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FINANCIAL AND ECONOMIC POLICY OF UKRAINE IN THE CONDITIONS OF WAR WITH RUSSIA: CURRENT PROBLEMS AND PROSPECTS FOR DEVELOPMENT

POLITYKA FINANSOWA I GOSPODARCZA UKRAINY W WARUNKACH WOJNY Z ROSJĄ: AKTUALNE PROBLEMY I PERSPEKTYWY ROZWOJU

Abstract: The article is focused on the examination of the current problems of financial and economic policy of Ukraine in the conditions of war with Russia. The authors highlight that logistical challenges related to the war continue to put strain on the economy, particularly those related to the operation of ports, transport networks and energy infrastructure. The war has also caused an imbalance in the foreign exchange market and an unprecedented increase in the budget deficit. Tax revenues were limited due to declining economic activity. The authors suggest ideas for the further development of the financial and economic policy of Ukraine. In particular, the import of luxury goods can be a good alternative to direct conversion of funds into foreign currency. It is already noticeable that there are various restrictions on the import and purchase of foreign exchange assets. These measures are already beginning to be applied, but they need to be expanded and deepened. It is also necessary to limit people's desire for savings, because in conditions of instability, savings will inevitably flow into the currency.

Zarys treści: Artykuł koncentruje się na analizie bieżących problemów polityki finansowej i gospodarczej Ukrainy w warunkach wojny z Rosją. Autorki podkreślają, że wyzwania logistyczne związane z wojną nadal obciążają gospodarkę, szczególnie te związane z funkcjonowaniem portów, sieci transportowych i infrastruktury energetycznej. Wojna zaburzyła równowagę na rynku walutowym i bezprecedensowy wzrost deficytu budżetowego. Dochody podatkowe były ograniczone z powodu malejącej aktywności gospodarczej.

Autorki proponują perspektywy dalszego rozwoju polityki finansowej i gospodarczej Ukrainy, w szczególności import towarów luksusowych może być dobrą alternatywą dla bezpośredniej konwersji środków na walutę obcą. Już teraz zauważalne jest wprowadzenie różnych ograniczeń dotyczących importu i zakupu aktywów walutowych. Środki te już zaczynają być stosowane, ale należy je rozszerzyć i pogłębić. Konieczne jest również ograniczenie chęci ludzi do oszczędzania, ponieważ w warunkach niestabilności oszczędności nieuchronnie wpłyną do waluty.

Keywords: financial and economic policy of Ukraine, war, currency exchange rate, export, import, unemployment
Słowa kluczowe: polityka finansowa i gospodarcza Ukrainy, wojna, kurs wymiany walut, eksport, import, bezrobocie

Introduction

Russia's invasion of Ukraine, which began a year ago, has led to great loss of life, mass displacement and significant damage to infrastructure. The impact on economic activity has also been huge: real GDP has fallen sharply, inflation has risen sharply, trade has been seriously disrupted and the budget deficit has risen to unprecedented levels.

Immediately after the invasion, the authorities quickly adapted monetary policy to maintain financial and exchange rate stability. More recently, in order to compensate for the significant loss of international reserves, an exchange rate devaluation was carried out, which helped to stabilize foreign exchange reserves and maintain overall macroeconomic and financial stability.

Fiscal policy focuses on priority defence spending, welfare payments, humanitarian needs and, where possible, some rebuilding of critical infrastructure.

Uncertainty about the size of funding needs remains extremely high and depends on the duration of the war and its intensity, and economic risks loom large, including related to potential additional damage to critical infrastructure or new disruptions in the agricultural and energy sectors.

More than 7 million Ukrainians, about a fifth of the population, have left the country or become internal immigrants, which puts pressure on the social protection system.

There are also problems in the labour market due to changes in the size and composition of the labour force because of the large external migration and mobilization. The number of registered unemployed people per vacancy has jumped from 6 to 12 since the beginning of the war, and research data indicates that the unemployment rate has risen to 40%. Real wages have dropped significantly.

The state budget of Ukraine

Rapid estimates show that GDP growth declined by 37.2% year-on-year in the second quarter of 2022.[1]

However, the IMF notes, along with the fact that active hostilities have moved to the eastern and southern regions, activity in non-combat zones has stabilized and the economy is adapting to the conditions of war.

