НАПРЯМ 4. ФІНАНСИ, БАНКІВСЬКА СПРАВА ТА СТРАХУВАННЯ

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THE IMPACT OF A FIXED EXCHANGE RATE ON STABILIZATION PROCESSES IN THE COUNTRY

The Ukrainian economy has faced new challenges due to the full-scale Russian invasion. Russian aggression has caused panic among the population and macroeconomic instability in the country. Ensuring financial stability and reducing inflationary pressure have become key priorities. Since the beginning of the full-scale Russian invasion of Ukraine, the National Bank of Ukraine (NBU) has implemented a fixed exchange rate regime of the Hryvnia to the US Dollar.

Exchange rate policies are focused on two major types: a floating exchange rate and a fixed exchange rate. A floating exchange rate is determined by the interaction of supply and demand of currency in the exchange market, without significant intervention by the government or central bank. In the fixed regime the exchange rate is set by the state authority at a certain level against another currency and is maintained by the state authority for a certain period of time [1, pp. 187–188].

Currently, a floating exchange rate is a characteristic feature of developed economies (except for the European Union member states) that prefer a free market economy. However, it should be noted that a floating exchange rate regime is not reliable at all times.

A temporary fixed exchange rate is a relatively common and effective tool for mitigating recessions [2, p. 43].

The dynamics of the official exchange rate of the hryvnia against the euro and the US dollar (average for the period) are shown in Figure 1.

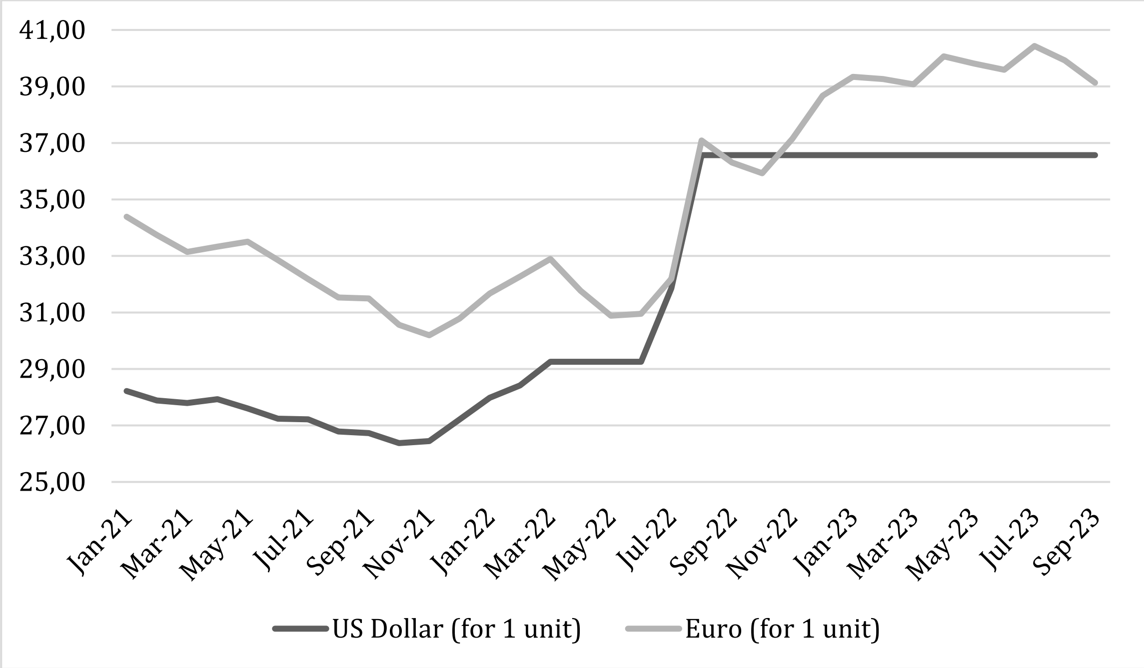

Figure 1. Dynamics of the official exchange rate of the hryvnia to the euro and the US dollar from January 2021 to September 2023 (average for the period)

Source: Compiled by the authors based on [7]

We can observe that the support for the fixed exchange rate policy of the hryvnia to the US dollar by the NBU has started since February twenty-fourth. However, in July, the hryvnia depreciated by 25% against the US dollar, from 29.2549 to 36.5686 UAH/USD. At the end of July last year, the hryvnia exchange rate against the euro also devalued by 25%, from 29.8064 to 37.2689.

According to the "Inflation Report for January 2023", the fixed exchange rate played a crucial role in maintaining control over inflation under martial law [3, p. 12]. According to the National Bank of Ukraine, if the hryvnia exchange rate had not been fixed, inflation would have increased by approximately eight percentage points by June 2022, reaching 30% per year [4].

To maintain a fixed exchange rate at the specified level, the NBU must conduct currency interventions. Interventions involve buying or selling domestic currency in the foreign exchange market. In a fixed exchange rate regime, the central bank sells foreign currency for domestic currency, thereby withdrawing it from the circulation. Currency interventions require sufficient international reserves to ensure unlimited impact on the market and protection against speculative attacks [5, pp. 19–20].

Maintaining a fixed exchange rate can deplete the country’s international reserves, making it costly in the long run and causing significant currency devaluation.

The National Bank has abolished the fixed exchange rate of the hryvnia against the US dollar since the third of October. However, according to the "Inflation Report for July 2023", currency fluctuations of the hryvnia to the US dollar will be restrained by the NBU interventions to maintain macrofinancial stability, which will provide an opportunity to keep the hryvnia’s exchange rate relatively stable in comparison with foreign currencies in the future [6, p. 37].

Thus, the effectiveness of the fixed exchange rate is explained by its use in the short term that is characterized by price inflexibility. The National Bank of Ukraine has been implementing monetization of the budget deficit as a solution to the increasing deficit caused by the full-scale invasion of Ukraine. An increase in the amount of money in circulation typically leads to a decrease in its value, which in turn affects the depreciation of the national currency. Currency fluctuations can significantly impact the currency market participants. If the exchange rate falls, the level of foreign currency denominated debt and the price of imports rise. However, during the implementation of a fixed exchange rate, the central bank is obliged to maintain the value of the national currency at a constant level against another currency. This reduces the need for investors and businesses to hedge against currency risks and facilitates their forecasting and planning. Therefore, the fixed exchange rate policy serves as an anchor for price stability, which helps to avoid significant national currency fluctuations, ensures price stability in the domestic market, and curbs panic among market participants in the short-term perspective.

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