INFLATION RISK PREMIA IN THE TERM STRUCTURE OF INTEREST RATES

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Abstract

This paper estimates the size and dynamics of inflation risk premia in the euro area, based on a joint model of macroeconomic and term structure dynamics. Information from both nominal and index-linked yields is used in the empirical analysis. Our results indicate that the inflation risk premium on euro area 10-year nominal yields was approximately equal to 20 basis points on average over the 1999-2007 period. The inflation premium has also been subject to moderate, but statistically significant fluctuations. For the post-2003 period in which reliable index-linked bond prices are available, our results suggest that increases in the raw break-even inflation rate above 2%, the upper bound of the ECB's definition for price stability, have mostly reflected variations in the inflation risk premium, while long-term inflation expectations have remained well anchored. (JEL: E43, E44)