FORECASTING INFLATION WITH A RISING REPO RATE

Market pricing and survey data of analysts' opinions both currently show expectations of some increase in the repo rate during the forecast period. External observers foresee a repo rate two years ahead that is somewhat higher than indicated by market prices. In the Riksbank's main scenario, however, inflation is forecast as usual on the technical assumption that the repo rate remains at the current level of 4.25 per cent; this serves to bring out the consequences for the formation of monetary policy. An illustrative calculation is therefore presented here that incorporates a path for the repo rate that is in line with market expectations as reported in the survey that Prospera undertook on behalf of the Riksbank in October 2002.

The survey data show expectations that the repo rate will be raised to 4.50 per cent in the coming twelve months, followed by an increase to 4.75 per cent after twenty-four months.[28] 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 assessment in the main scenario, the short rates are judged to be about 0.2 percentage points higher one year ahead and about 0.4 percentage points higher after two years, while the average effect on long rates stops at less than 0.1 percentage point. The higher level of interest rates also points to some strengthening of the exchange rate; during the forecast period the TCW index is judged to be an average of not quite 0.5 per cent stronger than in the main scenario.

All in all, it is considered that higher interest rates and a stronger exchange rate would lead to somewhat lower GDP growth in the forecast period. Moreover, the somewhat stronger exchange rate dampens import prices.

28 These are the median values of the expectations.

Table B3. Modified inflation forecast, incorporating the interest rates expected by the money market.
Percentage change and percentage points

	Annual rate 2002	Annual rate 2003	12-month rate September 2003	12-month rate September 2004
CPI	2.4 (0.0)	2.3 (0.1)	2.2 (0.1)	2.4 (0.1)
UND1X	2.6 (0.0)	1.8 (-0.1)	1.7 (-0.1)	1.8 (-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.

Lower resource utilisation and a stronger exchange rate both tend to subdue UND1X inflation (Table B3). CPI inflation would, however, be somewhat higher than in the main scenario because here the downward effects on inflation are countered by the impact of higher house mortgage interest expenditure. The effects are all very slight.