Federal Republic of Germany

Ratings

Federal Republic of Germany	
Action: **Affirmed**	24 Mar 23
Foreign Currency LT	AAA
Local Currency LT	AAA
Action: **Affirmed**	24 Mar 23
Foreign Currency ST	K1+
Local Currency ST	K1+

Ratings are based on KBRA's Sovereigns Rating Methodology, published 20 December 2021 and utilise the ESG Global Rating Methodology published 16 June 2021. KBRA's rating scales and definitions are found here.

Outlook/Watch

Federal Republic of Germany	
Long-Term Ratings	Stable

Economic Snapshot

	2022e
Per Capita Income (US$, PPP)	63,835
Real GDP Growth (% Change)	1.8
Inflation Rate (Average %)	8.5
Budget Balance (% GDP)	-2.3
Current Account Balance (% GDP)	4.2
External Debt (% CAR or GSPI)	167
Level of Economic Development	High
Default History	None recent

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Executive Summary

KBRA affirms the Federal Republic of Germany's long-term issuer ratings. KBRA also affirms the short-term issuer ratings of the sovereign.

Ratings Outlook: The Stable Outlook reflects Germany's large, diversified and globally important economy, high degree of economic resiliency, strong governance and institutional framework, prudent policy environment, and healthy public finance position. Germany's considerable fiscal capacity and high degree of financial flexibility allow the government to respond to external shock. The Outlook considers risks around energy supply, inflation, tightening monetary policy, and their impact on economic growth and public finances.

Key Credit Considerations

The ratings were affirmed because of the following key credit considerations:

- Germany's large, advanced, high income, and globally important economy. Germany's economic resiliency is underpinned by its highly diversified economy, its status as a leading global exporter, and its position as the largest European economy.
- Germany's balanced growth model generates stable growth and employment and is characterised by a moderate dependence on debt financing as compared to many peer countries.
- Germany's robust institutional profile is backed by a pragmatic and consensus-based policymaking environment, strong governance metrics, long-standing political stability, its central role in the European Union (EU), and significant global geopolitical importance.
- Germany's strong public finance position is backed by a robust fiscal framework that includes a debt brake rule and commitment to balanced budgets. Although the national fiscal rules have been temporarily suspended, a high degree of fiscal flexibility has allowed Germany to enact a substantial policy response to support the economy through both the pandemic and the current energy crisis.
- The Bund's status as Europe's benchmark fixed income instrument affords Germany a high degree of financing flexibility. Germany's deep and liquid capital markets, the Bund's safe haven characteristics, low average funding costs and robust investor demand ensures that Germany's debt burden is highly affordable.
- Germany's large structural current account surplus and positive net international investment position (net creditor position) highlight robust external account metrics driven by persistent trade account surpluses and large returns on its stock of overseas investments.
- Uncertainties and spill over effects arising from the war in Ukraine could continue to challenge both macroeconomic and fiscal metrics, depending on the longevity of unfavourable conditions.
- The higher cost of credit and tighter financing conditions within the euro area, coupled with an ongoing supply gap within the energy sector and the rising cost of labour has the potential to challenge growth over the medium term. KBRA notes that Germany has made significant progress to date with regard to diversification of energy supply.

Rating Sensitivities

There is no upward pressure on Germany's ratings at the highest rating level.	+
Negative rating pressure could arise if commitment to fiscal consolidation wanes, leading to persistent budget deficits and a sustained increase in the government debt-to-GDP burden. A significant and pro-longed recession could also exert downward pressure on the rating.	–

ESG Management
KBRA typically analyses Environmental, Social, and Governance (ESG) factors through the lens of how the sovereign plans for and manages relevant ESG risks and opportunities. More information on KBRA's approach to ESG risk management in sovereign ratings can be found here. Over the medium-term, governments will need to prioritise ESG risk management and disclosure with the likelihood of expansions in global ESG-related regulations, including adherence to the commitments of the Paris Agreement, and rising investor focus on ESG issues. For more on this theme please consider this research piece: European ESG Regulation Part 1 An Overview of the European Green Deal.

