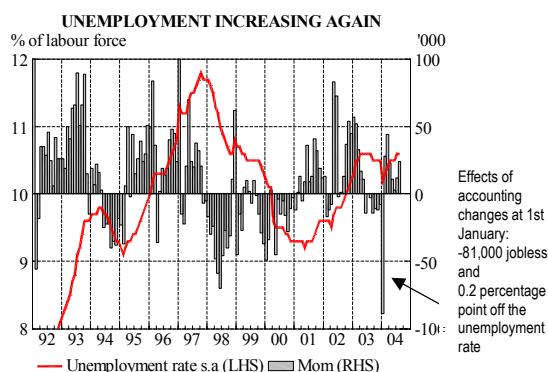


## ODDS ON FOR THE RECOVERY TO REMAIN JOBLESS

- Despite the continuing upturn in the manufacturing sector, the labour market has still not picked up. Employment is only now starting to stabilise, and recruitment indicators continue to point a modest improvement. Furthermore, current dynamics in each sector of the economy are unfavourable to job creation. Construction has been in a slump for some time and commerce and personal services have been hurt by weak household demand and are structurally less job generative than in other European countries. As for the two sectors that are currently benefiting from the global recovery – financial and business services are in a restructuring phase, while manufacturing is seeking to restore profits through an enormous competitiveness drive.
- The “Hartz” measures launched in 2003 and designed to reduce unemployment have had a limited impact on job growth. So far, only traditional anti-unemployment measures, such as business start-up assistance and cuts in social security contributions on low wages have had an effect, with 250,000 fewer jobless in H2-03 (non seasonally adjusted). The forthcoming cut in unemployment benefits may have a significant impact in getting people back to work. Above all, however, these reforms have aroused the permanent mistrust of the general population towards the government’s economic policy.

### The labour market is still not improving

For several months we have witnessed a rise in unemployment as the “Hartz” measures lose their impact. Despite the economic recovery, employment remains in the doldrums, with the economy destroying 64,000 jobs since the beginning of the year (sa).



However, poor employment performance is not a new experience for Germany and is not simply the result of weaker growth relative to the rest of the eurozone. Since reunification, German growth has produced fewer jobs than other European countries. So far, the economy has created very few jobs at the expansion stage of the business cycle. Labour productivity did not slow down during previous recoveries, such as in 1997, unlike in other large European economies. In other words, Germany has generated far fewer jobs than its European neighbours relative to its growth rate. This trend has continued since 2002.



### The structure of the production system does not encourage strong employment

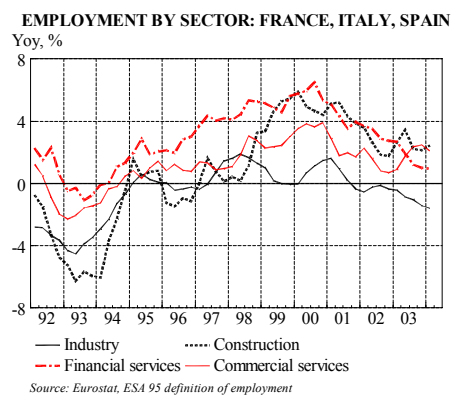
The economy is centred on manufacturing, which is capital intensive, while personal services (wholesale and retail trade, hotels and restaurants, etc.), which are labour intensive, are under-

represented.

### BREAKDOWN OF EMPLOYMENT AND VALUE ADDED BY SECTOR (2003)

VA Employment (% of total)	Industry excl construction	Construction	Commercial services	Financial and business services	Public services
Germany	24.4 21.2	4.2 6.0	18.0 25.4	30.5 15.7	21.7 29.2
France	18.8 15.6	5.0 6.0	18.6 23.2	31.0 16.5	24.0 34.6
Italy	21.6 22.2	5.0 6.9	23.5 25.0	27.3 13.7	20.0 27.8
Spain	18.8 18.0	9.7 11.1	27.8 27.5	20.1 10.3	20.5 27.5

Source: Eurostat, the ESA 95 definition of employment, value added at 1995 prices  
 1: NACE G, H, I: wholesale and retail trade, hotels and restaurants, transport, storage and communications; 2: NACE J, K: financial intermediation, real estate, rental and business services; 3: NACE L - P: public administration and defence, social security, education, health and social work, other community, other social and personal services.

