German January inflation brings some relief for the ECB

As national measures dropped, the European measure remained unchanged. German inflation should bring some relief for the ECB as it takes away fears of a further re-acceleration

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The just-released flash estimate of German inflation for January is a welcome surprise for both consumers and the European Central Bank, showing a drop in headline inflation to 2.3% year-on-year, from 2.6% YoY in December. Core inflation came down to 2.9% YoY from 3.3% YoY. The European inflation measure came in unchanged at 2.8% YoY. While gasoline prices continued to increase in January, household energy prices were down compared with last year.

Inflation to stay within the 2% to 2.5% range this year

The available regional state data suggests diverging energy price trends, with electricity and gas prices for households actually dropping month-on-month as prices for heating oil went up. Services inflation slowed down somewhat but remains close to 4% YoY.

Looking ahead, the stickiness of inflation at slightly too high a level still looks set to continue as favourable energy base effects continue to peter out. Meanwhile, the delayed pass-through of higher costs on services inflation is still in full swing. This is also reflected in another increase in selling price expectations in services in January. These third-round effects of higher inflation are definitely not over yet. At the same time, this morning's data confirmed that the cooling of the labour market is very much real. The number of those unemployed in Germany reached a 10-year high in January, not only showing that hopes of a consumption revival this year might have been overdone, but also boding well for more disinflationary pressures later this year.

We might not agree with the entire macro assessment the ECB gave yesterday but, at least for Germany, a scenario of inflation settling down in the range of 2% to 2.5% over the course of the year seems realistic.

ECB to continue cutting rates

For the ECB doves, today's German inflation data is good news as it paves the way for more rate cuts to come. How far will the ECB cut rates? After yesterday's press conference and the following Bloomberg story about potentially scratching the label 'restrictive' for the monetary policy stance after the next rate cut, this question remains unanswered. We will know more about where the ECB sees the neutral level of interest rates next week, when the central bank publishes a new staff report. However, don't hold your breath. It's unlikely that we'll see any point estimate of this neutral interest rate but rather a range or even several ranges, based on several economic models and methodologies.

All in all, as long as the eurozone can avoid a more stagflationary scenario, the ECB can continue cutting rates far into neutral territory or even below, in case eurozone growth persistently disappoints.

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