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THE UKRAINIAN F 0 A ECONOMY

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Ukraine has been subject to full-scale Russian aggression since 24 February 2022, with major implications for Ukraine's economic performance and economic management. Martial law has temporarily restricted civil and political rights and allowed the government to introduce command management in the economic sphere. ese war-related prerogatives have been used only partly (for example, in the energy and transportation sectors, restricting convertibility of the hryvnia and banking transactions with foreign currency), while the dominant role of the private sector and market forces has been maintained in other respects.

As a result of war damages and territorial losses, Ukraine's real GDP contracted by about 30 percent in 2022. Ukraine also experienced severe balance-of-payments and budget tensions in the rst months of the war. Intensi cation of foreign nancial aid from the second half of 2022 helped to achieve relative macroeconomic stability in the rst half of 2023. e prospects of the Ukrainian economy depend on the length of the war, associated damages and the size of external nancial aid.

Before February 2022, Ukraine's record of economic and governance reform was mixed; the war stopped most reforms. On the other hand, obtaining European Union candidate status in June 2022 provided a new incentive to implement comprehensive governance reforms related, in particular, to the judicial system, media, national minorities, public1 (es)3.2 (ult ofPrR2cAant n)7 (a)alHu7.e (am)7-7 (i)tric157.696-45onal/T1_3 3 (T

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1 Introduction

Ukraine has been subject to full-scale Russian aggression since 24 February 2022.[1] Understandably, the focus of international public opinion and the expert community has been on military and political developments in Ukraine and around, international sanctions against the aggressor, aid to Ukraine, and prospects for post-war reconstruction (see, for example, Gorodnichenko *et al*, 2022; Boyarchuk *et al*, 2023; Aslund and Kubilius, 2023). Less attention is given to how the Ukrainian economy has been managed during the war and how it has performed.[2] The question of economic management will become increasingly critical as the conflict continues.

This paper analyses Ukraine's war economy management and performance, according to information available in June 2023. We begin with a brief description of the Ukrainian economy at the end of 2021, that is, after the termination of most of the COVID-19-related administrative restrictions in the middle of Volodymyr Zelensky's presidential term, but before the beginning of the Russian aggression (section 2). Section 3 describes the mechanism of war economy management. Section 4 analyses macroeconomic management in war conditions. Section 5 discusses economic performance in 202 and 2023. Section 6 looks at the progress of Ukraine's candidate status (see European Council, 2022). Section 7 contains policy co

Our analysis is based on International Monetary Fund official data sources and the estimates of Ukrainian and interna However, part of the 2022 data used in our analysis a example, revoking a Russia-Ukraine free trade agreement (1 January 2016) were severe blows to the Ukrainian economy and increased the security risk for investment and business activity.

The slow pace of reforms helped build powerful oligarchic groups[4] that benefited from macroeconomic imbalances, structural distortions and opaque legislation. They parasitised on numerous state-owned enterprises

3 The war economy management (2022-2023)

The Russian aggression, which started on 24 February 2022, triggered the immediate introduction of martial law by Presidential Decree No. 64/2022 for 30 days, then extended several times by the Verkhovna Rada (the Ukrainian parliament).[5]

Martial law changed how the country was managed in many essential areas. Civil and political rights were temporarily restricted, some opposition political parties considered pro-Russian were suspended, all national television channels were consolidated into one platform, and military censorship was introduced. General mobilisation was announced and men aged 18-60 were banned from leaving the country without special permission. The authorities could impose curfews, restrict movement within the country, search homes and property, control correspondence and take over private and communal property for state needs.

The establishment of martial law had repercussions on territorial administration. Territorial communities played a critical role over the first days and even weeks of the war when the operability of the central power was seriously damaged. The leaders of local communities predominantly stayed in place and started acting independently according to their situation. In this context, martial law established local military administrations subordinated to the President, which operated alongside civilian administrations and leaders at all territorial units (oblast [region], rayon [district], municipality). In May 2022, the prerogatives of local military-civilian administrations were expanded to improve the system's manageability. Although the President can appoint and dismiss heads of local military administrations, in most cases, elected leaders of local communities have been nominated for these positions.

