



Germany's jobs miracle

Short-time work, flexible labour contracts and healthy companies

April 27, 2010

- Despite the deepest recession in post-war history the German labour market has remained surprisingly stable. Barely 200,000 jobs have been lost since October 2008.
- The factors responsible for Germany's jobs miracle were the extension of the Kurzarbeit short-time work scheme, less paid overtime and the reduction of positive balances on working-time accounts. All in all, the cutback in working time saved around 1.2 million jobs.
- The ability to weather the storm was predicated on the greater flexibility of the German labour market and in particular the financial health of companies before the crisis.
- However, companies are probably gradually running out of workforce management options, so the unemployment rate is set to inch up further in 2010/11.
- With an unemployment rate of only slightly over 9% by then, this would be a success story by international standards.

Germany posts one of smallest increases in unemployment anywhere

While pessimists had forecast at the onset of the recent economic crisis that the jobless total would eventually rise to over 5 million and the unemployment rate to over 12%, the German labour market remained relatively stable. The number of unemployed has increased by barely 200,000 to a seasonally adjusted 3.38 million since its low in October 2008. Not even the unusually severe winter resulted in any significant increase. Since summer 2009 the number of unemployed has even been on a declining trend. All in all, the unemployment rate has risen by less than ½ pp, to 8% at last reading. Among the major industrial countries, Germany posted one of the smallest increases in unemployment anywhere, which comes as a surprise since German GDP took one of the hardest hits in 2009 at minus 5%, outstripped only by Ireland and Finland. In France, the contraction was not even half as pronounced at 2.2%. According to International Labour Office (ILO) data, since Q4 2008 the standardised unemployment rate has risen by 1 to 1 ½ pp in Belgium, the United Kingdom and the Netherlands, close to 2 pp in France, roughly 5 pp in Spain and some 6 pp in Ireland. However, during the last two decades, Germany's performance differed considerably from that of the other countries. After reunification, employment grew by an average of 0.2% p.a. in Germany, noticeably trailing the readings in France and Italy (0.7% p.a.) and Spain (2.6% p.a.) in particular. Now, Germany has miraculously outperformed with a "mini-Beschäftigungswunder".

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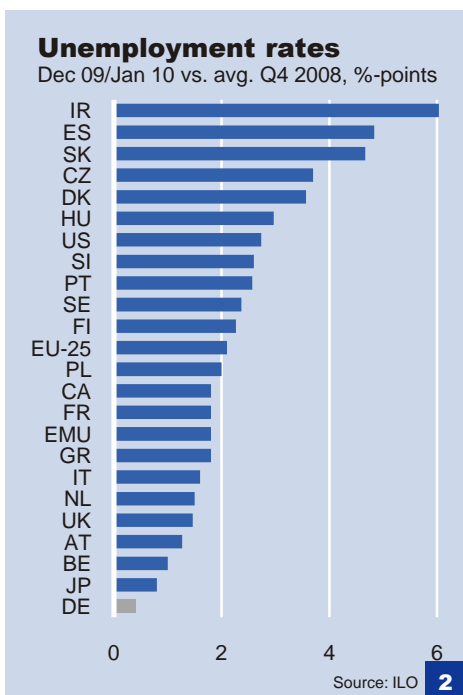
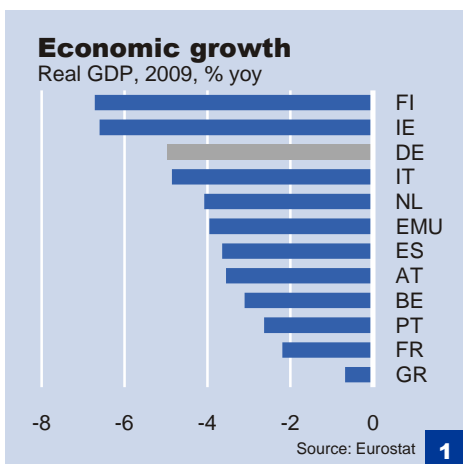
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Kurzarbeit – silver bullet of employment policy?

Unlike a miracle which defies explanation, though, there are concrete reasons for the only modest increase in unemployment in Germany. No doubt the extension of the short-time work scheme has been a significant factor. The funding for short-time work serves the purpose of bridging a phase of joblessness, preventing job redundancies and avoiding the costs of having to rehire staff once jobs are available again. Short-time workers receive 60% of their net wage differential (normal working hours minus actual working hours) from the Federal Employment Agency (BA), or 67% if there is a child living in the household. At the beginning of 2009, the ruling grand coalition government of CDU/CSU and SPD initially extended the funding for short-time work from 6 to 18 months, and upped the period in spring 2009 to 24 months. In addition, social-security contributions are fully reimbursed by the BA if employees undergo training to upgrade their skills during this time. Also, the review and application procedure for companies was noticeably simplified.

