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THE INFLUENCE OF DECISIONS ON INCREASING SOCIAL STANDARDS ON MONETARY POLICY

Abstract. Raising social standards is an essential instrument of social policy by the state. However, the decision to raise the minimum wage rather sharply should consider its impact on fiscal and monetary policy.

The article aims to study how government decisions on social standards (in particular minimum wages) can influence monetary policy decisions based on inflation targeting.

Results of the research. The method of analysis of indicators and consequences of the introduction of inflation targeting in Ukraine, geographical neighbors and countries with similar economies is described. It is determined that the final effect of changes in social standards on inflation depends on the entire transmission mechanism, which includes several interrelated reactions, and maybe stretched over time, depending on both the speed of transmission of the impulse and the specifics of institutional regulation.

It is established that the criterion for a dramatic increase in the minimum wage is a significant upward shift of the minimum wage to the average wage ratio curve. In this case, as we have shown, inflation expectations worsen, which modifies somewhat the behaviour of economic agents and is transferred to current inflation rates in the future. Raising social standards is a good decision of the government in order to maintain household incomes. However, to ensure the neutrality of such a decision for fiscal and monetary policy, it needs to be aligned with its objectives and strategies.

Keywords: social standards, monetary policy, inflation targeting, minimum wage, GDP, government.

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ВПЛИВ РІШЕНЬ ПРО ПІДВИЩЕННЯ СОЦІАЛЬНИХ СТАНДАРТІВ НА МОНЕТАРНУ ПОЛІТИКУ

Анотація. Підвищення соціальних стандартів є важливим інструментом соціальної політики держави, однак ухвалюючи приймаючи рішення щодо різкого підвищення мінімальної заробітної плати, потрібно враховувати її вплив на фіскальну і монетарну політику.

Метою статті є проведення аналізу, яким чином рішення уряду в галузі соціальних стандартів (зокрема збільшення мінімальної заробітної плати) можуть взаємодіяти з рішеннями в галузі монетарної політики, яка базується на таргетуванні інфляції.

Описано методику здійснення аналізу показників і наслідків упровадження інфляційного таргетування в Україні, країнах — географічних сусідах і країн зі схожою економікою. Визначено, що остаточний ефект від впливу змін соціальних стандартів на інфляцію залежить від дії всього передаткового механізму, що включає кілька взаємопов'язаних реакцій, які визначаються як швидкістю передавання імпульсу, так і особливостями інституційного регулювання.

Установлено, що критерієм різкого підвищення рівня мінімальної зарплати є суттєве зміщення кривої відношення мінімальної зарплати до середньої зарплати вгору, що погіршує інфляційні очікування, наслідком яких є модифікація поведінки економічних агентів з подальшим перенесенням на показники поточної інфляції в майбутньому. Підвищення соціальних стандартів є благим рішенням уряду з метою підтримання доходів населення, однак для забезпечення нейтральності подібних рішень для фіскальної та монетарної політики воно повинно бути погоджено з їхніми цілями і стратегічними завданнями.

Ключові слова: соціальні стандарти, грошово-кредитна політика, таргетування інфляції, мінімальна заробітна плата, ВВП, уряд.

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Introduction. The modern foundation of monetary policy is the inflation targeting regime according to the rule formed by the American economist D. Taylor (December 1993). The essence of which is the need and feasibility of lowering interest rates by a certain amount if inflation falls below the target or if real GDP falls below potential GDP, as well as an increase in the central bank's interest rate by a certain amount, provided that the inflation rate rises above the target or real GDP rises above potential GDP. That is, the Taylor rule is a tool that allows the country's central bank (in our case, the NBU) to determine the level of key interest rates based on two fundamental indicators — inflation and GDP (or state of the economy), which is a clear benchmark for monetary policy states.

The course of inflation targeting in our country implies that the NBU tries to keep inflation at a given planned level by pursuing an effective monetary policy, consistent with the above-described Taylor's rule, to ensure price and financial stability and promote sustainable GDP growth.

