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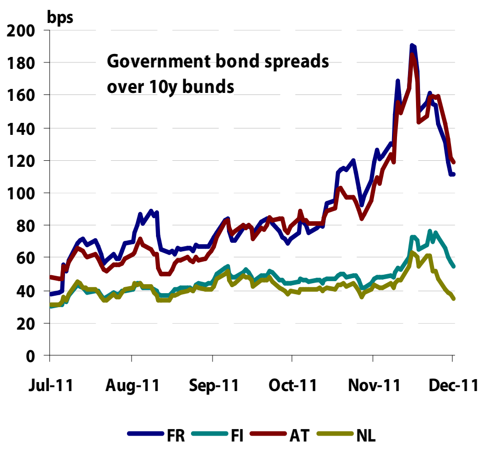
France: AAA status is difficult to defend in a stressed scenario.

- The escalation of the debt crisis has put France's top credit rating in question, as its budget and current account deficits are larger compared to other AAA euro area countries.
- Failure to tackle the euro area debt crisis would put the French public finances in peril, mainly through three channels: higher borrowing costs, injection of public funds for banks' recapitalization and issuance of EFSF loans.
- Debt servicing costs above 5% seem to be the threshold beyond which the sustainability of the French debt is in danger.
- In our baseline scenario, French public debt is projected to approach 90% of GDP in 2013, challenging its AAA status. Therefore, continued fiscal vigilance and steady primary surpluses are necessary to defend the AAA grade.
- Weaker GDP growth in 2012 than forecasted by the government may raise the need for additional fiscal measures. However, political resistance to further austerity is likely due to the upcoming presidential elections.

The intensification of the euro area crisis has fanned market concerns about the debt dynamics of core countries, most notably France. Spreads of French government bonds over German bunds have widened, illustrating markets concerns about the country's top credit rating (Figure 1). While currently all of the three major rating agencies have a stable outlook for French credit, they have warned that its rating is at risk, as France seems to be the weakest among its AAA rated European peers.

France's AAA status is backed by political stability and a robust and diverse economy with strong brand names and high value-added products. However, its fundamentals are weaker compared to those of other AAA countries, thus rendering the country vulnerable to further intensification of the sovereign debt crisis (Figure 2). While France has managed to increase the share of its total exports to emerging markets, its economy remains less open relative to other countries (Figure 3). The negative trade balance has

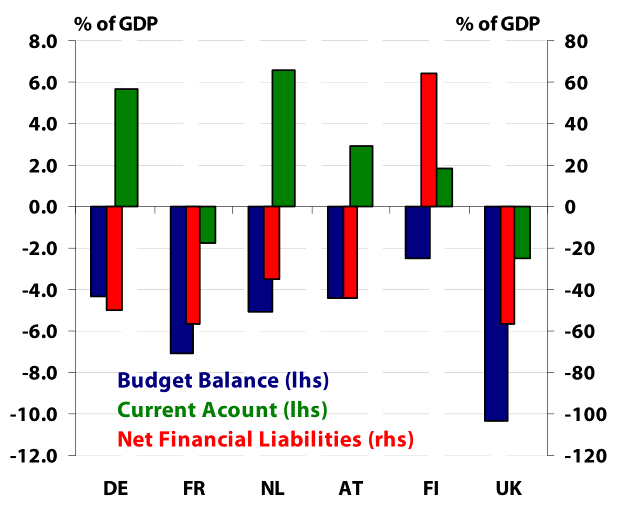
Figure 1



Source: Bloomberg

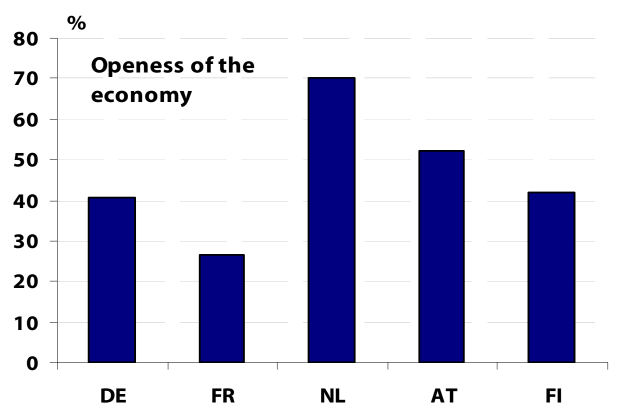
resulted in a current account deficit which, although it remained stable during the financial crisis, it may start widening as imports rise due to stronger domestic demand and higher commodity prices. Fiscal expansion during the financial crisis has led France's government debt to soar to 82.3% of GDP in 2010, about 20 percentage points higher relative to 2007. While this debt level stands slightly lower than that of Germany (83.2%), France's budget deficit has climbed to -7.1% of GDP, higher than that of other top rated euro area countries. With respect to net financial liabilities, France compares poorly with its AAA peers.

