EXECUTIVE SUMMARY

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STUDIES ON
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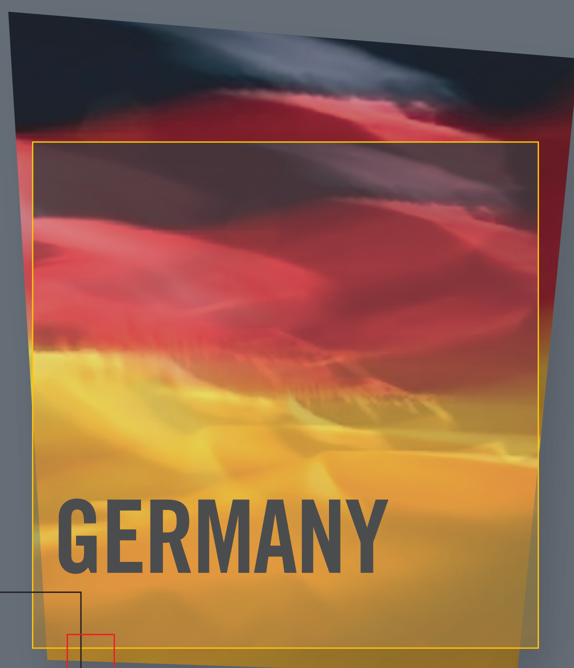

GERMANY

A JOB-CENTRED APPROACH

Executive summary and policy recommendations

Germany experienced one of the most dramatic declines in output as a result of the 2008 crisis...

The crisis had a significant impact on growth in Germany in terms of both magnitude and duration. GDP fell 4.7 per cent in 2009; in comparison, growth in advanced economies fell by just over 3 per cent in the same period. The recession also persisted over five consecutive quarters, starting in the last quarter of 2008. In 2010, however, growth returned to positive territory, first moderately – 2.1 per cent in the first quarter – but then more prominently as GDP expanded by 3.9 per cent in the second quarter, almost double the EU-27 average of 2.2 per cent.

Underlying the steep declines in output were Germany's exposure to both the US financial system where the financial crisis originated, and the ensuing decline in aggregate demand. The German financial system was directly affected by the sub-prime mortgage crisis and the fall of Lehman Brothers, as a number of financial institutions had invested heavily in collateralized debt obligationss and related asset-backed securities. The losses incurred by the German financial system spread quickly through the real economy. In addition, as the financial crisis escalated to an economic crisis, external demand dried up. Global trade fell 12 per cent in 2009, and with over 40 per cent of GDP in Germany dependent on exports, the export-oriented manufacturing sector was hit hardest – output in manufacturing fell by more than 25 per cent between the third quarter of 2008 and the first quarter of 2009.

With the rebound in trade activity taking place in the second half of 2009, German exporters benefited considerably from the strong recoveries and demand from emerging markets, notably in Asia..

...and yet employment fell marginally.

Despite the steep declines in output, employment levels remained relatively stable, falling only 0.2 per cent in 2009. Among advanced economies, where the fall in GDP was much lower than in Germany, employment fell by 1 percent, i.e. five times more than in Germany. The unemployment rate, which reached a peak of 8.1 per cent in February 2009, fell to 6.6 per cent by the end of 2010 – one of the lowest rates in the EU.

Even youth, who are often more vulnerable to downturns, fared reasonably well. Despite rising to nearly 11 per cent in the second quarter of 2009, the youth unemployment increase was short-lived and the rate has since fallen by more than 2 percentage points – as of September 2010, Germany had the lowest youth unemployment rate in Europe at 8.5 per cent.

The remarkable employment performance reflects, first, adjustments through lower working hours instead of layoffs...

One of the main mechanisms with which firms adjusted to the downturn was by reducing the volume of hours worked. Between 2007 and 2009 average work hours per salaried worker fell by 3.3 per cent (8 per cent in manufacturing). A key factor behind increased recourse to working-time reductions is the fact that, before the crisis, many workers had accumulated significant overtime. More fundamentally, the relatively high costs associated with dismissals of regular workers make working time reductions cheaper than layoffs. In addition, given the uncertainty of the length of the crisis, firms did not want to lose high-skilled workers – who had been relatively scarce before the onset of the crisis.

...second, well-designed government support of short-time work...

