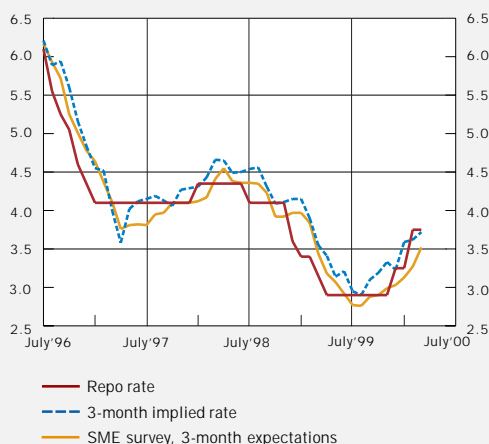


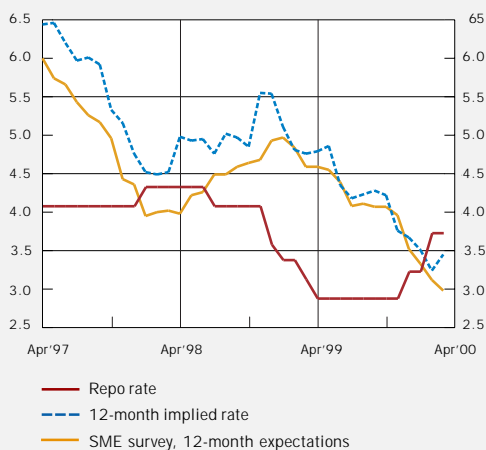
MARKET REPO-RATE EXPECTATIONS

Figure B1. The repo rate and expectations three months earlier.
Per cent



Sources: SIX Market Estimates (SME) and the Riksbank.

Figure B2. The repo rate and expectations twelve months earlier.
Per cent



Sources: SIX Market Estimates (SME) and the Riksbank.

A central bank stands to benefit from a clear picture of the repo-rate expectations of market players. It is then easier to avoid disturbing market pricing unnecessarily through statements or monetary policy adjustments. Expectations of the future repo rate can be derived from survey data, market letters and market prices for various types of interest instruments. The Riksbank uses the yield curve for Swedish Treasury paper to compute the implied forward interest rate curve, from which the market's interest rate expectations are then derived.¹¹ The Riksbank also follows a number of surveys of inflation, interest rate and exchange rate expectations that are produced by, for example, Statistics Sweden and SIX Market Estimates (SME).

Repo-rate expectations are based on, for instance, inflation prospects in the economy and the Riksbank's monetary policy signals and decisions. In the short run, the co-variation between these expectations and the path of the repo rate is an indication of the degree of transparency in the Riksbank's inflation targeting policy.¹² It may therefore be of interest to study how successful market players have been in predicting the repo rate.

Expectations of the repo rate three and twelve months ahead, derived from implied forward interest rates and survey data, are shown in Figs. B1 and B2, respectively, together with the repo rate's actual path.¹³ The three-month expectations seem to catch the repo rate's future path relatively well. Predicting the repo rate twelve months ahead has been considerably more difficult. The explanation for this is, not least, that few observers foresaw the weak price trend in recent years.

Figs. B1 and B2 also indicate that the expectations derived from surveys have been better predictors than implied forward interest rates, which have generally pointed to a higher level than the surveyed expectations. An explanation for the latter may be that the implied forward rates include various types of risk premium

11. The implied forward interest rate curves are estimated with the aid of the extended Nelson & Siegel method, cf. Svensson, L. (1995), Estimating forward interest rates with the extended Nelson & Siegel method, Quarterly Review 3, Sveriges Riksbank.
12. The general uncertainty associated with assessing inflation affects both the feasibility of clear monetary policy signalling by the Riksbank and the market's possibilities of predicting the repo rate.
13. Note that the expectations have been shifted forward in the chart to make it easier to compare them with the outcome to which they refer.

and therefore, particularly during periods of unrest when prices fluctuate widely, tend to overestimate how the repo rate is actually expected to develop. A case in point is the situation last autumn, when the money market was characterised by uncertainty about the future development of interest rates. At that time the difference between implied forward rates and survey data widened to about 1 percentage point (Fig. B3). The opposite applied, however, during the financial crisis in the autumn of 1998, when expectations of cuts in instrumental rates and a flight to secure short-term paper contributed to downward pressure on interest rates and thus to a difference that at times was negative.

One way of looking more closely at whether surveyed expectations have in fact been better predictors than implied forward interest rates is to calculate the accuracy of different forecasts with the same horizon. The results confirm the impression that surveyed expectations have been better than implied forward rates at catching the repo rate's future path (Table B1). They also confirm the conclusion that expectations for the somewhat longer term are less accurate than short-term expectations.

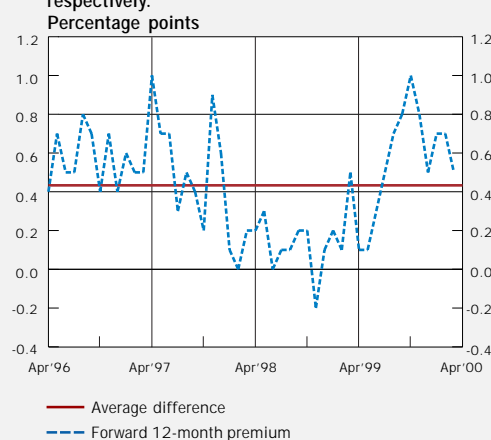
Table B1. Mean squared error of forecasts based on implied forward interest rates and survey data.

	3-month horizon		6-month horizon		12-month horizon	
	Implied forw. rate	Survey	Implied forw. rate	Survey	Implied forw. rate	Survey
Mean squared error	0.11	0.07	0.48	0.28	1.77	1.10

Note. The smaller the error, the better is the predictive power of the forecast.

Source: The Riksbank.

Figure B3. Difference between expectations of repo rate 12-month ahead derived from implied forward interest rates and SME surveys, respectively.



Sources: SIX Market Estimates (SME) and the Riksbank.