SCOPE Scope Ratings

Credit Rating Announcement

20 October 2023

Scope affirms Germany's AAA rating with Stable Outlook

The ratings are supported by a wealthy, large, diversified economy, sound public finances and a strong external position. Transition risks related to carbon neutrality targets, an ageing population and global geopolitical risks are challenges.

For the updated report accompanying this review, click here.

Rating action

Scope Ratings GmbH (Scope) has today affirmed the Federal Republic of Germany's long-term local- and foreign-currency issuer and senior unsecured debt ratings at AAA. Scope has also affirmed the short-term issuer ratings at S-1+ in local and foreign currency. All Outlooks are Stable.

Summary and Outlook

Germany's AAA/Stable ratings are underpinned by the following credit strengths: i) its wealthy, large, diversified economy; ii) its robust fiscal policy framework and strong track record of fiscal discipline; and iii) a highly competitive external sector. These factors supported the economy's resilience and provided the government with the required fiscal space to effectively respond with countercyclical measures to the recent wave of economic shocks including the Covid-19 pandemic and the energy crisis following the escalation of the war in Ukraine. However, the recent shocks also highlighted structural weaknesses that will become increasingly relevant over the coming years if not adequately addressed by the current and future governments. In particular, challenges relate to: i) transition risks for energy-intensive industries given carbon neutrality targets and low levels of public and private sector investment relative to peers; ii) an ageing population, resulting in rising pension liabilities and downward pressure on the country's medium-run growth potential; and iii) vulnerabilities related to global geopolitical risks.

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

The ratings/Outlooks could be downgraded if, individually or collectively: i) protracted fiscal deterioration resulted in a persistent increase in public debt over the medium term, for example due to rising structural spending pressures or a significant weakening in the country's growth outlook; and/or ii) a severe macroeconomic or financial system shock resulted in a weaker growth outlook.

Rating rationale

The first driver for the affirmation of Germany's AAA ratings is the country's wealthy, large and diversified economy. As Europe's largest economy, the country benefits from a strong and well-diversified export industry including motor vehicles, electrical goods, machinery and equipment, and chemical goods, which supported economic resilience during the Covid-19 pandemic. As a result, Germany's GDP decreased by just 3.8% in 2020 compared with an EU average of 5.6%. However, the country's high value-added, export-oriented, energy imports-dependent economy has been slow to recover compared with peer countries due to global supply chain disruptions, skills shortages, a weak global economy and sharply higher inflation following the escalation of the Russia-Ukraine war. Supply chain disruptions particularly impacted German car manufacturers, while higher energy prices are a significant challenge for the chemical industry.

While a more severe scenario including acute gas shortages failed to materialise, the economic recovery remained muted with GDP growth of 1.8% in 2022. Due to the continued stagnating economy during H1 2023, total output was just 0.2% above pre-pandemic levels at the end of Q2 2023, while stronger rebounds have been seen in most other highly rated countries such as Denmark (+8.0%), the Netherlands (+6.3%), Switzerland (5.6%) and Sweden (+5.2%), and in the Euro Area as a whole (+3.2%). High inflation and rising interest rates have slowed activity in the construction sector and reduced households' purchasing power. While industrial output remains under pressure, real wages have started to recover which is expected to support consumption. Scope expects GDP to contract by 0.4% in 2023, before gradually recovering to 0.9% in 2024. An ageing population and low levels of investment mark material headwinds for the long-term growth potential, which Scope estimates at 0.8%.

Headline HICP inflation peaked at 11.6% YoY in October 2022 driven by a rise in energy prices and rising input costs, but it has since fallen to 4.3% in September 2023. Headline inflation is expected to fall further as energy prices decline and electricity price caps introduced by the government mitigate the impact of renewed price increases. While inflationary pressures remain exceptionally high, core HICP inflation has also started to ease, falling to 4.8% in September, down from historic highs of above 6% in the previous three months. Like other major central banks, the ECB has been rapidly tightening its monetary policy to tame price pressures. Key ECB interest rates increased sharply, with the deposit rate reaching 4.0%. This is the highest level since 2008 and 450bps higher than in 2019. The recent easing of inflation increases the likelihood that the ECB will avoid further policy hikes, although monetary policy is expected to remain tight throughout 2024.

