The Riksbank's inflation target - clarification and appraisal (memorandum)

Summary

The subject of this memorandum is the formulation of monetary policy in the context of the amended Riksbank Act. At the meeting on 4 January 1999 the Executive Board decided that the current formulation of the monetary policy target continues to apply. Future monetary policy will still aim at keeping the change in the consumer price index at 2 per cent in a somewhat longer, annual perspective, with a tolerance interval of ±1 percentage point.

A clarification of monetary policy's formulation is called for, however. Monetary policy is normally conducted so as to be on the target, defined in terms of the CPI, one to two years ahead. Departures from this general rule may be warranted for two reasons. One is that the CPI can be pushed upwards or downwards in the relevant time perspective by one or more factors that are not considered to affect inflation more permanently. Changes in interest expenditure, indirect taxes and subsidies are examples of such factors. The other reason for departing from the rule can be that a quick return to the target in the event of a sizeable deviation can sometimes be costly for the real economy. In the event of either of these situations occurring, the magnitude of the deviation from the inflation target, defined in terms of the CPI, that may be motivated 1 to 2 years ahead will be clarified by the Riksbank in advance.

Facilitating an appraisal of monetary policy is particularly important in view of the Riksbank's more independent status as of 1999. Clarification along these lines will simplify backward-looking assessments of monetary policy. It will be easier than at present to distinguish the extent to which deviations from the target were a consequence of deliberate choices when the policy was decided. An account of the policy outturn will be presented regularly by the Riksbank in connection with the Governor's first appearance each year before the Parliamentary Standing Committee on Finance. The account will be based on the path of the CPI, measured both as consecutive 12-month change figures and as the moving 12-month average of those figures. If the CPI changes have moved outside the tolerance interval, the reasons for this will be explained, taking into account any factors that had been identified in advance.

1 Introduction

In connection with the latest amendments to the Riksbank Act (1988:1385), which came into force 1 January 1999 and prescribe an explicit objective for monetary policy, there is reason to clarify the formulation of monetary policy as well as the implementation of the Riksbank's inflation target and to propose forms for appraising the Riksbank's actions. At the meeting on 4 January 1999 the Executive Board of the Riksbank decided that target for monetary policy continues to apply. At the same meeting, Deputy Governor Lars Heikensten was given the task of reporting back to the Executive Board with proposals for a clarification of monetary policy, for instance as regards the handling of transitory effects when formulating policy. The report on this assignment is contained in this proposal for clarifications of monetary policy's formulation.

In order to elucidate its policy, the Riksbank intends to announce in advance when there may be grounds for departing from the ambition of fulfilling the target, defined in terms of the CPI, in 1 to 2 years time. A process is also proposed by which monetary policy could be appraised by the Riksbank's principal and by external observers. This is particularly important in view of the Riksbank's more independent status.

2 Monetary policy's fundamental aim

The objective of monetary policy is specified in Chapter 1, Article 2 of the amended Riksbank Act as being to maintain price stability. The adoption of this objective stemmed from the insight, in economic theory as well as from practical experience, that high inflation exacts social costs. A low level of inflation provides a good foundation for economic growth.

In the light of this perception, in the early 1990s a broad political consensus decided to bring inflation in Sweden down to a good European level. The Riksbank announced an inflation target for monetary policy in January 1993: as of 1995, inflation measured as the change in the consumer price index was to be limited to 2 per cent, with a tolerance interval of ±1 percentage point. The primary purpose of the tolerance interval was to indicate that deviations from the target rate would probably occur. At the same time, the specific interval manifested the ambition to restrict those deviations.

The level of inflation targeted by the Riksbank corresponds to that chosen by most other central banks that aim monetary policy at price stability. Another consideration was the perception that monetary policy in the European Union is directed at approximately this level. In its decision in January 1993, moreover, the Governing Board judged that the initial rate of underlying inflation would be 2 per cent.

The inflation target was formulated in the terms of the consumer price index (CPI). This index was chosen mainly because it is the most familiar representation of inflation in Sweden and this was considered to be particularly important for establishing confidence in a new monetary policy regime. The CPI also has many other advantages: it covers a very large proportion of household consumption, is published regularly and its statistical properties are well known.

The arrangement with a distinct target and a tolerance interval made it clear from the beginning that monetary policy's reactions to expected deviations in inflation would be symmetric. The Riksbank would regard unduly low inflation as just as serious as unduly high. A distinct target also created a good starting point for appraisals of monetary policy.

