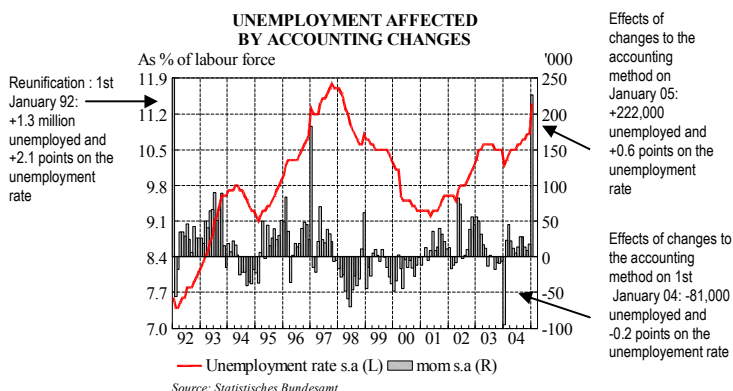


## THE REFORM OF THE LABOUR MARKET ENTERS A NEW PHASE

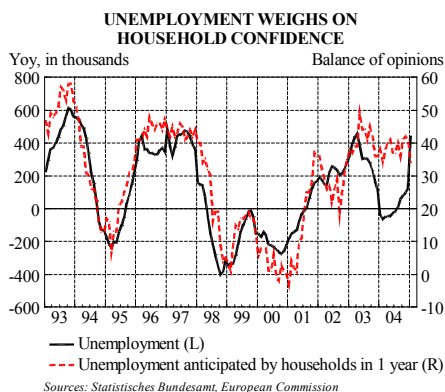
- The coming into force of the last section of the labour market reform, the Hartz IV law, has led to a rebound in the number of unemployed accounted for and has now exceeded the symbolic 5 million mark (non-seasonally adjusted figures), a level not witnessed since World War II. For the time being, this latest stage in the reform of the labour market could cause a fall in household confidence, which was just beginning to rebound.
- The Hartz IV law will increase incentives to return to work, which should enable long-term unemployment to be reduced. Given the current pace of economic growth and the low number of job starts expected in the trade sector, Hartz jobs look likely to be the only ones improving.

### The Hartz IV law caused unemployment to leap in January

In January the number of unemployed registered reached unprecedented levels, not witnessed since reunification: +227,000 persons in s.a. figures. The rate of unemployment now stands at 11.4% of the labour force, four tenths of a point off its record in 1997. This increase is due to the registering of beneficiaries of the *Sozialhilfe* (minimum income) that are able to work and pre-retired persons. If we exclude the coming into effect of the Hartz IV law, the number of s.a. unemployed would only have risen by 5,000 persons. The non-seasonally adjusted figure is even more alarming, as the month of January normally sees a marked decline in activity in the construction sector. February's statistics look set to swell by between 30,000 and 40,000 additional persons as a result of the lag time needed to collect the information.



Given its impact in the media, the spike in the level of unemployment (even if it only sheds greater transparency on the real unemployment situation) risks having a destabilising effect on households even though the majority of the population seemed to be resigned to the reforms: the demonstrations held this summer in East Germany (the "Montagsdemo") have quickly lost momentum.



The Gfk household confidence index improved significantly in February (a 1 point increase, which the institute estimates equivalent to 0.1 point of additional spending yoy), while it has been stagnant at a low level since August, thanks to tax reductions that came into effect in January. Meanwhile, the European Commission's household confidence index in January returned to

its October 2002 level. The frightening unemployment figures could weigh on this renewed optimism.

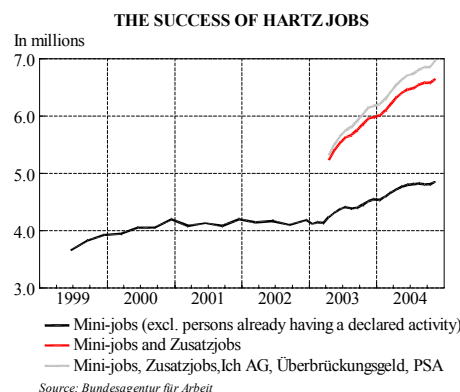
### ...but it should subsequently fall

Since their creation in 2003, Hartz jobs have been the main channel for the unemployed to return to work (see *September 2004 Monthly Economic Report*):

