

Dr. Gertrud R. Traud  
Chief Economist/  
Head of Research

[research@helaba.de](mailto:research@helaba.de)

Editor:  
Dr. Stefan Mütze

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Landesbank Hessen-Thüringen  
MAIN TOWER  
Neue Mainzer Straße 52-58  
60311 Frankfurt am Main  
phone: +49 69/91 32-20 24  
fax: +49 69/91 32-22 44

### Hands off the VAT

Contrary to the worldwide trend, consumer sentiment in Germany has held up surprisingly well. Consumers are currently playing a crucial role in preventing the recession from turning into a depression. It is all the more surprising that we are seeing another debate about an increase in the VAT in 2010 (Japan 1997 sends greetings!). The more this debate progresses, the more pre-emptive effects should be expected this year. But the picture is that much gloomier next year. To finance the higher debt load, the government should cut spending instead of raising taxes. Bleeding consumers is not a solution, but a path into the next crisis.

#### The German consumer: solid as a rock in troubled times

With the collapse of the investment bank Lehman Brothers in September of last year, almost the entire world fell into gloomy mood – but not the entire world, since the German consumer resisted the collective depression.

#### GfK consumer climate trending upward

Since September of last year, the GfK consumer climate indicator has been trending upward. This is doubly surprising: Germans have the reputation of being rather reluctant consumers, so that a brightening of consumer sentiment during the most severe recession of the post-war period seems very unusual. While GDP declined last quarter by 3.8% from the previous quarter, consumer spending actually rose by 0.5%.

#### Two possible explanations:

How is it, then, that the German consumer, in particular, avoided the universal mood of gloom and doom? Several possible explanations can be proposed:

#### Expansionary fiscal measures are having an effect

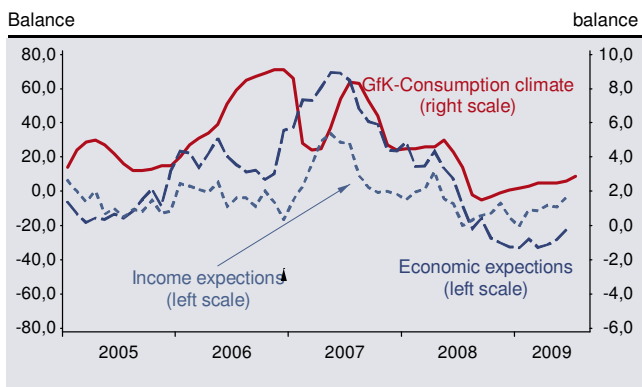
1) The situation for the consumer may be far less dire than the general economic indicators would seem to suggest. In Germany, unlike in many other countries, there are no negative wealth effects from a collapsing real estate market. In addition, the repercussions of the recession have so far been contained. Even though the labor market has been worsening also in Germany since November of last year, the decline in employment has so far been clearly smaller than the magnitude of the recession would have led one to expect. The massive state support for short-term work, a response to economic conditions, contributed substantially to cushioning the decline in employment. The development of collective bargaining wages has so far also had a stabilizing effect on consumption. And many can thank the Federal Constitutional Court: it decided at the end

of last year that the regulation on the commuting allowance would apply again retroactively to 2007. And even if the tax breaks on the income tax were rather modest at the beginning of this year, they also contributed to stabilizing income. An increase in the child allowance and the bonus of 100 Euro per child replenished the household budgets of families. And let us not forget the scrapping bonus: in the first months of this year, a noticeably greater number of cars were purchased than in the comparable period last year.

**Fear of inflation spurs consumption**

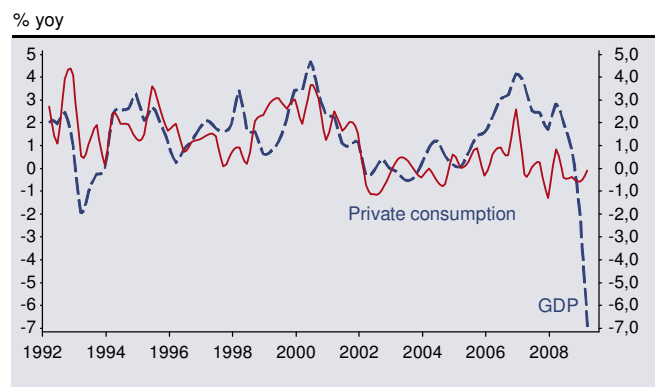
2) However, it is also possible that consumer are not looking at the current background conditions, but are trying to anticipate the future: the strong decline in inflation from more than 3% at the middle of the last year to about zero now has substantially increased the real disposable income. As a result, especially the felt inflation, which was in the double-digit range in the middle of last year, has dropped to a level more or less equal to the actual inflation. While the savings rate shot up along with the rapid rise in inflation, we can now observe, accordingly, a decline in the savings rate. Consumers are taking advantage of sales, sense that it is a good time to buy right now, and consume accordingly. If we simultaneously take a look at the expectations of consumers concerning the price trend, we can see that a pronounced fear of inflation exists, which can be read from, among other things, a heightened demand for gold. Thus, the fear of inflation has already become the topic of conversation among regulars over a beer.

More positive income and economic expectations



Sources: EcoWin, Helaba Research

Consumer spending stabilizes the economy



Sources: EcoWin, Helaba Research

**Do not burden the consumer again right away**

Thus it is also possible that the fear of inflation causes consumers to believe, in an environment of high risk aversion and lower returns, that consumption right now is in the final analysis the most sensible strategy. By behaving the way he is, the German consumer is currently making a major contribution to preventing the recession from turning into a depression. That makes it all the more surprising that an increase in the VAT in 2010 is already being discussed (Japan 1997 sends its greetings!). The more concrete this discussion becomes, the more anticipatory effects can be expected this year. However, the picture is that much gloomier next year, for in spite of an impending recovery in the global economy, it will not be enough to reinvigorate the job market. To finance the higher tax burdens, politicians should cut spending instead of raising taxes. Bleeding the consumer is not a solution, but the road into the next crisis.

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