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Snap

Germany: Headline inflation backtracks further, core remains low

German inflation provides little evidence of a sustainable increase in underlying inflation

Based on the results of seven regional states, German headline inflation recorded another marginal drop and slowed down to 2.0% year on year in July, from 2.1% YoY in June and 2.2% YoY in May. Measured by the harmonised European consumer price index, headline inflation remained unchanged at 2.1%, suggesting eurozone headline inflation (to be released tomorrow) could hit the 2% mark for the fourth time in the last five years.

Returning to Germany, headline inflation at around 2% YoY, however, is not so much the result of the ECB's ultra-loose monetary policy but rather the result of higher energy prices. In fact, where available, regional core inflation measures remained broadly unchanged and only slightly above 1%, indicating that underlying inflationary pressures in the economy remain low.

Judging from the available components, German inflation data still tells a two-sided story: while prices for consumer goods have gradually accelerated in recent months, inflation on services has slowed down and has even been negative for a couple of months for communication. Also, whether it was the World Cup effect or just the ordinary sales season is hard to tell, but prices for clothing and shoes were the biggest drag on headline inflation.

Looking ahead, there are still few signs supporting the ECB's general optimism that underlying inflation in the entire eurozone is picking up. Despite a very long economic cycle, low unemployment and rising wages, the German economy shows little sign of overheating, not even a significant pick-up in underlying inflation. Instead, headline inflation is mainly dominated by external and one-off factors.

In this regard, the current heatwave could push up food prices and hence headline inflation in the coming months. But with little upside pressure on underlying inflation, chances that headline inflation will fall back under 2% towards the end of the year are much higher than staying at, or closely above, the 2%-mark.

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