Economic-policy priorities and management mechanisms had to be subordinated to war needs, the need to defend the country, save the population, supply the army and scale up military production. Among other prerogatives, military administrations acquired the right to use capacities and labour resources of enterprises, institutions and organisations of all forms of ownership for defence needs. The logic of the war economy led to command management and administrative restrictions in many policy areas. On the other hand, some extraordinary circumstances forced authorities to permit more flexibility and economic freedom, at least temporarily.

Before the war, the government performed some price monitoring for socially essential commodities, including some fuels. Since the start of the war, the authorities did not introduce any additional price regulation. On the contrary, after missile attacks on Ukraine's main refinery and fuel deposits triggered a fuel crisis in May-July 2022, the authorities eased price controls to incentivise traders to increase fuel imports.

However, on 24 February 2022, the National Bank of Ukraine (NBU) introduced several restrictions on foreign-exchange (FX) operations. It banned foreign cash withdrawals by individuals from accounts held in Ukrainian banks, foreign currency sale to banks, online purchase of foreign currency, loan repayments and interest payments abroad. Legal entities were allowed to spend foreign currency for critical imports, according to the list defined by the authorities. Upper limits were introduced for cashless operations from hryvnia (UAH) credit and debit cards abroad. That is, both the capital account

[5] At the end of 2018, then President Petro Poroshenko introduced martial law for 30 days in ten regions of East and South Ukraine as the reaction to the blockade of the Kerch Strait by Russia.

to Russia[10]

Figure 3: NBU Gross International Reserves, $ billions, January 2018-May 2023

Source: IMF, National Bank of Ukraine

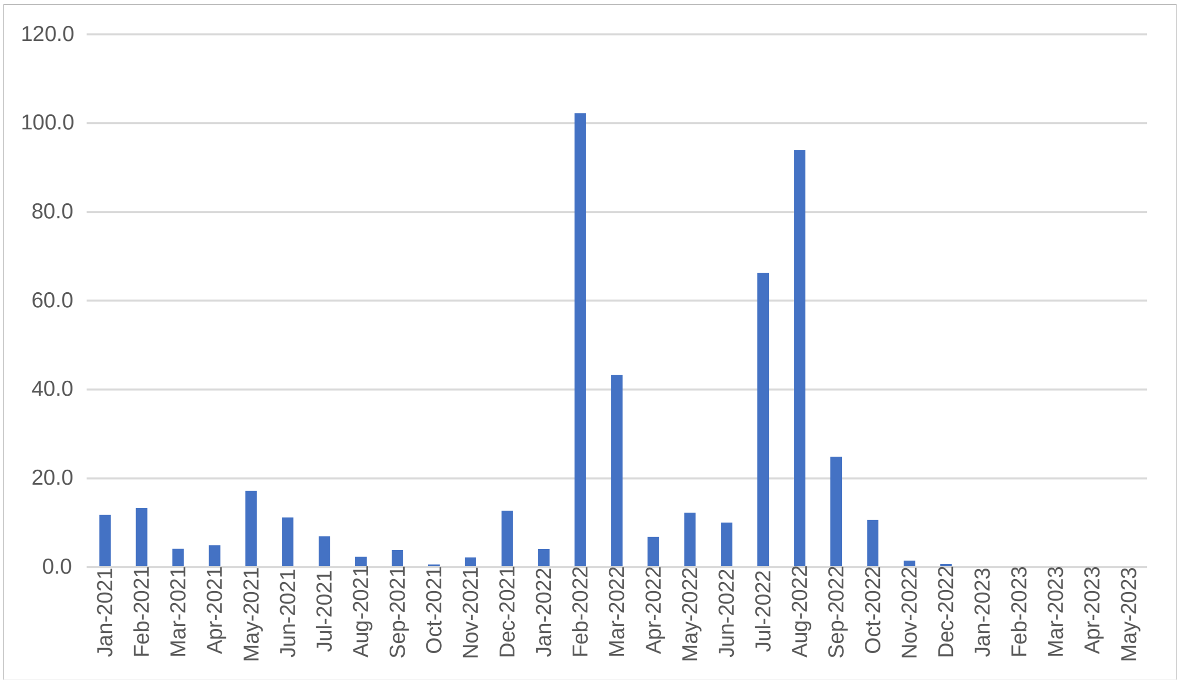
Figure 4: The NBU net FX interventions, $ millions, January 2022-May 2023

