

Euro Rates Strategy

S&P revises France's AA outlook to negative: market implications

- **France remains AA, but its outlook is now negative:** On Friday, S&P revised its outlook on its AA rating of France from stable to negative. The main driver concerned S&P's assessment of France's deteriorating budgetary position in light of constrained nominal and real GDP growth. The negative outlook itself reflects S&P's view that "*a robust recovery of the French economy could prove elusive*" and that there is now a one in three chance S&P could downgrade France by one notch over a 24 month period should events continue to disappoint to their baseline scenarios.
- **The 2015 budget plan:** The government's 2015 budget plan shows that it will not meet its previous consolidation objectives on the grounds of much lower-than-expected inflation and that the already-fragile economy would suffer too much if additional expenditure savings or revenue raising measures were to be implemented. Given the persistence of 'low-flation', our economists continue to expect the ECB to launch a QE programme later in 2014 year or in early 2015 given the serious damage that a triple-dip recession could inflict on the euro area project, let alone on debt sustainability perspectives (*Euro Economics Weekly - France: Rejecting Austerity, For Now*).
- **Impact on OATs – we see various supports:** From a markets perspective, such a revision to a rating outlook at the high end of the credit quality spectrum is unlikely to have significant and lasting impact in our view. The move this morning in spreads does not reflect any significant reappraisal of France relative to other others (and note there is up to €7.5bn in OAT supply this week). Furthermore, an affirmation by S&P that France continues to have a rather stubborn deficit is hardly new news. Given its high rating, superior liquidity and wider supports (not least ECB policy), we remain broadly constructive on OATs and believe the market will remain supported over the medium term.
- **Impact on SSAs:** Following the announcement on the outlook on France by S&P, the same rating agency revised the outlook of the EFSF and also moved the AA rating to negative. S&P does not rate the ESM. For various reasons we believe the EIB is less directly connected to the rating of France, relative to the EFSF, and believe there is a chance its own S&P rating outlook will remain stable. French agencies rated by S&P that benefit from either explicit or implicit guarantees from France are likely to have their outlook also moved to negative in our view.

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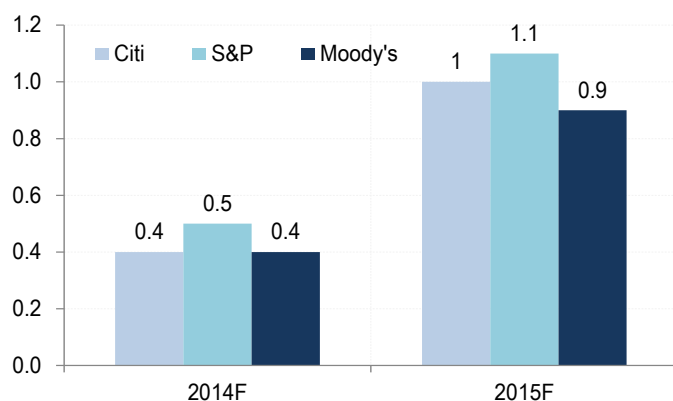
France – S&P revises AA outlook to negative

Rating now on negative outlook on receding fiscal space

Rating remains AA, but outlook negative: On Friday, S&P revised its outlook on its AA rating of France from stable to negative. The main driver concerned S&P's assessment of France's deteriorating budgetary position in light of constrained nominal and real GDP growth. In addition, S&P indicated that *"due to policy implementation risk, related to the budgetary consolidation and structural reforms, a recovery of the French economy could prove elusive and that France's public finances might deteriorate beyond 2014, although this is not our base scenario"*.

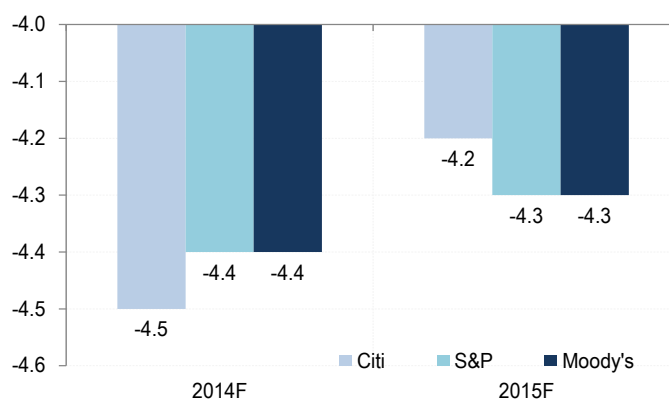
Growth and deficit numbers revised: Specifically, S&P now expects a deficit in France to average 4.1% of GDP over 2014-2017, having previously expected 3.2% on average in April. Furthermore, S&P lowered its growth forecast from 1.3% on average to 1.2% on average over 2014-2017. S&P considers that most risks to its revised GDP forecasts are to the downside and that implementation concerns regarding the reform agenda remain. The negative outlook reflects the notion that S&P considers there to be a one in three chance that the rating could be lowered by one notch over the next 24 months should events disappoint to their base case.

