Haut Conseil des Finances Publiques

Opinion n°HCFP-2016-01

on the macroeconomic assumptions of the 2016-2019 Stability Programme

12 April 2016

The High Council of public finance received the referral file from the Government on 5 April 2016 on the macroeconomic assumptions associated with the proposed Stability Programme for the years 2016 to 2019, under article 17 of the constitutional bylaw n°2012-1403 of 17 December 2012 on public finance planning and governance. The High Council adopted the following opinion after deliberations on 8 and 12 April 2016.

Summary

After two years of stagnation in 2013 and 2014, the Eurozone has experienced a moderate recovery for one year (with an annual growth rate slightly higher than 1,5 % of GDP).

This rising growth is triggered by three simultaneous factors: lower energy prices, a depreciating euro, and the reduction of budget cuts. In addition, the more expansive monetary policy induces exceptionally low interest rates. Lastly, tensions on financial and credit markets, which penalized peripheral Eurozone countries, have eased substantially.

Nevertheless, the ongoing European recovery may not be able to resist further deteriorations in the extra-European economic environment (slowdown in Chinese growth, hardships of oil-producing countries, risk regarding the ability of the US economy to maintain its current pace of growth in the medium term) or emerging barriers to growth in Europe (re-establishment of border controls, exit of the United Kingdom from the European Union, geopolitical risks and terrorist threats).

The growth forecasts submitted by the Government remain unchanged in line with the initial Budget bill for 2016 (1,5 %), and with the Stability Programme of April 2015 for 2017 and 2018 (respectively 1,5 % and 1¾ %). Concerning 2019, a growth of 1,9 % is expected by the Government.

With regard to 2016, the High Council of public finance considers that the Government's forecast, although situated in the upper range of economic forecasts, remains within reach. The 2,3 % increase in the private wage bill expected by the Government seems a little high. The downwards revision of the inflation forecast made by the Government is moving in the right direction and the annual average consumer price inflation will probably be close to zero in 2016.

Concerning 2017, 2018 and 2019, the High Council reckons that the GDP growth scenario is plausible, even if the acceleration of growth hypothesis at the end of the period is fragile. The High Council also points out the downwards risks attached to this scenario, either related to the world growth or earmarked to the Eurozone.

However, the potential growth submitted by the Government seems overestimated, in particular in 2016-2017, and the persistence of a significant output gap throughout the period is unlikely to occur.

The High Council considers that this substantial output gap, higher than most existing estimates, tends to increase the cyclical component of the deficit and to underestimate the structural deficit. The High Council emphasizes the fact that this underestimation minimizes the effort needed in order to reach a balance in public finance in the medium term.

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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 2016-2019 Stability Programme.

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.

2- On the information submitted

The High Council of public finance received the referral file from the Government on 5 April 2016 on the macroeconomic assumptions of the 2016-2019 Stability Programme. The referral 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 the underlying assumptions and the economic scenario for 2016-2019. This opinion is based on all the information available at the day of its publication: last statistics and other details provided by the Government related to economic policies.

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 Statistical and Economic Studies (INSEE), the Banque de France and forecasting institutes such as COE-Rexecode or the French Economic Observatory (OFCE).

Moreover, as permitted by article 18 of the constitutional bylaw, 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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[1] Representatives of OFCE, COE-Rexecode, the Banque de France and France Stratégie.

After a general analysis of the economic context (I) – a moderate recovery in Europe and a world growth in decline –, the High Council delivers its opinion on the macroeconomic forecasts submitted by the Government in the Stability Programme for 2016 (II) and for 2017-2019 (III).