Germany's short-time work programme (Kurzarbeit) was the most widely used means by which firms were able to stabilize employment through working-time reductions – the programme accounted for one-third of the reduction in hours. The programme was widely promoted by the Government through a series of public relation activities – which proved crucial to promote awareness and facilitate implementation. Under the programme, the Federal Employment Agency covers a portion (up to 67 per cent) of the wage losses incurred through reduced working hours and compensates between 50 and 100 per cent of the social security contributions of employers. In the years preceding the crisis the programme had fewer than 100,000 recipients on average, but as the crisis worsened the Government stepped up its efforts and made a series of amendments to the programme, notably (i) relaxing criteria to access the programme; (ii) extending its duration (up to 24 months); and (iii) adding training provisions. The programme has led to a number of successes:

- *Employment stability*: Over the period of the crisis, labour productivity per worker and per hour declined significantly, especially in the manufacturing sector, which is an indication of labour hoarding. Indeed, on average 1 million workers in 2009 – at its peak in April 2009 1.4 million workers – were participating in the programme. A wide spectrum of firms took advantage of reduced working time, including many SMEs, with those most affected by the crisis being over-represented (i.e. manufacturing in western regions).

- *Income support*: Although wage levels fell per employee with the reduction in hours worked, overall aggregate income levels were higher than if employment levels had been adjusted instead of working hours. This provided an important boost to aggregate domestic demand and overall confidence.

- *Limited deadweight losses*: An analysis of enterprises benefiting from the short-time work arrangements reveals that only one-third of firms expecting demand increases took advantage of the short-time work programme, suggesting limited deadweight effects (i.e. firms that did not need the programme used it less). Additionally, up to two-thirds of firms using the programme expected steady or rising employment levels for the forthcoming year, which suggests that the programme may have had some influence on stabilizing employment.

- *Tripartite solutions*: A unique feature of the programme is that the costs and benefits are shared among workers, employers and government: (i) while firms are still responsible for wage-related expenses, they avoid the unnecessary costs associated with employee turnover and can draw on existing labour and skills when demand returns; (ii) the Government incurs the direct costs associated with the compensation provided to workers and employers, but the social and economic costs of higher unemployment are avoided, while instilling a sense of confidence in the economy; and (iii) workers are able to maintain their jobs but, as a result of reduced hours worked, have lower earnings.

...third, strengthened support to the most vulnerable...

The Government reinforced existing labour market and social programmes to mitigate the impact of the crisis on the most vulnerable. This also helped strengthen their automatic stabilizing effect:

- *Improved unemployment benefits:* The monthly benefit for Unemployment Benefits Part II (UB II) was increased from €351 to €359 per month, benefiting 4.9 million people on average over the course of 2009.

- *Reduced social security contributions:* As part of the second stimulus package, social security contributions for Unemployment Benefits Part I (UB I) were reduced temporarily from 3.3 per cent in 2008 to 2.8 per cent for 2009 and 2010 (rising to 3.0 per cent in January 2011).

- *Reinforced Public Employment Service*: In an attempt to improve the ratio of unemployed persons to caseworkers, the first two stimulus packages announced measures to recruit on a short-term basis 1,000 and 4,000 additional staff. The PES also allocated €1.12 billion in 2009 for training purposes – of which €200 million was targeted to reemployed temporary workers (in the same firm) and another €770 million for the extension of a reeducation programme for elderly and low-skilled workers. Moreover, the Federal Government through loan provisions and grants has ensured that the PES can run a deficit during times of crisis. This means the PES can function as an automatic stabilizer, i.e. there is no disruption in benefits and programmes or increases in contribution rates during downturns.

- *Pension guarantee:* In June 2009 the Government guaranteed that pension benefits would not decline. Given that pensions are indexed to wage developments, pensions would have fallen (due to the effective wage reduction resulting from lower hours worked). Without the measure it is estimated that in 2009 pensions would have declined by roughly 2 per cent in west German states and by 0.54 per cent in the east German states. Over 20 million pensioners have benefited from the guarantee.

- *Other social benefits:* Although previously announced, the social assistance benefit (Heizkostenzuschuss) to cover heating costs was increased from €91 to €142 per month

– benefiting approximately 800,000 households in 2008. In addition, the Child Benefit (Kindergeld) was increased, benefiting some 15 million recipients in 2009.

... fourth, broader macroeconomic support measures...

The Government also introduced a series of new initiatives to stimulate economic activity in a number of sector-specific areas, including direct credit support to enterprises:

- *Credit to sustainable enterprise*: In March 2009 the Government established a €115 billion fund (Wirtschaftsfonds Deutschland) for credit guarantees and other support for enterprises, of which €15 billion was reserved for SMEs. In addition, export guarantees worth €22.4 billion were issued in 2009, constituting an 8.2 per cent increase over 2008 and the largest increase in six decades.

