Macro Comment 10/01

Shahin Kamalodin

Demystifying the German labor market

The astonishing resilience of the German labor market has caught everyone by surprise. But this is mostly due to the government's short-shift scheme and creative statistics, among other things. The question is, therefore, will the labor market deteriorate in 2010? The answer is yes if the global economic recovery remains anemic going forward, which is our baseline scenario.

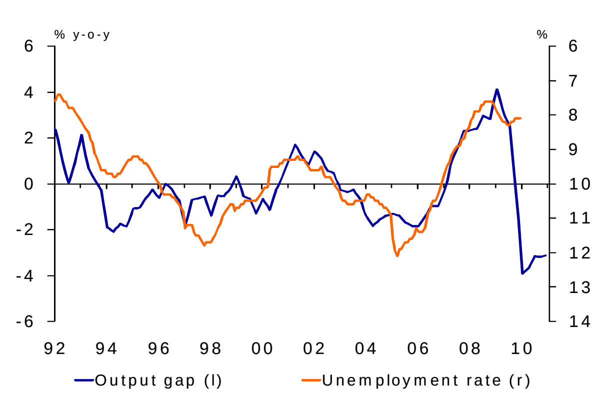
The increase in German unemployment amid the huge drop in output since late last year has caused quite a confusion amongst market participants – with good reason. The rate of unemployment has increased by 'only' 0.5 percentage points since its trough at the end of 2008 to 8.1% in December while the output gap has widened to levels not seen since the second world war (see figure 1). So this brings us to two important questions.

1. What has caused the German labor market to decouple from the economy?

The answer is not so straightforward. Part of the reason for this development is the German firms' bad memories of the skills shortage they faced in 2006-07, which was caused by premature lay-offs in the recession of 2002-03. This experience now creates an incentive for the companies to hoard labour as much as they can afford in the hope of being better prepared for sunnier days. Of course, the government's short-shift (*kurzarbeit*) scheme gave the firms a helping hand. Under this scheme, the government pays up to 67% of a worker's lost wage if firms show that they need to cut back their hours due to waning demand. The period of time during which companies can take advantage of the scheme has gradually been raised from 12-18 months in November 2008 to 24 months from July 2009. The newly extended scheme was supposed to run out at the end of 2010 but the deadline was postponed again. For that matter, German firms can still apply for the subsidy until the end of 2010, for a period of 12-18 months. From 2011 onwards, the old 6 month scheme will apply. The *kurzarbeit* scheme has been perceived by many as being highly successful in preventing companies from aggressively slashing their workforce. This is obviously the case as the number of workers joining the scheme skyrocketed from around 50,000 in September 2008 to 1.53 million in May 2009 – a 30-fold increase within nine months (see figure 2). The latest figure available suggests that the number of short-time workers has dropped to 1.07 million in September although this improvement is due to seasonality. The increase in the number of new applications from firms for short-time work to around 150,000 in November-December from roughly 100,000 per month since mid-2009 also suggests that this drop will be a temporary phenomenon. Although this is still a far cry from the 700,000 applications the labour agency received in February 2009.

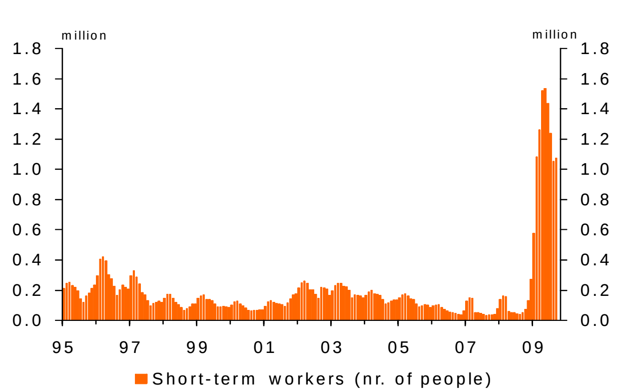
But to really understand how useful this scheme was, we need to determine how high unemployment would have been if it did not exist. Through a rough, back-of-the-envelope calculation, we can provide an estimate of the distortionary effect of this scheme. Assuming that around one-third of the employees that were placed