Analysis of research and statement of the problem. The issue of inflation targeting and algorithms for its effective implementation is continuously in the field of view of the world scientific community; this issue was especially acute during the spread of the pandemic caused by the COVID-19 virus. Among the significant number of scientific works, we highlight the works that serve as the foundation for further research on effective monetary policy tools through inflation targeting and its features in our country. In particular, the latest works of D. Taylor in terms of inflation targeting in developing countries, in which the author analyses the experience of targeting the rules of monetary policy and the peculiarities of monetary policy in countries with economies undergoing stages of formation and formation [1]. Findings of F. Mishkin and A. Posen on the experience of inflation targeting on the example of its implementation in New Zealand, Canada, Great Britain, and Germany [2]. Improving the discipline of monetary policy through an approach to inflation targeting to ensure greater transparency and consistency was studied by B. Bernanke and F. Mishkin [3]. The reaction of monetary policy to the influence of external factors under conditions of insufficiency and opacity of information in compliance with the Taylor rule was studied by K. Warburton and E. Jackson [4]. A. Angeriz and F. Arestis evaluated the effectiveness of inflation targeting with intervention analysis [5].

Among domestic scientists, we will highlight the works of V. Mishchenko on methodological and methodological problems of introducing inflation targeting in Ukraine [6], O. Petryk in terms of conceptual foundations of inflation targeting [7], V. Gordienko in terms of the impact of inflation targeting as a method of ensuring price stability [8]. Paying tribute to respected scholars, we emphasise that the effect of social standards on monetary policy, based on inflation targeting, requires in-depth research in this direction.

The article aims to study how government decisions on social standards (in particular minimum wages) can influence monetary policy decisions based on inflation targeting.

The central scientific hypothesis of the work is the following statement: an unjustified increase in the minimum wage and other social standards leads to the emergence of additional risks of accelerating inflation and deterioration of inflationary expectations, which have a fiscal nature, and the corresponding reaction of the central bank to an increase in the key rate, as a result of which the trajectory of its dynamics and parameters change of macroeconomic equilibrium. To test this hypothesis, the study includes two interrelated stages. At the first stage, it is verified whether the transition to targeting inflation leads to a decrease in its average annual level in post-socialist and developing countries like Ukraine. At the second stage, the main characteristics of the reaction, including the preventive one, of the NBU to sharp increases in the minimum wage that took place in 2017 and 2021 are identified.

Results of research. One of the main directions of economic policy in Ukraine is monetary policy, the main subject of the central bank's implementation. Thanks to monetary policy, the central bank is robbing a common strategy, but its financial stability is to blame for its financial stability [9]. The function of securing the strength of the hryvnia has been assigned to the NBU without regard to the national legislation, and the priority goal is to achieve price stability.

There are three main types of monetary strategy in modern practice — monetary, currency, and inflation targeting. Within the framework of such a strategy, a general target indicator (target, from English — «target») is obtained to reach a using tool of penny-credit policy. There can be much money, the exchange rate, and inflation to target monetary strategy. The skin monetary strategy can change the minds and specialities of health. In Ukraine, before the official announcement of the inflation targeting regime, preparations were made before the official announcement. So, the dispute is unimportant to the significance of the inflated targeting in science and finance stakes; in birch 2016, NBU presented a road map to transition to the inflation target [10].

We are carrying out the analysis of the inheritance and possibilities of the policy of the inflation targeting in the applied countries, the geographic neighbours of Ukraine and the country with a similar economy to allow the development of the strategy of the monetary prospect. It is

crucial to have many converts for the deceased prelude to the country in which the regime of inflation targeting is more important than Ukraine. So, in the first middle of the country, the monetary regime became obsolete in Poland, having been repaired since 1998 the Russian Federation and Ukraine stopped before the inflation targeting regime.

