FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Germany at 'AAA'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 15 Sep 2023: Fitch Ratings has affirmed Germany's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Credit Strengths: Germany's 'AAA' rating reflects its diversified, high value-added economy, record of sound public finances and strong institutions as reflected in the World Bank's governance indicators. The rating is also supported by Germany's position as the benchmark sovereign issuer in the eurozone, which ensures very strong financing flexibility. The record of persistent, high current account surpluses demonstrates the competitiveness of Germany's export sector and supports its net external creditor and positive net international investment position.

Stagnation, Weak Recovery: Fitch expects the German economy to contract by 0.4% in 2023 (from 0.1% expansion previously), as 1H23 GDP outturns were weak and sentiment and industrial indicators show persistent challenges for the rest of the year. Weaker global and China growth are having an adverse impact on the export sector, while domestic consumption is suffering from still high inflation, tighter financing conditions and reducing consumer confidence. Our current expectation is for GDP to expand by 0.7% in 2024 and 2% in 2025 in line with a recovery in private consumption and a cyclical upturn in exports and investments.

The economy is supported by a still solid labour market, although it starting to show signs of cooling. Lower job creation, together with an increasing labour force, should lead to a slight rise in unemployment in 2024-2025 (but it will stay significantly below the 2020 3.7% rate).

Structural Challenges: Germany's growth performance in the last five years (0.6%) and in our forecasts is among the weakest in the 'AAA' rating category, reflecting in part structural challenges such as adverse demographics and slowing productivity growth. The authorities are under increased pressure to implement ambitious reforms to improve growth potential.

Key areas of focus are increasing the number of qualified migrants (a recent reform was approved), reducing bureaucracy, accelerating green and digital transition and supporting the small and medium size companies that are the backbone of the economy. However, growing disagreements among the ruling coalition parties creates some uncertainty around the scope and effectiveness of reforms.

Declining, but Persistent Inflation: We forecast inflation (measured by the Harmonised Index of Consumer Prices, HICP) to average 6.4% in 2023, 3.1% in 2024 and 2.2% in 2025. The trend is driven by base effects, the impact of monetary tightening and easing labour market pressures. Core inflation, estimated at 5.5% in July, remains sticky and is a factor behind inflation remaining above the 2% European Central Bank target in our forecast period.

Wage growth has accelerated in recent quarters (averaging 6%) but we do not expect sustained pressure over the medium term as labour conditions soften. Energy price risks persist (particularly given higher prices for both gas and oil in recent weeks), but government subsidy schemes are likely to be extended until April 2024 and offset some of the impact.

Fiscal Prudence, Transparency Issues: Commitment by the German authorities to fiscal prudence reinforces the record of sound public finance management. It will also support the efforts by monetary authorities to contain inflationary pressures, while complying with European fiscal rules (which are likely to be reinstated in 2024). However, it also creates important policy trade-offs, in particular given the macroeconomic headwinds. Increasing reliance in recent year on off-budget funds create an element of uncertainty around the fiscal outlook, reducing transparency.

Narrowing Fiscal Deficits: We expect a better fiscal performance in 2023, with the general government fiscal deficit falling to 2.3% of GDP, largely driven by under-execution of off-budget funds. Spending from the Economic Stabilisation Fund has been much lower than planned (currently a quarter of the EUR80 billion, or 2% of GDP, earmarked for this year) given lower prices and demand.

The 2024 budget and medium-term fiscal objectives presented by the authorities seek further consolidation of the core budget, in line with the reinstatement of debt-brake fiscal rule. Assuming ongoing challenges in meeting off-budget funds expenditure targets, we see the deficit falling further to 1.2% in 2024 and 0.5% in 2025.

Falling Debt: Under our baseline scenario, the combination of moderate nominal economic growth and lower deficits will lead to a gradual decline in public debt/GDP, from 66.2% in 2022 to 61.9% in 2025. This will be slightly above the pre-pandemic levels, and well above the current 'AAA' median of 39.3% of GDP (but compared with 91% in the eurozone). The average debt maturity is just under eight years, so higher yields will lead to only a gradual increase in interest expenditure. We expect the interest payments-to-revenue ratio to increase to 1.9% in 2025 from the 1.2% low reached in 2022, still well below the 3.6% average in 2010-2020.