Environmental Factors
Germany is a world leader on climate action and is one of the few advanced economies globally that has legislated to be Co2 neutral by 2050 (Climate Action Plan and stipulated in the Paris Agreement). Germany has reduced its greenhouse gas (GHG) emissions by 55% compared to the levels in 1990, and in June 2021 passed a new climate legislation, setting higher emission reduction targets for 2030 of at least 65% and 88% by 2040. In addition to EU targets, Germany set out its own national reduction targets and has committed to becoming greenhouse neutral by 2045 and negative by 2050. Building on from this, Germany had originally planned to phase out nuclear power last year, but the government have decided to leave two of the three nuclear plants active until April 2023 due to energy crisis. Germany also plans to end coal reliance by 2038. The EU has approved a EUR28 billion German renewable scheme which runs until 2026, it is aimed at rapidly expanding wind and solar power use supporting Germany's target to generate 80% by 2030 (this was increased from 65% in April 2022). Due to the supply cut of Russian gas, the government temporarily revived coal fired power stations that were due to close or replace gas plants. Aside from industry power, the government aims to advance the energy efficiency of its housing, offering tax incentives for upgrades. Elsewhere, the transport sector is set to undergo massive change, along with a digitalisation strategy and investment in railways, expanding cycle routes and the electrification of the vehicles, both in public and private use.

The introduction of the Sustainable Finance Strategy was the landmark announcement in 2021 in Germany. As major investment and financing is needed in order for the sovereign to transition to carbon neutrality, this new strategy will help allocate capital towards the green conversion. The government hopes to use a "traffic light" system that makes it easier to recognise green and sustainable investment opportunities. This is an innovative and leading approach to green financing which many other sovereigns might soon adopt. According to the Federal Statistics Office (Destatis), industry enterprises (excluding construction) spent a total of EUR3.5 billion in 2019 on systems which prevent emissions or enable resources to be used more carefully. The government is actively gearing German industry towards energy efficient production processes. With this in mind, Germany has set out a National Hydrogen Strategy in order to become a global leader in this space. The government wants to establish a green hydrogen market and establish related value chains, as the economy shifts towards operating from renewable energy. In the aftermath of the war in Ukraine, as KBRA expected the German government has scaled up plans towards renewable energies and sustainability as it looks to wean itself off the reliance on fossil fuels.

Social Factors
KBRA focuses on social factor risk in terms of stakeholder preferences. In recent years, there has been a surge in demand across Europe for green bonds and Germany is very much at the forefront of this market, building out a green sovereign curve. Germany has five green bonds in issue at different benchmarks along its curve. The German government has announced it plans to issue EUR15 billion to EUR17 billion of Green Federal securities throughout 2023 (3% of its total bond issuance for this year) The proceeds of the green issuance are allocated towards climate change mitigation and adaption, protection of marine resources, pollution control and protection of biodiversity, amongst other areas. Safeguarding Germany as the benchmark standard in capital markets and with stakeholder interest in mind, the Finance Agency works to ensure transparency for investors with regard to green spending. In conjunction with this, the Finance Agency acts prudently with its issuance in order to foster reliable, liquid markets for investors of green bonds. Transparency of this issuance can be followed under the Treasury's Green Bond Allocation Report. Furthermore, the German Finance Agency highlights on its website that Germany was awarded "Most Impressive Government Green/SRI Bond Issuer" in the Global Capital Bond Awards 2021 for its outstanding performance in the field of Green Government securities.

Governance Factors
In May 2021, the government passed the Information Technology Security Act 2.0, which looks to build on initial legislation by increasing information security controls around cyberattacks. It features heightened security obligations and increased penalties. For operators of critical infrastructures, there is additional oversight such as an obligation to register with the Federal Office for Information Security (BSI), while critical operators must also enable attack detection systems. The BSI published an IT security report this year highlighting that IT-related threats to Germany had never

been higher. The report illustrated the extent of the threats, citing a serious increase in new variants of malware, software designed to disrupt, impair, or gain unauthorised access to a computer system.

Although Germany has long held its own national Sustainability Strategy, with its own targets, the decision was made in 2017 to align this strategy with the United Nations 2030 Agenda and the associated 17 Sustainable Development Goals. Following on from this in March 2021, the government adopted the German Sustainable Development Strategy (DNS) 2021. In order to track its progress, the government will lean on the Federal Statistical Office for sustainability reporting.

In 2021 the German legislator passed a new Supply Chain Act, which became effective in January 2023 for companies with at least 3,000 employees and is scheduled to come into forced from January 2024 for companies with at least 1,000 employees. It will target supply chain due diligence obligations with regards to human rights and the environment. This represents a significant step forward for human rights and sustainability, given that Germany is the 3rd most important economy to global trade, and even more meaningful when considering the economy's very large dependence on tradeable goods.

