Haut Conseil des Finances Publiques

Opinion n°HCFP-2017-1

on the macroeconomic assumptions of the 2017-2020 Stability Program

10 April 2017

Under article 17 of the constitutional bylaw n°2012-1403 of 17 December 2012 on public finance planning and governance, the High Council of public finance delivers an opinion on the macroeconomic assumptions associated with the Stability Program for the years 2017 to 2020. The following opinion was adopted after deliberations on 10 April 2017.

Summary

The growth forecasts submitted by the Government for 2017 (1.5 %) are slightly higher than most of the available forecasts. Given the favorable consumer and business surveys and the improvement of the global growth, the High Council considers that this forecast is plausible, even though some of the data about French economic activity are disappointing at the beginning of the year.

The High Council considers that the private wage bill forecast is also plausible. He considers that Government's inflation forecast for 2017 (1.2 %), which is at the low end of the March 2017 consensus forecasts, is reasonable.

The High Council notes the downward revision of the growth and inflation rates in the Government's forecasts for 2018, 2019 and 2020. This revision is in agreement with its observations expressed in its opinion on the April 2016 Stability Program. He considers that this scenario, more prudent, can be a reasonable basis for the budgetary consolidation path.

The High Council insists again on the unlikelihood of the Government's estimate of the output gap and potential growth. The evaluation of a large output gap leads to artificially reduce the structural deficit and consequently to downplay the effort to provide in order to rebalance public finances.

The High Council considers that the next public finance programming law needs to correct those estimations and set the output gap and potential growth assumptions on realistic basis. Estimates in the public finance programming law need to guarantee the internal consistency of the macroeconomic scenario and to take into account estimates made by external institutions and organizations. It must be possible to adapt those assumptions in the process of a public finance programming law if necessary.

Finally, given the instability of the output gap measure and, as a consequence, of the estimate of the structural budget balance, the High Council suggests also taking into account in the public finances' assessment some other indicators which are better to reflect the fiscal stance, such as the structural effort.

Introductory remarks

1- The opinion's scope

Under the article 17 of the constitutional bylaw of 17 December 2012, the High Council of public finance received the referral file from the Government to give its opinion on the macroeconomic assumptions of the Stability Program.

Thus, the following opinion is not about the scenario for public finance itself. However, given the effects of public finance on growth in the short and medium terms, the High Council took into account other issues related to public finance in order to assess the consistency of the macroeconomic assumptions submitted by the Government.

The Stability Program is published in a specific context, at the very end of the presidential and parliamentary term. Thereby, in the light of the experience of recent years, the High Council draws in this opinion some lessons, which could be useful for the preparation of the next public finance programming law.

2- On the information submitted

The High Council of public finance received from the Government on 4 April 2017 the referral file on the macroeconomic assumptions of the 2017-2020 Stability Program. The file was supplemented with detailed answers to a questionnaire previously addressed to the relevant administrations.

3- On the methodology used by the High Council

To assess the realism of the macroeconomic forecasts submitted by the Government, the High Council considered all the information available at the day of its publication: last statistics and other information provided by the Government.

The High Council's opinion relies on the last economic forecasts produced by several institutions, including international organizations – the European Commission, the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) –, the French National Institute of Statistics and Economic Studies (INSEE), the Banque de France and forecasting institutes such as COE-Rexecode or the French Economic Observatory (OFCE).

An exchange with the ministers responsible for the economy, finance and budget was organized on their request.

Moreover, the High Council organized hearings with representatives of the Treasury General Directorate, the Budget Directorate, INSEE and other institutions and experts from outside the French Ministry of finances[1].

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After a general analysis of the economic context (I), the High Council delivers its opinion on the macroeconomic forecasts submitted by the Government in the Stability Program

[1] Representatives of OFCE, COE-Rexecode and the Banque de France.

