

## THE JOB MARKET REMAINS A CAUSE OF CONCERN

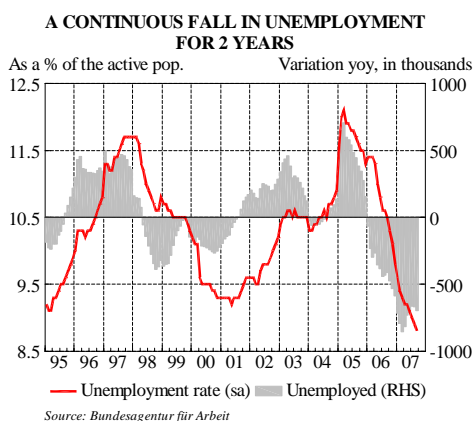
⚡ There has been a spectacular improvement in the jobs market since 2005. Unemployment is in freefall, and job creations, particularly for traditional contracts, are up significantly. All sectors have contributed, and indeed, jobs are being created in the construction sector and industry for the first time since 2000.

⚡ The positive figures from the construction aside, job increases have nevertheless been less marked than in the previous period of economic growth between 1998 and 2000. Thus in the service sector, the main growth sector in the jobs market, the rate of job creations is not as dynamic as in the past.

⚡ Above and beyond the structural improvement in the economic and financial situation of SMEs, structural problems remain a real problem in the medium term. Construction is not likely to continue to contribute positively and the underlying trends in industry remain unfavourable. Moreover, the Hartz laws have fallen short of expectations. Growth in employment in consumer services is lower than that seen from 1998 to 2000 and growth in numbers of Mini-jobs since 2005 is only very relative. With regard to long-term unemployment, results remain mixed, while numbers of vacant posts have reached historic levels.

### Recent trends on the job market are positive for the most part

#### Unemployment is in freefall



The job market has been particularly dynamic since 2006. The number of unemployed, over 5 million at the beginning of 2005, has dropped progressively to reach a figure of around 3.6 million in September 2007. The drop in unemployment, from 12.1% (sa) of the active population in March 2005 to 8.8% in September 2007, has come about very quickly. This is truly remarkable in terms of previous performance, in particular in comparison with the last cycle of economic growth, from 1998 to 2000. The reduction in unemployment has had an impact on all sectors of the job market traditionally in difficulty. The unemployment rate for under 25s fell from 13.3% in March 2005 to 8.9% in September 2007; the rate for foreigners has dropped from 26.3% to 19.1%. In the East, the rate is still higher than in the West (14.7% as against 7.3% in September 2007) but improvement there is also significant (19.3% at the beginning of 2005).

#### Creation of "higher quality" jobs...

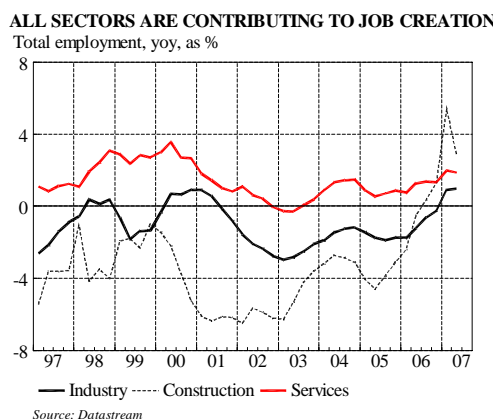
As a logical corollary to the drop in unemployment, job creations have been on the rise since the beginning of 2006. Economic growth has had a positive impact on job creation, reaching 2% yoy in the first quarter of 2007, then levelling off at 1.6%. Although in yoy terms, growth in jobs is still less than that recorded between 1998 and 2000, net job creation was over 600,000 posts over the year to September, which is comparable to that of 2000.

One of the characteristics of the current phase is the strong growth in "standard" contracts, in other words, contracts subject to full social security contributions. This category of wage earner has grown significantly since 2001, particularly at the beginning of 2007 when it made up almost 70% of new jobs. On the other end of the scale in terms of job insecurity, Mini-jobs - that is jobs with low salaries (< EUR 400) and often part time, around 4.9 million people

- went through a bad period at the end of 2006, mainly because of the end of football World Cup contracts and the wait-and-see reaction of employers to the uncertainty brought about by the increase in VAT at the beginning of January 2007. Once this had passed however, the annual growth rate returned to +2% yoy as from the spring, confirming the importance of this category on the job market.



#### ... and well distributed over different sectors



In what represents a remarkable change, all sectors have contributed to the positive employment figures in 2007. Indeed, there have been positive developments in manufacturing industry and the construction sector. The service sector does nevertheless remain the most dynamic area in terms of job creation.

