Editorial

Prof Dr Klaus F. Zimmermann,
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calls for an acceleration of the German tax reform and lower European interest rates to prevent a recession in Germany.

The current economic slowdown has hit Germany severely. This is partly a result of the slowdown in the US, and partly a consequence of rising costs fuelled by higher petrol and food prices. The South-East Asian economies also fail to demand German exports in sufficient quantities to help maintain full order books and confidence in German industry. German companies are responding to the negative export signals by slashing costs and laying off workers, thus further weakening expectations and local demand. These forces have a dampening effect on the whole EU, which so far has grown more robustly than Germany.

In the US, the reduction in asset prices induced by the crash of the new economy appears to have significantly dampened consumer expectations. The policy measures implemented by the Bush administration are only now taking effect, so that, at best, the American economy will gain momentum later this year. However, such improvement may be too late and too small to lift the German economy out of its current weakness. At worst, the American economy will head for a hard landing. Such a scenario would raise the risk of a recession in Europe and emphasise the need for a coordinated European policy response.

Domestically, the tax reform agreed last year and implemented in its first stage in January 2001 has helped to maintain consumer demand. It effectively, though unintentionally, compensated households for the higher petrol and food prices and the small additional burden imposed by the new ecological taxation, thus limiting its expansionary effect. While earlier in the year there was consensus that this fiscal boost would stabilise growth, this effect seems to be at least delayed.

The German government is rightly committed to achieving a balanced budget by 2006. With weakening world-wide growth and the threat of a recession in Germany, the government should, however, re-assess its medium-term policy mix and examine to implement the next steps of its tax reform much earlier. This could imply substantial tax reductions already in 2002. It would improve the incentive structure in Germany and send a clear signal that the government is committed to growth. Furthermore, the European Central Bank should recognise the short-term nature of the inflationary pressure and lift the monetary constraint on European economic growth. The ECB should hence lower interest rates to stimulate demand and signal its belief in the long-term price stability of the euro. This would help to soon stabilise growth.