However, private consumption and investment remain weak due to declining purchasing power, financial constraints and large-scale migration abroad.

The IMF still predicted that Ukraine's GDP would shrink by about 35% over the year. Inflation would reach 30% by the end of 2022.[2]

Logistical challenges related to the war continue to put strain on the economy, particularly those related to the operation of ports, transport networks and energy infrastructure[3].

The war also caused an imbalance in the foreign exchange market, but after the National Bank devalued the exchange rate peg by 25%, the pressure eased.

The war is causing an unprecedented increase in the budget deficit. Tax revenues are limited due to declining economic activity. Meanwhile, despite the reduction in secondary spending, the deficit has continued to rise, mainly due to defence spending. As a result, the budget deficit excluding external grants is estimated to have reached 13.9% of 2022 GDP at the end of August. Thanks to a significant increase in non-tax income, which is provided by external grants, the total budget deficit at the end of August was lower and amounted to about 8% of GDP.

Among the payments charged by tax and customs authorities, the main revenues were received from: value added tax on goods imported into the customs territory of Ukraine, UAH 26.8 billion; corporate income tax, UAH 23.6 billion; personal income tax and military duty, UAH 13.7 billion; value added tax on goods produced in Ukraine, UAH 12.0 billion (collected – 25.6 billion, reimbursed – 13.6 billion UAH); rent for subsoil use, 5.8 billion UAH; excise tax, 5.5 billion UAH; and import and export duty, 2.7 billion UAH (Table 1).

Table 1. The main revenues to the State Budget of Ukraine in 2022

Source of revenues	Amount, billion UAH
value added tax on goods imported into the customs territory of Ukraine	26.8
corporate income tax	23.6
personal income tax and military duty	13.7
value added tax on goods produced in Ukraine	12.0

1 https://www.weforum.org/reports/global-risks-report-2023, [accessed: 07.02.2022].
2 https://www.imf.org, [accessed: 17.02.2022].
3 Strulik, H., *Capital Tax Reform, Corporate Finance, and Economic Growth and Welfare*, "Journal of Economic Dynamics and Control" 2003, vol. 28(3), pp. 595–615.

Source of revenues	Amount, billion UAH
rent for subsoil use	5.8
excise tax	5.5
import and export duty	2.7

Source: https://index.minfin.com.ua/ua/finance/budget/gov/income.

At the same time, given that the war has become protracted, the IMF called the prospects for 2023 low-key and extremely uncertain.

The problems of the currency exchange rate

Judging by the number and radical nature of the economic changes made, we can say that at the moment the government of Ukraine is mostly struggling with two things:

1. Exchange rate growth (devaluation) of the hryvnia. At first a law was passed on critical imports (banning the import of goods except those on a permitted list) and along with this all customs duties were abolished. This law was subsequently repealed and customs duties reinstated. Serious currency restrictions were imposed. Also, to maintain the exchange rate, the National Bank of Ukraine was forced to sell almost $14 billion from reserves (this is almost 40%). However, recently it was still forced to raise the hryvnia exchange rate by 25%. The measures that indirectly put pressure on the currency exchange rate included raising the key rate to 25%. It is also now planned to introduce a 10% fee for foreign exchange transactions, i.e. for any purchase of goods from abroad.

2. Labour rights. Back in March, law 2136 was passed, which allows employment and collective bargaining agreements to be suspended due to hostilities, essentially leaving workers without pay indefinitely. This seemed little and the following draft laws were accepted:

– draft law 2352, leaving mobilized workers without salary;
– draft law 5161, which allows concluding employment contracts that do not guarantee the permanent provision of work;
– draft law 5371, which essentially abolishes the Labour Code for small and medium enterprises (fewer than 250 people).[4]