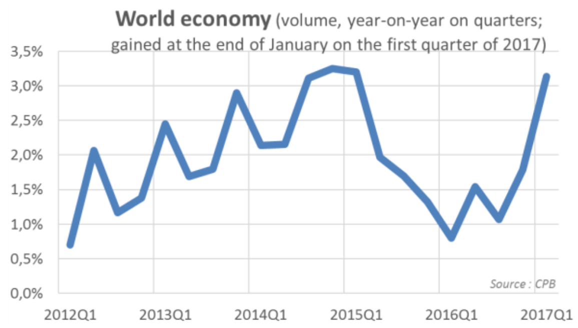
for 2017 (II) and for 2018-2020 (III). It then presents some observations on the forecasts of output gap and potential growth.

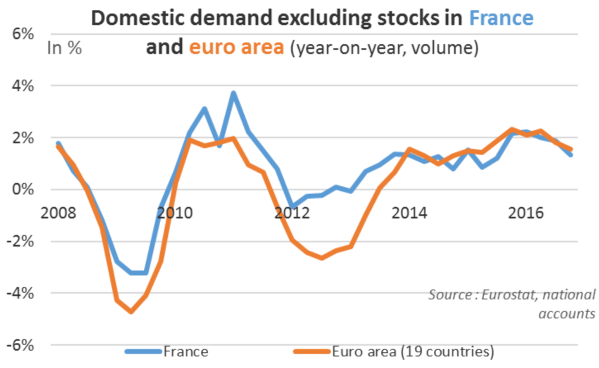
I- A better global and European economic environment

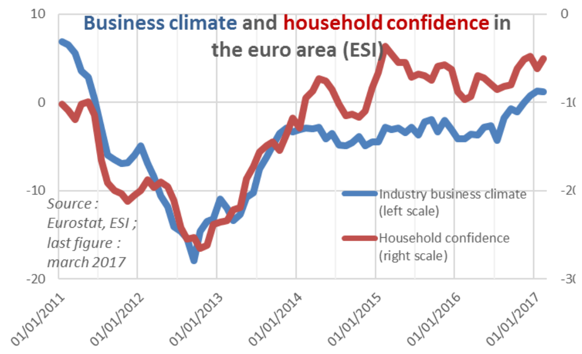
Several recent trends in the global economy have strengthened the recovery in the euro area, which started two years ago (1). The intensity of this recovery remains, however, subject to significant uncertainties (2). The outlook is also better for France but uncertainty remains about its ability to respond to the increase in demand (3).

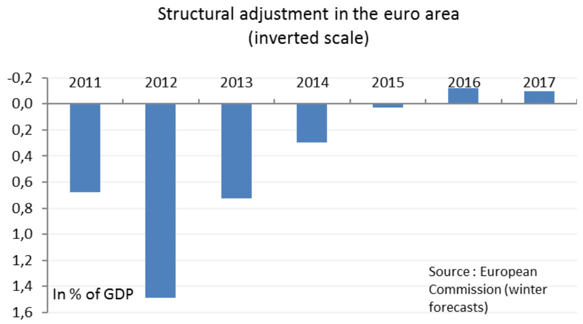
1- A recovery of the world economy

At the beginning of 2017, the recovery has become confirmed for the world economy. In particular, the United States is accelerating after a less favorable year of 2016, Chinese growth is stabilizing, Russia is recovering and Brazil is emerging from the economic recession. World trade has been recovering since the end of 2016.









Overall, the global environment looks more favorable for the euro area and for France. In 2015 and 2016, the European recovery happened in a weak world trade environment. This factor is reversing in 2017 and it is now a supporting element for the euro area.

European growth, following on from the framework of generally less restrictive fiscal policies and powered by external factors, has become more robust as it has expanded across all components of demand and is generating significant job creations. In 2016, it showed a capacity to resist the occurrence of events that were perceived as significant risks (vote on the Brexit, Italian referendum ...). At the beginning of 2017, this growth is improving, according to the latest consumer and business surveys, which show a marked improvement in the business climate, particularly in Germany.

