Forecasting inflation with a rising repo rate

Expectations of the repo rate among market operators have been revised downwards since the December Inflation Report. Market pricing shows that there are currently expectations of a reduction in the repo rate during the Riksbank's forecast period. On the other hand, surveys of individual analysts indicate expectations of a raise in the rate two years ahead. In the Riksbank's main scenario, however, inflation is forecast as usual on the technical assumption that the repo rate will be unchanged at the present level of 3.75 per cent; this serves to clarify 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 February 2003.

According to this survey, the repo rate is expected to remain unchanged one year ahead and to be raised to 4.25 per cent two years ahead.[22] 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 assessments in the main scenario, the short rates are judged to be approximately 0.20 percentage points higher one year ahead and about 0.50 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 is also expected to strengthen the krona slightly. The krona's TCW exchange rate is assessed on average to be just under 0.5 percentage points stronger during the forecast period 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 stronger exchange rate will subdue import prices (see Table B5).

Lower resource utilisation and a stronger exchange rate both tend to slightly subdue UND1X inflation. But CPI inflation would be somewhat higher than in the main scenario because the downward effects on inflation are countered by the impact of higher house mortgage interest expenditure. On the whole, the effects are very small.

Table B5. Modified inflation forecast, incorporating the interest rates expected by the money market. Percentage change and percentage points

	Annual rate 2003	Annual rate 2004	12-month rate March 2004	12-month rate March 2005
CPI	2.6 (0.1)	1.6 (0.1)	1.1 (0.1)	2.1 (0.1)
UND1X	2.5 (0.0)	1.2 (-0.1)	0.7 (-0.1)	1.7 (-0.1)

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

Source: The Riksbank.

22 These are median values of the expectations.