Bloomberg

France’s AAA Rating May Be Vulnerable

By Gregory Viscusi - Aug 7, 2011

The decision by Standard & Poor’s to downgrade the U.S. credit rating leaves France as the AAA country most likely to lose its top grade, some investors and economists say.

France is more expensive to insure against default than lower-rated governments including Malaysia, Thailand, Japan, Mexico, Czech Republic, the State of Texas and the U.S.

“France is not, in my view, a AAA country,” said Paul Donovan, London-based deputy head of global economics at UBS AG. “France can’t print its own money, a critical distinction from the U.S. It is not treated as AAA by the markets.”

While all three major credit-rating companies have confirmed France’s top level in recent months, market measures indicate increasing investor skittishness over the country’s vulnerability to the European debt crisis. Euro-region central bank governors will hold emergency talks today over how to protect Spain and Italy and limit fallout from the U.S. cut.

“If Italy and Spain have difficulties, are we sure that, for instance, France can still be considered a ‘core’ country?” said Marco Valli, chief euro-area economist at UniCredit Global ‘Core’ is becoming a narrower group of countries.”

While France’s debt of 84.7 percent of gross domestic product is less than Italy’s 120.3 percent, as a percentage of economic output it has risen twice as fast as Italy’s since 2007. French government debt totaled 1.59 trillion euros ($2.3 trillion) at the end of 2010, according to the European Union; Italy's was about 1.8 trillion euros. France has had a larger budget deficit than Italy every year since 2006. S&P rates Italy A+, four levels below France.

France’s rating at Standard & Poor’s is in a “stable perspective,” Jean-Michel Six, the firm’s chief economist for Europe, said in an interview with France Info radio today.

AAA in Euro

In the euro area, Germany, Austria, Finland, Luxembourg, and the Netherlands also have the top rating.

Neil Mackinnon, a strategist at VTB Capital in London and a former U.K. Treasury official, said that France is in a group of European nations whose credit quality now faces more scrutiny.

"Euro-zone countries like France, Italy and Belgium, and even the U.K., are vulnerable to downgrade," he said.

France is the most costly AAA country to protect against default. Credit default swaps on France trade at 143.8 basis points, almost triple the U.S. Spain is at 407.6 basis points and Italy at 386.8 basis points. Swaps on Switzerland, the safest country, are at 35.3 basis points.

A basis point equals $1,000 annually on a swap protecting $10 million of debt.

French Policies

French Finance Minister Francois Baroin has said that the government has taken action, such as raising the retirement age and not replacing one of every two retiring civil servants since 2007, to improve its public finances.

French 10-year bonds yield 3.14 percent, down from 3.48 percent since the start of June. Still, the difference between the yield of French and German 10-year bonds has risen in that same period to 81 basis points from 36 basis points.

Before going on holiday, President Nicolas Sarkozy on July 26 wrote a letter to every member of Parliament, making his case for adding a balanced-budget requirement to the constitution. He hasn't yet called a joint session to approve such a measure because a three-fifths majority is required, and the Socialist Party is opposed to amending the constitution.

S&P confirmed France's rating on Dec. 23, Moody's Investors Service on May 4, and Fitch on May 31. They all cited a diversified economy and solid political institutions. They all warned that efforts to cut its debt must be maintained.

Narrowing Deficit

Sarkozy has committed to cutting the budget shortfall to 5.7 percent of output this year, 4.6 percent next year and 3 percent in 2013. The Socialist Party's two leading candidates for next year's presidential election have also pledged to reach the 3 percent deficit target in 2013.

"If French authorities do not follow through with their reform of the pension system, make additional changes to the social-security system and consolidate the current budgetary position in the face of rising spending pressure on health care and pensions, Standard & Poor's will unlikely maintain its AAA rating," S&P said in a June 10 report.

To contact the reporters on this story: Gregory Viscusi in Paris at gviscusi@bloomberg.net

To contact the editor responsible for this story: James Hertling at jhertling@bloomberg.net