Given that the primary goal of inflation targeting policy is to reduce inflation in the medium term. The method of analysis of indicators and consequences of the introduction of inflation targeting in Ukraine and the countries neighbouring our country provides:

1) fixing the year of implementation of the inflation targeting regime in each individual surveyed country;

2) study of inflation targeting in Ukraine and neighbouring countries at the time of introduction of inflation targeting and for 2021;

3) calculate the average inflation index in the context of each country for ten years before and ten years after introducing the inflation targeting regime. The consumer price index (CPI) was used to study the inflation rate because, for inflation targeting, one of the targets is usually chosen — the consumer price index or the «core» inflation rate. For the adequacy and comparability of data, the input indicators for calculating averages were data on World Bank inflation by country (Inflation, consumer prices) [10]. Inflation data for the year (January-December, respectively) were used as the year before the previous year. As known, the CPI for the year (cumulative index) is determined by the product of monthly inflation indices and is an indicator that shows not the price level, but their dynamics, so when calculating the average values used the geometric mean formula, because this average should be used to calculate average values in the time series. In each of the studied countries, the years of introduction of inflation targeting were different. For example, in Poland, ten years before introducing inflation targeting is 1988—1997, 10 years after — 1998—2007. In Moldova, the inflation targeting regime was introduced in 2010, so ten years before the introduction of IT is 2000—2009, 10 years after — 2010—2019. Similarly defined in other countries. It is also worth noting that Russia and Ukraine introduced inflation targeting from 2015 and 2016, respectively, so for these countries, the average value of inflation after the introduction of IT is calculated for the available period — in Russia for six years (2015—2020), in Ukraine for five years (2016—2020);

4) the formation of visas resulting from the inflation targeting regime’s effectiveness in the development of the researched countries and Ukraine. The examples of the descriptions of these indicators are grouped in *Table*.

Table

Fundamental indicators of inflation targeting of Ukraine’s geographical neighbours

Country	Year of implementation	Inflation target at the time of implementation, %	Inflation target for 2021, %	CPI, % (10 years before IT)	CPI, % (10 years after IT)
Poland	1998	4.0	2.5+/-1	77.0	4.5
Hungary	2001	7.0	3.0+/-1	20.2	5.6
Romania	2005	7.5+/-1	2.5+/-1	42.1	5.4
Turkey	2006	5.0+/-2	5.0+/-2	48.0	8.3
Georgia	2009	6.0	3.0	7.6	3.3
Moldova	2010	5.0+/-1	5.0+/-1,5	11.8	6.0
Russian	2015	4.0	4.0	9.2	6.3
Ukraine	2016	12.0+/-3	5.0+/-1	13.4	9.9

Source: formed and calculated by the authors according to the central banks of each country and the World Bank [11].

Analysing the data shown in *Table*, we can state that the introduction of inflation targeting in the studied countries took place in different periods. All countries had different preconditions for the transition to such a monetary regime. At the time of implementation in most countries, the inflation target was higher than the current target for 2021. In developed countries, the inflation target is usually 2 %; however, this figure is higher in developing countries. Most countries surveyed have set interval targets, but this may be the exact value of inflation, as in Russia and Georgia. In Ukraine, the inflation target is set at 5 +/- 1, the same target, but at different intervals, also in Turkey and Moldova. In Ukraine and neighbouring countries, where they moved to a

monetary strategy of inflation targeting, the average inflation index for ten years before the introduction was much higher. After the transition to IT, all countries have approached the inflation target. The inflation index has become much lower at an average of 10 years than before introducing IT. In particular, the average inflation index in Poland before the introduction of IT was 177 %, after — 104.53 %; in Turkey — before the introduction of 148 %, after — 108,29 %; in Romania — before the introduction of 142.1 %, after — 105.39 %. The mentioned characterises the effectiveness of this monetary strategy.

In neighbouring Belarus, the regime of transition to inflation targeting, as a tool for implementing monetary policy, was scheduled to occur on 1.01.2021. However, according to the National Bank of Belarus board, it is too early to switch to the inflation targeting regime. First of all, because not all conditions are created for this, the necessary changes have not been made to the legislation [12].

