10 May 2019

Public Finance

French Republic - Rating Report

AA

STABLE OUTLOOK

Credit strengths

- Large and diversified economy
- Structural reforms
- High investment
- Favourable debt structure

Credit weaknesses

- Elevated public debt
- Persistent fiscal deficits
- Labour market challenges

Rating rationale and Outlook:

The AA rating is supported by the French Republic's large and diversified economy, its track record of structural reforms and high investment underpinning growth potential, and the favourable debt structure. At the same time, elevated public debt levels, persistent fiscal deficits and labour market challenges remain structural weaknesses.

The Stable Outlook reflects Scope's expectation of a continuation of the government's reform programme and public debt to remain elevated, and stable.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	France	Peer comparison	
		Average	Belgium
Domestic economic risk			
Public finance risk			
External economic risk			
Financial risk			
Political and institutional risk			
Qualitative adjustment (notches)	3		3
Final rating	AA		AA

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with one selected country chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Continuous reform implementation
- Path of sustained fiscal consolidation

Negative rating-change drivers

- Roll-back of structural reforms
- Unsustainable fiscal policies

Ratings and Outlook

Foreign currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/ Stable

Local currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: SCOP

Domestic economic risk

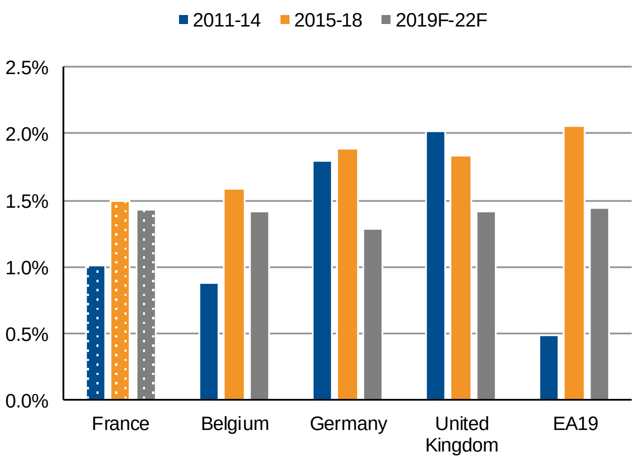
Growth potential of the economy

Stable growth outlook despite structural challenges

Following a period of stagnation with low growth potential (around 1% p.a.) and real annual growth averaging only 0.8% during 2012-16, economic activity in France picked up in 2017 (2.3%). This upward trend was sustained through 2018 (1.6%) despite a weaker global environment. Buoyant investment and foreign demand backed absorption in 2018, while consumption growth remained subdued. Higher tobacco taxes and the one-time increase of the general social security contribution (CSG) also put constraints on disposable household income in early 2018.

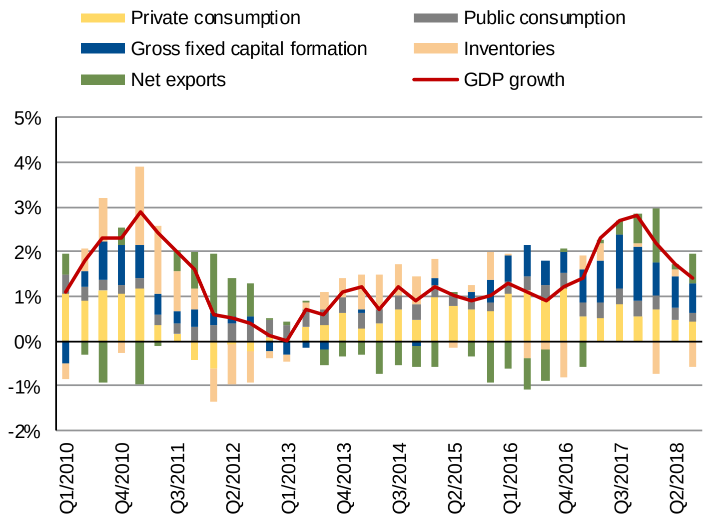
In 2019, we expect economic growth to moderate towards 1.3%, below previous expectations but above European peer levels (**Figure 2**). This will be driven by a rebound in domestic consumption supported by positive fiscal measures, and the robust labour market. Business investment is also projected to remain dynamic on the back of labour market reforms and favourable refinancing conditions. Compared with 2018, lower export growth driven by weaker global growth and ongoing economic and political uncertainty in part related to *gilets jaunes* social protests could weigh on the growth outlook (**Figure 3**).

Figure 2: Average real GDP growth among peers (%)



Source: IMF, World Economic Outlook

Figure 3: Real GDP growth (YoY, %)



Source: Eurostat, European Central Bank

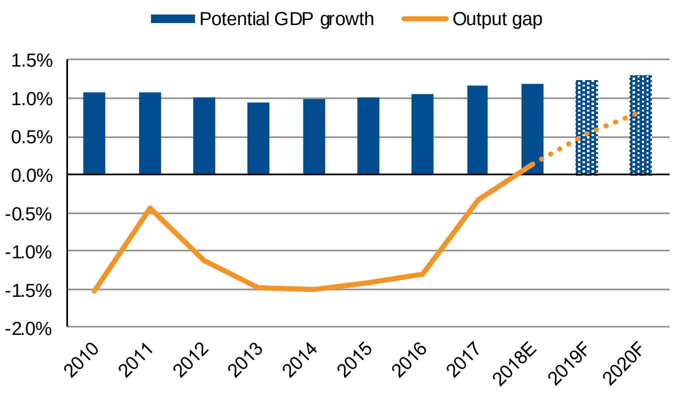
Labour market reforms have stimulated potential growth…

The French government under President Emmanuel Macron has enacted major supply-oriented reforms to stimulate growth potential. These include tax cuts for employers and employees, reduced ancillary wage costs, and a reform of the tax system aimed at reducing distortive (i.e. the wealth tax) while broadening the tax base by increasing the CSG solidarity tax rate. We believe these measures could support the growth potential by around 0.1-0.2 percentage points (pp), as already reflected in the higher-than expected expansion during H2 2018 (**Figure 4**).

…but the tax wedge still prevents broader job creation

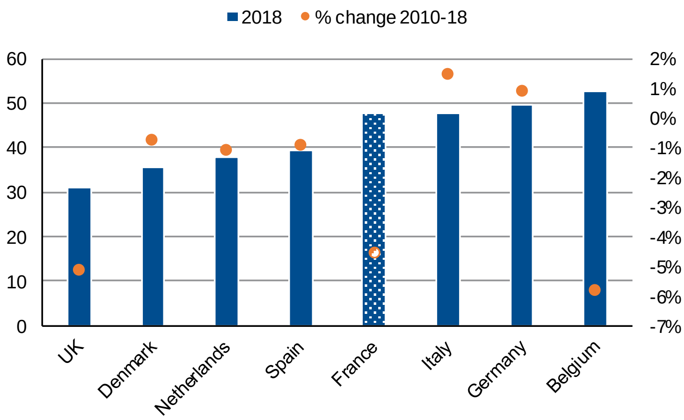
Despite a strong record of reforms and a sizeable reduction of labour costs, France still ranks among the five OECD countries with the highest tax wedges (**Figure 5**). The tax wedge measures the ratio of taxes paid by a worker (single worker without children) as a share of total wage costs for the employer. The persistently high labour costs have prevented more broad-based employment growth, especially for the low-skilled.

Figure 4: Growth potential and output gap (YoY, %)



Source: European Commission

Figure 5: Tax wedge (% of labour costs)[1]



Source: OECD, Scope Ratings GmbH

Economic policy framework

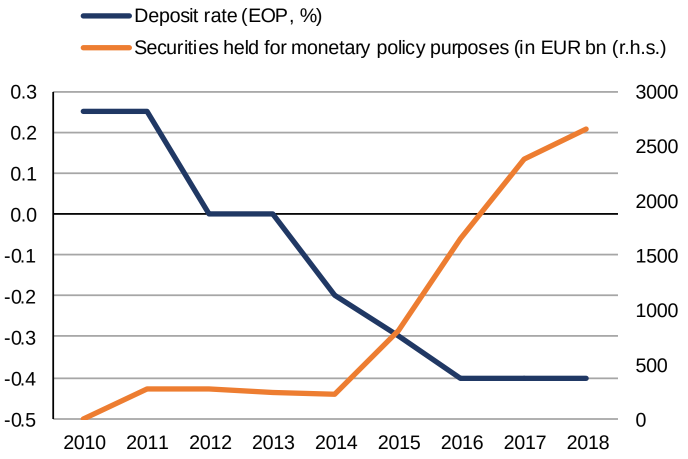
Leader of European integration process

France is a major architect and guarantor of the European institutional framework. As the second-largest euro area economy, the country is decisive in preserving and driving the consolidation of European integration. The current government has been a leading force behind reforms to deepen political integration over the medium term, pushing for a common EU budget and a digital tax regime. France also benefits from a favourable monetary policy, with the ECB holding close to 15% of its State debt[2].

