11 June 2020

Euro Area Research

Germany's VAT cut sends euro inflation on a roller coaster

- **Drawing on the historical precedent of the German VAT hike enacted in January 2007, we expect Germany's VAT cut to lower euro inflation by c.0.2 percentage points on average in 2020.**
- **We are sceptical that other countries will follow the German example of broad-based VAT cuts, but targeted cuts on travel and tourism-related items remain an option.**

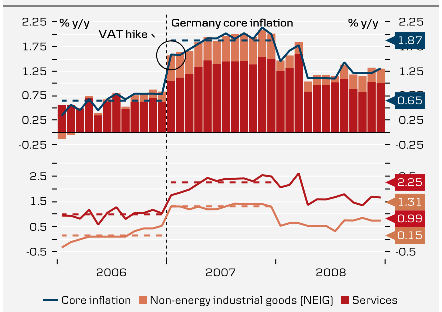
Germany's government keeps opening the spending taps and at the beginning of June unveiled another sizable recovery stimulus package of EUR130bn (3.8% of GDP). As part of the package, VAT rates will be temporarily cut from 19% to 16% (lower band from 7% to 5%) from July until December 2020.

While the VAT cut is welcome from a growth perspective by boosting consumer spending, it will also have a marked impact on the short-term euro area inflation outlook as HICP data is collected from the shelf price displayed in shops or advertised by service providers. As normal inflation rates will hence be distorted by the effect of the tax changes, focus will also turn to the HICP at constant tax rates (also published by Eurostat), which filters out these effects and provides a better gauge of price changes due to supply and demand.

Drawing on the lessons from 2007

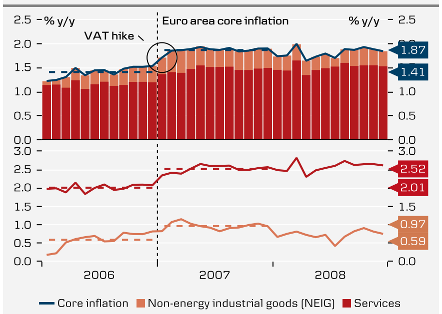
The 2007 German VAT hike from 16% to 19% boosted average HICP inflation by some 1.6pp in Germany and 0.4pp in the euro area as the chart on the right illustrates. The price increases were more or less exclusively centred on core inflation, as food items which are taxed at the reduced rate of 7% were excluded from the VAT hike. Overall, average German core inflation was boosted by more than 1.2pp during 2007 and euro area core inflation by c.0.5pp, with both services and non-energy industrial goods (NEIG) prices contributing to the increase. Within services, the impact was most pronounced for communication, miscellaneous, recreation and transport services, while the effect on package tours and housing services stayed more muted. For NEIG inflation, durables and non-durables prices in particular registered a marked boost, while the impact on semi-durables (clothing & footwear) was more muted.

VAT hike boosted German core inflation by some 1.2pp during 2007...



Source: Eurostat, Macrobond Financial, Danske Bank

... and also left its mark on euro area core inflation



Source: Eurostat, Macrobond Financial, Danske Bank

Other reading

- *Euro Area Research - The road to recovery, 14 May*

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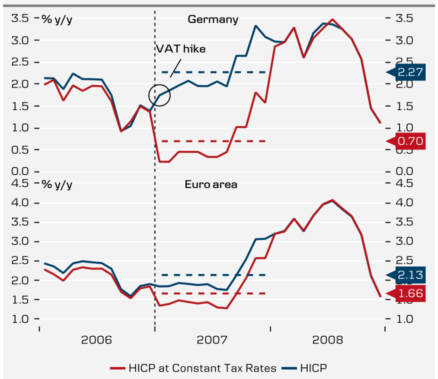
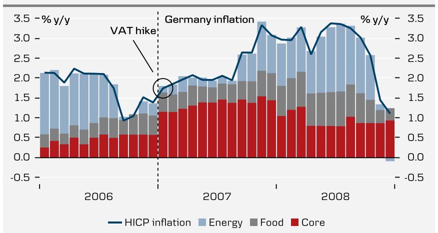


Source: Eurostat, Macrobond Financial, Danske Bank

2007 VAT hike mainly boosted German core inflation



Source: Eurostat, Macrobond Financial, Danske Bank

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Firms' price response crucial

With respect to the current German VAT cut, we expect to see similar dynamics as in 2007, with the **majority of the HICP impact to stem from lower core inflation**. However, as the VAT cut this time also includes the reduced tax bracket (from 7% to 5%), we expect some impact on food price inflation as well.

