German inflation breaks 2%, clouding chances of a September rate cut

An uptick in German inflation suggests that the risk of significant inflation undershooting is still more than overdone. At the same time, the increase weakens the case for an ECB rate cut at the September meeting

Stuttgart, Germany. We think today's data dims the chances of a cut from the European Central Bank next month

The just-released flash estimate of German inflation for August brought an end to the disinflationary process of the last months. Headline inflation, according to the national measure, increased to 2.2% year-on-year, from 2.0% YoY in July, while the European measure accelerated to 2.1% YoY, from 1.8% YoY in June. Core inflation remained unchanged at 2.7% YoY. At 0.1%, the monthly price increase was slightly higher than normal for the month of August.

Headline inflation will continue to hover around 2%

The available regional state data shows that the uptick in German inflation was mainly driven by higher food prices and leisure costs, while the positive base effects from lower energy prices became a bit less favourable.

While August inflation data came in somewhat higher than expected and could continue to pick up once more in September, headline inflation should come down again towards the end of the year. Favourable energy base effects are petering out, while core inflation should be coming down somewhat.

At the same time, it remains to be seen how European and US companies will react to US tariffs. While one scenario could see prices falling in the eurozone due to overcapacity and weaker sales in the US, globally operating companies might try to actually increase prices in Europe in order to offset profit-squeezing in the US. A rather domestic theme will be the cooling of the German labour market, which should take away wage pressures and consequently inflationary pressures.

All in all, we expect German inflation to hover around 2% until the end of the year.

German inflation data further weakens ECB case for a September rate cut

As far as the European Central Bank is concerned, today's German inflation data will catch the hawks' attention, as it bolsters the argument for a high bar to yet another ECB rate cut.

More generally speaking, when the ECB returned from its summer break, several more favourable developments had strengthened its wait-and-see stance, at least at first glance: the 'it-could-have-been-worse' trade agreement between the US and the EU, a weak-but-not-disastrous second quarter GDP growth reading, as well as still improving business sentiment indicators which have rather strengthened than weakened the case for staying on hold at the September meeting.

However, we think that it is still too early to rule out a September cut. Why? First of all, the ECB doves have been very silent since the end of the summer break, and it has been the traditional ECB hawks trying to shape the policy debate. Also, there is a growing awareness among eurozone policymakers in general that the trade framework agreement between the US and the EU is anything but set in stone. The built-in conditionality on many aspects has left sufficient room for new escalations.

And, finally, there is a handful of arguments that a too-hawkish stance could eventually backfire and increase the risk of inflation undershooting. As ECB staff are currently also preparing a fresh round of macro projections for the September meeting, the euro has gained another 2% since the June projections, bond yields are up by some 30bp and French public finances are back on markets' radar screens. And even if the central bank fiercely disputes that it reacts to monetary policy in other countries, a Federal Reserve starting an aggressive series of rate cuts would only add to the risks of inflation undershooting.

All in all – and even if it might be counterintuitive given the resilience of the eurozone economy – we still wouldn't rule out another insurance rate cut, following the principle that it wouldn't do any harm but could eventually do good. Admittedly, though, today's German inflation data has not strengthened the case for a rate cut in September.

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