2- This recovery remains subject to significant uncertainties

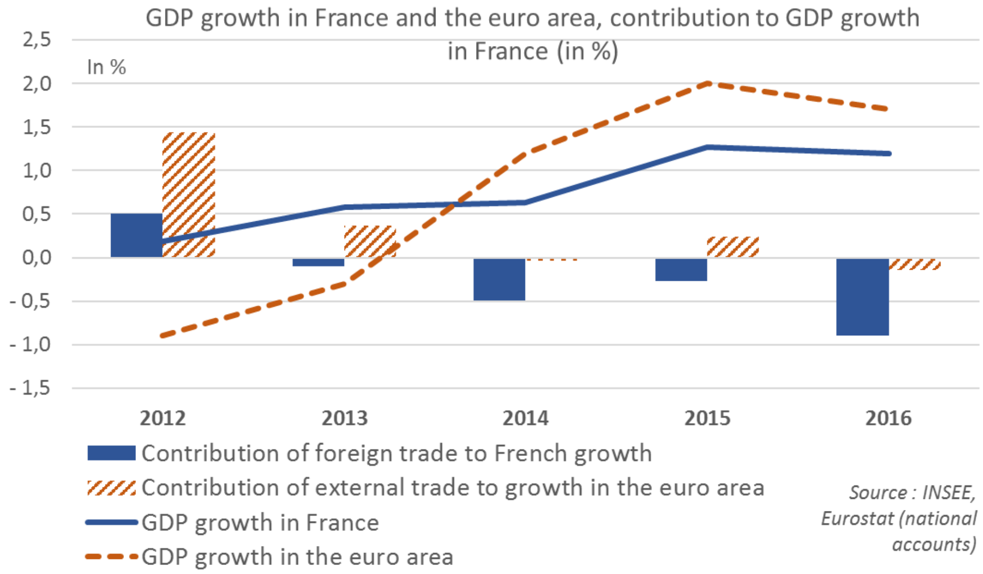
Even if we are in a context of improving global prospects, certain risks have not disappeared.

In addition to the uncertainties linked to the elections in France and Germany, the main current uncertainties relate to the US economy, including rising inflation, rising interest rates or the impact of possible protectionist measures.

In the longer term, some other risks could materialize: the accommodative policy mix in China supports activity, but is accompanied by an increase in internal imbalances; the effective implementation of Brexit remains a vehicle for uncertainties and risks in the medium term; financial risks are still present (sensitivity of emerging countries to variation in exchange rates, sharp rise in doubtful loans in certain emerging countries, banks' balance sheet weakly adjusted in certain euro area countries,…).

3- In France, improved prospects but an interrogation on the capacity of the economy to respond to the increase in demand

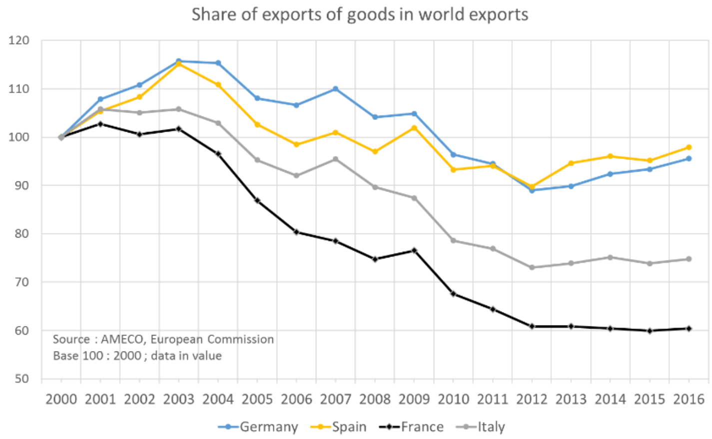
France experienced a recovery in domestic demand comparable to the euro area's one in 2015 and 2016. But its GDP growth was weaker than its European neighbors' one, especially in 2016. This more moderate growth is mainly due to the strongly negative contribution of foreign trade to growth (- 0.8 point).

