Written by **Bob Adelmann** on November 21, 2011

France Slides Towards Debt Downgrade

Moody's rating service warned on Monday that France's coveted triple-A credit rating is in jeopardy as a result of the country's "elevated borrowing costs … amid a deteriorating growth outlook." Senior credit officer Alexander Kockerbeck said "As we noted in recent publications, the deterioration in debt metrics and the potential for further liabilities to emerge are exerting pressure on France's creditworthiness and the [current] stable outlook of the government's Aaa debt rating."

In May of this year Fitch Ratings confirmed France's triple-A rating with a "stable" outlook but warned that "continued fiscal consolidation is needed to stabilize and then start to reduce public debt, which reached 81.7 percent of GDP as of [the end of] 2012."

In August Fitch repeated that its rating for France remained triple-A but noted that the rise in the prices of credit default swaps (CDS) "may be a sign that the markets are concerned over the euro zone's ability to prop up weaker countries in the EU." Credit default swaps are often used as a form of insurance against the default of a debt issuer.

In October Moody's Rating Service warned that it could cut its rating on France's sovereign debt "if the situation deteriorated in the next three months." Monday's announcement by Moody's confirmed that the situation has in fact deteriorated significantly, with interest rates on France's 10-year notes rising to nearly two full percentage points above similar debt issued by Germany, which so far also sports a triple-A rating by the three credit rating services.

An increase of just one percent will cost the French government $4 billion annually just in increased interest, and, according to Moody's, "with the government's forecast for real GDP growth of a mere 1 per cent in 2012, a higher interest burden will make achieving targeted fiscal deficit reduction more difficult."

The root cause of the rise in interest rates stems from demands in the bond markets for increased yields to offset the increased risks of default, and because of the debt deal hammered out for Greece last month. That deal, yet to be finalized, required private investors to take a "voluntary" haircut of 50 percent in order to allow Greece to continue to borrow from the International Monetary Fund. The word "voluntary" was necessary as it would mean that payments under credit default swaps wouldn't be triggered, thus protecting the banks what underwrote them from suffering further losses.

Put simply, a large part of the losses due to Greece's default was being pushed onto private investors who thought they had insurance but discovered they didn't. Now that the CDS mechanism has been rendered essentially worthless, interest rates are going up. As Christopher Wood, an equity strategist for CLSA, a highly regarded broker in Hong Kong, explained, the bailout of Greece with private investors' capital "raised the issue of whether the CDS market any longer provides a realistic way of hedging European sovereign or European bank credit risk."

Tim Rice, senior vice president at D.A. Davidson, another broker specializing in fixed income securities, explained:

> Going forward, people are going to demand a higher yield on other sovereign credits, especially in the euro zone, because they can't be sure their assumptions in terms of risk management are the same as they were previous to the Greek deal.

Selling in the bond market lowers the prices of bonds held in inventory, which impacts the capital structure of banks holding large amounts of European sovereign debt. This in term puts pressure on the French government which has promised to stand behind those banks if, or when, they get in trouble. Kockerbeck put it succinctly in his report from Moody's: "Stress on banks' balance sheet can lead to further increases in liabilities on the government's balance sheet when further government support to banks is needed."

This is not limited to France by any means. With the six largest U.S. banks — JPMorgan, Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley — holding substantial positions in European sovereign debt, Fitch Ratings was forced to note on Thursday that "Unless the euro zone debt crisis is resolved in a timely and orderly manner, the broad credit outlook for the U.S. banking industry could worsen."

The obscure "voluntary" haircut imposed on owners of Greek debt is potentially the trigger event that begins the unraveling of the global debt structure. If so, interest rates will continue to rise, defaults will increase, and governments will be pressured to come to the rescue of the big banks once again.