K-Sov and Rating Methodology Steps

Germany Sovereign Credit Rating K-Sov	
Rating Determinant	**Equivalent Rating Range**
Macroeconomic Performance	AA
Government Financial Strength	AAA
External Vulnerability	AAA
Structural Robustness	AAA/AA
K-Sov Germany	**AAA range**

Determining the K-Sov is the first step of KBRA's Sovereign Ratings Methodology. Germany's K-Sov stands at the top end of the rating scale across all four rating determinants. This strong performance reflects the large size and global importance of the German economy, stable macroeconomic environment, healthy public finance position, high degree of financing flexibility, and robust external account position. Germany's access to liquidity is overweighted in the K-Sov. Germany's structural robustness indicators are characterised by a centrist and consensus-based policy framework, central role in the EU, and global geostrategic importance. The second step considers trend analysis, peer comparisons, additional metrics and factors influencing credit risk that may not be included in the K-Sov analytics, as well as willingness to pay. These items are highlighted within each section. Finally, the alignment of foreign currency and local currency sovereign ratings is determined.

Macroeconomic Credit Metrics

	2014	2015	2016	2017	2018	2019	2020	2021	2022e	2023f	2024f
Gross Domestic Product USD bn	3890.1	3357.9	3468.9	3689.5	3976.2	3888.7	3886.6	4262.8	4031.1	4120.2	4337.4
Real GDP Growth	2.2	1.5	2.2	2.7	1.0	1.1	-3.7	2.6	1.8	0.9	1.4
Population mns	81.0	81.7	82.3	82.7	82.9	83.1	83.2	83.2	83.3	83.4	83.4
Total Credit/GDP	0.0	185.4	192.3	186.8	185.8	186.1	207.9	203.5	198.8	-	-
to Government	-	0.0	69.1	64.5	61.2	58.8	68.9	68.9	67.7	-	-
to Households	0.0	53.7	53.4	52.9	52.6	53.3	57.8	56.8	56.2	-	-
to Private Corp.	0.0	0.0	64.2	64.8	67.4	68.5	74.4	72.5	72.1	-	-
Savings/GDP	27.6	28.3	28.5	28.8	29.9	29.7	29.1	30.6	26.9	26.6	27.3
Investment/GDP	20.4	19.7	20.0	21.0	21.9	22.1	22.1	23.3	22.7	21.3	21.0
Current Account Balance/GDP	7.2	8.6	8.5	7.8	8.0	7.6	7.0	7.4	4.2	5.3	6.3
Net International Investment Position/GDP	40.8	46.5	51.4	56.3	62.5	71.2	76.3	66.0	74.4	-	-
Inflation (HICP) YoY	0.8	0.7	0.4	1.7	1.9	1.4	0.4	3.2	8.5	7.2	3.5
Unemployment Rate	4.7	4.4	3.9	3.6	3.2	3.0	3.6	3.6	2.9	3.4	3.3
ECB Refinancing Rate - Year-end	0.05	0.05	0.00	0.00	0.00	0.00	0.00	0.00	2.5	-	-
10-Year Bonds % - Year-end	0.5	0.6	0.2	0.4	0.2	-0.2	-0.6	-0.2	2.6	-	-
General Government Revenues/GDP	44.9	45.1	45.5	45.5	46.3	46.5	46.1	47.5	46.4	46.2	46.3
General Government Expenditures/GDP	44.3	44.1	44.4	44.2	44.3	45.0	50.4	51.3	49.7	48.7	47.8
Fiscal Interest/Revenues	2.7	2.4	2.1	1.8	1.6	1.2	0.9	0.9	1.3	1.5	1.5
General Government Balance/GDP	0.6	1.0	1.2	1.3	2.0	1.5	-4.3	-3.7	-2.3	-3.1	-1.5
General Government Structural Balance/Potential GDP	1.2	1.2	1.2	1.1	1.6	1.3	-2.9	-3.0	-3.0	-1.8	-1.1
General Government Cyclically Adjusted Balance/Potential GDP	0.8	1.2	1.1	0.8	1.5	1.3	-2.9	-3.1	-3.0	-1.8	-1.1
Primary Balance/GDP	1.8	2.0	2.1	2.2	2.7	2.1	-3.9	-3.3	-2.7	-1.8	-0.8
Gross Government Debt/GDP	75.3	71.9	69.0	64.6	61.3	58.9	68.0	69.6	71.1	68.3	65.6
Gross Government Debt/Revenues	167.7	159.5	151.5	142.0	132.5	126.6	147.5	146.5	153.2	147.9	141.7

Sources: National Sources, IMF World Economic Outlook, IMF Fiscal Monitor, UN, World Bank, World Economic Forum, EC, Eurostat, BIS, Bloomberg

Step I: K-Sov Scorecard Analysis

Macroeconomic Performance

Germany's large, advanced, and highly diversified economy, status as a leading global exporter, globally important industrial sector, and its status as Europe's largest economy underpin its macroeconomic strength. A high reliance on exports to drive growth leaves Germany exposed to global trade developments as illustrated in the pandemic year of 2020. Pre-pandemic real GDP growth averaged 1.7% (2015-19), which was slower than the US (2.4%), largely stemming from structural issues common across the euro area, such as labour market slack, relatively low productivity, and wage growth. Germany's solid macroeconomic performance rating determinant also reflects a low unemployment rate and a stable inflationary environment pre-2022. Notably, Germany's growth performance – which has been a bit short of average compared to peers --is underpinned by only a moderate amount of leverage economy wide, underscoring efficiencies in addition to reduced credit risk. The war in Ukraine, and subsequent spill over effects, has challenged some of these underlying macroeconomic credit metrics.

