German inflation ends the year too high

German inflation accelerated in December, bringing back the spectre of stagflation to the European Central Bank. Inflation will first continue to accelerate before slowing again in the course of the year

The difficult last mile is back. The just-released flash estimate of German inflation for December indicates that the summer celebrations over successfully conquering the inflation monster were premature. On the contrary, with headline inflation accelerating and economic sentiment remaining weak, the spectre of stagflation is back, at least in the short run.

German headline inflation came in at 2.6% year-on-year, up from 2.2% YoY in November. Back in September, headline inflation was still at 1.6% YoY. The European inflation measure came in at 2.9% YoY.

Inflation to settle down in range of 2% to 2.5%

Due to a public holiday in several German states today, there isn't any regional data providing further insight into the underlying inflation drivers. However, recent developments suggest that the re-acceleration in German inflation was mainly the result of less favourable energy base effects.

Looking ahead, the stickiness of inflation at slightly too high a level still looks set to continue as favourable energy base effects will continue to peter out while wages are increasing. Meanwhile, the delayed pass-through of higher costs on services inflation is still in full swing. Many Germans have seen their insurance premiums increase by almost 30% YoY at the start of the new year. Add to that higher CO2 and somewhat increasing gas prices, and headline inflation looks more likely to accelerate than decelerate in the near term. However, with the current turn in the labour market, wage growth should come down more significantly than previously thought, leading to more disinflationary pressures later this year. As a result, we expect inflation to eventually settle down in a range of 2% to 2.5% over the course of the year.

ECB to look through current inflation acceleration

This week's inflation data will be the last before the ECB's next meeting on 30 January. What will follow is a series of confidence indicators and the first tentative estimates of GDP growth in the fourth quarter of 2024. With all the information available so far, it looks as if the spectre of stagflation is back in the eurozone - a scenario that could actually get worse if trade tensions escalate. This is a complication for the ECB which could further widen the current divergence between hawks and doves.

But will higher inflation in December and January stop the central bank from further cutting rates? Not really. At 3%, the deposit interest rate is still restrictive and definitely too restrictive for the current weak state of the eurozone economy. Even if some might argue that there is very little monetary policy can do to solve structural issues, political instability and uncertainty in many countries will force the ECB to continue doing the heavy lifting. Also, as long as the current inflationary pressure is anticipated to diminish over the course of the year, the ECB is likely to overlook the present inflation resurgence. While the experience of being slow to address rising inflation will deter the ECB from adopting ultra-low rates, the desire to stay ahead of the curve remains a compelling reason to return interest rates to neutral as swiftly as possible.

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