The German labour market has proved to be resilient despite slower economic momentum, with the unemployment rate remaining near historically low levels of around 3%. The employment rate is elevated at 77.5% as of Q2 2023, 0.5pp above its end-2019 level. Scope expects the labour market to remain tight in the medium term, with the unemployment rate averaging 3.1% this year and 3.0% in 2024. This is despite recent, more moderate employment gains and a gradual decline in unfilled vacancies. Price rises have outpaced nominal wage increases, causing real earnings to decline since Q3 2021, but these have started to stabilise in Q2 2023 and are expected to increase during the second half of this year.

The second driver supporting Germany's AAA rating relates to the country's solid fiscal policy framework and strong track record of fiscal discipline. Federal and state debt-brake laws, introduced for the federal government in 2009 and binding for state governments since 2020, limit structural deficits to 0.35% of GDP a year for the federal government and 0% for state governments. This helped place Germany's general government debt on a clear downward trajectory in the decade leading up to the pandemic, from 82% to 60% over 2010-19. Unprecedented fiscal support measures in response to the pandemic and energy crises led to a sharp jump in debt levels to 69% of GDP in 2021, before resuming a stable downward trend. Scope expects the debt-to-GDP ratio to fall to 65.5% this year, gradually declining to 58.9% by 2028.

The debt brake was suspended at the onset of the Covid-19 crisis and again after the escalation of the Russia-Ukraine war, enabling the government to fund large budgetary measures. Public funds allocated to mitigate the energy crisis' impact on the private sector are estimated at EUR 226bn (6.3% of GDP) including

EUR 158bn to shield households and firms and EUR 68bn to meet liquidity needs of utilities[1]. To help respond to the recent crises, the government announced two extra-budgetary funds of EUR 100bn in June 2022 to increase military spending towards NATO's 2% of GDP target, and EUR 200bn in September 2022 to shield households from the energy crisis. As of August 2023, EUR 2.1bn of debt was issued related to the military fund and EUR 61.9bn related to the energy crisis fund. While falling gas prices indicate that not all of the energy crisis fund will be used, Scope expects any remaining credit authorisations to be re-purposed to help fund the long-term energy transition.

Scope expects Germany's headline budget deficit, including extra-budgetary spending, to remain elevated at 2.6% of GDP in 2023, up from 2.5% last year. From 2024, fiscal policy then starts to gradually tighten as crisis support measures are phased out and tax revenues increase, with the deficit falling to 1.9% in 2024, before gradually declining to around 0.9% by 2028. There is a higher degree of uncertainty concerning budget deficit estimates compared with pre-pandemic forecasts. While the government has decided to reimplement the debt brake from 2023, the use of special funds, with spending spread over several years, increases expected general government deficits beyond debt brake limits.

The third driver underpinning Germany's AAA rating is the country's strong external position, which has remained stable during the pandemic. This external strength is reflected in the country's very large, persistent current account surpluses, averaging 7.6% of GDP in the decade up to 2021. The escalation of the Russia-Ukraine war and the associated sharp rise in energy import prices, as well as weaker external demand from key trading partners including China, exerted significant downward pressure on the trade balance in 2022. China was Germany's most important trading partner in 2022 for the seventh consecutive year with a trading volume of EUR 299bn, followed by the United States (EUR 248bn) and the Netherlands (EUR 230bn). The weaker external environment caused the current account balance to fall to 4.2% of GDP in 2022, its lowest level since 2003 and the biggest decline since German reunification. The weakening in 2022 was mainly due to the sharp rise in energy import costs following the escalation of the Russia-Ukraine war and the normalisation of travel imports after two years of low activity due to pandemic-related travel restrictions. Particularly the high energy costs caused the goods trade balance to fall despite some easing of supply chain disruptions which supported motor vehicle exports. Easing energy prices also supported a recovery in the current account balance which averaged 6.2% in the year to August 2023, although remaining around 2pp below pre-pandemic levels.

