German inflation continues to surge making things even more complicated for the ECB

With headline inflation on the rise, the ECB's attempt to avoid the taper conversation will become more and more complicated. However, we think German headline inflation could eventually range between 3% and 4% in the second half of this year

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Headline inflation is accelerating like the temperature outside

Based on inflation outcomes of several regional states, German inflation in May came in at 2.5% year-on-year, from 2.0% in April. The harmonised index relevant for European Central Bank policymaking increased to 2.4%, from 2.1% in April - the highest level since November 2018.

This acceleration in German inflation is mainly due to higher energy prices but don't forget that all the lockdowns still distort these numbers and imputed prices as many goods and services are simply unavailable.

All inflation drivers in full swing

Today's May inflation data shows that the entire range of potential inflation drivers is currently in full swing.

Higher producer prices on the back of supply chain disruptions, higher commodity prices and the gradual reopening of the economy are all leaving their marks on consumer prices. According to data from regional states, prices for household goods, services and leisure activities were the main drivers of headline inflation.

> *We think German headline inflation could eventually range between 3% and 4% in the second half of this year*

The fact that headline inflation has now surged from -0.7% YoY in December last year to 2.4% in May will cause concern for many Germans, and the bad news is - there is more to come. With supply chain disruptions, like higher container prices, delivery problems with semiconductors and elevated commodity prices, producer prices are set to increase further, possibly putting more pressure on consumer prices.

Add to this some post-lockdown reflation in a few sectors, which will gain momentum soon, and the reversal of the German VAT rate and German (and eurozone) inflation, the only way is up. In our view, German headline inflation could eventually range between 3% and 4% in the second half of this year.

How long can the ECB really avoid the taper conversation?

Like the US, every single data point shows accelerating inflation in the eurozone, which raises questions about the raison d'etre for ultra-loose monetary policy.

Despite higher inflation, accelerating vaccination roll-out and the strong economic rebound, the ECB looks set to stick to its current stance. Last week, ECB Executive Board member Isabel Schnabel, who seems to be giving most informative speeches and interviews for those looking for the ECB's reaction function, set the scene by warning against "a premature withdrawal of either fiscal or monetary support".

> *This is just another reminder that the rise of inflation won't be over any time soon. For the ECB, this means that it will be increasingly difficult to avoid the taper talk. The avoidance strategy might work next week but not for much longer.*

Consequently, when the ECB meets again next week, the main focus will be on avoiding any tapering talk.

Why? Even if economic developments, in our view, clearly justify at least having a first discussion, the sheer mention of such a discussion could push up bond yields further and consequently undermine the economic recovery before it has actually started. The fact that several more dovish statements were made by ECB officials recently underlines this view. However, the ECB will not be able to avoid the tapering discussion for long.

This discussion will gain momentum over and after the summer, and we expect the ECB to engage in its own twist eventually: gradually ending asset purchases under the PEPP while increasing them under the old Asset Purchase Programme.

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