German inflation highest since 1992

Germany's inflation acceleration continues and will put more pressure on the European Central Bank's December debate on how to proceed with its asset purchases next year

German consumers are facing higher prices which will put pressure on the ECB

Based on inflation outcomes of several regional states, German inflation in September came in at 4.1% year-on-year, from 3.9% in August. The harmonised index relevant for the ECB jumped to 4.1%, from 3.4% in August.

The surge in headline inflation was driven by the full base effects from a VAT reversal, which also shows in subcomponents such as prices for clothing and leisure, higher energy prices and price mark-ups post-lockdown in the leisure and hospitality services. Higher producer prices on the back of supply chain disruptions, higher commodity prices and the gradual reopening of the economy are still being felt and will continue to impact consumer prices. Together with the reversal of the German VAT rate, headline inflation could even get close to 5% towards the end of the year.

Looking further ahead, some one-off factors should disappear at the start of next year but the recent surge in energy prices, as well as continued supply chain frictions and post-lockdown price mark-ups, are likely to keep German inflation above 2% throughout most of 2022.

December debate at ECB on next steps for asset purchases is likely to be heated

The last time German inflation stood above 4% was in June 1992. Needless to say that the world back then looked very different. It was a year after the East-German mark disappeared into the D-mark, Germany lost the final of the European football championship against Denmark and Helmut Kohl was still chancellor.

Coming back to today's inflation, the recent surge will do very little to bridge the gap between the two inflation camps: one arguing that inflation drivers are transitory and that base effects will disappear or even reverse next year and the other seeing a broad risk of accelerating inflation. We remain somewhere in the middle. While structural factors like labour market slack or digitalisation indeed argue in favour of a more benign approach to inflation, we are seeing the most fertile breeding ground for second-round effects in a long while.

> *We wouldn't be surprised to see the ECB reducing its asset purchases in 2022 to a larger extent*

In fact, we do see two kinds of second-round effects materialising. The first is the pass-through from higher producer prices to consumers. In the past, producers absorbed higher costs by profit margin squeezing. This time around, they seem to be willing to pass on higher costs to consumers as illustrated by the fact that selling price expectations in both the manufacturing and services sector are currently at record highs. The second pass-through channel will be wages. The narrative that German wage settlements were well-behaved this year belongs to history. Latest announcements show that unions are going into upcoming negotiations with demands linked to current inflation numbers, not to inflation expectations.

Admittedly, monetary policy can hardly bring down inflation driven mainly by one-off factors. However, constantly higher inflation rates and a high risk that the ECB has actually entered a period in which its longer-term inflation forecasts frequently turn out to be too low, compared with too high in the years prior to the pandemic will put more pressure on how much monetary accommodation the eurozone economy really needs. We would no longer be surprised to see the ECB reducing its asset purchases in 2022 to a larger extent than thought after the August meeting.

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