Rating Determinant 1: Macroeconomic Performance (20%)	Equivalent Rating Range
Nominal GDP ($B)	AAA/AA
Nominal GDP Growth (%)	A/BBB
Real GDP Growth (%)	A/BBB
Inflation (%)	AAA/AA
Unemployment (%)	AAA/AA
K-Sov Macroeconomic Performance	**AA**

Economy Resilient to Headwinds, Challenges Remain

German economic performance through 2022 has been somewhat less robust than some of its European peers, although recently largely due to the harsher impact of the energy shock on its economy. The economy grew by an estimated 1.8% for 2022, lower than France (2.6%) and markedly lower than Spain (5.5%) and the Netherlands (4.4%). Despite rising inflation, growth was supported by increased demand, primarily within services, which followed the reopening of the economy post-pandemic. However, persistent inflation weighs on consumer purchasing power, negatively impacting private consumption. Construction activity has declined, stemming from a fall in demand for construction services due to the high cost of materials, reduced household purchasing power and increased financing costs from tighter monetary policy. Investment and private consumption had not reached their pre-pandemic levels by Q3 2022 and decreased in Q4 2022, with growth contracting by 0.4%. That said, investment growth is forecast to improve, aided by the easing of energy price inflation, gradual adjustment of supply chains and solid corporate finance order books. However, higher financing costs and geopolitical uncertainty will likely have a negative impact. Corporate margins are being increasingly squeezed due to increases in producer prices. Whilst the macroeconomic environment has deteriorated, growth forecasts for 2023 are less pessimistic than originally feared and have been positively revised. The Kiel Institute recently revised up their growth forecasts for 2023 and 2024 to 0.5% and 1.4%, respectively.

KBRA highlights that much of the macroeconomic weakness stems from energy supply issues, rising costs and continued tightening of monetary policy. Higher inflation is being realised principally through elevated energy and food prices, amongst other channels. The rising cost of living is pulling down disposable incomes, while inflation is eroding savings. German industry, which typically contributes around 30% of GDP, faces higher input costs, while the lack of physical supply of energy is hampering production. Inflation is persisting well above target in Germany, as is the case for many economies globally. Inflation peaked at 11.6% in October 2022, largely driven by the surge in energy prices, while food price pressures in Germany are also substantially higher than most advanced economies. Energy prices have since eased, while government intervention, coupled with price caps and diversification of energy supply has prompted headline inflation to decline slightly to reach 9.2% in January of this year.

Excluding food and energy, the inflation rate was 5.6% in January 2023. In KBRA's view, wages have increased substantially relative to the pre-pandemic period, and while this will likely underpin price pressures over the longer term, it also helps illustrate the extent to which external pressures are now impacting the underlying economy. Being part of a monetary union, Germany's autonomy to react to its inflation level is subordinated to the European Central Bank (ECB). This is important to bear in mind with regard to how various eurozone economies can recover at a different pace, especially when considering the composition of their economy with regard to energy sensitivity.

The German labour remains stable and relatively tight, despite economic headwinds and tighter credit conditions. The latest reading of unemployment stood at 5.5% in February. As of 1 January 2023, over one million Ukrainian refugees were living in Germany (1.3% of the German population) with the majority of them registered women and children. This compares to approximately 3.9% and 0.2% of Polish and French populations, respectively. Over the longer term, increased immigration and reduced employment-related barriers for migrant workers will be positive for the German labour force, which is experiencing demographic pressures common to many advanced economies.

Ultimately, the ongoing supply gap in the energy market will likely keep prices, and input costs, elevated, leading to a more restrictive credit environment and potentially weaker growth.

Government Financial Strength

Germany's long-standing prudent budgetary stance is underpinned by a robust fiscal framework that includes a constitutionally mandated debt brake rule and commitment to a balanced budget position. Germany suspended its national fiscal rules in response to the COVID-19 pandemic but announced its return to these judicious measures in January 2023. In the pre-pandemic era, Germany adhered to EU fiscal rules with regard to debt and deficits (3% of GDP for the government deficit and 60% of GDP for government debt, the Maaastrict criteria). Germany's solid budget surpluses and falling government debt burden pre-pandemic left the public finances in a strong position to respond to successive external shocks, including the Covid-19 pandemic and recent energy crisis. The benchmark fixed income status of the German Bund, strong investor demand, and high degree of financing flexibility further underscores Germany's robust government financial strength.

