

## Germany: Domestic data illustrates the ECB's dilemma

A slight increase in inflation and a strong labour market is exactly what the ECB loves to see. However, despite solid German data, the March meeting will be the first test case for Lagarde's communication skills



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Based on regional data and the first estimate, headline inflation came in at 1.7% year-on-year in February, from 1.6% YoY in January. This is the highest level since April 2019.

Judging from available regional data on the different components, inflation was mainly driven by higher prices for food and alcohol. While these are the more volatile components, relatively high price inflation for consumer goods seems to be more than only a mark-up during Christmas sales. In fact, for ECB hawks, the latter could be regarded as evidence that underlying inflation has finally started to pick up. However, with the recent drop in oil prices, headline inflation looks set to move south again in the coming months, even if supply chain disruptions could locally and temporarily lead to some upward pressure on producer prices.

Earlier today, the German labour market showed further signs of resilience. The total number of

unemployed dropped in February, keeping the unemployment rate stable at 5%.

Until now, the German labour market has shown a remarkable resistance against external shocks, like global trade conflicts, the manufacturing slump or recently the coronavirus. Strong domestic demand, services and demographics have increased the labour market's immunity. However, successes of the past are no guarantee for the future and underneath the strong headline numbers, there are already some cracks. The number of people working under short-time work schemes has increased to some 120,000, higher than during the eurozone debt crisis, but still far below the 1.4 million people during the financial crisis in 2008/9.

Also, regional data shows that unemployment rates have started to increase, mainly in regions hosting manufacturing companies. Looking ahead, the fact that recruitment plans in the manufacturing sector dropped to the lowest level since 2009 will put pressure on the labour market in the coming months.

Today's macro data is just a snapshot and probably the last pre-corona data for the German economy. The data paints a picture of an economy with strong domestic demand and some increase in underlying inflationary pressure. Just as the ECB would love it.

Talking about the ECB, today's data was probably the last set of hard data for the new staff projections, which will be presented at the next ECB meeting in two weeks from now. It will be a very challenging meeting for the ECB.

The available data points up to now give little reason to revise growth forecasts but the latest news flow on the spreading of the virus to Europe, poses both a supply and a demand-side shock to the economy, as well as market turmoil, add a very queasy feeling to the meeting. In our view, there is very little the ECB could and actually would do at the current juncture. More of the same, like a rate cut or stepping up QE, would do very little to stabilize the economy or support public sentiment and the health sector.

Therefore, we expect the ECB to soften the December language, point out new downside risks to growth and to promise to monitor closely all developments and finally to stand ready to act. A balancing act if the current turmoil continues until the ECB meeting. The March meeting will definitely be the first test case for Christine Lagarde's communication skills and her ability to steer markets.

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