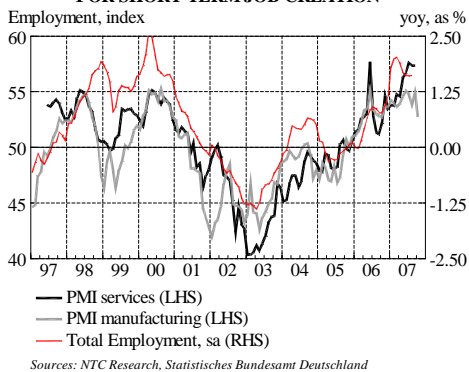
#### In the short term, the outlook is good

In spite of the pronounced fall in PMI indexes for manufacturing and, in particular, the services sector in September and October, recruitment intentions are still up, particularly in the service sector. This is not surprising as the job market trends are lagging behind GDP growth. Current figures for the service sector are however at record levels and are equal to those seen for the industry in the

previous growth cycle. Net job creations will therefore remain stable until the end of the year, at around 1.5% yoy.

All in all, employment should be up 1.7% in 2007, an increase of 670,000 more posts than last year.

#### THE OUTLOOK REMAINS GOOD FOR SHORT-TERM JOB CREATION



#### Has the job market overcome its structural problems?

EMPLOYMENT IS UP BUT NOT TO THE LEVELS OF 1998-2000

	Total employment (yoy as %)				Average annual contribution to change in the job market (in %)	
	2004	2005	2006	2007*	1998-2000	2006-2007**
<b>Total</b>	+0.4	-0.1	+0.6	+1.7	+1.5	+1.2
Construction	-3.0	-3.9	-0.3	+4.1	-0.2	+0.1
Industry (incl. energ.)	-1.4	-1.7	-1.0	+0.9	+0.0	+0.0
Semi-processed goods	-1.5	-1.1	-0.4	+2.2	-	-
Capital goods	-1.4	-1.2	-0.5	+1.6	-	-
Consumer goods	-3.9	-2.6	-1.0	-0.1	-	-
Services	+1.3	+0.8	+1.2	+1.9	+1.8	+1.1
Fi. and Bus. services	+2.8	+1.6	+3.3	+4.3	+0.9	+0.6
Consumer services***	+0.9	-0.4	+0.1	1.4	+0.5	+0.2
Non-consumer services	+0.8	+1.2	+0.9	+1.1	+0.4	+0.3

Sources: Bundesbank, Destatis

\* H1 2007 in comparison with the same period for the previous year. \*\* Most recent available figures Q2 2007

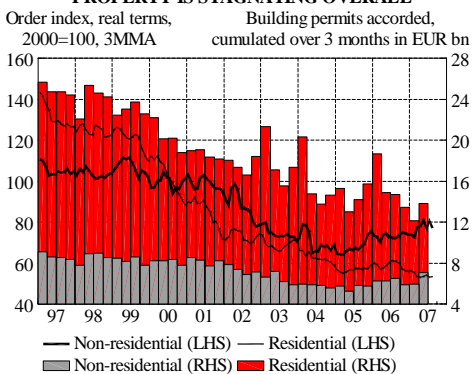
\*\*\* Retail, hotels and restaurants, transport, communications and personal services

#### Sector by sector, trends are mostly unchanged

## The construction sector has moved from being an area of job losses to neutral.

The construction sector was subject to a long period of recession from 1995 to 2005. This had a significant impact on growth and on the job market. The total number of employees fell by almost 1.07 million, or 33%, over ten years. Since the third quarter of 2006, the job market in this sector has been up. Taking the first two quarters together in order to cancel out variations resulting from the particularly warm winter, the jobs total progressed greatly in the first two quarters (+4.1% yoy). Salaried work has however dropped sharply since April, which does not augur well. Indeed, the construction sector is going to return to a situation of stagnation after a brief recovery in 2006.

#### PROPERTY IS STAGNATING OVERALL



Residential property is suffering from the fact that aid measures to help people accede to ownership are coming to an end, as well as

the increase in VAT, leading to a temporary surplus in housing starts. Household debt (96% of disposable income in 2006) and empty housing stocks also remain high, bringing rental prices down in a country where house ownership is traditionally low (only 42% in 2002).

