German inflation provides new argument for ECB hawks

The slight increase in German inflation not only highlights the stickiness of inflation but also suggests that a September rate cut is not a done deal, yet

The just-released flash estimate of German inflation in July shows that there is still some way to go before it is back to the European Central Bank's target of 2%. Headline inflation came in at 2.3% year-on-year, slightly up from 2.2% YoY in June. The European inflation measure came in at 2.6% YoY from 2.5% in June.

Inflation to remain sticky

Today's German inflation data not only illustrates the ongoing impact of base effects and earlier government measures on present inflation but also highlights that inflation remains sticky above 2%. Judging from available regional state data, services inflation remained close to 4% YoY. While hotel and restaurant prices came down somewhat, leisure costs and clothing price inflation went up. Monthly changes show actual price drops in clothing as a result of summer sales and hospitality services, as companies probably reversed some of the price markups from the Euro2024.

Looking ahead, the stickiness of inflation at slightly too high a level looks set to continue as favourable energy base effects are petering out while, at the same time, wages are increasing. Leading indicators like selling price expectations do not give real guidance currently but very recently re-accelerated and remain slightly above the historical average in services and below the historical average in manufacturing. In any case, with new high wage demands, it is hard to see German wage growth coming down in the second half of the year.

As a result, we continue to expect inflation to hover within the broader range of between 2% and 3% rather than returning in a straight line to 2%.

September rate cut not a done deal, yet

For the ECB, today's data releases have not made things any easier. In fact, in terms of growth, the divergence has widened, with Germany falling behind while countries like France and Spain are enjoying a decent recovery. While German data is stagflationary, the eurozone as a whole provides a picture of a relatively solid but potentially fading recovery with sticky inflation. It is this stickiness of inflation that will strengthen the doubts around another rate cut at the September meeting. A cut to tackle the fading recovery or stay on hold to further fight inflation? The ECB will have six more weeks to chew on this question.

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