At the start of 2010, the government decided to set the funding period for companies applying to join the scheme in the current year at 18 months. Without this amendment, funds for short-time work would only have been available for six months again as of January 1, 2010. This means that companies can benefit from the Kurzarbeit scheme until mid-2012. As things stand now, the BA will from 2011 discontinue the practice of shouldering the related social-security contributions. However, there are hints that the government will once again extend parts of the regulation.

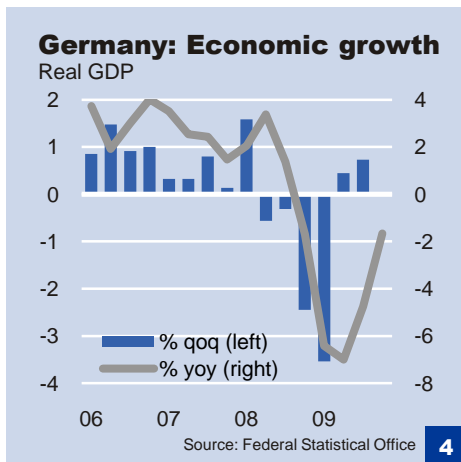
1 ½ million on short-time work at the peak

With the onset of the economic crisis in autumn 2008 the number of short-time workers skyrocketed, peaking at over 1.5 million in mid-2009. This was the highest reading since the reunification years when the number of short-time workers had climbed to over 2 million. Since mid-2009 the number has declined again by a good 40%, to just under 0.9 million. The reduction of short-time work in summer 2009 was probably attributable to the holiday season, but the further decrease towards year-end 2009 suggests that companies started to increase working hours again as their order books swelled in the course of the global recovery.

On average, short-time workers were employed for roughly two-thirds of their normal working hours. This is backed by calculations from Germany's Institute for Employment Research (IAB) showing that, on average, working hours fell by some 15.2 hours per employee due to short-time arrangements in 2009. This means that the use of short-time work saved up to 400,000 jobs, on paper. BA expenditure on short-time work totalled EUR 4.6 bn in 2009, or roughly 9.5% of the total BA budget. Originally, the BA had budgeted only EUR 300 m for short-time work for 2009, indicating that such a sharp economic slump was not expected. The BA has earmarked over EUR 3 bn for short-time work for 2010, which we believe is a realistic estimate.

Short-time work – a suitable instrument for Germany

Short-time work arrangements were also expanded noticeably in virtually all the other industrial countries, with most of them very closely resembling the German model. Why was this policy more successful in Germany than in other countries with a similar structure? The answer lies partly in the nature of the crisis. In

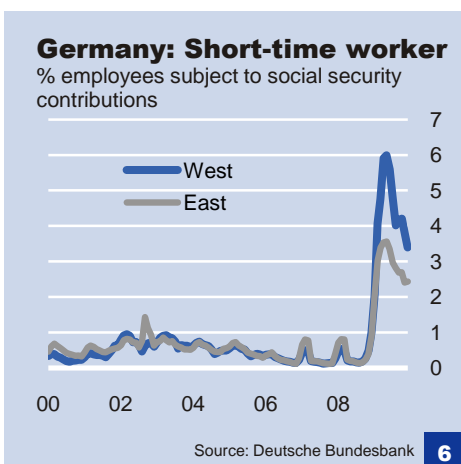


Germany, it was comparatively easy for short-time work to cushion the impact of the recent crisis – with international trade being its transmission mechanism – in terms of the slump's duration and intensity. The 5% contraction of German GDP was confined mainly to the winter half of 2008/09, so the slump hit hard but was relatively short. By Q2 2009, the German economy had returned to growth. Just as the German economy was hit harder than other European countries by the synchronised global recession on account of Germany's very open market structures, it is now benefiting more than average thanks to the robust synchronised upswing. This may have been reflected in the short-time work level especially towards end-2009. Similarly, the chances have risen that the pick-up in order activity, especially from abroad, will result in a further increase in working hours and thus to a further decrease in short-time work. The pronounced cyclical pattern deflates the argument – at least partially – that short-time work acts to preserve existing structures and thus reduces the structural flexibility of the economy.

Latest crisis mirrored in the structure of short-time work

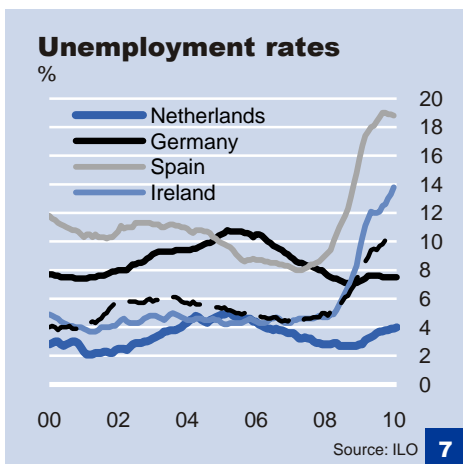
The particular features of the latest recession are mirrored in the structure of short-time work. West Germany's manufacturing industry, with its heavy bias to exports, has borne the brunt of the downswing. In the metals industry, over 35% of all employees subject to social security contributions were working short shifts in mid-2009. Of the over 813,000 workers in the auto industry some 21.5% were not working full shifts. The mechanical and electrical engineering sectors opted for short-time work more than others, with shares of close to 25% and 22% respectively. But, on average, only just over 5% of the total labour force was in short-time work at this time.

