeal for hryvnia-based assets, reinforce the stability of the exchange rate, and gradually mitigate inflationary pressures. Furthermore, the choice to maintain the key policy rate at its current level is motivated by the need to uphold exchange rate stability.

Additionally, it creates suitable circumstances for the persistent reduction of inflation and the alleviation of the most oppressive foreign exchange constraints.

As the Ukrainian economy was gradually adapting and the psychological shock of the conflict subsided, there was a need to change the approach to monetary policy. With low yields on hryvnia assets, there was an increased risk of dollarization of the economy and the financial system losing valuable resources. The depreciation expectations of households and businesses were also vulnerable to changes in the war situation, especially those on the frontline and other situational factors. To address these issues, the NBU decided to intensify its interventions to sell foreign currency. However, the difference in the cash market exchange rate and the official exchange rate widened, exacerbating the negative effects on the economy caused by multiple exchange rates and restrictions on foreign exchange transactions and cross-border transfers.

The NBU admitted that the fixation of the exchange rate at USD/UAH 29,25 had a restraining effect on the cost of goods and services and influenced inflation and exchange rate expectations. Economic agents were adapting to the war, and consumer imports recovered faster than exports due to restrictions on seaports that were till July. During that period, The U.S. dollar strengthened markedly against most currencies, including reserve currencies, and the fixed exchange rate caused more imbalance in the economy and high pressure on international reserves. As a result, the members of the Monetary Policy Committee agreed that maintaining the exchange rate at pre-war levels was unjustified and that improvements in export logistics and imports justified a policy change. However, returning to a floating exchange rate was seen as premature, so a one-time adjustment of 25% was made to fix the exchange rate at a new level of USD/UAH 36,56 per USD. This adjustment was expected to reduce demand for noncritical imports, improve the competitiveness of domestic production, and stimulate exports. External financing and the exchange rate adjustment allowed international reserves to be maintained at a sufficient level (as of May 1, 2023, Ukraine had reached its historical value of USD 35,9 billion in international reserves, covering 4,9 months of future imports), strengthening the NBU's ability to control the exchange rate and inflation trends [8].

According to the recent situation with inflation in Ukraine, it has been decreasing at a great rate than predicted for the third consecutive month (as of April 2023, the annual consumer inflation dropped to 17,9%, which was much lower than in December 2022 – 26,6%; the rates of price growth were also lower than the trajectory outlined in the NBU`s Inflation Report published in January 2023). This decline is attributed to the significant supply of food, sufficient fuel reserves, and improvements in inflation and exchange rate expectations. The latter is mainly due to the NBU's consistent monetary policy that seeks to maintain exchange rate stability and increase the appeal of hryvnia savings.

The decrease in inflation is anticipated to persist, mainly because of the reduced expense of energy resources in the worldwide market, limited internal demand, and the influence of the monetary policies implemented by the NBU. Considering the collective impact of these factors, alongside the significantly improved situation in the energy sector, the NBU has modified its inflation projection for 2023, lowering it from 18.7% to 14.8% [8].

At the same time, the notable decline in inflation every year is mainly due to the elevated reference point of the previous year, coupled with the mild winter climate that reinforced this pattern. Nevertheless, the strain on production expenses for businesses remains prominent, including the challenges of managing operations and adapting logistics networks amidst the ongoing conflict. As a result, the ongoing conflict remains a major source of uncertainty, which poses a significant risk to future inflation trends. That`s why NBU highlights the necessity to keep the key policy rate at a high value to bolster the impact of previous measures by the regulator and facilitate additional growth in the investment appeal of hryvnia savings.

In addition to it, the NBU has taken steps to strengthen the monetary transmission and increase interest rates on hryvnia deposits, including tightening reserve requirements (RR) for current accounts and demand deposits. Moreover, starting from February 11, 2023, banks can use a wider range of domestic government debt securities to cover up to 50% of their total required reserves. The NBU implemented this measure to encourage banks to actively participate in auctions held by the Ministry of Finance and help revive the domestic debt market, thereby avoiding direct funding of the budget deficit by the NBU in 2023 [8]. At the same time, these measures taken to immobilize liquidity may not be sufficient due to constant inflows of foreign exchange and government debt securities returning to the banking system. So, the question arises of what additional tools to protect hryvnia retail and corporate deposits from inflation and optimize the operational design of monetary policy to make hryvnia assets more attractive could be implemented. The members of the MPC also believe that NBU's measures to stimulate hryvnia term deposits and stabilize the FX market should create conditions for easing FX market restrictions, which adversely affect business activity.

From September 15, 2023, the National Bank decided to reduce the key policy rate from 22% to 20%. The further slowdown of inflation and the NBU's ability to ensure exchange rate stability make it possible to continue the rate reduction cycle while maintaining the sufficient attractiveness of hryvnia savings. Such a step will support the economy's recovery and, at the same time, will not create threats to macro-financial stability. Furthermore, from October 27, 2023, the key policy rate was set at 16% [8]. Moreover, the NBU sees the possibility of an additional reduction in the discount rate at the next meeting. At the same time, the expected trajectory of inflation limit the scope for softening the interest rate policy next year. A return to the cycle of lowering the key policy rate in 2024 will be possible only in the event of a significant reduction in the risks to exchange rate stability and inflationary dynamics.

Conclusions. Making any forecasts for 2024-2025 and recommendations is extremely complicated due to the high level of uncertainty associated with the war. The policy rate's expected path should be aimed at ensuring monetary conditions that will sustain exchange rate stability, improve expectations, and achieve a lasting reduction in inflation. The NBU must be ready to modify the timing and pace of policy rate changes depending on developments in the foreign exchange market, inflation dynamics, the stability of international support, and the effectiveness of measures to enhance the appeal of hryvnia instruments.

One of the most important things that the NBU should not do in the following years is the restoration of monetary financing of the budget deficit. First of all, it is a pledge made by both the government and the central bank to the IMF as part of the new credit program – EEF. Secondly, it will only resume the inflation pressure and undermine the independence of the NBU. Consequently, it is very vital to attract as many as possible international financial aid and increase the appeal of government securities among individuals and businesses. In addition to the sale of the NBU`s bonds at a rate equal to the policy rate, it is necessary to ease the process of bond purchase for citizens through online banking and popularize it as a patriotic way to support the country during the recovery period. This action could make the better attractiveness of funds in the domestic market.

An equally important factor is the communication carried out by the NBU with the economic agents at different levels. The regulator needs to pay significant attention to communication, since it is through effective communication with various target audiences, including the public, consumers of financial services, the academic community, state policy entities (which is specific to Ukraine), media, economic and financial entities, and experts (both domestically and internationally), as well as international organizations and other external partners, that the NBU can succeed.

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