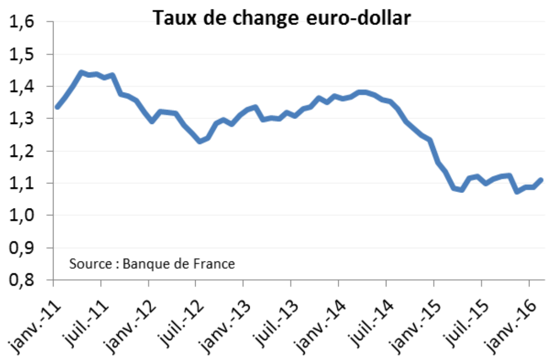
I- Context: a moderate recovery in the Eurozone, a world growth in decline

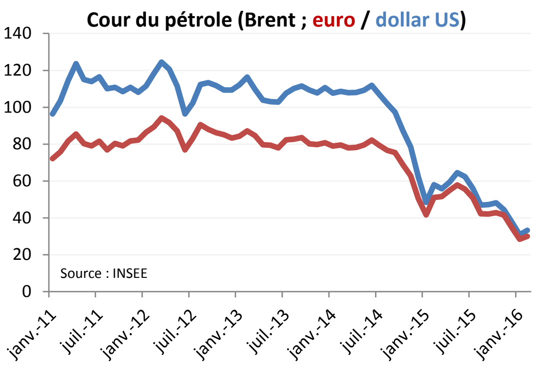
A moderate recovery in the Eurozone a year ago (1), strengthened by new factors of growth in the last months (2), but in a context of threats on world growth (3).

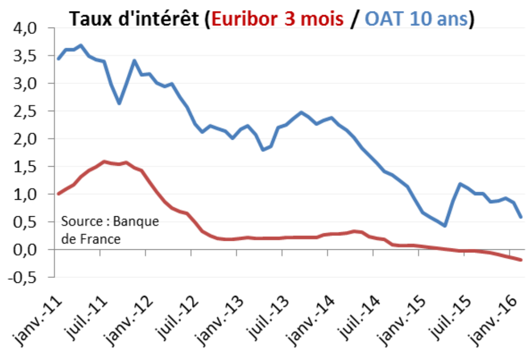
1- A moderate recovery in the Eurozone

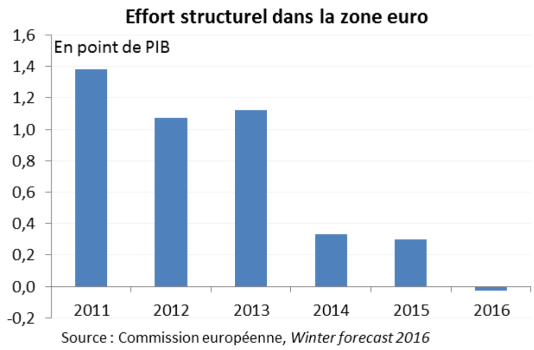
After two years of stagnation in 2013 and 2014, the Eurozone has experienced a moderate recovery for one year (with an annual growth rate slightly higher than 1,5 %).

This rising growth is triggered by three simultaneous factors: lower energy prices, a depreciating euro, and the reduction of budget cuts. In addition, the more expansive monetary policy induces exceptionally low interest rates. Lastly, tensions on financial and credit markets, which penalized peripheral Eurozone countries, have eased substantially.









These changes have led to an increase in European domestic demand which had declined in 2012 and 2013. This pick-up in demand is the major fact of the recent European environment. The European growth is now at an annual average rate of 2 %, with higher rates in Spain, Germany and Netherlands. If the European growth is largely driven by consumption, investment also contributes to boost the recovery since the beginning of 2015. Moreover, growth rates are less heterogeneous between European economies than in the previous years.

This strengthening of European demand is accompanied by an increase in intra-European trade and by a strong rise in imports from the Eurozone, whereas Eurozone exportations are affected by the grim economic context in the rest of the world. Thus, external trade has a negative contribution to the Eurozone growth.

2- New factors bolstering growth in the last months

Some growth drivers strengthened in the recent period. Oil price decreased again at the end of 2015 and now stands at $40, $15 below its value of the summer 2015. This additional fall will affect consumer prices and improve both households' purchasing power and corporate business' margins.

In the short term, budgetary policies in Europe may not be restrictive. Their overall orientation may be neutral or slightly expansive in 2016. Some countries slackened their effort after a return to a balanced budget or after having reached a deficit-to-GDP ratio below the 3 % reference. According to the European Commission, public finance will have a slightly expansive effect in Germany, Italy and Netherlands in 2016, and a roughly neutral effect in Spain.