Stable inflation and exchange rate environment

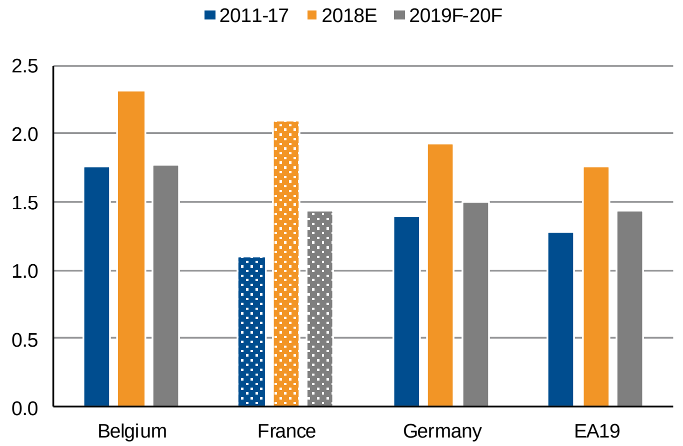
Headline HICP inflation averaged 2.1% in 2018, largely due to higher energy prices (**Figure 7**). Going forward, we expect only moderate price increases of below 1.5% over 2019-20 despite the ECB's continuous expansionary monetary policy (**Figure 6**). When comparing with peers, we anticipate wages to grow moderately in line with those in Germany. France's minimum wage and pensions are linked to consumer prices, but second-round effects did not materialise in the past.

Figure 6: Monetary policy stance



Sources: European Central Bank, IMF

Figure 7: Consumer prices (% change YoY)



Sources: IMF, World Economic Outlook

[1] The figure does not yet include the permanent reduction of social charges to French employers, which replace the former CICE tax credit in 2019
[2] Agence France Trésor, Monthly Bulletin March 2019, Christophe Duval-Kieffer (Nomura)

Macroeconomic stability and sustainability

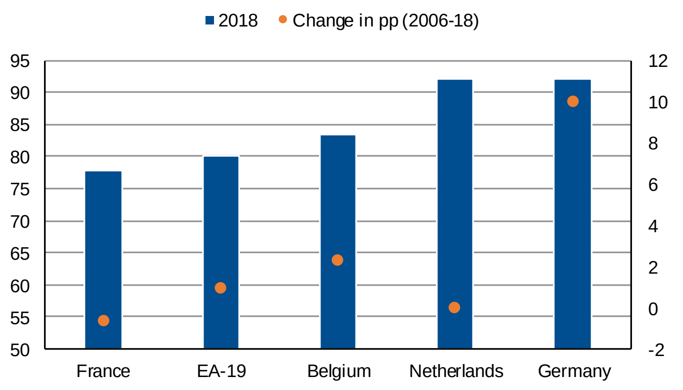
Strong reduction in unemployment rate since 2015…

The rebound of the French economy has helped to decrease overall unemployment from 10.4% in 2015 to 9.1% in 2018. The impact of policy-related measures to reduce labour cost was particularly felt in 2016 and 2017. As a result, private sector employment is set to increase further over the forecast horizon, though at a more moderate pace than in previous years. Going forward, corporate tax cuts could also contribute by stimulating employment, which remains relatively low compared to euro area peers despite steady improvements in the past. In 2019, we expect the increase in private sector employment to be partly offset by a drop in public sector-subsidised jobs. Jobs growth could further reduce unemployment towards 8% by 2021 if the government completes its reform agenda[3].

…while youth and structural unemployment remains high

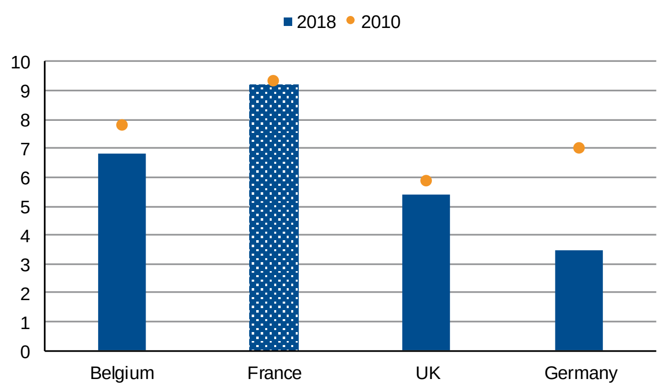
On the other hand, structural and youth unemployment in France remains high compared to peers (**Figures 8 and 9**). The process to stimulate job creation picked up in France since 2017, with the Macron government's efforts to better align education and training systems to labour market needs. However, such reforms take longer to have a material economic impact, compared with cuts on taxes or social contributions. Therefore, we expect only a gradual reduction in structural unemployment from 9.2% in 2018 to 9.0% in 2020[4].

Figure 8: Youth employment (% of population aged 20-34 with at least upper-secondary education)



Source: Eurostat

Figure 9: Structural unemployment (% of labour force)



Source: AMECO

Relatively low income inequality through redistribution…

Even with persistently high unemployment, alongside nationwide protests and campaigns against state reforms, income inequality in France remains among the lowest in the euro area (**Figure 10**). The ratio of income-earners in the top 20% versus the bottom 20% is below EU average, but higher relative to pre-crisis levels. France's traditionally strong labour unions have lost some bargaining power since the crisis, with the interests of many unemployed outsiders remaining underrepresented. Unions have sought to retain worker privileges (the 'insiders') in the face of high unemployment and demographic change. However, the share of involuntary part-time workers has continued to increase since the Global Financial Crisis, contributing to an erosion of labour union power (not only in France). At the same time, the government has introduced a set of policy-related measures (such as a childcare system), which favour women's participation in France and could contribute to a lower share of involuntary part-time work going forward.

Through non-progressive social security charges and indirect taxes, France's highly redistributive tax and benefit system could become less effective in combating inequality,

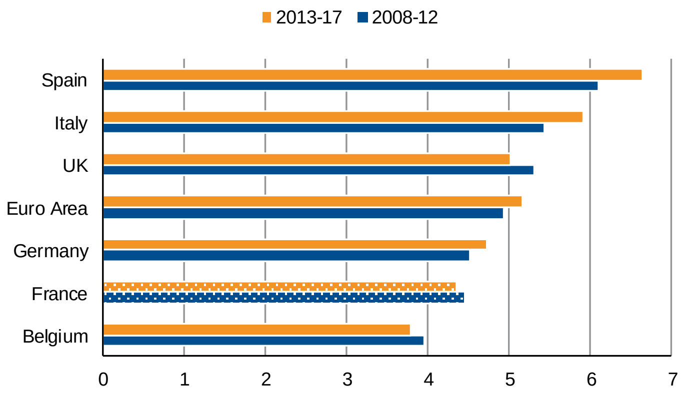
[3] IMF, World Economic Outlook Database, April 2019
[4] AMECO, data for peers in 2020: Belgium: 6.5%, UK: 5.4%, euro area: 7.8%.

especially for low-income workers. Indeed, the yellow vests movement was sparked by plans to increase indirect taxes, such as the fuel tax, to offset lower labour taxes. We therefore expect the government for its remaining term to avoid further indirect tax hikes without initiating compensatory measures.

…but persistent underachievement in skill tests

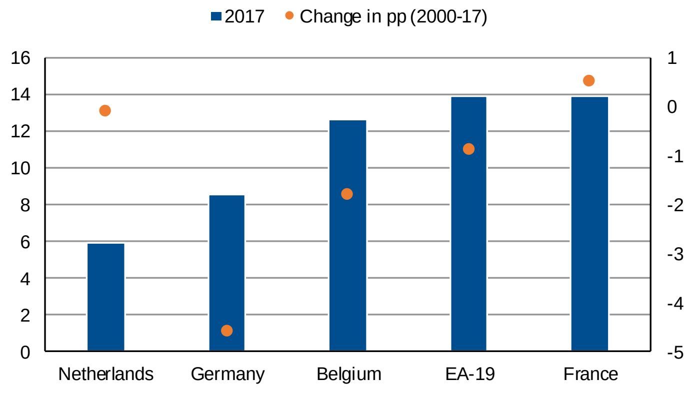
Even with the relatively low income inequality, job opportunities remain latent in France. The high level of youth unemployment can be traced back to deficiencies in education and the restrictive nature to labour market entry in France. The latest PISA tests (2015) show that 15-year-old French students fare worse in reading, maths and science than in peer countries (see **Figure 11**). This underscores the importance of the government's initiated educational reforms, particularly for the low-skilled and migrants.