Despite these credit strengths, Germany's ratings face important medium-term credit challenges.

First, the country faces significant transition risks among energy-intensive industries given carbon neutrality targets and low levels of investment relative to other countries with AAA ratings. Germany's emissions reduction targets are ambitious, with carbon emissions set to be cut by more than 300m tonnes from 2022 levels by 2030[2]. Since 2010, the annual carbon emission reduction averaged 1.8% which will have to increase to 6.4% if 2030 targets are to be met. The Council of Experts on Climate Change noted that the 130 measures under the government's Climate Protection Program 2023 will help narrow the current gap towards targets specified in the Federal Climate Change Act. However, even if measures are fully implemented, the Council expects that the current program falls short of the legal emission reduction requirements[3]. The shift away from Russian gas requires the establishment of new and reliable energy supplies which are leading to higher energy costs in the short term while the country diversifies its energy mix. The rapid shift towards a low-carbon economy exposes several industries to transition risks, including Germany's large motor vehicle, chemical and energy sectors, which remain heavily reliant on fossil fuels. Elevated energy prices following the transition away from Russian gas have already started to erode some of the countries' competitive advantages in certain sectors such as the chemical industry.

Large public and private sector investments will be needed to meet these ambitious targets. Historically, Germany's public and private sectors have invested less than those in other AAA rated peer countries.

Capital intensity, measured as net capital stock per person employed, remained broadly unchanged in Germany over the past two decades while increasing in the EU on average by +18%, and in other highly rated peer countries such as Sweden (+9%), the Netherlands (+12%) and Denmark (+21%). To support future investments, the government continues to focus on improving planning and approval procedures, including simplifying procurement processes and addressing staff shortages in municipal governments[4].

Second, Germany's ageing population will result in rising pension liabilities and downward pressure on the country's medium-run growth potential over the coming years. Since the current government has maintained pension benefits and has not increased the retirement age, the gap between payments to pension recipients and contributions will continue to widen in the years to come as life expectancies of incoming retirees increase. This will result in a rising imbalance in Germany's pay-as-you-go pension system and will result in meaningfully higher healthcare-related costs. The IMF estimates that the net present value of pension spending between 2022-50 will amount to 26.7% of GDP, which is significantly higher than for the UK (11.1%) and France (2.4%)[5]. In Germany's 2023 budget, EUR 121bn (25.4% of the total budget) is earmarked for pension spending. According to previous projections by the Ifo Institute[6], future spending on pensions could rise to 60% of the annual budget by 2050 if no reforms were undertaken. The planned introduction of a share-based pension fund can be an important pillar, but additional reforms will be needed.

The ageing population is the main driver for a declining medium-term potential growth. Scope currently estimates Germany's growth potential at 0.8%, the weakest among peer countries with AAA ratings. Over the coming years, the country's challenging demographics will exert increasing pressure on its growth potential. The Federal Statistical Office estimates that the working age population (aged between 20 and 66 years) will decrease by 1.6 million people by the mid-2030s, from currently 51.4 million people, even with high net immigration. Lower productivity and a shrinking labour force could further reduce the country's potential output. Policies to increase labour force participation and productivity, combined with substantial investments in the country's capital stock, can help slow this trend.

Finally, rising global geopolitical tensions pose challenges to Germany's strong export-oriented economy which is dependent on highly integrated international supply chains. While the country successfully diversified from Russian gas supplies, it comes at the cost of higher gas prices over the coming years, eroding the competitive advantage in some of Germany's more energy intensive sectors such as the chemical industry. The growing tension in the Middle East could further push up energy costs. Additional vulnerabilities stem from the elevated political tensions between the United States and China, which has been Germany's most important single trading partner in 2022 for the seventh consecutive year. In particular, China remained Germany's most important source of imports estimated at EUR 192bn, followed by the Netherlands (EUR 120bn) and the United States (EUR 92bn). De-risking its reliance on China will be challenging and gradual. The IfW Kiel Institute notes that Germany sources at least 85% of some rare earth metals from China which are used, for example, in battery production and are classified as critical by the EU[7].

