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What do the prices of UK inflation-linked securities say on inflation expectations, risk premia and liquidity risks?

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What do the prices of UK inflation-linked securities say on inflation expectations, risk premia and liquidity risks?

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Abstract

The difference between yields on nominal and inflation-linked government bonds or inflation swap rates are important indicators of the outlook for inflation and are monitored regularly by central banks, including the United Kingdom's Monetary Policy Committee (MPC). However, in the United Kingdom, inflation-linked instruments reference RPI inflation, whereas the MPC's target is CPI inflation of 2%. In this paper we extract market expectations for UK CPI inflation with the help of UK RPI-linked gilt prices, which is a novelty in the literature. To better extract useful information about expectations for CPI inflation, we develop a no-arbitrage term structure model and decompose the forward inflation curve into: measures of CPI inflation expectations; the expected wedge between RPI and CPI inflation; estimates of inflation risk premia and estimates of liquidity risk premia. We show that long-horizon expectations of CPI inflation fell in the 1990s, after the introduction of inflation targeting and the creation of the MPC, and have since remained fairly stable at around 2%.

Keywords: Affine arbitrage-free dynamic term structure model, breakeven inflation, inflation expectations, risk premia, funding liquidity, survey expectations

***JEL* classification**: C40, E31, E43, E52, G12.

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