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Managing the War through NBU Regulations

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Abstract

This research paper analyzes the response of the National Bank of Ukraine (NBU) to the Russian occupation and its impact on the country's exchange rate and capital outflow. In the face of a full-scale invasion, the NBU swiftly enacted measures to halt the functioning of the currency market, except for client sales of foreign currencies. Subsequently, the bank imposed limitations on personal and commercial money transactions, introducing several changes to the rules governing the interbank foreign exchange. This situation necessitates a multilevel analysis to assess the righteousness of the NBU's restrictions and the micro and macro consequences of their decision. Through this research, a comprehensive understanding of the NBU's decisions and their implications on Ukraine's economy and financial stability can be gained. Evaluating the exchange rate and interest rate changes over time will provide insights into the effectiveness and costs associated with the NBU's measures. This analysis is crucial for determining the overall benefit of the NBU's decision in the challenging context of war.

Keywords: NBU, National Bank of Ukraine, Ukraine, War, Economics, Regulation

1. Introduction

In response to the full-scale invasion of the Russian occupiers, the National Bank of Ukraine fixed the exchange rate and maintained a massive outflow of capital from the country. The National Bank of Ukraine (NBU) swiftly enacted a resolution in conjunction with the imposition of martial law throughout Ukraine on February 24, 2022, and specifically resolved to halt the functioning of the currency market of Ukraine, except for client sales of foreign currencies. After the war's first month, the NBU imposed several limitations on both personal and commercial money transactions. Since then, the bank has changed "the rules of the game"
numerous times, but the workflow on the interbank foreign exchange has remained remarkably tight. This situation needs multilevel analysis to fully grasp the righteousness of NBU's restrictions, as their decision had both micro and macro consequences. Although when in as dire a situation as war, one does not have time to calculate the possible future success of the decision, a deep examination is required to state whether NBU's choice is more beneficial than it is costly.

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Firstly, to examine the regulations one needs to define currency regulation, which is the state's regulation of international settlements and the procedure for conducting currency transactions. A state's currency regulation is an objective economic necessity, which is caused by the international economic integration of the state into the international community and is associated with international cooperation in production and the expansion of international trade. This leads to the exit of the process of concentration and centralization of capital beyond national borders. According to the current legislation of Ukraine (Article 11 of the decree of the Cabinet of Ministers "on the system of currency regulation and currency control"), the National Bank and the Cabinet of Ministers have certain powers in the field of currency regulation. The NBU's power in terms of monetary policy and currency regulation includes: the establishment of the rules for conducting currency transactions in Ukraine by residents and non-residents; the definition of the structure of the foreign exchange market of Ukraine, as well as the procedure and conditions for trading currency values; establishment of the procedure for transferring, importing, and sending currency valuables to and from Ukraine; the making and defining of the procedure for residents to open accounts with banks outside Ukraine and for non-residents to open accounts with authorized banks of Ukraine; the creation and implementation of general rules for issuing licenses and individual licenses for currency transactions to residents and non-residents, the issuing of these licenses and the decision to cancel them; etc.

To see the progression of the exchange rate and interest rate changes, the timeline may be the best way to analyze the NBU's actions and the consequences that followed. During the first six months of the war, the NBU adjusted interest regulations while still keeping the established exchange rate as it was on the day of the invasion. Thus, the historical analysis will be done starting from the first day of the war. On February 24 the NBU fixed the official exchange rate at UAH 29.25 per US dollar. Moreover, the NBU has restricted the purchasing of currency online while retaining the ability to pay with bank cards in Ukraine and abroad.

Table 1: Exchange rate on February 24

	NBU	Banks (average value)	Card exchange rate (PrivatBank)	Black market
Bid	29.25	25.20	29.25	30.10
Ask		30.15	31.15	30.80

Moving further into March, the NBU started restricting personal international card transfers. From Hryvnia bank accounts, transfers to digital wallets and cryptocurrency

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purchases were prohibited. Owners of currency cards were still able to use this feature, but only up to 100,000 UAH per month (equivalent). The withdrawal of money from Hryvnia accounts abroad was restricted within the same parameters. The regulations implemented were intended to aid in the elimination of conversion schemes; since the start of the war, Ukrainians have developed some illegal and unethical ways to purchase cash below market value. To convert the money into US dollars, consumers moved money from Hryvnia cards to Revolut and Wise accounts as well as cryptocurrency sites, or they withdrew currency from foreign ATMs at the card rate with subsequent resale in Ukraine already at the market rate. Despite such a limit of the NBU, it ended up being insufficient and a month later the National Bank had to take new measures.

