Developments in longer-term inflation expectations in the euro area

Boxes

Box 4

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After having reached low levels in mid-January, longer-term inflation expectations in the euro area have recovered. The decline observed over the previous two years has thus come to a halt. These movements – with some differences – were also observed in the United States and the United Kingdom. Longer-term inflation expectations are generally seen to be an indicator of the credibility of central banks in achieving their price stability objectives and should, therefore, remain solidly “anchored”. The anchoring of inflation expectations requires longer-term expectations not to respond to changes in shorter-term inflation developments. Against this background, the box reviews past developments of longer-term inflation expectations, comparing them on the basis of market-based and survey-based indicators.

Both market-based and, albeit to a lesser extent, survey-based measures of longer-term inflation expectations declined between early 2013 and early 2015. Expectations of inflation five years ahead, as expressed in the ECB’s Survey of Professional Forecasters (SPF), fell from 1.98% in the first quarter of 2013 to 1.77% in the first quarter of 2015 (see Chart A). The one-year forward inflation rate four years ahead derived from market-based measures decreased from 2.0% in early 2013 to 1.2% in January 2015, while the five-year inflation-linked swap rate five years ahead fell from 2.4% to 1.5% over the same period.1

Some of the differences in the behaviour of market-based and survey-based measures of inflation expectations may stem from inflation risk premia. Part of the decline in market-based measures in the euro area over the last two years may have reflected not only the downward movement in baseline expectations, in line with survey-based measures, but also a decline in inflation risk premia. In 2013 and 2014, data releases on inflation persistently surprised market participants to the downside, which may have resulted in a more prominent pricing-in of downward risks to inflation and in low or even negative inflation risk premia.

Declines in market-based measures of longer-term inflation expectations were also observed in other countries. Market-based measures of longer-term inflation expectations

\[ \text{Sources: Reuters and ECB.} \]

\[ \text{Note: The inflation-linked swap data extend up to 14 April 2015.} \]

1 In evaluating the developments in market-based inflation expectations, it is crucial that the full variety of market-based indicators of inflation expectations is considered. The indicators derived from inflation-linked swaps are considered most reliable since they are less affected by seasonality and liquidity distortions than indicators derived from bonds. The latter are nonetheless crucial for cross-checking the signals derived from inflation-linked swaps.
also declined in the United States and the United Kingdom, although the decline in the euro area was more prolonged, starting in early 2013 (see Chart B).

Against this backdrop, the Governing Council announced an expanded asset purchase programme in January 2015. Many indicators of actual and expected inflation in the euro area had drifted towards historical lows. Monetary policy measures were thus undertaken in order to address the risks of too prolonged a period of low inflation and potential second-round effects on wage and price-setting that could adversely affect medium-term price developments.

Since January 2015, both market-based and survey-based measures of longer-term inflation expectations in the euro area have recovered from their low levels. After having declined to 1.5% in January 2015, five-year inflation-linked swap rates five years ahead rose to around 1.7% in mid-April, while the one-year forward rate four years ahead derived from market-based measures increased from 1.2% to 1.5% over the same period. The survey-based euro area forward inflation curve derived from the latest SPF (that for second quarter of 2015) moved upwards as well. In particular, the average point-forecast for longer-term inflation expectations increased by 0.07 percentage point to 1.84%.

The recovery of longer-term inflation expectations in the euro area indicates that both professional forecasters and market participants are now again more confident that inflation will return to a level below, but close to, 2% over the medium term.