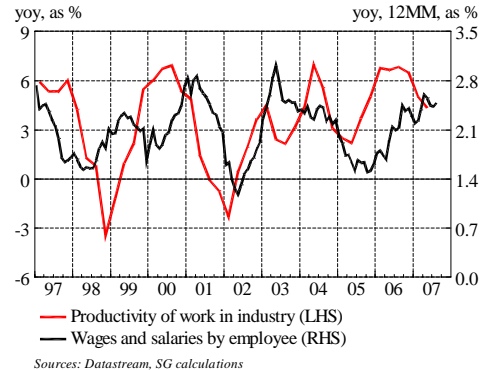
In contrast, the outlook for the non-residential market is more favourable, particularly in the office sector where demand is currently strong. Vacancy levels, still high however, will come down slowly in terms of available space and this will limit pressure on rents. Lastly, the financial crisis and the increase in the cost of risk means significantly tougher lending conditions. Thus, the non-residential sector is only likely to bring about a levelling off in terms of the construction sector overall.

The construction sector will not provide a great source of jobs in the medium term but a return to the losses seen between 2002 and 2005 would seem to be out of the question.

## Industry will continue to opt for productivity over job creation.

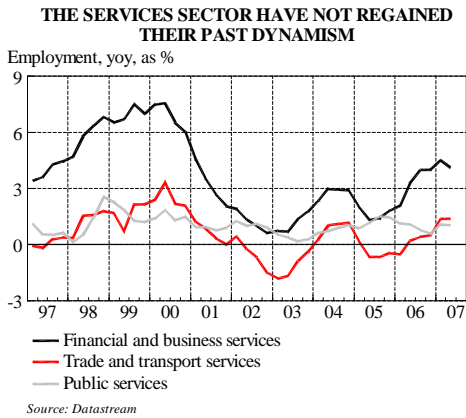
Jobs in the manufacturing sector also showed improvement in the fourth quarter of 2006 and the first quarter of 2007, but suffered a setback in the second quarter, stagnating in terms of job creations. In fact, although the job market in the capital and intermediate goods industries has been progressing since the end of 2006, reaching +2.4% and +2.6% yoy in July, the consumer goods sector is struggling. After a rapid rise at the beginning of this year, the job market then tailed off in February for perishable goods and in May for non-perishables. In July, employment was down 0.3% in both sectors. The impressive performances in the capital and intermediate goods sectors are a result of improvements in industrial production and exports, linked to high overseas demand and a boom in productive investment. The consumer goods sector has not been subject to the same developments.

#### FALLING PRODUCTIVITY AND RISING WAGES IN INDUSTRY (EXCL. CONSTR.)



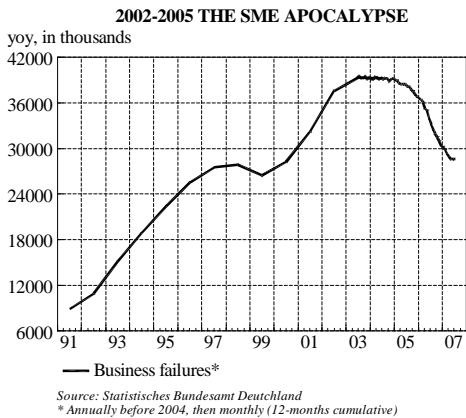
In the short term, current trends are going to continue. However the underlying trends in manufacturing industry remain unfavourable for jobs. Indeed, in order to regain price competitiveness in the face of increasing staff costs resulting from reunification and in order to compete with emerging countries, German firms have had to combine improvements in productivity with controls on staff costs and a reorganisation of production lines, notably with relocations to Eastern Europe. However, salary negotiations in the metallurgy and electronics sectors, which set the tone for salary developments in other industrial sectors, have resulted in substantial wage increases (around +3% yoy). Gains in productivity are also down as a result of the downturn in exports, there being a strong correlation between the two variables. Lastly, uncertainties resulting from the financial crisis are likely to encourage a certain amount of circumspection in exporting industries. In conclusion, new jobs in industry reached a peak in terms of the economic cycle at the beginning of 2007. Employment will now return to its downward trend in the sector.

## In the service sector, the job market is less dynamic



Over the last ten years, the service sector has contributed most strongly to the job market. In the current cycle of economic expansion, as in the period 1998-2000, virtually all job creation has been from the service sector. Employment growth has, however, been poor since 2006 compared to the previous period of expansion. The elasticity of the job market to growth in the real value added (VA) of market services<sup>1</sup> was indeed +0.6 between the first quarter of 2006 and the second quarter of 2007, as against +1.2 between 1998 and 2000<sup>2</sup>. Also, the contrast between the dynamism of the job market in business and financial services and the relative lack of movement in other business services (retail, hotels and restaurants, personal services), has shown a marked contrast to the previous period of growth.

