Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
FRENCH REPUBLIC	Assigned Ratings/Outlook: **AA /negative**	Type: Monitoring, unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	26-08-2016 29-05-2020 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 29 May 2020

Creditreform Rating has revised its outlook on the French Republic to "negative" from "stable", and affirmed the unsolicited long-term sovereign rating of "AA". Creditreform Rating has also affirmed France's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA".

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Key Rating Drivers

1. Very large and prosperous economy featuring a sizeable domestic market that generally contributes to resilience against cyclical swings in global activity; despite improvements, France still lagging peers as regards competitiveness and its business environment; challenges related to structural labor market shortcomings
2. Covid-19 and related restrictions cause a severe deterioration of near-term growth outlook, with stark declines on the supply and demand side; while the baseline assumption is for this to be a temporary phenomenon, and a recovery is to start taking place based on a gradual removal of restrictions over the coming months, uncertainty remains extremely high
3. Strong institutional framework, also supported by large benefits from EU/EMU membership; the government's commitment to continue implementing structural reforms seems credible despite setbacks amid hard-to-find political consensus in society
4. Large headline deficit and rising borrowing requirements will likely prompt debt-to-GDP ratio to spike from already high levels amid collapsing economic activity and corona emergency measures; fiscal metrics should improve next year as economic activity should see a rebound, but public debt ratio should decrease only very gradually; medium-term risks associated with age-related costs remain an issue despite pension reform; high debt affordability and sound debt management
5. Risks derived from the external position appear limited; while we deem the downward-trending NIIP as moderately negative, the elevated and rising external debt-to-GDP ratio is balanced by low external funding costs and a considerable amount of foreign assets; current account balance expected to widen somewhat

Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the French Republic from stable to negative, reflecting

(i) that contracting economic growth and confinement measures will see the headline deficit rise materially and above our previously assumed level, and prompt debt-to-GDP to soar to record highs, thereby aggravating the sovereign's key weakness;
(ii) fiscal sustainability concerns raised by very high uncertainty as to what extent and at which pace the sovereign will be able to bring the debt ratio back to more sustainable levels; and
(iii) our expectation of nose-diving economic growth, with possible negative reverberations to medium-term growth, also as reforms currently suspended may be postponed in light of Covid-19.

Macroeconomic Performance

France's credit ratings are supported by a favorable macroeconomic performance profile, characterized by its very large economy, which boasts high income and productivity levels and is deeply integrated into European supply chains. Notwithstanding some progress, structural challenges pertaining to the overall business environment and labor market persist. The Covid-19 pandemic will likely cause a steep but temporary decline in the development of economic output and the labor market, although these assumptions are subject to a high level of uncertainty.

In its tenth consecutive year of expansion, French real GDP growth eased from 1.7% in 2018 to 1.3% last year, moderating further from an intermediate peak in 2017, although proving relatively resilient compared to the economic development of its main trading partners, in particular Germany, which grew half as fast (0.6%). Stiff opposition against the government's pension reform accompanied by strikes put a dent on last year's growth, resulting in declining GDP growth in the last quarter of 2019 (-0.1% q-o-q).

Overall, domestic demand (excluding inventories) remained a growth driver last year, contributing 1.8 p.p. to France's output expansion (2018: 1.3 p.p.), with private and public consumption as well as gross fixed capital formation (GFCF) all registering higher growth rates than a year before. Growth was led by broad-based investment growth, as GFCF expanded by 3.6% (2018: 2.8%), with investment in construction, intellectual property products and machinery/equipment all contributing, but ended the year in near-stagnation (Q4-19: +0.2% y-o-y). Private consumption grew by 1.2% in 2019 (2018: 0.9%), aided by ongoing positive labor market developments including employment growth of 1.2% (2018: 1.0%), moderate inflation rates, and a rather expansionary fiscal stance. Against this backdrop, imports also increased more strongly than in 2018, leading to net exports acting as a drag on GDP growth in 2019, as export growth softened compared to the preceding year (2.0% vs. 3.5%), despite being partly supported by sizeable aircraft deliveries. The change in inventories subtracted another 0.4 p.p. from GDP growth in 2019.

