

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



Source: Shutterstock

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.

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

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

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.