Source: National Bank of Ukraine

4.2 Monetary management

Since the beginning of the full-scale Russian invasion, the NBU has focused on maintaining the functionality of the banking system and supporting monetary stability. It provided banks with ample refinancing options to ensure the safety and liquidity of the banking system (Figure 5). In just the last three days of February 2022 banks received UAH 92.3 billion via the refinancing channel (equivalent to $3.2 billion). Then the size of this support went down, amounting to UAH 43.3 billion ($1.5 billion) in March 2022. The second wave of support came in July and August 2022. Then it went rapidly down, practically disappearing in the first five months of 2023. This was the effect of the high level of liquidity in the banking sector.

Figure 5: NBU refinancing of the banking sector, billions UAH, January 2021 – February 2023



Source: National Bank of Ukraine.

The residual balances in commercial banks' correspondent and transitory accounts at the NBU amounted to above UAH 120 billion ($4.1 billion) per day towards the end of February 2022 and the beginning of March 2022. This was well above the pre-war level of UAH 50 billion to 60 billion ($1.7 billion to $2.1 billion) daily (Figure 6).

In March 2022, the liquidity was additionally maintained by an increase in the NBU portfolio of Treasury bonds (T-bonds) by UAH 20 billion ($0.7 billion). By the end of 2022, the value of T-bonds held by the NBU had increased by UAH 394.4 billion ($12.2 billion) (Figure 7). On the other hand, NBU interventions in the FX market and the emission of the NBU deposit certificates (see subsection 4.1) reduced UAH liquidity.

Initially, on 4 March 2022, the NBU left the prime interest rate unchanged at 10 percent because of the prevailing uncertainty (Figure 8). However, excessive pressure on the FX market and abundant liquidity forced the NBU to raise the prime rate by 15 points to 25 percent starting 3 June 2022. The refinancing rate was 27 percent, while the overnight deposit certificate rate was 23 percent.

Figure 6: Liquidity of the banking system, UAH billions

By the end of 2022, foreign financial aid flows had become more regular and predictable, allowing the NBU to cease deficit financing from the beginning of 2023. Furthermore, a predictable schedule of foreign aid enabled the NBU to reduce excessive liquidity in the banking system. In January 2023, the NBU increased mandatory reserve requirements for commercial banks in two steps, effectively curbing excessive liquidity. Notably, the NBU envisaged that mandatory reserves should be held in T-bonds, thus stimulating demand for this instrument.

Fiscal deficit financed by the NBU credit and intensive FX interventions were the main factors determining the money supply in 2022. At the end of 2022, the monetary base increased by 19.6 percent and broad money (M2) by 20.8 percent, compared to the end of 2021. Table 1 shows that credit to the government was the main factor contributing to the growth of the monetary base. In contrast, NBU intervention in the FX market worked in the opposite direction (via 'Other items net').

4.3 Fiscal management

The first months of the war were dramatic for public finances. Imports almost stopped (see subsection 3.1). In the first days of the war, the finance minister announced that customs collections were only 15 percent of the pre-war level. The authorities reacted to the shock with the abolition of value-added tax and import duties on almost all imports. Excise duties were abolished for fuel imports, and the VAT rate was cut to 7 percent from the previous 20 percent. A new form of simplified taxation (the sale tax rate of 2 percent) was introduced, with even large businesses eligible for the regime.

