Crisis Analysis and Recommendations
The German Labour Market Miracle on the Test Block

Orders stagnate, exports collapse and companies go into insolvency – but the German labour market is showing itself to be robust. A small miracle. Yet if one looks closer, risks become apparent. So, how will things go on from here? What large and small screws must be adjusted if the labour market is to survive the economic crash as well as possible?

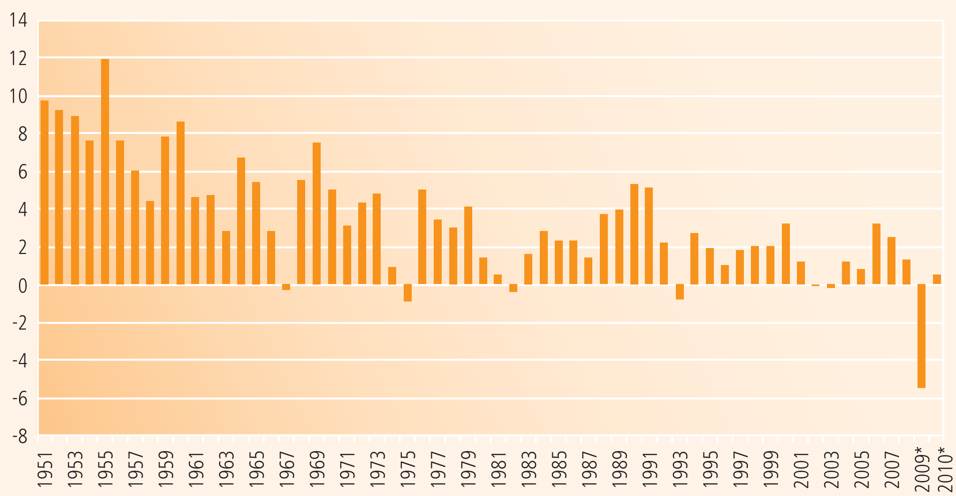
Real gross domestic product (GDP) has only contracted five times before in the 60-year history of the Federal Republic of Germany: during the 1967 recession, at the time of the two oil-price crises in 1975 and 1982, during the adjustment crisis in the 1990s after German reunification and in the year 2003 when, after the dotcom bubble burst, the after-effects of the terror attacks on the World Trade Center in New York accelerated the decline of the world economy even further. Against the collapse in GDP of 5 to 6 per cent that was to be expected for 2009, these crises in economic development, each of which was linked to a massive rise in unemployment and in part to serious socio-political distortions, appeared like a mild breeze (see Figure 1).

The situation does not appear as dramatic when, instead of yearly growth rates, deviations from trends in real GDP are considered (see Figure 2 on page 7). According to this, the two oil-price crises were each linked to a collapse relative to the development trend of 2 to 3 per cent. The adjustment

Figure 1

Growth rates of real gross domestic product 1950 to 2010

In per cent



Note: * estimated

Source: Federal Statistical Office ©IAB

crisis in the wake of reunification in the 1990s and the recession year of 2003 now appeared clearly weaker with a deviation from trend of about 1 per cent; the crisis of 1967 at 4.5 per cent below the long-term trend far stronger. The world recession of 2009 similarly leads one to expect a cyclic deviation of up to 4.5 per cent below the long-term trend. Be that as it may however, the abruptness with which GDP collapsed at the end of 2008 and the beginning of 2009 exceeds all that has gone before.

The shockwave reverberating from this world recession is without doubt enormous. Germany as a country strongly dependent upon exports has been especially hard hit by the breakdown of demand on the world markets. After Japan, our national economy is having to deal with the most massive drop in real GDP of all the largest OECD countries.

The labour market miracle in detail

This is why it is all the more remarkable that the German labour market – even a year after the crisis erupted – is showing itself to be surprisingly robust. The tendency is to talk of a "German miracle". But as miracles require explanations, several questions naturally arise: Why has unemployment risen here much less than in other countries, such as Spain, Denmark, the United Kingdom or the USA, although GDP declined distinctly less there? What role did labour market regulations play, and what role labour market policies? Will employment be subject to more negative effects in the further course of the crisis?

