



Annex A to the minutes

DATE: 6 September 2017
DEPARTMENT: Monetary Policy Department

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Reg. no. 2017-00691

CPIF target variable for monetary policy and band to illustrate variations in inflation

Decision by the Executive Board

The Executive Board hereby decides that:

1. The target for monetary policy is for the annual change in the consumer price index with a fixed interest rate (CPIF) to be 2 per cent. In practice, the CPIF has been more important for the formulation of monetary policy in recent years than the CPI. This is now being clarified by also formally defining the inflation target as a 2 per cent annual change in the CPIF. The change in the formulation of the target thus does not change how monetary policy is conducted; it clarifies how the Riksbank interprets its task of maintaining price stability.
2. A variation band will be used to illustrate in a simple way that monetary policy's ability to steer inflation in detail is very limited and that inflation normally varies around the inflation target. A variation band that stretches between 1 and 3 per cent captures approximately three-quarters of the outcomes for CPIF inflation since mid-1995.
3. The variation band does not affect the formulation of monetary policy, but is only to illustrate the fact that inflation normally varies. The Riksbank always strives for 2 per cent inflation, regardless of whether it is initially inside or outside the variation band.
4. The decisions will apply with effect from the monetary policy decision on 6 September 2017.

Background

Ever since inflation targeting was introduced in 1993, the Riksbank has defined the target in terms of the annual change in the consumer price index, CPI. However, the CPI has characteristics that could sometimes make it problematic to use as guidance for monetary policy. One reason is that repo-rate adjustments, through their effect on households' mortgage rates, have large and direct effects on the CPI which are not connected to underlying inflationary pressures and which also move the CPI in the

opposite direction. This means, for example, that interest rate cuts, which are intended to bring inflation up, instead further lower CPI inflation over the short term.

It has been a well-known fact that the CPI has characteristics that mean it is not an ideal target variable since the introduction of the inflation target. The Riksbank has therefore regularly allowed developments in other price indices than the CPI to affect the repo-rate decisions. In recent years, the CPIF (the CPI with a fixed interest rate) has de facto served as a target variable insofar as the Riksbank has usually aimed for CPIF inflation being close to 2 per cent within a couple of years. The idea has been that, even if interest rates sometimes go up and sometimes go down, CPI and CPIF inflation will coincide in the long run when the interest rate hikes and cuts offset one another.

In the wake of the global financial crisis, the Riksbank, like many other central banks, has made substantial policy-rate changes and the divergence between the CPI and the CPIF has therefore been significant at times. This has led to problems with communication, with regard to both the long-term trend in inflation and the direction of monetary policy. The Riksbank has therefore investigated the advantages and disadvantages of different alternatives to the CPI. A Riksbank Study was published in 2016.¹ In May 2017, the Riksbank sent a memorandum for consultation with the concrete deliberation of formulating the inflation target in terms of the CPIF.² No change in the level of the inflation target was considered.

The investigations made have also taken up the question of normal variations in inflation. Monetary policy is conducted under great uncertainty. There exists uncertainty over the way the economy functions and how inflation is determined, at the same time as monetary policy measures act subject to long and varying time lags. Monetary policy therefore has very limited ability to steer inflation in detail. In the discussions on monetary policy, both prior to and after the financial crisis, unexpected changes in inflation of a few individual tenths of a percentage point have sometimes attracted considerable attention. This indicates that the Riksbank needs to further develop its communication on normal variations in inflation. It was considered in the above-mentioned memorandum that a variation band should be used in the communication.

The comments of the referral bodies

The Riksbank's memorandum from May 2017, which said that the Riksbank was considering formulating the inflation target in terms of the CPIF and using a variation band to show the variations in inflation, was sent to 50 organisations and authorities.

