**Inflation Targeting by the European Central Bank**

Since its formation in 1999, the European Central Bank (ECB) has used an “explicit” inflation target as a policy guide. According to the ECB’s web site:

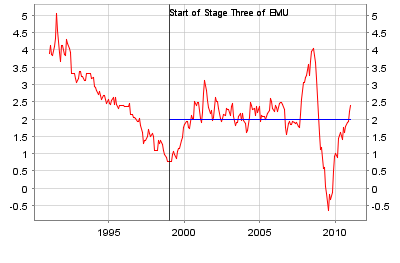
“The primary objective of the ECB’s monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term.”

Central bankers often use the term “anchoring of inflation expectations.” This term refers to the bank achieving its inflation target so to avoid changes in “inflationary expectations.” If the ECB can consistently meet its announced inflation target of 2%, financial markets and businesses will hold their inflationary expectations stable (i.e., anchor inflationary expectations).

Furthermore, on its web site, the ECB noted that inflation, which refers to a general increase in consumer prices, is measured by an index which has been harmonised across all EU Member States. This measure of inflation is referred to as the Harmonised Index of Consumer Prices (HICP). The HICP is the measure of inflation which the ECB uses to define and assess price stability in the euro area as a whole.

The ECB chart below shows inflation in the euro area(annual percentage changes). As you can see, HICP is currently running above the ECB’s 2% target rate (January annualized data at 2.4%).

Average HICP inflation since 1999



**ECB May Raise Rates on Inflation Risks, Bloomberg.com**

February 18, 2011 (Bloomberg) -- European Central Bank Board member [Lorenzo Bini Smaghi](http://search.bloomberg.com/search?q=Lorenzo+Bini+Smaghi&site=wnews&client=wnews&proxystylesheet=noir_wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1) said the central bank may need to raise interest rates as global inflation pressures mount.

“As the economy gradually recovers and global inflationary pressures arise, the degree of accommodation of monetary policy has to be monitored and, if needed, corrected,” Bini Smaghi said. Commodity-price increases will “have an unavoidable impact” and “it is a key challenge for monetary policy to avoid spillovers and maintain inflation expectations in check,” he said. “This requires the ability to take pre-emptive actions if needed.”

Bini Smaghi’s comments suggest officials are becoming more concerned about [inflation](http://noir.bloomberg.com/apps/quote?ticker=ECCPEMUY%3AIND), which has already breached the ECB’s 2 percent limit and is running at the fastest pace in more than two years. The ECB has held its [benchmark rate](http://noir.bloomberg.com/apps/quote?ticker=EURR002W%3AIND) at a record low of 1 percent for almost two years, helping to haul the euro area out of recession.

While the sovereign debt crisis is crimping growth in high- deficit nations, Germany’s economy is booming. Forecasters in an ECB survey this month raised their longer-term inflation

“The continued firm anchoring of inflation expectations is essential,” Bini Smaghi said.

The euro jumped almost a cent against the dollar to as high as $1.3642 after the remarks were published. Government bonds fell. Policy makers are “telling the market that it can’t expect the main rate to be kept at an emergency level until the debt crisis is solved,” said [Marco Valli](http://search.bloomberg.com/search?q=Marco+Valli&site=wnews&client=wnews&proxystylesheet=noir_wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), chief euro-area economist at UniCredit Group in Milan.

“Markets now see a risk of the first rate increase coming as early as September,” said [Laurent Bilke](http://search.bloomberg.com/search?q=Laurent+Bilke&site=wnews&client=wnews&proxystylesheet=noir_wnews&output=xml_no_dtd&ie=UTF-8&oe=UTF-8&filter=p&getfields=wnnis&sort=date:D:S:d1), head of global inflation strategy at Nomura International in London. “The inflation outlook warrants that.”

Barclays Capital changed its rate forecast today, and said it expects the first 25 basis-point increase in September and another in December. Barclays previously predicted the ECB wouldn’t tighten until June 2012.

Asked whether markets are correct to assume that the ECB may raise rates later this year, Bini Smaghi said: “Financial market participants know that the ECB’s objective is to maintain price stability for the euro area as a whole. The ECB has clearly and repeatedly communicated its alertness.”

Political tensions in the Middle East and North Africa are stoking oil prices, while in Germany, where import-price inflation is running at the fastest pace in 29 years, workers are demanding bigger pay increases.

Euro-area inflation accelerated to 2.4 percent in January, and a survey of purchasing managers in the manufacturing industry this month showed input-price inflation jumped to a record in France, Italy and Austria.

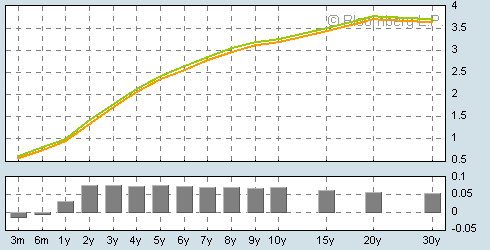
The debt crisis and economic divergences in the 17-nation currency bloc are complicating the ECB’s task of applying a one- size-fits-all monetary policy. While Germany’s economy grew 3.6 percent last year, the most since reunification two decades ago, Ireland, Greece, Portugal and Spain are struggling to emerge from their slumps.

Policy makers convene in Frankfurt for their next rate- setting meeting on March 3, when the ECB will also publish new growth and inflation forecasts.

**Impact on Yield Curve (data for Feb 18, 2011): German Bunds**

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| |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | **COUPON** | **MATURITY DATE** | **CURRENT PRICE/YIELD** | **PRICE/YIELD CHANGE** | | **3-Month** | 0.000 | 05/11/2011 | 99.88 / .60 | 0.005 / -.015 | | **6-Month** | 0.000 | 08/10/2011 | 99.66 / .79 | 0.005 / -.006 | | **1-Year** | 1.250 | 12/16/2011 | 100.24 / .97 | -0.025 / .030 | | **2-Year** | 1.000 | 12/14/2012 | 99.3 / 1.40 | -0.135 / .077 | | **3-Year** | 2.250 | 04/11/2014 | 101.43 / 1.78 | -0.235 / .077 | | **4-Year** | 2.500 | 02/27/2015 | 101.48 / 2.11 | -0.29 / .075 | | **5-Year** | 2.000 | 02/26/2016 | 98.06 / 2.42 | -0.355 / .077 | | **6-Year** | 3.750 | 01/04/2017 | 106.02 / 2.63 | -0.41 / .073 | | **7-Year** | 4.000 | 01/04/2018 | 107.1 / 2.85 | -0.465 / .072 | | **8-Year** | 3.750 | 01/04/2019 | 104.92 / 3.04 | -0.51 / .071 | | **9-Year** | 3.250 | 01/04/2020 | 100.54 / 3.18 | -0.52 / .068 | | **10-Year** | 2.500 | 01/04/2021 | 93.73 / 3.25 | -0.57 / .071 | | **15-Year** | 6.250 | 01/04/2024 | 128.2 / 3.50 | -0.745 / .062 | | **20-Year** | 4.750 | 07/04/2028 | 112.44 / 3.77 | -0.77 / .056 | | **30-Year** | 3.250 | 07/04/2042 | 91.85 / 3.70 | -0.94 / .054 | |

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