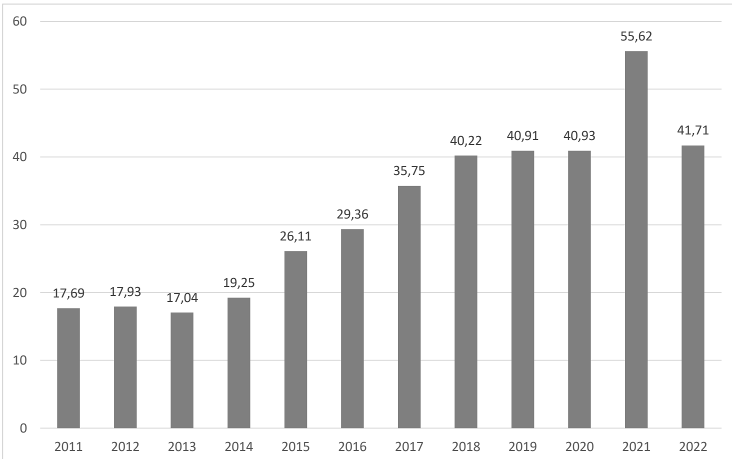
Ukraine has a huge import dependence even in its main export industries, for example, food. Therefore, the devaluation of the hryvnia itself is neither bad nor good. In a war, it is just a necessity.

Moreover, even before the Russian invasion, it was obvious that the Ukrainian currency was too overvalued. The invasion destroyed the usual logistics, blocking

[4] https://rev.org.ua/finansovo-ekonomichna-politika-ukra%D1%97ni-pid-chas-vijni, [accessed: 15.02.2022].

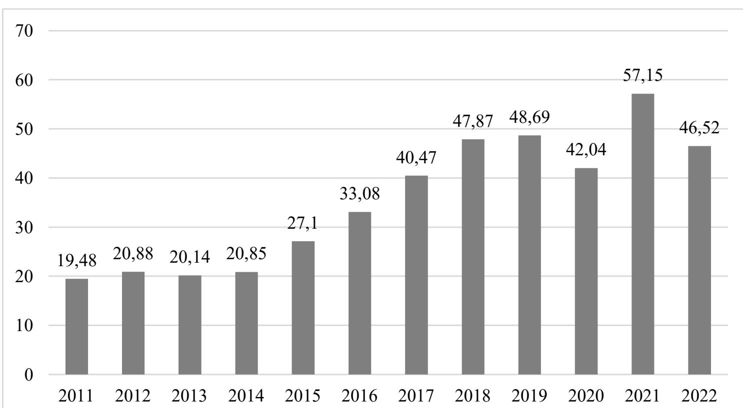
seaports, destroyed many production chains – exports fell significantly, while imports recovered very quickly. Exports of goods decreased by 35% in 2022 and imports decreased by 19.6% (Fig. 1, 2).

Fig. 1. Dynamics of changes in the export of goods from Ukraine during 2011-2022, $ billion



Source: https://www.ukrstat.gov.ua.

Fig. 2. Dynamics of changes in the import of goods into Ukraine during 2011–2022, $ billion



Source: https://www.ukrstat.gov.ua.

Devaluation makes things worse for importing enterprises as prices for all imports increase, but it creates better conditions for exporting enterprises. For the same amount of foreign currency they receive a larger amount of hryvnia, and salaries, taxes and other expenses are paid in hryvnia. Additionally, a 10% tax on the purchase of currency for imports is already being worked out, which will make the situation of all importers even worse.[5]

Businesses have, for many years, become accustomed to cheap imports and the lack of necessity to produce many important components within the country.

This behaviour is called the "entrepreneurs strike" when, in response to the inconvenient demands of society, entrepreneurs respond with public disobedience. If we do not want to further imbalance the economy of Ukraine, the deterioration of conditions for importers of consumer goods is necessary, since almost all military products are supplied from abroad and are almost impossible to import, unlike many consumer goods. Every imported consumer good bought reduces the amount of military items we could buy.[6]

If we want to steadily reduce imports we will have to move in one form or another to deploy a full import substitution which will result, in many cases, in a deterioration of the quality of the finished product, this being normal for any import substitution in the initial stages. The war is for a long time. Accordingly, we will be in a situation of foreign currency deficit for a long time. Drastically reducing imports and replacing them with domestic goods or, alternatively, changing consumer habits, is an uncontested policy for us for many years to come.

Unfortunately the correct, albeit belated, steps to reduce imports are combined in the current policy with an extremely high key rate of 25%, which will make any large-scale changes in the structure of the economy impossible.

