

## Disinflationary trend in Germany gains momentum in May

Another drop in headline inflation suggests that the disinflationary trend in Germany is gradually broadening. However, it will not (yet) stop the European Central Bank from hiking rates again



Inflation in Germany is decelerating

German headline inflation continued its downward trend, coming in at 6.1% year-on-year in May (from 7.2% YoY in April). Today's data marks the next stage of a gradually broadening disinflationary process as the drop in headline inflation is no longer exclusively the result of base effects but also the result of dropping prices. Headline inflation has now dropped from its winter peak of 8.8% to 6.1% YoY and the HICP measure came in at 6.3% YoY, from an 11.6% peak in October last year. For the first time this year, prices actually dropped compared with last month, mainly for energy and food but also for transportation as a result of the newly introduced €49 ticket for public transportation.

### Disinflationary trend gradually broadening

Today's drop in headline inflation will support the view of those who advocated that the inflation surge in the eurozone was mainly a long but transitory energy and food price shock with an unpleasant pass-through to the rest of the economy. If you believe this argument, today's drop in headline inflation marks the next stage of a longer disinflationary trend: first, it was negative base

effects pushing down headline inflation, and now it is actually falling prices in the same categories accelerating the disinflation. However, signs that the disinflationary process is actually spreading to other parts of the economy are still missing. According to available regional data, even the base effect outside of energy and food is still very limited.

Looking ahead, let's not forget that inflation data in Germany and many other European countries this year will be surrounded by more statistical noise than usual, making it harder for the European Central Bank to take this data at face value. Government intervention and interference, whether that's temporary or permanent, and has taken place this year or last, will blur the picture. In Germany, for example, the newly introduced €49 ticket already helped to push down inflation in May. However, the reversal of last year's negative base effects from the energy relief package for the summer months should automatically push up headline inflation again between June and August. It will take until the end of the year for headline inflation to fall into the 3%-4% range.

Beyond that statistical noise, the German and European inflation outlook is highly affected by two opposing drivers. Lower-than-expected energy prices due to the warm winter weather are likely to push down headline inflation faster than recent forecasts suggest. On the other hand, recent wage settlements and still decent pipeline pressure in services are likely to keep core inflation high. We continue to expect that German headline inflation will average around 6% this year.

## Weak growth and dropping inflation but ECB will continue hiking

For the ECB, macro data released since the May meeting has had something for everyone. The eurozone economy has turned out to be less resilient than anticipated a few weeks ago and confidence indicators, with all the caveats currently attached to them, point to a weakening of growth momentum again. As headline inflation is gradually retreating, the risk increases that any additional rate hike could quickly turn out to be a policy mistake; at least in a few months from now. However, at the same time, the ECB seems to have given up linking policy decisions too close to their own forecasts (rightly so) and has put more than usual emphasis on actual inflation developments. With this in mind, the unwritten law that high inflation can only be defeated for good with positive real interest rates remains a strong argument for the ECB hawks. As we have learned over the last 12 months, the ECB seems to prefer to go too high with rates rather than stop prematurely. This is why we expect the ECB to continue hiking by 25bp at its next meeting in two weeks from now.

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