Figure 1: Labor market decouples



Source: OECD, Reuters EcoWin

Figure 2: Long live the short-shift scheme



Source: Reuters EcoWin

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on this scheme would have been fired, we estimate that the rate of unemployment would be around 9% in September 2009 (see figure 3). This estimate corresponds with the findings of the German Federal Labour Agency (BA). According to the BA, the short-shift scheme has led to an average cut of 30.2% in work time of those affected, which is equal to 336,000 full-time jobs as of Sept. 2009. In other words, if all those jobs would *not be needed* then the “adjusted” rate of unemployment in September would be again 9%. Thus, the rate of unemployment in both hypothetical scenarios would be 0.8 percentage points higher in September in comparison to the official estimate if there was no *kurzarbeit* scheme.

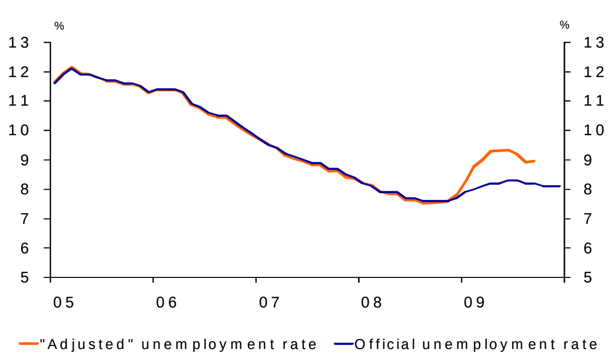
Other less distortionary factors were also at play in keeping the unemployment rate in check. In May 2009, the statistical office (Destatis) made an important change in its statistical methodology that dampens the official unemployment by about 15,000-20,000 per month until April 2010. According to this new rule, all people who are looking for a job through private agencies are no longer counted as unemployed. The government has also increased the provision of publicly funded "1 euro” jobs – which pays between EUR 1 and EUR 2 per hour on top of unemployment benefits.

The final reason why unemployment has remained roughly stable in the past couple of months is that many discouraged workers are exiting the labor force instead of joining the jobless pool. This is very much evident from the continuous drop of employment, which has dropped by an average 17,000 per month since it reached its cyclical peak in October 2008.

2. Can the labor market defy economic gravity forever?

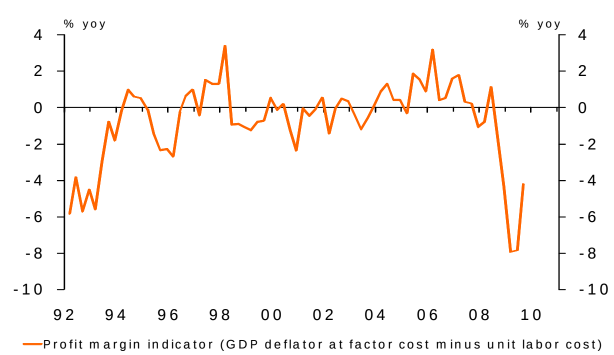
No. The surge in unit labor costs (5.07% y-o-y in 09Q3) will greatly squeeze companies’ profit margins. This fact combined with tighter credit conditions means that either final demand (both domestically and internationally) needs to recover strongly, or firms will need to slash jobs/wages in order to avoid filing for bankruptcy. In brief, something’s got to give. Given that we do not envisage a robust V-shaped recovery for the global economy (i.e. unit labor costs will remain high), more jobs need to be shed in the future if the German firms wish to retain their competitive status in the global marketplace. This is because cutting wages amid strong resistance from labor unions is at best limited. That said, it’s also important to note that the labor market will not deteriorate as much as economists feared only a few months ago. With the benefit of hindsight, we know that part of the sudden collapse in output was due to the producers’ fear of an end-of-the-world scenario in the aftermath of Lehman’s bankruptcy. Thus, the temporary nature of this panic meant that many jobs were saved with good reason. However, this does not mean that the government should subsidize all jobs until the economic recovery is secured because this will prevent the necessary adjustments needed in a dynamic economy. In times of crisis, many jobs will be lost permanently and workers need to find employment in new industries.

Figure 3: The “adjusted” unemployment rate



Source: Rabobank, Reuters EcoWin

Figure 4: Profit margins under pressure



Source: Rabobank, Reuters EcoWin

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