IMPLICATIONS OF THE RECENT SOVEREIGN CREDIT RATING DOWNGRADE FOR FRANCE AND OTHER EURO ZONE COUNTRIES

On January 13 2012, Standard and Poor's (S&P) downgraded the credit ratings for several countries belonging to the European Monetary Union (EMU), also known as the Euro Zone. Most notably, these included France, for which the long-term sovereign credit rating has been downgraded by one notch from AAA to AA+. France is the second largest EMU economy after Germany and accounts for about 17 percent of total outstanding debt of the EMU, after Germany and Italy at 22 percent and 20 percent, respectively.

The downgrade reflects the impact of deepening political, financial and monetary problems facing EMU countries, several of which continue to struggle to stabilise their sovereign debt position. With Austria downgraded to a similar extent, the only EMU countries still rated AAA are Germany, Finland, Netherlands and Luxembourg. In turn, this has negative implications for the capacity of the Euro Zone to support members facing difficulties in meeting their debt obligations, particularly in view of S & P now having downgraded the rating for the proposed bailout fund, European Financial Stability Fund (EFSF), for which France is expected to be a major contributor.

The downgrade notwithstanding, the French economy remains well-diversified and resilient, wealthy, and has a highly-skilled and productive labour force. Set against this, there are concerns about the relatively high public debt, and S&P has indicated that a further downgrade is possible if corrective measures are not instigated. The French government has responded by committing to accelerate the implementation of measures to address budgetary consolidation and structural reform.

The decision to downgrade France and others was not a surprise as S&P had placed all EMU members, including those for which the ratings remain unchanged, on credit watch since December 2011. Consequently, market reaction was subdued and changes in currency and bond yields were muted. It is noteworthy that the other major rating agency, Moody's Investors Service, has maintained the AAA rating for France, although it warned that deterioration in the debt position was putting the rating under pressure. Nonetheless, the cautious optimism that characterised market sentiment early in the New Year has been undermined and it is now imperative for EMU members to progress without further delay to agree a convincing package of measures to control the crisis.

On balance, the unfolding developments in the EMU countries pose a significant risk to the global economy and financial markets. As a result, the euro is likely to depreciate and remain weak in the medium term, and a scenario under which the euro does not survive in its current form should not be discounted. Any impact of the crisis on the management of the foreign exchange reserves by the Bank of Botswana will be addressed through the well established investment policies and guidelines that are kept under regular review to ensure that they remain relevant and applicable.