The main prerequisites for the successful functioning of the inflation targeting regime are the lack of fiscal dominance, is the contradictions that arise between the macroeconomic goals of the country in terms of inflation, economic growth, unemployment, etc. and the government's work to prevent default on its liabilities due to significant public debt and deficits. As a result, the state's financial resources are directed to servicing the external debt, and there is a deficit of investment in the real sector [13]. Another essential aspect is the coherence of monetary and fiscal policies, which is the maintenance of national macroeconomic goals and the coordination of the use of instruments of both policies. In the event of an increase in the current account deficit beyond acceptable limits, it is not straightforward for the country to maintain financial stability, as has been the case in Turkey and Argentina.

The interdependence and interaction of monetary and fiscal policies are difficult to overestimate. The fiscal policy mainly affects inflation in the country and employment; in turn, monetary policy determines the interest rate, affects output and employment, respectively, which is closely correlated with government spending, tax revenues collected, and the formation of the overall budget balance. For example, if unemployment in a country rises, the government increases spending on this category of people, but tax revenues fall due to rising unemployment.

Inflation targeting policy aims to anchor inflation expectations with the ultimate goal of reducing the volatility of the leading macroeconomic price indicators (CPI, PPI, GDP deflator), creating a medium to a long-term macroeconomic environment conducive to investment and sustainable self-sustaining economic growth.

- the aim of implementing inflation targeting regime by central banks is to anchor inflation in order to provide economic agents with better predictability in decision-making in the medium and long term;
- a gradual lowering of the inflation target leads the economy to a state of self-sustained growth with low inflation and a fiscal deficit that does not threaten financial stability
- sharp (the expected growth exceeds the evolution of expected inflation/median wage/GDP per person employed) increase in social standards causes a particular impact on the expected inflation, which depends on the strength of the carryover effect;
- increased inflation expectations require a revision of the medium-term — forecast trajectory of the discount rate, which affects the decision-making of economic agents in the future and the current period, affecting short- and medium-term interest rates.

An increase in the minimum wage by itself may not affect the parameters of inflation targeting policy if there is no or little transmission mechanism for its transmission to the individual factors of demand inflation and cost inflation. Even among prominent financiers, there is a view that an increase in social standards is neutral for inflation expectations if the parameters of the budget deficit do not change [14]. In our view, this impact occurs for several reasons:

- 1) in unstable democracies, raising social standards is a rather frequently used instrument of political struggle, which has a pronounced populist character and threatens to unbalance public finances and accelerate inflation [15];
- 2) planned budget deficits may differ from actual deficits, and changes may be made during budget execution;

3) budget expenditures by economic classification have different impacts on macroeconomic dynamics; in particular, additional capital expenditures to improve infrastructure are characterised by a more significant multiplier effect than additional current expenditures related to wage increases or current transfers.

A general scheme for the transmission of the initial impetus associated with a sharp increase in social standards, in particular the minimum wage, can be represented by the following provisions:

- the adjustment of the basic indicators (institutional regulators) of basic social standards causes a corresponding change in the institutional environment, which leads to changes in specific categories of citizens’ income and the cost of production;
- the implementation of the relevant changes manifests itself as an initial impulse, which has a particular strength, which can be measured quantitatively or qualitatively based on a specific methodology;
- the impact of the initial impulse on personal income and the cost of production depends on the characteristics of the transfer mechanism, which may involve several stages and whose effectiveness can also be measured quantitatively or qualitatively;
- the final effect of changes in social standards on inflation depends on the entire transmission mechanism, which includes several interrelated reactions, and maybe stretched over time, depending on both the speed of transmission of the impulse and the specifics of institutional regulation.

The cumulative effect of the initial momentum transfer results from the multiplicative impact of a set of reactions. Thus, the transformational mechanism of the impact of rising social standards on the key rate is determined by the functioning of its elements and the characteristics of the responses.

