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The return of inflation: Now expecting 2% for 2021

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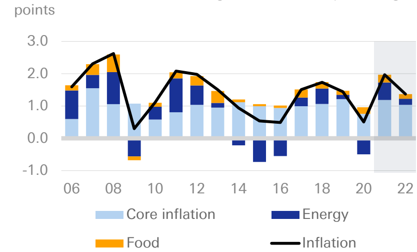
- In January 2021, the CPI inflation print of 1.0% yoy (0.8% mom not seasonally adjusted and 1.3% mom in seasonally adjusted terms) surprised massively to the upside. Although a huge part of the January jump can be attributed to special factors (like the VAT hike, higher energy prices or the introduction of CO_2 pricing in the transport and building sectors) – i.e. to transitory factors policymakers should look through without further ado – the strong rise in core goods prices (excluding energy) begs the question whether the strong January print could herald stronger underlying inflation dynamics.
- We now project the annual (average) inflation rate to increase to 2.0% in 2021 (previously: 1.4%) on the back of considerably higher energy prices (contributing around ½ pp to inflation), the VAT re-hike (approximately +0.4 pp) as well as the introduction of CO_2 pricing in the transport and building sectors. Core inflation (excluding food/energy) is set to average 1.5% in 2021 (2020: 0.9%). In 2022, headline inflation should ease back to 1.3% as the VAT and energy price effects will level off.
- Over the next few years we still see strong arguments for a continuation of structurally low inflation dynamics (negative output gap, weak labour market, reduced wage negotiation power by unions). However, we clearly see risk that price dynamics could strengthen more strongly through impaired supply conditions.
- Major upward risks in the medium term stem from a greater-than-anticipated loss in potential GDP (reducing aggregate supply and hence leading to price pressures should demand overshoot), higher market concentration / pricing power of surviving firms in the aftermath of the pandemic, a release of pent-up demand meeting temporarily reduced supply, higher state-administered prices (driven by empty public purses) as well as rising labour market shortages (due to population ageing) and employers' incidental wage costs (due to the prospects of higher social contribution rates). These risks could fall on futile grounds given a continuation of ultra-expansionary monetary and fiscal policies beyond the point of necessary reversal ("too easy for too long").

German CPI inflation with a strong upside surprise in January

As a result of the corona pandemic – and its overall disinflationary effects (at least for the time being) – as well as on the grounds of various transitory factors (temporary VAT reduction, lower energy prices) – national consumer price inflation subsided to just +0.5% in 2020 (2019: +1.4%). While core inflation (excluding energy and food prices) fell to just +0.9% (from +1.5%), energy prices eased by 4.8%, thus shaving off around ½ percentage point from the overall inflation rate.

Figure 1: Consumer price inflation outlook for 2021/22 (consumer price index - national definition)



Source: Federal Statistical Office, Deutsche Bank Research

Figure 2: Consumer price developments (purpose of use)

	Weight	Change compared to same period one year ago		Monthly change in the % yoy rate		Change compared to previous month		5-year average of monthly rate (2016-20)		Deviation of monthly rate from 5-year average	
	per mill	% yoy		percentage points		% mom		% mom		%	
	2015	Jan-21	Dec 20	Jan 21 / Dec 20	Jul 20 / Jun 20	Jan-21	Jul-20	January	July	Jan-21	Jul-20
Consumer price index (not seasonally adjusted)	**1,000.00**	**1.0**	**-0.3**	**1.3**	**-1.0**	**0.8**	**-0.5**	**-0.6**	**0.2**	**1.4**	**-0.7**
Food / non-alcoholic beverages	96.85	1.9	0.4	1.6	-2.7	2.6	-2.7	0.7	-0.4	1.9	-2.3
Alcoholic beverages / tobacco / narcotics	37.77	2.1	1.7	0.4	-1.7	0.8	-0.6	0.2	0.0	0.6	-0.6
Clothing / footwear	45.34	1.1	-5.4	6.5	-2.3	1.1	-4.6	-5.1	-4.0	6.2	-0.6
Housing / water / electricity / gas / other fuels	324.70	0.7	0.2	0.5	-0.4	0.9	-0.4	0.3	0.0	0.7	-0.4
Furnishings / household equipment / maintenance	50.04	1.2	-0.9	2.0	-2.1	2.0	-1.9	0.0	-0.5	2.0	-1.4
Health	46.13	0.0	-0.5	0.5	-0.8	1.0	-0.8	0.3	-0.1	0.6	-0.7
Transport	129.05	0.5	-2.7	3.2	-1.3	3.6	-0.1	-0.4	0.1	4.0	-0.2
Communications	26.72	-1.5	-3.4	2.0	-2.1	2.2	-2.2	0.0	0.0	2.1	-2.2
Recreational / cultural services	113.36	1.7	1.0	0.7	0.0	-5.7	3.7	-5.3	-5.3	-0.5	9.0
Education	9.02	1.6	0.5	1.1	-0.1	0.8	0.0	0.7	0.7	0.0	-0.7
Restaurants / hotels	46.77	1.8	1.8	0.0	-0.4	0.3	0.0	0.2	0.2	0.0	-0.2
Miscellaneous goods / services	74.25	2.4	1.4	1.0	-1.0	1.1	-0.6	0.2	0.2	0.9	-0.8