The key rate is, in fact, the interest rate that affects bank loan interest. If the state raises the rate, credit becomes more expensive, aggregate demand and investment slows, it is more expensive for businesses to take credit for enterprise development and it is more expensive for people to take loans for purchases.

The rate increase reduces aggregate costs in the economy, which reduces demand and slows price growth. Of course, this comes at the cost of economic growth; enterprises reduce investment and people reduce purchases. Businesses either do not launch new projects and do not hire people, or even reduce employee numbers and cut back on existing projects.

Obviously, import substitution still requires a fairly large-scale investment. That is, in order to pay the loan taken for new production, it is necessary that it shows a yield of 25%, and it is unlikely that in wartime many entrepreneurs can boast of such results.

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5 Cloyne, J., Hürtgen, P., *The Macroeconomic Effects of Monetary Policy: A New Measure for the United Kingdom*, *"American Economic Journal: Macroeconomics"* 2016, vol. 8(4), pp. 75–102.

6 Le Manh Vu, Suruga Terukazu, *Foreign Direct Investment, Public Expenditure and Economic Growth: The Empirical Evidence for the Period 1970–2001*, "Applied Economics Letters" 2005, vol. 12(1), pp. 45–49.

The possibilities of economic restructuring

The need for a large-scale structural change is obvious to everyone. The official justification is the fight against inflation. The logic is the following: to reduce demand, prices for goods will also be reduced. However, two forces participate in the formation of the price, supply and demand, and therefore inflation is divided into demand inflation and supply inflation.[7]

Supply inflation is caused by supply-side constraints such as the cost of logistics, administration, raw materials and credit. Changes in demand do not directly affect this inflation.

For example, some product costs 100 units, including 10 units which were the cost of its delivery to the place of sale. If tomorrow due to some kind of shock (for example, restrictions at borders, as during COVID; blockades of ports, as now we have) the cost of delivery increases by 5 times, it will become 50 units and the price of the product will increase to 140 units. At the same time, even a drop in demand is unlikely to make the price fall as, after all, this will not make the costs less, but rather the contrary (larger lots can be profitable).

Is it possible to blame the side of demand, not supply, for rising prices? Of course, the first reaction of sellers to the increase in demand is to increase prices. But then new sellers come in, or the old ones expand production, supply catches up with demand and price growth stops. Of course, such a production rise is not rapid and then the increase in demand may chronically outpace the growth of supply. In this case, prices will not rise until they destroy most of the demand.

This mechanism allows not only the eno.ichment of sellers of scarce goods, but also prevents the appearance of a commodity deficit, replacing it with a reduction in the number of those who want to buy the goods.[8]

In what situation can demand growth definitely not be satisfied with the growth of supply in any near term, because of which inflation will grow continuously? In the most general form, this is a situation of lack of resources and production capacity. When all people are fully engaged, all production facilities are at full capacity and raw materials are used as efficiently as possible.

The current situation is not at all like this as unemployment, despite the outflow of the population, is breaking records. If a high rate does not help reduce price growth, then why is it needed? Most likely, the main reason is an attempt to reduce the demand for imported goods and foreign currency in general. The logic is simple: a high rate reduces the amount of money in the private sector. After all, if there is a lot of money, then it will inevitably be converted into currency either directly bypassing various currency restrictions or in the form of imports. All the talk about the need to return "confidence in the hryvnia" is absurd – while there is a war, no one will consider any

[7] Blasselle, A., Poissonnier, A., *The Taylor Principle Is Valid Under Wage Stickiness*, "Journal of Macroeconomics", vol. 16(2), pp. 581–596.

[8] Barakchian, S., Crowe, C., *Monetary Policy Matters: Evidence from New Shocks Data*, "Journal of Monetary Economics" 2013, vol. 60(8), pp. 950–966.

assets in hryvnia as a reliable investment. The more money people have on hand, the more they will try to convert into foreign currency.

Moreover, the import of luxury goods can be a good alternative to direct conversion of funds into foreign currency. You cannot transfer more than 200 thousand hryvnias per month to a foreign account, but you can safely buy, for example, a car worth several hundred thousand dollars and use it as an investment.