First, let us consider the ratio of the minimum wage to the average monthly wage as a basic coefficient, the use of which will make it possible to characterise the strength of the impulse. Given that minimum wage revisions mainly occur in January or December, the most considerable impact of the initial impulse will be in the first half of the year. This situation is a consequence of a particular time lag, within which the impulse on prices is transferred as a result of transmission mechanisms. The statistical basis for this study is the average monthly wage since January 2002. Before this period, the minimum wage transmission mechanism was practically nonexistent due to the absence of institutional rules determining the recalculation of wages in the public sector following changes in the minimum wage. The data on the dynamics of the minimum wage was collected by the authors based on the analysis of the decisions of the Cabinet of Ministers of Ukraine and the Verkhovna Rada of Ukraine.

The authors’ calculations of the ratio of the minimum wage to the average wage are presented in *Fig. 1*.

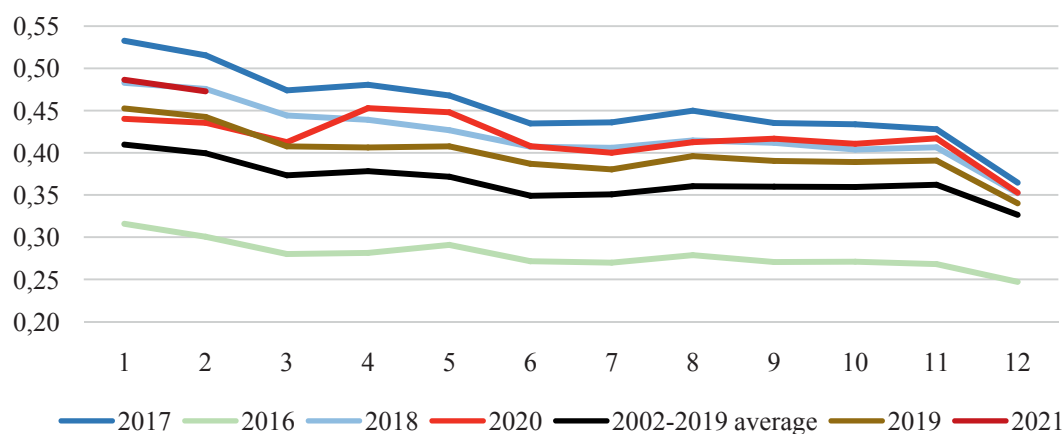


Fig. 1. Minimum wage to Wage ratio by months

Source: Ukrstat [16], the authors’ research.

Analysis of *Fig. 1* shows that following a sharp increase in the minimum wage from UAH 1,600 to UAH 3,200 on January 1, 2017, there was a historic high for the Minimum wage to Wage ratio of 0.533. Minimum wage increases occur discretely, usually at the beginning of the year, after which the initial impetus is passed on to the average wage. Also, in 2017, the Minimum wage to Wage ratio declined to 0.365 by the end of the year due to the subsequent wage increase. In 2020, the Minimum wage to Wage ratio, starting at a level not much lower than 2019, increased significantly in spring due to lower average wages in response to the spring pandemic-related lockdown. Beginning in June 2020, the figure declined and over the following months almost repeated the 2018 figure. The increase of the minimum wage from January 1, 2021, follows the 2018 scenario, and the decision to postpone the subsequent minimum wage increase from July 1 to December 1 will take away the extra impetus for the end-of-year increase in aggregate earnings when the increase from December 1 is equivalent to the increase from the new year.

The graph in *Fig. 2* shows the development of inflation expectations for the next 12 months from 2015 to 2021. This indicator that the NBU uses to calculate the real Key rate development over the next 9 to 12 months. In this way, inflation expectations are the most critical indicator when deciding on the Key interest rate.