Source : Federal Statistical Office, WEFA, Deutsche Bank Research

Figure 3: Consumer price developments (special classifications)

	Weight	Change compared to same period one year ago		Monthly change in % yoy rate		Change compared to previous month		5-year average of monthly rate (2016-20)		Deviation of monthly rate from 5-year average	
	per mill	% yoy		percentage points		% mom		% mom		%	
	2015	Jan-21	Dec 20	Jan 21 / Dec 20	Jul 20 / Jun 20	Jan-21	Jul-20	January	July	Jan-21	Jul-20
Consumer price index (not seasonally adjusted)	**1,000.00**	**1.0**	**-0.3**	**1.3**	**-1.0**	**0.8**	**-0.5**	**-0.6**	**0.2**	**1.4**	**-0.7**
Goods	468.16	0.6	-1.8	2.4	-2.0	2.5	-1.9	-0.4	-0.4	2.9	-1.5
Services	531.84	1.4	1.1	0.3	-0.2	-0.8	0.8	-0.9	-0.9	0.1	1.7
CPI excluding food and energy	811.30	1.4	0.4	1.1	-0.7	0.0	-0.1	-0.5	-0.5	0.5	0.4
Food	84.87	2.2	0.5	1.7	-2.7	2.6	-2.7	0.6	0.6	1.9	-3.3
Energy	103.83	-2.3	-6.0	3.7	-2.1	5.4	-0.7	-0.4	-0.4	5.7	-0.4
Consumer price index (seasonally adjusted)	**1,000.00**	**0.9**	**-0.2**	**1.1**	**-1.0**	**1.3**	**-0.8**				
CPI excluding food and energy	896.17	1.4	0.3	1.1	-0.6	0.9	-0.5				
Food	84.87	2.2	0.5	1.7	-2.8	2.0	-2.5				
Energy	103.83	-2.3	-6.0	3.7	-2.1	5.4	-0.7				
Goods excluding energy		1.0	-1.0	2.0	-1.5	2.2	-1.4				
Services	531.84	1.3	1.1	0.2	-0.3	0.1	-0.1				
Rents	232.75	1.3	1.3	0.0	0.0	0.2	0.1				

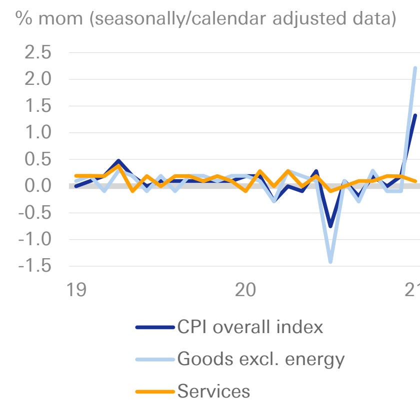
Source : Federal Statistical Office, Deutsche Bundesbank, WEFA, Deutsche Bank Research

In contrast, food prices rose at 2.4%, and hence even stronger than in 2019 (1.4%), adding 0.2 percentage points to inflation (see figure 1).

