



Economic Assessment of the Euro Area

Winter 2015/2016

January 2016

1. Introduction

The Euro Area economy performance in 2015 was in line with expectations in our previous ‘[Economic Assessment of the euro area](#)’ from last January with output growth reaching 1.5 per cent. This increase in GDP was almost double the disappointing performance in 2014 and suggests that the Euro Area is finally beginning to emerge from the post 2010 downturn. Furthermore, this improved performance in 2015 was set against increases in world output of 2.9 per cent – 0.8 per cent less than what was envisaged this time last year.

Table 1: Summary of Key Forecast Indicators for Euro Area

	2015	2016	2017
GDP (% change)	1.5	1.8	1.8
Inflation Rate (Harmonised)	0.1	0.6	1.3
Unemployment Rate	10.9	10.1	9.5
Govt. Balance as % of GDP	-2.0	-1.9	-1.8

2. Global and Euro Area Outlook

The weakness of the emerging economies has been curbing global GDP and trade since last year and is contributing to the deep fall of raw material prices, among which oil prices are below the lows recorded during the 2009 crisis. At the same time, the outlook for the advanced countries has been improving and our projections for the global economy this year and the next point to a moderate acceleration compared with 2015. The federal fund rate hike in December by the US Federal Reserve marked the end of the zero interest rate policy in the US but so far it does not seem to have reduced the uncertainty on financial markets. The US monetary and fiscal policies are going to maintain their support to the economic cycle in the coming quarters. In January 2016 the FED confirmed its cautiousness for more interest rate increases.

Table 2: Summary key forecast indicators for the world economy

	2015	2016	2017
World real GDP (%)	2.9	3.0	3.3
World trade of goods (%)	1.4	2.7	3.0
Brent oil prices (\$/b)	53.2	38.0	45.0
Euro/\$ exchange rate	1.11	1.10	1.10

At the beginning of 2016, the global outlook remains subject to downside risks. The new tensions emerged in China's financial markets at the beginning of this year and the renewed concerns about its domestic growth, matched with the deep recession in Brazil and the prolonged crisis in Russia weight down the expectations on global growth making more difficult for the industrialized countries to shelter from this weakness.

In this context, the euro area economy continued its gradual recovery in 2015 and in the third quarter posted the tenth successive quarter of rising activity. Growth, however, moderated somewhat in the course of the year, from 0.5 percent q-o-q in the first quarter to 0.4 percent in the second quarter to 0.3 percent in the third quarter. While private consumption continued to expand at a robust pace, supported by higher real disposable incomes as a result of lower energy prices and rising employment, investment growth faltered, probably reflecting uncertainties about the economic outlook associated with economic developments abroad but also economic policies in the euro area. At the same time economic sentiment continued improving, suggesting that the upturn is still on track. The latest estimates of the [EUROFRAME-EUROGROWTH Indicator](#) signal robust GDP growth of close to 0.7% in the last quarter of 2015 and 0.5% in the first quarter of 2016.

For 2015 as a whole, GDP growth is likely to reach 1.5 percent, matching [last year's EUROFRAME forecast](#). Differences in the pace of growth were relatively pronounced across countries, with economic momentum particularly high in Ireland, Spain and Slovakia and Austria, Finland and Greece being the laggards. The situation in the labour market continued to improve; employment growth picked up and the unemployment rate decreased by 1 percentage point in the course of the year to 10.5 percent (November).

HICP inflation in 2015 dropped further to zero, down from an already low 0.4 per cent in 2014. The deceleration was, however, solely due to lower energy prices. Consumer price inflation excluding energy actually accelerated during 2015, from 0.4 per cent in January to around 1 per cent at the end of the year. With the oil price having dropped further in recent weeks (see Par. 4), headline inflation is likely to remain depressed in the coming months. On our assumption of oil prices averaging 38 and 45 dollars per barrel (North Sea Brent) this year and next, respectively, we expect the negative impact of energy prices on inflation to gradually fade. Annual average inflation rate is forecast at 0.6 per cent in 2016 and 1.3 per cent in 2017.