Figure 2



Source: Eurostat

Figure 3



Note: Openess is measured as total exports of goods and services as percent of GDP
Source: Eurostat

France's top rating grade is underpinned by political willingness to improve the country's public finances. Continued commitment to attain fiscal consolidation is crucial in the country's effort to defend its AAA status. Last August, the government revised its real GDP forecast for 2012 to 1.75% from 2.25% and announced a series of measures aiming at saving debt equal to €48.4bn by 2016. However, escalation of the debt crisis has lead to a deterioration of economic sentiment since August, forcing the government to further revise downwards its GDP projection to the more realistic figure of 1% and adopting an additional frontloaded pack of measures in order to avoid an additional amount of debt worth €64.7bn. The government targets a balanced budget by 2016 (table 1).

Table 1

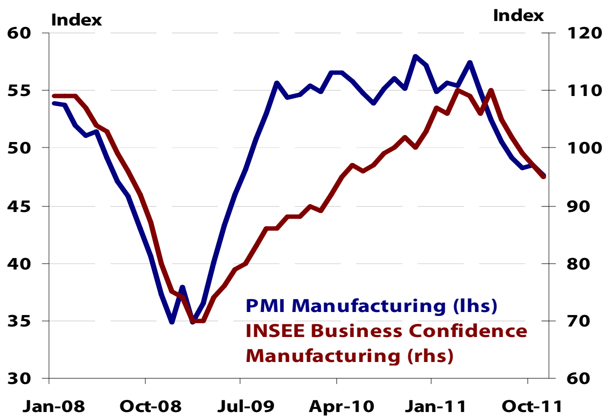
	2011	2012	2013	2014	2015	2016	Debt saved
August measures (€bn)	1.2	10.4	9.9	9.4	8.7	8.7	48.4
November measures (€bn)	0	7.0	11.6	13.3	15.3	17.4	64.7
GDP projections (% y-o-y)	1.75	1.0	2.0	2.0	2.0	2.0	
Budget deficit projections (% of GDP)	-5.7	-4.5	-3.0	-2.0	-1.0	0	

Source: Agence France Tresor

The August and November announcements combined yield measures for 2012 worth €17.4bn in order to reduce the budget deficit to 4.5%. The government calculations rely on a GDP growth projection for 2012 at 1%, which we consider to be rather optimistic. Risks to the French economy remain to the downside due to the fiscal austerity drag, the unfavorable external environment and persistent political uncertainty concerning the resolution of the debt crisis. Leading indicators point to a continued deterioration of the economic sentiment, particularly marked in the manufacturing sector (Figure 4). As a result, investment is expected to remain subdued, while inventory drawdown will weigh on economic growth. Despite the rebound in personal consumption in the third quarter of 2011, household expenditures will most likely remain weak, as the unemployment has reached a new cyclical high. Therefore, we expect GDP growth to contract in Q4/11and Q1/12 and come out slightly above zero in 2012. This implies that additional measures may be necessary to hit the fiscal targets. However, delivery of additional austerity may need to curb increasing political resistance due to the presidential elections scheduled for next spring.

The budget execution data so far suggest that the government will attain its fiscal targets for 2011, i.e. 5.7% of GDP. According to the budget law, total revenues are projected to fall 0.5% compared to 2010. In the nine month execution until September, revenues have overshot the target, as they increased by 0.9%. The increase is mainly attributed to VAT revenues that have come out stronger (up 5.1% versus a full year target of 3.9%). Expenditures fell by 13.6% in the nine month period versus a target of 14.2% of y-o-y reduction.

