Regional German inflation data show hidden disinflationary trend

Regional data point to a slight drop in German headline inflation in July. While this would be too little to give any relief to the ECB, the underlying trend shows encouraging disinflationary signals

Falling monthly prices for food, clothing and transportation have pushed down headline inflation

According to recently-released regional data, German headline inflation looks set to have remained broadly unchanged in July. The data so far show monthly inflation at 0.3% month-on-month. If confirmed at the national level, this would bring down headline inflation to around 6.3% year-on-year, from 6.4% YoY in June. The harmonised European measure could slightly nudge down to 6.7% YoY, from 6.8% YoY in June.

At first glance, these numbers suggest uncomfortably high inflationary pressures in Germany and very little relief for the ECB. Underneath these headline numbers, however, the disinflationary trend continues and should gain new and even stronger momentum after the summer.

Hidden disinflationary trend continues and should gain momentum after the summer

Inflation data in Germany and many other European countries continue to be surrounded by more statistical noise than usual, making it harder for the European Central Bank to take this data at face value. Government intervention and interference, whether temporary or permanent or occurring this year or last, will continue to blur the picture.

In the case of Germany, headline inflation is and will be affected by several base effects: while lower energy prices exert downward pressure on inflation, the end of last summer's temporary government energy relief measures and cheap public transportation have added upward pressure. Looking at monthly price changes actually paints a more promising picture of German inflation dynamics. For the fourth month in a row, food prices have dropped month-on-month. Prices for clothing have dropped sharply, probably reflecting weaker demand, price discounts and also sales season. At the same time, however, prices for packaged holidays were sharply up, suggesting that at least this summer holiday operators still have strong pricing power.

With still lower-than-expected energy prices, dropping food prices and fading pipeline price pressures in both services and manufacturing, German (and eurozone) inflation could come down faster than the ECB expects, at least after the summer. There is a high chance that we are currently witnessing the last leg of services inflation, mainly in tourism. We see German headline inflation falling to around 3% towards the end of the year.

Admittedly, the risks to this outlook are obvious: sticky core inflation, wage pressures and government measures to support the demand side of the economy. Also, we stick to the long-held view that, structurally, inflation will be higher over the coming years than pre-pandemic. Demographics, derisking and decarbonisation all argue in favour of upward pressure on price levels. However, be cautious when hearing comments that inflation will never come down. These comments might come from the same sources that only a few years ago argued that inflation would never surge again. This does not mean that the loss in purchasing power as a result of the last inflationary years will be reversed any time soon. It only means that headline inflation can come down faster than currently anticipated.

Something for everyone at the ECB

For the ECB, this is the first day after the end of its autopilot mode, and there is something for everyone: for the doves, the disinflationary trend, be it covert in Germany or more open in other eurozone countries, and for the hawks better-than-feared GDP growth data for the second quarter. Whether to pause or to continue hiking at the September meeting will be highly dependent on these two trends. The faster the worsening of the growth outlook and the disinflationary trend will be, the higher the chance of a pause, but also vice-versa. This is the data dependency mentioned so many times yesterday by ECB President Christine Lagarde at its best.

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