

## Germany: Inflation unchained

German headline inflation made the expected summer jump in July, reaching its highest level since the summer of 2008. And there is more to come



Based on inflation outcomes of several regional states, German inflation in July came in at 3.8% year-on-year, from 2.3% in June. The harmonised index relevant for the European Central Bank jumped to 3.1%, from 2.1% in June; the highest level since the summer of 2008.

The surge in headline inflation was driven by the full base effects from the VAT reversal, which also shows in subcomponents like prices for clothing and leisure. Today's inflation surge will do very little to bridge the gap between the two inflation camps; one arguing that inflation drivers are transitory and that base effects will disappear or even reverse next year and the other seeing a broad risk of accelerating inflation. We remain somewhere in the middle. While structural factors like labour market slack or digitalisation indeed argue in favour of a more benign approach to inflation, we are seeing the most fertile breeding ground for second-round effects in a long while.

### Next stop 4%

Higher producer prices on the back of supply chain disruptions, higher commodity prices and the gradual reopening of the economy are all impacting consumer prices. Together with the reversal

of the German VAT rate, headline inflation could even exceed 4% towards the end of the year.

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. In fact, today's European Commission sentiment indicators showed that selling price expectations in the German manufacturing sector were at an all-time high and close to an all-time high in the services sector. This is strong evidence of the lingering pass-through from higher producer prices to consumer prices. Also, don't rule out that headline inflation north of 4% at the end of the year will affect wage negotiations in 2022.

All in all, even if the ECB has a different view on the entire eurozone, we think that in Germany, at least, the breeding ground for second-round effects has hardly ever been more fertile than it is now, on the back of economic reopening. This means a pass-through from producer to consumer prices, as well as a pass-through from consumer prices to wages. Judging from last week's ECB meeting, there is very little the ECB plans to do in order to tackle longer-lasting inflationary pressures. To a large extent rightly so, as monetary policy can hardly bring down inflation which is driven by one-off factors. However, there will no doubt be some Germans hoping that inflation will be re-anchored.

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