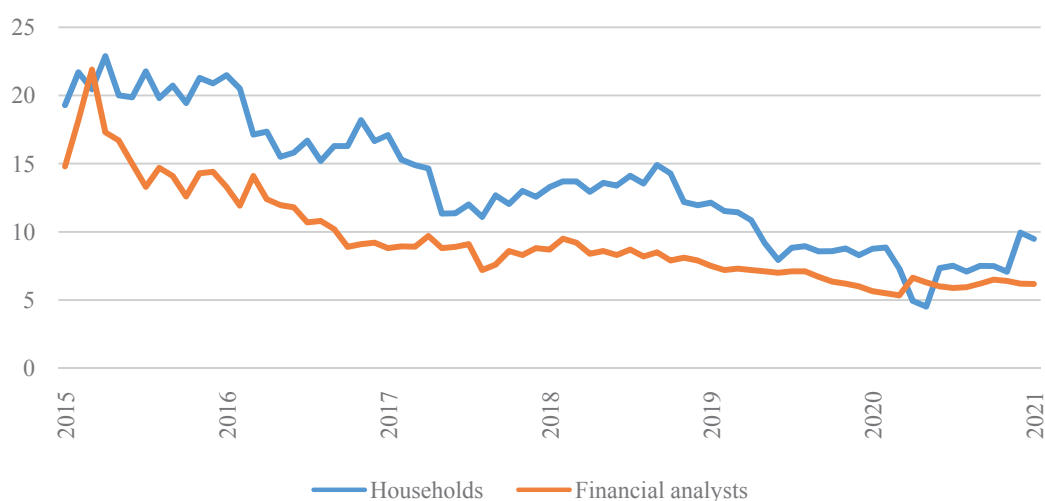


Fig. 2. Inflation expectations of households and financial analysts (%)

Source: NBU [17], the authors' research.

Fig. 2 shows that the inflation expectations of households exceed the inflation expectations of financial analysts throughout the entire period under investigation, except for a minor period in the first half of 2015 and 2020, when the inflation expectations of financial analysts are higher than those of households. Households' inflation expectations as of January 1 each year are always higher than expected in the previous month. While households' inflation expectations tended to change more significantly during each year and over the entire period under study, financial analysts' inflation expectations generally had a more constant downward trend, with no significant upward fluctuations. Overall, inflation expectations are characterised by an overall downward trend, which can be explained by a decline in the general level of inflation in Ukraine. In the past four years, inflation expectations have been in the range of 5–10 % and amounted to 6.2 % at the start of 2021. At the same time, inflation expectations during the same period have a greater amplitude of 5–18 % and amount to 9.5% at the beginning of 2021. As the data shows, both households and financial analysts' inflation expectations are overestimated relative to the inflation rate that has taken place in our country over this period.

Overall, we see a general downward trend in inflation expectations, but this reversed twice in 2017 and mid-2020. Moreover, it is at this point that decisions on minimum wage increases fall to be taken. In summer 2020 in particular, extensive discussions on future minimum wage increases led to an increase in inflation expectations even in the context of the observed low inflation rate and

the absence at that time of two drivers for higher inflation in early 2021 in many countries: Oil price increases due to a recovery in global demand and food prices due to a poor harvest.

The next element of the transmission mechanism is the translation of higher inflation expectations into CPI dynamics and central bank monetary policy decisions. NBU decisions are based, among other things, on current inflation and inflation expectations. Although there is a global trend for key rates to be lowered or fixed, the NBU will respond with a Key rate hike to 6.5% in spring 2021 (Fig. 3) and is likely to raise it again at 50 bps.

