German inflation surges in March

Higher energy, commodity and food prices have pushed German headline inflation to the highest level since 1974. The bad news is that this will not be the end of accelerating inflation. For inflation, the only way is up and double-digit numbers can no longer be excluded

Inflation in Germany will only have one direction in the coming months: up

German headline inflation surged once again as the war in Ukraine pushed up energy and commodity prices. According to a first estimate based on the regional inflation data, German headline inflation came in at a 48-year-high of 7.3% year-on-year in March, from 5.1% year-on-year in February. In the autumn of 1981, headline inflation stood at 7.1% and 7.2%. HICP inflation stood at 7.6% year-on-year, from 5.5% year-on-year in February. With the war in Ukraine and continued upward pressure on energy, commodity and food prices, there is only one direction for German inflation: up, up and away – but it definitely is not a beautiful balloon.

Inflation will only have direction in the coming months: up

The fact that German headline inflation was about to increase further was a given. The only question was “how high”. At 7.3% year-on-year, headline inflation is at its highest level since April 1974. The last time inflation was that high, Germany was about to win the football World Cup for the second time, Sweet’s ‘Teenage Rampage’ was number in the official singles chart top 100 in Germany, and ABBA had just released its career-shaping song ‘Waterloo’.

Looking at the available components of regional data suggests that core inflation should have also accelerated further to above 3%. There was an unusual degree of variation across the regional states, which was probably due to differences in energy prices and different pricing strategies of local utility providers. In general, inflation is still mainly driven by energy and food prices but the pass-through as well as the almost forgotten post-lockdown reopening inflation is showing higher prices for clothing but also hospitality and leisure services.

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. The pass-through to all kinds of sectors is in full swing. Add to this the additional price mark-ups 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. 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.

Stagflation dilemma for ECB is worsening

For the European Central Bank (ECB) this high risk of stagflation in the eurozone will put the planned to policy normalization under pressure. While growth is about to test recessionary territories, at least in the first half of the year, headline inflation will be much higher for longer. In such a macro-economic environment, the ECB's focus seems to have shifted to inflation and no longer growth. However, as much as the ECB couldn't do anything to bring Asian containers faster and cheaper to Europe or to step up microchip production in Taiwan, there is very little the ECB can do to stop the war or to bring down energy prices. The ECB will want to focus on inflation expectations and as long as these expectations remain fairly anchored, we only expect an end of the so-called unconventional measures over the next 12 months, i.e an end to net asset purchases and an end to negative deposit rates. It would need a clear end to the war, lifted sanctions combined with stepped up fiscal stimulus to engage the ECB in a more genuine tightening cycle.

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