

Rates: The asymmetry in the ECB's symmetrical inflation target

As our economics team [expects the European Central Bank to ease at either next week's meeting or the](#) one in September, we look at the implications for Rates markets of a potential change in its inflation target



Source: iStock

5Y5Y inflation swaps

Rates markets are not pricing in higher inflation despite imminent ECB easing



Source: Bloomberg, ING

Rethink on inflation

Yesterday, [Bloomberg news quoted ECB sources as saying](#) the central bank is looking into altering its inflation target of 'below but close to 2%'. The news should not come as a surprise. President Draghi has repeatedly voiced his preference for a symmetrical inflation target which would allow the ECB to 'look through' episodes of higher inflation. Nor is this happening in a vacuum; the Federal Reserve is also undergoing a review of its tools and strategy and the ECB's own difficulties in maintaining inflation at target have prompted calls for a rethink.

Impact on Rates

A change in the inflation target would be significant for Rates markets nonetheless, were it to come to pass. For instance, investors would infer this reduces the risk of a premature withdrawal of stimulus when inflation shows signs of edging back to target. It would also dampen market reaction in cases of hawkish dissent to easing decisions.

The implications for Rates markets are twofold. The first and most obvious conclusion is that it would contribute to the further anchoring of expectations of 'lower for longer' interest rates. The second implication pertains to the credibility of the ECB's inflation-boosting effort. Given the persistent undershoot of its target, the ECB would be more likely to influence markets' inflation expectations by introducing new tools.

Steeper or flatter curve?

And here would lie the asymmetry in the ECB's symmetrical inflation target: without new tools, investors might conclude that the central bank has simply decided to push harder on the same string. This would thus imply little need for longer-dated Rates to offer compensation for anticipated inflation and result in a lower and flatter yield curve.

If, on the other hand, a new inflation target precipitates a debate on what tools are at the ECB's disposal, then curve dynamics may well shift to steepening. This is a more distant prospect however, with most current policy tools fraught with difficulties. Rates investors may well wait and

see how this debate evolves before pricing more inflation down the line.

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