Finally, the European Central Bank announced further monetary easing on 10 March 2016, putting downwards pressures on the interest rates in the Eurozone and leading to their convergence.

Nevertheless, the depreciation of the Euro's exchange rate came to an end. It has even been rising a bit in the last few weeks.

The revival of growth in the euro area could be reinforced in the medium term, and finally exceed the potential rate, given the catch-up capacities suggested by the negative output gaps of most countries. However, the euro area could also be affected by major risks.

3- Threats to growth in the world and specific risks in the Eurozone

The ongoing European recovery occurs in a context of dampening world growth. An additional worsening of the extra-European economic environment or the realization of some intra-European specific risks could put an end to the recovery in the euro area.

In volume terms, the world trade growth fell down: it nearly stood at 2,5 % in 2015, compared with an average of 6,5 % per year in 2000-2007. It may slightly recover in 2016. This weakness probably stems from the end of the geographical fragmentation for some production processes, and can suggest a weakening contribution to growth from the deepening of world trade.

Chinese growth decreased significantly and this slowdown goes in hand with a rise in global financial risks. Moreover, the situation deteriorated in many oil producing emerging countries and more generally in commodity producing countries, in particular in Russia and Brazil which may experience a prolonged recession.

In the United-States, GDP growth is around 2,5 % per year. However, with low productivity gains and a situation close to full employment, there are doubts about the capacity of the United-States to maintain their current growth rate in the medium term.

Other important risks are particularly dedicated to Europe: the re-establishment of internal border controls could penalize intra-European trade; the potential exit of the United-Kingdom from the European Union; geopolitical risks and terrorist threats; the wait-and-see attitude related to the forthcoming elections… Moreover, despite the reinforcement of financial regulation in the last few years, financial weaknesses remain in several countries.

These risks are difficult to quantify. They call for caution in assessing the growth forecasts.

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II- Remarks about the scenario for 2016

1- The scenario of the Government

According to the Government referral file, "*[…] the growth may strengthen gradually with a smaller heterogeneity in growth rates within the euro area. The low price of oil, the previous depreciation of the euro and the accommodative monetary policy of the ECB may promote economic growth, leading to an acceleration driven by the domestic demand in 2016.*"

In the case of France, "*imports and exports will probably fall in 2016 after a year in 2015 of high paces […]. On the whole, foreign trade contribution to growth may be around -0,3 point in 2015 and -0,3 point in 2016 […].*"

"The strengthening of consumption will continue in 2016 […] (+1,6 %), in a context of improving outlooks in the labour market." […] "The recovery in employment was confirmed in 2015 […] mostly driven by the competitiveness and employment tax credit (CICE in French) and the implementation of the responsibility and solidarity pact. Job creation may accelerate in 2016 (+190 000 per year on average), in particular with the program "Embauche PME" encouraging SMEs recruitment.

Corporate investments are expected to increase more sharply in 2016 […] than in 2015 (+3,2 % after +2,0 %), driven by the significant increase of business' margins and by economic policy measures, such as the exceptional tax advantage for productive investments."

"On the whole, the recovery of French economy will probably strengthen in 2016 […] (+1,5 % […] after +1,2 % in 2015) […]. The fall in oil prices until March 2016 will yield another year of nearly zero inflation (+0,1 %)."

2- Opinion of the High Council

a) About GDP growth

The GDP growth planned by the Government (1,5 % in 2016) is similar to the one of the initial Budget bill for 2016. However, growth drivers have been slightly modified: in the 2016-2019 Stability Programme, growth is more explained than before by changes in inventories (see box "*Uncertainties on stocks contribution to GDP growth*") whereas the contributions to growth of both household demand (in terms of consumption and investment) and exports have been revised downwards compared to the initial Budget bill for 2016.