Table 2: Exchange rate on March 24

	NBU	Banks (average value)	Card exchange rate (PrivatBank)	Black market
Bid	29.25	29.25	29.25	31.50
Ask		30.00	29.58	32.50

The regulatory institution allowed banks to sell foreign cash to the population in the middle of April. It determined the specifics of setting the exchange rate, allowing a deviation of no more than 10 percent from the official indicator on the day of the transaction. Expectedly, a few days after the introduction of the new rules, the average exchange rate in banks increased, unlike the card rate, which remained as close as possible to the official indicator of the NBU.

Table 3: Exchange rate in the middle of April

	NBU	Banks (average value)	Card exchange rate (PrivatBank)	Black market
Bid	29.25	29.77	29.25	32.30
Ask		32.17	30.03	32.50

The NBU reduced the maximum amount that Ukrainians can withdraw each month from hryvnia accounts at international ATMs from one hundred to 50,000 hryvnia as of May 20. On May 21, the National Bank relaxed limitations on the rate that approved institutions can charge consumers for the purchase of foreign currency in cash. Before this, there should have been a 10 percent difference

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between the comparable rate and the official rate. Similar limitations on debiting money from client accounts that are funded with hryvnia cards overseas have also been eased. A week later, the exchange rate between UAH and USD in banks and on the black market steadied around 35 to 36 UAH per USD. Notwithstanding the regulator's softening, the card rate stayed much lower. A month and a half later new changes were implemented.

Table 4: Exchange rate at the end of May

	NBU	Banks (average value)	Card exchange rate (PrivatBank)	Black market
Bid	29.25	35.50	29.25	36.40
Ask		36.50	32.67	36.65

At the beginning of July, PrivatBank[1] became the first financial institution to introduce a card exchange rate that was comparable to the buying and selling of cash in its branches. He was followed by other financial firms. A week later, all the currency exchange indicators were nearly the same, except the regulator's official exchange rate. More than a month after the NBU abolished the limitation on currency conversion in the corridor "official NBU rate + 10%," banks increased the card rate. The banks were reluctant to act at first, preferring to wait for the situation to normalize, but they were forced to make this choice due to the ever increasing risks. After all, the pressure was put on gold and foreign exchange reserves by the devalued card rate. Every month the NBU spent more and more to maintain the exchange rate. So, in June, the NBU sold about $4 billion of reserves on the foreign exchange market. These reserves were also used to cover losses from conversion schemes. With the growth of the exchange rate to the market, these schemes became unprofitable.

However, there is a drawback. Over 4 million recorded Ukrainians who left the nation after February 24 and who were and are currently living abroad, according to the UN data[2], have been impacted by these developments. For them, the exchange rate from their local currency to the currencies of other European nations will be 35 UAH per USD rather than 32 as it was prior to the banks' shift in policy. Entrepreneurs and sole proprietors who are required to sell a portion of their foreign exchange earnings are exempt from these adjustments. They continue to use a conversion rate of UAH 29.25 + 1 percent when buying and selling currencies.

1 PrivatBank is the largest Ukrainian bank in terms of assets and the leader of the Ukrainian retail banking market.

2 UNHCR, "Situation Ukraine Refugee Situation"

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Table 5: Exchange rate in the middle of July

	NBU	Banks (average value)	Card exchange rate (PrivatBank)	Black market
Bid	29.25	35.50	35.58	36.40
Ask		36.30	35.58	36.85

The termination of the NBU's set rate could be the next significant development in the foreign exchange market. The move was supported at the end of the summer by Oleg Ustenko[3], the advisor of the president of Ukraine on economic matters. According to the expert, the National Bank has already exerted all of its efforts to preserve the hryvnia, and it is now time to assist exporters and the Ministry of Finance, which receives taxes from a variety of sources, including imports. In case the fixed hryvnia exchange rate is rejected, the market rate may slightly decline, according to the official's upbeat prediction of how the market will respond to this move. However, it is difficult to predict how the situation with the exchange rate will change. Despite that, by the end of the same month there has been a new exchange rate change fixation; the official exchange rate of the hryvnia to USD was recorded at a new level of 36.5686 UAH per USD. Looking at such changes, an assumption could be made that the institution expected that such restrictions and constantly growing exchange rates would stop, or at least limit people from withdrawing money abroad or moving their assets. However, it had the opposite effect and as of now the hryvnia exchange rate is reaching 40.00 UAH per USD. According to the data provided by various sources, during the entire period of war, Ukraine received fewer money transfers from abroad and more citizens' funds went abroad. According to the NBU, in 2022, the country received money transfers totaling 13 billion USD—13.5 percent less than a year earlier when 15.03 billion USD were received. Such an influx of money did not completely cover the withdrawal of funds by the population. After all, the previous report of the NBU suggests that in May-December 2022, Ukrainians conducted card operations abroad for up to UAH 361.4 billion (seven times more than the same indicator in 2021)[4].. In the dollar at the average exchange rate, this is almost 10 billion rubles. Moreover, the data represents only eight months (May-December) of 2022, and if the dynamics are recalculated for the whole year, it becomes about 14 billion. The National Bank explained that they did not collect card reports at the beginning of the war, and did not have accurate information for the first four months (January-April). The NBU also clarified that 13

[3] Goshovatyuk, 2022

[4] These are card payments in foreign retail chains, and cash withdrawals from foreign ATMs.

