German inflation retreats in January but not enough for real relief

Headline inflation came down in January but not as much as expected as the disappearing base effects from the VAT reversal are still more than offset by high energy prices

Shoppers in Bremen, Germany

German headline inflation retreated less than expected at the start of the year. According to a first estimate based on the regional inflation data, German headline inflation came in at 4.9% Year-on-Year in January, from 5.3% YoY in December. HICP inflation stood at 5.1% YoY, from 5.7% YoY in December.

Inflation will first broaden before significantly dropping

With today's inflation data, one of the so-called one-off effects from 2021 has disappeared. The base effects from the VAT reversal no longer show in Year-on-Year inflation rates. However, the picture that remains is still one of elevated inflation rates.

In fact, today's German inflation data has something for everyone, both 'team transitory' and 'team permanent'. While core inflation measures seem to have come down somewhat, everything related to energy prices still shows almost unchanged inflation rates. It seems as if the disappearance of the VAT reversal base effect has simply been replaced by higher energy prices and pass-throughs from those. Remarkably, prices for packaged holidays and leisure were also up significantly. That's a sign that price markups are here to stay for a while.

> *It's hard to see inflation coming down significantly any time soon*

Looking ahead, even with the end to the base effect from the VAT reversal, the pass-through from higher energy and producer prices is far from over. Higher gas prices have been passed on to most German households from the start of the new year. Based on personal anecdotal evidence, all kinds of administrative prices and even TV broadcasting prices have gone up. Add to this additional price-markups in the hospitality, culture and leisure sectors once the current round of restrictions is over and it is hard to see inflation coming down significantly any time soon. It will take until late summer to see inflation slowing down to any significant degree when lockdown-related price markups are over and negative energy price base effects kick in. Chances are strong that average inflation over the entire year will be higher this year than in 2021. Even with headline inflation falling back to around 2% at the end of the year, we currently expect inflation to average 3.5% over the entire year.

Implications for the ECB

For the European Central Bank, today's German headline inflation data will most likely lead to yet another upward revision of its inflation projections. Still, we see the ECB in no position to consider hiking interest rates any time soon. The drivers behind high inflation and higher inflation projections are still mainly driven by supply-side constraints and not by demand. In other words, tightening monetary policy would do little to ship containers faster from Asia to Europe or reduce energy prices. Consequently, the ECB needs to make a fine distinction between a falling necessity to continue stimulating the economy and actually bringing higher inflation down.

At its upcoming meeting on Thursday, the ECB will have to confirm its new hawkishness without sounding too hawkish. If market expectations surge too quickly, higher interest rates could undermine the economic recovery. On the other hand, too much dovishness could damage the ECB's credibility as an inflation fighter. This is why the ECB needs to avoid rushing from inflation patience to inflation panic. How could they do it? Confirm the December decisions, keep the door open for faster asset purchase reductions and stress the sequencing of policy rate hikes only after asset purchasing ends.

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