

## German inflation cools off but likely to resurge soon

The latest drop in German headline inflation masks another surge that we think is around the corner, adding to an increasingly heated debate at the ECB about potential next steps towards tapering



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The drop in German headline inflation is nothing more than a thunderstorm in the summer: it brings a short period of cooling off but not really a game-changer.

Based on inflation outcomes of several regional states, German inflation in June came in at 2.3% year-on-year, from 2.5% in May. The harmonised index relevant for the ECB decreased to 2.1%, from 2.4% in May.

The fall in headline inflation is just a short stop before another surge. In July, the full base effects from the VAT reversal will show for the first time, probably pushing inflation to above 3%. A continuing surge in headline inflation together with what currently could be the most fertile breeding ground for second-round effects will further fuel the tapering debate.

## Entire range of potential inflation drivers in full swing

Despite today's drop, the entire range of potential inflation drivers are still 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 impacting consumer prices.

According to data from regional states, prices for household goods, services and hospitality services were the main drivers of headline inflation, with food prices and prices for leisure activities slightly taking off inflationary pressure in June. But don't be fooled by today's drop in headline inflation - there is more to come soon.

For *Soccernomics* fans, tonight could be a crucial moment for German inflation. If the journey of "Die Mannschaft" ends in Wembley, merchandise could end up on the bargain counter, leading to disinflationary pressures. If the journey continues, stronger demand for merchandise and beverages could push up inflationary pressures. For the others and on a more serious note, it is clear that in any case, the post-lockdown reflation will gather momentum in the coming months and together with the reversal of the German VAT rate will start pushing up headline inflation into the range between 3% and 4% from July onwards.

Admittedly, the surge in German inflation (and eurozone inflation) can still be attributed to one-off factors. However, 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 eurozone manufacturing sector were at an all-time high and close to an all-time high in the services sector. Strong evidence of a lingering pass-through from higher producer prices to consumer prices.

### Summer challenge for the ECB: find the right way forward

At the last policy meeting and even since then, the ECB has stuck to its very benign view on inflation.

An inflation outlook of 1.4% in 2023 is anything but scary, however, this benign take could soon be subject to some rethinking. In fact, in our view, the breeding ground for at least one edition of second-round-effects has hardly ever been more fertile than currently on the back of reopenings of the economy. A pass-through from producer to consumer prices as well as a pass-through from consumer prices to wages.

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The problem for the ECB is that an event like a pandemic is so unprecedented that models based on historical pass-throughs could easily and quickly become invalid. Sure, in the longer run, a negative output gap, slack in the labour market and longer-term damage from the pandemic argue against runaway inflation but won't stop the debate about whether the

eurozone economy still needs the current level of monetary stimulus going into the second half of the year. In our view, it will become increasingly difficult for the ECB to stick to its benign take on inflation. Reintroducing a risk assessment for the inflation outlook could, in our view, improve the ECB's credibility.

Judging from recent comments, the doves and hawks at the ECB are starting to position themselves for what will become a heated tapering debate over the summer months. Contrary to the situation in the US, the ECB's tapering will not be a process to completely stop asset purchases but rather a strategy to bring the Pandemic Emergency Purchase Programme (PEPP) to a subtle end by March 2021 and have the traditional Asset Purchase Programme (APP) take over entirely.

As much as eurozone citizens are currently hoping for a carefree summer, ECB policymakers will inevitably lose some time (and relaxation) over the right way forward.

## Author

### Carsten Brzeski

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

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