Since the west German states have a heavier export bias than the east German states, short-time work was mainly concentrated in the south of Germany and the manufacturing regions of west Germany. Nonetheless, unemployment jumped in the southern and western regions during the recent recession, while the east German rate returned to its previously observed downtrend following a temporary increase (March: 12.5%). The east German unemployment rate was down 0.6 pp on its mid-2009 high in March 2010, while the rate in Baden-Wuerttemberg to the southwest, for example, went up by about ½ pp. The same picture is presented by the ratio in short-time work. The number of short-time workers in west Germany peaked at 6% of all workers obliged to make social security contributions, and in east Germany at only 3 ½%. Before the crisis erupted, the reading was around 0.2% in both west Germany and east Germany.



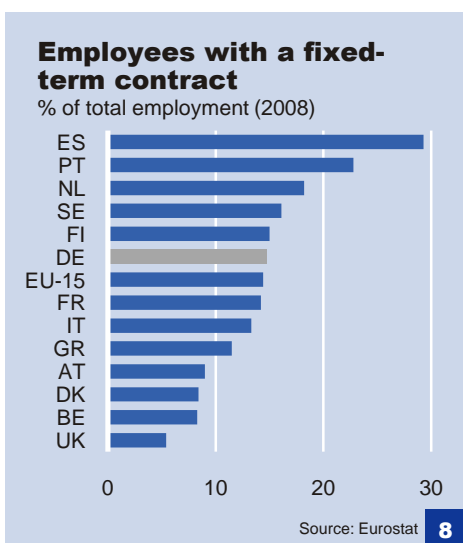
Germany left largely unscathed by structural shocks

One of the reasons that labour market performance was better in Germany than in some other European countries, especially Spain and Ireland, was that Germany was not additionally impacted by structural adjustments in the real estate markets. As an instrument of labour market policy, short-time work only makes sense if it addresses a temporary drop in demand triggered mainly by external effects. By contrast, short-time work is not a suitable instrument for addressing the long-term structural employment adjustments which, in Spain for instance, boosted the unemployment rate to over 19% when the house price bubble burst. Generating roughly 12% of value-added and employing over 15% of the workforce, the



construction sector is disproportionately large in Spain by European standards. In Germany, construction only accounts for slightly more than 4% of total value-added and a 5% share of employment. Since it is scarcely likely that building activity in Spain will return to the pre-crisis level, short-time work would, like a subsidy, create false incentives and delay the necessary process of consolidation. However, some of the problems in the German automotive industry are probably also structural in nature.

Compounding the problems in Spain are further institutional features peculiar to its labour market. For instance, some 30% of all employees and about 80% of all new hires in Spain have a temporary labour contract. As such, it is cheaper for Spanish companies to terminate jobs by not renewing contracts than to save them by offering short-time work. This is reflected in the huge increase in Spain's unemployment rate. In Germany, by contrast, only about 15% of workers have a fixed-term contract, putting Germany roughly in line with the EU average.



Flexible companies are at least just as important as short-time work

Not only the extension of the short-time work programme but also other factors can help explain Germany's jobs miracle. These are mainly attributable to a labour market that has become more flexible as a whole thanks to more modern collective wage agreements and the Hartz reforms enabling companies to react more nimbly in adjusting working hours when demand slumps and thus to secure employment. The opening clauses agreed in the collective bargaining process were used to adjust working hours and wages to match order levels. Moreover, flexible labour arrangements enabled positive balances on working-time accounts to be reduced. According to IAB calculations, these balances declined by an average of 8.9 hours per employee in 2009. Paid overtime also plunged, so firms recorded 10 fewer hours of paid overtime per worker in 2009. This means that these two instruments combined reduced the average working time by 25% more than the government-supported short-time work programme. There had never been changes of such a scale on these flexible components of working time before.