To find an answer to these questions it is first helpful to break GDP growth up into its main components. From a macroeconomic perspective more output can be produced if more people are in employment, if the annual working time per person increases or if the output per hour grows. The GDP growth rate is thus the sum of the rates of change in employment, annual working time, and hourly productivity. If GDP does not grow but rather shrinks, then this applies likewise but with the reverse sign. When one compares the average

Table 1

Components of GDP and changes in overall employment

Average values first half-year 2008 and first half-year 2009

	Rate of change	Effect on the number of persons in overall employment (-: burden, +: relief)	
	in per cent	in per cent	in thousand persons
GDP (1)	-6.8	-6.8	-2,704
Long-term trend of output per hour (2)	+1.3	-1.3	-519
Sum of (1) + (2)		-8.1	-3,223
Cyclic deviation from long-term trend of output per hour (3)	-3.7	+3.7	+1,462
Working time (4)	-4.6	+4.6	+1,845
Balance (1) + (2) + (3) +(4)		**0.2**	**84**

Aid to reading: If GDP declines by 6.8 per cent and output per hour increases at its trend rate (1.3 per cent), this would result in terms of figures in a drop in the number of persons in employment by 8.1 per cent. In actual fact, output per hour fell by 2.3 per cent (measured against the long-term trend of 3.7 percent). Together with the decline in working time at the level of 4.6 per cent this means that the number of persons in employment actually rose by 0.2 per cent, or 84,000 persons, despite the economic collapse.

Source: Own calculations, Destatis and IAB database ©IAB

values for the first two half-years of 2008 and 2009, then German GDP has fallen by 6.8 per cent according to national accounts. With roughly 40 million persons in the active labour force in Germany one would normally expect with such a decline in real GDP a minus of around 2.7 million persons in employment – presupposing there are no changes in working time and no changes in hourly output (see Table 1). If one assumed that the output per hour did not remain constant but grew by roughly 1.3 per cent per year in accordance with its trend rate, the balance would look even less favourable as this would correspond to an additional drop in the number of persons in employment of a good half-million. In total, and in terms of figures, this would result in the enormous sum of 3.2 million employed persons (or 8 per cent of all persons in employment) who would no longer be needed under the current economic crisis. In actual fact, however, neither the overall level of total employment nor employment subject to social security contributions sank within this period.

The explanation of the "German miracle"

Luckily there are mechanisms available that ensure that such a gigantic wave of job destruction does not take place. Typically both the working time and output per hour drop in a recession, for instance. Companies are able to adjust to reduced demand for their products not only by having fewer employees but also by a deliberate underutilization of their workforce. The latter is often termed "labour hoarding". Labour hoarding is an important buffer to cushion the effects that a recession has on employees and thus also a central component of flexibility within the individual establishment. It stands in contrast to external flexibility by means of dismissals for example, or the use of hired labour through temporary work agencies.

Hoarding labour takes place on the one hand through the reduction of working time with the help of cutbacks in overtime, resetting the balances on working time accounts, and short-time work. On the other, companies also decrease the intensity of the work during the remaining working time. For example, employees undertake machine and plant maintenance, training and other activities not immediately relevant for production. This is reflected in a reduction in the (measured) output per working hour. According to the statistics, the macroeconomic output per hour of the first two half-years of 2008 and 2009 fell by 2.3 per cent. Measured against the long-term growth trend of 1.3 per cent, output per hour had dropped by 3.7 per cent – a sizeable effect which, in terms of figures, safeguarded the employment of near to 1.5 million people. Added to this is the impact of reduced working time at the level of 4.6 per cent, which is equal to a good 1.8 million persons in employment. Here subsidized short-time work only plays a minor role. In this way the average number of short-time workers at the end of the first quarter lay near to 814,000 persons higher than in the first quarter of 2008. Based on an average loss of work of 35 to 40 per cent this corresponds to 285,000 to 325,000 full-time employees. As some of the short-time workers are employed on a part-time basis, the effect of short-time work on the employed persons is likely to have amounted to 300,000 to 350,000 in terms of figures.

In short, it can be maintained that the robustness of the German labour market can be explained by an intensified hoarding of the labour force, namely a good 3.2 million persons in relationship to persons in employment and a good 2.2 million in relation to employees subject to social security contributions. To formulate it more pointedly: in the first half of 2009 Germany had roughly 3.2 million more persons in employment than it actually required. There has never before been such an underutilization of the labour force in Germany.

