Norwegian inflation forecasts, January 2006

This is the fourth 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 four quarter rate of change in the Norwegian consumer price index, adjusted for taxes and energy prices (CPI-ATE). The forecast horizon is 16 quarters, from 2006(1) to 2009(4).

The January 2006 inflation forecast is shown in the fan-chart below. The point forecasts are shown as a black line, and the 90% prediction intervals are indicated by the symmetric fans. The inflation target of 2.5% is also indicated, as well as the recent inflation history, from 2001(1) to 2005(4) (red line). In 2006 inflation is projected to increase moderately from its present level. The forecasted rate of inflation is then increasing more vigorously in the period 2007-2009, making a level of inflation in the range of 2.0%-2.5% a more likely event.

The forecasting mechanism itself, it 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 inflation forecast together with forecasts of the main explanatory variables in the “inflation equation”. The main explanation of the upswing in inflation is the reduced rate of unemployment forecasted by the model. The last panel of the graph shows that the interest rate differential (difference between domestic and foreign interest rate) is increasing in the forecast period.