AN ILLUSTRATION OF INFLATION FORECASTING WITH A RISING REPO RATE

Market pricing and survey data on analysts' opinions indicate expectations at present that the repo rate will be raised successively in the coming two years. The inflation forecasts of most external observers likewise incorporate a rising repo rate. In the main scenario, however, inflation is forecast as usual on the assumption that the repo rate will be unchanged; this serves to bring out the consequences for the formation of monetary policy. An illustrative calculation is therefore presented here that incorporates repo rate increases in line with market expectations as reported in Statistics Sweden's survey in September 2000.

The survey data show expectations of repo rate increases to 4.00 per cent three months from now, to 4.50 per cent after one year and to 4.75 per cent two years ahead.[40] Here it is assumed that the short-term market interest rates broadly follow the repo rate, while the pass-through to the longer rates is judged to be smaller. Compared with the main scenario, the short rates are judged to be 0.5–1.0 percentage point higher, while the effect on long rates stops at approximately 0.1 percentage point. The higher level of interest rates is considered to strengthen the krona: in the forecast period the effective exchange rate is judged to appreciate about 1 per cent more than in the main scenario.

Compared with the main scenario, a path for the repo rate that follows the expectations in Statistics Sweden's survey accordingly gives a higher level of interest rates and a stronger exchange rate in the forecast period. This in turn means that the combined effect on demand from interest rates and the exchange rate is judged to be less expansionary than in the main scenario.

The higher interest rates compared with the main scenario are judged to have some downward effect on the growth of both consumption and investment. Moreover, the stronger exchange rate tends to curb net exports. All in all, this is judged to reduce GDP growth to some extent in both 2001 and 2002. The damping of activity is also assumed to result in a somewhat weaker wage trend.

40 The median value of the expectations.

Table B5. Modified inflation forecast, incorporating the interest rates expected in Statistics Sweden's survey in September 2000. Percentage change and percentage points

	Annual rate 2000	Annual rate 2001	12-month rate September 2001	12-month rate September 2001
CPI	1.3 (0.0)	1.7 (0.3)	1.7 (0.3)	1.9 (-0.1)
UND1X	1.4 (0.0)	1.4 (-0.1)	1.4 (-0.1)	1.7 (-0.2)

Note. The figures in parentheses are the difference from the main scenario's rate of inflation with an unchanged repo rate.

Source: The Riksbank.

The higher interest rates imply increased interest expenditure for households and this affects price tendencies already during 2000. Compared with the main scenario, CPI inflation is therefore judged to be marginally higher in 2000 and 0.3 percentage points higher in 2001. It is only towards the end of the forecast period that the weaker demand and the lower import prices associated with a stronger exchange rate begin to affect inflation more substantially. This has to do with the assumption that the repo rate increase is spread over the coming two years and that monetary policy's influence on prices is lagged. The weaker demand and lower import prices therefore begin to subdue UND1X inflation only in the course of 2001, by approximately 0.1 percentage point. During 2000 the impact is somewhat greater, about 0.2 percentage points.