Creditreform Sovereign Rating

Creditreform Rating
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Rating Object	Rating Information	
FRENCH REPUBLIC	Assigned Ratings/Outlook: **AA- /positive**	Type: Follow-up Rating, unsolicited
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 28-07-2017 “Sovereign Ratings”

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Rating Action

Neuss, 28 July 2017

Creditreform Rating has revised its outlook on the French Republic to positive 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-”.

Key Rating Drivers

1. Prosperous and productive economy complemented by an improving macroeconomic outlook, with GDP growth gradually accelerating and unemployment on a downward trajectory; gradual gains in cost competitiveness supported by contained unit labor costs
2. Backed by a significant parliamentary majority, the new administration has committed itself to adopting far-reaching reforms with regard to taxes, pensions and labor market policies – though implementation remains subject to uncertainties
3. Slowly progressing budget consolidation continued in 2016; risk of failure with regard to 3%-deficit target this year is mitigated by additional saving measures by the new administration; assuming no sharp increase in financing costs, debt-to-GDP ratio expected to stabilize beyond 2018
4. External risks limited against the backdrop of a moderate current account deficit and net external liability position of the economy

Reasons for the Rating Decision

Creditreform Rating has revised its outlook on the French Republic to positive from stable. The positive outlook is underpinned by our expectation that (i) the recent performance of key macroeconomic indicators, which point to an improvement in economic conditions, will remain in place; (ii) the headline budget deficit continues to narrow and public debt can be stabilized at current levels; and arguably most importantly (iii) the new, reform-oriented government, which is supported by a significant parliamentary majority, pushes through the proposed reforms and adheres to its envisaged path of policy-making.

France's credit rating continues to be supported by the very high quality of its institutional framework. As compared to its euro area peers, the country achieves higher scores on most of the World Bank's World Governance Indicators (WGI). The World Bank flags, in particular, the efficiency of the public service sector and low prevalence of corruption. Thus, France currently ranks 23rd out of 209 countries (2015) in terms of government effectiveness and 26th according to the WGI Control of Corruption score – well above the respective median ranks of the euro area (rank 31 and 42).

As regards France's macroeconomic performance, our credit assessment balances the country's wealthy and diversified economy, firming GDP growth and an improving labor market against structural growth impediments, hampering the country's medium-term growth perspectives. According to the IMF, France's GDP per capita was estimated at USD 42,314 (PPP terms) in 2016, and remains well above the euro area median (USD 36,833). High per capita income levels do not only mirror France's productive workforce but also a strong presence of high value-added industries in the country's service sector (e.g. information & communication, scientific and technical services).

Meanwhile, we believe that a moderate but sustained economic recovery is underway. GDP growth, which averaged at only 0.6% over 2012-14, firmed in 2015 (1.1%) and maintained its momentum in 2016. Last year, GDP expanded by 1.2%, entirely driven by strong domestic demand, with private consumption explaining most of the increase in economic output. Spending of households recorded the strongest growth rate (+2.2%) since 2007, benefiting from ongoing employment growth and the low-inflation environment. Output growth was also fueled by investment, which grew sharply by 2.8% y-o-y in 2016, partly due to temporary fiscal incentives. In particular, private sector business investment experienced strong growth (+3.6%). By contrast, net exports detracted 0.8 p.p. from GDP growth last year. On the back of vivid domestic demand, import growth was reported at 4.2%, while exports expanded less dynamically. As a result of subdued global demand, delays in aircraft deliveries and strikes in French refineries, exports grew by only 1.8%.

In our view, French output growth is set to accelerate to 1.6% this year. Domestic demand should remain the main driver of output expansion, though household spending should lose some steam. We believe that private consumption is about to weaken somewhat, as the expected pick-up in inflation is likely to put pressure on disposable household income but hold up well against the backdrop of employment growth. Thus, the number of job vacancies has increased significantly over the recent quarters, as indicated by Ministry of Labor data. At the same time, investment growth got off to a good start at the beginning of the year, coming in at 1.2% (q-o-q) in Q1-17, lifting GDP growth to 0.5%. On the whole, investment activity should presumably remain robust. While the tax credit for productive investment ran out in Apr-17, investment should be supported by upbeat business sentiment, favorable financing conditions and solid corporate profit margins, which the Banque de France expects to remain broadly unchanged in 2017 before gathering pace going forward. Somewhat slower domestic demand should translate into decelerating, though resilient import growth, while improving global growth perspectives

should be conducive to France's export performance – resulting in a less negative contribution of net trade to growth.

Against this background, it has to be noted that there are signs of improvement as regards the cost competitiveness of the French economy. After French export market shares were on a downward trajectory since 2002, the French share in global exports has stabilized since 2013. Supported by modest wage increases and policy measures to contain labor costs, real unit labor costs stabilized in 2013-16 (-0.3%, 2010-13: +1.4%; AMECO data). To be sure, we believe that regaining cost competitiveness remains a challenge going forward, given the slow pace of the adjustment.