- *Green-oriented initiatives*: The Government introduced a “cash for clunkers” programme, which made available a €2,500 premium to individuals who owned a car more than nine years old and were willing to purchase a new car that complied with the EU’s Euro4 emission standard. The total budget for this measure was initially planned to be €1.5 billion, but as a result of the popularity and widespread uptake of the measure an additional €3.5 billion was allocated. Additional financing and credit guarantees were targeted at enterprises which engage in the development of electro- and hybrid cars and fuel cell technologies.

- *Other measures*: The automotive sector also benefited from a temporary, one-year exemption from motor tax for new cars purchased between November 2008 and June 2009. In addition, €10 billion was earmarked until December 2010 for infrastructure investment projects. The aim of the initiative was to promote investments in universities, schools, child care, hospitals, and information technologies. Additionally, the Federal Government designated €2 billion for transportation infrastructure.

...finally, social dialogue played a big role.

Success of the above measures is grounded in effective social dialogue. Employment-oriented measures are often a product of negotiated worker–employer agreements or firm-level pacts. The government also undertook discussions with employers and working council representatives of DAX 30 companies in relation to fiscal measures.

The importance of social dialogue at the macroeconomic level is highlighted through the Global Economic Linkages Model (GEL) developed at the International Institute for Labour Studies. The model demonstrates that effective collective bargaining can cushion the fall in both output and employment. In particular, the output and employment multipliers of fiscal measures are larger when firms and workers negotiate both wages and hours than in the absence of such bargaining.

Looking ahead, the immediate challenge will be to ensure that, first, jobseekers get benefits and well-designed job-search services...

As the economy enters the recovery phase, the Government has now adopted a strategy of fiscal consolidation. Of the €11.2 billion to be saved in 2011, more than a third is expected to come from changes to policies and programmes delivered by the Ministry of Labour and Social Affairs. This is being undertaken with the objective of achieving a balanced budget by 2016.

Such retrenchment, if badly designed, could affect the pace of job recovery. There are currently close to three million unemployed workers receiving some form of unemployment benefit and job-search support. A continuation of a number of policies and programmes is needed to keep workers in contact with the labour market and avoid skills erosion:

- *Continue to improve client/unemployed ratio within PES*: The efforts to recruit additional staff in an attempt to improve the effectiveness of service delivery to unemployed persons was a welcome step, as is the new law to reduce the ratio to 1:75 (for persons under 25) and 1:150 (persons 25 and over) for UB II recipients. It will be important to ensure that fiscal retrenchment measures do not compromise these crucial targets.

- *Reinvigorate training initiatives*: Despite improvements in recent years, 1.4 million people or 48 per cent of the unemployed in Germany have been without work for more than a year – one of the highest figures in advanced economies. More than 900,000 have been without work for over 24 months. Skill requirements have changed over the past two years, at the same time as unemployment has caused the erosion of skill sets. Close to one-third of the unemployed have only primary education and no more than 56 per cent has secondary education. Greater utilization of training support for unemployed workers is urgently needed. Importantly, over the course of the crisis the Government allocated a significant amount of resources for training, much of which went unused. For example, of the €150 million additional resources to PES for training, only €35 million was used. Efforts are also needed to improve the delivery and effectiveness of training programmes, perhaps by leveraging private–public partnerships.

...second, that employment prospects of vulnerable groups improve, as the workforce is expected to decline…

While the urgent challenge will be to absorb all the current labour market slack, in the medium term Germany is confronted with a declining labour force which could affect overall growth patterns and productivity. Growth in the working-age population has been flat over the past five years and in 2009 it was negative. Among the G20 countries, Germany has the third highest ratio of the population aged 65 and over to the working-age population aged 15–64 (behind Japan and Italy). Already before the crisis, firms were beginning to be confronted with the challenge of labour shortages. Policy-makers do have a number of options, but no one option in isolation will be sufficient. Over the coming decades, a comprehensive strategy to improve labour market participation of key groups is needed.

- *Older workers*: In Germany, there is steep decline in participation rates for the age group 60–64: participation rates among this group are 45 percentage points lower compared to those aged 50–54. Germany's Perspektive 50 plus programme, which focuses on long-term unemployed older workers, is a welcome step. But a more comprehensive strategy is required that (i) ensures that the pensions and benefit systems do not harm decisions to continue working; and (ii) improves the employability and working conditions of older workers such that they are willing and able to extend their working lives.

