Article | 29 February 2024

German disinflation continues in February, sending mixed signals to the ECB

Today's German macro data will fuel speculation about an early ECB rate cut as disinflation continues and economic activity remains weak. However, underneath the favourable headline inflation rate, there are still enough price pressures to worry about – which should deter the ECB from cutting rates too early

According to the just-released flash estimate, German inflation has dropped again, with the February headline number coming in at 2.5% year-on-year from 2.9% YoY in January. It's the lowest level since June 2021. The European inflation measure came in at 2.7% YoY from 3.1% in January. Remember that the main differences between the national and the European inflation measures are differing weights for individual consumer goods as well as the fact that the national measure includes prices for gambling and owner-occupied housing.

Earlier today, the drop in real retail sales in January (-0.4% month-on-month, from -0.5% MoM in December) showed how difficult any rebound in private consumption this year will be. The meagre increase in real wage growth (+0.1% in 2023 compared with 2022) has not been enough to bring back consumption. Uncertainty and higher interest rates have clearly driven precautionary savings. This uncertainty looks set to stay as the February labour market data suggests. The seasonally-adjusted unemployment rate remained unchanged at 5.9%, but the seasonally unadjusted change in the number of those unemployed was the sharpest increase in the month of February since 2013.

Two opposing trends will shape the 2024 inflation picture

Back to inflation. Today's drop in headline inflation is mainly the result of favourable energy and food base effects. Inflation excluding energy remained almost stable. However, these favourable base effects mask a more worrying trend of monthly price increases. Particularly in the services sector, price pressure accelerated.

Looking ahead, inflation developments in the coming months will be determined by two opposing trends: more disinflation and potentially even deflation as a result of weaker demand, but also new inflationary pressures due to less favourable base effects, supply chain frictions as a result of the tensions in the Red Sea, as well as government interventions and austerity measures. Let's not forget that not all of the announced austerity measures in Germany have actually been implemented. Forward-looking indicators like selling price expectations in industry and services rebounded at the turn of the year but have come down again in February. An encouraging signal, but still, it's too early to claim victory. As a result, we expect German inflation to gradually rebound over the coming months before settling between the 2.5% and 3% range in the second half of the year.

Mixed signals for the ECB

At first glance, today's German inflation data brings some relief for the European Central Bank and could support calls for a rather early rate cut – especially given that economic sentiment in the eurozone remains bleak. However, underlying inflation illustrates just how difficult the last mile will be for the ECB and clearly argues against cutting rates too early. As a result, the ECB will want to wait to be entirely sure of what the trend of both headline and underlying inflation will be. Here, wage developments remain key and as long as the economy doesn't fall off a cliff, the ECB will sit tight, waiting for more data.

For next week, the main challenge for the central bank – and ECB President Christine Lagarde – will be regaining ownership of the narrative. Since the start of the year, the cacophony of national central bankers commenting on the timing of future rate cuts has resembled a very noisy atonal choir. We sometimes wonder whether central bankers should really try to give any forward guidance that goes beyond the next meeting. Instead, what could help at next week's meeting may be a further clarification of the central bank's reaction function, e.g., which piece of data the ECB wants to see before deciding on rate cuts.

In fact, we think that three criteria need to be fulfilled before the ECB will start cutting rates: i) long-term inflation forecasts (which currently have inflation back at 2.0% from the third quarter of 2025 onwards) need to remain unchanged; ii) nominal wage growth needs to come down to around 4%; and iii) actual inflation should be at least at around 2.5% for a few months, as the central bank would fear harming its credibility when cutting rates with an actual inflation rate of around 3%. Of course, any unexpected severe financial market stress or a severe recession of the eurozone economy could trigger an earlier rate cut.

Looking beyond the timing of a first rate cut, the next question is how far and how fast the ECB would go. Here, the fact that the eurozone economy is not in recession and risks to inflation and the inflation outlook remain to the upside (be it due to cyclical but also structural drivers) plays an important role. Financial market participants still seem to be betting on a simple and swift reversal of the rate hikes of the last two years. However, this kind of turnaround traditionally only takes place if the economy falls into a severe recession. As this is not our base case scenario (and also not the ECB's), we expect the central bank to only very gradually engage in a series of rate cuts. At least for this year, rate cuts by 25bp at meetings with new macro forecasts look like the most plausible scenario for this cautious and gradual rate cut cycle.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

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