Germany: Inflation - still an Easter hangover

The sharp drop in German headline inflation will further support the ECB's current easing bias.

According to the just-released first estimate based on the results of several regional states, German headline inflation came in at 1.3% year-on-year in May, from 2.1% in April, and the lowest level since April last year. The national inflation measure dropped to 1.4% YoY, from 2.0% in April.

The main inflation drivers were lower food prices, continued price drops in communication and services and lower prices for leisure and package holidays. The latter shows once again the ever-returning impact of the Easter Bunny on German headline inflation, an up and down hopping which this year distorts inflation for three months. As expenditures for leisure and packaged holidays are also included in core inflation measures, available regional core inflation proxies point to a significant drop in core inflation. This is true not only in Germany (probably from 2% YoY to around 1.5% YoY), but also in the entire Eurozone.

Leaving the Easter Bunny fluctuation aside, today's inflation data show that core inflation in the Eurozone is still moving sideways and actually has been doing so since 2015. The ECB's hope that headline inflation would move towards the ECB's medium-term aim is increasingly being derailed rather than delayed. In fact, if it were not for oil prices, the last years of monetary stimulus have avoided a further drop in underlying inflation but have not succeeded in bringing inflation close to target. The German experience also casts doubts about the ECB's view that the pass-through of higher wages on inflation is still intact. In fact, the German experience shows that even though the transmission from a tighter labour market to stronger wage growth has, since 2016, finally matched previous periods, the transmission from higher wage growth to faster inflation still barely exists. Margin squeezing to maintain (international) market shares, more price transparency due to digitalization and more competition and mobility in the service industry (also due to digitalization) could be the main drivers eventually debunking the textbook relationship between wage growth and higher inflation.

More arguments for the ECB's easing bias

All of this means that the ECB will stick to its current easing bias. Clearly, low inflation also gives rise to discussion on whether the definition of price stability is still up-to-date and whether unconventional measures are still needed in a low inflation situation without deflationary risks. However, in the current set-up and at least until the change of guard in November, the ECB will do whatever it takes to bring (medium-term) inflation back to target. As a consequence, even though it's not our base case, additional easing measures over the summer should not be ruled out.

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