Rating Determinant 2: Government Financial Performance (50%)	Equivalent Rating Range
General Government Revenues % GDP	AAA/AA
General Government Balance % GDP	AAA/AA
General Government Cyclically Adjusted Balance % Potential GDP	AAA/AA
General Government Debt % GDP	AA/A
General Government Debt % Revenue	AAA/AA
General Government Interest % Revenue	AAA/AA
Access to Liquidity/Vulnerability to Sell-off	AAA
Contingent Liabilities	AAA/AA
Fiscal Arrears	AAA/AA
K-Sov Government Financial Performance	**AAA**

Ease of Funding and Financing Flexibility Allows For Response to External Shock

Germany has generated a balanced fiscal position since 2012 and gross government debt-to-GDP declined to 58.9% in 2019, down more than 22 percentage points since its peak during the global financial crisis. Germany's healthy public finances afford it tremendous flexibility to respond to external shocks, for example enabling a significant fiscal support package in response to the pandemic and the current energy crisis. Budget consolidation since the pandemic has been progressive but slow, with the deficit narrowing from 4.3% in 2020, to 3.7% in 2021 and 2.3% in 2022. However, the EC anticipates that the budget deficit will once again expand to 3.1% this year. In order to offset the costs associated with the energy crisis in Europe, government expenditures are elevated, while conversely, revenues are likely to decline in line with the economic slowdown. Spending on defence and climate policy are also expected to increase significantly, creating some uncertainty over the planned deficit target.

Overall, the economic spillover effects from the Russia-Ukraine war, and subsequent energy crisis, could sustain the German budget deficit for longer than initially expected, while fresh budgetary commitments also make balancing the books difficult. For example, the government announced a stimulus package worth EUR65 billion in September 2022 in order to ease the cost-of-living burden. Only one month later, a EUR200 billion energy support package or "protection shield" (largest announced by a European government) was announced for businesses and consumers struggling with energy price increases, financed by new borrowing through the reactivated Economic Stabilisation Fund (ESF).

Slight changes made to the debt brake, including allowances for reserves of special funds and delayed repayment schedules of debt, afford more budgetary flexibility to the government. In the Finance Ministry's Stability Programme report, it states the government's medium-term objective is to ensure that its general government structural deficit does not exceed 0.5% of GDP. Narrowing the structural balance might prove difficult with transfers supporting climate action sustainability elevating expenditure, while social care spending and pensions will sustain this increase. For example, the Bundesbank anticipates that structural deficits are likely to continue and register 1% of GDP even as far off as 2025, as a result of increased spending, relating to pensions, climate change mitigation and the military. Separately, legislative changes to certain taxes might hamper revenue, for example the solidarity surcharge which was redesigned in 2021. However, KBRA also highlights that while expenditure pressures persist and fiscal metrics could remain stretched, Germany's low debt, ease of funding and budgetary flexibility afford it the capability to deal with unforeseen and undesirable circumstances.

Gross government debt increased slightly from 69.6% in 2021 to 71.1% in 2022. The German Finance Ministry initially forecasted debt-to-GDP to hover around 65% over the short-term and it remains to be seen when debt will move back towards the Maastricht level. KBRA notes that although German public debt is elevated relative to its recent past, it stands at a much lower level than that of European and major advanced economic peers. Furthermore, Germany can comfortably meet its higher borrowing requirement due to its very strong access to liquidity. Germany's flight to quality dynamics reflects the Bund's European benchmark fixed income status as well as the very sound management and performance of the economy. Germany has very low net government debt, which averaged 46% pre-pandemic, and while the IMF estimates it will rise to 48% this year, it is expected to reduce to 44% by 2027. Germany's net remains low in comparison to peers, second only to Canada in the G-7.

The German government benefits from low financing rates relative to its peers, which reflects market confidence in the sovereign and its economic resilience, which have contributed to benchmark status. Being a euro area member, Germany avails of ECB policies that safeguard liquidity and maintain credit provision. ECB support for the economy during periods of stress provides euro area sovereigns with a substantial safety net. For example, the extensive asset purchase program in operation throughout the pandemic allowed euro area governments to borrow and spend in order to combat a potential economic downturn, while maintaining market confidence. Although many euro area sovereign curves have shifted significantly higher in recent quarters, German cost of issuance remains easily affordable. Germany's average cost of debt has risen but is stable at 1.04% and this allows greater flexibility to increase spending in the face of external shock. This also helps illustrate the ease and flexibility of funding the sovereign enjoys on the capital markets. The average maturity on German government debt is 9.6 years, which helps to minimise refinancing risks.

