



Decision

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DEPARTMENT: Monetary Policy Department

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■ The Riksbank removes the tolerance interval from its specified monetary policy target

Proposed decision

It is proposed that the Executive Board decide that:

1. The Riksbank removes the tolerance interval +/- 1 percentage point from its specified monetary policy target. Consequently, the target for monetary policy will only be specified as a target for inflation, according to which the annual change in the consumer price index (CPI) is to be 2 per cent.

Background

Pursuant to Chapter 9, Section 13 of the Instrument of Government, the Riksbank has responsibility for monetary policy in Sweden. The objective of the Riksbank's activities is, according to Chapter 1, Section 2 of the Sveriges Riksbank Act, to maintain price stability.

When the decision on guidelines for monetary policy was made on 14 January 1993, the Riksbank specified the target for monetary policy, to be to limit the annual increase in the consumer price index in 1995 and onwards to 2 per cent, with a degree of tolerance of +/- 1 percentage point.

Considerations

The idea of the tolerance interval was to make it clear that deviations from the inflation target were probable, and that the Riksbank's aim was to try to limit these deviations.¹ If the deviations are large and last for long periods, the target may lose credibility.

In the light of the experiences gained since the inflation target was introduced, there is reason to review the need for an explicit tolerance interval around the inflation target.

There is currently widespread understanding among the participants in the economy for the fact that monetary policy is conducted under uncertainty. Unforeseen events occur

¹ Memorandum "Riksbankens inflationsmål – förtigligande och utvärdering", 4 February 1999, registration no. 1999-00351 DIR, or L. Heikensten, "The Riksbank's inflation target – clarifications and evaluation" Sveriges Riksbank Quarterly Review No. 1, 1999.

from time to time, which can cause inflation to overshoot or undershoot the target to a relatively large degree; sometimes by more than one percentage point. Deviations from the inflation target can also be part of a deliberate strategy by the Riksbank. The Riksbank conducts what is known as flexible inflation targeting. This means that at the same time as monetary policy is aimed at attaining the inflation target; it is also to support the objectives of general economic policy for the purpose of attaining good growth and a high level of employment. It is therefore possible to allow inflation to deviate from the target temporarily, as part of a deliberate strategy to stabilise production and employment. This is also one of the reasons why deviations from the inflation target can at times be larger than the tolerance interval. A recent example is the large repo rate cuts made in connection with the financial crisis, which contributed to CPI inflation undershooting the lower limit of the tolerance interval.

Since the inflation target began to apply in 1995 inflation has deviated from the target by more than 1 percentage point around half of the time. It has thus not been unusual for inflation to be outside of the tolerance interval. However, because of the confidence in the inflation target that has been established, these deviations do not have any tangible consequences for long-term inflation expectations among economic agents.

To summarise, one can conclude that the tolerance interval has become obsolete: There is considerable understanding for the fact that inflation commonly deviates from the target and that the deviations are sometimes larger than 1 percentage point. Inflation can thus be outside of the tolerance interval without threatening the credibility of the inflation target. Such deviations have proved to be a natural part of monetary policy.

Finally, it can be noted that the Riksbank has for a long time now closely analysed and explained deviations from the inflation target in its Monetary Policy Reports and Monetary Policy Updates. This is done regardless of whether the deviation is outside of or within the tolerance interval. Removing the tolerance interval should thus have no consequences for the inflation target as such, or for the way in which monetary policy is conducted and communicated.

The tolerance interval was part of a decision on guidelines for monetary policy made by the then Governing Council of the Riksbank on 14 January 1993. Given the above, the Executive Board should therefore decide to remove the tolerance interval in its specification of the monetary policy objective.