- *Women*: the participation rate of women in the labour market is considerably lower than in many advanced economies and significantly lower than the participation rate of men. In 2009, only 53 per cent of women were active, compared to close to 66 per cent among men. In this context, a number of policy levers merit consideration, including an increase in the number of childcare establishments, especially for young children (1–2 years old). A recent Government initiative to improve the provision of childcare for children less than 3 years old will be effective from 2013 and should help increase the day-care coverage and encourage an earlier labour market return of parents – especially mothers and single parents. However, more efforts may be needed to raise women's participation rates. For example, measures to de-penalize the tax situation of joint and single parents could help. Currently, low-income single parents are confronted with an effective tax rate in the order of 80 per cent, the highest among OECD countries. Likewise, joint parents face a "splitting rule" that acts as a disincentive to the participation in the labour market of the lower earner.

…third, it is crucial that wages grow in line with productivity gains…

Real hourly wages in the private sector declined in the years preceding the crisis (2003–2006). Only the United States had lower wage growth over this period among selected advanced economies with available information (Australia, France, Germany, United Kingdom and United States). With the onset of the crisis, real household disposable income actually fell in the first three quarters of 2010. Part of the challenge lies in the fact that real wages in Germany have been growing slower than productivity since the 1990s, with the gap widening in recent years. Interestingly, the gap has narrowed during the crisis, given that declines in labour productivity have outpaced declines in real wages per hour. Employers and workers should seize the opportunity to ensure that the gap does not widen further and that future gains in productivity are rewarded with wage improvements. If properly designed through effective social dialogue at the enterprise level, this could provide a boost to disposable income that could have positive spillover effects without compromising competitiveness.

…and firms, especially SMEs, will need better access to finance for investment purposes.

German firms tend to rely heavily on bank financing for external funds, but equity financing is limited except for large firms – a situation which is exacerbated by weak competition, higher user costs of capital (and likely to rise with higher capital requirements under the Basel III framework) and limited access to venture capital. For example, the lending rates charged by German banks to firms have hovered around 10 per cent in the past decade, while for all major European economies and the United States it has been lower than 6 per cent. A comparison of capital structures illustrates that German SMEs tend to rely heavily on bank debt – around 50 per cent, while for other European economies it is around 30 per cent. But while the equity ratio for Germany SMEs has edged up since the early 1990s, it is still considerably lower than in its European counterparts.

As such, pre-crisis investment trends show that Germany has seen one of the largest declines in real investment among advanced economies. Between 1980 and 2006, investment as a percentage of GDP in Germany declined by more than 6 percentage points – more than double the decline in other high-income countries. As a result, in 2006 investment as a percentage of GDP was two percentage points lower than the high-income OECD average.

In order to stimulate investment activity and promote the creation and sustainability of viable enterprises, a number of reform options exist:

- *Promoting innovation and entrepreneurship:* Germany lags behind in entrepreneurship development, as small and medium-sized start-up firms face numerous difficulties in succeeding. But Germany can learn from the experience of other advanced economies that have successfully managed to facilitate start-ups. For example, countries such as Republic of Korea and the United States have programmes that encourage and facilitate the commercialization of new technology, products, and services.

- *Improving funding conditions for SMEs:* The credit fund (Wirtschaftsfonds Deutschland) established by the Government has proved to be very popular among medium-sized firms – over 95 per cent of the applications for financing have come from medium-sized enterprises. The fund, which was closed in December 2010, benefited nearly 20,000 companies. Conditional on evaluating the success of this initiative, the Government could consider launching similar initiatives until some of the more structural weaknesses of the German financial system have been addressed. The government should also consider ways to encourage medium-sized and small firms to tap into equity financing, e.g. by giving tax incentives to list themselves publicly. This has the potential of offering firms a new source of finance.

- *Boosting employment and labour incomes in line with productivity*: Promoting employment prospects of represented group and ensuring closer connection between wages and productivity, in line with the above recommendations, would help stimulate the domestic engines of economic growth and investment. This would also support a more dynamic Euro-zone economy, thus improving the prospects for German exports to other Euro-zone countries.

Socially-inclusive policies were key to Germany's success in responding to the crisis and should serve as the foundation for future action.

In comparison with other advanced economies, Germany's response to the crisis was rather comprehensive in nature. Several initiatives were introduced to stabilize employment by leveraging the use of social benefits – while being mindful of labour market objectives and work incentives. Germany also made concerted efforts to reinforce social safety nets that were accompanied by support at the enterprise level to sustain the viability of businesses. This had the double dividend of focusing on jobs and providing support to domestic demand and business through income growth. In many instances this was supported by effective social dialogue.

Moving forward, it is essential that such a socially-inclusive approach – which proved so successful for overcoming the crisis – be pursued. Germany would be rewarded with further significant gains, both economic and social.