FORECASTING INFLATION WITH A RISING REPO RATE

Market pricing and survey data of analysts' opinions indicate current expectations of a repo rate increase in the coming two years. The inflation forecasts of most external observers likewise incorporate repo rate increases. In the main scenario, however, inflation is forecast as usual on the technical 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 2001.

The survey data show expectations of a repo rate of 3.75 per cent three months from now, followed by increases to 4.0 per cent one year ahead and 4.5 per cent after two years.[16] Here it is assumed that the short-term market interest rates will broadly follow the repo rate, while the pass-through to the longer rates is smaller. Compared with the main scenario, the short rates are judged to be approximately one half of a percentage point higher, while the effect on long rates stops at between 5 and 10 basis points. The higher level of interest rates is also judged to strengthen the exchange rate to some extent.

Compared with the main scenario, a path for the repo rate that follows market expectations accordingly means that the combined effect on demand from interest rates and the exchange rate is judged to be somewhat less expansionary than in the main scenario.

The higher interest rates are judged to have some downward effect on the growth of both investment and household consumption. Moreover, the somewhat stronger exchange rate acts as a damper on net exports and import prices. All in all, this is judged to result in marginally lower GDP growth in both 2002 and 2003. Moreover, the more subdued economic activity leads to somewhat lower inflationary pressure (Table B5).

16 The median value of the expectations.

Table B5. Modified inflation forecast, incorporating the interest rates expected in Statistics Sweden's survey in September 2001. Percentage change and percentage points

	Annual rate 2001	Annual rate 2002	12-month rate Sept. 2002	12-month rate Sept. 2003
CPI	2.6 (0.0)	2.0 (0.0)	1.5 (0.0)	2.1 (0.0)
UND1X	2.8 (0.0)	2.3 (-0.1)	1.6 (-0.1)	1.9 (-0.1)

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, with effects on the development of the consumer price index. This is countered by somewhat lower GDP growth. CPI inflation is therefore judged to match the picture in the main scenario both one and two years ahead, while UND1X inflation is about 0.1 percentage point lower at both time points. The impact is not larger than this because effects of monetary policy take time to materialise and the greater part of the expected increase in the repo rate occurs towards the end of the forecast period.