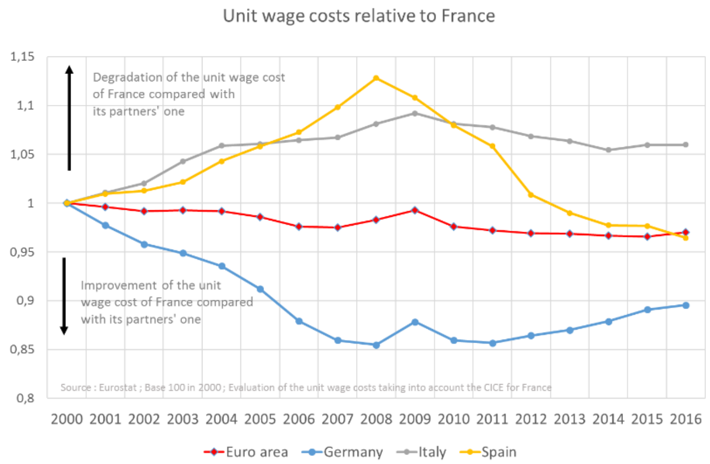


This negative contribution in 2016 is explained in half by two exceptional factors: fall in agricultural production because of climatic conditions and decrease in tourist frequencies following the terrorist attacks.

Nevertheless, the highly negative development of foreign trade in 2016 also raises the question of the ability of the French production system to take advantage of the increase in domestic and foreign demand.

Competitiveness of the French economy is still fragile





France lost market shares throughout the decade 2000-2010. The share of its exports of goods in world exports has been reduced from 5% in the early 2000s to about 3% in 2012. However, this deterioration has been slowing in recent years with a near stabilization since 2012.

This unfavorable trend reflected the lack of cost and non-cost competitiveness of the economy in the first decade of 2000.

Cost competitiveness has begun to recover, notably with the introduction of the *Competitiveness Pact* 'CICE' (tax credit for competitiveness and jobs) and the reductions in contributions made since 2014.

Considering these developments and the disappearance of the exceptional factors that had a negative influence in 2016, most of the forecasts presented by the forecasting organizations in early 2017, and the Government scenario, assume a neutral or quasi-neutral contribution of foreign trade for the years to come up.

However, the strong elasticity of imports to domestic demand over the recent period suggests that other structural factors related to non-cost competitiveness are at work. Consequently, doubts remain about the ability of the French economy to meet domestic and external demand.

II- Observations on the forecast for 2017

1- The scenario of the Government

According to the Government, *"In the euro zone, the recovery in operation for three years will probably continue.*

The rise in inflation induced by the rise in energy prices would penalize the purchasing power of households and consequently, private consumption."

"After a 1.2% increase in 2016, the recovery of the French economy may confirm in 2017 (+ 1.5%). Domestic demand would slowdown but the accounting contribution of foreign trade would improve substantially in 2017."

"Inflation is expected to recover in 2017 to + 1.2%, after + 0.2% in 2016, mainly due to rising energy prices and regulated tariffs. Core inflation would be stable at + 0.6%."

2- Opinion of the High Council

a) About GDP growth

The GDP growth planned by the Government (1,5 % in 2017) is unchanged from the one associated with the initial budget bill for 2017.

The assumptions for global and euro area growth (3.4 % and 1.6 % respectively) and for world trade (3.3 %) are also unchanged. They are part of the acceleration trend observed since the autumn of 2016 and confirmed by the most recent indicators. They are in line with the forecasts of international organizations.

In France, the main factors that hampered growth in 2016 are expected to disappear or diminish in 2017. A return to normal agricultural production and an increase in tourism would make a significant contribution to growth.

French domestic demand, which recovered in 2015 and 2016, would slow down in 2017 (1.4% after 1.9% in 2016 in the Government's forecast) due to the impact on consumption of the least purchasing power gains resulting from the rise in inflation. The slight downturn expected for business investment is consistent with the end of the over amortization tax measure. The prediction of the upturn in household investment is supported by available data on building permits and housing starts, which illustrate the strong demand for new housing. However, improving household investment would not be enough to offset the slowdown in consumption and business investment.

