German inflation remains unchanged in February

German inflation remained unchanged in February. Together with French and Italian inflation data, German inflation numbers should pave the way for a rate cut next week by the European Central Bank

The just-released flash estimate of German inflation for February brought some small relief for the ECB, showing headline inflation unchanged at 2.3% year-on-year. Core inflation came down to 2.6% YoY from 2.9% YoY. The European inflation measure came in unchanged at 2.8% YoY.

Earlier today, retail sales and labour market data indicated that expectations for a consumption-driven economic recovery are likely to be dashed once again. While the meagre increase in retail sales by 0.2% month-on-month in January was too little to offset the weak final quarter of 2024, the very gradual turning of the labour market continued in February.

Headline inflation to remain between 2% and 2.5% this year

The available regional state data suggests that favourable energy base effects as well as falling prices for alcohol, healthcare and household goods put downward pressure on inflation, while food prices accelerated again. Services inflation also continued its very gradual easing trend.

Looking ahead, one important driver of headline inflation will still be energy prices, which have gone on a rollercoaster ride in recent months. A ride that could easily continue, depending on whether geopolitical tensions soften or escalate. Regarding underlying inflation, however, there will be two opposing trends determining the future path of inflation. On the one hand, the cooling of the labour market should take away wage pressures and consequently also inflationary pressure, while on the other hand, the delayed pass-through of higher services costs is still in full swing. At the same time, the recent increase in selling-price expectations in industry is also concerning and could be aggravated by upcoming European tariffs.

As a result of these opposing trends, we see German headline inflation settling down in the range of 2% to 2.5% throughout the year, or to paraphrase the ECB: “close to but above 2%”.

Today's inflation data from eurozone countries paves the way for an ECB rate cut next week

For the ECB, today’s inflation data, not only from Germany but also from France and Italy, will have cemented the case for another 25 basis point rate cut next week. The main question, however, will be what’s next for the ECB. At 2.5%, the policy rate would be at the upper end of the neutral interest rate range. More hawkish ECB officials, like Isabel Schnabel, have started to push back against additional rate cuts. The critical communication to watch next week is whether the ECB drops the “restrictive” label from its official stance. Given the currently unprecedented high level of uncertainty, a complete drop of the “restrictive” label might be too hawkish. Some modification, e.g. towards “less restrictive” or “hardly restrictive anymore” might be better options to signal a possible end to the current autopilot.

In any case, given the structural weakness of the eurozone economy as well as looming tariffs and lower inflationary pressure on the back of a turn in the labour market, we still think that eventually the ECB will have to bring rates down to at least 2%, to make sure that rates are no longer restrictive but possible even accomodative.

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