Norwegian inflation forecasts, January 2007

This is the sixth of a sequence of forecasts of the Norwegian rate of inflation using a small scale econometric model to produce automatized inflation forecasts, AIRs. The approach taken, and model used, is the same as has been useful in analyzing the recent forecasts failure affecting Norges Bank's inflation forecasts, see Nymoen (2005).

The forecasted variable is the 4 quarter rate of change in the Norwegian consumer price index, adjusted for taxes and energy prices ((CPI-ATE). The forecast period is 13 quarters long, from 2007(1) to 2010(1).

The January 2007 inflation forecast is shown in the fan-chart below. The point forecasts are shown as a thick blue line, and the 90% prediction intervals are indicated by the symmetric fans. Inside the fans, two thinner blue lines show a 60% interval: Based on the forecasting model, future inflation rates inside this narrower interval are more likely events than inflations rates outside the narrower forecast band. The recent inflation history, from 2001(1) to 2006(4) is shown by the red line.

Inflation is projected to increase quite vigorously in 2007. The forecasted rate of inflation is then increasing more moderately in the period 2007-2009, making inflation in the range of 2.0%-2.5% a likely event.

The forecasting mechanism used (the AIR model) consists of an equation for the rate of inflation (CPI-ATE), and 8 equations which are needed to forecast the following variables: the (logarithm of the) rate of unemployment, productivity growth, the nominal and the real exchange rates, foreign inflation (in foreign currency), domestic and foreign interest rates and oil prices. The
theory behind the inflation forecasting equation, and the econometric specification of the whole system is explained in Nymoen (2005).

The figure below shows the nominal 3 month interest rate, which is forecasted together with inflation and the other variables in the AIR forecasting system. The interest rate is forecasted to increase from 3.6% in 2006q4 to 4.1% in 2007q1 and to 5.3% in 2008q1. In the rest of 2008 and in 2009, the increase in the forecasted interest rate is more moderate. At the end of the forecast period, the interest rate is still below the rates in 2002. The forecasts indicate a widening gap between Norwegian and foreign interest rates, which contributes to exchange rate appreciation in the forecast period.