External Vulnerability

KBRA views Germany's external vulnerabilities as low, underpinned by structurally large surpluses on the current account and a large positive net international investment position (NIIP). Germany enjoys one of the strongest external positions globally, which is expected to be maintained in the years ahead. The persistent current account surplus, averaging 8% of GDP from 2010 to 2020, reflects several features of the German economy. In the first instance, Germany's large, competitive, and globally important industrial sector and status as one of the leading global exporters is reflected in significant surpluses on the merchandise trade account. A high domestic savings rate amongst the household and the public sectors, alongside investment income from significant foreign investment holdings, produce consistently large surpluses on the primary income account that reflect a NIIP of 74.4% of GDP in Q3 2022. The merchandise trade and primary income account surpluses comfortably outweigh structural deficits on the services and secondary income accounts. German trade is sufficiently robust to withstand external shocks. However, weak external demand, as inflation erodes purchasing power globally, weighs on export growth in Germany. Furthermore, the short-term outlook for Germany's current account surplus is somewhat uncertain and contingent on the rebound in external demand, while the Russia-Ukraine war could continue to weigh on trade and industry through this year and next. However, external demand could receive a boost from China's re-opening. A shift towards deglobalisation, which could impact Germany's vibrant export sectors, could pose challenges to Germany's current account dynamics. Sanctions on Russia continues to have impact German industry with regard to production and exports. Russia accounted for 2.3% of total German trade in 2021.

Rating Determinant 3: External Vulnerability (10%)	Equivalent Rating Range
Current Account Balance % GDP	AAA
K-Sov External Vulnerability	**AAA**

Structural Robustness

Germany's structural characteristics are important factors underpinning its sovereign rating. A robust institutional framework, high degree of government effectiveness, consensus-based policymaking environment, the country's central role in the EU and euro area, as well as its significant geopolitical influence substantiate Germany's structural robustness, in KBRA's view. Germany's advanced and globally competitive economy, coupled with its status as Europe's largest economy and one of the leading global exporters, underscores its economic resiliency. Germany's significant and timely financial and public health response to the coronavirus pandemic highlights robust institutional capacity.

Rating Determinant 4: Structural Robustness (20%)	Equivalent Rating Range
Socio-Political Risk	AAA/AA
Security Risk	AAA/AA
Geostrategic Importance	AAA/AA
Systemic and Economic Risk	AAA/AA
Per Capita GDP (PPP Basis)	AAA/AA
Institutional Indicators	AAA/AA
K-Sov Structural Robustness	**AAA**

New Government Faced Stiff Challenges in First Year
Germany's relatively new three-party coalition, which comprises of the Social Democrats, the Greens, and the Free Democratic Party, has already faced challenges in its first year. The war in Ukraine, the energy crisis and the fiscal response have tested the mettle of the German cabinet. Fiscal pressure is building, and the Finance Ministry delayed the budget and financial plan over differences within the three-way coalition. Additional pressure exists around topics of spending, rising interest rates and collective bargaining. Ultimately, the government is expected to push for a greener, more digital future, edging Germany even more firmly to the global forefront on climate action, which is especially meaningful given its leadership role in the EU. Changes to taxation are likely over the medium-term, with higher income taxes on individuals, possibly in anticipation of pension pressures. Wider EU themes, such as a common EU investment policy or common debt could be encouraged under this government.

Structural Challenges of Banking Sector Amplified by Macro and Geopolitical Headwinds
The German banking sector delivered a resilient performance throughout the pandemic, in KBRA's view, however it is facing increased risks and uncertainties amplified by recent liquidity and funding challenges at certain US banks as well as Credit Suisse. German banks' main challenge is low profitability due to high costs and strong competition. That said, the sector benefits from strong liquidity and a resilient capital position, with an average CET1 ratio of 14.8% at end-September 2022, according to the European Banking Authority (EBA). While the banks' revenues should benefit from raising interest rates, higher credit costs will weigh on profitability. KBRA expects asset quality to deteriorate over the coming quarters as the implications of inflationary pressures feed through to the economy and customers' affordability straining debt servicing. That said, the non-performing loan (NPL) ratio stood at low 1% at end-September 2022, according to the EBA.

