German inflation slows in June

A slight drop in German headline inflation in June keeps the door open for another ECB rate cut in September, even though inflation remains too sticky at slightly too high a level

The just-released flash estimate of German inflation in June signals some easing of inflationary pressures, keeping the door open to further European Central Bank rate cuts. Headline inflation came in at 2.2% year-on-year, down from 2.4% YoY in May. The European inflation measure came in at 2.5% YoY from 2.8% in May. After the reversed base effect from last year's introduction of cheap public transportation in May, inflation is mainly back to where it was in March and April.

Slowing but not low enough, yet

Today's German inflation data not only illustrates the ongoing impact of base effects and earlier government measures on present inflation but also stresses that inflation remains sticky above 2%. Judging from available regional state data, it is goods and transportation inflation as well as energy price inflation that has come down. At the same time, services inflation remains at elevated levels. Monthly changes show actual price drops in clothing as a result of summer sales, health care, transportation and energy while prices for hotels and restaurants, potentially as a result of the Euro2024, increased.

Looking ahead, the stickiness of inflation at slightly too high a level looks set to continue as favourable energy base effects are petering out while, at the same time, wages are increasing. With recent new wage demands, it is hard to see German wage growth coming down in the second half of the year.

As a result, we continue seeing inflation hovering within the broader range of between 2% and 3% rather than returning on a straight line to 2%.

Door to September rate cut still open

When many ECB members meet in Sintra this week for the annual central banking forum, the future path for the central bank's monetary policy will definitely be a topic of discussion during informal meetings or during the coffee break. While in the past, a first rate cut after peak interest rates always marked the start of a full rate-cut cycle, this time around the case for a series of rate cuts is much less obvious. The big difference between the current situation and previous periods of rate-cut cycles is that past cycles were mainly triggered by either a recession or a crisis. Fortunately, none of these is currently threatening the eurozone economy. Instead, the ECB's main reason to 'remove the top level of restriction', as ECB chief economist Philip Lane had put it, is the expectation that inflation will nicely settle down at 2% from the end of 2025 onwards.

At the current juncture, it would be premature, if not to say irresponsible, for the ECB to give any forward guidance for the September meeting and beyond. It is clear, however, that the ECB will have to find a balance between potential reputational damage and rising concerns about a too-optimistic inflation forecast. Regarding the potential reputational damage, deviating from rate cuts could make the June rate cut decision look like a mistake, while particularily elevated wage growth increases the risk that the ECB's inflation forecasts for late 2025 and 2026 are too benign. For now, today's German inflation numbers leave the door open to another rate cut in September, even though wage developments could still motivate some officials to postpone the next rate cut to the winter.

Author

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