Consumer price weakness triggered by gains in terms of trades from lower oil prices does not weigh on demand. On the contrary, it directly supports purchasing power and thus consumption. The European Central Bank (ECB) nevertheless remains concerned about the trend in consumer prices. With HICP inflation having been below the ECB's medium-term target of close to 2 per cent since the beginning of 2013 monetary authorities are afraid of losing credibility such that inflationary expectations could lose their anchor. In response the ECB once again loosened its policy by lowering the interest rate on excess reserves to a negative 0.3 per cent and announcing to extend the duration of its asset purchase programme by 6 months to March 2017. Meanwhile the ECB's Bank Lending Survey indicates that borrowing conditions have eased on aggregate and credit demand has increased, suggesting

that the expansive monetary policy is increasingly starting to have effect. This forecast is based on the assumption that the interest rate will remain close to zero until the second half of 2017. The prospect of persistently low interest rates in the euro area coupled with the expectation of a continuation of the gradual increase of short-term rates in the US that has started in late 2015 has kept downward pressure on the exchange rate. The forecast assumes the dollar/euro exchange rate to be close to 1.1 over the next two years.

Fiscal policy has been less restrictive in 2015 than in the previous two years. The reduction of the consolidated euro area budget deficit from 2.6 to 2 per cent in relation to GDP has been supported by improved growth. The fiscal stance is expected to be close to neutral in 2016 and 2017 and could be even noticeably expansive in some countries, including Germany. While public consumption is expected to remain tightly controlled, the focus has shifted to implementing structural reforms that improve the business environment in some countries, such as France (see box on structural reforms in France). The EU investment plan to stimulate investment, while ambitious, is not expected to actually stimulate substantial additional investment activity.

Based on the assumptions of continued strong monetary stimulus, a competitive exchange rate, the absence of significant fiscal restraint and a persistently lower oil price, we expect the recovery in the Euro Area to continue this year and next. Due to a global environment that lacks momentum (with only moderate growth in the US, continued gradual deceleration in China and other emerging economies in substantial economic difficulties) the pace of expansion will accelerate only slightly, however. Real GDP is forecast to rise by 1.8 per cent in 2016 and 2017, respectively (Table 3). The economic expansion in Europe outside the euro area is forecast to remain robust, with solid growth between 2.5 and 3 per cent in the Central and Eastern European countries (see chapter 3 on CEE outlook). In the euro area domestic demand is expected to be the main driver with robust private consumption supported by rising real incomes reflecting higher employment and the effect of lower energy prices. Investment should continue to expand at the recent moderate pace, supported by improved monetary conditions. External trade is projected to be less supportive for economic growth compared to 2015 as exports are projected to decelerate in response to weak global demand and the fading of the stimulating effects from the strong devaluation of the euro in 2014/15. Unemployment should continue to gradually decline, and the unemployment rate fall to 9.5 per cent in 2017, which is still high by historical standards.

There are a number of risks that could change the outlook for the euro area significantly. There is still uncertainty with respect to the handling of the crises in distressed euro area countries, not only in Greece, and renewed doubts about the sustainability of the approach could again negatively affect financial markets and impair any recovery in investment. Currently the negative repercussions of the drastic fall in commodity prices on commodity producing countries and uncertainty about the economic outlook for China is haunting the markets and threatening to depress economic confidence. Last not least there is uncertainty about the economic impact of the large inflow of refugees into the EU. For the time being the effect on the outlook in the countries most affected is assessed to be positive due to an

associated fiscal stimulus and a rise in the labour force (see box on effect of refugees on the outlook). There is, however, the risk that the apparent inability of European countries to agree on a common approach to the problem and increasing signs of disintegration of the Schengen area as well as the perception the capacity or willingness of communities to acceptably deal with the number of refugees may finally reduce consumer sentiment and weigh on demand.

Table 3 Euro area forecast details

Annual Percentage Change	2013	2014	2015	2016	2017
GDP	-0.2	0.9	1.5	1.8	1.8
Private Consumption	-0.6	0.9	1.6	1.7	1.5
Government Expenditure	0.2	0.8	1.5	1.9	1.5
Total Investments	-2.6	1.3	2.5	2.5	2.9
Total Domestic Demand	-0.6	0.9	1.6	2.0	1.9
Exports of goods and services	2.2	3.9	4.6	3.4	3.5
Imports of goods and services	1.4	4.2	5.1	4.1	3.9
Trade Balance (as % of GDP)	2.1	2.5	3.6	4.2	4.0
Current account balance (as % of GDP)	1.8	2.1	3.6	4.3	4.1
Harmonised Consumer Prices	1.3	0.4	0.1	0.6	1.3
Standardised Unemployment rate (%)	12.0	11.6	10.9	10.1	9.5
Government balance as % of GDP	-3.0	-2.6	-2.0	-1.9	-1.8
Government debt as % of GDP	93.4	94.5	94.1	92.6	91.3

