German inflation edges closer to ECB’s 2% benchmark

Germany's gradual disinflation process continued in May, with headline inflation expected to dip below the magic 2% threshold in the coming months

Falling monthly prices for food, clothing and transportation have pushed down headline inflation

The just-released flash estimate of German inflation for May brought some more relief for the European Central Bank as headline inflation remained unchanged at 2.1% year-on-year, while the European inflation measure dropped to 2.1% YoY from 2.2% YoY in April.

Core inflation came down somewhat to 2.8% YoY, from 2.9% in April. It’s not a big move, but the process of gradual disinflation continues.

Inflation is trending lower and should now hover around 2% until year-end

The available regional state data suggests that falling monthly prices for food, clothing and transportation – as well as lower heating oil and gasoline prices compared to last year – pushed down headline inflation. Meanwhile, services inflation remained broadly unchanged.

It appears that US President Donald Trump not only made the German economy great again – at least for one quarter, as frontloading effects boosted the economy – but also played an important role in bringing down inflation. The drop in oil prices, as well as the stronger euro exchange rate, have added to disinflationary pressures in Germany, and the entire eurozone.

Unrelated to US trade policies, the softening German labour market is also exerting downward pressure on inflation. Although inflation expectations have recently ticked up, we interpret this as a misreading – attributing inflationary effects to current trade tensions, which are unlikely to materialise as long as Europe refrains from retaliation – rather than as a sign of mounting inflationary concerns.

Looking ahead, at least in the nearer term, German inflation is likely to continue its downward trend, probably dropping below 2% over the coming months. More structurally speaking, two opposing trends will shape the future path of inflation. On the one hand, the cooling of the labour market should take away wage pressures and consequently inflationary pressures; on the other hand, the government's fiscal stimulus is likely to push up inflationary pressure towards the end of the year and beyond.

As a result, and based on lower energy prices, we now expect German headline inflation to hover around 2% throughout the second half of the year.

ECB looks set to cut rates again next week

For the ECB, today's German inflation reading should bring further relief: the process of gradual disinflation is continuing. Even if the latest developments in the trade and tariff saga have somewhat strengthened the case for a pause next week, arguments for a rate cut are much stronger.

The expected downward revision of the inflation forecasts and a much earlier drop in headline inflation to below 2%, alongside the rising risk of inflation undershooting, should tilt the balance towards a 25bp rate cut. It is another rate cut that can be titled as an insurance or risk management cut. It won't do any harm if the economy continues to prove resilient or trade tensions fade away, and it will have been exactly the right decision if resilience falters.

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