Figure 1. Real GDP expectations for France (%)



Source: Citi Economists, S&P, Moody's

Figure 2. Deficit expectations for France (%)



Source: Citi Economists, S&P, Moody's

The 2015 budget plan

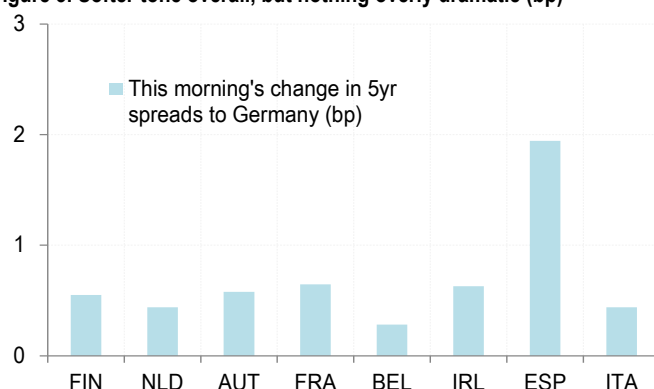
Clear reform agenda: The French 2015 budget plan shows that it will not respect its previous fiscal consolidation objectives on the grounds that the already fragile economy would suffer too much if additional expenditure savings or revenue-raising measures were to be implemented. In terms of the fiscal consolidation efforts, the government is targeting €21bn of savings in 2015, with the remainder of the total €50bn effort equally split between 2016 and 2017. The largest share of the adjustment is to be obtained from the social security budget (€9.6bn: €3.2bn from the health budget and €6.4bn from benefits), followed by the central government and its agencies (€7.7bn) and local authorities (€3.7bn). Note that the government decided to frontload some of the expenditure savings by focusing on social security (45.7% of the 2015 effort compared to 40% of 2015-17).

What happens next: The proposed 2015 budget would fall short of previously agreed targets in terms of structural budget deficit reduction. Therefore, assuming that the version submitted to the EC by 15th Oct does not contain any supplementary measures to narrow the budget deficit, we expect the outgoing EC will ask for some amendments to be made. Overall, we believe France's ability to deliver some reforms and its desire to reach a deal on a more appropriate policy mix, suggest to us that eventually some compromise will be able to be reached with the Commission and the EU Council. For full details, please see our economists' [Weekly - France: Rejecting Austerity, For Now](#).

Market implications for OATs – we remain constructive

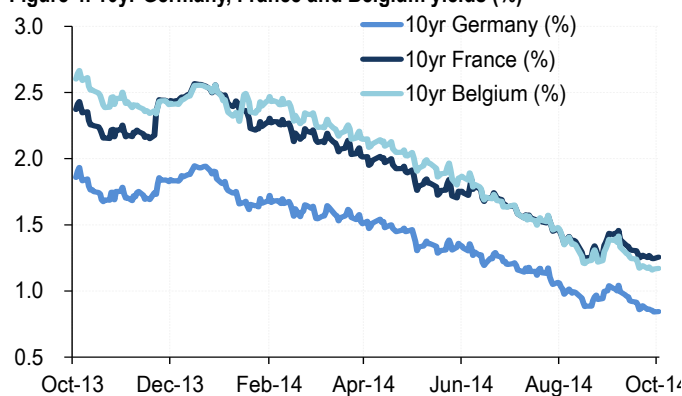
Balancing domestic concerns vs wider supports: France is still rated AA (and Aa1 by Moody's) and remains the core liquid alternative to Germany. The move this morning has hardly been tantamount with a radical re-pricing of French as a sovereign credit, spreads to Germany are bare 1bp wider. Note also there is €6.5bn-€7.5bn in OAT supply later this week in the 3yr, 4yr and 5yr sectors. There are of course other, more dominant market drivers – not least ECB policy – that are likely to eclipse such a move on a rating outlook at the high end of the credit quality spectrum. The fact that France will miss a 3% budget target is nothing new. What will shape the domestic fundamental backdrop over the medium term is how the policy mix evolves in the face of the weak economic EMU context in our view.

Figure 3. Softer tone overall, but nothing overly dramatic (bp)



Source: Citi Research

Figure 4. 10yr Germany, France and Belgium yields (%)



Source: Citi Research

Implications for supras and agencies – EFSF vs EIB

Supras: Following the announcement on the outlook on France by S&P, the same rating agency revised the outlook of the EFSF and moved the AA rating to negative. The rating of the EFSF by S&P reflects the fact that the EFSF's obligations are fully guaranteed by members that S&P rates AA or above. The outlook reflects S&P's outlook revision on France (which has a 21.88% weight in the structure, much higher than Finland (1.93%) which downgraded to AA+ on Friday). This is unsurprising given the strong connection the EFSF has with its large guarantors. However, we do note the clear difference here between S&P's approach vs Moody's. Moody's has the EFSF rated Aa1 *stable* whereas it rates France Aa1 with a negative outlook due to its own, separate assessment of the various credit drivers. S&P does not rate the ESM, but does rate the EIB at AAA stable. France owns 16.17% of the EIB's total capital. We believe that due to enhanced credit supports (such as EIB's wider shareholder base, ECB liquidity access, paid in capital, strong asset quality), its own rating is not as linked to France specifically. This means a move to revise EIB's rating outlook is not as automatic, with a reasonable chance it remains AAA stable in our view.

French agencies: Agencies enjoying either an explicit or implicit guarantee (such as those with EPIC status), that are rated by S&P, are likely to have their outlook moved in line to negative, akin to France, in our view.

Conclusion – deficit in focus, but there are other market drivers

France's liquidity remains its key market strength and fundamentally, the government is committed to an ambitious reform agenda. Although there are wider economic headwinds, Citi's base case remains for full blown ECB QE later this year or early next year. Given such factors, we believe France will remain supported over the near and medium term. We would add on any significant weakness.

Appendix A-1

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