3. Central and Eastern Europe (CEE) outside the Euro Area

Economic growth in the CEE region will remain solid in 2016, around 2.6 per cent. Along with the recovery in the EU, further increases in volumes of trade and investment from Western Europe are expected to be seen in the CEE countries. Economic revival in the region will be fueled by domestic demand (supported by a fiscal easing in countries such as Poland) and exports. We believe Poland (3.5 percent) and Romania (4.0 percent) will be the highest-performing countries, along with the Czech Republic - the country with the lowest unemployment rate (5.0 percent) in the CEE region. Furthermore, in the coming years we foresee a continuation of the trend in the reduction of gross public debts in the Czech Republic, Hungary, and Romania. Expansionary monetary policy and record low interests rates resulting from low inflation pressure (deflation was seen in Poland, Croatia, Romania and Bulgaria in 2015) will remain present at least in the first half of 2016. After that period, moderate increases in the level of prices are expected.

Nevertheless, two factors may retard this positive outlook. The first is the ‘gap’ in the EU funding. The last tranche under the 2007 – 2013 investment cycle has already been disbursed in 2015, and the funds under the next investment cycle (2014-2020), will be available in 2017

at the earliest. Another issue that may shake the output in the region is political uncertainty, which could be exacerbated by the migrant crisis and possible policy responses.

4. Focus on: Shale oil production, low oil prices and economic development in the US, Japan and the Euro Area

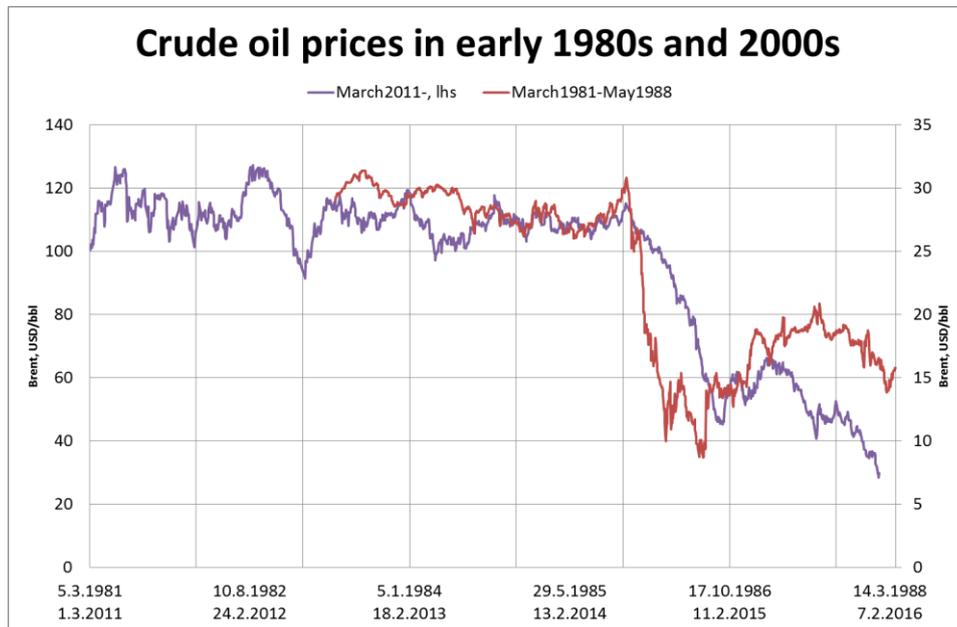
Declining crude oil prices have both continued to depress inflation and strengthen the strong positive impact on fragile economic growth in the industrialised countries since our previous report in January 2015. The price of oil (Brent) has since fluctuated and declined by nearly forty per cent to close to 30 dollars per barrel in January 2016. The magnitude of this further decline has been a surprise. It had been widely expected (The Economist 2014) that oil prices would have stabilised following a reduction in high-cost US shale oil production, which had been one of the key reasons behind the overall oil price decline.

The key reasons for the sharp oil price decline since June 2014 were the easing of the crude oil markets as shale oil and other high-cost production have continued surprisingly robust even with low prices, OPEC production has been growing and growth prospects of Chinese growth deteriorated. The OPEC policy of supporting prices through production cuts ended in November 2014 would have further accelerated price falls. The decision was followed by an increase in OPEC production, which will expand further in 2016, as the embargo on Iran by the US and the EU is suspended.