The slowdown in domestic demand would be offset by an improvement in external trade, whose contribution to growth, which was very negative in 2016, would be closer to neutrality. The High Council considers that this recovery is not yet achieved (see box).

While the economic surveys are well oriented, the data available on the activity at the beginning of the year are contrasting - positive for services and construction, disappointing for industrial production - and seem to foreshadow a low growth in the first quarter.

For the whole of 2017, international organizations agree to predict that France growth will be 1.4% (European Commission in February, OECD in March and IMF in April).

The Government's forecast (1.5%) is slightly higher than most available forecasts. In view of the favorable consumer and business surveys and the improvement of global growth, the High Council considers that this forecast remains plausible, although some

data reflecting the activity of the French economy are disappointing at the beginning of the year.

b) Employment and wage bill

The government expects an increase of about 170,000 in market-sector employment in 2017 (annual average), after 155,000 in 2016, compared to just over 150,000 expected for 2017 in the last September budget bill.

Regarding private wage bill, the increase in 2016 (2.5 %, of which 1.1 % for employment and 1.4 % for average wage) was slightly lower than the last September Government's forecast (2.6 %). The forecast for 2017 is 2.8 %, of which 1.1 % for employment and 1.7 % for nominal average wage. It is slightly higher than the one in the last September budget bill (2.7 %). The upward revision was due to employment while the forecast of average wage is unchanged despite the increase of the hypothesis on inflation (by 0.4 percentage points).

The forecast of payroll for 2017 is thus slightly higher than the year-on-year evolution expected by ACOSS[2] at mid-year, which is 2.5 %.

The High Council considers nevertheless that the forecast of payroll is also plausible.

c) Consumer prices

The government is raising its forecast of consumer prices increase for 2017 to 1.2 % on annual average, compared with 0.8 % in last September in the assumptions associated with the budget bill. Core inflation (excluding volatile commodities) would be 0.6 % in 2017, so the same as in 2016.

The year-on-year rate of inflation has picked up in recent months with the return to a positive contribution from oil prices. It stands at 1.1 % in March 2017. INSEE expects its quasi-stability on the continuation of the first half: it would be 1.1 % in June under the assumption of a price per barrel of 55 $ which would be stable over the forecast horizon. Service prices would accelerate slightly. The core inflation estimated by INSEE would be around 0.7 % in the middle of the year.

The upward revision of the Government's forecast for France is parallel to that of the ECB for the euro area as a whole. Indeed, the ECB has raised its projected rise in consumer prices for 2017 to 1.7 % in March (versus 1.2 % in September).

The High Council considers that the Government's inflation forecast for 2017, which is at the low end of the March 2017 consensus, is reasonable.

III- Remarks on the scenario for the years 2018 to 2020

1- The scenario of the Government

According to the Government's referral file, *"growth would reach 1.5 % in 2018. The activity would increase by 1.6 % in 2019 and 1.7 % by 2020." "This acceleration of activity would only allow a very gradual diminution of the output gap, which would still be wide on the horizon of programming, reflecting the measured character of the real growth scenario."*

[2] Agency responsible for the collection of social contributions.

"Inflation would gradually recover, in line with the objective of the European Central Bank. The increase in consumer prices would be 1.1 % in 2018, 1.4 % in 2019 and 1.5 % in 2020."

2- On the macroeconomic scenario for the years 2018 to 2020

The High Council notes that the Government has reduced its growth forecast for the years 2018 and 2019 by a quarter of a percentage point in comparison to the 2016 Stability Program.

Moreover, the scenario of the Stability Program is based on a moderate increase in consumer prices of 1.5 % by 2020. The dynamic of GDP deflator is in line with that of consumer prices. GDP growth in value would accelerate gradually from 2.0 % in 2016 to 2.5 % in 2018 and 3.2 % in 2020. Growth in the private wage bill would be at a more sustained pace than nominal GDP growth (2.5 % in 2017, 2.9 % in 2018 and 3.5 % in 2020).