Meanwhile, France's unemployment rate dropped from 9.0% to 8.5% in 2018-19, still remaining markedly above the level registered for the euro area as a whole (7.5% in 2019).

We also note that the country continues to display a comparatively low labor participation, which slightly declined from 71.9% to 71.7% in 2018-19 (EA: 73.7%). Youth unemployment (15-24y), while improving over the last few years, remains an issue, with France's LFS adjusted rate still markedly above euro area levels (Q4-19: 20.2% vs. EA-19 15.4%).

Looking ahead, the year 2020 is set to see a massive decline in real GDP. According to the first estimate for Q1, total output slumped by 5.8% against the preceding quarter, the biggest drop since 1949, mainly owing to the self-imposed shutdown of non-essential activities since mid-March amid the outbreak of the novel coronavirus. Private consumption plummeted by 6.1%, while GFCF fell by 11.8%. Overall, domestic demand fell sharply, taking 6.6 p.p. off GDP growth, somewhat balanced by the supportive inventory component (+0.9 p.p.). Net foreign trade erased a further 0.2 p.p. as exports dropped by 6.5% and imports declined by 5.9%. The fact that France was among the weakest economies in Europe (among those which have reported as of 19 May) can partly be traced to strikes against the pension reform at the beginning of the year and the French construction sector. Labor unions flagged inadequate labor conditions, thus bringing production to a halt and prompting a double-digit decline in value added of the construction sector in Q1 (-14.1% y-o-y).

Corona-related restrictions to public life were in place until 11 May, after which they began to gradually unwind, aiming to have large parts of the population return to work and restarting activity in industry, commerce and services. Travel restrictions are gradually being lifted, and non-essential shops and industry, as well as primary schools, have begun to reopen since then, following a differentiated regional approach.

In order to counter the economic fallout from the spread of the virus and from the associated lockdown, French authorities are providing a loan guarantee scheme and export/credit insurance with a fiscal envelope of EUR 315bn (13.0% of 2019 GDP), as well as a EUR 110.5bn package (approx. 4.6% of 2019 GDP). The package comprises health system measures to financially aid hospitals and health care professionals, and bolster the supply of medical devices; support for the corporate sector by means of e.g. tax and social security deferrals, swiftly refunding tax credits, and direct financial assistance for SMEs and micro enterprises; and income support for households via the extension of unemployment benefits, higher sick leave reimbursements for Covid-19 affected workers and parents facing the consequences of school closures, the postponement of the unemployment insurance reform, the so-called Solidarity Fund, and an exceptional partial activity financing mechanism.

As for macroprudential measures, authorities have fully released the countercyclical capital buffer to ensure uninterrupted bank lending to SMEs that are obviously highly dependent on bank lending. Meanwhile, the ECB is flanking euro area member states' measures via an even more accommodative monetary policy stance, providing the Pandemic Emergency Purchase Program (PEPP) comprising EUR 750bn on top of increased net asset purchases to the tune of EUR 120bn under the existing asset purchase program (APP) until the end of the year. In addition, it has implemented a number of measures to ensure liquidity to the banking sector, along with a comprehensive set of collateral measures to mitigate the tightening of financial conditions across the euro area. Measures to temporarily mitigate the

effect of rating downgrades on counterparties' collateral availability have also been announced.

Overall, we expect French real GDP growth to decline by about 8.4% in 2020, followed by a rebound of approximately 5.6% next year. Our baseline scenario assumes a gradual recovery from Q3 as confinement measures are progressively lifted going forward, which is clearly subject to a high degree of uncertainty and prone to revisions as more information becomes available on the economic fallout, exit strategies, as well as on the novel coronavirus itself and possible ways of dealing with it. As illustrated by data on European confinement measures compiled by the Blavatnik School of Government, the French government has followed an approach which may be considered to be among the most restrictive so far, with its measures only matched in terms of stringency by countries such as Italy, Spain, Portugal, and Cyprus at the height of the crisis. Arguably more importantly, recent data shows that the stance has remained more restrictive from a European perspective until recently (as of 17 May). One can also not rule out another wave of infections that may again require France to fall back on drastic, broad-based restrictions.

Prior to the outbreak of Covid-19, the stage seemed set for domestic demand to remain a growth engine in 2020, after recovering from some slowdown related to the general strike over the pension reform. Private consumption was set to increase in light of continued employment growth, some fiscal relief (reduction in housing tax and the reduction in income tax), and moderate inflation rates.