Uncertainties on inventories contribution to GDP growth

Quarterly national accounts show a contribution to growth of changes in inventories of 0,7 point in the third quarter of 2015, and of 0,6 point in the fourth quarter (after -0,5 in the second quarter). This is equivalent to a global contribution of changes in inventories of 0,4 point in 2015 and to a carryover at the end of 2015 Q4 for 2016 from 0,6 to 0,7 point.

Regarding 2016, the contribution to growth from changes in inventories planned by the Government is positive and around 0,4 point in annual average, mostly because of the carryover. This is a point of discrepancy with most forecasts available (in particular with those of international organizations). However, Government's forecast is consistent with the economic outlook (*Note de Conjoncture*) of March 2016 from the French National Institute of Statistical and Economic Studies.

The composition of growth, at the end of 2015, will probably change in favour of other demand components in the future revisions of the accounts. Moreover, positive contributions of the changes in inventories for two consecutive years are not unusual. Such positive contributions have already been recorded several times in the past and even in greater proportions.

The High Council notes that the Government revised downwards its assumptions about world trade growth in volume terms for 2016 with respect to the Budget bill for 2016 (3,2 % instead of 5,2 %) and that this new assumption is now closer to international organizations forecasts (3,5 % for the European Commission, 3,1 % for the IMF and 3,3 % for the OECD). The High Council had said, in its opinion on the Budget bill for 2016, that the Government was optimistic about world trade in volume. Now, the High Council considers the stabilization of export market shares credible given the gains in competitiveness recorded recently.

Moreover, domestic demand should benefit from positive factors, in particular from an increasing household purchasing power in a context of high savings rate.

The increase of business' margins, which resulted in lower oil prices and in a reduction of compulsory levies (taxes and social contributions), improved corporates' financing capacity and could boost investment.

Last September, the High Council considered, in its opinion on the Budget bill for 2016, that the growth forecast for 2016 could not anymore be qualified of "prudent" (as it was in April 2015). Nevertheless, given the situation of domestic demand in Europe, it remains within reach.

The Government maintained its growth forecast while international organizations generally revised their estimations downwards since last fall. For that reason, the Government's projection is now situated in the upper range of economist forecasts (1,3 % according to the *Consensus Forecasts* of March), in particular in the upper range of international organizations forecasts (the OECD anticipates a 1,2 % growth, the European Commission 1,3 % and the IMF 1,1 %). On the side of national institutions, forecasts are more heterogeneous (OFCE plans 1,6 % and Coe-Rexecode 1,2 %).

Government's forecast is, however, consistent with last quarterly accounts and with the short terms previsions submitted by the INSEE in its economic outlook (*Note de Conjoncture*) of March 2016[2]. Consumer and business surveys remain favourably oriented even if they were a bit shrinking over the last few months.

Finally, the High Council of public finance considers that the Government's forecast, although situated in the upper range of economic forecasts, remains within reach.

b) Employment and wage bill

The strengthening of employment in the scenario of the Government is consistent with the recovery of growth, but the increase in the number of jobs forecasted for 2016 (+130 000 employments in annual average in the non-farm business sector) seems high, mostly because of high estimates of employment policies effects (the competitiveness and employment tax credit – CICE in French –, implementation of the responsibility and solidarity pact and of the recruitment premium).

Government's employment prospects are thus more favourable than INSEE's forecasts for the first semester 2016: in comparison with the scenario submitted by the INSEE, the Government plans 37 000 extra jobs for the first semester of 2016 on the same survey scope.

Concerning private wages, the High Council already said that the 2,8 % rise planned in the Budget bill for 2016 was too high. In the Stability Programme, this forecast has been revised downwards (down to 2,3 %). Nevertheless, 2,3 % remains higher than the percentage forecasted by the national unemployment insurance (Unedic; 2,0 % in annual average for 2016) and by the French national insurance contributions (ACOSS; 1,9 % on a year-on-year basis at the end of the first semester 2016).

[2] To reach an average annual growth rate of 1,5 %, it is necessary to have a quarterly growth from 0,4 to 0,5 % at the fourth and fifth quarters.

