German inflation brings comfort for ECB

A drop in headline inflation in October and strong retail sales in September provide further evidence of Germany's 'Goldilocks' economy

Not too hot, not too cold

While many in Germany are enjoying a long weekend due to public holidays, Monday's macro data suggest that the economy is in the midst of a 'Goldilocks' period. Strong industrial data over the summer and an Ifo index at record high were today supplemented by strong retail sales and dropping inflation in September and October.

Retail sales, in real terms, increased by 0.5% MoM in September, from -0.2% in August, providing further evidence of strong private consumption. On the year, retail sales were up 4.1% (partly driven by favourable base effects). The strong labour market and low inflation remain the main drivers of German private consumption. And there are no signs there'll be any changes to this picture anytime soon.

1.6% German CPI (YoY)

Inflation to remain low

In fact, inflation remains low. Based on the results of five regional states, German headline inflation dropped to 1.6% YoY in October, from 1.8% YoY in September; the first drop since June this year. Based on the harmonised European definition (HICP), and more relevant for ECB policymaking, headline inflation even dropped to 1.5% YoY, from 1.8%.

Looking at the available components at the regional level shows that today's drop in headline inflation was mainly driven by energy base effects. Measures of core inflation remained stable. Stable core inflation, however, masks two diverging trends in German prices. While prices for consumer goods have increased with an annual rate of above 2% for quite some time, the ongoing decline in communication costs and lower prices for services continue to keep core inflation at bay.

With the current upward trend in oil prices, negative base effects from energy prices could quickly disappear again. However, ongoing structural factors such as increased competition in the service sector on the back of digitalisation, little upward pressure on wages due to the stronger euro, and globalisation and automatisation should keep German headline inflation clearly below 2% until the end of the year and beyond.

> As long as the current showcase model of the Eurozone economy – the German economy – which is also most advanced in the current cycle does not show any signs of accelerating inflationary pressure, the ECB will feel extremely comfortable with its dovish tapering.

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