German inflation edges up in August

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Higher fuel prices have pushed up headline inflation to 2.9% year-on-year in August

The just-released first estimate of August headline inflation shows a small uptick in headline inflation on the back of higher energy prices again. German headline inflation came in at 2.9% year-on-year in August, from 2.8% YoY in July. The European inflation measure, more relevant to the European Central Bank, also came in at 2.9% YoY. Core inflation remained unchanged at 2.4% YoY, while services inflation slowed down for the second month in a row, to 2.8% YoY, from 2.9% YoY in July.

Looking at the available components, the August increase is mainly the result of energy price base effects. There were very little signs of knock-on or indirect effects of higher energy prices on the rest of the economy. In fact, it is currently still only oil prices that are pushing up inflation, while gas and electricity prices are actually still down compared with last year.

Looking ahead, the path of headline inflation remains highly affected by the war in the Middle East and oil prices. The recent swings in oil prices have been another reminder that it’s almost impossible to come up with oil price assumptions for any inflation forecast that lasts for more than a few days. However, in our new base case scenario, we are assuming that the war will continue and relief will only come after the US mid-term elections. Against this background, oil prices would stay higher for longer, pushing up headline inflation to above 3% and keeping it there at least until year-end. Low gas storage levels are likely to lead to higher gas prices over the next weeks, ending up as higher retail prices at the start of next year. Together with some knock-on effects from higher energy prices on transportation costs, as well as the inflationary impact of the drought on food prices and other industrial products, it could now take until the end of 2027 before headline inflation drops below 2% again.

As worrisome as this might sound, the current inflation picture remains structurally different from the inflation wave in 2022. Selling price expectations in both industry and services have again dropped below pre-war levels. At the same time, consumers’ willingness and also financial ability to pay higher prices is much lower than in 2022. As a result, it will be hard for companies to pass through higher production costs. Instead, margin squeezing will be the game in town.

The stage looks increasingly set for another rate hike at next week's ECB meeting. Not only because some ECB members actually advocated for a rate hike at the July meeting, but since the July meeting, the eurozone economy has shown an almost unexpected resilience to the war in the Middle East. This is partly due to good luck and the fact that Asian competitors were hit harder by the closure of the Strait of Hormuz and lost orders to European competitors, but also due to long-announced fiscal stimulus.

At the same time, headline inflation has continued to edge higher, even if other inflation measures like core and services currently give no reason to panic. With oil prices remaining elevated and the risk of a fresh gas price shock increasing, most ECB policymakers are likely to see the case for another rate hike.

Even if the ECB doesn’t like the term, the second rate hike this year would also fall into the category of ‘insurance rate hike’, or maybe more to the ECB’s liking: a rate hike to strengthen the ECB’s credibility and to preempt any possible indirect or even second-round effects from the current energy price shock.

Whether the ECB will really go beyond a September rate hike is a completely different story. With one additional rate hike, the deposit rate would still be within the range the ECB itself calls neutral. Going further would mean that the ECB sees restrictive monetary policy as necessary. But there is a big difference between an economy that has shown resilience and an overheating economy that needs restrictive monetary policy. We still find it hard to see that in times of public finance woes and surging bond yields, the ECB would really be willing to pour more oil into the fire. Or in other words, it is hard to see that the ECB would be willing to risk a recession to tackle what is still a textbook supply-side shock.

Source: https://think.ing.com/snaps/german-inflation-at-3-for-first-time-since-january-2024/