

ARTICLE – CPIF as target variable for monetary policy

The Riksbank has decided that 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. To illustrate the fact that monetary policy has little opportunity to govern inflation in detail and that inflation varies around the inflation target over the short term, the Riksbank will also start to use a variation band. The variation band ranges between 1 and 3 per cent and captures approximately three-quarters of outcomes for CPIF inflation since mid-1995. The Riksbank will continue to strive for 2 per cent inflation, regardless of whether it is currently inside or outside the variation band. The variation band is thus not a target range.

The CPIF as target variable for monetary policy

Since the inflation target was introduced in 1993, it has been defined in terms of the consumer price index (CPI). The selection of this measure when inflation targeting was introduced was largely due to it being a well-known and well-established measure. But the CPI has characteristics that make it problematic to use as guidance for monetary policy. The main reason is that changes to the Riksbank's policy rate have direct short-term effects on inflation that are not connected to underlying inflationary pressures. For example, when the Riksbank cuts the repo rate with the aim of raising the rate of inflation, mortgage rates fall. These are included in the owner-occupied housing expenses item in the CPI and the rate cut will therefore exert a downward pressure. This direct effect thus goes in the 'wrong direction'. In other words, the policy rate cut leads to a drop in near-term CPI-inflation.

Due to the CPI's characteristics, the Riksbank has long allowed the development of other price indices to influence interest rate decisions. In recent years, the CPIF (the CPI with a fixed interest rate) has, in practice, acted as guidance for monetary policy decisions. The assumption has been that CPI inflation and CPIF inflation will coincide in the long term, when rate rises and rate decreases cancel each other out. However, in recent years, deviations between the CPI and CPIF have been large, both upwards and downwards, which has led to problems in communication.

Large and protracted differences between CPI and CPIF inflation can cause a number of problems. Possibly the most serious of these is that participants are starting to question whether the Riksbank is really stabilising CPI inflation by stabilising CPIF inflation at around 2 per cent, thereby weakening confidence in the inflation target. Another

problem is that evaluations of monetary policy are made more difficult if there are major differences between the progression of the variable that guides the Riksbank in practice and the formal target variable. The change in the definition of the target has been made to further clarify how the Riksbank interprets its task of maintaining price stability.

Variation band put into use

Regardless of the target variable, it is not possible for the Riksbank to govern inflation precisely and attain the target of 2 per cent inflation every single month. To illustrate this, and to serve as a reminder that inflation over the short term fluctuates for many different reasons, the Riksbank has therefore decided to start to use a variation band. The variation band ranges between 1 and 3 per cent and captures approximately three-quarters of CPIF outcomes since 1995.³ The variation band is an easy way to illustrate the fact that inflation normally fluctuates. In other words, the variation band is not a so-called target range.⁴ The Riksbank will continue to strive for 2 per cent inflation, regardless of whether it is currently inside or outside the variation band.

No change to monetary policy conducted

The changes now being introduced have been agreed upon by the Riksbank after considering the views of a wide range of referral bodies.⁵ The CPIF as target variable and the use of a variation band do not involve any change to the monetary policy being conducted. It is important to safeguard the task of the inflation target as nominal anchor for price-setting and wage-formation. The aim of monetary policy will continue to be the stabilisation of inflation at 2 per cent. These changes entered into effect in conjunction with the monetary policy meeting of 6 September 2017.

³ 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.

⁴ For a discussion of the terms target range and tolerance band, see "The Riksbank's inflation target – target variable and interval", Riksbank Studies, September 2016.

⁵ For a list of the 50 organisations and authorities among which the proposal was circulated, see Consultation response on memorandum "Change of target variable and introduction of variation band".