In March 2022, consolidated budget revenues (without off-budget funds) increased by 8.0 percent y/y on the back of advance tax payments of Ukrainian enterprises, which rushed to help government finances. However, this enthusiastic attitude did not last long. In April 2022, consolidated budget revenue (net of grants) plummeted by 34.6 percent y/y, in May 2022, by 15.8 percent y/y, and in June 2022, by 29.1 percent y/y. Taking into account external grants, revenue declined by 18.3 percent, 5.1 percent and 2.6 percent y/y, respectively.[12]

By June 2022, when the military situation stabilised, it became clear that internal economic activities would also revive after the first months of the shock. From July 2022, the authorities withdrew tax exemptions for imports and applied excise duties on fuel imports (although 7 percent VAT on fuels remained unchanged). Consequently, from July 2022, budget collection started improving noticeably.

A cessation of the reduced VAT rate on fuels and elimination of the special enterprise tax regime (see above) is one of the conditions of the IMF Extended Fund Facility (EFF) programme approved in March 2023 (IMF, 2023a).

In 2022, general government (GG) revenues increased by 31.6 percent in nominal terms compared to 2021, according to the IMF World Economic Outlook database of April 2023. GG revenues increased from 36.3 percent in 2021 to 53.2 percent as a share of GDP. Such an increase can be explained by a higher nominator (nominal revenue) and a lower denominator (decline in nominal GDP). Foreign grants contributed 9.8 percent to GDP (IMF, 2023a), that is, to 18.4 percent of GG revenue. Payroll tax (social security contribution) collections grew by 21.8 percent y/y despite millions of refugees abroad and a substantial wage drop. Remuneration for the military was the primary source of payroll tax growth.

[12] Monthly fiscal data presented in this subsection come from Ministry of Finance statistics.

Figure **9**: Consolidated budget expenditure (excl. pension fund): functional disaggregation, % of GDP, 2011-2022

Source: Finance Ministry of Ukraine, NBU

Nominal GG expenditure in 2022 increased by 55.9 percent compared to 2021 and reached 69.9 percent of GDP (40.3 percent in 2021, see Table 2). Such a significant change (by almost 30 percentage points of GDP) can be explained by: (i) a considerable increase in military and security spending[13] (higher nominator), and (ii) a decline in GDP (lower denominator). Figure 9 shows a change

In 2022, the GG deficit amounted to 16.7 percent of GDP (Table 2), of which 11.4 percent was financed from external sources and 7.8 percent by the NBU.[14]

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5.5 Trade

In 2022, Ukraine's main exports were food (57.2 percent), metals (14.4 percent) and minerals (10.0 percent imports of Ukrainian grain (against the EU external trade policy rules). The EU introduced preventive safeguard measures, adopted by the European Commission on 2 May 2023 (Kleimann, 2023).

Since 2013, the EU has become Ukraine's leading trading partner (Zachmann *et al*, 2020), accounting for 60.7 percent of commodity exports and 44.4 percent of imports in 2022 (Tables 6-7). The war accelerated Ukraine

Before the war, Ukraine started to prepare for integration into the continental European electricity system – coordinated by the European Network of Transmission System Operators for Electricity (ENTSO-E). After the invasion began, the Ukrainian energy system was disconnected from the Russian system (the legacy of the Soviet electricity network) and was synchronised with the continental European system. In June 2022, Ukraine began commercial electricity exports to the EU. However, missile strikes from October 2022 stopped these exports. At time of writing, the connection is used for exports and imports and serves as essential infrastructure for stabilising the Ukrainian system.

Official data on energy production, supply and consumption in 2022 are unavailable in June 2023, but expert estimates suggest that electricity consumption dropped by 31.5 percent y/y in 2022. Industrial consumption declined by 45 percent (in the steel industry by 52 percent), and household consumption declined by 16 percent compared to 2021.[22]

Transit of Russian oil (the Druzhba [Friendship]

Most forecasts of agriculture production in 2023 remain pessimistic, amid sharp contraction of sown areas and reduced crop yields due to lower fertiliser investments.

5.9 Financial sector

The Ukrainian banking sector showed resilience during the initial stages of the Russian invasion, thanks to the NBU preventive measures. The NBU

7. Finalising

Goriunov, D., B. Prokhorov, M. Samoiliuk and V. Nozdrina (2023) 'Ukrainian Capital', *Policy Paper*

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