The High Council still considers that the 2,3 % increase in the private wage bill expected by the Government is a little high.

b) Consumer price inflation

In its opinion on the Budget bill for 2016, the High Council estimated that the consumer price inflation could be lower than in the Government's scenario (1,0 %).

The Government significantly revised downwards its forecast, bringing it to 0,1 % in the Stability Programme of April 2016. This revision is mostly attributable to further decreases in oil prices since summer 2015.

On a year-on-year basis, the growth of prices is now negative (-0,2 % at the end of February) and may come back to zero at the end of the semester.

The High Council considers that the downwards revision of the inflation forecast made by the Government is in the right direction and that the annual average consumer price inflation may be close to zero in 2016.

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III- Remarks on the scenario for the years 2017 to 2019

1- The scenario of the Government

According to the Government's referral file, "*growth will probably be close to 1,5 % in 2017, 1 ¾ % in 2018 and 1,9 % in 2019. [...] This acceleration in activity will only lead to a progressive closing of the output gap, which may still remain unclosed over the horizon of the programming period, indicating Government's prudence on its effective growth scenario."*

"Inflation would go up in 2017 (+1,0 %), particularly driven by the dual effect of a mechanical increase in volatile inflation (the price of oil and the exchange rate are conventionally kept unchanged in the forecasting exercise) and the tightening of energy taxation. [...] Core inflation will also accelerate (+1,1 % after +0,8 %), due to inflation in services, which is boosted by the strengthening of inflation wage. Then, inflation may reach 1,4 % in 2018 and 1 ¾ % in 2019 ».

2- Remarks on potential growth and the output gap

a) About the assumption on potential growth: a high estimate

Potential growth forecasts from 2015 to 2018 (1,5 % for 2016 and 2017, 1,4 % in 2018 and 1,3 % in 2019) are similar to those submitted in the Stability Programme of April 2015[3].

Review of the assumptions made by the Government to forecast potential growth

The public finance programming law for the years 2014-2019, voted in December 2014 and that applies today as a reference for the opinion of the High Council, followed the assumptions on potential growth made by the European Commission for France (estimates known in September 2014, but coming from the forecasts of May 2014).

Forecasts of potential growth:

Forecasts of potential growth

(in %)	2015	2016	2017	2018	2019
LPFP 2014-2019	1,1	1,3	1,3	1,2	1,1
Stability Programme of April 2015	1,1	1,5	1,5	1,4	nd
Stability Programme of April 2016	1,1	1,5	1,5	1,4	1,3
EU Commission (winter forecasts 2016)	0,9	1,1	1,2	nd	nd

source: LPFP, Stability Programmes, winter forecasts 2016 from the UE Commission

In April 2015, just a few months after the vote of the public finance programming law, the Government revised its potential growth forecast upward by 0,2 point for 2016 and beyond. The High Council, in its opinion of the 13 April 2015 on the 2015-2018 Stability Programme[4], indicated that this change in potential growth, a few months after the adoption of the Stability Programme, raised a fundamental question[5].

According to the Government, this increase of 0,2 point reflects the impact of new structural reforms, and in particular the effect of the law n° 2015-990 of 6 August 2015 in favor of growth, activity and equal economic opportunity (called “Loi Macron”). The estimation method of this 0,2 additional point as not been documented by the Government.

The Government made an identical hypothesis in the Stability Programme of April 2016 than in the Stability Programme of April 2015. On its side, the European Commission revised downwards its potential growth estimates for France since 2014 by 0,2 point in 2016 and 0,1 point in 2017.