In December (see our annual outlook for the German economy) we called that the German inflation rate would eventually return to normal in 2021. Specifically, we projected the headline rate (national CPI definition) to rise to 1.4% in 2021. This forecast was based on the outlook for (a) stronger GDP growth and hence some more core inflation, (b) the re-increase in VAT rates (adding approximately 0.4 pp if passed through by half), (c) modestly rising energy prices due to the oil price recovery as well as (d) additional price-increasing effects stemming from the introduction of CO_2 pricing in the transport and building sectors.[1]

Based on these factors, consensus expected a return to clearly positive inflation readings in January 2021 (December 2020 readings: +0.5% mom / -0.3% yoy). However, at +0.8% mom / +1.0 % yoy, respectively, the actual January inflation prints turned out much stronger than expected (consensus:+0.4% mom not seasonally adjusted / +0.7% yoy). In seasonally adjusted terms, the CPI index jumped even more strongly by +1.3% mom (December: +0.2% mom) (see figure 4). While core goods/services prices (CPI excluding energy and food) jumped by +0.9% mom in seasonally-adjusted terms (December: 0%), the CPI food and energy price components increased even by +2% mom and +5.4% mom, respectively (compared to -0.8% mom and +1.7% mom in December) (see figure 3). The surge in January readings has prompted us to dig one layer deeper to better understand the underlying dynamics. Particularly, we want to understand whether the January readings are just driven by one-offs or noise or if there are some emerging structural dynamics behind the January jump (at least to some degree).

Figure 4: Consumer prices: Jump around!



Source : WEFA, Deutsche Bundesbank, Deutsche Bank Research

A deeper look into the January readings

In purely arithmetic terms, the re-hike in VAT rates in January 2021 should have pushed the overall consumer price index around 1.6% higher (see the June 2020 note by the Federal Statistical Office). As the VAT hike is generally not fully passed through by firms, the actual VAT effect is likely to be much smaller. Still, in case of a pass-through rate of 50% (about the ratio temporary VAT reduction last summer) the price effect could be as much as +0.8% if immediately taken place in January.

Pronounced rises in energy as well as food price components have also boosted the January inflation print (contributions of roughly +0.6 and +0.2 percentage points in seasonally adjusted terms, respectively). The price-increasing effect stemming from the introduction of CO_2 pricing in the transport and building seems to have boosted transport prices (see figure 2) (admittedly, the increase in the CPI transport component is also driven by the general rise energy/fuel prices because of e.g. higher oil prices).

Hence, a large part of the inflation spike can indeed be explained by these transitory/ special factors, though not all. In our view, it is particularly worth looking at the change in core goods prices (goods excluding energy). In seasonally adjusted terms, prices for these goods soared by +2.2% mom in January (the highest monthly increase since February 1995!), lifting the yearly rate to +1% (from -1% in December). Moreover, core goods prices increased much more in January 2021 than they decreased in July 2020 when the VAT rates had been reduced (+2.2% mom in January 2021 vs. -1.4% mom in July 2020). This discrepancy has made us more concerned with regard to future inflation dynamics. Concerns which have

1 These effects are overall expected to outweigh the price reduction effects from lower electricity prices due to a reduction of the renewable energy surcharge. The Deutsche Bundesbank expects a net price-increasing effect of 0.3 and 0.2 percentage points in 2021 and 2022, respectively.

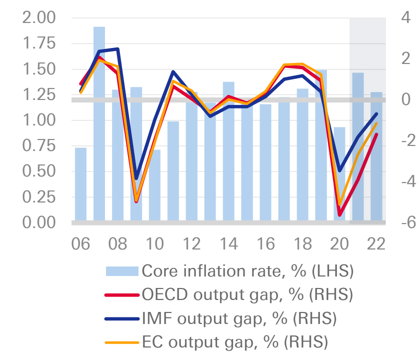
also been visible in the rise in German 10y break-even rates as well as in 5y/5y-swap rates since late last year.

What factors would speak for a structurally higher inflation?

Overall, we still do not (yet) expect a considerable structural (i.e. permanent) rise in the inflation rate (i.e. to levels of clearly above 2%). This is because the still negative output gap (under-utilisation of production capacities) is likely to curtail unions' bargaining power in upcoming wage negotiations (see figure 5). Still, we see a rising risk that price dynamics could strengthen more considerably than what markets are currently anticipating – provided certain risk factors would materialise.

