

## German disinflationary trend pauses for the summer

German inflation increased in June to 6.4% year-on-year, from 6.1% YoY in May. But what looks like an end to the disinflationary trend of the last few months is only a temporary break. Disinflation should gain more momentum after the summer



With lower-than-expected energy prices and dropping food prices, German inflation could come down faster than the ECB expects

According to the just-released first estimate, German headline inflation increased in June, coming in at 6.4% year-on-year (from 6.1% YoY in May). The harmonised European measure showed German headline inflation at 6.8% YoY, from 6.3% in May. This marks an end to the disinflationary trend seen over the last six months. However, a closer look at the data suggests that the disinflationary trend will gain new and even stronger momentum after the summer.

### Disinflationary trend has paused, not stopped

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 temporary or permanent or occurring this year or last, will continue to blur the picture.

Today's inflation data show that headline inflation is and will be affected by several base effects: while lower energy prices insert downward pressure on inflation, the end of last summer's temporary government energy relief measures has inserted upward pressure. Looking at monthly price changes actually paints a promising picture of German inflation dynamics. For the third month in a row, food prices have dropped month-on-month. Prices for clothing have dropped for the first time since January; a tentative sign of weaker demand and price discounts.

With still lower-than-expected energy prices, dropping food prices and fading pipeline price pressures in both services and manufacturing, German (and eurozone) inflation could come down faster than the ECB expects, at least after the summer. In fact, there is the risk that another chapter will be added to the misconceptions of inflation dynamics: after 'inflation is dead' and 'inflation is transitory', we could now have 'inflation will never come down'.

Don't get us wrong, we still believe that, structurally, inflation will be higher over the coming years than pre-pandemic. Demographics, derisking and decarbonisation all argue in favour of upward pressure on price levels. However, be cautious when hearing comments that inflation will never come down. These comments might come from the same sources that only a few years ago argued that inflation would never surge again. This does not mean that the loss in purchasing power as a result of the last inflationary years will be reversed any time soon. It only means that headline inflation can come down faster than currently anticipated.

We see German headline inflation falling to around 3% towards the end of the year. Admittedly, the risks to this outlook are obvious: sticky core inflation, wage pressure and government measures to support the demand side of the economy.

## ECB will continue to hike

ECB President Christine Lagarde made it clear at this week's ECB forum in Sintra that the job is not done, yet.

We, however, still think that the ECB is too optimistic about the eurozone's growth outlook. Historic evidence suggests that core inflation normally lags headline inflation while services inflation lags that of goods. These are two strong arguments for a further slowing of core inflation in the second half of the year and reasons to start doubting the need for further rate hikes.

But, the ECB simply cannot afford to be wrong about inflation (again). The Bank wants and has to be sure that it has slayed the inflation dragon before considering a policy change. This is why it is putting more emphasis on actual inflation developments, and why it will rely less on forecasts than in the past. As a consequence, the ECB will not change its tightening stance until core inflation shows clear signs of a turning point and will continue hiking until then.

If we are right and the economy remains weak, the disinflationary process gains momentum and core inflation starts to drop after the summer, the ECB's hiking cycle should end with the September meeting.

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