- In November 2004, 6.65 million persons were classed as being in low paid employment (less than EUR 800 per month gross). If we exclude the mechanical effects of the increase of the EUR 325 ceiling to EUR 400 in April, around 450,000 mini jobs (as the main activity) were created. We should add to this figure the "extra jobs" (*Zusatzjobs*), which swelled to 40,000 in October with the creation of "ein-euro jobs". Extra jobs increased sharply in 2004, no doubt in anticipation of the more severe unemployment compensation conditions on 1st January 2005. Overall *Zusatzjobs* rose by 800,000 persons between April 2003 and November 2004. Despite the income from employer social contributions (EUR 330 million per month), mini jobs and *Zusatzjobs*, which granted tax relief on employee social security contributions, turned out to be very costly for the *Bundesagentur für Arbeit*: in total, social contributions (health, retirement, dependency paid for unemployed, subsidised employment) cost EUR 2.5 billion in 2003.

- In December 2004, 330,000 persons participated in company creation schemes (*Ich AG* and *Überbrückungsgeld*, the older programme, which had an increase in candidates in 2004), representing a rise of 270,000 persons since the launch of *Ich AG* on 1st January 2003. These two schemes cost EUR 1.7 billion in 2003 and looks set to rise to EUR 2.3 billion in 2004.

- Only figures for the job placement agencies (*PSA*), which work with private companies, have remained stable. They have "employed" around 27,000 unemployed since the beginning of the year. Their recruitment has stagnated and they are functioning at 75% of their capacity. This scheme represented EUR 175 million in 2003 and looks set to increase to EUR 350 million in 2004.



Overall, around 1.5 million persons (non s.a. data) are not, or no longer included in unemployment statistics (although participants in the *Ich AG* programme were formerly unemployed, those having mini jobs no doubt for the greater part come from the black market).

These figures, nevertheless, refer to part-time employment (mini jobs) or employment that is still not stable (*Ich AG*, where the medium-term feasibility is still not guaranteed). The reform of mini jobs should bolster the activity rate, especially for women cohabiting; however, this would encourage women to work less (no requirement for minimum work hours) to benefit from the tax advantages on offer (for a couple, if one of the two members has a mini job, above EUR 400 per month the compulsory levies increase greatly). On the whole, the positive effects of the mini jobs reform on the labour supply (as a full time equivalent) and the tax revenue generated look likely to be limited. (see *DIW, Discussion paper n°438, "Work incentives and labour supply effects of the Mini-jobs reform in Germany", September 2004*).

The main issue in the German economy is not addressed: the labour supply is constrained greatly by the structure of compulsory levies (the total taxes and social contributions payable to the general government). For a family with two children, taking into account all social aid (unemployment, family benefits), "up to gross earnings of EUR 1,660, net income (after tax, social contributions) practically does not change at all in response to changes in gross earnings: for every extra euro earned, the employee loses one euro in welfare benefits" (see *Hans-Werner Sinn, "The laggard of Europe", CES-Ifo Forum, Spring 2003*). Hartz jobs therefore remain a classical example of support measures to employment, but their effectiveness is debatable given their high cost.

### ... with the increase in incentives to return to work

Hartz jobs are beneficial when linked to incentives to return to work as represented by the Hartz IV law (the merger of *Arbeitslosenhilfe* and *Sozialhilfe* in a single *Arbeitslosengeld II* benefit). *Arbeitslosenhilfe*, the former long-term unemployment benefit represented 53% of the net wage (57% with at least one child) without a limitation on the duration (in theory up to 66 years old), against 60% for the unemployment benefit *Arbeitslosengeld I* (67% with at least one child). This was replaced by a fixed sum of EUR 345 in the West, and EUR 331 in the East, to which a special social aid is added ("*Miete+Heizung*"). Taking into account this aid and the housing aid paid previously under *Arbeitslosenhilfe*, a single unemployed person living in East Germany, whose salary was EUR 1,500 gross (around EUR 1,100 net) now receives EUR 579 under *Arbeitslosengeld II* against EUR 610 with *Arbeitslosenhilfe* (after receiving EUR 666 under *Arbeitslosengeld I*). Net income which a single person may benefit with a mini job is EUR 650 (EUR 800 gross), which would encourage this person to take such a job when he reached the *Arbeitslosengeld II*.

However, in order to reduce the effects of the Hartz IV law, a transition system is planned for two years (in our example, the unemployed person under *Arbeitslosengeld II* would receive a total benefit of EUR 637 in the first year, EUR 608 in the second and EUR 579 from the third year). The reform also constitutes a strong incentive for former beneficiaries of *Sozialhilfe*, who must now prove that they are looking for a job.