The High Council notes the downward revision of the GDP growth and inflation assumptions in the Government's forecast. This revision is in line with the comments made in its opinion on the Stability Program of April 2016. The High Council considers that the more prudent scenario of GDP growth and inflation adopted for the years 2018 to 2020 may constitute a reasonable basis for the construction of public finance trajectories.

IV- Remarks on potential growth and output gap

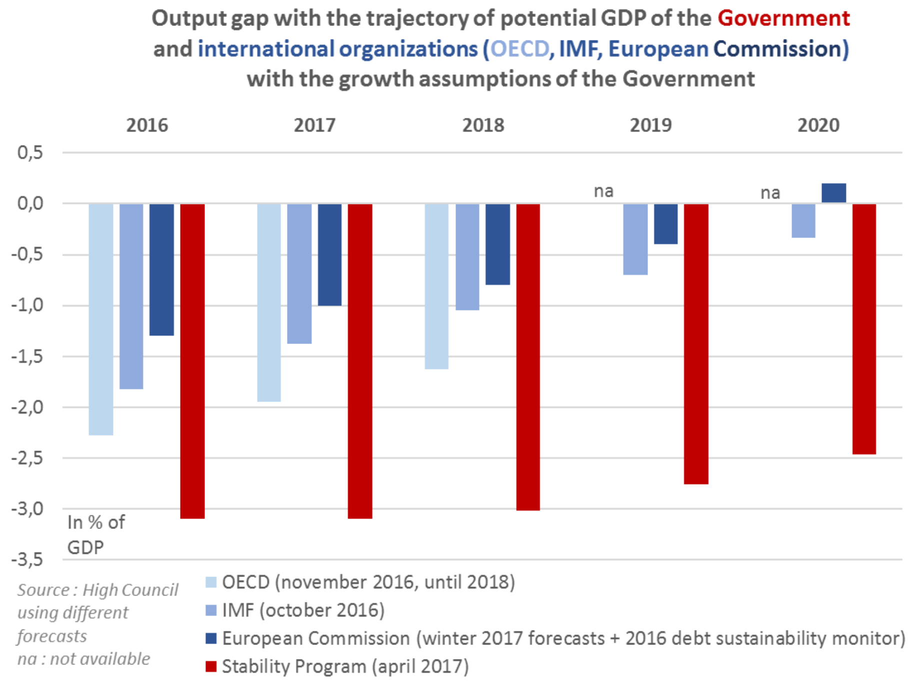
I- About the assumptions on potential growth

The High Council notes, as in its previous opinions, that the potential growth assumptions retained in the stability programs (1.5 %, 1.4 %, 1.3 % and 1.4 % for the years 2017-2020) are still significantly higher than estimates by international organizations and the European Commission (which are between 1.1 % and 1.3 %).

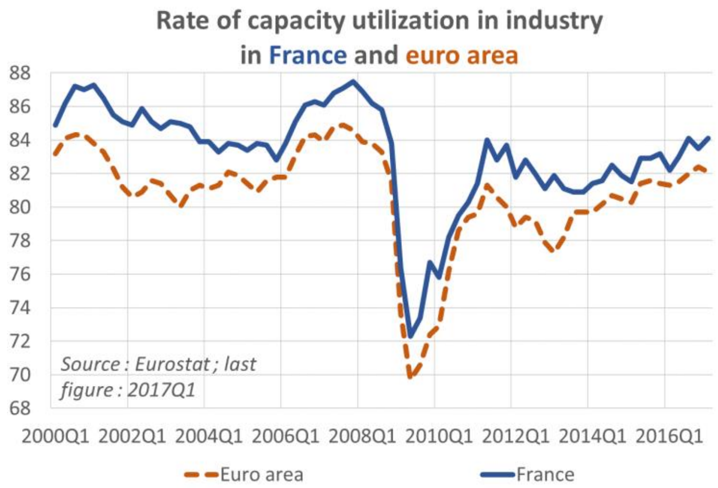
1- About the assumptions on output gap

The Government's estimate of the output gap[3] for 2016 (- 3.1 %), in the April 2017 Stability Program, is unchanged from the Stability Program of 2016. It is much wider than the ones estimated by the European Commission and the IMF (- 1.3 % and - 1.8 % respectively, see chart below). This output gap would remain very large over the period 2017-2020 in the Government scenario.