If the restrictions linked to Covid-19 are loosened and eventually fully relaxed, private consumption should see a rebound later this year; however, given the sharp decline already reported for Q1-20 and a likely steeper decline in Q2-20, household expenditure will most likely register a highly negative growth figure for 2020 as a whole. While households will likely be more inclined to save in view of the huge uncertainty around the novel virus, the tax measures mentioned above should somewhat cushion the shock on household income, along with low oil prices combined with the government support measures, especially with regard to the short-term work scheme ('partial activity mechanism').

The number of workers in the partial activity scheme has surged from 0.16m in mid-March to 12.37m on 11 May (DARES data). The number of people seeking jobless claims, on the other hand, rose by a record 7.1% in March from February, offering a glimpse of the fast-deteriorating job market. The total number of people registered at government employment agencies as seeking work rose by 246,100, the biggest monthly increase since records began in 1996. In the end, the further outlook for consumption remains very difficult to forecast given the high level of uncertainty over eventual insolvencies and job losses as a consequence of Covid-19. Contingent on the actual number of jobs saved, the rebound will be more or less pronounced.

A similar development to private consumption may be expected for GFCF, where business investment had looked set to lose some momentum, but would have remained bolstered by ongoing favorable financing conditions. While government initiatives and ECB emergency measures will cushion the worst effects, we now expect a sharp fall in GFCF, driven

by disrupted supply chains, production downtime, and tremendous uncertainty on economic and health prospects. To be sure, a lift-off starting in the second half of the year, as envisaged for household spending, seems somewhat more uncertain for investment activity. In this regard, not only the timing and speed of resuming production and the provision of services seem of importance, but also how sales markets evolve and how cautiously companies - in particular those engaging in export activities - will act regarding the near future.

Shedding light on the pervasive uncertainty and expected economic damage, March's French PMI recorded its largest contraction since the survey was launched, as did the business climate indicators of INSEE and the Banque de France (BdF). The PMI recovered somewhat in May, after hitting all-time lows in April. We note that global discord over trade practices, which pre-dates corona, could further contribute to uncertainty surrounding business investment. Furthermore, Brexit-related turbulence cannot be ruled out if the EU and the UK fail to reach agreement over their future relationship, although we consider an extension of the transition period beyond 2020 the most likely scenario in view of the current extraordinary circumstances.

Prior to the outbreak of the coronavirus, net exports should have been broadly neutral amid robust domestic demand and somewhat softer export growth in the context of simmering tensions over trade practices; now, with Covid-19 severely impairing trade flows and supply chains, exports should plunge, while imports will also suffer from the concurrent decline in domestic demand. Net foreign demand is thus likely to drag on GDP growth.

In this vein, the corona pandemic is putting tourism under immense pressure. According to data provided by the French Ministry for the Economy and Finance, tourism plays an important role for the French economy, as it is estimated to contribute 7.4% to GDP (2018) and 8.7% to employment (2016). The governments' tentative assumption that tourist flows could normalize by the end of the year may prove too optimistic, as the effect on France's tourism sector may well be longer-lasting given unclear prospects for traveling, and a possible severe loss of confidence by potential travelers. BdF's March monthly business survey suggests that the loss of economic activity in accommodation and food services may be graver than in other industries, judging by business leaders' responses to prospects after 11 May.

That being said, we remain of the view that France's large economy provides for a certain degree of resilience against external shocks. In 2019, France was the seventh-largest economy in the world, with a gross domestic product totaling USD 2.7tr in current prices (IMF data). Against the backdrop of its large and prosperous domestic market, France seems fundamentally better-shielded from cyclical swings in global economic activity than e.g. its main trading partner Germany. In 2019, exports accounted for about a third of GDP (31.4%), comparing low to Germany's 46.9% and 48.0% in the euro area as a whole. Sectors such as manufacturing and financial services, which tend to be more cyclical, only accounted for 10.8% and 3.8% of total gross value added (GVA) respectively in Q4-19 (Eurostat data), compared to 16.3% and 4.5% in the euro area.