Furthermore, compensation conditions have been tightened considerably. A beneficiary of *Arbeitslosengeld II*, who refuses a placement, training or "acceptable" job, will have his benefit reduced by 30% and the transition subsidy will be withheld for three months. After four consecutive refusals, all aid will be suspended for three months. For beneficiaries under 25 years old, *Arbeitslosengeld II* is suspended for three months following the first refusal. Criteria for distance, unsuitability for training, the conditions of work or a less attractive salary than in previous employment are not accepted. This has provoked an important discussion in Germany regarding which job is "*zumutbar*" and which is not: in theory an "acceptable" job is any job that is not too removed from the unemployed person's qualifications and which does not prejudice his employability. Moreover, all young persons seeking employment who are under 25 years old, must pass an "integration

interview" in the employment agency in order to reach agreement on the precise objectives (employment, apprenticeship or other qualification).

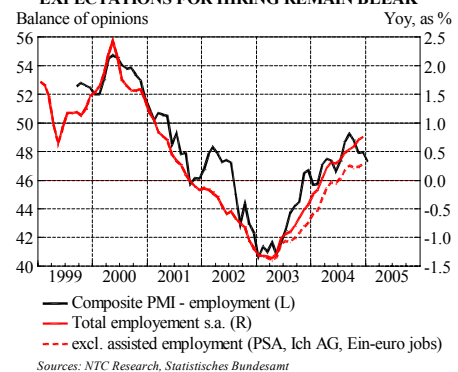
The government expects unemployment to shrink by 200,000 by the end of the year (long-term unemployment represents 40% of the total), and in the longer term the financial cost should be reduced (in 2003, the cost of *Arbeitslosengeld I* and *Arbeitslosenhilfe* rose to EUR 45.5 billion not including a further EUR 21 billion for the active aid schemes for the unemployed such as training, *Ich AG*, etc. The total direct cost of unemployment represented 10% of the total German budget). The Bundesbank expects there to be a stronger correction (-150,000 unemployed via "*ein-euro jobs*", -100,000 via the modification of compensation criteria and -25,000 via the improvement of placement services at the *Bundesagentur für Arbeit*).

On 1st February 2006 an additional step will be taken for incentives to return to work for old workers, with a reduction in the maximum compensation period for *Arbeitslosengeld I*: this will be reduced to 12 months for the under 55s and 18 months for the over 55s against the current 12 months for the under 45s, 18 months for the 45-46 age group, 22 months for the 47-51 age group, 26 months for 52-56 age group and 32 months for the over 57s.

### The rebound in trade employment is not for this year

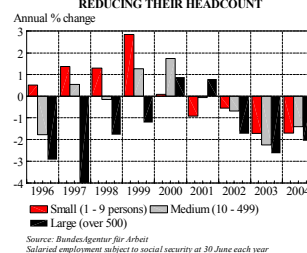
Climate surveys from the PMI or the KfW out of the *Mittelstand* indicate that employment expectations are still very modest.

#### EXPECTATIONS FOR HIRING REMAIN BLEAK

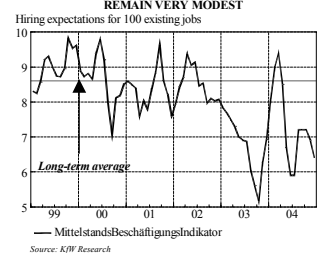


Companies may still continue to favour the improvement in their financial ratios. They will all the more postpone major recruitment plans since prospects for new sales are still modest in Germany and the CEEC and emerging Asia, which were previously buoyant, have now slowed. The *Mittelstand* is still constrained by restrictive conditions for access to credit. Large corporates are committed to medium to long-term cost cutting plans (Deutsche Bank announced 1,900 redundancies in Germany and the creation of 1,200 jobs in lower cost regions; Volkswagen and Daimler announced that they would develop production in the dollar area to protect themselves against a rise in the euro).

#### COMPANIES OF ALL SIZES ARE REDUCING THEIR HEADCOUNT



#### HIRING EXPECTATIONS OF SME REMAIN VERY MODEST



Productivity has slowed in the service and construction sectors since the third quarter. However, this is due to the modest growth performance in the middle of the year and not to a jump start in employment. Furthermore, the usual slowdown of productivity (when a recovery becomes mature) has still not fed into the manufacturing sector.

Gaël ROBERT – +33 1 42 14 27 96

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