It is already noticeable that raising the rate is too indiscriminate a weapon to combat the flow of funds into the currency. More effective would be to use the point constraints. For example, various restrictions on the import and purchase of foreign exchange assets. These measures are already beginning to be applied, but they need to be expanded and deepened.

It is also necessary to limit people's desire for savings, because in conditions of instability, savings will inevitably flow into the currency. The most interesting point arises here: the tendency to save in different groups of the population is different, so a more selective approach is also needed.[9]

Instead of such continuous measures as raising the rate, it is recommended to use more selective measures, for example, to introduce progressive taxes, i.e. those in which the percentage of tax increases at higher levels of income. So that tax growth does not interfere with investments, tax deductions for investments in production should also be introduced. This system, when money is spent on investment in production, can be offset from taxes paid earlier. Such a system operates in the United States for projects in the field of renewable energy.

Raising taxes in this way will help to do the same as raising the key rate, in that they reduce the amount of money in the private sector, thereby reducing the demand for foreign currency. This measure will be selective, reducing funds from those who are more inclined to buy expensive imports and foreign currency. It would also be possible to introduce luxury taxes on expensive cars, real estate and jewellery etc.

Conclusions

In general, everything can be used as an investment to save funds from inflation. If we want to not only make rich people a little poorer, but also make poor people a little richer, we can directly influence the value of salaries by introducing, for example, community service for unemployed people.

In this case, the amount of wages will determine the minimum wage in the country. Such programmes are already planned, but the level of payment for them is extremely low, corresponding to the minimum salary of 6700 hryvnia. By increasing this threshold, the private sector could be forced to compete for an employee and, accordingly, raise salaries.

In order for such programmes to be successful, it is better to move the decision-making centre on the implementation of such work to the local level of

[9] Le Manh Vu, Suruga Terukazu, *Foreign Direct Investment...*, op. cit., pp. 45–49.

the municipality. As a result, various local initiatives, including volunteer ones, could apply for the need for labour and do useful things for society, such as weaving camouflage nets, delivering humanitarian aid and helping in refugee centres etc. As long as we have tasks that need to be completed to improve our defence capability, we cannot allow the situation of unemployment.

After these measures, it is possible to reduce the key rate and introduce additional programmes of preferential lending and financing for investments in production. Such grant and loan programmes are already being prepared, but so far, they do not exceed several billion hryvnias per year, which, of course, is very small. After that, the state should help with all the necessary resources (finances, administration, etc.) in areas that become a greater priority for us, such as import substitution of basic consumer goods and dual-use goods etc.

First, if we believe that the new reality associated with shock is with us for a long time (several years at least), then it is necessary to completely rebuild the economy:

- close one production and create new ones;
- retrain employees;
- completely change the structure of import and export;
- change the ratio of different industries, geographical location of labour and production capacities.

Obviously, such actions require the mobilization of all possible resources. After all, in such a situation we cannot afford:

- a large amount of free finances (savings) in the private sector;
- unspecified means of production;
- and even more so, unused labour.

The second option, if we believe that the external shock is temporary and everything will end soon, then our task is the opposite:

- to preserve the former structure of the economy by all forces; to do this, it is necessary to reduce investment and allow many enterprises and employees to idle to reduce costs;
- it is necessary to encourage those who try their best to preserve production as it existed, for example, by subsidizing them. Such a “subsidy” of imports can be considered a long support of the hryvnia exchange rate by NBU due to reserves in the first months of the invasion.

Of course, we will not win without Western support, and we must fully promote the need to help Ukraine at all levels. However, we ourselves are obliged to do everything possible to successfully withstand the long war of attrition. Instead of half-hearted and late steps, we need to recognize the need for changes in our economic model and start using all possible resources to rebuild it.

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Summary

Uncertainty about the amount of funding needs remains extremely high and depends on the duration of the war and its intensity, and economic risks loom large, including related to potential additional damage to critical infrastructure or new disruptions in the agricultural and energy sectors. Various local initiatives, including volunteer ones, could apply for the need for labour and do useful things for society, such as weaving camouflage nets, delivering humanitarian aid and helping in refugee centres etc. As long as we have tasks that need to be completed to improve our defence capability, we cannot allow the situation of unemployment.