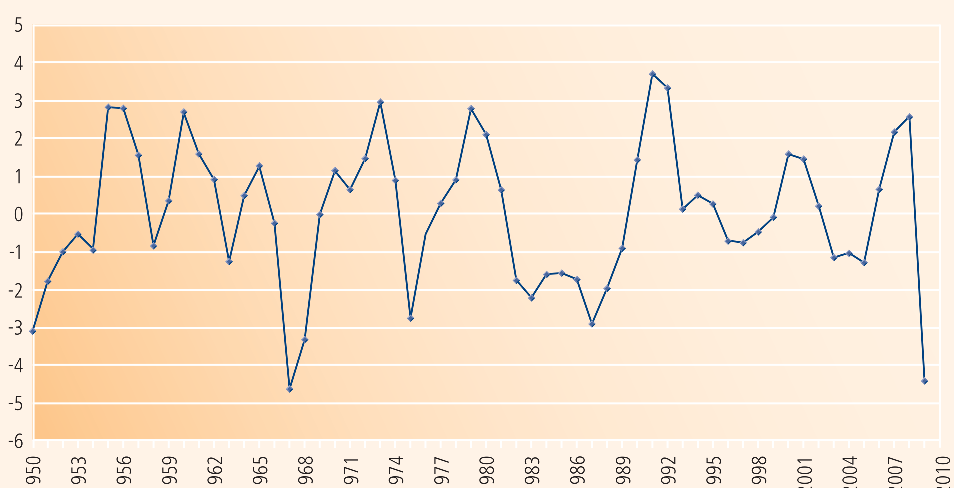
The reasons for hoarding labour

Why have companies hoarded labour to such an extent? One reason might be that the massive collapse in the economy came quite unexpectedly and employment could not be adjusted from one day to the next because of institutional barriers such as employment protection. The lion's share of the labour hoarding stems from a deliberate decision on the part of companies, however. For many companies, their regular workforce well-acquainted with their tasks and with an abundance of know-how related to their specific works or location are the most important capital. Such capital is not given up easily, but rather one attempts to retain it. Many companies can still clearly remember how hard it was to recruit highly qualified specialized workers towards the end of the last upswing. At the same time they are becoming increasingly aware of the fact that on account of the economic development the younger generations will not be able to

Figure 2

Trend deviation from real gross domestic product 1950 to 2009

in per cent



Note: The determination of trend takes place by means of a Hodrick-Prescott filter ($\lambda = 100$). 2009 on the basis of GDP estimated values.

Source: Own calculations with data from Destatis ©IAB compensate for older employees retiring from work. But flexibility within individual establishments is not to be had for free by companies during the crisis; it will only be used as long as the expected cost of recruiting new staff during the next upswing is higher than the costs of employees. When companies hang on to their workforce, unit labour costs nevertheless increase on account of low hourly productivity. As a result, economic viability and competitiveness suffer noticeably. It is similar when short-time work is utilized: while no direct wage costs are incurred for the loss of work, various additional wage costs, the so-called "remaining costs", are incurred.

As rising unit labour costs cannot simply be tagged onto the price in times of economic weakness, financial pressure grows with the duration of the crisis. Companies will therefore only hoard their labour force beyond a short initial phase if they view their market prospects in the medium term as good and have a certain financial bolster at their disposal. Both are probably the case with a large section of the companies affected. The crisis of 2009 especially hit export-dependent establishments in the manufacturing industry in economically prospering regions. As a rule it was a question of establishments that were strongly orientated to technology, ones which had earned well over the last years and had products with a future at their disposal. The fact that it is sensible to retain the core workforce when there is temporarily less demand is obvious. However, if the point of upturn is a long time in coming, the pain threshold will be reached sooner or later.