Figure 4



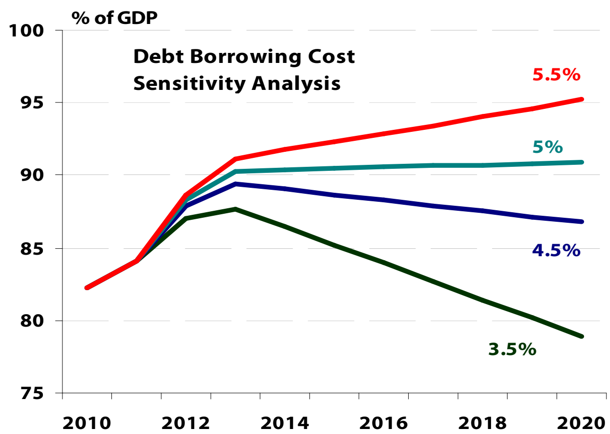
Source: Bloomberg

Figure 5 depicts the dynamics of French debt for various debt servicing costs. In our calculations we assumed a real growth rate of 2%, inflation of 1.8% and a primary surplus equal to 1% from 2014 onwards. If borrowing costs remain at the current level (3.5% for 10 year government bonds) the debt-to-GDP ratio will peak in 2013 and start declining thereafter. If interest rates rise by 100bps to 4.5%, our baseline scenario, the debt-to-GDP ratio peaks at slightly below 90% which seems to be roughly the upper limit considered by rating agencies for assigning France a AAA credit rating. However, the rate of decline is small, as by 2020 the debt-to-GDP ratio falls only by about 3 percentage points. This suggests that if debt servicing costs rise, stricter fiscal austerity is required in order to achieve larger primary surpluses. This may prove challenging, as France does not have a good record of running primary surpluses for long periods of time. Finally, an increase in borrowing costs by 150bps to 5% seems to be the threshold that destabilizes the debt dynamics under our assumptions. Therefore, in a stressed scenario with significant erosion of markets confidence, likely to occur if policymakers fail to stem contagion of the debt crisis, France could hardly defend its AAA status.

In the case further contagion of the debt crisis materializes, French public debt sustainability will be adversely affected by French banks' exposure to weak periphery members. Compared to other AAA-rated countries, the French banking sector has the largest exposure to Greece and Italy, including both the public and the private sector, both in absolute figures (€55.7bn and €416.4bn, respectively) and as percent of GDP (Figure 6). According to the latest BIS data, Greek government debt holdings at end Q2 stood at about €11bn. Assuming a 50% haircut, losses from the private sector involvement to the Greek debt restructuring represent around 1.4% of total capital and reserves of the French monetary financial institutions. These losses can be accommodated by banks. Losses may be even smaller given that exposure has most likely declined since June 2011. According to the EBA estimations, French banks need to raise €8.84bn to achieve core tier 1 ratio of 9%. Cash flows and deleveraging may help the banks to build the required capital buffer, reducing the need to tap the markets. However, losses from adverse developments concerning the Italian debt seem more difficult to absorb, raising fears that in a stressed scenario a substantial injection of public funds may be needed to keep French banks afloat.

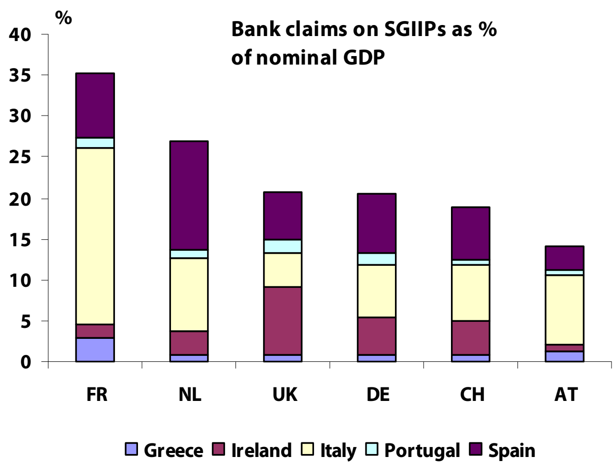
Besides bank losses, the escalation of the debt crisis can hit directly the French public finances through EFSF loans. France is a guarantor country and based on its contribution key, its share in the EFSF mechanism is €158.5bn out of total guarantees of €780bn. This amount corresponds to about 8% of GDP and it would increase gross debt to 90.3% As doubt that the Italian debt can be rehabilitated solely by economic reforms is growing, there are mounting signs that France's contribution to the EFSF will be fully deployed, thus placing an extra burden to its fiscal consolidation effort.

Figure 5



Source: Eurobank

Figure 6



Source: BIS,Eurostat

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