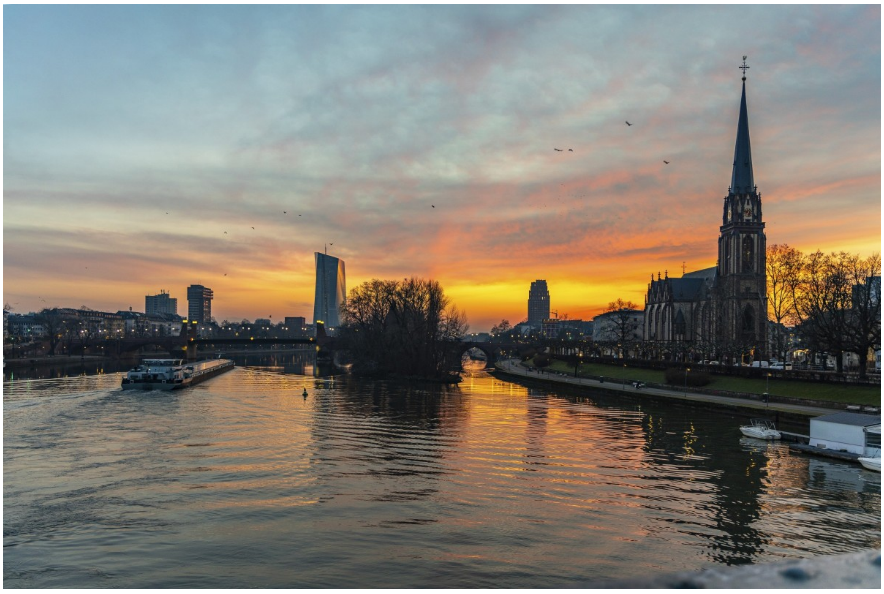
Slowing German inflation paves the way for further rate cuts

Germany's headline inflation has continued to slow down, but we're anticipating more volatility in the coming months



We think accelerating disinflationary trends in the near term could motivate the ECB to bring policy rates deeper into neutral territory

The just-released flash estimate of German inflation for March brought further relief for the European Central Bank as headline inflation came in at 2.2% year-on-year, down from 2.3% YoY in February. Core inflation came down to 2.5% YoY from 2.6% YoY. The European inflation measure dropped to 2.3% YoY from 2.8% YoY in February.

Inflation to remain volatile

The available regional state data suggests that falling prices for alcohol and transportation, as well as heating oil and gasoline, pushed down headline inflation. Meanwhile, higher prices for clothing and leisure exerted upside pressure.

Looking ahead, one important driver of headline inflation will still be energy prices, which have been on a rollercoaster ride in recent months and increased again lately. This is a ride that could easily continue, depending on whether geopolitical tensions soften or escalate.

But there is more. The looming escalation of trade tensions and possible European retaliation to US tariffs could add to inflationary pressures in the short run. In the longer run, however, any trade war could also turn into a disinflationary force for Germany and the eurozone if growth were to weaken and companies potentially have to sell their increased inventories. European goods initially produced for the US market might end up in the European market at dumping prices.

Turning to Germany-specific developments, two additional opposing trends will clearly affect the future path of inflation. On the one hand, the cooling of the labour market should take away wage pressures and consequently inflationary pressure; on the other hand, the delayed pass-through of higher service costs is still in full swing.

As a result of all of this, we expect headline inflation to remain volatile but to broadly remain within the range of 2% and 2.5%.

All options on the table at the ECB's next meeting once again

A lot has happened since the ECB's March meeting – and slightly more than two weeks ahead of its next meeting, it's clear that all options will be on the table once again.

The German fiscal U-turn has moved from announcement to reality, but it's still yet to be implemented. The EU's efforts to increase defence spending have gained more traction, and US tariffs on European cars have become reality, which could also be the case for blanket tariffs two days from now.

At the same time, leading indicators suggest that the ECB's forecast of 0.2% quarter-on-quarter growth in the first quarter might again have been too optimistic, while inflation continues to slow down. In short, it looks as if the longer-term outlook for the eurozone has improved, while the shorter-term outlook looks darker again. It's not easy to conduct monetary policy in such a macro environment. And despite potential fears of longer-term inflationary risks as a result of fiscal stimulus, the potentially accelerating disinflationary trends in the near term could motivate the ECB to bring policy rates deeper into neutral territory.

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