

## German inflation increases and drops at the same time

The national inflation measure increased in January, while the European measure dropped. This shows that inflation numbers will be surrounded by lots of noise this year as government measures and statistical changes continue to affect inflation numbers. Not an easy task for the European Central Bank



German inflation data in January was surrounded by statistical noise

Some say that haste makes waste. Others say that there are fewer challenging jobs than being a German statistician these days. In any case, the long-awaited first estimate of German inflation in January confirmed the very gradual retreat of inflation, without giving any reason for relief. Headline inflation came in at 8.7% year-on-year, from 8.6% YoY in December. The monthly change of 1.0% illustrates that inflationary pressure is far from being over. The HICP measure came in at 9.2% YoY, from 9.6% in December. The fact that German headline inflation can increase and drop at the same time has to do with a rebasing of the national time series and changes in the weights.

### Expect more noise in inflation data

According to the German statistical office, it did not send any German numbers to Eurostat last week. How Eurostat dealt with this missing piece of information when preparing its first eurozone

inflation estimate might become clearer in the coming weeks. In any case, with today's German inflation data, chances are high that the initial eurozone number of 8.5% YoY will be slightly revised upwards, probably by 0.1 percentage point.

Turning back to German inflation, January data will not have been the last inflation print surrounded by statistical noise. In fact, according to Bundesbank estimates, energy price caps and cheap public transportation tickets will lower average German inflation by 1.5 percentage points this year. The energy price cap will come into effect as of 1 March but will be paid retroactively. It is unclear how the statistical office has taken this effect into account. And there is more. Negative base effects from last year's energy relief package for the summer months should automatically push up headline inflation between June and August.

## Long and complicated path towards lower inflation

More generally speaking, 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. 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, not a broader-based disinflationary process.

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. 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. The risk is high that what started as supply-driven inflation could morph into demand-driven inflation. And not only in Germany.

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 over the course of the new year remain highly uncertain. For now, we expect German inflation to come in at around 5.5% 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.

## ECB to focus on core inflation

For the ECB, today's drop in German headline inflation shows how slow and gradual the disinflationary process in the eurozone will be. It also shows that headline inflation is currently not the best inflation tracker. Therefore, even if last week's Q&A session left more questions than answers, the ECB's intention is clear: focus on core inflation and core inflation projections. As long as core inflation remains stubbornly high, the ECB will continue hiking rates and will not for a single second consider future rate cuts. A 50bp rate hike at the March meeting has been pre-announced and looks like a done deal. Beyond the March meeting, the ECB seems to enter a new game in which further rate hikes will not necessarily get the same support from the Governing Council as hiking deep into restrictive territory increases the risk of adverse effects on the economy. The main

question beyond the March meeting will be whether the ECB will wait to see the impact of its tightening on the economy or whether it will continue hiking until core inflation starts to substantially come down. In the former case, the ECB could consider a pause in its rate hike cycle and hike again at the June meeting. The latter would see continuous meeting-by-meeting hikes, possibly at a smaller size of 25bp.

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