

## Germany: Disinflation for now but deflation risk increases

The September fall in German inflation is mainly the result of low energy prices and the VAT reduction. However, disinflation can easily turn into deflation



Source: Shutterstock

Based on the inflation outcomes in several regional states, German inflation came in at -0.2% year-on-year in September, from 0.0% YoY in August.

The lowest reading since January 2015. The harmonised index, relevant for ECB policymaking, dropped to -0.4% YoY, from -0.1% in August.

The regional data paint a picture of diverging inflationary trends in the German economy.

The negative base effect from low energy prices is keeping headline inflation low but there is more: the VAT cut of July is most visible in prices for food, clothing, other consumer goods and increasingly also for other leisure activities and packaged holidays. At the same time, the fact that the increase in hotel and restaurant prices is still very much in line with the trend seen prior to the VAT cut suggests that lower taxes are also used to support businesses and are not necessarily

entirely passed on to consumers.

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Looking ahead, German headline inflation should first fall further before gradually rebounding next year; at least if the German government sticks to the plan of reversing the VAT reduction in January. In July 2009, headline inflation came in at -0.7% YoY; a record which could be broken in October or November.

At the start of the crisis, there had been speculation about whether this current crisis would be an inflationary or deflationary event. For the time being for Germany, the conclusion is crystal clear: it is disinflationary. Since the VAT reduction, around 50% of the top 100 components of the inflation measure have recorded negative inflation rates.

During the last fears of deflation in 2014 and 2015, this was never more than 30%.

Almost needless to say that the ECB hardly ever reacts to actual inflation developments but to inflation expectations and forecasts. Many aspects of the recent drop in inflation can be explained rationally: VAT reduction, social distancing, devastating summer for tourism in many countries. Also, in a positive scenario with a vaccine coming to the rescue, some of these trends could be reversed next year.

However, it would not be the first time that falling prices, driven by one-off factors, combined with economic uncertainty and increasing unemployment could develop into a deflationary spiral.

Latest speeches, comments and leaks from ECB officials show that balancing between this 'rather act now to prevent worse from happening' and 'it is temporary and all will be fine next year' is anything but easy.

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