The production of high-cost producers continued to be rather robust, although oil prices have been drifting well below the break-even levels of most shale oil producers (about 58 USD/bbl on average for WTI by Rystad Energy 2014), however, new investments have declined very rapidly. For example, the number of rigs (which drill the holes for wells) had declined more than 60 per cent by the end of 2015. Pumping from existing wells may, continue as long as the price is above the unit variable costs of the well. Production of shale oil will, however, start falling rapidly in 2016, because production from the shale wells will typically decline by more than half in the first year without new drilling (Mearns 2015) or productivity improvements.

The decisions of OPEC to withdraw from their price stability scheme in November 2014 and abandon their formal quota system in December 2015 were rational choices. The policy change followed after the realization by OPEC and in particular Saudi Arabia that the increase in competitive production was induced by the high prices of the early 2000s (Chojna et al. 2013). The development resembles that in the early 1980s (See picture 1.) when OPEC targeted high and stable prices, which triggered or strengthened production in the North Sea, Alaska and the Soviet Union (Gately, Princeton 2014 1986). Finally, OPEC was forced to abandon price support in 1986 due to a strong decline in market shares and revenues. The

new competitive production equilibrium was here to stay and a long period of low prices followed.



In 2014 OPEC had a choice between three different strategies. First, they could have continued to support oil price by cutting production. This would have decreased both the production and market share, while supporting their high-cost competitors. Second, a wait-and-see policy which would have led to similar, albeit weaker effects. A rise in the shale oil production had made the supply curve (industry cost curve) flatter, which made these policies more costly. OPEC selected the third option by allowing their production to rise in an attempt to force high-cost producers to cut their output and thus to increase OPECs market share at the cost of lower prices and smaller revenues.

Obviously, the risk of even lower prices is high. According to the EIA, the US oil production should decline this year quite strongly, but on the other hand OPEC production is growing at an even faster rate, while the growth of demand for crude oil is expected to slow, which will keep downward pressure on the oil price.

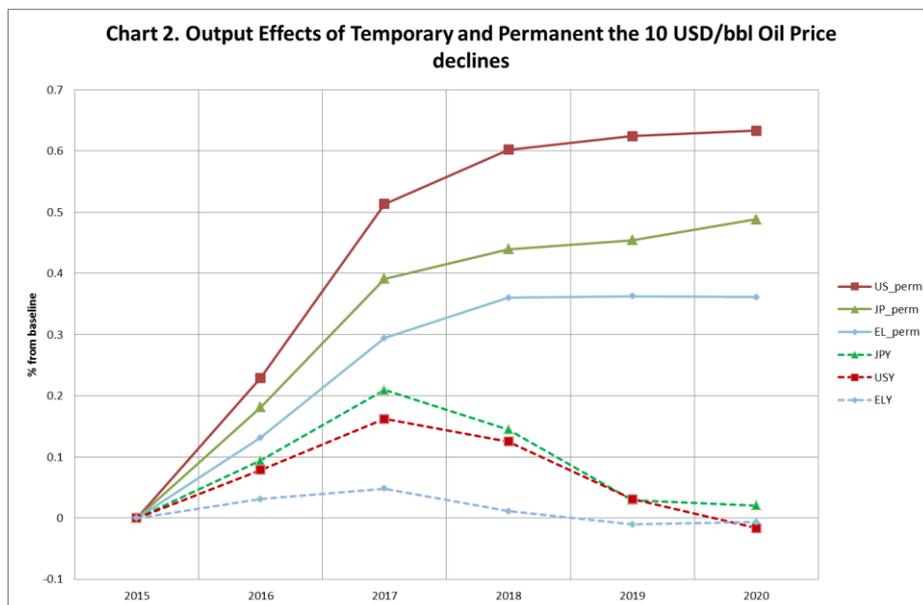
A decline of crude oil may still have significant output and inflation effects

We use the National Institute of Economic and Social Research's structural global econometric model, NIGEM model to study the effect of a further 10 USD/bbl decline in the price of oil due to weaker market balance. The decline of the price is mainly due to a rise in supply dominated by the US¹. (IEA 2015). We run the model with standard assumptions with two different scenarios in order assess the impact of a price decline.

