German inflation drops to 8.6% in December

Lower oil and gasoline prices and the first phase of the government's gas price cap have pushed down headline inflation in December. Still, at current levels, inflation remains a major concern in 2023

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Leaving the peak behind

The first estimate of German headline inflation came in at 8.6% year-on-year in December, down from 10% in November. The HICP measure also dropped, to 9.6% YoY, from 11.3% YoY in November. This inflation reading brings some relief as the trend of ever-rising inflation rates has been reversed. However, at 8.6% YoY, inflation remains one of the biggest economic concerns of the new year.

Long and complicated path towards lower inflation

Available regional data suggests that the drop in headline inflation was mainly driven by lower oil and gasoline prices and the first phase of the government's gas price break. Food price inflation is still above 20% YoY. If anything, core inflation will have remained unchanged or slightly higher than in November, when it was 5% YoY.

Looking ahead, headline inflation in Germany seems to have reached its peak and, unless there is another large surge in energy prices again, double-digit inflation numbers should be behind us for a long while. However, the path towards substantially lower inflation rates won't be easy. For the time being, it is lower energy prices and hence base effects, as well as government interventions that are pushing down headline inflation.

In fact, the German and European inflation outlook is highly affected by two opposing drivers. Lower-than-expected energy prices due to the warm winter weather could, if they remain at current levels, push down headline inflation faster than recent forecasts suggest. In its December forecasts, for example, the European Central Bank used technical assumptions for gas and oil prices in 2023 that were clearly above current prices. On the other hand, there is still significant pipeline pressure stemming from energy and commodity inflation pass-through. For example, many households will only face the sharp gas and electricity price increases this month. Also, despite some recent weakening, companies' selling price expectations are still high, suggesting that the pass-through of higher production costs is not over, yet. Also, the ongoing war and new price negotiations in the agricultural sector are likely to keep food price inflation high. Finally, the downside of government support schemes is that they could extend inflationary pressures, though at a lower level. All of this means that it is a safe bet to claim that German headline inflation has seen the peak and double-digit inflation rates are over, but the pace and size of the inflation retreat in the course of the new year remain highly uncertain. For now, we expect German inflation to come in at around 6% for the entire year 2023 but unfortunately, the lessons of the last two years have taught us that new revisions could be in the offing….

For the ECB, today's drop in German headline inflation is another reminder that an energy price shock can actually turn around almost as quickly as it has emerged. At least based on current energy prices, headline inflation in the entire eurozone could come down faster than the ECB had forecast in December. However, the past experience of energy price shocks has also shown that headline inflation can come down quickly, while core inflation remains stubbornly high and can even continue to increase. Therefore, today's inflation numbers are not a relief, yet, only a reminder that eurozone inflation is still mainly an energy price phenomenon. The ECB cannot and will not base its policy decisions on highly volatile energy prices. Instead, the central bank will, in our view, hike interest rates at the next two meetings by a total of 100bp. Only at the second meeting in March will we see updated macro forecasts. If energy prices have remained at their current levels by then, the ECB will have to revise down its own inflation forecasts, and calls for at least a pause in the current hiking cycle will grow louder.

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