Both the implementation of monetary policy and its analytical framework have been developed during the six years since inflation began to be targeted. In recent years the Riksbank has been more open about the motives that guide policy. One example is the quarterly Inflation Report, which includes a presentation of the inflation forecast. The point has also been made that monetary policy is formulated for a longer perspective;

certain types of transitory and sudden shocks are allowed to affect the CPI without prompting policy adjustments. This applies, for example, to changes in indirect taxes or house mortgage interest expenditure.

There are no grounds at present for any fundamental changes in the formulation of the monetary policy target. But in the light of experience there are reasons why the formulation of policy should be clarified in some respects. The work of constantly developing and improving both the guiding principles and the implementation of policy will, of course, continue. When proposals have been presented by the CPI Inquiry (dir. 1997:144), there may be occasion, for instance, to consider which index of inflation should guide policy. One alternative to the CPI could be the HICP, which is being constructed under EU auspices. There may also be cause for a future assessment of monetary policy's formulation and target in the light of the move to Stage Three of EMU and the monetary policy of the European Central Bank.

3 Clarifying the formulation of monetary policy

It is now generally accepted that in the long run monetary policy has little, if any, direct effect on growth and employment. Monetary policy is, however, capable of contributing to economic stability and thereby providing growth and employment with a good foundation. This perception is indeed reflected in the Riksbank's assignment as formulated in the amended Riksbank Act. But it is also clear that monetary policy does have consequences for the demand situation and employment in the short run.

Even if inflation were to be clearly above or below the target, a quick return to the target (in a matter of months, for example) might be achieved with drastic interest rate adjustments. However, such a policy could result in marked and undesirable fluctuations in real economic activity. This has to do with the considerable time lag before monetary policy acts, with the largest effect on inflation in the interval of one to two years. That is one reason behind the Riksbank's decision to focus policy on fulfilling the 2 per cent target for CPI inflation just 1 to 2 years ahead. By focusing monetary policy on this horizon it is possible to limit any negative short-run effects on the real economy. Even so, there may still be reasons for also considering inflation's forecast path in the coming year as well as beyond the target horizon.

This simple policy rule needs to be elucidated in two respects:

1. One respect concerns situations when CPI inflation in the relevant time perspective is being affected by specific factors that are judged to have no substantial permanent impact on inflation or the inflation process. When policy is formulated in these situations, there may be grounds for explaining in advance that a deviation from the CPI target is warranted.

A good example of a situation of this type is to be found in the autumn of 1998. Between two consecutive Inflation Reports the Riksbank's forecast for the CPI 1 to 2 years ahead was lowered as much as 0.5 percentage points simply because of a change in the property tax for the year 2000. A transitory effect of this kind on inflation should not warrant a marked repo rate cut, such as would have been needed to restore the CPI forecast to the targeted rate 1 to 2 years ahead.

Experience in Sweden and elsewhere indicates that the transitory effects on inflation which should not be fully countered by monetary policy are mainly of three kinds:

– The first type has to do with the Riksbank's own operations. A repo rate adjustment, up or down, affects house mortgage interest expenditure, which is a sizeable component of the CPI. This is evidently not an effect on the CPI that the Riksbank ought to counter. Transitory effects of this kind have played a major role in CPI movements in recent years. On average, in the period 1996–98 the impact of the interest factor on housing costs held back the annual increase in the CPI by 0.7 percentage points.

– Monetary policy effects of indirect taxes and subsidies can be analysed in a similar way. If the effects on inflation from existing or proposed changes to taxes and subsidies are judged to be transitory and to fade beyond the steering horizon, monetary policy ought not to be formulated to counter them. Moreover, in the same way as with a repo rate adjustment's effect on interest rates, there is a link here with economic policy. An increase in the VAT rate, for example, may have been made in order to subdue demand and curb inflation further ahead.

– Similar problems may arise in connection with supply shocks. Price movements for petroleum and other imported goods, for example, that are judged to have only transitory effects on domestic inflation ought not to elicit monetary policy countermeasures.

It should be underscored that the question of what constitutes a transitory effect is complex. In many instances there is no simple answer and even if clarity is the aim, the fact remains that the assessments are difficult. This is particularly evident in the case of supply shocks. To what extent do import price movements, for example, reflect transitory factors rather than international competition's more long-term consequences? This suggests that supply shocks may need to be analysed particularly closely and cited selectively as an argument for departing from the CPI target.

