

## Article: Why is it important that inflation rises towards the target?

**In recent years, inflation has been some way below the target of 2 per cent and long-term inflation expectations have fallen. The Riksbank has taken forceful monetary policy measures aimed at bringing inflation closer to the target and curbing the downward trend in expectations. Monetary policy has been made more expansionary, even though both the real economy and credits have grown at a reasonable rate. In this unusual macroeconomic situation, there may be reason to question why it is so important for inflation to rise towards the target of 2 per cent.**

Just a few decades ago, it was genuinely difficult to know whether inflation would be 2, 5 or even 10 per cent. This made it difficult for companies to plan their operations and for households to plan their personal finances. Perhaps the clearest example of these problems concerned the development of wages. During the 1970s and 1980s, average inflation was high and the rate of price increase could vary considerably from year to year. To compensate for these rapid price increases, employees and their representatives often demanded large wage increases. But the wide fluctuations in inflation were difficult to predict and consequently large and unexpected fluctuations in real wages also arose. Companies thus found it difficult to predict how their own costs would develop and it became difficult to predict the profitability of various investment projects. It similarly became difficult for households to plan ahead.<sup>4</sup>

When the inflation target was presented in 1993, its aim was to anchor and stabilise household and corporate expectations of inflation a few years ahead. During the first years of inflation targeting, monetary policy was entirely focused on bringing inflation down to 2 per cent and thereby making the target credible. The policies pursued were quite soon successful: inflation fell from relatively high levels to 2 per cent and inflation expectations correspondingly adapted to the target. This low and stable inflation was probably one of several circumstances that contributed towards both GDP and real wages growing relatively rapidly from the mid-1990s onwards.

Today, economic policy faces different challenges compared with the situation just over 20 years ago. For monetary policy, the main challenge comes from inflation having been below target for a number of years. Of course, CPIX inflation temporarily below the 2 per cent target does not entail any major problems for the economy. Neither the Riksbank nor any other central bank has the possibility of exactly stabilising inflation. But if prices rise at a rate significantly slower than 2 per cent for a longer period of time, there is an obvious risk that the target's credibility will be questioned.

A loss of credibility means that most participants no longer expect inflation a few years ahead to be close to the target. For individual companies and households, it is then more difficult to form expectations of the future development of prices and wages. There is also a large risk that various participants' assessments of future inflation will show increasing variance. Under such circumstances, with increasing uncertainty and disagreement over future inflation, the Riksbank's task of stabilising inflation may rapidly become more difficult. Many people associate large fluctuations in inflation with a situation in which average inflation is also high, as was the case in the 1970s and 1980s. But if inflation expectations stop being anchored at the inflation target, volatility also risks increasing, even if average inflation is low.

Increased uncertainty and disagreement over future inflation create socio-economic costs. It will be more difficult for individual companies to judge how their own costs and revenues will develop, thereby increasing the riskiness of investments and new recruitments. For households, among other things, it will become more difficult to judge the yield from different forms of saving. If uncertainty over future inflation increases, it will also become more difficult to agree on the terms for different types of contract. One important example is the wage agreements negotiated by the labour market parties, for which inflation expectations have central significance.<sup>5</sup>

To sum up, there are therefore compelling reasons for the Riksbank to defend the credibility of the inflation target. A credible target creates stability and predictability. It is thus imperative that inflation now continues to rise and that it approaches the target of 2 per cent as soon as possible.

<sup>4</sup> An overall description of how price-setting and wage-formation worked in the 1970s and 1980s is given in Gottfries, Nils (2010), "Fungerar den svenska lönebildningen? (Does Swedish wage formation work?), appendix to The Long-Term Survey of the Swedish Economy 2011.

<sup>5</sup> If the inflation target loses credibility, this may also give rise to other socio-economic costs. One example expressed in academic literature is the central bank's poorer capacity to stabilise resource utilisation. See Debelle, G. (1999), "Inflation Targeting and Output Stabilisation", *RBA Research Discussion Paper*.