German inflation still on the rise

German headline inflation came in at 7.4% year-on-year in April. The acceleration is slowing but a reversal is not in sight. Instead, inflationary pressure in Germany is broadening

German headline inflation surged once again as the war in Ukraine pushed up energy and commodity prices and inflationary pressure broadens. According to a first estimate based on the regional inflation data, German headline inflation came in at 7.4% year-on-year in April, from 7.3% year-on-year in March. The HICP measure came in at 7.8% YoY, from 7.6% in March. Over the coming months, the conversation between experts and headline inflation will be: "I say jump and you say 'how high'?". German inflation continues to see only one trend: up.

German inflation could enter double-digit territory in the summer

We've stopped digging out illustrations of the times when inflation in Germany was at comparable levels. Let’s put it like this: most citizens and policymakers have hardly ever seen these kinds of inflation rates in their professional lives.

Sure, the surge in headline inflation is still dominantly driven by energy and commodity prices. However, looking at available regional data, the pass-through of these higher prices to the broader economy is in full swing. In some regional states, food inflation was already at double-digit levels and prices for packaged holidays, leisure activities, hospitality and more general services have been accelerating in recent months. The inflation rate for these items is far above the European Central Bank's 2% target. In fact, in March only 21 out of the 94 main components of the German inflation basket had inflation rates of 2% or less.

Looking ahead, with the war in Ukraine and continued tension and upward pressure on energy, commodity and food prices, headline inflation in Germany will accelerate further in the coming months. In this regard, it is interesting that the ECB today released an analysis of why its inflation forecasts have been so wrong over the last few years. The ECB blames it mainly on energy prices and the fact that the oil price futures the ECB uses as technical assumptions have not been good forecasters of actual energy price developments. What the ECB does not address in its analysis, however, is the pass-through of higher energy and commodity prices on other prices. We still think that the underestimation of these pass-through effects has been the main reason for the ECB's misjudgement on inflation since the pandemic. The ECB simply underestimated that, post-lockdown, there would be so much demand that producers wouldn't have to shrink profit margins to absorb higher costs. Instead, they have been able to pass through all of the higher costs to the consumer. With this in mind, we likely have not seen the last forecast error.

We think that the pass-through to all kinds of sectors is still in full swing. Add to this the additional price mark-ups in the hospitality, culture and leisure sectors after the end of lockdowns and it is hard to see inflation coming down significantly any time soon. Against the backdrop of recent geopolitical events, we now expect German inflation to average at more than 8% this year with a chance that monthly inflation rates will enter double-digit territory in the summer.

Pressure on the ECB to act increases

For the ECB, increasing inflation numbers by the month add to the pressure to normalise monetary policy. Even though the ECB doesn't target actual inflation and can do very little to bring down inflation imminently unless it starts producing oil, gas or microchips, it is hard to justify overly accommodative policies. With the last ECB meeting and recent comments by ECB officials, it is clear that a consensus view has emerged on ending the so-called unconventional measures, ie net asset purchases and negative deposit rates before the end of the year. The only open issue is the timing. An end to net asset purchases by the end of June seems a done deal but whether the first rate hike will really come in July or only in September remains very open. We wouldn't put too much money on recent official comments regarding the data for a rate lift-off. Everything will depend on actual data until the June meeting. Up to now, there has been hardly any hard data available on the imminent impact of the war in Ukraine on the eurozone economy. By June, the ECB will have a new set of forecasts, plus the first hard data points for the months of March and April. The better these data are, the higher the likelihood of an early rate lift-off and vice versa.

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