INFLATION ASSESSMENTS AND MONETARY POLICY

The target for monetary policy is a 2 per cent annual change in the CPI, with a tolerance interval of ±1 percentage point for derivations from this interval. Policy is constructed in the light of an assessment of price developments in the coming twelve to twenty-four months. In each Report the time perspective is shifted approximately one quarter into the future. This means that even if the Riksbank's appraisal of future economic activity and inflation is unchanged, different monetary policy conclusions may be called for because the period being assessed has shifted ahead. For the time being, monetary policy will be based primarily on an assessment of consumer price tendencies from 2000 Q2 up to and including 2001 Q1.

Monetary policy is sometimes described with a simple rule of thumb: if the inflation forecast in the main scenario (based on an unchanged instrumental rate) indicates that inflation will deviate from the target in twenty-four months time, then the instrumental rate should be adjusted accordingly. However, predicting future inflation is not straightforward. The Riksbank therefore also assesses the uncertainties in inflation's future path.

The overall picture of inflation prospects consists in practice of an assessment of probabilities. Together with a main scenario—the most probable outcome—a number of risk scenarios are weighted into the final assessment on which the formation of monetary policy is based. The uncertainty surrounding the main scenario is not necessarily symmetric. Upside risks predominate at times, while on other occasions it can seem more probable that inflation will be lower than in the main scenario. The assessment in the main scenario is supplemented by the appraisal of the risk spectrum, which can constitute an important argument for tightening or loosening the monetary stance. Another matter than may be worth mentioning here is that the formation of monetary policy can be influenced by the inflation assessment's uncertainty as such. A high degree of uncertainty can be a reason for a more cautious attitude, thereby avoiding excessively large shifts in interest setting and the formation of expectations.

There are two grounds for refraining at times from directing monetary policy so that the CPI target is fulfilled in twelve to twenty-four months time. One is that in the relevant time perspective consumer prices may be pressed up or down by a factor or factors with an effect on inflation that is not expected to be permanent. Examples of such factors are changes in interest expenditure and altered taxes and subsidies. The other ground from departing from the rule of thumb is that, after a major deviation, a rapid return to the targeted rate may be costly for the real economy. If either of these situations applies, the magnitude of the deviation from the CPI target that may be motivated twelve to twenty-four months ahead is clarified by the Riksbank in advance.