Germany’s January inflation rate reached 1.9%, the highest since mid-2013. Last summer it was still 0.4%. The rise is mostly due to the development of the crude oil price, which had collapsed up to the end of January 2016 and has since recovered. But since the recent oil price rally is not expected to continue, the inflation rate will soon drop again. Most of the palpable effect on purchasing power is therefore over.

According to our calculations, inflation will decline again from March to around 1.5% at the end of 2017. Prices of services and goods without energy and food are increasingly set to be the main drivers of inflation over the course of the year. We therefore estimate that Germany’s inflation rate in 2017 is in a process of normalisation that will probably not be completed until 2018 provided the European economy continues its currently good performance.

However, Germany’s inflation trend is not the yardstick for the European Central Bank’s monetary policy. Its policy follows the rates of price increases in the entire euro area, which are currently much weaker than in Germany. The ECB will therefore not rein in its expansionary monetary policy as fast as an isolated analysis of the German inflation rate may currently imply. For this to happen we would need to see growth rates in euro area to pick up further.

Energy prices currently main driver of inflation
The monthly inflation rate in Germany, calculated as the variation of the national consumer price index on the same month of the previous year, has been driven very significantly by its energy price component since 2014 (Figure 2). Energy prices, for their part, which comprise prices for household energy (heating oil, among others), are noticeably influenced by the current crude oil price, which fell sharply from mid-2014 to early 2016. It hit rock bottom at the end of January 2016, when the price of Brent crude briefly touched readings below USD 28 a barrel. It has since recovered. Today, a good year later, the price of Brent crude is almost exactly twice as high, at around USD 55 a barrel.

Assuming the price of crude oil and the USD/EUR exchange rate develop in accordance with their forward prices up to the end of the year – with forward markets currently showing only minor increases to USD 57 a barrel and USD 1.09 per euro – and the variation in the energy price component of the consumer price index continues to follow the Brent price, the resulting picture would be as follows (Figure 1):

The assumption of a relatively steady oil price is plausible. Although the global economy is recovering, which is likely to lead to a rise in demand for oil, the supply of US shale oil has also been expanding since the price of crude oil again exceeded the threshold of USD 45 a barrel last spring. Thus, further oil price increases should remain very subdued. With regard to the USD/EUR exchange rate, a certain risk exists for a weaker euro if the new US administration does implement stronger fiscal stimuli. But, in our estimate, even that would result in only very limited additional upward pressure on the German inflation rate.

Headline inflation likely to recede in March already
The other prices in our inflation model are based on the development of the domestic economy. We expect the current upswing to continue. Service prices, in particular, should continue their upward trend on the back of continued strong domestic demand in Germany. We assume a similar trend for the prices of goods (without energy and without food, beverages and tobacco). The upward pressure on the latter should be slightly lower, however, because goods are more extensively traded internationally than services and are therefore subject to stronger competition and price pressure.

As can be seen, the strongest effect of the oil price rises since February 2016 on Germany’s inflation is already appearing in January and February of this year. Our simulation shows that the rate of energy price increases should fall relatively quickly at first (from March on) and then moderately over the rest of the year. In December it could even be close to zero (Figure 1).
The prices of food ultimately respond to energy price changes, though with a time lag and to a lesser extent. Energy is an important input factor for the production of food, especially in the form of heating and refrigeration. We therefore expect food price growth rates to pick up slightly at first in 2017 and then to gradually decrease later on in the year (Figure 2).

In this scenario, Germany’s inflation rate will rise just above the 2% mark in February but drop again in March. After a subsequent phase of a relatively stable rate of slightly over 1.5%, it will probably fall again to just under 1.5% towards the end of the year. The reason for the decline will then be the renewed drop in the influence of energy prices and what we expect to be a declining contribution of food prices to inflation. Towards the end of 2017, the inflation rate in our simulation will be driven almost exclusively by services and goods without energy and without food, beverages and tobacco. In other words, core inflation – defined as headline inflation without price increases for energy and food, beverages and tobacco – will then probably stand again above headline inflation.