The Riksbank's role as an independent central bank means that the members of the Executive Board may not seek or receive instructions when conducting monetary policy (known as the prohibition against instructions). On the other hand, members of the Executive Board and the Riksbank's experts may engage in discussions of the monetary policy framework with external authorities and organisations to create a well-founded and comprehensible monetary policy. This was the purpose of sending the memorandum for consultation to various organisations and authorities.

¹ "The Riksbank's inflation target – target variable and interval", Riksbank Studies, September 2016.

² See "Change of target variable and introduction of variation band", annex 1 to decision on 11 May 2017, Sveriges Riksbank.

On the question of the target variable, most of those consulted agree that the CPIF would be a better target variable. One response advocated the HICP, the EU-harmonised CPI that is used by the ECB, for instance, and like the CPIF is not directly affected by changes in the interest rate.

With regard to the variation band, there is a greater spread in the responses from the bodies consulted. Many of the consultation responses note that a variation band could increase understanding that inflation varies and will not be exactly 2 per cent in each individual month. Several of the consultation responses express concern, however, that a variation band could incorrectly be perceived as a target range. A target range is an inflation target that is defined in terms of a range, where there is no requirement that inflation should attain the middle of this range.³

Some consultation responses have claimed that it is better to await the outcome of the ongoing parliamentary inquiry into the monetary policy framework and the Sveriges Riksbank Act. Other consultation responses say that in that this question lies within the Riksbank's current mandate, there is no reason to await the parliamentary inquiry.

Considerations

The Executive Board has read the consultation responses and notes the following.

With regard to the proposal to change from the CPI to the CPIF, there is substantial support among the consultation responses. On this question, therefore, nothing new has come to light.

With regard to the use of a variation band to illustrate the normal fluctuations in inflation, the Executive Board notes that some consultation responses express concern that a variation band could be confused with a target range and/or lead to inflation expectations being less firmly anchored.

In this context, the Executive Board wishes to emphasise that the variation band is only intended to illustrate in a simple manner that inflation normally varies from one month to the next and that it therefore will not be 2 per cent all of the time. The Riksbank always strives for inflation to attain the target of 2 per cent, so the target is not expressed in terms of any interval, and the variation band thus is not a target range. Further, a variation band that stretches between 1 and 3 per cent covers approximately three-quarters of the monthly outcomes for CPIF inflation from mid-1995 to mid-2017.⁴ The width of the variation band is based on the historical development of inflation and may therefore need to be reviewed to be able to fulfil its role in the Riksbank's communication.⁵

The Executive Board emphasises that the changes now being made do not entail any change in the monetary policy conducted, but aim for increased clarity as to how the Riksbank interprets its task of maintaining price stability. In practice, the CPIF has been

³ See also "The Riksbank's inflation target – target variable and interval", Riksbank Studies, September 2016.

⁴ The inflation target was introduced in 1993 but did not start to apply until the start of 1995. Statistics Sweden began publishing the CPIF in July 2008, at the request of the Riksbank. Statistics Sweden's time series stretches back to 1988.

⁵ The band is calculated using a very simple method. In future, the band may become both broader and narrower, depending on the developments in inflation. If inflation is more stable than it has been historically, the band may become narrower, if the same simple method is used.



more important for the formulation of monetary policy than the CPI for some time. This is now being clarified by defining the inflation target as a 2 per cent annual change in the CPIF. The objective of monetary policy – to maintain price stability – is still to stabilise inflation at 2 per cent. The variation band is not a so-called target range. The Riksbank will always strive for 2 per cent inflation, regardless of whether it is initially inside or outside the variation band.

With regard to the question of awaiting the parliamentary inquiry, the Executive Board emphasises that specifying the price stability target is part of the mandate the Riksbank currently holds in accordance with the Instrument of Government and EU law. The ongoing parliamentary inquiry and the Riksdag's processing of the proposals put forward can be expected to take several years. It is not a good idea to postpone increased clarity for the current monetary policy. The change in target variable can now be implemented without drama both given that it is a question of already established practice and that CPI and CPIF inflation are currently very close to one another.