The country's service sector is rather dominant, as reflected in the 79.3% share of total GVA (EA: 73.7%), generally helping to stabilize the economy in times of weakening external demand, particularly as high value-added sectors such as ICT services (5.5% of GVA) and business services (14.4%) are more pronounced than in the euro area as a whole (4.9% and 11.6% respectively). The higher significance of such high value-added sectors in France may deliver part of the explanation as to why the country's productivity per hour worked exceeded the EU-27 level by 25.5% in 2018, one of the highest readings in the euro area.

Competitiveness appears to remain a challenge to the French economy. Following improvements until 2016, the country's global export market share has been diminishing, equaling 3.60% last year (2016: 3.77%), largely driven by a declining services export market share. However, things may improve somewhat going forward, with indicators such as real unit labor costs falling by 1.3% in 2019, driven by real wage restraint alongside stagnant real labor productivity growth (AMECO data), pointing towards having gained some ground compared to main trading partners. In the same vein, France moved up two notches from 17 to 15 in the World Economic Forum's (WEF) 2019 Global Competitiveness Report, although still trailing the most competitive EU members and the UK in this ranking. According to WEF, the country performs well regarding infrastructure (rank 9), health (rank 7), and innovation capability (9), whereas its labor and product markets are assessed as mediocre by European standards. While we see steadfast efforts to address this issue (PACTE, see below), France's business environment is regarded as moving in the middle range among the EU-27, overall placed at rank 32 out of the 190 countries considered, according to the World Bank's latest Doing Business Report. With that, France's position remained stable compared to the previous year and was still lagging behind most AA peers in our rating universe.

Segmentation continues to be a pertinent issue on the French labor market, as gaps in unemployment for low-skilled workers and those with migration backgrounds remain relatively large compared to the rest of the population. Young people also remain disproportionately affected by high unemployment, although some improvement is visible here. As regards job security, the share of fixed-term contracts in total employment in France still compares unfavorably with the euro area as a whole (14.4% of total employment 15-64 in 2019, EA: 13.6%), but has been declining somewhat since 2017.

Further strengthening of the business environment and continued efforts to enhance labor market integration and upskilling seem essential to increasing France's non-price competitiveness and help foster productivity, as emphasized by the French National Productivity Council (CNP). Moderate expectations for total factor productivity (TFP, AMECO data) and subdued labor productivity dynamics put more emphasis on such calls. As indicated by the 2019 EIB Investment Survey, availability of skilled staff and heavy labor market regulation were found to be key barriers to investment, more so than in the EU on average.

Given that some structural reforms already under way have been suspended, as measures to protect the population's lives and hinder the spread of the coronavirus obviously needed to be prioritized (also see below), we see a downside risk of these being delayed for longer, potentially constraining the medium-to-longer-term growth outlook. Developments in this regard will thus have to be monitored closely.

Institutional Structure

France's strong institutional set-up, and merits entailed by its deep integration into the euro area and the EU, continue to constitute a credit strength in our assessment. The country enjoys access to broad and deep capital markets, and while monetary policy is conducted by the highly credible and accountable ECB, the size of France's economy partly makes up for the lack of flexibility in monetary policy. Owing to its economic weight, French economic developments arguably have a notable impact on the ECB's monetary policy, which also appears relatively well-aligned with the cyclical situation in France. We have generally not observed any major interest rate differentials since the euro has been introduced. Furthermore, French inflation rates have by and large moved in line with the euro area average.

The sovereign's long-standing track record of high governance standards represents an important pillar of our institutional assessment. Among the World Bank's Worldwide Governance Indicators (WGI), the country compares favorably with the euro area median as government effectiveness, rule of law, and control of corruption, where France is ranked 18th, 24th and 26th out of 209 countries respectively (EA median: 35, 32 and 41). We note favorably that its ranking has improved markedly in terms of government effectiveness as compared with the preceding year (2018: 26/209). Compared to AA-peer Finland, there is quite a gap to bridge in this regard, but when set against Austria or the UK, the picture is more mixed.