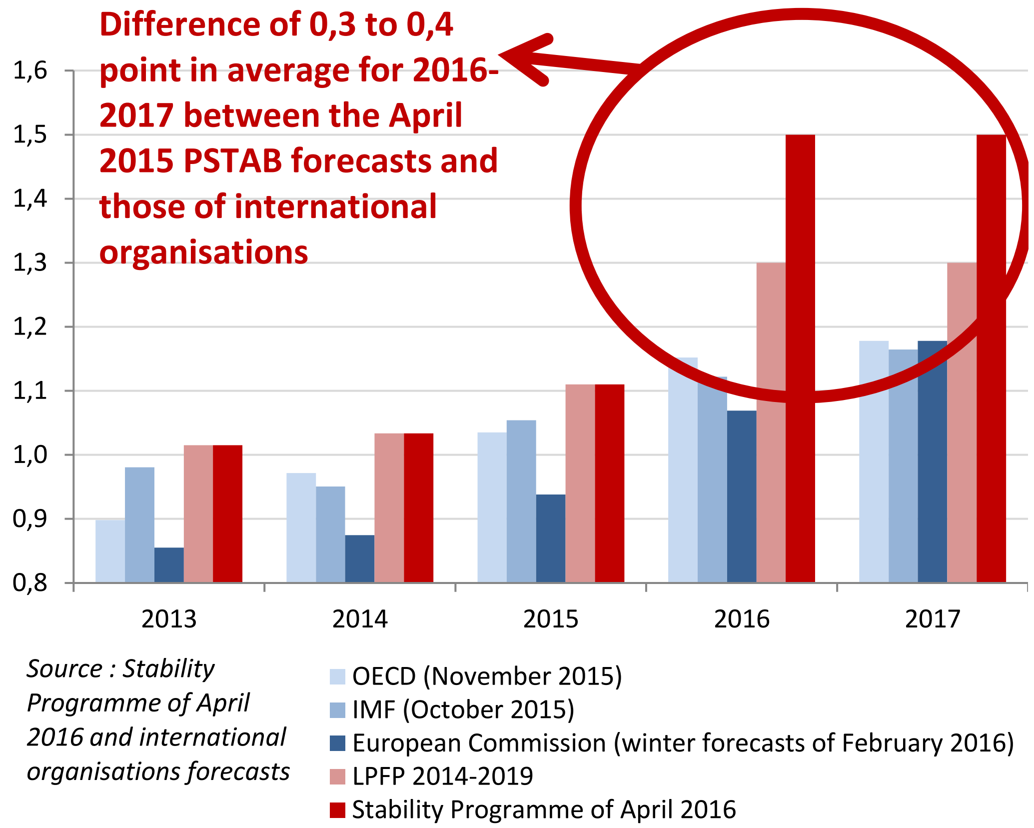
[3] 2019 had not been covered by the Stability Programme of April 2015.

[4] Opinion n° HCFP-2015-01 about the macroeconomic forecasts on which the 2015-2018 Stability Programme is based.

5 “*The High Council regrets that the potential growth forecast, whose estimation is highly uncertain, has already been revised only a few months after the adoption of the public finance programming law in December 2014*”, opinion n° HCFP-2015-01 about the macroeconomic forecasts on which the 2015-2018 Stability Programme is based.

The High Council observes that the potential growth submitted by the Government (1,5 % both in 2016 and 2017) is now much higher than international organizations estimates (between 1,1 % and 1,2 % for 2016-2017), as indicated in the following graphic.

French potential growth : Government and international organisations forecasts



Source : Stability Programme of April 2016 and international organisations forecasts

Moreover, the High Council questions on the potential growth profile, with an expected pick in 2016-2017 and then a slowdown in 2018 and 2019. This pattern doesn't seem very consistent with a progressive recovery boosted by a gradual speeding up of investment.

Overall, the High Council considers that the potential growth submitted by the Government seems overestimated, in particular in 2016-2017.