In the medium term, we expect growth dynamics of the French economy to be moderate as the country has experienced sluggish TFP growth for some time, pointing to structural rigidities in labor and product markets. Furthermore, size-related regulation of businesses and the tax regime continue to hamper growth. Comparing the "Big 4" euro area economies, taxes on corporate profits (CIT) are relatively high in France. High taxation is also mirrored by France's position in the World Bank's assessment of the country's business environment (rank 20/32 OECD high-income countries). Nevertheless, there is some upside risk to medium-term growth, mostly driven by policy measures taken since 2015 and envisaged reform steps. To improve the business environment, the so called Macron law was enacted in 2015, including a reform of regulated professions and removing some regulatory restrictions. Notably, more than 90% of the measures requiring an implementation decree are in effect. Some progress has also been made in the area of taxation and the new administration is aiming to further reduce the tax burden (see below).

The labor market showed signs of improvement in 2016. Dropping from 10.4 to 10.1% (annual average), France experienced a decline in unemployment for the first time since 2011. Labor market reforms, as well as tax credits and social security contribution cuts (CICE and RSP) which had been implemented stepwise since 2013, seem to have contributed to the recovery of the labor market. However, the labor market situation remains challenging in view of a high share of long-term unemployment and persistent labor market segmentation. In particular, the activity rates of younger people and non EU-born residents are still comparatively low. The monthly average of the unemployment rate fell to 9.6% in May-17, down from 10.1% a year before, and we expect unemployment to remain on its gradual downward path.

Having said this, a stronger decline in unemployment appears possible as the government urges the implementation of far-reaching labor market reforms. Already in his campaign President Macron stated that a comprehensive labor market reform would be among his top priorities. Currently, the government seems determined to tackle the labor market reform as swiftly as possible. On 28 June 2017, a draft law was presented to the cabinet which would allow the government to push through legislation by means of an executive order. Reform proposals are mainly intended to enhance labor market flexibility by moving collective bargaining on wages and working time from the industry to the company level. What is more, dismissal compensation rewards should be capped and trials in labor tribunals accelerated. This should enhance incentives to hire, as firms are currently exposed to elevated uncertainty regarding the costs and expenses in the event of dismis-

sals. We believe that an implementation of these measures would benefit France's labor market performance in the medium term.

At present, however, the impact of labor market reforms on unemployment and job creation is hard to assess as employers, trade unions, and the parliament are involved in ongoing consultations concerning the labor market agenda. Hence, the size, composition and timing of possible labor market policies are clouded with uncertainty – the final executive decree should be published by September. Together with labor market reforms, the new government is planning to overhaul the unemployment benefit system. High unemployment rates recorded over recent years have been a drag on the financial situation of the unemployment insurance (UNEDIC). Last year, UNEDIC was running a deficit of EUR 4.2bn, which added to the insurance's already high debt stock. As a result of repeated deficits, UNEDICs debt climbed to a high EUR 30bn at the end of 2016. In a recent statement, PM Phillipe announced that the government will present a draft law on a reform of the unemployment benefit system in 2018 which intends to strengthen incentives to take up job offers and make unemployment insurance more inclusive, extending insurance coverage on self-employed and workers who have resigned.

Although at a slow pace, fiscal consolidation is making headway. After the headline deficit amounted to 3.6% of GDP in 2015, it narrowed to 3.4% of GDP, slightly above the projection in the 2016 stability program (3.3% of GDP). Budget improvement was driven by the economic recovery and revenue growth, which outpaced expenditure growth last year. Despite an extension of social security contribution cuts and some tax relief for households and firms, total receipts were up 1.4% y-o-y. At the same time, expenditures expanded by a modest 1.1% in 2016 (2010-15 avg.: 2.1%), benefiting from a further decrease in interest expenses, flat intermediate consumption and a marginal increase in employee compensation.

With regard to this year, the reduction of the CIT rate from 33 to 28% has been phased in for SMEs with income below EUR 75,000. On the expenditure side, the former government revised its consolidation target down for the 2015-17 period from EUR 50 to 40.7bn. This shortfall is partially covered by a set of complementary measures, including lower spending on social security and higher dividends from the Banque de France. As a result, French authorities project the budget deficit to narrow to 2.8% of GDP this year. As highlighted by the Cour des Comptes in its annual report from 26 June 2017, there is a substantial risk of deviation from this target assuming unchanged policies in the second half of 2017. In a no-policy-change scenario, the Cour des Comptes is projecting a budget deficit of 3.2% of GDP in 2017 – mainly due to higher state expenditure. Its projection also factors in budgetary risks related to a potential recapitalization of state-owned AREVA with costs totaling at EUR 4bn.