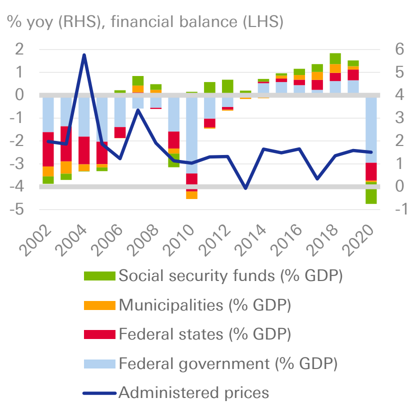
What exactly are these upward risks factors? Generally, there is a risk that the corona pandemic not only leads to temporarily lower aggregate demand (and hence actual GDP) but also structurally suppresses aggregate supply (and hence potential GDP). So current output gap estimates have to be interpreted even more carefully than during normal times. As the output gap is an unobservable economic variable, there is the risk that policymakers could overestimate the level of under-utilisation of the economy's production capacities, by underestimating the degree of permanent capacity losses.

Figure 5: Negative output gap is dampening core inflation



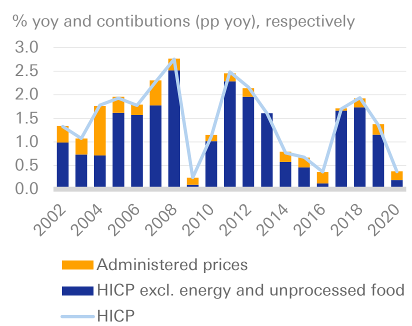
Source : OECD, IMF, EC, Federal Statistical Office, Deutsche Bank Research

Figure 6: Administered prices (HICP) vs. German public finances (national accounts data)



Source : Federal Statistical Office, Eurostat, Deutsche Bank Research

Figure 7:HICP: Effect from administered prices on the headline inflation rate



Source : Eurostat, Deutsche Bank Research

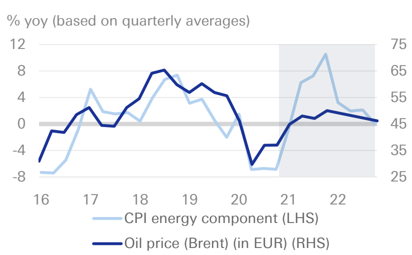
Against the backdrop of the current considerable fiscal and monetary support packages, inflation dynamics could resurface quickly. In this context, the expected increase in corporate insolvencies (in particular in the most heavily hit services sectors like the restaurant, hotel, retail or exhibition industries) could result into stronger pricing power by surviving firms. In order to increase their profit margins (squeezed by the pandemic), many firms could be tempted to increase selling prices. On a separate note, increasing labour supply shortages due to rapid population ageing could further boost wage and price pressures over the medium term. The Deutsche Bundesbank argues (see December 2020 Monthly Bulletin) that a normalisation of the economy as well as rising labour market shortages could eventually result into stronger wage increases around the year 2023 (both are drivers for higher core inflation). In addition, further upward price pressures are likely to emerge from the expected rise in social contribution rates (statutory health, unemployment and public pension insurance) in 2022/23 which are set to drive employers' incidental wage costs higher. As we already wrote in the past, the federal government's contribution guarantee of no more than 40% (for the time being only) promised up to the end of 2021 ("social guarantee 2021") is looking quite shaky as a result of dire public finances (see our Focus Germany, Sept 2020).

Empty public purses could also drive the inflation rate higher, especially at the local level. With the financial burdens being placed on public budgets becoming ever more apparent, it does not seem unreasonable that prices for some state-administered goods and services could soon rise noticeably (see figures 6 and 7) (for more information see also our inflation article in Focus Germany, Nov 2020). That said, state-administered prices climbed by a strong +1.0% mom / +2.4% yoy in January 2021 (from 0% mom / +2.0% yoy in December 2020).

Inflation outlook: Now expecting 2% for the full-year 2021!

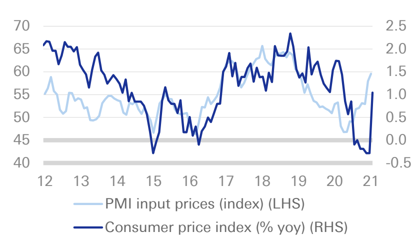
After the surprise January readings, we now expect the CPI inflation rate to jump on average to 2.0% for the whole year 2021 (forecast as of Dec-2020: 1.4%) (see figure 1). A large part of this marked upward revision in our 2021 inflation forecast can be explained by the prospects for a much stronger increase in energy prices (accounting for around 0.4 percentage points). Meanwhile, both the successful admissions of COVID-19 vaccines as well as the OPEC's decision to expand oil supply only gradually in 2021 have supported oil prices. In light of considerably higher oil prices (Brent to average USD 60 per barrel in 2021; +30% compared to 2020 in EUR terms) (see figure 8) and due to supposedly stronger-than-expected price effects from the introduction of CO_2 pricing, we expect the CPI energy component to rise by more than 5% in 2021, thus contributing around ½ percentage point to the inflation rate (2020: -4.8% and hence almost -½ pp).

