FORECASTING INFLATION WITH A REPO RATE BASED ON MARKET EXPECTATIONS

In the main scenario, 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. However, market pricing and survey data on analysts' opinions currently indicate a somewhat different picture of the repo rate's expected path in the coming two years. The repo rate two years from now is generally expected to be higher than at present. An illustrative calculation is therefore presented here that incorporates repo rate increases in line with market expectations as reported in Prospera's survey in November 2001.

The survey data show expectations of repo rates of 3.5 per cent three months from now, just over 3.6 per cent one year ahead and 4.25 per cent after two years.[21] 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 20 basis points lower one year ahead and 30 basis points higher after two years, while the effect on long rates stops at an average of 5 basis points higher. The higher level of interest rates two years ahead is also judged to strengthen the exchange rate marginally.

Thus, a path for the repo rate that follows market expectations has conflicting effects on demand from short- and long-term interest rates and the exchange rate. All in all, the expansionary effect from short-term interest rates is judged to be stronger one year ahead than the restrictive effects from higher long-term interest rates and the stronger exchange rate. After two years, however, the combined effect on demand from interest rates and the exchange rate would be less expansionary than in the main scenario. Inflation between one and two years ahead is affected mainly be the more expansionary conditions after one year and less by the expected interest rate increase during 2003. But on the whole, the effects on inflation are virtually negligible.

21 The median value of the surveyed expectations.

Table B5. Modified inflation forecast, incorporating interest rates derived from market expectations.
Percentage change and percentage points

	Annual rate 2002	Annual rate 2003	12-month rate December 2002	12-month rate December 2003
CPI	1.7 (-0.1)	2.2 (0.2)	1.9 (-0.1)	2.3 (0.2)
UND1X	2.1 (0.0)	1.9 (0.0)	2.0 (0.0)	1.9 (0.0)

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

Source: The Riksbank.

CPI inflation one year ahead is held back slightly by lower interest expenditure and a marginally stronger exchange rate. Higher interest expenditure during 2002 leads, however, to somewhat higher CPI inflation after two years. UND1X inflation, on the other hand, is judged to be more or less unchanged both one and two years ahead (Table B5).