FINANCIAL TIMES

May 9, 2012 8:17 pm

Bundesbank signals softening on inflation

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By Ralph Atkins in Frankfurt

The Bundesbank, the most hawkish of central banks, has signalled it would accept higher inflation in Germany as part of an economic rebalancing in the eurozone that would boost the international competitiveness of countries worst-hit by the region's debt crisis.

A future German inflation rate above the eurozone average could be part of a natural adjustment process as crisis-hit countries pulled themselves out of recession, the Bundesbank argued in evidence to German parliamentarians submitted on Wednesday.

It followed comments at the weekend by Wolfgang Schäuble, German finance minister, backing stronger wage increases, which would boost domestic demand – benefiting other European countries exporting goods and services to Germany – but could drive German inflation rates higher.

The Bundesbank has for some time seen European Central Bank policy as too loose for Germany. The willingness to contemplate higher domestic inflation in public comments points to a new-found flexibility in German thinking.

Despite the Bundesbank's conciliatory stance on inflation, German policy makers have been among the toughest in insisting that Greece sticks to its agreed reform programme underpinning its bailout in the aftermath of Sunday's Greek election in which most voters rejected the plan. Speaking in Brussels, Mr Schäuble said that changing the bailout terms would unleash "catastrophic uncertainty" in financial markets.

In its evidence, the Bundesbank rejected "actively" weakening the competitiveness of German companies or loosening fiscal policy in the hope of boosting demand elsewhere in the eurozone, but it argued that as crisis-hit "periphery" economies restructured, their competitiveness relative to Germany would improve.

"In this scenario, Germany could in the future have an inflation rate somewhat above the average within the European monetary union, although monetary policy will have to ensure that inflation overall in the Emu is consistent with the goal of price stability and that inflation expectations remain firmly anchored," the bank said.

The commentary could help counter widespread fears that Germany's deep-seated angst about inflation – rooted in the hyperinflation of the 1920s – will restrict policy makers' room for manoeuvre in combating the region's debt woes by, for instance, pushing for the ECB to raise interest rates prematurely.

"It is confirmation that the Bundesbank is aware of what is going on in the periphery in terms of deflationary pressures on wages," said Gilles Moec, European economist at Deutsche Bank. "There is no way around this – it is the reverse of what happened in the first 10 years of the euro."

German inflation, at 2.2 per cent, is currently below the eurozone rate of 2.6 per cent. But that could change in coming years if crisis-hit countries saw inflation rates falling sharply or even turning negative. Germany has so far weathered the eurozone crisis much better than other European economies, which has encouraged higher wage demands, while low interest rates have encouraged a mini-house price boom in some parts of the country.