Figure 8: Oil price vs. CPI energy component



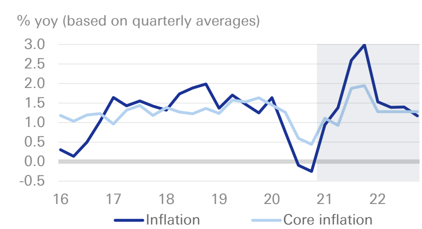
Source : Federal Statistical Office, Deutsche Bank Research

Figure 9: CPI headline rate vs. PMI input prices



Source : IHS Markit, WEFA, Federal Statistical Office, Deutsche Bank Research

Figure 10: Headline inflation rate could temporarily jump towards 3%-threshold

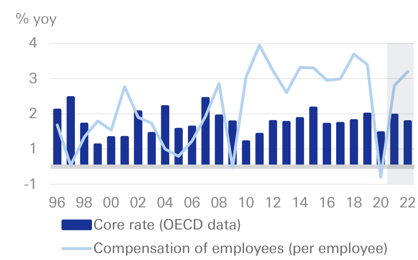


Source : Federal Statistical Office, Deutsche Bank Research

Moreover, we expect an even stronger inflationary boost from higher food price dynamics. In our view, food prices are to set to increase by around 2.8% in 2021, thus contributing almost ¼ percentage points to the overall inflation rate (2020: +2.4% and +0.2 pp). In this context, it is worth noting that the HWWI food price index (measured in EUR terms) was up by 17½% yoy in January 2021. Finally, we project the core inflation rate to increase to around 1.5% in 2021 (2020: 0.9%) and thus a little stronger than expected back in December 2020 (1.4%). Both high-frequency data (PMI input/output prices (see figure 9), PMI capacity utilisation in the manufacturing sector or surging freight rates due to comparatively strong global trade due to a well-performing Chinese economy) also point to somewhat stronger prices pressures going forward. Still, a huge part of the relatively high core inflation forecast reading of 1.5% (2016-20 average: +1.2%) can be explained by the reversal of the VAT rate in early January 2021. The Deutsche Bundesbank estimated in its December 2020 Monthly Bulletin that around ½ percentage points of their core inflation forecast of 1.5% for 2021 (HIPC definition!) will be driven by the VAT re-hike. Looking at the quarterly profile, we can imagine that the headline inflation rate could temporarily spike to as much as 3% towards the end of the year end before sliding back to roughly 1 ½% by the first quarter of 2022 (once the price-lifting factors eventually level off) (see figure 10). The Bundesbank recently noted that the yearly HICPI inflation rate could temporarily exceed the 3% threshold during the course of the year. Finally, the European Commission now projects Germany's HICP inflation rate to increase to 2.3% in 2021 before sliding back to 1.3% in 2022 (see Winter 2021 Economic Forecasts).

In 2022, similar to the European Commission's HIPC forecast, we forecast the average annual headline inflation (national definition) to slide back to just 1.3% as the positive VAT and energy price effects will taper off and structural price-dampening effects (a weak labour market and reduced pricing power by unions) will still prevail on average preventing a stronger rise in the inflation rate. That said, our inflation projections remain highly contingent on the COVID-19 cycle and hence the future growth path. Given the strong January reading we now view the inflation risk more skewed to the upside. In particular, the risk of a higher market concentration – and thus stronger pricing power by surviving firms – as well as a delayed turning away from ultra-expansive monetary and fiscal policies are in our view the key risks factors to watch as they could in the worst case prompt structurally higher inflation dynamics going forward.

Figure 11: Core inflation vs. compensation of employees



Compensation of employees (per employee): Forecasts are taken from the Deutsche Bundesbank (Monthly Report December 2020)

Source : OECD, Deutsche Bundesbank, Deutsche Bank Research

Appendix 1

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