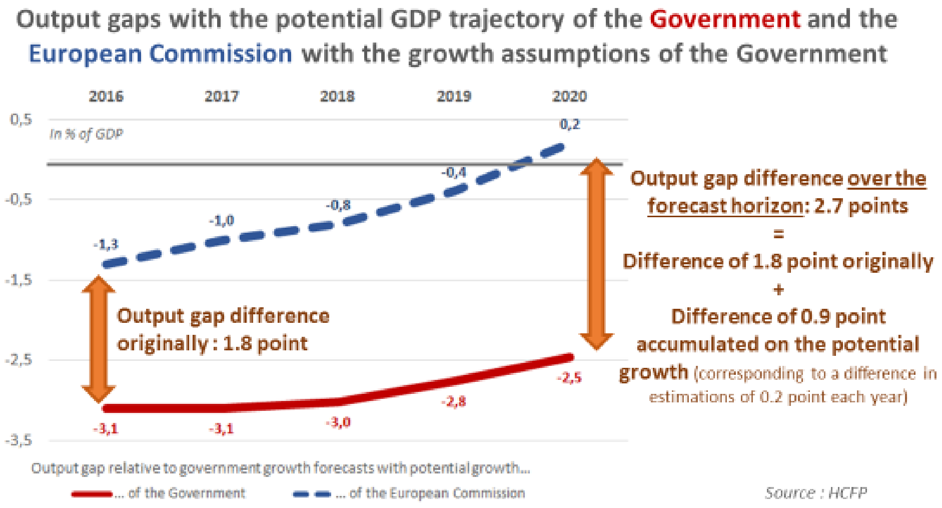
[3] Gap between actual GDP and potential GDP.



Such a wide output gap is meant to reflect a significant underutilization of inputs. This assumption is not consistent with the near-historical average level of industrial capacity utilization observed in recent quarters (see chart below).



The divergence of diagnosis between the Government and the main international institutions and the European Commission, noted by the High Council for several years, has two origins: an initial output gap (in 2016) which is very high compared to other existing estimates and a potential growth which exceeds every year most of the available estimates (see chart below).



The High Council considers that the Government's scenario, which would lead to a negative output gap over a very long period (more than 12 years) and which only marginally closes at the forecast horizon, is not consistent. As it had already pointed out in previous opinions, the High Council considers that "such an important and long-lasting under-utilization of the factors of production does not coincide with the acceleration of investment and inflation presented in the Government scenario"[4].

From this point of view, the medium-term scenarios of international organizations and the Commission, in which the output gap would be almost closed by 2020, appear to be more coherent.

3- Its consequences to assess the soundness of public finance in structural terms

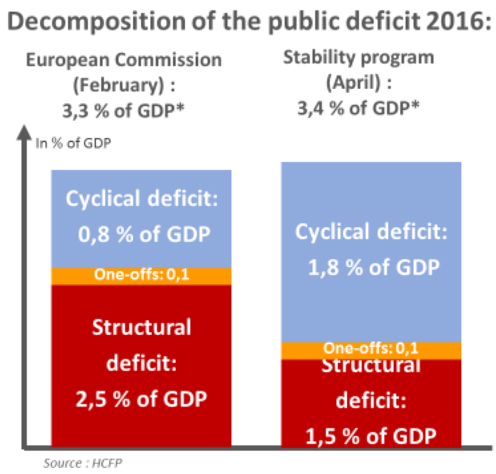
This overestimation of the output gap induces a bias in the decomposition of the public deficit between its cyclical component and its structural component, by underestimating its structural component.