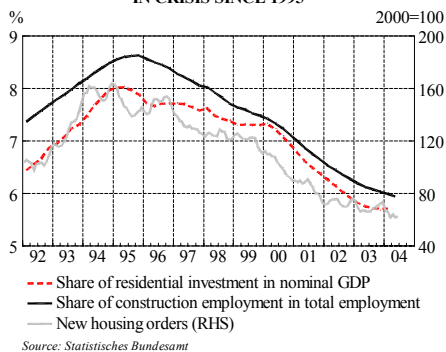


In addition to this statistical snapshot, some unfavourable dynamics are at play, which will continue to weigh heavily in the short term. The construction sector is suffering an overcapacity crisis, financial services are in the process of restructuring and small businesses face major financial difficulty.

## Construction has been hard hit

Since the property bubble burst in the mid-1990s, the construction sector has been mopping up spare capacity without managing to complete the process. There are still 1 million empty dwellings in the former RDA, and 15% of offices remain unoccupied in Frankfurt. Consequently, the weight of this sector in the economy continues to shrink, whether in terms of value added or jobs (Germany's few periods of economic recovery - late 1999 or late 2003 - did not produce an upturn in employment). In the short term, the government's plans to cut subsidies for homebuyers ("Eigenheimzulage") will further maintain pressure on capacity within the sector. In the medium term, its weight in the economy, which has fallen below pre-bubble levels is now within the European average (but construction still accounts for a disproportionately high percentage of overall employment relative to its share of VA) and should stabilise so that employment trends in construction should end up following the business cycle again.

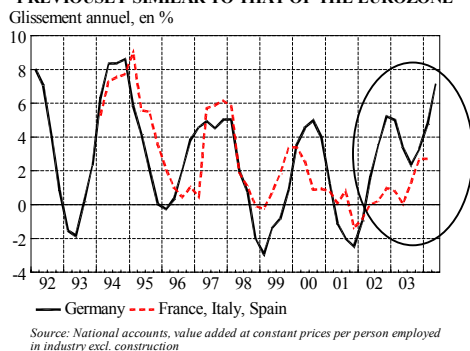
THE PROPERTY MARKET HAS BEEN IN CRISIS SINCE 1995



## The beginnings of a productivity bubble in the manufacturing sector

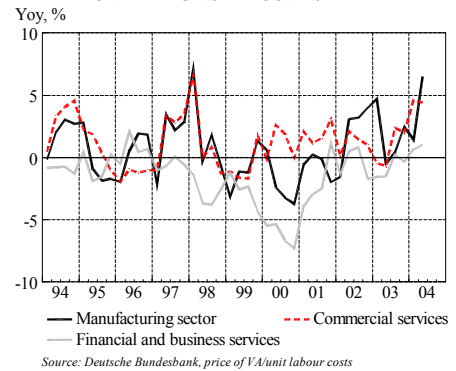
Productivity in the manufacturing sector is extremely cyclical and particularly well correlated with the export cycle (without lag). It does not account for the overall underperformance of the German economy in terms of employment. The plunge in productive investment (a close correlate of industrial employment) since 2000, has crippled recruitment since 2002. But with exports booming, new jobs should start appearing again once the recovery in capacity investment is confirmed.

