

## AN ILLUSTRATION OF INFLATION FORECASTING WITH A RISING REPO RATE

**Table B2. Modified inflation forecasts incorporating expected interest rates in Statistics Sweden's survey in September 1999. Percentage change**

	Annual rate 1999	Annual rate 2000	12-month rate Sept. 2000	12-month rate Sept. 2001
<b>CPI</b>	0.4(+0.1)	1.4(+0.3)	1.5(+0.4)	1.7(-0.3)
<b>UND1X</b>	1.5(0.0)	1.7(-0.1)	1.7(-0.1)	1.9(-0.2)

Note. The figures in parentheses are the difference from inflation according to the main scenario with an unchanged repo rate.

Sources: Statistics Sweden and the Riksbank.

Market pricing and survey data indicate expectations at present of a successive increase in the repo rate in the coming two years. The inflation forecasts of many external observers likewise presuppose a rising repo rate. In the Riksbank's inflation forecast, however, the repo rate is assumed to be unchanged (in order to bring out the forecast's consequences for the formation of monetary policy). An illustrative calculation is therefore presented here, based on repo rate increases in line with the expectations of money market players as reported in Statistics Sweden's survey in September 1999. This illustrative assessment is compared with the main scenario, which is based on the repo rate remaining unchanged.

The survey data show expectations of repo rate increases to 3.15 per cent in three months' time, 3.80 per cent twelve months ahead and 4.25 per cent after twenty-four months.<sup>32</sup> 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 only partial. Compared with the main scenario, the average level of short rates is judged to be almost one percentage point higher in the forecast period, while the effect on the long rates stops at approximately 0.3 percentage points. Higher interest rates relative to the rest of the world are assumed to lead to a stronger exchange rate: the average level of the TCW index in the forecast period is judged to appreciate approximately one per cent more than in the main scenario.

This example accordingly gives a higher level of interest rates and a stronger exchange rate in the forecast period than foreseen in the main scenario. The higher interest rates are judged to lead to somewhat more restrained growth of private consumption and some slackening of investment. At the same time, the stronger exchange rate tends to dampen export growth and activity in export-related parts of the Swedish economy. The overall effect is judged to be that annual GDP growth would be about 0.2–0.3 percentage points lower in 2000 and 2001.

The CPI increase in this alternative in 1999 and 2000 is judged to be somewhat higher than in the main scenario (Table B2). This is because the higher interest rates entail increased house mortgage expenditure,

<sup>32</sup> The median value of the expectations.

which gives higher CPI inflation initially. The restrictive effects on demand and import prices do not have an appreciable impact on CPI inflation until late in the forecast period, by which time the direct CPI effects from house mortgage costs are diminishing. The aggregate effect on CPI inflation in twenty-four months time is judged to be -0.3 percentage points. The impact on underlying inflation occurs already in 2000, when UND1X inflation is judged to be approximately 0.1 percentage point lower than in the main scenario with an unchanged repo rate. The successive repo rate increases would be likely to go on lowering UND1X inflation during 2001; the effect in that year is calculated to be approximately -0.2 percentage points.