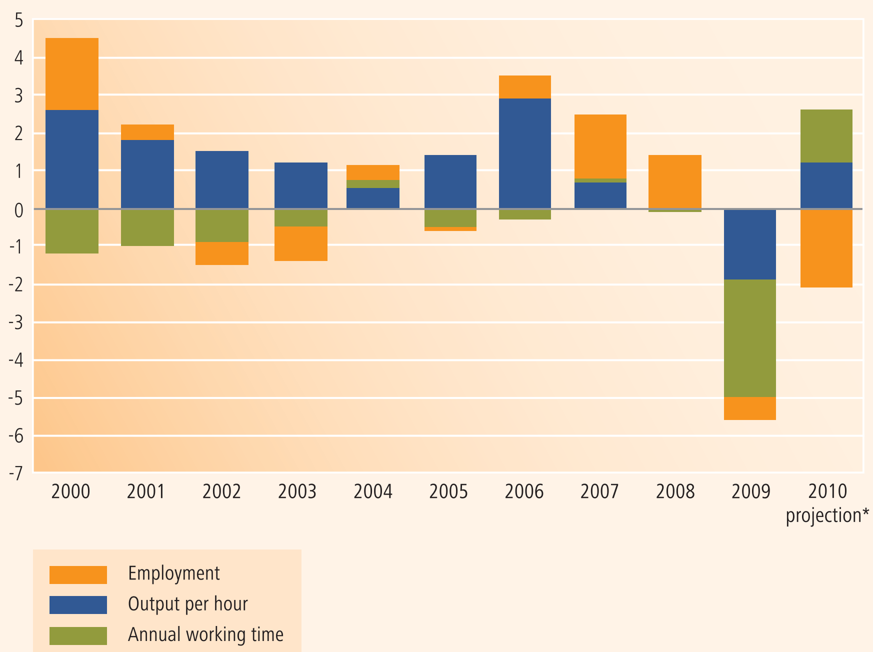
Overall developments 2009

It seems very unlikely that labour force hoarding to the extent mentioned above will be sustained. In order to approximate output per hour to normal values once more, companies whose sales do not recover in the foreseeable future will reduce their workforce. No new staff will be recruited. Dismissals due to circumstances within the establishment themselves will take place increasingly. Despite this negative development, the cushioning of the macroeconomic shock

Figure 3

Components of GDP development 2000 to 2010

in per cent



Note: medium variant of the IAB projection for 2010 assuming a growth in real GDP of +0.5 %.

Quelle: Destatis, Federal Employment Agency, own IAB calculations.

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will nevertheless still function comparatively well, seen over 2009 as a whole.

The IAB projections of mid-September 2009 for the whole of the current year make it clear that the greatest part of the decline in real GDP of 5.5 per cent that was to be expected has been able to be absorbed by flexibility at the establishment level. On balance, employment will fall by only 0.4 per cent which corresponds to a decline of 160,000 persons (see Figure 3 on page 8). When one considers the components of GDP development over the context of time, the special characteristics of the crisis year 2009 stand out very clearly once more.

The collapse as of 2010

A further deterioration in the labour market in the coming year is only to be prevented if the flexibility measures within establishments can be upheld for the most part or become obsolete through very strong economic growth. From where we stand now, both seem unlikely. Due to the high export-dependency of the German economy, strong economic growth would presuppose that the world economy recovers. This would have to take place speedily and be so strong that it balanced out the massive collapse suffered. Even if there are gradually more and more signs that the bottom of the recession has been reached and that there is obviously a reversal in trend towards hope of improvement – up to now little suggests that there will be a renewed upswing of similar speed and strength to the recession. Without a clear signal that the order books are going to normalize soon, strategies of flexibility at the establishment level will meet their limitations more and more often. The strain of profitability and of competition on companies will be so strong that a good many will react with dismissals. How severely the labour market will indeed collapse next year therefore not only depends on how far real GDP has actually fallen this year; what is also decisive is how long the recovery process will last and what structural distortions it is accompanied by. Both on the micro- and on macroeconomic level, uncertainty about this is high.

There has been great speculation over the last months on the course of the economic recovery process. The discussion revolves around letters of the alphabet which are intended to symbolise the possible developments. The debate is dominated by V, W, L and U. Although almost nothing can really be excluded, V – with a rapid crash, brief bottoming out and a steep climb – and L – with an even steeper crash, fairly long bottoming out and a certain upswing – are unlikely. In view of the world economy that is apparently only recovering slowly, V is hardly a relevant perspective anymore. L would presuppose that it would not be possible to leave the bottom reached after the great crash for a long time. However the somewhat improving business expectations, not only in this country, contradict such a scenario. W and U are a little more likely because in each case one is reckoning with a recovery process that has a time lag and because temporary setbacks, for instance after the expiry of worldwide programmes in support of the economy, are by all means possible. We consider an asymmetric course which we cannot represent with the said letters as the most likely one: a downright crash followed by a cautious improvement – something like a deformed root sign:

Along with the question of how quickly the economy will find its feet again, it is of central importance whether – and to what extent – the major economic crisis will be followed by a need for structural adjustment. The highly competitive nature of and the strong position on the market enjoyed by German export industry before the crisis could well prove to be an advantage in the wake of recovery if the product portfolio of German industry were to meet with increased world demand once more. In the mid- to long term it seems indeed plausible that the global hunger for capital goods prompted by the need to modernize in up-and-coming economies could get key areas of the German export sector, such as engineering and plant construction, going again.