Indeed, by estimating the output gap at - 3.1% of GDP in 2016, which corresponds to a particularly low position in the cycle, the Government assesses the cyclical component of the public deficit at 1.8 % of GDP, compared to 0.8 for the European Commission, which takes a twice as less output gap.

Accordingly, the Government estimates that the structural deficit is limited to 1.5 % of GDP in 2016 (compared with 2.5 % for the Commission). This allows it to post a return to structural balance by 2019 through a structural effort of 0.5 % of GDP per year. With this same adjustment of 0.5 point per year, the return to structural equilibrium[5] would take five years under the Commission's assumption for the output gap. Achieving this goal in three years would require a much larger annual structural effort.

[4] Opinion n° HCFP-2016-01, 12 April 2016, on the macroeconomic forecasts associated with the Stability Program bill for the years 2016 to 2019.

[5] The European Fiscal Compact defines that member states must achieve a "Medium-Term budgetary Objective" (MTO) which corresponds to a structural balance higher than - 0.5 % of GDP.



**: the public deficit was forecasted at 3.3 % of GDP in February 2017 and was released at 3.4 % of GDP in March 2017 by Insee. The European Commission's latest estimate of the structural deficit was made in February, while the stability program of April 2017 takes the data of the public deficit published by Insee in March.*

The High Council stresses that this underestimation of the structural deficit minimizes the effort required to reach the balance of public finances in the medium term. The effort envisaged in the Stability Program is unlikely to lead to the achievement of the structural balance objective in 2019, given that there are significant risks which could prevent from achieving the public deficit targets for 2017, both structural and effective. In this respect, the latest budgetary information and measures communicated by the administrations do not alter the critical assessment made by the High Council in its opinion of last September on the public deficit forecast for 2017.

4- The articulation of the various exercises of forecasting and programming of public finances

The High Council stresses the problems of consistency between the forecasting and programming exercises posed by the estimates of output gap and potential growth.

It points out that the assumptions adopted for the output gap and potential growth in the December 2014 public finance programming law were at the time in line with those of the European Commission. However, the Commission revised them down several times, while the French Government not only kept its estimate of the output gap for 2014 but also raised its assumptions of potential growth from 2016 onwards. Consequently, a divergence between the estimates of the French government's output gap and those of the Commission appeared and has continued to widen until it reached almost 2 percentage points in 2016 and could exceed 2.5 points in 2019.

These developments have led to an unlikely output gap and an inconsistency between this gap and the more realistic growth scenario adopted by the Government. The two exercises for estimating potential GDP and constructing medium-term forecasts are therefore disconnected, while they should be closely linked.

Consequently, the High Council stresses the importance of fixing on a realistic basis the assumptions of output gap and potential growth. This implies that the initial estimates of the public finance programming law should be set at levels ensuring the internal consistency of the macroeconomic scenario and consider the estimates made by external institutions and bodies.

These assumptions must be adapted in the course of public finance programming law if necessary.

Finally, given the instability of the output gap measure and, as a consequence, of the estimate of the structural budget balance, the High Council suggests also taking into account in the public finances' assessment some other indicators which are better to reflect the fiscal stance, such as the structural effort.

The High Council insists again on the unlikelihood of the Government's estimates of the output gap and potential growth. The evaluation of a large output gap leads to artificially reduce the structural deficit and consequently to downplay the effort to provide in order to rebalance public finances.

The High Council considers that the next public finance programming law needs to correct those estimations and set the output gap and potential growth assumptions on realistic basis. Estimates in the public finance programming law need to guarantee the internal consistency of the macroeconomic scenario and to take into account estimates made by external institutions and organizations. It must be possible to adapt those assumptions in the process of a public finance programming law if necessary.

Finally, given the instability of the output gap measure and, as a consequence, of the estimate of the structural budget balance, the High Council suggests also taking into account in the public finances' assessment some other indicators which are better to reflect the fiscal stance, such as the structural effort.

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This opinion has been published in the *Official Journal* of the French Republic and attached to the Stability Program transmitted by the Government to the European Commission and the European Council.