GERMANY'S INDUSTRIAL PRODUCTIVITY CYCLE WAS PREVIOUSLY SIMILAR TO THAT OF THE EUROZONE



However, with working hours showing a tendency to increase and firms obviously determined to regain their competitiveness (as illustrated by their readiness to relocate production), there is a risk that job creation will be pushed back to the second half of 2005. The productivity cycle is particularly strong at present (it is growing almost as fast as it was following the reunification shock). This could mark the beginnings of a bubble. However, manufacturers have started to rebuild pricing power and unit labour costs are falling. This has led to a sharp increase in unit margins, which should prevent a productivity bubble from developing.

UNIT MARGINS REBOUND SHARPLY



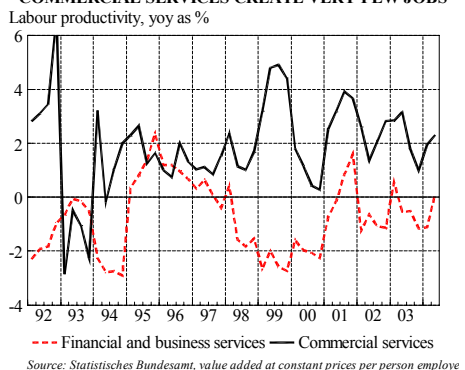
## Business services have been the only significant source of new jobs in the past

The services sector is largely to blame for the small number of jobs created by the German economy. Almost all of the new jobs generated since the mid-1990s have come from business services (IT, consultancy, etc), whose overall share grew from 6.5% in 1991 to 12% in 2002. Job creation in the sector was very high during the period 1998-2000, when it outpaced activity (8% per year, while VA grew only 4% per year). Recruitment may therefore plummet when the industrial recovery feeds through to this sector.

Employment in the banking sector has been hit by the concentration of ownership among both public and private banks, which is intended to increase profitability. The German banking sector is near the bottom of the league of eurozone countries in terms of profitability criteria, largely because the sector is broken up into a multitude of different establishments: in 2002, there were 2,400 credit institutions in Germany versus 929 in France. The fall in employment was already very noticeable in 2002 and this trend has every reason to continue. In 2002, financial services (banks, insurance companies, financial intermediaries) still represented a little over 3% of total employment in Germany and France alike, but less than 4% of VA in Germany against almost 5% in France.

The "commerce, transport, hotel and restaurant and communications" sector has still not recovered fully and has proved incapable of generating employment in the past. Labour productivity in this sector has risen an average of 3% yoy in Germany since 1999, despite contracting in the rest of the eurozone owing to continuing high job creation in Italy and Spain. In fact, high labour costs and structural rigidities affect this sector the most.

COMMERCIAL SERVICES CREATE VERY FEW JOBS

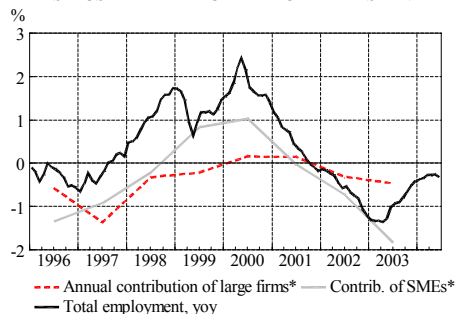


## SMEs in financial bother

Businesses with less than 500 employees (the *Mittelstand*, most of which are larger mid-sized companies) account for a particularly large portion of the economy (99.7% of businesses, 50% of VA, 70% of employment and 83% of apprenticeship places), particularly the larger SMEs (businesses with between 100 and 500 employees).

These account for a quarter of employment – a bigger share than those with over 500 employees. However, their financial health deteriorated throughout the 1990s, with falling profits and rising debt, due to their exposure to domestic demand (they are over-represented in the construction and commercial sectors). Last year, these problems culminated in a record number of bankruptcies.