Figure 10: Income inequality, 20% highest and 20% lowest income-earners (S80S20)



Source: Eurostat

Figure 11: Underachievement in reading, maths and science (PISA), % of 15-year-old students



Source: Eurostat

Public finance

Fiscal policy framework

Fiscal balance benefits from growth rebound and low refinancing rates…

In 2018, the French deficit improved for the ninth consecutive year and narrowed to 2.5%, well below both the 3% Maastricht criterion and government expectations of 2.7%. While deficit reductions since 2014 were mainly driven by higher growth, and therefore cyclical in nature, the primary deficit remains between -1.6% and -1.8%, a significant improvement since the crisis. The consolidation was achieved by a reduction in expenditure growth from above 2% p.a. over 2003-07 to +0.9 p.a. over 2013-17. Since 2014, improvements of the structural deficit have consecutively remained behind targets as defined by the EU to reach the medium-term objectives (MTO) (**Figure 15**).

…while consolidation plans are further postponed

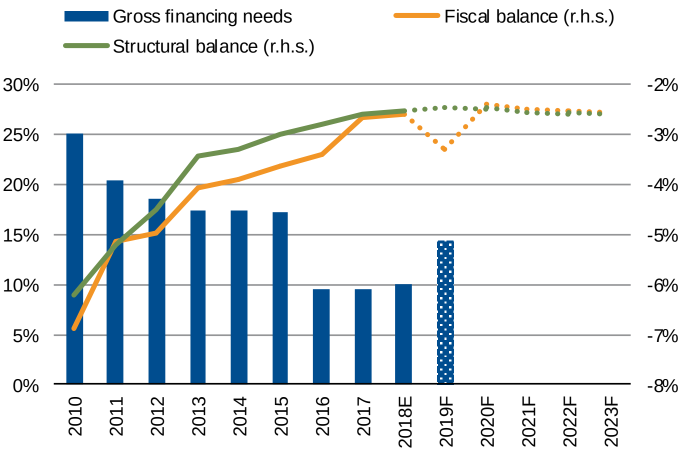
Greater fiscal stimulus, following urgent measures to retain public support, and downside risks on growth will return the 2019 budget deficit above 3% of GDP, a non-negligible deviation from the previous official target of 2.8%[5] and a temporary breach of the Maastricht threshold. Recently announced measures on the deficit are estimated at EUR 9bn, resulting in an expected increase to 3.1% of GDP. It is important to note, though, that this figure includes the one-off transformation of the tax credit for competitiveness and employment (CICE) into permanent reductions in employer's social security contributions, which we expect to account for 0.9% of GDP. Despite the higher-than-projected deficit, we do not expect the European Commission to initiate a formal deficit procedure, given the one-off measures and intense structural reforms, which require counterbalancing fiscal efforts to strengthen household purchasing power.

[5] As included in the DBP for France in 2019

Structural deficit to remain high over the medium term

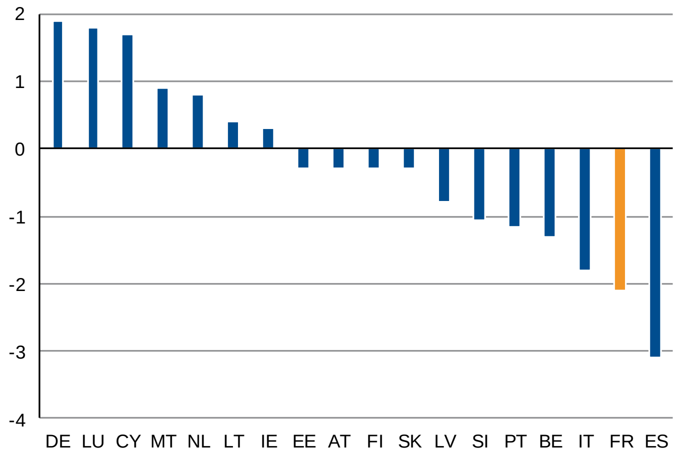
In its 2019 Stability Programme, the government defined four objectives to be met by 2022: i) cut the deficit by more than 2 pp; ii) reduce the government expenditure rate by around 3 pp; iii) cut aggregate taxes and social security contributions by more than 1 pp; and iv) reduce debt by 2 pp. Changes to the expenditure structure have been postponed to the latter half of the five-year term. Current projections show that the fiscal and structural balance will improve only gradually over the forecast horizon. Going forward, we anticipate that spending cuts will be difficult to design if public protests continue. France is currently second last in terms of the distances from the medium-term budgetary objectives (MTOs) set by the European Commission, only in front of Spain (**Figure 13**).

Figure 12: Fiscal performance, % of GDP



Source: IMF, World Economic Outlook

Figure 13: Structural adjustments and distance from MTOs (% of potential GDP)



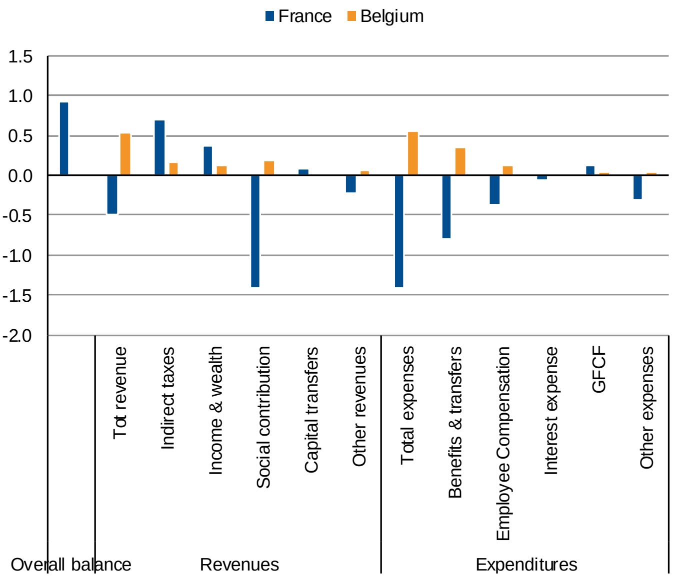
Source: ECB, countries´ DBPs and recommendation by EC

Public spending reduced without hampering growth

France has a large public sector, with the highest expenditure to GDP ratio in the euro area of 56.2%[6] (2018), currently projected to decrease gradually towards 54.1% by 2020. Close to 50% of total expenditures relate to social security spending (pensions, health). In terms of nature of spending, compensation of employees represents 25% of expenditures. While revenue-side fiscal measures have been mainly budget-neutral (shift from direct to indirect taxes), the government plans to cut social payments and public-employee spending (**Figure 14**). This will include a moderation of social benefits indices such as for retirement pensions (at least until 2021), the continued reduction of subsidised employment contracts by reducing public sector headcounts, and ongoing efforts to curb healthcare spending. The European Commission has included the growth-friendly budget in its Draft Budgetary Plan (DBP) for 2019, leaving investment expenditures unchanged. The DBP projects that public investment will increase by up to 3.6% of GDP in 2019, about 1 pp above the euro area average. Going forward, we expect a moderate reduction in public spending during the Macron government's remaining term. Unless economic growth significantly outperforms projections, additional fiscal restraint could raise additional opposition, including from local political authorities.

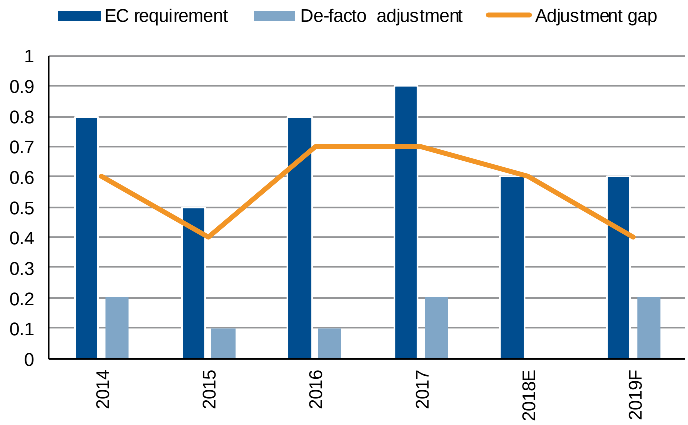
[6] EC Autumn Economic Forecasts, October 2018; and including the CICE as a spending item

