German headline inflation continues gradual downward trend in April

After energy price inflation, it is now food price inflation that has started to drop as a result of base effects, pushing down German headline inflation. Core inflation, however, still doesn't show any sign of retreating

To paraphrase Meghan Trainor's song: it's all about that base. German headline inflation continued its downward trend, coming in at 7.2% year-on-year in April (from 7.4% YoY in March), but what looks like a broader disinflationary process is still only disinflation on the back of base effects. Yes, headline inflation has now dropped from its winter peak of 8.8% to 7.2% YoY and the HICP measure came in at 7.6% YoY, from an 11.6% peak in October last year. But the sharp drop in headline inflation is mainly the result of negative base effects from energy prices and in April for the first time also food prices. Underlying inflationary pressures, however, remain high and given that the month-on-month change in headline inflation was still above historical averages for April, there is no reason to cheer.

Food price inflation finally starts to come down

Today's drop in headline inflation will support the view of those who always advocated that the inflation surge in the whole eurozone was mainly a long but transitory energy price shock. If you believe this argument, today's drop in headline inflation is the start of a longer disinflationary trend. As much as we sympathised with this view one or two years ago, inflation has, in the meantime, also become a demand-side issue, which has spread across the entire economy. The pass-through of higher input prices, though cooling in recent months, is still in full swing. Widening profit margins and wage increases are also fuelling underlying inflationary pressure, not only in Germany but in the entire eurozone.

Headline inflation to come down further but core will remain high

Available German regional components suggest that core inflation remains high. While energy price inflation continued to come down and food price inflation for the first time started to slow down, most other components showed broadly unchanged inflation rates. At the same time, selling price expectations in the manufacturing sector have almost dropped back to their historical averages but selling price expectations in services remain high. All of this suggests that the pass-through of inflationary pressure is gradually slowing down but is far from over.

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 or has taken place this year or last, will blur the picture. In Germany, for example, the Bundesbank estimated that energy price caps and cheap public transportation tickets will lower average German inflation by 1.5 percentage points this year. And there is more. Negative base effects from last year's energy relief package for the summer months should automatically push up headline inflation between June and August.

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 at around 6% this year.

25bp rate hike most likely at next week's ECB meeting

For the ECB, today's data had something for everyone. Positive and negative surprises on growth and rather erratic inflation data can be used by both doves and hawks. As a result, an already heated debate on whether to hike rates by 25bp or 50bp will become even more heated. We still think that next week's Bank Lending Survey results will tilt the balance in one of the two directions. Given the growing divide within the ECB, a rate hike of 25bp would still be a typical European compromise. However, today's fireworks of very opposing data points have not made the ECB's life any easier.

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