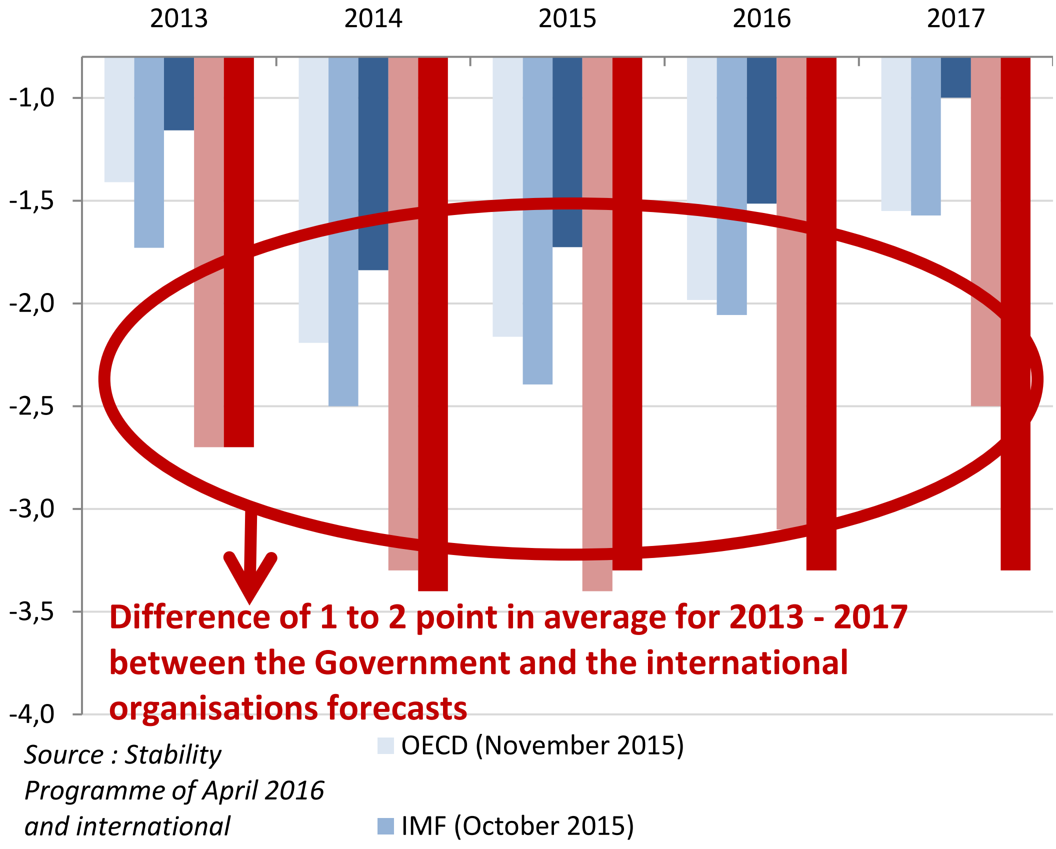
b) About the persistence of a significant output gap throughout the period

As potential and effective growth patterns until 2018 are kept unchanged with respect to the previous Stability Programme of April 2015, the output gap remains identical. Consequently, the output gap is similar to the one of the Stability Programme of April 2015, and is expected to remain very wide throughout the period. Kept constant at -3,3 % from 2014 to 2017, it should shrink slowly by 2018 to reach -2,5 % at the end of the programming period.

In its opinion on the Stability program of April 2015[6], the High Council expressed its doubt about the realism of a persistent wide output gap on the medium term.

The High Council still considers that the persistence of a significant output gap throughout the period is unlikely to occur. As already mentioned in its previous opinion, the High Council still considers that "an important and long-lasting underutilization of production factors is not consistent with the speeding up of investment and inflation, as planned in the Government's scenario". If an important growth catch-up occurs, it would follow the trend of the present economic recovery. Thus, the output gap would be partially closed by 2019, and much lower than anticipated by the Government. Otherwise, without such a catching-up effect before 2019, part of the production losses related to the crisis seems to be irrecoverable. Therefore, the output gap estimate should also be smaller than anticipated by the Government.