¹ The model does not make any difference with respect to a supply or a demand as a source of a shock nor the size or the sign of the change, which may make a difference (See e.g., EU 2015).

In the model, oil price decline decreases import prices, which in turn depress inflation and improve trade balances in oil-importing countries. Lower inflation among other effects lead to an increase in the real disposable income of households and lowers real long-term interest rates reducing the user cost of capital, which will increase private consumption and investments, respectively. Central banks follow a simple rule in which they will adjust their policy rate in order to close any gap that exists between the targets for nominal GDP and inflation and the actual series.

Intervention interest rates are the key policy variables, which transfer the effects of an oil price shock to the real economy. In simulation the results are restricted by the “zero-lower-bound” on the policy rates of many central banks. The zero-lower-bound restricts the ability of central banks to react to deviations from their targets, which could dampen the effects on output as a result of the shock, especially in cases of the Euro Area and Japan, where the rates are very close to zero.

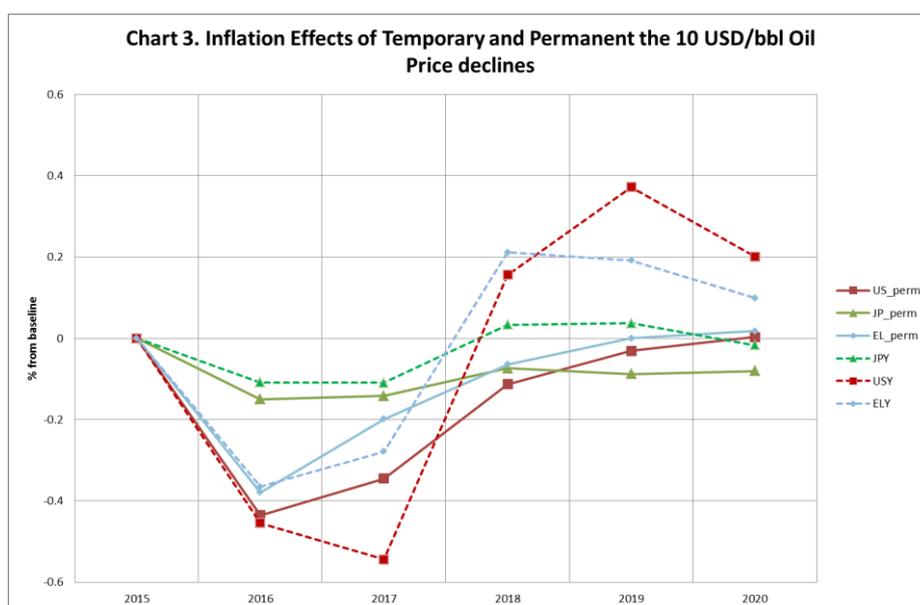


In the first scenario, we have assumed that the price shock lasts two years and the expectations are forward looking with the exception of consumption, which is backward looking. The second scenario is like the first one, but we assume that the price decline is permanent. We report here the GDP and inflation effects in charts 2 and 3.

A temporary 10 USD/bbl oil decline for two years provides a boost for the GDP in the three presented countries. The effect on Euro Area GDP is very low, just a bit over zero in the first year. The effects on the Japanese and the US GDP were both slightly below one tenth. The effects in the second year – deviations from base line - are more than doubled in all three countries and dissipate rapidly afterwards with the shock.

The permanent oil price decline by 10 USD/bbl has naturally much stronger impact on GDP than a temporary shock. In the first year of simulation Euro Area GDP would be a bit over 0.1 per cent higher than in the baseline. In Japan and the US, the effect would be about 0.2 and 0.25 per cent, respectively. In the long run, the simulated path of output remains permanently above the baseline. The effect is again the lowest in the Euro Area. A permanent oil price decline will provide permanent output effects, which follow from a fall in the terms of trade and the real long term interest rate (See Barrell and Pomerantz 2004).

In oil exporting countries, the mechanisms are roughly same, but the effects are the opposite. The oil exporting countries suffer from a significant loss of income. As net exporting countries represents around 15 per cent of global GDP, a negative impact from a decline in oil price on the world economy is significant. According to our calculations a 10 USD/bbl decline in the oil price would mean a 165 billion USD (0.2% of world GDP) transfer from oil exporting countries to oil importing countries². Nevertheless given the higher share of the net importing countries and their higher propensity to consume and to import (Prometeia 2015), it seems reasonable to expect some positive effects also on the global GDP and trade, as well.