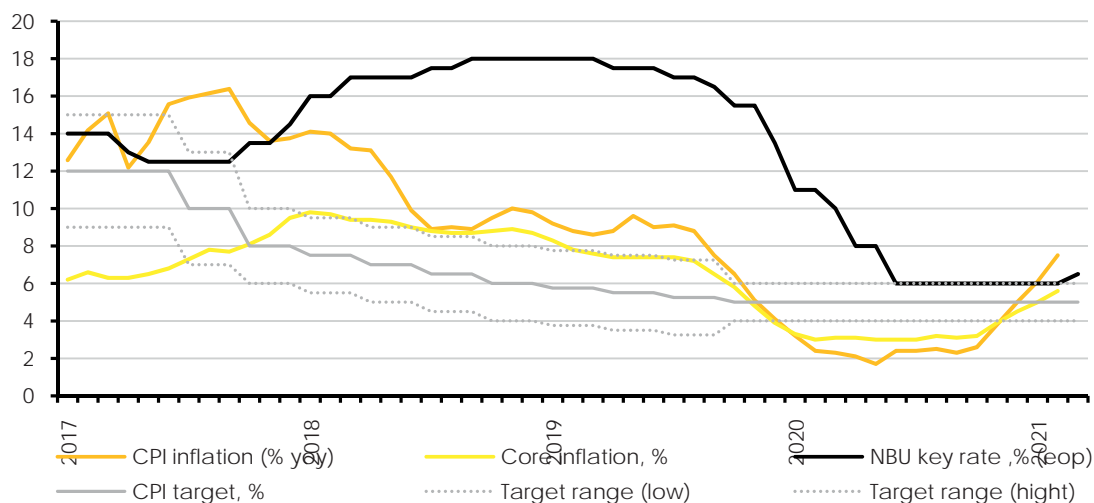


Fig. 3. CPI, target range and Key rate, %

Source: Ukrstat [16], NBU [17], the authors' research.

It should be noted that the NBU has moved to tighten monetary policy by moving to increase the discount rate. This thought is evidenced by Figure 3, which shows that the National Bank has responded by raising the discount rate in response to core inflation and CPI. As can be seen, 2017 sees the highest CPI and core inflation rising, reaching a peak at the start of 2018. Such a trend can be explained as a consequence of the jump in the Minimum wage to Wage ratio in 2017, shown in Figure 1. Thus, there is a transmission mechanism for changes in social standards with a time lag of one year: change in social standards — change in CPI and inflation — change in the NBU discount rate. The situation is similar in 2020—2021, when, in response to an increase in the Minimum wage to Wage ratio in 2020 compared to the previous year 2019 and partly 2018, the inflation rate and CPI begin to rise by the end of 2020, increasing the NBU discount rate as well.

Conclusions. Thus, the research made it possible to formulate conclusions, which are contained in the following provisions:

1. Verification of the implementation of inflation targeting in Ukraine and neighbouring developing countries has confirmed the first scientific statement that under the conditions of applying this monetary strategy, a reduction in the average annual inflation rate is achieved. Proof of this is the calculation of average yearly inflation before and after introducing inflation targeting in the studied countries. The implementation by central banks of countries using inflation targeting, transparent communication policy, and prudent decisions to change the discount rate reduces inflation expectations, thus reducing inflationary fluctuations, contributing to improving financial stability in the economy.

2. Raising social standards is an essential instrument of social policy by the state. However, the decision to raise the minimum wage rather sharply should consider its impact on fiscal and monetary policy. Obviously, an increase in wages in the public sector will increase the budget deficit, all other factors remaining unchanged. At the same time, such a decision will also influence further monetary policy decisions.

3. The criterion for a dramatic increase in the minimum wage is a significant upward shift of the minimum wage to the average wage ratio curve. In this case, as we have shown, inflation expectations worsen, which modifies somewhat the behaviour of economic agents and is transferred

to current inflation rates in the future. The central bank, which aims to anchor inflation, will be forced to shift to tightening monetary conditions by hiking the discount rate. That was the situation in Ukraine in 2017 and will continue in 2021.

4. Raising social standards is a good decision of the government in order to maintain household incomes. However, to ensure the neutrality of such a decision for fiscal and monetary policy, it needs to be aligned with its objectives and strategies. At best, it is recommended to adopt a specific set of rules for raising the minimum wage, which should be approved in advance and be clear, sufficiently flexible and understandable to market participants. A similar solution is already in place for the annual recalculation of pensions, where the actualisation rate is the arithmetic average of nominal wage increases and inflation. Although such a mechanism is very simplistic and not flexible, it is still better than discretionary decision-making, which can unbalance public finances and affect monetary policy.

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