**THE FALL IN EMPLOYMENT IN 2002-2003 IS MOSTLY ATTRIBUTABLE TO MITTELSTAND**

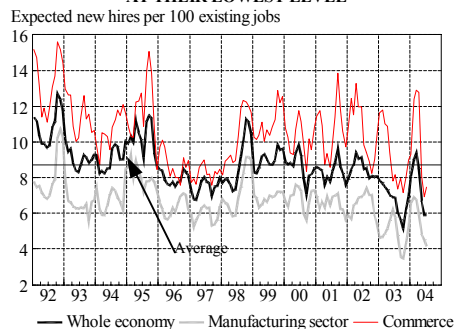


Sources: Statistisches Bundesamt for total employment, Bundesagentur für Arbeit for employment per size of company

\* calculated using incomplete data relating to employees who are subject to social insurance contributions at 30th June of each year (i.e. 27 million jobs versus 38.2 million for total employment). In this case Mittelstand denotes firms of less than 500 persons.

Attempts to restore the financial health of these firms are currently being thwarted by problems with access to credit, which are therefore preventing them from taking on new staff. Furthermore, the KfW indicator shows that hiring plans are at their lowest, having been spurred on at the turn of the year by the rebound in construction activity and a general increase in optimism associated with the considerable improvement in global growth.

**THE HIRING PLANS OF SMEs ARE ALMOST AT THEIR LOWEST LEVEL**



Source: KfW Research, MittelstandsBeschäftigungsIndikator

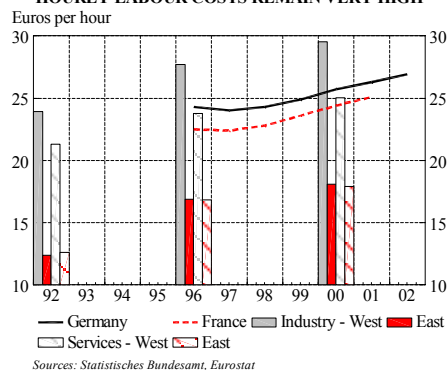
**The government is starting to tackle the structural problems affecting the labour market**

**The rise in labour costs is an obstacle to employment**

German wage growth has been moderate since the mid-1990s, with the notable exception of 1999 and 2002, when wage negotiations pushed the hourly wage up by 3% throughout the economy. Nonetheless, German labour costs are still the highest in the eurozone. First they were driven up by the alignment of East German wages with those of West Germany. (The Ost-Mark was valued at a 1:1 rate with the Deutsche Mark, then wages rose 40% between 1992 and 1996). This was followed by a steady increase in social security contributions (from 35.3% in 1991 to 39.2% in 1995 then 42.1% in 2003). Furthermore, the lack of wage differentiation (between industry and services in the East and between the different qualifications owing to wage negotiations aimed at closing the wage gap between skilled and unskilled occupations) appears to be crippling demand for unskilled labour. In order to promote these kinds of jobs, the government has introduced a reduction of payroll taxes on low wages (mini jobs), which has proved a success. Meanwhile, pension and especially healthcare reform should manage to halt the rise in social security

contributions.

**HOURLY LABOUR COSTS REMAIN VERY HIGH**



Sources: Statistisches Bundesamt, Eurostat

**Back-to-work incentives are not strong enough**

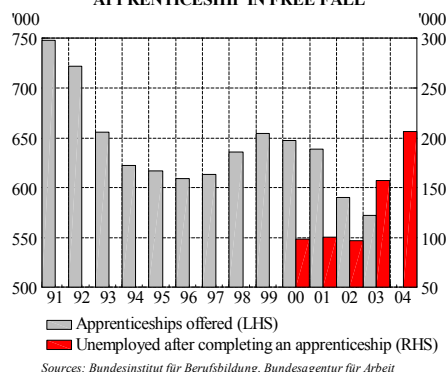
Another factor that explains Germany's poor performance on employment is the lack of incentives to return to work because of the size of benefits. A fifth of the registered unemployed may be voluntarily without work according to the DIW (*"Unemployed and unwilling to work?"*, *Economic Bulletin*, June 2002). The bulk of the voluntarily unemployed are aged over 50, who can receive benefits for a longer period, and young women with children because of the lack of childcare facilities for very young children. In fact, the reservation wage is relatively high, especially for low wage earners. Eurostat calculates the "unemployment trap" for low wage-earners to be 88%, which is one of the highest rates in Europe (the "unemployment trap" refers to the percentage of gross remuneration that is "absorbed" by the loss of benefits and the increased tax rate and social security contributions when a person who has been unemployed for a while starts a new job).