Step II: Peer Comparatives, Trends, Willingness to Pay

In Step II of the sovereign rating approach, KBRA evaluates peer comparisons, recent trends and outlook, and its evaluation of willingness to pay. The war in Ukraine, and subsequent economic sanctions against Russia, have dented the economic outlook for Germany, while also highlighting energy as a particularly sore point for the sovereign. Prior to Russia's invasion of Ukraine in 2022, Germany had a significant reliance on Russia for energy with a third of its oil, over a quarter of its coal and half of its gas requirement.

By comparison, sovereigns such as Spain, Portugal, and Ireland, for example, are also big gas importers but only a fraction, if any, comes from Russia. Aside from market price dynamics, physical supply of energy remains a challenge for Germany. However, tremendous progress has been made with regard to diversification of energy supply, storage capacity and demand reduction. Ahead of this milder winter, Germany was able to fill its storage capacity, while through 2022, demand for gas was 25% lower than the 2019-2021 average. In terms of supply, a floating LNG terminal at Wilhelmshaven was operationally ready before the winter last year, while the recently added floating LNG terminal at Brunsbüttel further aids storage resilience. Germany will add several more floating terminals this year, while there are also plans for a fixed terminal over the medium term. The sovereign is also importing more gas via Belgium, France and directly from North Sea producers. Outside of gas, Germany announced in January that it will join the Mediterranean hydrogen pipeline project, called H2Med in efforts to reduce dependence on Russian energy and shift from fossil fuels to cleaner energy. H2Med aims to bring "green" gas (green hydrogen made from water via electrolysis using renewable energy) from the Iberian Peninsula to the rest of Europe. France, Portugal and Spain previously agreed to build the pipeline and it is expected to be operational by 2030. For more on this theme, please consider this KBRA research piece: Europe's Energy Crisis - Potential Impact of Russian Gas Supply Changes

Looking past this near-term disruption, Germany's economic recovery will also be supported by the EU's EUR724 billion (in current prices) Recovery and Resilience Facility (RRF), to be funded via debt issuance from the official European institutions. Germany's large-scale domestic budgetary response to the pandemic and energy crisis, alongside its support of EU-wide initiatives to support the economic bloc throughout the crisis, signify a notable shift in its policy stance to fiscal support from fiscal prudence—a move that could have positive spill over effects for the rest of the EU, and being self-reinforcing for German growth through the conduit of intra-EU trade. Moreover, improved health of EU member countries is a net positive for benefactor countries, such as Germany. The sovereign, through the RRF, can receive grants totalling EUR25.6 billion by 2026. The grants will be utilised under the German Recovery and Resilience Plan, which strategises six priority areas, although clearly focuses on a greener and digital future. The plan includes 40 measures and will allocate funds to transition the economy towards decarbonisation and renewable energy, such as electric mobility, building refurbishment and hydrogen technology (42% of the plan is earmarked to support climate objectives). Germany will expand its digital infrastructure, emphasising investment in education and the public administration (at least 52% of the plan will foster digital transition).

Over the medium-term horizon however, risks could emerge for German trade. A shift towards deglobalisation or structural changes in China towards a tertiary model could exert pressure on export performance outside of the EU. Moreover, the trade surplus has been shrinking since 2017. However, in terms of intra-EU competitiveness, Germany's industrial sector is deeply embedded into global and European supply chains. An overarching challenge related to the global evolution towards both a greener, more sustainable future and digitalisation. German industry has been adaptive in the past to such challenges. Furthermore, the end of the zero-COVID policy in China could help pave the way for Global economic recovery. KBRA also notes that the relatively higher cost of energy and tighter financial conditions could challenge growth over the medium-term.

Pension Problems

Looking further ahead, demographic pressure could challenge growth in Germany in the coming decades. This was highlighted in the German Stability Programme this year and is a common theme across many sovereigns. Low birth rates and an aging society has caused a reliance on immigration to support growth. Destatis forecasts that there will be considerably more people entering retirement in Germany by 2035. The number of people aged 67 or over is expected to rise by 22% to 20 million, rising further to 21.4 million by 2040. The aging of the population is likely to increase healthcare and pension costs for the state and weigh on public finances. Overall, expectations are that the workforce will shrink and the country's ability to achieve the same level of output from a reduced labour force may prove difficult. There are also knock-on effects from an aging population on innovation and investment. KBRA notes that Germany's position and ability to withstand its demographic challenges is supported by its relatively low gross and net debt and its relative substantial funding of its public pension system. Moreover, reform of the system is likely over time to address the shortfalls of the country's public pension schemes, in KBRA's view.