Still, we believe that a budget deficit below 3% of GDP is within reach in 2017, as we are cautiously optimistic with regard to the government's determination to comply with EU deficit targets in order to strengthen its credibility. In a speech addressing the lower house of parliament on 04 July 2017, PM Philippe expressed the government's intention to meet the 3%-deficit target this year, not by raising taxes but through additional savings. According to government officials, the central government budget will experience expenditure

cuts in the amount of EUR 4.5bn this year, with the interior and defense ministry accounting for the bulk of savings. In the medium term, the government plans to slash public expenditures are even more ambitious. Public spending may be reduced by 3 p.p. of GDP over the next five years. Savings would be used to counter-finance a reduction of the tax burden by 1 p.p. of GDP and to ramp up investment in environment, health, and education. We view the implementation of these measures – in particular lower taxes – as conducive to the competitiveness of the corporate sector. Moreover, the budgetary rebalancing from consumption towards higher investment could boost the country's potential growth rates in the medium term.

Putting the economy on a higher growth trajectory would also facilitate a reduction of France's elevated government debt levels. Although the government debt trend flattened last year, the sovereign's debt-to-GDP ratio further increased from 95.6 to 96.0% in 2015-16. Thus, France and the euro area (2016: 89.2%) continue to show divergent debt trends. It has to be emphasized that sharply rising interest rates – not backed by stronger growth or higher inflation – could pose a risk to France's medium-term fiscal sustainability. However, we believe that debt should stabilize at current levels in 2017-20 and interest rate risks should be somewhat mitigated by the structure of French government debt. As shown by recent AFT data, short-term debt accounted for only 8.9% of the French debt stock, while the average maturity of negotiable debt was extended from 7.1 (end of 2015) to 7.6 years (end of May-17). Also, financing conditions remain favorable, mirrored by vivid investor demand for a 30y-benchmark bond issued in May-17. Demand for the bond, which was finally issued with a yield of 1.997%, exceeded the issuance volume by factor 4.4. In general, France benefits from the ECB's ongoing PSPP, as well as from the size and liquidity of its government bond market, which should make the sovereign's debt a safe haven asset in times of financial market distress.

Meanwhile, financial soundness indicators signal that the French banking sector (assets-to-GDP: 251.2%) is in good shape. Banks' reliance on net interest income is relatively low, which is supportive to profitability in the current low-interest-rate environment. Throughout 2016, French banks' asset quality continued to improve and capital buffers were further strengthened. The ratio of NPLs dropped to a low 3.5% between Q1-16 and Q1-17 and the CET1 ratio was reported at 13.8% (Q1-17), up from 13.2% a year before.

As regards the French external position, we currently see no major imbalances. Assessing key external metrics, the vulnerability of the French economy seems limited at the moment. While France continued to be in a moderate net external debtor position, with the NIIP standing at -15.8% of GDP in 2016 (2015: -16.4% of GDP), the current account posted a deficit of 0.9% of GDP – in line with the average of the last five years. The slight deterioration of the current account balance seen in 2016 was mainly driven by the trade in services balance, which declined by 0.4 p.p. We expect the current account to remain broadly unchanged and post small deficits going forward.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of AA- is positive, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to improve over the next 12-18 months.

Factors which could translate into a rating upgrade include continued economic growth and a further declining unemployment rate, as well as a sustained fiscal consolidation and absence of fiscal slippages reflected in a durable reduction in the headline deficit and a stabilizing government debt trend. More importantly, the ongoing reform momentum should be sustained. Key reforms should be implemented without significant delays and should not be rejected in the parliamentary process and social dialogue. Enhancing trend growth and improving the business environment should remain high priorities to the government.

Conversely, we could revise our outlook to stable if medium-term GDP growth significantly falls short of our current expectations. This would entail adverse repercussions as lower GDP dynamics put additional pressure on the sovereign's already high debt-to-GDP ratio via the denominator effect. In the same vein, delaying or watering down structural reforms, which are currently under discussion, could lead to fiscal slippages and result in a further increase of public debt levels.

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Ratings*

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

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	2.1	0.2	0.6	0.9	1.1	1.2	1.6
GDP per capita (PPP, USD)	38,6572	39,2511	39,912	40,6746	41,4314	42,314	43,653
Inflation rate, y-o-y change	2.3	2.2	1.0	0.6	0.1	0.3	1.2
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.1	82.0	82.2	82.7	82.7	n.a.	n.a.
Fiscal balance/GDP	-5.1	-4.8	-4.0	-3.9	-3.6	-3.4	-3.0
Current account balance/GDP	-1.0	-1.2	-0.9	-1.1	-0.2	-0.9	n.a.
External debt/GDP	182.3	200.4	197.5	193.3	205.8	202.6	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. The 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.

The rating was conducted on the basis of Creditreform Rating´s “Sovereign Ratings” methodology. Creditreform Rating AG 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 Creditreform Rating´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality 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 and that the rating action was and is free of any existing or potential conflicts of interest. 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 Creditreform Rating´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

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