The first-year effects of the 10 USD/bbl oil price decline on inflation are close to 0.4 percentage point in the US and the Euro Area. The effect on Japanese inflation is less than half of the effects in the other countries. The inflation effects of a temporary shock are the strongest in the US, because of the economy’s high oil intensity, which means larger reduction in the cost of production than in the other two countries. In the longer run, all price paths converge towards the baseline.

² Calculated on imports and exports of oil in 2013 (BP 2014) regarding 82 countries that represent more than 90 per cent of the world economy. A reduction from 108.6 USD/bbl in 2013 to the most recent price of 30 USD/bbl means a transfer of around 1300 billion, about 1.8% of world GDP (Prometeia, 2015).

The relative size of the impacts by countries depends primarily on the magnitude of the shock and the energy intensities of the economies. The US has the highest intensity and so are the simulation results. Also, it is assumed that economic agents do not change their historical behaviour. If, for example, consumers would start saving more to improve their balance sheets, the impact would be smaller.

Conclusions

Oil prices declined surprisingly sharply in a year to close to 30 USD/bbl in early January 2016. The model results provide a base for judging the potential effects of the price decline. In our scenario, the Brent oil price is forecasted to increase in the coming quarters as long as the impact of the suspension of the embargo on Iran will fade and many emerging countries will surpass their trough and a mild recovery will take place. We expect Brent oil price to be around 38 USD/bbl on average in 2016 and 45 USD/bbl in 2017.

According to NIGEM simulations, the effects of a 10 USD/bbl decline in oil prices on the Euro Area, the US and Japan could be significant particularly in the long term. The output effects are the weakest in the Euro Area as a result of the lower oil intensity than the other two countries presented here. The price decline has a positive effect on other oil importing countries like China as well, but a significant negative effect on the oil exporting countries. However, given the higher share of the net importing countries of the world GDP and their higher propensity to consume and to import, it seems reasonable to expect some positive effects on both global GDP and trade, as suggested by the results presented above.

The inflation effects are more mixed, but they are rather strong in the first two years in the US and in the EU, while the effect in Japan was more modest. On the other hand a large negative impact on consumer prices is problematic for central banks as in many banks like the ECB, policy rates are restrained by the zero-lower-bound, which means the deviation of inflation from the central bank target are even more difficult to close. This may strengthen a discussion surrounding deflation and add pressure for a continuing of low rates and more unconventional policy measures in Japan and in the Euro Area and a more gradual path of rate rises in the US.

Finally, it is now worth reminding that oil markets are very unstable and the models are simplifications of economic systems. For example, the recent oil prices movements have developed very successfully from the perspective of the oil consumers, difficulties of oil exporting emerging economies may have stronger repercussions on investments in advanced economies through trade or through financial markets than seen in this note. Furthermore, ongoing conflicts in the oil producing regions could change the path of oil prices quickly and substantially.

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Box: The impact of the inflow of refugees on the forecast with a focus on the case of Germany

The inflow of refugees into Europe has increased dramatically in the second half of 2015 to an extent that the economic outlook could be significantly affected, at least in some countries. In this note we briefly discuss the effects of the current wave of irregular migration on the government budget, growth and the labour market focusing on Germany, where the highest number of refugees is expected to be accommodated.

In Germany, the number of registered refugees was almost 1.1 million in 2015, although this figure may be slightly exaggerating the actual inflow due to some double counting. For 2016 the scenario includes an additional 1 million of refugees. The fiscal cost of such a number of refugees is substantial. For 2016 government expenditures directly related to the refugee inflow are projected to amount to €24 bn, after €6 bn in 2015, corresponding to 0.8 percent and 0.2 percent of GDP, respectively. The expenditures include direct personal assistance as well as additional staff and investment related to the accommodation of refugees.

Associated with the additional expenditures will be some additional tax revenues (from income tax and VAT, for example). Also, we expect some reallocation of funds in reaction to the increased strain on the government budget, which will reduce the refugee related fiscal impulse to an estimated 0.4 percent of GDP in 2016. Given the high capacity utilization in Germany we expect some fiscal slippage due to price increases and higher imports. As a result we expect the fiscal multiplier to be relatively small. All in all, 2016 GDP growth in Germany will be raised by 0.4 percent as a result of the refugee inflow, according to our estimates. In terms of GDP components, expenditures related to the refugee inflow will predominantly show up in government consumption and private consumption expenditures.