To encourage people back to work, the latest "Hartz" laws have tightened the conditions for receiving benefits and will reduce the amount of assistance paid to the long-term unemployed on 1st January 2005, before reducing the entitlement period for all unemployed people in 2006.

**The apprenticeship model is in crisis**

*Ausbildung*, one of the special features of the German education system, which traditionally ensured that education met the needs of the labour market in the German "social market economy" is going through an unprecedented crisis

**APPRENTICESHIP IN FREE FALL**



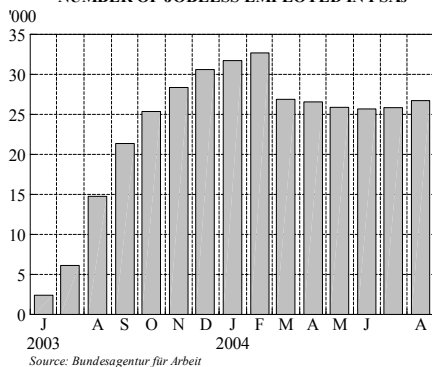
Sources: Bundesinstitut für Berufsbildung, Bundesagentur für Arbeit

Apprenticeship places have shown a remarkable decline since 2001, with the number of candidates unable to find a place rising from 20,000 to 35,000 in 2003. The situation looks set to be dramatic this year, with only 480,000 places available in August (6% less than last year). To halt this trend, the government passed an *Ausbildungspakt* with employer organisations intended in principle to create 300,000 new apprenticeships and 25,000 work experience placements over three years. However, this agreement does not involve funding and places employers under no obligation.

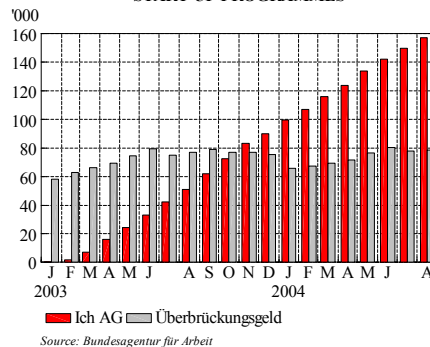
## AGENDA 2010: REFORM OF THE LABOUR MARKET

