

Germany: Last deflation

December was another month of deflation but the end of the VAT cut, a reversal of negative base effects from energy prices and some reversal of social distancing deflation should push headline inflation in only one direction from here: up



Based on the inflation outcomes of several regional states, German inflation came in unchanged at -0.3% year-on-year in December. The harmonised index, relevant for European Central Bank policymaking, also remained unchanged at -0.7% YoY. Headline inflation has now been in negative territory since August, the first time since reunification that German headline inflation has been negative for five consecutive months.

Near term outlook: the only way is up

The drivers behind negative inflation rates are still the ongoing, though fading, negative base effect from low energy prices and above all, the VAT cut in July. The VAT reduction is most visible in prices for clothing and other consumer goods. At the same time, social distancing and the lockdown announced in November are also leaving their mark on prices. Not only does the lockdown complicate proper measuring of inflation, as some services are simply not available, the pandemic has also (temporarily) changed lifestyle and spending patterns - changes that are not reflected in the composition of the price index.

Looking ahead, today's inflation number should mark the end of a government-induced period of deflation. The reversal of the VAT cut should push headline inflation to around zero in January and higher readings thereafter. Also, at current oil price levels, the negative base effect from lower energy prices should start to reverse in spring. Finally, once the lockdown measures are eased again, a reversal of the social distancing deflation, at least in some sectors, looks possible. Headline inflation could even touch the 2%-mark towards the end of 2021. However, before getting too nervous about inflation, we highlight that the economy will not reach its pre-crisis level before early-2022, unemployment and insolvencies are bound to increase and a further euro appreciation will be rather deflationary, putting a lid on any inflationary pressure.

Still, and at least for a short while, for German inflation, the only way is up.

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