We favorably assess the ongoing implementation of pivotal structural reforms and the government's efforts to push forward in this respect. As elaborated in our past reviews, the French government started a multi-pronged process of far-reaching reforms pertaining to the labor market, business environment, and taxation, which we view as key in terms of unlocking higher potential growth and enhanced competitiveness. The education and training reforms, which the sovereign has been implementing since mid-2017, appear to have shown initial positive results, but will have to be monitored further. The latter also holds true with regard to the Action Plan for Business Growth and Transformation (PACTE), adopted in 2019. Alongside the ongoing implementation of labor market reforms, the government seeks to lower the tax wedge on labor for average-wage earners, which has been trending downwards but still ranks among the highest in the OECD (2019: 46.7%), primarily via turning CICE into a permanent reduction in employers' social security contributions. Further measures geared towards enhancing the business environment concern the lowering of corporate income tax rates, which are also among the highest in the OECD. In the same vein, other taxes on production, which compare relatively high when set against respective rates in the other major euro area economies, are envisaged to be decreased as part of the 'Productive Pact'. The Pact was supposed to be presented in April, setting out the government's strategy as regards industry and innovation in connection with the ecological transition and with the aim of achieving full employment by 2025, but seems to have been postponed due to the outbreak of Covid-19. The Big Investment Plan, which supports moves towards a greener economy focusing on the energy efficiency of buildings and incentives to switch to less polluting vehicles, may also take longer to be implemented against this background, or may only be partially implemented.

We are aware of the resistance that authorities have encountered in segments of society, recalling the ‘gilets jaunes’ movement of 2018/19, which began as a protest against higher fuel taxes, and at the turn of the year voicing strong opposition to pension reform. In both cases, the French leadership was forced to make significant concessions, underscoring challenges to implementing landmark reforms swiftly and according to their envisaged scope. By the same token, the political situation has not become easier, as discontent among members of President Macron’s La Republique en Marche (LREM) has reportedly been growing more recently. Against this backdrop, Macron lost its absolute majority in parliament in May, with several MPs defecting from LREM. On top of this, the newly established ‘Écologie Démocratie Solidarité’ and ‘Agir Ensemble’ movements are the ninth and tenth group in the lower house respectively, making the political landscape even more fragmented.

Having said this, President Macron seems firmly committed to continuing on his reform path. Efforts to overhaul the fragmented pension system are dragging on, whereas the initial plan to also increase the statutory retirement age of 62 years has been dropped, although to our understanding the current version incorporates strong incentives to work longer than this. The government ultimately activated article 49-3 of the French constitution, allowing it to bypass a vote, although at the expense of further alienating opponents. In the wake of this process, the government also survived two motions of no-confidence that had been put forward by the far left and the Republicans, highlighting the rift among political groups and lack of political consensus more generally. In light of the corona crisis, the reform has been suspended while approval of the Senate, where the Republicans are the strongest group, is pending.

Fiscal Sustainability

The sovereign's rather gradual approach to consolidating its public finances since 2010 has to be seen against repeated underperformance against fiscal targets, an elevated debt level, as well as challenges to fiscal sustainability stemming from high age-related costs. With the corona pandemic likely to substantially drive up the debt level in the short term, risks to fiscal sustainability have risen, although they are mitigated to some extent by high debt affordability and sound debt management.

France’s general government deficit increased from 2.3% of GDP in 2018 to 3.0% of GDP last year. The higher deficit compared to 2018 was mainly a result of lower revenues, largely driven by turning CICE into a permanent reduction of social contributions. Excluding this one-off effect, the deficit would have posted at 2.1% of GDP. Total government revenue increased by 1.2% in 2019 (2018: 2.5%), with net social contributions falling by 3.8% (2018: -1.4%) and the personal income tax intake rising by just 1.6% compared to 13.9% in 2018. CIT revenues increased by 7.8% vs. a fall of 5.1% a year before. Total government expenditure meanwhile rose by 2.6% in 2019 (2018: 1.3%), with social benefits growing by 2.7% (2018: 1.8%) and public wages rising by 1.5% (2018: 1.5%).

