Easter bunny cannot stop German disinflation

Disinflationary trends broaden as headline inflation drops for the fourth month in a row

Even the Easter Bunny can't stop German disinflation. According to the just-released flash estimate, German inflation has dropped for the fourth consecutive month, with the March headline number coming in at 2.2% year-on-year from 2.5% YoY in February. The European inflation measure came in at 2.3% YoY from 2.7% in February, slightly lower than consensus expectations and the lowest level since June 2021.

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.

Inflation could drop to 2% as soon as next month

To some extent, today's drop in headline inflation could mark the second leg of a longer disinflationary trend in Germany. The first leg was simply due to favourable energy and food base effects. The second leg could be a more general cooling off of inflationary pressures as a result of the European Central Bank's monetary policy tightening and hence weaker demand, as illustrated by monthly price changes that remained slightly below historical averages for the month of March. Also, despite the early timing of Easter this year, prices for leisure, packaged holidays and hotels and restaurants rose less than expected month-on-month than expected. The Easter bunny effect, ie the base effect stemming from the timing of Easter, was hardly visible this year.

Looking ahead, headline inflation in Germany could drop to 2% as soon as next month, before rebounding somewhat in the months after. In general, inflation developments will be highly determined by weaker demand but also 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. Our view that inflation will hover within the broader range of between 2% and 3% rather than continuing on a straight line to 2% or less is confirmed by forward-looking indicators. Selling price expectations in manufacturing, for example, have returned to a six-month high and are only slightly below long-term averages. In the eurozone, selling-price expectations are even at a 10-month high. At the same time, however, selling price expectations in the services industry have come down since the start of the year but remain above historical averages.

What to expect from next week's ECB meeting

At first glance, today's German inflation data brings some relief for the ECB and could support calls for rate cuts as early as next week. With inflationary pressures fading away, why wait for a first rate cut until June? Well, the bottoming out of the eurozone economy, as illustrated by leading indicators as well as lending growth, undermines any calls for rate cuts to save the eurozone economy from falling further into stagnation. Also, still-elevated domestic and services inflation in the eurozone as a whole illustrates just how difficult the last mile will be for the ECB and argues against cutting rates too early. As a result, the ECB will want to wait to be entirely sure of the trend for both headline and underlying inflation. Here, wage developments remain key and as long as the economy doesn't fall off a cliff, the ECB will sit tight next week, waiting for more data and the June meeting.

The discussion at the coming ECB meetings will no longer be on 'whether' but rather on 'when' and 'how much' the ECB should cut interest rates. Remember that the ECB's staff projections in January had inflation returning to target in the second half of 2025, while growth would be slightly above potential both in 2025 and 2026. Given how the ECB's models work, the ECB would have to cut rates by some 100bp to get to these, what the ECB would call, favourable macro outcomes. Assuming a June rate cut is almost cast in stone, the ECB will be discussing the size and sequence of rate cuts. We think that as long as 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), the ECB will opt for a "slow hand" policy of rate cuts by 25bp each every quarter. Any more aggressive rate cut scenario would smell like panic and require a more adverse growth outlook for the eurozone.

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