It remains to be noted that the strong inflation increases in Germany since last summer in all likelihood will cease already from February. In fact, inflation will probably drop again from March. In addition, core inflation will – according to our estimates – continue to rise. With respect to inflation, Germany is currently thus undergoing a welcome normalisation process.1

**Developments more subdued in the euro area**

Now and in the course of 2017, Germany’s inflation rate thus stands significantly above those of the euro area as a whole and, hence, also much higher than the inflation rates of the remaining euro countries (excluding Germany, Figure 3). This helps the individual euro countries converge and is due to Germany’s healthy domestic economy, which has been benefiting not least from the ECB’s monetary policy.

The inflation difference between Germany and the remaining euro area is likely to remain steady at around 0.5 percentage points over the course of the year (Figure 3). This marks the continuation of a trend that began during the peak of the euro crisis. Since then, Germany has been benefiting not just from the ECB’s monetary policy but also, and strongly, from capital inflows looking for a safe haven. The resulting very low interest rate environment has been providing an additional boost – along with other factors – to construction in particular. The relatively low (effective) exchange rate is also helping the export industry which is so important for Germany. Before 2013, German inflation was usually below that of the remaining euro area – and far lower even in the phase between 2001 and 2005 when Germany was referred to as the “sick man of Europe” (see again Figure 3).

**But the euro area is also returning to normality**

Even if the euro area without Germany currently exhibits inflation on a markedly low level, a cautious normalisation of price growth is emerging there as well. In 2016, after dipping slightly at the start of the year, core inflation in the euro area stabilised at around 0.8% later on and then rose again slightly to 0.9% in December.

Energy price increases lead to higher core components of the consumer price index with a time lag in the overall euro area as well. Besides, after years of high risk premiums in the capital markets, restrictive fiscal policies and weak lending, the economies there are finally recovering, too. If the recovery continues, wage and salary trends – as the main drivers of core inflation – should pick up again, if cautiously at first. The unemployment rate in the euro area is still around two percentage points above the level of the upswing years preceding the financial crisis. And yet, that rate has fallen steadily since early 2013 and sentiment indicators suggest that the trend has continued at the start of the year. If the correlations of the past remain at least reasonably valid, euro-area core inflation should have bottomed out (Figure 4). We therefore expect core inflation to rise to 1.2% by the end of 2017, to then stand just above headline inflation (of 1.1%).

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1. Source: Federal Statistical Office, own calculation

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Figure 4: Unemployment and inflation in the euro area (in per cent)

Sources: Federal Statistical Office, Eurostat, own calculation

**ECB only responsible for managing euro area inflation**

It is important to analyse euro-area developments because the ECB is mandated to target its monetary policy solely at the inflationary trend of the entire euro area – and not to that of individual countries. It will therefore not change its monetary course just because Germany’s inflation this year will edge closer to a rate of about 2% again. This development needs to materialise for the euro area as a whole. But in our simulation that will not yet be the case in 2017. Nevertheless, we expect a rise in core inflation which should give the ECB scope to further reduce its monetary stimulus later this year.

**Conclusion**

It is a positive sign that inflation in Germany almost reached the 2% mark in January for the first time since mid-2013. After all, a closer analysis reveals two things. First, the current significantly higher inflation readings are only of short-term nature because they are mainly driven by volatile energy prices. Second, however, a slight upward trend in the core components of the consumer price index is also becoming apparent. As a consequence, deflationary risks are fading.

We expect German headline inflation in 2017 to develop on a path that can be interpreted as a normalisation after a phase of extremely low rates of price increases. The trend in the remaining euro area, by contrast, is noticeably more subdued. The euro area as a whole therefore does not yet meet the conditions for the ECB to substantially change its monetary stance. Nevertheless, our inflation picture definitely leaves room for a further – if only slight – reduction in the degree of monetary expansion later in the year.

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1 Normalisation here is understood in the meaning of the ECB’s definition, which regards price level stability as inflation below, but close to, 2%. Germany’s inflation rate since unification has in fact been close to this value, at 1.7%.