Looking into this year, we will almost certainly see a huge increase in the headline deficit, driven by the containment measures and the initiatives to mitigate the economic, health, and social impact (see above) which have been introduced by the Revised Budget Law for

2020 as well as the Second Revised Budget Law. Amid receding revenue and the full operation of automatic stabilizers, discretionary spending will rise materially. To save jobs and prevent widespread corporate bankruptcies, authorities have implemented a EUR 110.5bn emergency package, of which roughly EUR 42bn should affect the budget directly, including a EUR 24bn envelope to finance short-time work arrangements, as well as EUR 8bn for spending on health devices. A so-called solidarity fund was set up, endowed with EUR 7bn in support for self-employed, freelancers and micro enterprises. As of 18 May, EUR 3.23bn was granted for approx. 2.4m businesses, with the bulk active in commerce, and food and accommodation.

Measures enacted prior to the corona outbreak, such as steps to boost households' purchasing power following the 'Grand National Debate' that was held as a result of the 'yellow vest' protests, could amount to about 0.3% of GDP in 2020, also exerting a slightly negative impact on the general budget balance. Overall, we would cautiously forecast a deficit of approx. 9.4% of GDP for 2020. In the following year, the general government deficit should moderate on the back of the assumed economic recovery following a gradual unwinding of restrictions, assuming that the emergency spending would be limited to 2020. Obviously, such assumptions are surrounded by considerable uncertainty. The State's borrowing requirements have increased substantially as compared to the 2020 budget bill, by EUR 94.1bn to EUR 324.6bn (13.4% of 2019 GDP), which is envisaged to be mainly financed by the issuance of medium- and long-term debt and by increasing the outstanding BTF volume.

Against this background, we expect the French debt-to-GDP ratio to leap to just over 115% of GDP this year, before edging down to some 114% of GDP in 2021. We thus assume the public debt ratio to soar to record highs, thereby aggravating the sovereign's key weakness, as France's general government debt has remained stubbornly high over the last decade, totaling 98.1% of GDP in 2019, virtually unchanged since 2016. Hence, France's public debt ratio remains among the highest in the euro area (EA-19: 84.1%) and higher than those of most of its AA-peers in our rating universe. In the medium term, we assume debt to come down only very gradually, chiefly as a result of the expected recovery in economic output, but we view the extent to which it will be possible to bring the public debt ratio back to more sustainable levels as highly uncertain, as is the pace.

We have to highlight that fiscal risks are heavily tilted to the downside as, with hindsight, fiscal targets stipulated in the budget bills and concurrent stability programs do not seem to have kept track with the fiscal stance conveyed by the multi-annual programming law over the recent years. Furthermore, additional measures to fight the pandemic may need to follow, depending on how the exit strategy evolves and whether the infection numbers can be contained. Indeed, authorities have already confirmed their intention to provide massive and unprecedented support to the national tourism industry and the French automobile industry.

As to contingent liabilities, we are aware that total public guarantees according to Eurostat have been broadly stable over the last few years, but amounted to an elevated 11.6% of GDP in 2018. Such liabilities should go up noticeably in the wake of having to deal with the corona fallout, given the government's exceptionally large guarantee package (EUR 315bn),

which aims to support businesses and acts as a complement to the budgetary support mechanisms in the form of subsidies, loans, or equity capital. The PGE scheme allows enterprises to apply for guaranteed loans to support their cash flow, and as of 7 May, approx. EUR 66.5bn had been granted to support roughly 387,000 businesses.

In this regard, one should also mention the EUR 540bn corona package agreed among the Eurogroup on 9 April, providing a safety net for member states via ESM, corporates via EIB, and workers through SURE. Equally important is a prospective fiscal stimulus in terms of a recovery fund to support the hardest-hit EU economies. While details on the financial support program would have to be fleshed out in detail, President Macron and German Chancellor Merkel have developed a mutual understanding on a blueprint. Such a recovery fund would require the unanimous agreement of all member states, so drawing conclusions on fiscal implications is highly speculative at this juncture.

We would continue to flag risks arising from age-related costs, which are estimated to remain among the highest in the EU, at least by 2035 (2016: 31.0% of GDP, EU Ageing Report), further amplifying medium-term risks. As mentioned above, the envisaged pension reform has been partly watered down and is currently suspended due to Covid-19. Developments have to be monitored vigilantly going forward.