Measure/Law	Date of entry into force	Expected/obtained effects
<b>Kapital für Arbeit:</b> low interest loans of up to EUR 100,000 paid by the <i>KfW</i> to those who provide work for an unemployed person	1st Nov 2002	8,000 unemployed people have already been hired thanks to this measure. The government had an unrealistic target of 50,000.
First and Second Laws on Modern Services in the Labour Market, also known as the <b>Hartz I and II laws</b> - <i>Mini-jobs</i> : the tax-free ceiling was raised from EUR 325 to 400 per month on 1st April, 2003. From now on, the employer pays a flat-rate sum of 25% (12% for households) of taxes and social-security contributions on a wage less than EUR 400. This rate rises on a sliding scale for earnings between EUR 400 and 800 until it reaches the standard rate. - <i>Ich-AG</i> : Assistance to unemployed people in setting up a business. A tapering subsidy over 3 years, with a first-year payment of EUR 600. A similar measure, <i>Überbrückungsgeld</i> , already exists.  - Creation of Personnel Service Agencies ( <i>PersonalServiceAgenturen</i> ) for the unemployed in most difficulty.	1st Jan 2003	- Between March 2003 and December 2003, the number of mini-jobs rose by 408,000 to 4.5 million (not counting those that constitute a second job). At least half of these arose simply from the lifting of the threshold on 1st April 2003.  - In August 2004, 236,700 former unemployed took part in business start-up programmes, including 150,000 in the <i>Ich AG</i> programme. These do not require the entrepreneur to have a business plan, which makes the viability of the new businesses very uncertain. - In August 2004, 800 <i>PSA</i> "employed" 26,700 previously unemployed people (70% of places are filled)
- Programme of assistance for long-term unemployed running between 1st September 2003 and 31st August 2005 - <i>Jump Plus</i> programme aimed at assisting 100,000 unqualified young people aged under 25 between 1st July 2003 and 31st December 2004. This is simply a follow-on of the <i>Jump</i> programme launched in 1999.		- Temporary measure designed to support vulnerable people who are at risk of a cut in benefits. - Classic "workfare" measure. This group of measures ( <i>PSA</i> , <i>Ich AG</i> , <i>Jump</i> , training, jobs for the long-term unemployed, etc) covered 1.3 million people in August 2004.
<b>Hartz III:</b> gradual restructuring of the Federal Labour Office (renamed the Federal Job Agency) to be completed in 2005. - Split of unemployment benefits and placements activities, with placements now managed by job centers - Gradual transformation of <i>PSAs</i> into temp agencies for the unemployed - Increased requirements for the unemployed in terms of signing on dates, geographical mobility and wages	1st Jan 2004	Designed to get unemployed people into work quicker (the target is to reduce the average job-search period to one week) Increase work incentives
Loosening of redundancy laws governing small businesses with less than 10 employees (versus 5 previously).	1st Jan 2004	Boost employment by making the labour market more flexible
<b>Hartz IV:</b> - Unemployment benefits ( <i>Arbeitslosenhilfe</i> ) and welfare benefits ( <i>Sozialehilfe</i> ) to be merged into a single benefit <i>Arbeitslosengeld II</i> worth EUR 345 per month in West Germany and EUR 331 in East Germany.  - Reduction of the unemployment benefit entitlement period from 32 to 12 months (18 for those aged over 55.)	1st Jan 2005  1st Feb 2006	- Boost back-to-work incentives for the 2 million people receiving <i>Arbeitslosenhilfe</i> benefits. Cut in the rate of long-term unemployment (one of the highest in the eurozone), improve the fiscal situation of municipalities with responsibility for social welfare.  - Increase back-to-work incentives
<b>initiative Pro-Mittelstand:</b> - Increase in the tax threshold (EUR 350,000 for turnover and EUR 30,000 for profit). - <i>KfW</i> and <i>Deutsche Ausgleichsbank</i> merged on 1st July 2003 to create a new bank specialising in the funding of SMEs, the <i>Mittelstandsbank</i> . - From 1st March 2004 the <i>Mittelstandsbank</i> launched mezzanine loans up to EUR 500,000 for start-up entrepreneurs and EUR 2 million for SMEs over five years old. - Master craftsman certification needed in 41 craft trades versus 94 previously. - Simplification of the administration needed to start up a business, particularly in terms of entering companies on the commercial register.	1st Jan.2004	- Improve the financial situation of SMEs, which have been hard hit by two years of slow domestic demand.  - Improve the financing of SMEs, which is currently impeded by the rising default rate and the restructuring of the banking sector, particularly the public banks - Facilitate the creation of sole proprietorships

NUMBER OF JOBLESS EMPLOYED IN PSAs

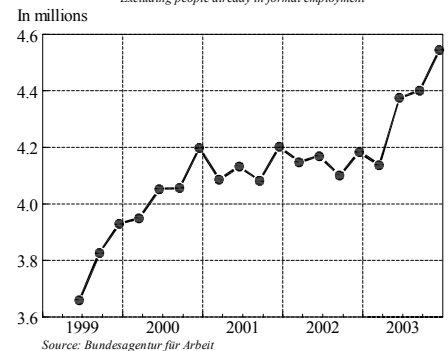


PARTICIPANTS IN BUSINESS START-UP PROGRAMMES



MINI-JOBS

Excluding people already in formal employment



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