It is at the same time however debatable to what extent the worldwide programmes aimed at reviving the economy will change the spectrum of demand, at least in the short term. For instance, the infrastructural measures that are frequently supported tend as a rule to strengthen the construction sector while hardly benefiting the engineering and plant construction sector. Likewise the car scrappage premium, which has been introduced in a number of countries, tends to help manufacturers of small cars and not the premium segment of the market.

Further prospects

It is highly likely that the progress made on the labour market between 2005 and 2008 will to a considerable extent be cancelled out by the crisis. In other words, the world recession will be hitting the German labour with a certain time delay – but nevertheless very hard. The forecasts currently available for the economic development in 2010 are at least assuming that there will be slight economic growth. Some banks are even more optimistic. Nonetheless: On account of the normalisation of productivity and working time that is to be expected, a strong drop in employment is to be reckoned with next year. With economic growth of 0.5 per cent, this will amount to a reduction in employment of 2.1 per cent according to IAB's most recent projections; that corresponds to 827,000 persons. In addition to this, what is foreseeable for the near future is that even in the case of an economic recovery – which is anything but certain at the moment – progress in building up employment in the following years will only take place very slowly. It can be presumed that the severe collapse of the economy will be followed by a phase of "jobless growth" in which companies first dismantle the productivity and working time buffer. What that means, though, is the following: A sweeping improvement in the situation on the labour market will only be realistic if 2010 is followed by a number of years of solid economic development.

At the same time a certain relaxation will ensue from the consequence of demographic change. A drop in the number of workers available over the next few years will allow unemployment to decrease even if the development in employment is slight. Yet demographic change also entails risks: without increased educational policy efforts by all involved, there will be the threat of acute bottlenecks in the recruitment of specialized workers, which could in turn threaten the foundations of future growth in a massive way.

The possibilities of adopting countermeasures

When political answers are sought for the presumably sharply growing labour market problems resulting from the crisis there are unfortunately no patent remedies. A cure-all with a strong and quick impact does not exist. Labour market policies can cushion the effects of the world recession, they can accompany adjustment processes and can set the right incentives; however, through labour market instruments alone, no glaring imbalance between the number of jobs and job-seekers can be eliminated. This certainly does not mean making a case for fatalism because, of course, „adjustment screws" – underpinned by research findings – can be identified and these can change the development of the labour market sustainably in a positive or negative way. First, however, the economic framework conditions must be right. On the one hand, the operativeness of the financial markets must be ensured and on the other it is a question of consequently improving conditions for growth – a type of growth that conserves natural resources as much as possible. It will be especially important to set an economic framework in such a way that in individual establishments – be they already existent or newly set up – promising capacities for the future and employment can be retained and/or extended. This is where labour market policy can provide support on the flanks by contributing with the means at its disposal to meeting the personnel requirements of growing branches and establishments, partially through effective qualification measures and partially by way of professional placement services and advice. At the same time labour market policy can support establishment-level agreements on employment security.

Good labour market policy, however, will be judged on the extent to which it is successful in continuing to do what is right and to avoid the mistakes of the past. The labour market reforms were indeed beneficial, as the distinct improvements in the situation on the labour market between the years 2005 and 2008 have shown. They were partially responsible for the latest upswing on the labour market and will shape the next upswing in a way supportive of employment. That is why it is important to remain on course. In bad times, the temptation is however great to adjust popular screws even if they are wrong. For instance, the extension of the duration of entitlement to unemployment benefit – which was no doubt well meant – would only reinforce persistent unemployment once again. The reintroduction of the similarly popular early retirement measures would also be the wrong signal in a situation in which it is vital to prepare an aging working population for a longer working life. And, finally, the massive and undifferentiated expansion of public employment programmes would endanger the recovery of the regular labour market. Sight must not be lost of the hard core of the unemployed whose competitiveness has been strongly curtailed because of minimal or devalued qualifications. Precisely at times of crisis it is especially difficult to integrate this category of persons. That is why labour market policy must maintain a healthy balance in its portfolio of measures between strongly competitive and competitively weak persons. Where measures to create employment are concerned, it is above all especially important in the coming period to give priority to persons who are under the greatest burden from problems. The reorganization of the low-pay area also gains in importance in this connection. Here income that safeguards one's existence should be strengthened by low taxes and reduction of social insurance contributions for the low paid, intelligent in-work benefit models, and carefully tared minimum wages in combination with wage subsidies dependent upon need. Further "adjustment screws" are education and further training in order to enable people to react in a more flexible way to the labour market. Precisely because the hard core of the unemployed – similarly to the impending lack of specialized workers – represents a long-term challenge for labour market and employment policy, the low wage sector and education remain central themes.

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