Looking at the financial sector, total assets of French banks came to 337.3% of GDP in Q3-19, up from 315.4% in Q3-18 (ECB data), continuing to make the French banking sector the largest among the four major euro area economies. Looking at their shock-absorbing capacity, we observe that banks' CET1 ratio was slightly up from 14.4 to 14.9% in the year to Q4-19 (EBA data), broadly on par with EU levels (15.0%). Asset quality remained relatively strong, as mirrored by a low and falling NPL ratio (Q4-19: 2.5%, Q4-18: 2.8%). At the same time, given the current fragile economic situation, buffers may have to be used, as the banking sector could become more vulnerable on the back of possible insolvencies and job losses that may see defaults rising and severely impair debt servicing in an environment in which banks were already faced with relatively high and rising private indebtedness before corona.

In particular, NFC debt is comparatively high from a EU perspective and – contrary to the general trajectory observed in Europe – continued to increase last year, concluding 2019 at 91.5% of GDP (ECB data, Q4-18: 88.6%). Following a moderation to some 4% in the second half of 2019, loans to NFCs grew at a rate of 6.6% y-o-y in March 2020, still comparing high with the euro area as a whole (3.1%). However, it is worth pointing out that risks associated with elevated corporate debt are tempered by the fact that the increase has been accompanied by a build-up of cash positions.

While we would characterize fiscal risks as having risen due to the corona pandemic, we would still deem strong debt affordability and prudent debt management as mitigating factors. The share of short-term debt made up for only 5.6% of negotiable government debt at the end of Q1-20, and the average weighted maturity equates to a high and stable 8.2 years (end Mar-20). Interest expenditure dropped by 13.4%, having the interest-to-GDP ratio fall further from an already low 1.7% to 1.4% last year (to 2.74% from 3.20% measured against total revenue). Having said this, in March this year 10-year French government

bonds came close to their all-time low of August 2019 (-0.44%) before rising into positive territory and, under higher volatility, oscillating around 0% against the backdrop of corona-related news flow. The spread to 10-year German government bonds has been hovering around 50bp since April, thus only slightly above the average 36bp seen over the last five years.

The recent ruling by the German Constitutional Court regarding German participation in the ECB's Public Sector Purchase Program (PSPP) could potentially have a negative impact on financial market conditions in the euro area, but we understand that there is a three-month period in which there may be further clarification on the matter. For now, we assume that the program will continue including German participation beyond this three-month horizon, thus ensuring a financial market environment conducive to supporting an economic rebound in the euro area.

Foreign Exposure

We continue to view risks pertaining to France's external position as limited, given that there are no signs of imbalances at present. More fundamentally, we deem its net international investment position (NIIP) to be moderately negative and not a reason for major concern. Still, the French NIIP declined to -23.3% of GDP at the end of 2019 (2018: -16.4% of GDP), mainly due to higher portfolio investment liabilities and, to a lesser extent, due to higher direct investment liabilities. This position should remain negative for the near future, reflecting the government and financial sector's external liabilities. In our view, the elevated and rising external debt-to-GDP ratio (2019: 230.1% of GDP) appears to be balanced by low external funding costs and considerable amount of foreign assets.

In 2019, the country recorded a slight current account deficit to the tune of 0.7% of GDP (2018: -0.6%), thus continuing a trend witnessed over the last 12 years. The somewhat lower surpluses in the primary income balance (from 2.5% of GDP to 2.3%) and the services balance (0.9% of GDP after 1.0%) last year offset a moderate narrowing of the deficits in goods trade and secondary income. Looking ahead, trade tensions had suggested a less benign international trade environment even without Covid-19, which would have supported the expectation of an ongoing and possibly somewhat higher negative position of the current account in light of robust domestic demand. Since we assume that the corona crisis will cause stronger disruption to exports, also bearing in mind potentially longer lasting detrimental effects via tourism, we would expect the current account deficit to widen somewhat more. According to preliminary BdF data, Q1-20 saw a sharp widening of the current account deficit to EUR 10.1bn, with a growing goods deficit despite the reduction in the energy bill and a strong decline in the services surplus due to the deteriorating travel balance. In our baseline scenario, which foresees a rebound of GDP growth later this year, such widening should, however, be limited.