Figure 14: Budget composition changes (2015-17 vs 2018-20), % of GDP



Source: AMECO

Figure 15: Structural fiscal adjustment, in pp



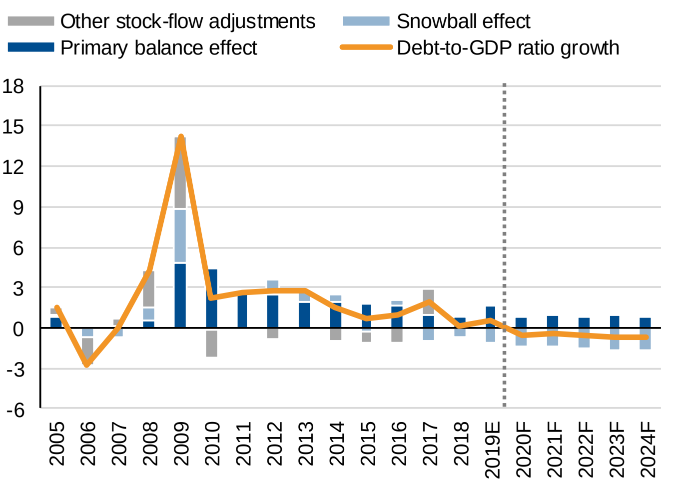
Source: European Commission

Debt sustainability analysis

High debt to GDP and only gradual decrease expected

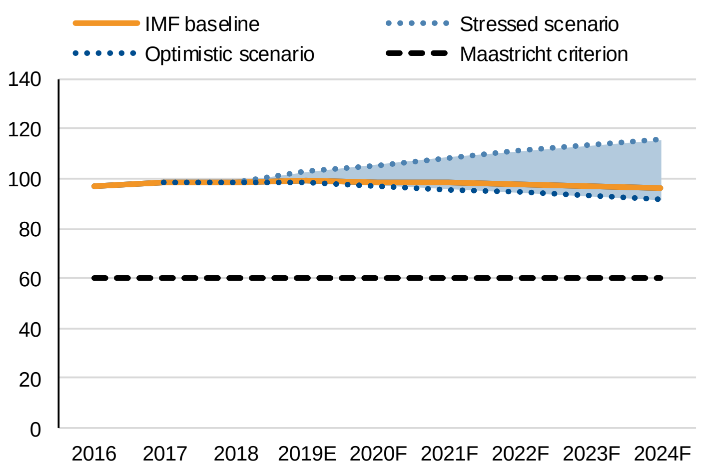
Over the last few years, low GDP growth and the legacy from the Global Financial Crisis have led to rising general government debt in relation to nominal GDP. We expect the debt ratio to stabilise at 98.4% before decreasing gradually. Persistent fiscal deficits have limited the reduction in the debt-to-GDP ratio in recent years and, according to our baseline scenario, public debt is unlikely to decrease substantially over the forecast horizon (**Figure 17**).

Figure 16: Contribution to gov't debt changes, % of GDP



Source: IMF, Scope Ratings GmbH

Figure 17: General government debt, % of GDP



Source: IMF, Scope Ratings GmbH
NB. These projections exclude the risk of banking sector-related contingent liabilities materialising on the government's balance sheet.

Scenario	Time period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt, end period (% of GDP)
History	2014-18	1.4	-1.4	1.2	98.6
IMF baseline	2019-23	1.5	-1.0	0.0	96.2
Optimistic scenario		2.0	-0.8	0.0	91.4
Stressed scenario		0.5	-2.5	0.8	115.6

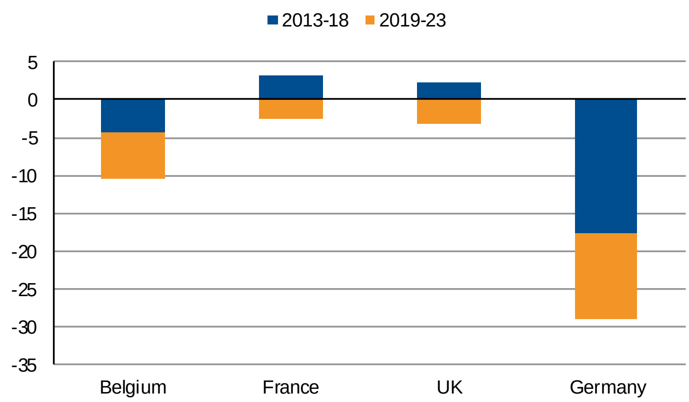
Lower age-related liabilities than those of peers…

In addition to high public debt, the French government faces contingent liabilities from future healthcare and pension payments. While actual pension and healthcare expenditures as a share of GDP are among the euro area's highest, France faces one of the lowest increases looking ahead. This is mainly due to its demographics, which are less unfavourable than in other European countries as well as to a set of reforms adopted since the 1990s that aimed at preserving the long-term sustainability of the pension system (**Figure 19**).

…but high pension obligations to public sector employees

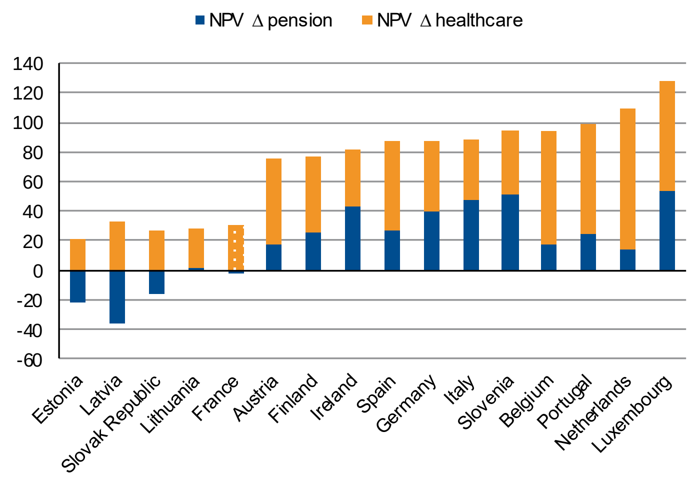
The French pension system is complex with many different mandatory retirement schemes across sectors, generous pension benefits, and a low statutory retirement age compared to that of European peers. The average effective exit age from the labour market was 61.8 years in 2017 and is projected to increase gradually towards 64.5 years by 2050. We expect pension expenditure to increase slightly until 2032 and to decline thereafter, thanks to a moderate increase in the old-age dependency ratio. The government has also announced a reform of the pension system, by reducing the number of coexisting pension regimes and strengthening the link between contributions and benefits. Future retirees can expect benefits to be tied to their accumulated contributions and remaining life expectancy at retirement.

Figure 18: Debt/GDP changes among peers (%)



Source: IMF WEO

Figure 19: Contingent liabilities, % of GDP



Source: IMF Fiscal Monitor, October 2018

Market access and funding sources

ECB is the main holder of French public debt

As of December 2018, the Eurosystem held EUR 420bn of French public debt acquired on behalf of its public sector purchase programme, accounting for close to 15% of negotiable state debt[7]. The ECB therefore is the main holder of French public debt, meaning its future monetary policy has implications for its funding strategy. It is expected

[7] Agence France Trésor, Monthly Bulletin, March 2019

that the ECB re-invests EUR 54bn of maturing French public bonds in 2019, in a continuation of its monetary strategy.

Favourable funding conditions over short and medium term

During Q1 2019, the AFT launched 38.8% of its total financing programme target (EUR 200bn), well above rates in previous years. The increased investor demand for French bonds is also evident in the record-low yields: 1.6% for a 30-year bond worth EUR 7bn. Based on its financing programme, the AFT plans to refinance debt totalling around 8% of GDP in 2019. Going forward, we expect these favourable funding conditions to prevail given the long maturity of outstanding debt (almost eight years) and France's low share of short-term debt (5.8% of total debt).

External economic risk

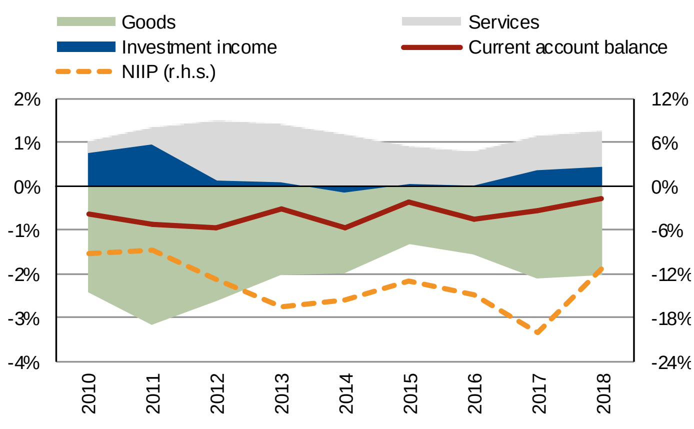
Current account vulnerability

Current account moves close to balance

France has had an annual current account deficit averaging -0.7% of GDP since 2010. While services and primary income contributed positively to the overall balance, a persistent and increasing deficit on traded goods explains the negative figures (**Figure 20**).

