German inflation data tilts balance towards a September rate cut

German inflation dropped below 2% for the first time since March 2021, opening the door for a rate cut at the European Central Bank's September meeting

The just-released flash estimate of German inflation in August has everything the ECB needs to continue cutting rates at the September meeting. Coming in at 1.9% year-on-year, from 2.3% YoY in July, German headline inflation is now at the lowest level since March 2021. The European inflation measure came in at 2.0% YoY, from 2.6% in July. Even better, the monthly drop of 0.1% was the first monthly decline in the month of August since 2020.

Finally signs of broader disinflation

Today's drop in German inflation is the result of lower energy prices and favourable base effects as well as lower prices for goods. Judging by available regional state data, services inflation remained close to 4% YoY but core inflation seems to have come down as well. While hotel and restaurant prices rose somewhat, leisure costs and clothing price inflation went down. Monthly changes show actual price drops in food and beverages as well as household goods and transportation.

At face value, this inflation report is great news for the ECB as it finally shows the first signs of a broader disinflationary trend, which goes beyond energy prices. At the same time, however, it is too early to give the all-clear on inflation both in Germany and the entire eurozone. This morning's wage data is one of the reasons for concern. German real wages increased for the fifth consecutive quarter, potentially fuelling inflationary pressures further down the road. Also, don't forget that German unions are going into the post-summer bargaining rounds with high demands. It could take longer than the ECB expects before wage growth in the eurozone comes down significantly. Finally, leading indicators like selling price expectations are currently sending mixed signals. After a recent re-acceleration, selling price expectations in both industry and services came down in August but remain slightly above the historical average in services and below the historical average in manufacturing.

All in all, we continue to expect inflation to hover within the broader range of between 2% and 3% rather than staying at the current 2%.

Today's inflation data clearly tilts the balance towards a September rate cut

If confirmed by tomorrow's eurozone inflation data, today's German data should make the decision to cut interest rates at the September meeting a bit easier for the ECB. Fading inflationary pressure combined with fading growth momentum offer an almost perfect macro backdrop for another rate cut. At the same time, however, forward-looking inflation indicators like selling-price expectations and wage growth show that there are still reasons to be cautious. In fact, let's not forget that for central banks, orchestrating a soft landing with inflation nicely settling at target without hurting the economy is like winning a gold medal at the Olympics: rare.

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