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billion USD of money transfers received in 2022 are funds from all sources: from official channels (banks, international transfer systems, mail) to unofficial sources (hand-to-hand transfer).

The NBU clearly did their best to restrain the outflow of currency from Ukrainian banks and the country in general, but it is crucial to understand that this deterrence merely delayed inevitable problems. Many people found options, such as the black market, to take money out of the country. It could be concluded that the restrictions adopted by the NBU were the reason that pushed many residents and non-residents to withdraw money from the country and not accumulate, create, or buy anything else (accounts, assets, etc.). Moreover, given the change in the fundamental characteristics of the Ukrainian economy during the war, the adaptation of consumer and economic behavior of businesses and the population to new realities, and the strengthening of the US dollar against other currencies, the hryvnia exchange rate (which was fixed at the beginning of the full-scale invasion) became inflated and gradually lost its inherent anchor for expectations. Maintaining a fixed exchange rate at an inflated level required an increasing expenditure of a limited number of international reserves, which forced the NBU to "refix" and adapt to prolonged conflict. As of now, it can be seen that the market still has low liquidity and is critically dependent on the daily support of the NBU. It can be viewed by observing several notions such as the fact that the volume of operations of banks without the NBU is two to three times less than the volume of operations with the participation of the NBU. Thus, the rigidity of regulations appeared to bring more costs than benefits to the economic system. Although the NBU aimed to control and keep an exchange rate low, it is not realistic to control the outflow of money, especially in the black market. The regulator's actions had something of a reversed psychological effect; the moment people were prohibited to make transactions, they were sent into a panic, partly due to the simple fact that the option was taken away from them. This panic spiraled into an even bigger desire to take all assets out of Ukraine. In addition, the rushed decision to fix an exchange rate may have seemed appealing and rational in the heat of the moment, but has actually enhanced the problem. Firstly, it was clear from the very beginning that the exchange rate would inflate. It would have been more logical to artificially inflate it and then fix it or let it fluctuate for a week or two. This strategy would have offset panic since it would have created the idea that economic restrictions would not hurt people traveling abroad and they should not move their money or assets anywhere else. Secondly, it was either a major miscalculation or a severe mistake to rely so heavily on the idea that reserve funds would not run out. Right now, Ukraine is heavily relying on international funding and help to even keep its economy afloat since they fixed the exchange rate to a new, higher rate. The new rate is at least more in line with the realities and current economic problems such as inflation, stagnation, and unemployment. However, it is important to remember that the given analysis may be slightly erroneous as there may be a lack of

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data for such sectors as the black market and illegal money laundering, be that in cash or otherwise. Furthermore, the data presented by the main financial institution should not be biased, yet one cannot operate under the assumption that it is as such. The NBU is a trusted source, however, there always may be additional information that is either not accounted for or hidden for the sake of maintaining control and avoiding panic among citizens.

Although past mistakes cannot be changed, the regulations can be reversed and conditions for the better of the economy could be implemented. A return to normality and stability in the exchange rate sphere would take some time. It is important to realize that the lifting of current currency restrictions cannot be instantaneous since the same mistake as at the beginning of the war would be repeated just at a different extreme. Furthermore, the dissolution of certain restrictions would be linked not to the time frame, but to macroeconomic conditions as it was during the peaceful times during the implementation of the roadmap for currency liberalization. Additionally, cancellation of the fixed exchange rate is possible only if the foreign exchange market can self-balance and the possibility of inflation being a nominal anchor is restored. Going further into the future, a return to the traditional principles and operations of currency intervention is possible after the aforementioned cancellation of the fixed exchange rate. A crucial prerequisite for this return is a significant increase in the supply of foreign currency (in particular from exporters) in the context of the revival of production and the resumption of transportation logistics. Thus, a gradual lifting of restrictions on currency trading and cross-border transfers is possible only as the balance of payments improves and the NBU's role in balancing the market decreases. The analysis of available data reveals that despite a clearly unsuccessful start to the management of the wartime exchange rates, the NBU has done a relatively good job to correct its mistakes. The dire circumstances and resulting chaos of the first half of 2022 forced the NBU to act rashly. After July, the institution started to correct its mistakes, yet not all could be reversed as many people already took the money out of the country and continue to do so.

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