External Sector Strengths: Germany's external finances are a key rating strength. Despite the weakness of some export sectors and falling global demand, the current account surplus (CAS) is projected to increase this year again, to 4.7% of GDP in line with falling import prices. We expect the CAS to rise modestly in 2024-2025, stabilising aat round 5% of GDP, assuming high domestic savings rate and resilience of most export sectors.

So far measures of price competitiveness do not show an overwhelming deteriorating trend, but clearly some energy-intensive industries have suffered permanent shifts. Overall, we expect Germany to maintain a comfortable net external creditor position, averaging 18% of GDP? in 2023-2025.

Resilient Banking Sector: The German banking sector's 'a' Banking System indicator reflects resilient asset quality and abundant funding and liquidity. The sector also has sound capitalisation, with the CET1 capital at 19.3% in 1Q23. This should limit the impact on German banks' credit profiles from the economic slowdown and falling credit demand.

Fitch expects an increase in corporate insolvencies and asset quality pressure to materialise from 2H23, primarily in energy-intensive industrial sectors such as the chemical, paper, glass industry or machinery sectors. Higher interest rates have temporary boosted the sector's profitability, mainly driven by much slower than expected deposit repricing. We expect this effect to be temporary and deposit repricing to catch-up in 2H23.

Real Estate Focus The real estate market remains under pressure, given rising interest rates and falling market valuations. Prices for both residential and commercial real estate are adjusting downwards (for example, residential house prices fell by close to 7% year-on-year in 1Q) and transactions are drying up. This has put pressure on some real estate developers, leading to some insolvencies and likely higher loan default rates.

Nevertheless, the impact thus far on the overall financial sector appears limited, in part due to some important mitigating factors such as the very high share of fixed-rate mortgage contracts (typically for 10 years) and sound, affordability-focused underwriting standards.

ESG - Governance: Germany has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Germany has a high WBGI ranking at 89.4, reflecting its long record of stable and peaceful political transitions, well-established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-Structural: A severe macroeconomic and/or banking system crisis that has a sizeable long-term impact on the economy/competitiveness.

-**Public Finances:** A sizeable increase in general government debt over the medium term, for example, due to a prolonged period of wider budget deficits or weaker growth.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- The ratings are at the highest level on Fitch's scale and cannot be upgraded.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Germany a score equivalent to a rating of 'AA+' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: +1 notch, to offset the deterioration in the SRM output driven by volatility from the pandemic and energy shocks, including on GDP growth. Fitch believes that Germany has the capacity to absorb it without lasting effects on its long-term macroeconomic stability.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

COUNTRY CEILING

The Country Ceiling for Germany is 'AAA', in line with the LT FC IDR at the upper limit of the rating scale. We view the risk of exchange and capital controls as de minimis. Fitch's Country Ceiling Model produced a starting point uplift of +3 notches and Fitch's rating committee did not apply a qualitative adjustment to the model result.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Germany has an ESG Relevance Score of '5[+]' for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Germany has a percentile rank above 50 for the respective governance indicator, this has a positive impact on the credit profile.

Germany has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Germany has a percentile rank above 50 for the respective governance indicators, this has a positive impact on the credit profile.

Germany has an ESG Relevance Score of '4[+]'for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Germany has a percentile rank above 50 for the respective governance indicator, this has a positive impact on the credit profile.

Germany has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Germany, as for all sovereigns As Germany has record of 20+ years without a restructuring of public debt, which is captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visitwww.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Germany	LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
	LC ST IDR	F1+	Affirmed	F1+
	Country Ceiling	AAA	Affirmed	AAA
senior unsecured	LT	AAA	Affirmed	AAA
senior unsecured	ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v2.0.0 (1)

Debt Dynamics Model, v1.3.2 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.14.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Germany	EU Issued, UK Endorsed

UNSOLICITED ISSUERS

Germany (Unsolicited)

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With Access to Internal Documents	No
With Access to Management	Yes

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

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ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Germany EUR 28.25 bln 4% bond/note 04-Jan-2037	DE0001135275	Long Term Rating	Unsolicited
Germany EUR 21.5 bln 4.75% bond/note 04-Jul-2040	DE0001135366	Long Term Rating	Unsolicited
Germany EUR 31.5 bln 2.5% bond/note 15-Aug-2046	DE0001102341	Long Term Rating	Unsolicited
Germany EUR 22.5 bln 1.5% bond/note	DE0001102358	Long Term Rating	Unsolicited

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