Rating Outlook and Sensitivity

Our rating outlook for France's long-term credit ratings is negative, as we assume that the risk situation underlying the key factors affecting sovereign credit risk is likely to deteriorate. While we usually provide for some forward guidance on the time frame underlying our outlook, we would abstain from this at this stage. The assessment and interpretation of economic developments in the near future is considerably more challenging than under normal circumstances, as is the case for other indicators, given the massive uncertainty surrounding developments around the novel coronavirus and the related economic fallout.

We could lower our ratings if fiscal metrics fail to improve, and it turns out that the expected significant deterioration in the public debt ratio is becoming more entrenched. Renewed infection waves requiring repeated lockdowns and/or policy-makers' failure to minimize the economic fallout would seem conducive to such a scenario. We could also consider a negative rating action if French medium-term growth weakens materially, implying that the lost output due to Covid-19 is significantly larger than expected at this stage, and the fallout from the pandemic causes a lasting negative impact on its labor market. A further delay of implementing reforms to enhance the business environment and address age-related spending pressures may also trigger a downgrade.

A positive rating action could be prompted by a strong and swift rebound in economic growth, and resuming improvements in the labor market along with a strong commitment to fiscal consolidation. A revitalized structural reform momentum would seem equally beneficial.

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Ratings*

Long-term sovereign rating	AA /negative
Foreign currency senior unsecured long-term debt	AA /negative
Local currency senior unsecured long-term debt	AA /negative

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	1.0	1.1	1.1	2.3	1.7	1.3	-8.4
GDP per capita (PPP, USD)	40,949	41,659	42,440	44,115	45,893	47,223	n.a.
HICP inflation rate, y-o-y change	0.6	0.1	0.3	1.2	2.1	1.3	0.6
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.9	82.4	82.7	82.7	82.9	n.a.	n.a.
Fiscal balance/GDP	-3.9	-3.6	-3.6	-2.9	-2.3	-3.0	-9.4
Current account balance/GDP	-1.0	-0.4	-0.5	-0.7	-0.6	-0.7	n.a.
External debt/GDP	209.1	209.2	211.8	208.8	216.3	230.1	n.a.

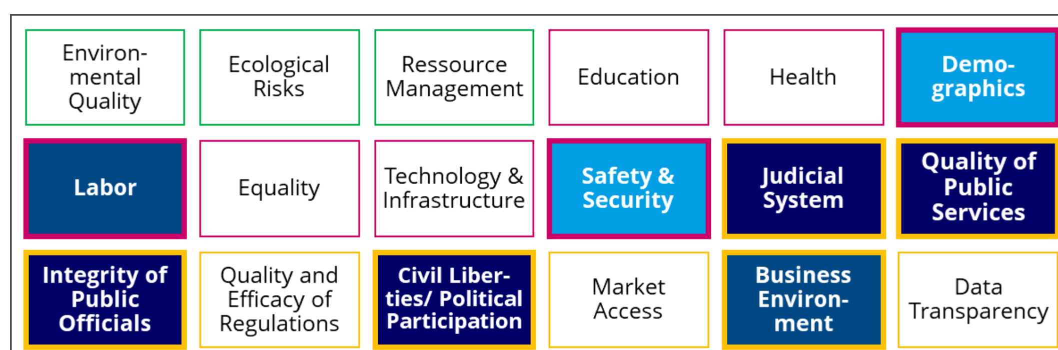
Source: International Monetary Fund, Eurostat, own estimates

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box



The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating's considerations on macroeconomic performance of the sovereign, and we regard the ESG factor 'Labor' as significant to the credit rating or adjustments thereof. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. Hence, we regard the ESG factor 'Demographics' as less significant in our ESG framework. What is more, cases of relatively frequent and/or broad based social protest in response to government policies would touch upon the social dimension as well, which is reflected among other things by the WGI "Political Stability", and would ultimately affect fiscal performance, so that we regard the ESG factor 'Safety and Security' as less significant.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	26.08.2016	AA- /stable
Monitoring	28.07.2017	AA- /positive
Monitoring	01.06.2018	AA /stable
Monitoring	05.06.2019	AA /stable
Monitoring	29.05.2020	AA /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is

allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Agence France Trésor (AFT) participated in the credit rating process as the AFT provided additional information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of AFT during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, Blavatnik School of Government, Banque de France, Agence France Trésor, INSEE, Ministère de l'Économie et des Finances, DARES.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no

other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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