Germany: Inflation shock

The surge in German headline inflation could pose a new communication challenge for the ECB

Watch out, the inflation monster is back

Based on inflation outcomes of several regional states, German inflation in January came in at 1.0% year-on-year, from -0.3% in December. The harmonised index, relevant for European Central Bank policymaking surged to 1.6%, also remained unchanged at -0.7% YoY.

This was the largest monthly increase in a long time.

More to come

Before anyone gets too scared, this surge is mainly the result of the reversal of last year's VAT reduction, higher energy prices and the new carbon tax.

On the back of the VAT cut reversal, core inflation has also increased. Judging from the available regional data to around 1.5% YoY. With the VAT increase, it is hard to disentangle the negative impact from the latest lockdown measures and the positive impact from a higher VAT on prices.

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Interestingly, the prices for clothing increased sharper than justified by higher VAT, probably another result of the lockdown comparing fictive prices of closed retailers with winter sale prices from last year.

Looking ahead, today's inflation number is just the beginning of a period of significantly higher headline inflation in Germany. The full impact of higher energy prices compared with last year will show in the coming months. Also, the full base effect from the VAT cut reversal will only be reflected in inflation numbers after the summer. Together with price mark ups in some sectors once the economy starts to reopen again, headline inflation in Germany could be pushed above 2% after the summer.

A new communication challenge for the ECB?

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. Nevertheless, these inflation developments could easily present a new communication challenge for the ECB.

Recent comments on possible yield curve control, warnings against premature tightening of monetary and fiscal policies as well as more emphasis on symmetry and hence the possibility of inflation overshooting are just a few tools the ECB could use to preserve what seems to be the ECB's latest treasure: favourable financing conditions.

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