German inflation up, not down

German headline inflation accelerated on the back of higher energy prices and continued pass-through effects. With the war in Ukraine and continued tension and pressure on energy prices, the only way for German inflation is up, once again

Man looking at receipt

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German headline inflation increased instead of further retreating in February. According to a first estimate based on the regional inflation data, German headline inflation came in at 5.1% year-on-year in February, from 4.9% YoY in January. HICP inflation stood at 5.5% YoY, from 5.1% YoY in January. With the war in Ukraine and continued upward pressure on energy prices, the direction for German inflation has changed: it is no longer down, but up.

Only way for inflation is up

These days, it is probably not the most important data point but just-released German inflation data suggests that the economic implications of the war in Ukraine are likely to bring back an economic nightmare from the past: stagflation.

Forget about disappearing one-off factors reducing headline inflation. This base effect is only visible in the price inflation for clothing. For the rest, high energy prices and the pass-through effects from high energy prices on other goods and services are pushing up headline inflation. As anecdotal evidence, this economist today noticed that the prices for his favourite car-sharing service had increased by 16% compared with the end of 2021.

Looking ahead, with the war in Ukraine and continued tension and upward pressure on energy prices, headline inflation in Germany will accelerate rather than slow down in the coming months. The pass-through to all kinds of sectors is in full swing. Add to this 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 around 4.5% this year and to stay above 3% even at year-end.

ECB's path to normalisation blocked again

For the European Central Bank, this inflation data and the overall economic picture since the start of the war in Ukraine have once again complicated the road to normalisation. Given that the cut-off for the ECB's staff projections was several weeks ago, any new inflation forecasts can be thrown into the waste paper bin as they are outdated. The new uncertainty, as well as the direct economic implications from the war, are still hard to model into numbers. As a consequence, we will probably have a situation at next week's ECB meeting in which the inflation projections for 2023 and 2024 could be at 2%, calling for ECB action. However, no one can seriously expect the ECB to start normalising monetary policy in such a moment of high uncertainty. Therefore, we expect the central bank to stick to the already announced rotation of its asset purchase programmes, i.e. ending the Pandemic Emergency Purchase Programme in March and increasing the Asset Purchase Programme from €20bn to €40bn, and changing the reduction path to €5-10bn per month, starting in May. Contrary to the December meeting, the ECB will want to avoid hinting at end dates for QE or starting dates for rate hikes. At the current juncture, the ECB needs to repeat the vows from Mario Draghi and Jean-Claude Trichet to "never pre-commit". If everything goes well, net asset purchases can still be ended in the third quarter and interest rates can be hiked for the first time before the end of the year, but this is not for next week's meeting.

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