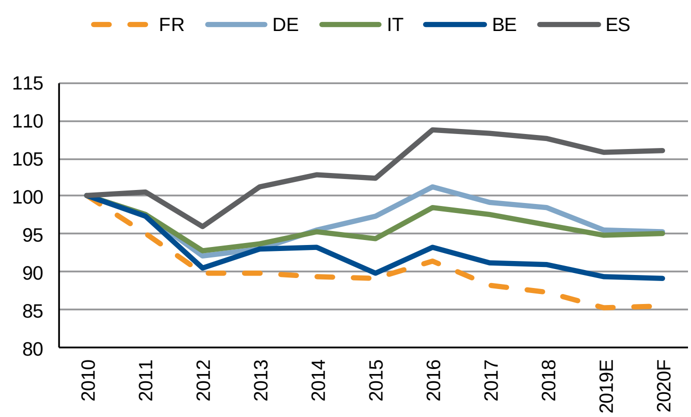
In the previous two years, the current account balance improved by 0.5% of GDP to a deficit of -0.3% in 2018, on the account of strong growth in services export offsetting the decline in the goods balance. While services benefitted from a rebound in tourism, the increasing deficit on goods follows higher energy prices and a deteriorating trend in the export of manufactured goods[8].

Figure 20: Current account and NIIP, % of GDP



Source: BdF, INSEE, Scope Ratings GmbH

Figure 21: Share of world exports (incl. EU), 2010=100



Sources: AMECO, Scope Ratings GmbH

For 2019, we expect higher import growth, boosted by the rebound in household purchasing power thanks to lower energy prices and higher disposable income. Conversely, exports are set to moderate, given the decline in deliveries expected for shipbuilding and aeronautical sectors following the 2018 boom as well as lower external demand from euro area partners, especially Germany. The expected drop of the current account balance in 2019 remains moderate, with major forecasting institutions projecting between -0.4 and -0.7% of GDP. Over the medium term, we expect external accounts to move towards zero.

France has lost trade shares since the crisis…

Despite the stable development of the current account, underpinned by a growing share of exported services (close to 30% of total exports), international competitiveness remains a vulnerability to the French economy.

[8] European Commission, Country Report, February 2019

Since 2010, France has lost 15% of its share of world exports, the largest decline among key peer OECD countries, while all of them lost shares with emerging markets' increasing weight (**Figure 21**). High wage growth relative to productivity gains led to a loss of cost competitiveness, especially against euro area trading partners. Unlike some of its peers, France has been unable to recover the lost market share, given the economy's specialisation in medium to low-tech sectors, which are more price sensitive than high-tech sectors[9]. Non-price-related factors also contributed to the loss in trade share, as shown by the slight fall in France's ranking in the global quality index of exports between 2003 and 2016[10].

…but structural reforms could help to restore competitiveness

In this context, we assess positively the recent implementation of structural reforms. The government's objectives – relieve labour market rigidities, lower the tax wedge, improve worker skills and reduce red tape – are expected to boost French economic competitiveness in the coming years. In line with the IMF, however, we caution that, while effects from the tax reforms are already tangible, other structural reforms, such as the reduction of labour market rigidities, will take more time. A sustainable increase in competitiveness also requires the success of educational reforms that bring the country closer to the technological frontier.

External debt sustainability

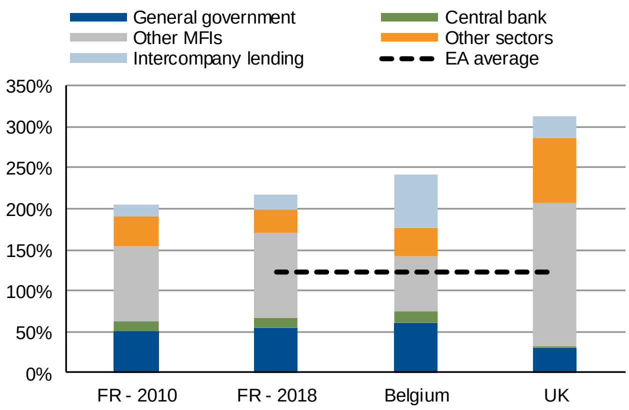
Negative, but sustainable net international investment position…

Following small, but persistent, current account deficits and stagnating GDP in the post-crisis period, France's net international investment position (NIIP) decreased to a low of around -20% of GDP in 2017 before recovering to -11.4% in 2018. Its current level and projected stable trajectory raise no sustainability concerns[11].

…driven by high external debt

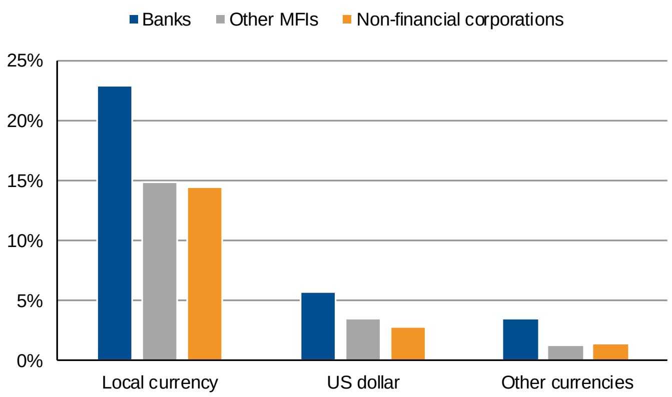
However, some vulnerabilities may arise due to the high and persistent stock of external debt, whose increase contributed to the deterioration of the NIIP in the past decade. In 2018, France's external debt, at 217.1% of GDP, was well above the euro area average (122.5%). In 2010, external debt was 205.9% relative to GDP, with the highest shares for government and financial institutions. Still, France appears less exposed to external imbalances than peers such as Belgium and the UK, whose external debt stocks in 2018 stood respectively at 241.3% and 312.7% of GDP (**Figure 22**). In addition, French international debt securities are mostly denominated in euros (**Figure 23**) and have long maturities and fixed interest rates.

Figure 22: External debt among peers, 2018, % of GDP



Source: BdF, INSEE, BNB, ONS, Scope Ratings GmbH

Figure 23: Outstanding international debt securities, Q4 2018, % of GDP



Sources: Bank for International Settlements (BIS), Scope Ratings GmbH

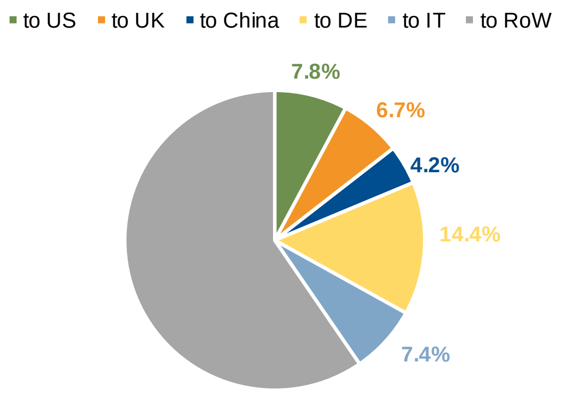
[9] IMF Article IV, June 2018
[10] Ibidem 6
[11] Ibidem 7

Vulnerability to short-term shocks

Political instability in the international environment pose trade risks…

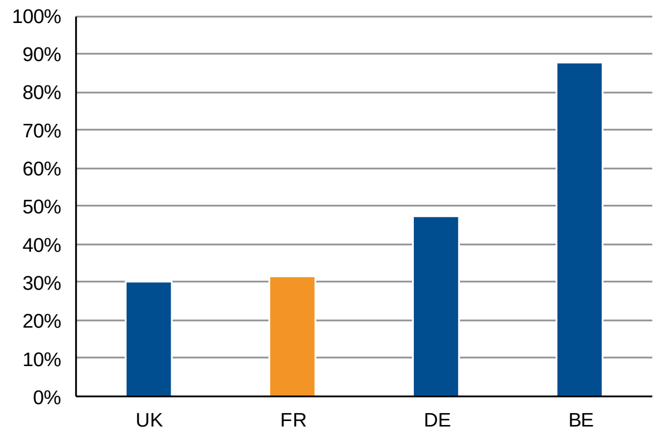
Protectionist trade policies in the US and China, political instability in Europe (the UK, Italy), and a slowing euro area economy, which is expected to also hit Germany, the main trading partner of France, could affect French economic activity and financial stability. Looking at the main trading partners, the countries most affected by current instabilities take up a large share of France's total exports and imports, with Germany, Italy, the US, the UK and China together accounting for almost 40% of French exports (**Figure 24**).

Figure 24: Major export destinations, 2018, % of GDP



Source: DGDDI, Scope Ratings GmbH

Figure 25: Export share to GDP, 2018, %



Sources: INSEE, Bbk, BNB, ONS

…but the French economy is more resilient than peers'

On the other hand, the French economy is more resilient to international trade shocks than export-oriented peers such as Germany or Belgium (**Figure 25**). Going forward, we expect buoyant private consumption and fiscal support to compensate for the expected downturn in global economic activity. External trade shocks will thus be limited to specific sectors, with only a minor spill-over risk to the general economy.