French output gap : Government and international organisations forecasts

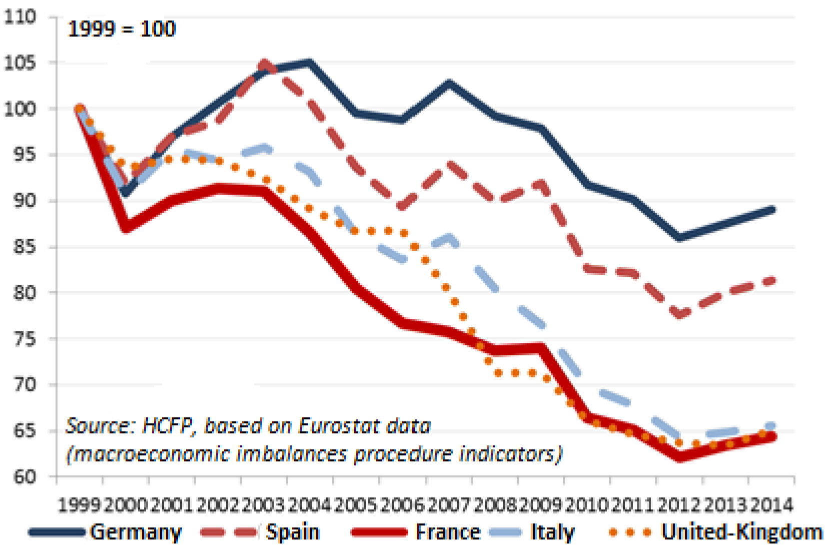


Source : Stability Programme of April 2016 and international

[6] Opinion n° HCFP-2015-01 about the macroeconomic forecasts on which the 2015-2018 Stability Programme is based.

The weak ability of the French economy to fully take advantage of the strengthening demand (domestic and external demand) raises concerns. The financial crisis of 2008-2009 and the long stagnation that followed affected productive capacities in France. The potential output decreased structurally. This fact is also suggested by the analysis of external trade: France's losses in export market shares during the decade 2000-2010 implied a cumulated loss in real GDP of several points. Then, losses gradually stopped since 2011 and now France carries out better performances, partly through exceptional sales.

Imports proved to be very dynamic in the last few semesters in comparison with the domestic demand. This can reveal the inability of national industrial suppliers to meet the demand. If several studies newly highlighted an improvement in cost competitiveness in France, others insist on the gap in non-cost competitiveness, mostly attributable to remaining structural obstacles to growth.



3- Opinion on the macroeconomic scenario for 2017-2019

The growth forecasts submitted by the Government are identical to those given in the Stability Programme of April 2015[7]. The High Council qualified these forecasts as prudent at the time, despite financial risks.

The scenario submitted by the Government does not take into account the potential risks mentioned in part I above. Beyond the realization of these risks, a question remains in all recent forecasting exercises: how large is the French output gap, and how fast can France close it?

In view of the government's assumptions on both potential growth and the output gap, the medium term scenario submitted by the Government may appear as prudent. It assumes a slow reduction in the output gap beginning in 2018, and excludes an output gap closure in the forecast period, which leaves margins for growth in the future.

[7] The Stability Programme of April 2015 covered the period 2015-2018 and did not include the year 2019.

However, the High Council assesses that the potential growth could be lower, in particular in 2016-2017, and that the initial output gap could be less broad. In this case, keeping for instance the European Commission's up-to-date assumptions, the scenario submitted by the Government would nearly lead to a complete closure of the output gap in 2019. Under these assumptions, the Government scenario would not be particularly prudent.

With regard to 2017, 2018 and 2019, the High Council considers that the GDP growth scenario is plausible, even if the hypothesis of an accelerated growth at the end of the period is fragile. The High Council also points out the downwards risks attached to this scenario, either related to the world growth or earmarked to the Eurozone.

The Government anticipates a speeding up of **inflation** in 2017, mostly due to the halt in the decrease of raw material prices. But the hypothesis of speeding up goes beyond its mechanical effect. Regarding the lower prices of oil, the slight Euro's appreciation and the still high level of unemployment, **the High Council considers that the rise of inflation could be more progressive than in Government's scenario.**

4- About the large output gap estimate: its consequences to assess the soundness of public finance in structural terms

The High Council reckons that the assumption made by the Government of a large output gap, higher than most existing estimates, tends to maximize the cyclical component of the deficit and to underestimate the structural deficit. The High Council emphasizes the fact that this underestimation minimizes the effort needed in order to reach a balance in public finance in the medium term.

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