Germany: Inflation up but still no signs of overheating

A small uptick in German headline inflation in November is no sign of overheating but mainly the result of higher oil prices and another vacation period.

Based on the results of six regional states, German headline inflation rebounded somewhat in November, increasing to 1.7% YoY, from 1.8% YoY in October. Based on the harmonised European definition (HICP), and more relevant for ECB policymaking, headline inflation accelerated slightly faster to 1.8% YoY, from 1.5%. The monthly increase of 0.3% was the strongest November increase since 2007.

Higher inflation mainly result of oil prices and seasonal effects

Looking at the available components at the regional level shows that today's increase is mainly the result of higher oil prices. In fact, the so-called energy base effect has turned from being disinflationary into being inflationary. The fact that the heating oil component in some regional inflation statistics increased by 15% YoY in November clearly supports this view. Also, the special public holiday combined with school vacations in many states pushed up prices for package holidays and other recreational activities. At the same time, measures of core inflation remained stable.

Stable core inflation, however, masks two diverging trends in German prices. While prices for consumer goods have increased at an annual rate of above 2% for quite some time, the ongoing decline in communication costs and lower prices for services continues to keep core inflation at bay.

Three reasons why inflation is and should remain subdued

Looking ahead, the big question remains why an economy which has been growing at full speed for several years, with record high employment and capacity utilisation above historical averages is not printing higher inflation numbers? In our view, there are at least three reasons for subdued inflation rates, both for current and future developments: the output gap, digitalisation and globalisation.

1. Despite strong growth, the output gap is only mildly positive. In the past, the German economy needed much bigger positive output gaps before sustainably printing inflation rates above 2%. Following previous patterns, the German economy could probably continue for at least another year at the current growth rate before pushing inflation above 2%.
2. Digitalisation and the related increase in price transparency but also higher competition in the service sector seem to structurally put a lid on inflation.
3. Globalisation and automation are probably the main reasons why there is little upward pressure on wages and inflation. The fact that all wage settlements this year came in with agreed nominal wage increases of 2%-2 ½% indicates that the spur in wage increases the ECB has pencilled in is far from certain.

German inflation outlook: watch these oil prices

All of this means that headline inflation seems to be mainly driven by external factors. Domestic price pressure remains subdued. Higher oil prices could easily push German headline inflation again above 2% early next year but that an oil-driven inflation hike would really make the ECB re-assess its current policy stance is highly doubtful.

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