Financial stability risk

Banking sector performance

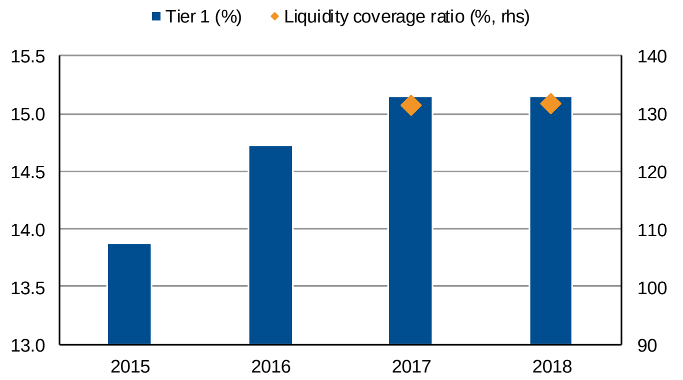
The banking sector is well capitalised…

The French banking sector shows solid and improving solvency, liquidity and credit quality ratios. The Tier 1 capital ratio increased from 13.9% in 2015 to 15.2% in 2018, while the liquidity coverage ratio, at around 130% in the past two years, stood well above minimum regulatory requirements of 100% (**Figure 26**). Non-performing loans have continued to decrease to 2.9% of total assets in Q2 2018, below the euro area average. EBA stress tests published last November indicate that, in a stressed scenario, the capital ratio of French banks would decline less than the European average. Lastly, according to the IMF, French banks comply with the new Basel requirement regarding the implementation of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL).

…but high costs put pressure on profitability

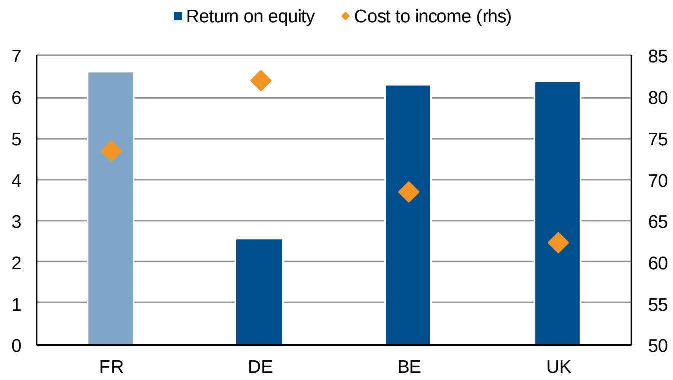
Notwithstanding their solid capitalisation, prospects for the banking sectors could deteriorate if profitability remains weak. While past ROEs were in line with EU peer levels, high and increasing costs remain a challenge for French banks (**Figure 27**). The cost-to-income ratio, at 73%, is among the highest in the euro area. Especially given the low interest rates and the shift towards digitalisation, cost-cutting will underpin the medium-term sustainability of the French banking sector. That said, French banks remain better-placed for structural adjustments than German competitors, with the combination of higher ROEs and lower cost-to-income ratios at the aggregate level.

Figure 26: Banking sector capitalisation and liquidity



Source: EBA

Figure 27: Banking sector profitability among peers, 2018, %



Source: EBA

Exposure to Italy a threat to otherwise strong capitalisation

A potential source of systemic risk for the French banking system is the significant exposure to the Italian economy. Any pressures on Italy's public debt and economy could pose contagion risks for the French economy. For major French banks, the two largest direct country exposures (through subsidiaries and branches) are the US followed by Italy[12]. As of June 2018, French exposures to Italy, including off-balance sheet transactions, totalled EUR 311bn, including EUR 221bn to non-financial companies and households and EUR 51.5bn to the sovereign[13]. This qualifies France as the most exposed euro area country to Italy, while a large part of the exposure is held by Italian subsidiaries of French banks, which are well capitalised.

Banking sector oversight and governance

European financial architecture

France's financial sector is deeply integrated in the European financial architecture, with its enhanced regulatory framework guiding banks towards greater robustness. However, the European financial architecture also remains incomplete. This is especially the case with the absence of a European Deposit Insurance Scheme, the third pillar of the Banking Union, which leaves the system vulnerable to financial shocks.

Proactive stance of domestic oversight on banking…

French authorities have shown a pro-active approach to anticipating risks[14]. In particular, the sustained growth in private indebtedness prompted the French High Council for Financial Stability to introduce two macroprudential measures for banks:

- For systemically important French banks, a cap on the exposure to large and highly indebted companies at 5% of eligible capital, in force since July 2018.
- For all banks, a higher countercyclical capital buffer to 0.5% of risk-weighted assets, set for the spring in 2020.

In addition, France is among the few EU countries with a fully designed and implemented macro-prudential and resolution framework in the insurance sector[15].

… and non-banking financial intermediation

Over recent years, non-bank financial intermediation (NBFI) has expanded steadily, outpacing growth in the banking sector. French regulatory authorities have made major progress in monitoring NBFI despite the complexities involved. At the domestic level, France's High Council for Financial Stability is now mapping the links between asset management and the wider financial system. At the international level, the European Systemic Risk Board is drafting an NBFI report for Europe, and the Financial Stability

[12] Bank of France, Assessment of Risks to the French Financial System, December 2018
[13] Ibidem 10
[14] Ibidem 6
[15] Ibidem 6

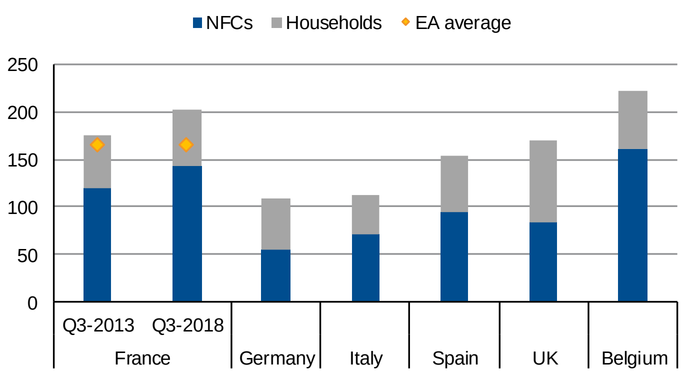
Board is collecting annual data to capture sector developments and identify the main risks NBFIs pose for financial stability[16].

Financial imbalances and financial fragility

Non-financial corporate debt driven by high investment and low financing costs

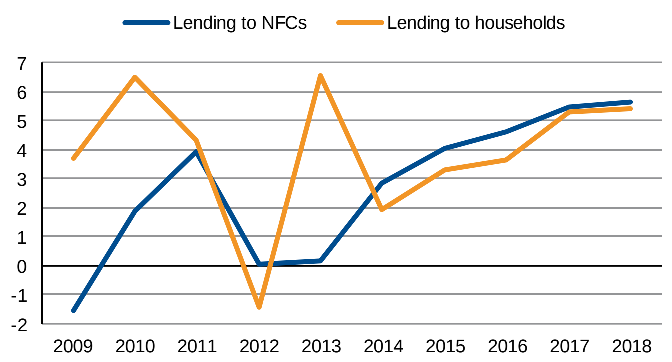
At 143.6% of GDP, non-financial corporate (NFC) debt[17] is high against the euro area average (107.0%) and still increasing, up 24 pp since 2013 (**Figure 28**). This is due to the international expansion of multinational enterprises, coupled with lower financing costs. Increasing private indebtedness has been accompanied by growth in bank lending. Since 2014, bank loans to NFCs have grown steadily by 3%-6% a year. Further growth in the already high NFC debt levels could destabilise the financial system if interest rates rise abruptly or the cycle reverses, affecting the solvency of the weakest NFCs[18]. Indeed, outstanding debt among NFCs tends to be floating rate, making them vulnerable to a sharp hike in interest rates[19]. Two important structural factors mitigate those risks. First, interest payments by NFCs relative to value added are the lowest in decades, despite being above the euro area average, underpinning an ability to sustain the indebtedness. Second, the proportion of short-term debt over total debt has decreased slowly but constantly since the Global Financial Crisis[20].

Figure 28: Private sector debt, Q3 2018, % of GDP



Source: ECB, National Statistical Institutes, Scope Ratings GmbH

Figure 29: Lending to the private sector, % YoY growth



Source: BdF, Scope Ratings

Household debt driven by easing lending conditions….

Household debt, at 59.4% of GDP, is close to euro area average (57.6%). Since 2014, loans to households have followed a similar trend as the loans to NFCs (**Figure 29**). The Bank of France has had to intensify monitoring as the increased debt ratio among households has been accompanied by an easing of property lending conditions. A sharp repricing of households' assets or a drop in their income, adversely affecting solvency, could emerge as a risk to the financial sector and the French economy as a whole. As mitigating factors, however, the Bank of France and the French Prudential Supervision and Resolution Authority signal that almost all property loans are fixed rate and guaranteed, thereby limiting negative spill-over onto the financial sector due to increasing interest rates and/or a reduced borrower solvency. In addition, the debt service-to-income ratio has been stable and close to 30% over the past years.