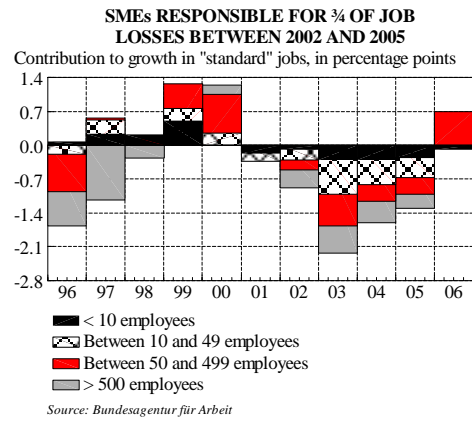
#### SME strike back



Firms of less than 500 employees (the *Mittelstand*) make up virtually all firms (99.7% in 2003) and the great majority of jobs (70%). In particular, large SMEs (companies with between 100 and 500 employees) represent ¼ of all jobs, a larger share than for firms of more than 500 employees. The financial situation of these firms worsened throughout the 1990s (drop in profits, worsening debt) because of over-exposure to internal demand, much larger than for bigger groups, particularly in the construction, distribution and business services sectors, where structures are more fragmented (high proportion of firms with less than 10 employees). Their difficulties culminated in a record number of business failures between 2003 and 2005 (around 39,300 per year in 2003 and 2004). SMEs were thus at the heart of the very high contraction in numbers of "standard" contracts.

<sup>1</sup> Ratio of variation in employment in market services over variation in the real VA in market services.

<sup>2</sup> For a growth of 1% in real VA of market services in a quarter in comparison with the same quarter of the previous year, employment was up by 0.6% between Q1 2006 and Q2 2007 and 1.2% between 1998 and 2000.



This recessionary period for SMEs was nevertheless accompanied by the elimination of less productive firms as well as significant restructuring and control of costs (partial transfer of production to Eastern Europe, wages freeze) and financial housekeeping (reduction in debt, improvements in profitability)<sup>3</sup>. This allowed the SMEs to benefit fully from the period of economic expansion, even if household consumption has not properly picked up. Job creation in 2006 was thus largely up in large SMEs (50 to 499 employees). Recruitment intentions are, moreover, once again posting high levels. The slowdown in activity is, naturally, going to result in a recruitment slowdown, above all in industry, but a return to the difficult situation of 2002-2005 would seem out of the question. Business should also benefit from increases in household consumption.



#### The results of job market reforms are disappointing

The main measures of the Hartz reforms between 2003 and 2005 were to create low-paid jobs and toughen conditions of access to employment insurance allocations (reduction in amounts and period of payments, stronger sanctions, etc.). This was an attempt to stimulate the unqualified services sector, where the cost of employing staff is an obstacle, and to remove the "benefits trap" by encouraging the long-term unemployed back into work. The sector where most jobs were created was in Mini-jobs (remuneration of less than EUR 400; jobs exonerated from full social security contributions) and Midi-jobs (remuneration between EUR 400 and 800; jobs treated like those subject to full social security contributions).

<sup>3</sup> Bundesbank, "The economic situation of small and medium-sized enterprises in Germany since 1997", Monthly Report, December 2006, p. 35-66.

**"HARTZ" JOBS HAVE LIMITED SUCCESS**

	Average annual contribution to change in employment (as %)			% of total employment 2006
	2004	2005	2006	
<b>Total employment</b>	<b>+0.4</b>	<b>-0.1</b>	<b>+0.6</b>	<b>100</b>
Jobs subject to full social security contributions (not including <i>mini-jobs</i> )	-1.4	-1.4	+0.2	64.9
<i>Midi-jobs</i>	+0.2	+0.4	+0.5	2.6
<i>Mini-jobs</i> (not including extra jobs)	+1.1	+0.0	+0.1	12.4
<i>Extra jobs (Nebenjobs)</i>	+1.0	+0.2	+0.3	4.9

Sources: Bundesagentur für Arbeit, SG

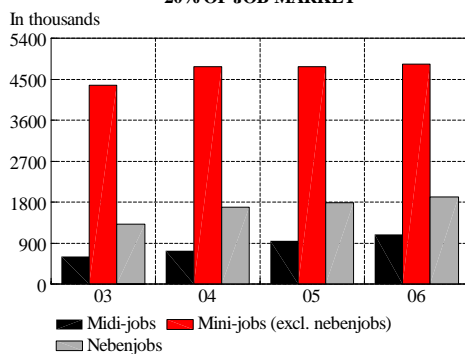
Looking at the results since 2005, the impact of the reforms seems mixed:

€# After the first wave in 2003 and 2004, growth of *Mini-jobs* has been erratic, marked by a short-lived boom before the football World Cup and a recovery since spring 2007. This category of contract would seem to be linked to periods of economic uncertainty and a wait-and-see policy by employers. Contribution to job creation since 2005 is very slight overall;

€# As we saw above, the demand for unskilled labourers during this period of growth has been less than over the period from 1998 to 2000: The elasticity of the job market to growth in the PV volume of market services, not including financial and business services, was 0.6 in this period as against 0.2 between Q1 2006 and Q2 2007;

€# Numbers of extra jobs (*Nebenjobs*) with remuneration of less than EUR 400 continue to increase rapidly (+8.1% in 2006). These jobs, done by people with another job elsewhere, have a negative impact on employment of the unskilled unemployed.

€# The *midi-jobs* category has shown far more dynamism than the other types of contract (+28.9% and +14.8% respectively in 2005 2006). In spite of its weak weighting (2.6% of total employment), it is a significant contributor to job creations and, seemingly, was a big factor in the rapid progress in "standard" employment in the first half of 2007.

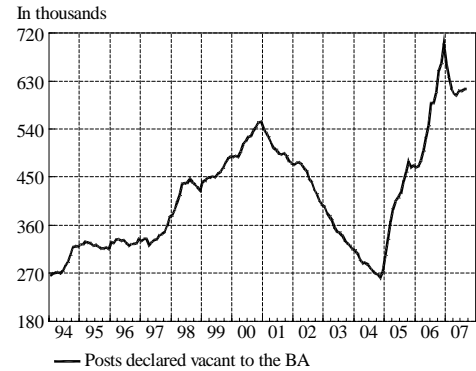
**"HARTZ" JOBS MAKE UP ALMOST 20% OF JOB MARKET**

Source: Bundesagentur für Arbeit

In fact, only the Hartz *Midi-jobs* have generated sustained interest from employers. On the whole, these jobs fulfill the objectives of the reforms. They are mainly concentrated in the service sector, in unqualified jobs, 75% of them are done by women and most are part time (59% of the total in 2006, 69% of female employment). In contrast, *Mini-jobs*, although representing 12.4% of total employment in 2006, almost 5 times more than *Midi-jobs*, do not contribute significantly to job creation and seem to have a negative effect on employment via casual jobs. These very poorly remunerated jobs seem then to correspond less well to demand in sectors requiring a lot of unskilled labourers.

The second major objective of the Hartz reforms is to reduce long-term unemployment. Since 2005, the positive developments on the job market have also had an impact here, the number of those

unemployed for more than 12 months dropping by 1.7% between Q1 2005 and Q2 2007, to reach 1.99 million people. Over the same period, the total reduction in unemployed was 24.2% and the fall in those who have been unemployed for less than 12 months was 37%. The figure for those unemployed for more than two years increased by 8%, with this category now representing almost ¼ of all unemployed, as against less than 16% at the beginning of 2005. This contrasts with the period 1998-2000, when the reduction in unemployment was more marked for the long-term unemployed.

**VACANCIES AT A PEAK**

Source: Bundesagentur für Arbeit

In spite of the still high levels of long-term unemployed, vacancies declared to the Bundesagentur für Arbeit, have levelled off at something over 600,000 posts this year (615,000 posts vacant in August) after exploding in 2005 and 2006. When you add data collected from recruitment agencies to these figures, vacancies in July were not far off the million mark, 80% of which were for "standard" contracts. This underlines the strong disparity between supply and demand in Germany.

According to a report published by the Ministry of the Economy, recruitment problems are mainly concentrated around qualified jobs (above all in science and technology) and in industry (construction of machine tools, electrical engineering, car construction). The cost to the German economy is estimated at around 1% of GDP each year. Faced with the lack of qualified people on the job market, the government has taken measures to target the immigration of qualified workers from Eastern Europe, even though this represents a limited source.

The current bright period in the job market does not therefore appear to be the result of any fundamental improvement. Sector by sector, major trends remain unfavourable to employment and the performance of the main contributor to employment, the service sector, is well below its performance in the previous period of growth. Moreover, the Hartz laws have only had a limited effect on unskilled employment and little at all on long-term unemployment. The German job market is still characterised by a strong disparity between supply and demand.

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