Profit share

Non-financial corporations

| | 2008 % gross value added | 2002-08 Change %-points |
|-----|-----------------------------|-------------------------------|
| FI | 43.8 | -1.2 |
| IT | 42.5 | -3.1 |
| AT | 42.1 | 2.6 |
| DE | 41.2 | 3.5 |
| NL | 40.2 | 2.2 |
| EMU | 39.0 | 0.8 |
| EU | 38.2 | 1.2 |
| BE | 38.0 | 2.9 |
| ES | 35.9 | -0.1 |
| UK | 35.2 | 2.0 |
| PT | 34.2 | -1.4 |
| DK | 33.8 | -3.7 |
| FR | 31.3 | 0.3 |

Source: Eurostat **9**

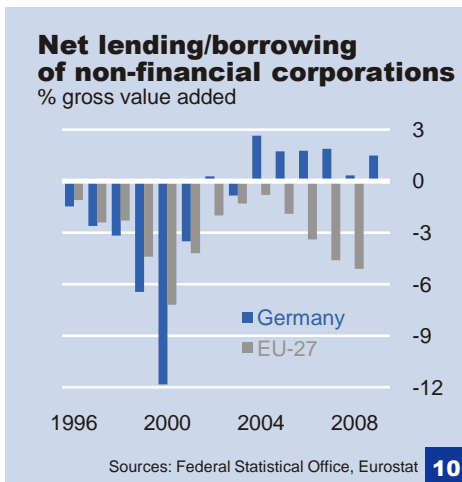
Probably 1.2 million jobs saved in all

IAB calculations show that employees' average annual working time fell by 3.2% during the past year due to short-time work and to the decreases in paid overtime and positive balances on working-time accounts. On paper, this corresponds to about 1.2 million jobs being saved by these instruments. Short-time work probably contributed "only" about one-third of the total. However, unit labour costs soared in Germany on the 5% contraction of GDP.

German companies in healthy starting position

The fact that the companies could respond so flexibly to the collapse in demand and nearly maintain their headcounts was not only attributable to the more flexible labour market structures but above all to their financial health. An analysis by Germany's Bundesbank says that in comparison with past recessions the companies entered the downswing with higher cash flows, better profitability and noticeably more robust financial health.

It says the profitability ratio, i.e. the operating profit of non-financial corporations in relation to gross value added, came to 41 ½% in



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Germany in 2008, topping the EU average of 38% and noticeably outstripping the ratio in France (31%) and Spain (36%). Moreover, between 2003 and 2008 the profitability ratio increased in Germany by 3 ½% pp, while remaining more or less flat in France and decreasing in both Spain and Italy. Furthermore, Germany's non-financial corporations reported a financial surplus vis-à-vis the other sectors since 2002, while the companies in many other countries were compelled to borrow in some cases substantial amounts to fund their investments and business activities. In France and Italy, companies needed to borrow sums totalling roughly 8% of their gross value added to finance investments in 2007, and the figure was no less than 24% in Spain, while German companies generated a slight surplus which rose to 1.5% of gross value added in 2008.

Companies running out of options ...

While short-time work is generally funded by the BA, the companies themselves also contribute a sizeable amount. For example, the BA reimburses half of the social security contributions for the first 6 months of short-time work and only fully from the 7th month. If workers upgrade their skills during this time, the contributions are shouldered from the outset. Depending on the duration of short-time work and the reimbursement ratio for social security contributions the companies' residual costs for short-time work may reach between 24% and 35% of their normal labour costs. The residual costs may still climb to as much as 48% if the companies have to subsidise short-time work on the basis of collective wage agreements. Such examples can be found in the agreements for the clothing, chemicals and metals industries, which provide for supplements to cover up to 90% of wages in the event of short-time work.

... but expect only a slight increase in unemployment

Against this backdrop we expect a continuation of short-time work also in the current year to a significant but gradually declining degree, if the global recovery makes further headway. Given the residual costs and still depressed production levels, though, companies are increasingly approaching the limits of what they can do. Despite the recovery, German GDP is still more than 5 ½% shy of its high in early 2008, while the number of workers obliged to make social security contributions is nearly ½% over its high for the same point in time. For this reason, even though the economy is recovering strongly and in our estimation set for 2% growth in 2010, unemployment is likely to rise towards 3.7 million by year-end with the unemployment rate then hitting 8 ¾%, up from 8% at present. During 2011, on GDP growth of 1 ¼%, the jobless figure may edge up by around 200,000 and the unemployment rate may then peak at 9-9 ¼%.



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Conclusion: A German success story

Government policy and business have been able to stave off the worst effects of the global recession in the German labour market by means of flexible working arrangements. The extension of short-time work is one part of the jobs miracle. However, the flexible handling of working time via a cutback in paid overtime and the reduction of positive balances on working-time accounts probably had an even greater effect. All things considered, these measures probably helped save about 1.2 million jobs. This became possible thanks to the increased flexibility of the labour market brought about by the Hartz reforms and to earlier consolidation efforts at companies

whose excellent financial starting position then enabled them to virtually maintain their full headcounts. However, the companies are gradually approaching the limits of what they can do, also in view of their residual costs, so the unemployment rate will probably continue to inch up in 2011. Anyway one looks at it, though, this would still be a German success story.

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