In any assessment of whether or not an inflationary shock is transitory, a central question is the impact on inflation expectations. Take, for example, an increase to an indirect tax that is judged to elicit higher wage demands and thereby affect the inflation process; if inflation expectations are influenced, the impact of what would otherwise be a transitory shock can thus be permanent, in which case the shock should be allowed for in the formulation of monetary policy.

2. The other case is when inflation for some reason has deviated markedly from the target. This raises the question of how quickly inflation should be returned to the target rate of 2 per cent. It is envisaged that, on average, the Riksbank should deploy its measures with a view to returning to the target in the course of the coming one to two years. But the size of the necessary interest rate adjustment and the period over which it should be implemented are matters that will have to be decided from case to case. A mechanical approach that invariably attempts to bring inflation back to the targeted level within the next one to two years could lead in certain cases to unduly

large and undesirable fluctuations in economic activity. The Riksbank's discretion in this respect is partly dependent on economic policy's credibility; strong confidence in monetary policy's commitment to long-term price stability, together with a credible economic policy in other respects, can enlarge the scope for flexibility in the policy's short-run formulation.

The conclusion from the discussion above is that the simple rule for monetary policy decisions—adjust policy so that the 2 per cent target for the CPI is fulfilled in one to two years—may need to be clarified in two respects. One is that the Riksbank may be justified in not concentrating on attaining a CPI increase of 2 per cent if it considers that inflation is being influenced by transitory effects. The other is that in the event of a considerable shock, there may be grounds for not attempting to return inflation to the targeted level immediately. In such a situation the Riksbank shall clearly state in advance—in the Inflation Report and in connection with monetary policy decisions—how it expects inflation to deviate from the target and why. In both cases the justification for deviations is the social costs that might otherwise be incurred on account of avoidable fluctuations in economic activity.

Finally it should be emphasised that these clarifications do not represent any change in the fundamental direction of monetary policy. The Riksbank is to continue along the same path as before but increase the clarity of its policy.

4 Appraising target fulfilment

For the credibility of monetary policy and its support in society it is important that the policy can be widely understood, discussed openly and appraised.

To be appraisable, the policy must be characterised by openness and the Riksbank needs to be explicit. It will then be easier to assess new information and predict how the Riksbank will act. Monetary policy can accordingly contribute to less uncertainty in financial markets and the economy in general. It is particularly important that the Riksbank provides clear information to its principal, the Riksdag. The Governing Council of the Riksbank acts as an important intermediary here between the Executive Board and the Riksdag. A good supply of information is essential for the Riksdag's appraisal of the Riksbank's operations.

The Riksbank is required to make a written report on monetary policy to the Parliamentary Standing Committee on Finance at least twice a year (Riksbank Act, Ch. 6, Art. 4). The Riksbank considers that these reports should coincide with its Governor's appearance before the Standing Committee. In connection with the first appearance each year the Riksbank intends to account for results of its policy. The material that is presented should include a comparison between the 2 per cent target for CPI inflation and the outturn. The above-mentioned clarifications are crucial here as they make it easier to determine whether deviations from the target are attributable to earlier decisions rather than to other factors, for example forecasting errors. The outturn for inflation is to be presented both as consecutive 12-month change figures and as the moving 12-month average of those figures.

In this context the tolerance interval will have an operational function. Whenever CPI inflation is outside the tolerance interval, the Riksbank is to present an explanation of the background to this. These explanations will serve, for instance, to highlight the transitory effects that are judged to have been acting and which the Riksbank took into account in the formulation of monetary policy. In this context, moreover, the Riksbank can show how target fulfilment has been affected by the rate at which inflation has been brought back to the target after a shock. Explanations of this kind can provide the Riksbank's principal with a foundation for appraising the Riksbank's forecasting ability and conduct of monetary policy.
As hitherto, in the Inflation Report the Riksbank is likewise to present the current path of inflation as well as its inflation forecasts in relation to the targeted rate and the tolerance interval.

5 Proposed decision

At the meeting on 4 January 1999 the Executive Board resolved that the formulation of the monetary policy target would continue to apply.

Against this background it is proposed that the Executive Board adopts the clarification of monetary policy's formulation and the process for appraising monetary policy that are proposed in this memorandum.