…but in a stable real estate market

Since household debt mostly consists of mortgage loans, the evolution of the housing market deserves close monitoring. Property prices continue to rise, albeit at a modest pace. The house price index has increased by 7% since 2015, ranging 4 pp above pre-crisis levels in 2018. At the same time, the housing market is following the typical dynamics in Europe, with prices spiking in large cities and stagnating in the countryside.

[16] Ibidem 10
[17] Calculated as balance sheet liabilities from debt securities and loans
[18] Ibidem 10
[19] Ibidem 10
[20] Ibidem 6

Overall, risks for a housing bubble, even in cities, remain contained, given that credit growth has increased only moderately. For instance, a sharp decline in commercial real estate prices can be contained by the financial sector's low direct exposure to this asset class (below 5% of their balance sheets[21]).

Institutional and political risk

Strong parliament majority to support reform agenda…

La Republique En Marche (LaREM) and its centrist ally, the Movement Démocrate (MoDem), have a comfortable majority in the lower house of the parliament, holding 413 of the 577 seats. The majority in the lower house and the unity between government and President frees up the government to pursue ambitious structural reforms as proposed and partly enacted by President Macron.

…but increasing extra-parliamentary opposition

The government, however, faces increasing public resistance to its political agenda, in particular from the *gilet jaunes*, which has gained national-wide support from various groups. Arguments of *gilets jaunes* protestors include among others a lack of support for vulnerable groups and the discrimination of regions with special needs such as the suburbs and the countryside. For now, the government has prioritised its reform programme alongside fiscal measures that support vulnerable low- and medium-income households including in December 2018 (EUR 6bn) and April 2019 (EUR 5bn) – at the expense of more expeditious fiscal consolidation, excluding planned but not concluded compensation measures to lower the overall impact on public finances.

Upcoming elections could interrupt reforms

The next presidential and parliamentary elections will be held in 2022, providing the government with ample room to continue its reforms. However, the upcoming elections to European Parliament in May and municipal elections in 2020 will test the government's popularity and support to the reform programme. The plan to abolish the municipal tax on real estate could erode local revenues and would therefore require additional federal transfers to preserve local political support. The upcoming elections will also test the cohesion within the current government, with the left and the right increasingly polarised.

Ongoing trade-off between consolidation, structural reforms and popular support

The trade-off between consolidation, structural reforms and popular support remains an ongoing challenge. The government's ability to balance these three objectives will be key to address the credit-relevant challenges of France.

Environmental, social and governance (ESG) factors

Rating-relevant ESG factors are generally supportive

We consider ESG sustainability issues during the rating process as reflected in our sovereign methodology. Governance-related factors are explicitly captured in our assessment of 'institutional and political risk', for which the French Republic scores highly according to the World Bank's Worldwide Governance Indicators. Qualitative governance-related assessments in the 'geo-political risk' category of our Qualitative Scorecard are assessed as 'neutral' compared with those of France's peers. Socially related factors are captured in our Core Variable Scorecard in France's high GDP per capita (EUR 36,292 in 2018), relatively low old-age dependency ratio but high level of structural unemployment. Qualitative assessments of social factors are reflected in 'macroeconomic stability and sustainability', for which we assess France as 'strong' relative to its peers. Finally, environmental factors are considered during the rating process but did not have an impact on this rating action.

France hosts Europe's largest green bond market

We also qualitatively assess the extent of policy actions regarding the Paris accord on climate change. France hosts the largest green bonds market in Europe and the third largest globally. In 2017, the French government launched the largest green bond to date, with a current outstanding volume of EUR 18.4bn (1.75%, maturing 25 June 2039).

[21] Haut Conseil de stabilité financière, OECD Economic Survey, April 2019

Since then, the government has continued to make progress with a more diversified issuance structure and new instruments.

Ambitious environmental goals, though policies are not yet defined

At the same time, President Macron has made it a priority to actively combat climate change. The government recently submitted a legislative proposal that commits France to carbon-neutrality by 2050. However, the government is yet to define how this will be achieved, opening the possibility for (at least temporarily) energy substitution by nuclear power. Also, plans for higher fuel taxes were cancelled as a response to the protests. France's revenues from environmental taxes have steadily increased since 2009, reaching 2.3% in 2017, but remain below the EU-28 average of 2.4%.

Methodology

The methodology applicable for this rating and/or rating outlook 'Public Finance Sovereign Ratings' is available on www.scoperatings.com. Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com. The rating Outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Outlook and rating-change drivers

The Stable Outlook reflects Scope's expectation of a continuation of the government's reform programme and public debt to remain high, but on a stable trajectory.

The ratings could be upgraded if: i) the process of structural reforms continues; and/or ii) there is a path towards sustained fiscal consolidation.
The ratings could be downgraded if: i) there is a roll-back of structural reforms; and/or ii) fiscal policies become unsustainable.

Foreign- versus local-currency ratings

France has low foreign-currency-denominated public debt. Consequently, we see no reason to believe that France would differentiate between any of its contractual debt obligations based on currency denomination. Furthermore, the recent history of sovereign defaults does not provide a strong justification for a rating bias in favour of either local-currency or foreign-currency debt.

Rating committee

The main points discussed were: i) France's growth potential outlook ii) the government's structural reforms, iii) fiscal policy developments, iv) debt sustainability, v) latest political developments vi) peer considerations.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, signals an indicative 'A' ('a') rating range for the French Republic. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative findings. For the French Republic, the following relative credit strengths relative to peers have been identified: i) growth potential of the economy; ii) economic policy framework; iii) macro-economic stability and sustainability; iv) market access and funding sources; v) current account vulnerability; vi) external debt sustainability; vii) vulnerability to short-term external shocks; viii) recent events and political decisions; ix) banking sector performance; x) banking sector oversight and governance; and xi) financial imbalances and financial fragility. The combined relative credit strengths and weaknesses signal a sovereign rating of AA for the French Republic. A rating committee has discussed and confirmed these results.

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Real GDP growth	
Real GDP volatility	
GDP per capita	
Nominal GDP	
Inflation rate	
Unemployment rate	
Old-age dependency ratio	
Public finance risk	**30%**
Primary balance	
Interest payments	
Gross debt	
Gross financing needs	
External economic risk	**15%**
External debt	
Currency turnover/reserves	
Net international investment position (NIIP)	
Current account balance	
Institutional and political risk	**10%**
World Bank Worldwide Governance Indicators	
Financial risk	**10%**
Non-performing loans (NPLs)	
Tier 1 ratio	
Credit to GDP gap (bubble)	
Credit to GDP gap (imbalance)	
Indicative rating range	**a**
QS adjustment	**AA**
Final rating	**AA**

QS

Maximum adjustment = 3 notches

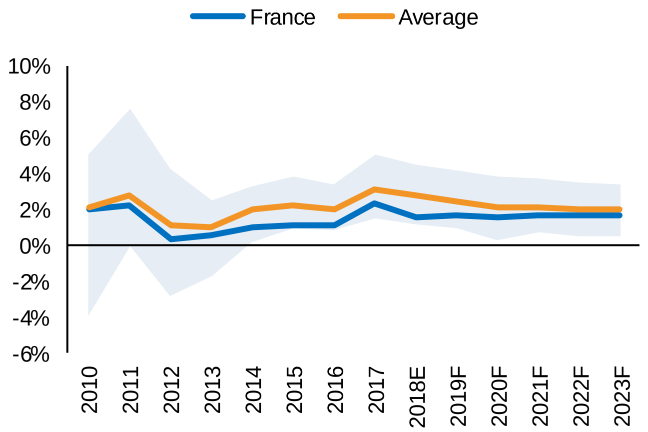
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	◉ Strong outlook, good growth potential	○ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential we under trend or negative
Economic policy framework	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Macro-economic stability and sustainability	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Fiscal policy framework	○ Exceptionally strong performance	○ Strong performance	◉ Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	◉ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	◉ Excellent access	○ Very good access	○ Neutral	○ Poor access	○ Very weak access
Current account vulnerability	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term external shocks	○ Excellent resilience	◉ Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Geopolitical risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Banking sector performance	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Banking sector oversight and governance	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate
Financial imbalances and financial fragility	○ Excellent	◉ Good	○ Neutral	○ Poor	○ Inadequate