Although a large part of the refugees are male adults in working age, we do not expect a massive immediate impact on the labour market. The labour force has been increased by an estimated 70000 persons in 2015 and is expected to rise by another 240000 in 2016 (corresponding to 0.1 and 0.5 percent of the labour force, respectively). The integration into labour market will likely be slow – according to evidence from available empirical studies every month around 2 percent of the stock of refugees can be expected to find a job. Under these assumptions the number of people in the labour force not in employment should rise by 200000 in 2016. The impact on unemployment will, however, be mediated by government training programmes.

The magnitude of these effects could be similar in some other heavily affected countries. ETLA's estimates for Finland expect a debt financed fiscal impact of 0.4 per cent of GDP and put the effect on GDP at 0.3 per cent. NIER estimates for Sweden suggest an even larger impact. In some countries (Denmark is an example) strict fiscal rules may increase the share of refugee related expenditures to be financed by expenditure cuts elsewhere, thus reducing the fiscal impulse of the inflow of refugees.

Box: France: The structural reforms strategy

Since mid-2014, France clearly embarked on a two-element new strategy: lowering the companies' tax burden, and implementing structural reforms to deregulate the French economy.

The companies' tax cut strategy aims both to allow French companies to regain competitiveness and to restore their margin rate (which declined from 33.5% in 2007 to 29.5% in 2014) and to reduce unskilled work costs. Until 2017, companies' tax cuts are expected to reach 40 billion Euros per year (i.e. 30 billion in terms of employers' social contributions and 10 billion in terms of corporate tax cuts). The cost of these measures is partly funded by a 10 billion rise in VAT and environmental taxation. The rest is supposed to be financed by public spending cuts (or by maintaining the public deficit). According to the financing assumption, the tax cuts would have a GDP impact of around + 1% in 2020, and would generate 300,000 jobs (the government); +0.2% and 260,000 jobs (OFCE).

In 2015, the territorial reform reduced the number of regions (from 22 down to 13) and specified their functions. A vast administrative simplification programme was launched. The law "for growth, activity, and equality of economic opportunity" (the so-called "Macron" law, under the name of the French Minister for Economy and Finance), passed in Parliament in 2015, has deregulated bus transportation services, reduced fees and introduced more competition in several regulated professions (notaries,...), facilitated building permits issuance, authorized some privatisations (local airports, armament industries), increased the possibilities to work on Sunday and evenings, reformed Labour Courts to facilitate layoffs and introduced mediation in workplace relations. At the same time, it is a compromise, which paradoxically introduces new regulations. Thus, it strengthens the powers of the Competition authority and allows Commercial courts to oblige shareholders to sell a company to buyers who commit to develop it. Opening shops on Sunday remains conditional to an agreement with trade unions. In 2016, a law on "the new economic opportunities" (the "Macron 2" law), is expected to introduce measures to promote the development and financing of new innovative companies, and also measures favouring self-entrepreneurship and to lower the qualification level required for some jobs (such as hairdressing, repair services, home maintenance). The French government expects these measures will have an impact of +1% of GDP by 2020.

For twenty years, many laws or agreements have already substantially increased the flexibility of employment and work organization in France. In 2008, a measure was introduced to put an end to a work contract, by an agreement between the employer and the employee. In 2013, agreements where employees accept to see a wage cut or longer working hours against the employers' commitment to maintain jobs have been made possible. The use of short-term contracts, interim, subcontracting, part-time jobs has increased. But employers claim for additional labour market deregulation, easier layoff procedures (less formalities, projects contracts, ceiling for compensation for unfair layoff) and, above all, for the possibility that branches and firms agreements derogate from national labour laws. The

Government launched a rewriting of the Labour Code, according to a three-level architecture. The first one will set a floor of intangible rights. The second will specify the areas open to negotiation of branches and enterprises. The third one will indicate the rules in place in the absence of branch or enterprise agreements. However, the Government said that companies and branches agreements will not be entitled to affect the minimum wage, legal working time and layoff procedures. So, in this field also, a compromise is searched. In 2016, the unemployment insurance rules will be renegotiated by social partners; the level and duration of unemployment insurance could be reduced.

So far, these reforms have not given a boost to the French economy. The Government wishes clearly to convince employers that he is pro-business and wishes to support companies' activities, but companies remain in the expectative and consider that these measures as insufficient.