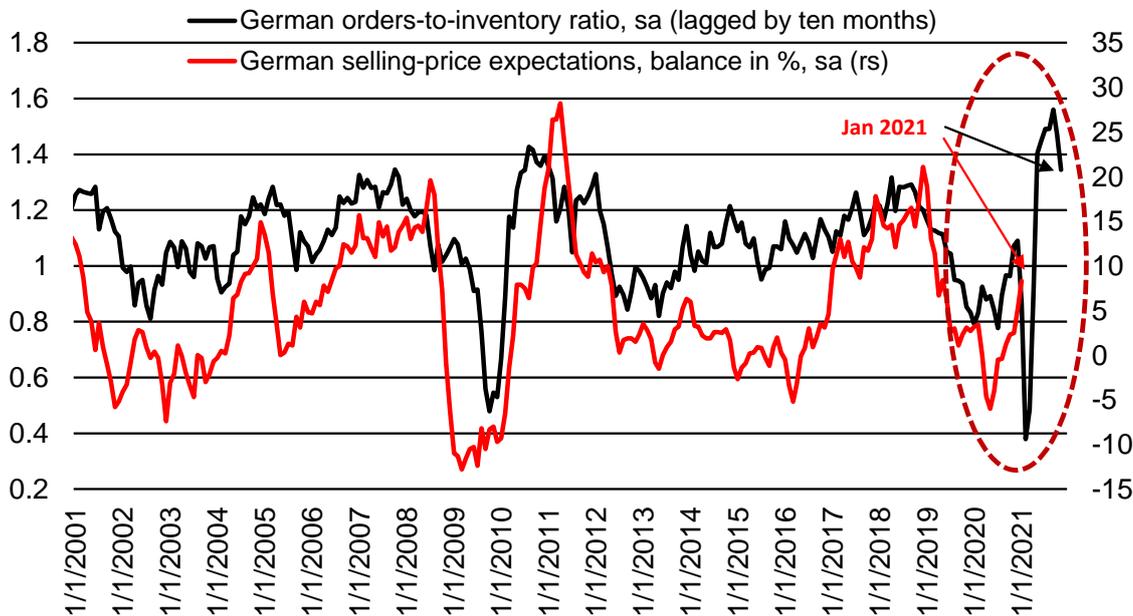


3% inflation in Germany? Maybe...but only temporarily



Source: European Commission, IHS Markit, UniCredit Research

- In a recent interview with a German newspaper, Bundesbank President Jens Weidmann said that inflation in Germany would rise above 3% by the end of this year. His statement triggered a lively public discussion about persistently higher German inflation in the years to come. While he also added that the increase will be temporary due to several one-off factors, this has received less attention in the public debate. Moreover, in terms of what conclusions can be drawn from higher German inflation, it remains clear that, what matters from the ECB's perspective is eurozone inflation, not German inflation per se.
- In our *Chart of the Week* we show that German inflation is indeed set to accelerate, as indicated by rising selling-price expectations. Besides one-off factors (such as the reversal of the VAT reduction in 2H20), this is driven by fundamental cyclical pressure as represented by a higher orders-to-inventory ratio, which will result in higher goods inflation. But the chart also shows that cyclical factors have begun to signal a weakening in momentum recently, which is why stronger price increases are unlikely to be sustained.
- In the chart we have lagged the German orders-to-inventory ratio in the manufacturing sector by ten months as it shows the highest correlation with German manufacturers' selling-price expectations at this time lag. In particular, before and during the 2008-9 financial crisis, the ratio ran well ahead of future selling-price expectations. In the post-financial crisis period, however, the ratio lost some of its predictive power before becoming highly correlated again more recently.
- The correlation of selling-price expectations with actual German goods inflation is relatively high, at about 75%. The correlation with the actual German headline all-item rate is weaker due to services inflation. But since goods prices account for about 50% of the German consumer price basket, inflationary pressure from goods makes a significant contribution to the headline reading.
- Going forward, we expect headline inflation to increase to above 2% on average in the second half of the year rather than to above 3%, but the exact number is ultimately less important. More importantly, we consider underlying inflation to be mainly driven by cyclical factors. With these having slowed over the last few months, we think that price increases will be limited. And with Germany likely entering a lower growth path at the end of this year, inflation will start to ease again in 2022.

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