Macroeconomic Forecasts

Macroeconomic Forecasts (2023-2027 average)					
Trends and Projections	**Germany**	**France**	**UK**	**Canada**	**US**
GDP Growth	1.5	1.4	1.3	1.8	1.6
Inflation	3.4	2.4	3.7	2.5	2.4
Current Account Balance % GDP	6.0	-0.8	-3.9	-1.0	-2.6
Government Revenues % GDP	46.4	51.3	35.6	40.9	31.6
Government Balance % GDP	-1.2	-5.1	-1.5	-0.8	-6.8
Government Primary Balance % GDP	-0.5	-3.5	-0.2	-0.9	-3.7
Government Interest Payments % Revenues	1.5	3.1	3.6	-0.4	10.0
Government Gross Debt % Revenues	137.0	224.4	207.0	228.7	408.3
Government Gross Debt % GDP	63.5	115.2	73.8	93.6	129.1

Sources: IMF World Economic Outlook, IMF Fiscal Monitor

Comparative Statistics

2022e Data	Germany	France	UK	Canada	US
Gross Domestic Product (USD bn)	4,031.1	2,778.1	3,198.5	2,200.4	25,035.2
Nominal GDP Growth (%)	5.9	5.2	9.8	12.8	8.9
Real GDP Growth (%)	1.9	2.6	4.1	3.5	2.0
Consumer Price Inflation (%)	8.5	5.8	9.1	6.9	8.1
Unemployment Rate - Latest Read	5.5	7.2	3.7	5.0	3.6
General Government Revenues % GDP	46.4	53.3	37.0	40.8	33.4
General Government Balance % GDP	-3.3	-5.1	-4.3	-2.2	-4.0
General Government Cyclically Adjusted Balance % Potential GDP	-3.0	-4.6	-4.3	-2.4	-4.0
General Government Gross Debt % GDP	71.1	111.8	87.0	102.2	122.1
General Government Gross Debt % Revenues	153.2	209.9	235.2	250.3	365.2
General Government Interest % Revenues	1.3	3.2	7.0	-1.1	5.5
Current Account Balance % GDP	4.2	-1.3	-4.8	0.5	-3.9
Per Capita GDP (PPP) - USD (World Bank)	63,835	56,200	55,862	57,827	75,180
Average Institutional Indicators (KBRA Ranking)	AAA/AA	AA	AA	AAA	AA
Human Development Index (Ranking)	6	26	13	16	17

Sources: IMF World Economic Outlook, IMF Fiscal Monitor

Finally, KBRA believes that Germany has a very high willingness to honour its debt obligations.

Step III: Local Currency vs. Foreign Currency Government Bond Ratings

KBRA has aligned the Federal Republic of Germany's foreign and local currency sovereign ratings based on its membership of the euro area and financing in euro, a reserve currency.

Conclusion

The German economy has demonstrated resilience to both domestic and global headwinds, such as inflation and energy supply. The growth outlook is supported by steady employment, easing energy price pressures and public investment. The government enjoys ample flexibility to provide stimulus and can partially offset the economic hit to households. Past this, KBRA expects the resumption of fiscal restraint followed by a robust recovery, albeit dependent on global demand conditions. Public debt will likely remain elevated over the short-term horizon, but Germany's benchmark status, financing flexibility, and highly affordable debt burden significantly minimize any material risks. Germany's large and diversified economy, long-standing institutional robustness, central role in the EU, and moderate and affordable government debt burden are important factors underpinning its sovereign rating.

Federal Republic of Germany Rating History		
Date	**Action**	**Rating/Outlook/Watch Status**
13-Nov-20	Assigned	LT Ratings: AAA (Stable) ST Ratings K1+
07-May-21	Affirmed	LT Ratings: AAA (Stable) ST Ratings K1+
05-Nov-21	Affirmed	LT Ratings: AAA (Stable) ST Ratings K1+
08-Apr-22	Affirmed	LT Ratings: AAA (Stable) ST Ratings K1+
23-Sep-22	Affirmed	LT Ratings: AAA (Stable) ST Ratings K1+
24-Mar-23	Affirmed	LT Ratings: AAA (Stable) ST Ratings K1+

Disclosures (for EU Sovereigns)

Further disclosures relating to this rating action are available in the EU/UK Information Disclosure Form. Additional information regarding KBRA policies, methodologies, rating scales and disclosures are available at www.kbra.com.

The ratings of Germany are unsolicited ratings. The rated entity or related third party did participate in the rating process and KBRA did not have access to the accounts and other relevant internal documents.

Related Publications: (available at www.kbra.com)

- European Sovereigns Demonstrate Shrewd Debt Management
- KBRA's European Securitisation Outlook 2023
- Europe's Energy Crisis: Potential Impact of Russian Gas Supply Changes
- Global Inflation: More Thematic Impulses
- European Energy Prices Stabilise but Risks Remain