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings GmbH

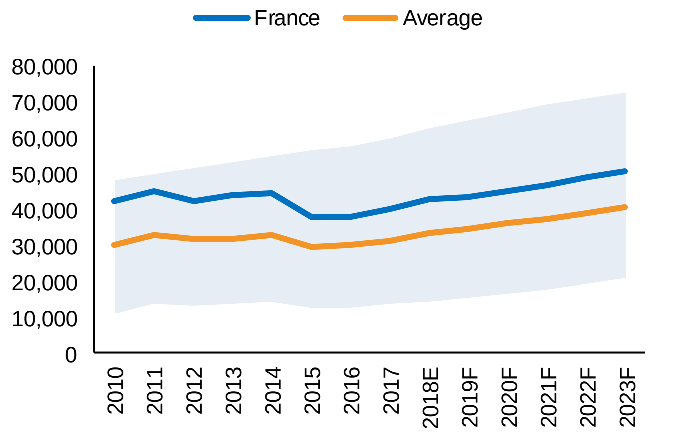
II. Appendix: Peer comparison

Figure 30: Real GDP growth



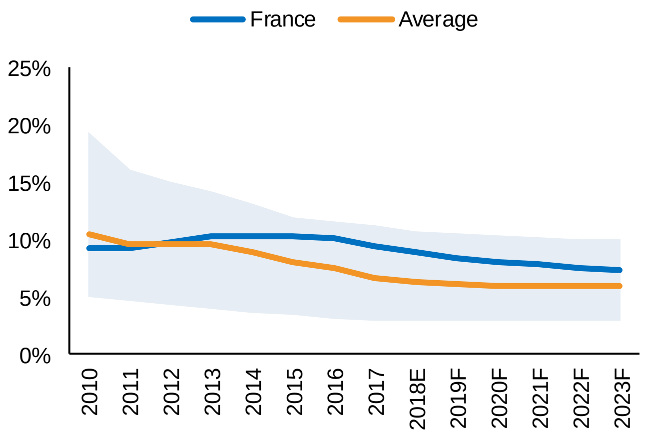
Source: IMF, calculations Scope Ratings GmbH

Figure 31: GDP per capita, USD



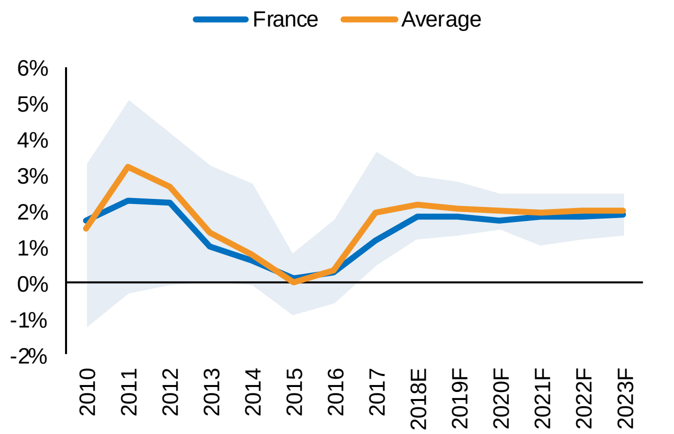
Source: IMF, calculations Scope Ratings GmbH

Figure 32: Unemployment rate, %



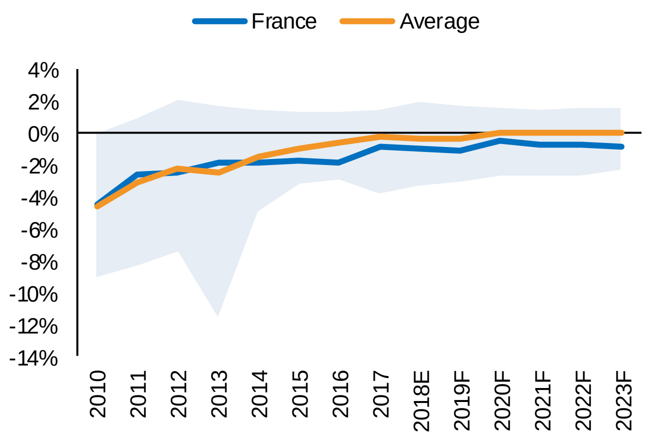
Source: IMF, Calculations Scope Ratings GmbH

Figure 33: Headline inflation, %



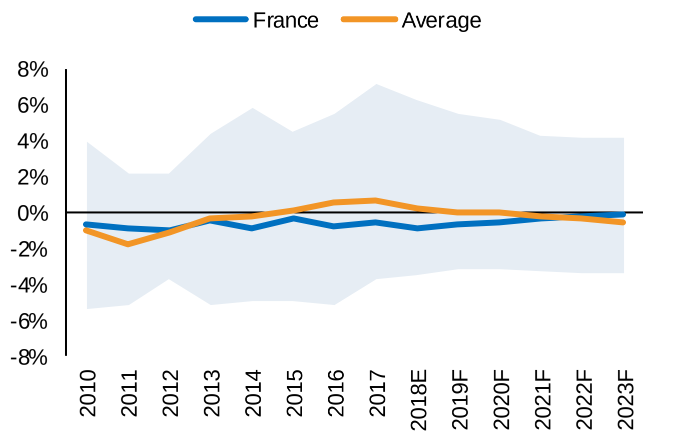
Source: IMF, Calculations Scope Ratings GmbH

Figure 34: General government primary balance, % of GDP



Source: IMF, Calculation Scope Ratings GmbH

Figure 35: Current account balance, % of GDP



Source: IMF, Calculation Scope Ratings GmbH

III. Appendix: Statistical tables

	2014	2015	2016	2017	2018E	2019F	2020F
Economic performance							
Nominal GDP (EUR bn)	2,149.8	2,198.4	2,228.6	2,291.7	2,349.0	2,415.0	2,488.1
Population ('000s)	64,028.0	64,301.0	64,469.0	64,618.0	64,725.0	65,021.0	65,319.0
GDP per capita PPP (USD)	40,141.6	40,564.5	41,358.0	42,850.4	-	-	-
GDP per capita (EUR)	33,575.4	34,189.8	34,568.2	35,465.2	36,292.4	37,141.1	38,092.0
Real GDP, % change	1.0	1.1	1.2	2.2	1.6	1.3	1.4
GDP growth volatility (10-year rolling SD)	1.6	1.6	1.5	1.5	1.5	0.6	0.6
CPI, % change	0.6	0.1	0.3	1.2	2.1	1.3	1.5
Unemployment rate (%)	10.3	10.4	10.1	9.4	9.1	8.8	8.4
Investment (% of GDP)	22.7	22.7	22.7	23.5	22.8	22.6	22.6
Gross national savings (% of GDP)	21.8	22.3	21.9	22.9	22.1	22.2	22.5
Public finances							
Net lending/borrowing (% of GDP)	-3.9	-3.6	-3.4	-2.8	-2.5	-3.3	-2.4
Primary net lending/borrowing (% of GDP)	-1.9	-1.8	-1.7	-1.0	-0.9	-1.7	-0.8
Revenue (% of GDP)	53.3	53.2	53.2	53.8	53.6	52.4	52.0
Expenditure (% of GDP)	57.2	56.8	56.6	56.5	56.2	55.7	54.4
Net interest payments (% of GDP)	2.0	1.9	1.7	1.7	1.7	1.6	1.6
Net interest payments (% of revenue)	3.8	3.5	3.3	3.2	3.2	3.1	3.1
Gross debt (% of GDP)	94.9	95.6	98	98.4	98.4	99.2	98.7
Net debt (% of GDP)	85.5	86.4	87.5	87.5	87.6	88.2	87.7
Gross debt (% of revenue)	178.0	179.8	181.7	183.1	184.1	189.1	189.8
External vulnerability							
Gross external debt (% of GDP)	209.1	209.2	213.5	210.8	-	-	-
Net external debt (% of GDP)	35.8	35.3	35.7	37.8	39.6	-	-
Current-account balance (% of GDP)	-1.0	-0.4	-0.8	-0.6	-0.7	-0.4	0.0
Trade balance (% of GDP)	-1.9	-1.1	-1.3	-1.8	-2.0	-2.1	-1.9
Net direct investment (% of GDP)	1.7	0.3	1.1	0.3	1.3	-	-
Official forex reserves (EOP, EUR mn)	23,603.0	33,407.0	37,174.0	31,470.0	42,384.0	-	-
REER, % change	0.4	-4.7	1.4	0.6	2.6	-	-
Nominal exchange rate (AVG, USD/EUR)	1.3	1.1	1.1	1.1	1.2	-	-
Financial stability							
Non-performing loans (% of total loans)	4.2	4.0	3.6	3.1	-	-	-
Tier 1 ratio (%)	13.1	13.8	15.0	15.3	-	-	-
Private debt (% of GDP)	141.5	142.8	146.6	148.2	-	-	-
Credit-to-GDP gap (%)	9.5	8.8	10.0	6.9	-	-	-

Sources: IMF, European Commission, European Central Bank, Central Bank of France, INSEE, World Bank, Haver Analytics, Scope Ratings GmbH

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