German inflation continues to fall very gradually

The very minor drop in headline inflation was probably the last inflation burst in Germany for a while. Next will be a disinflationary trend until the end of the year

German headline inflation came in at 6.1% year-on-year in August, down from 6.2% in July; the lowest level since March 2022. The harmonised European measure dropped to 6.4% YoY, from 6.5% YoY in July. On the month, German prices were up by 0.3%, the strongest monthly increase in August in more than 20 years, illustrating that the drop in headline inflation is mainly the result of base effects.

Last inflation burst in Germany. Next stop is disinflation

Inflation data in Germany and many other European countries continue to 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.

In the case of Germany, headline inflation over the summer months has been affected by several base effects: while lower energy prices exert downward pressure on inflation, the end of last summer's temporary government energy relief measures and cheap public transportation have added upward pressure. These are the base effects. Looking at monthly price changes, however, paints a more complicated picture of German inflation dynamics. For the fifth month in a row, food prices have dropped month-on-month in most regional states. At the same time, however, prices for heating oil and gas have risen again, reflecting higher market prices.

Even if the opposing trends described above suggest that high inflation will not simply disappear, the disinflationary trend is still in full play. Just think of today's import prices (-13% YoY) and last week's producer prices (-6% YoY), both indicate more disinflationary pressures to come.

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. There is a high chance that we are currently witnessing the last leg of services inflation, mainly in tourism. In short, today was probably the last inflation burst in Germany for a while. The next stop will be a sharp drop in German headline inflation in September. We continue to see inflation falling to around 3% by the end of the year.

Admittedly, the risks to this outlook are obvious: sticky core inflation, wage pressures and government measures to support the demand side of the economy. We also stick to the long-held view 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.

Today was a good day for ECB hawks

Macro developments over the summer have caused further complications for the ECB. While the rapid worsening of the economy should come as a surprise, at least judging from overly optimistic ECB growth forecasts so far, the speed with which headline inflation is coming down should still leave the ECB uncomfortable. Core inflation also remains too high and wage growth up until now signals that even without excessive wage settlements core inflation could stay higher for longer.

At least at face value, today was a good day for ECB hawks. The inflation prints in Spain and Germany have clearly strengthened the case to continue hiking at the September meeting – even if the German inflation increase was the very last inflation burst for a while and will be replaced by disinflation over the coming months.

As long as the ECB sticks to its current stance of putting more policy emphasis on actual data rather than expected data, a rate hike at the September meeting has become likelier.

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