For the magnitude of the HICP impact, two factors will be important beyond the applicable tax rates: the price setting behaviour of firms and consumers' response. In 2007, the higher VAT rates seem to have largely been passed on to consumer prices, as a back of the envelope calculation illustrates: with around three quarters of the German HICP basket taxed at the standard VAT rate, the VAT hike from 16% to 19% should have increased German inflation by 1.19/1.16 x 0.75 = 1.9pp. This is relatively close to the 1.6pp average difference registered between German HICP and HICP at constant tax rates in 2007.

Some companies in the car sector (an important part of durables) and recreational services have already indicated that the VAT cut will be fully passed on to consumers. However, in times such as these where margins generally are under pressure, we also expect some companies – especially in less competitive sectors – to be more muted in their price response to cushion operating costs. Furthermore, the temporary nature of the VAT cut might also dampen the pass-through, with the risk that it turns into just another industry subsidy.

The second unknown remains how consumers will react to the VAT cut. All else equal, lower prices should stoke demand - especially for big ticket items - and thereby partly compensate the downward pull on prices. However, in light of the lingering uncertainty expressed in consumer surveys about employment prospects and households' financial situation this demand effect could turn out to be more muted.

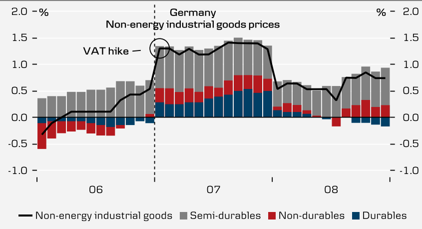
VAT cut to send euro inflation on a roller coaster, but still room for higher inflation in 2021 and beyond

Overall, we have lowered our profile for euro area HICP inflation by c.0.2pp in 2020 and 0.1pp in 2021 (see chart on the right). Taking into account Germany's 27.6% weight in the HICP, this is broadly in line with similar experiences of temporary VAT cuts, for example in the UK, where a temporary reduction in the VAT rate from 17.5% to 15% from December 2008 lowered the 12-month CPI rate by c.0.5pp (see *Economic and Labour Market Review, August 2009*).

While the VAT cut will depress core inflation rates in the coming months, it will also give an artificial boost in the latter part of 2021. However, **we expect the ECB to look through these gyrations in core inflation and focus on the medium-term inflation dynamics to determine its policy stance** – and while the ECB's mandate is focused on inflation (most recently illustrated by linking the PEPP to inflation), it also aims to create a conducive growth environment. **Looking into 2021 and beyond, we still see a case for (core) inflation rates to move higher**, both due to the mechanical effect from the temporary VAT cut, but also from the unprecedented monetary/fiscal easing and cost push inflation in some industries eventually emerging (see also *Euro Area Research - The road to recovery*, 14 May).

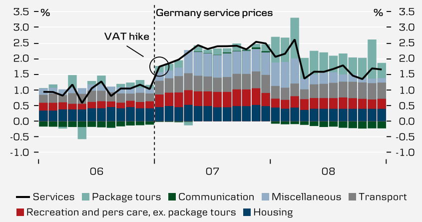
Apart from Germany, so far only Greece (2.2% HICP weight) and Belgium (3.8% HICP weight) have enacted similar (though much more limited) cuts in VAT rates on passenger transport, restaurants and some beverages to help the ailing tourism/hospitality sector. **Will other countries – notably France, Italy and Spain - follow suit? We remain sceptical.** Germany remains in a unique fiscal position and few other European countries can afford the loss of EUR20bn in tax revenues in the current situation, where fiscal fragilities are already looming large due to increased public spending needs. That said, targeted VAT cuts on travel and tourism-related items/services remain a possibility.

Durables and non-durables prices boosted by 2007 VAT hike...



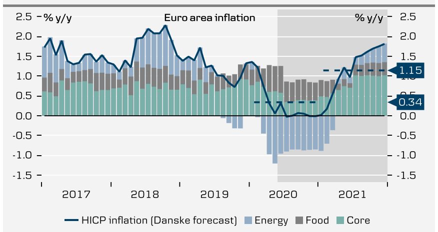
Source: Eurostat, Macrobond Financial, Danske Bank

... but price response in housing services and package tours more muted



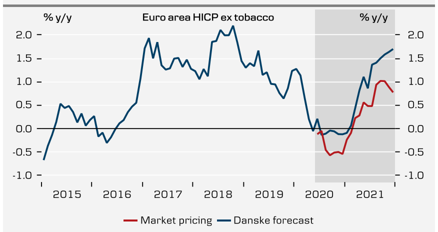
Source: Eurostat, Macrobond Financial, Danske Bank

Euro inflation to accelerate in 2021



Assumptions: EUR/USD at 1.12 in 2020 and 1.11 in 2021; Brent oil at 41 USD/bbl in 2020 and 46 USD/bbl in 2021
Source: Eurostat, Macrobond Financial, Danske Bank

Inflation market pricing too subdued



Source: Eurostat, Macrobond Financial, Danske Bank

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