Core Variable Scorecard (CVS) and Qualitative Scorecard (QS)

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, provides an indicative rating of 'aa+' for the Federal Republic of Germany. The qualitative scorecard (QS) can adjust this indicative rating by up to three notches depending on the size of relative qualitative credit strengths or weaknesses versus a peer group of countries.

For the Federal Republic of Germany, the following relative credit strengths have been identified: i) debt profile and market access; ii) current account resilience; iii) resilience to short-term shocks; and iv) low financial imbalances. Relative credit weaknesses are: i) low growth potential; and ii) elevated environmental risks.

The combined relative credit strengths and weaknesses generates a one-notch positive adjustment and indicates a sovereign rating of AAA for the Federal Republic of Germany.

A rating committee has discussed and confirmed these results.

Factoring of Environment, Social and Governance (ESG)

Scope explicitly factors in ESG sustainability issues during its ratings process via the sovereign methodology's standalone ESG sovereign risk pillar, with a 25% weighting under the quantitative model (CVS) and in the qualitative overlay (QS).

With respect to environmental factors, Germany receives high CVS scores for having low natural disaster risk. However, compared with peers, the country receives lower scores for carbon emissions per unit of GDP, greenhouse gas emissions per capita, and the ecological footprint of consumption compared with available biocapacity. Scope assesses Germany's QS adjustment for 'environmental factors' as 'weak'. Despite having achieved material progress in developing renewable energy production capacities over recent decades, Germany remains largely reliant on fossil fuels, which accounted for 76% of primary energy consumption in 2022 compared to around 70% in the EU. The government aims to reach climate neutrality by 2045 through an accelerated phase-out of coal and a rapid scale-up of renewable sources of energy, which are to cover 80% of the country's electricity needs by 2030. Meeting these ambitious targets will require continued, rapid structural changes to keep up with other highly rated economies. Germany ranks 11th within the World Economic Forum's 2023 Energy Transition Index[8] – an improvement from the previous year, but behind most other AAA rated sovereigns (which occupy four out of the top five ranks). Progress towards the government's emission reduction targets is monitored by the Council of Experts on Climate Change.

Regarding social factors, Germany scores high in the CVS for labour force participation but low for income inequality and old age dependency compared with peer countries. Germany managed to raise labour force participation before the pandemic but mostly in favour of the lower-paid sector. As of 2022, the participation rate improved following a decline in the previous two years but remains below pre-pandemic levels. Despite some recent improvements, net wealth remains unevenly distributed in Germany compared with other European countries with the share of total net wealth belonging to the wealthiest 10% of households amounting to around 56% in 2021 compared with 55% in 2017[9]. Guaranteeing equal opportunities for students remains a challenge, partly due to insufficient digitalisation and investment in schooling. Demographic pressures are rising and are more adverse compared to peers.

Germany benefits from high-quality institutions and a stable political environment. Although the last election delivered a fragmented parliament, the centre-left Social Democratic Party, the Greens and the liberal Free Democratic Party quickly established a three-way coalition and have reached compromises in key policy areas. Political infighting between coalition partners could lead to rising voter discontent and increased political fragmentation. National polling results indicate reduced support for the current coalition government and places the far-right AfD with 22% as the second largest party, although the next federal election is not due until October 2025.

Rating driver references

1. Bruegel: National fiscal policy responses to the energy crisis, June 2023
2. Federal Environment Agency forecast: 2022 greenhouse gas emissions down by 1.9%
3. German Council of Experts on Climate Change: Climate Action Program 2023
4. IMF: Germany 2023 Article IV Consultation
5. IMF Fiscal Monitor, October 2023

6. Ifo Institute: Die teure Bilanz der Rentenpakete der vergangenen Jahre, 2021
7. IfW Kiel Institute: German economy's dependence on China: Critical for individual products, February 2023
8. World Economic Forum: Fostering Effective Energy Transition 2023 Edition, June 2023
9. Bundesbank Monthly Report: Wealth in Germany up significantly, April 2023

Methodology

The methodology used for these Credit Ratings and Outlooks, (Sovereign Rating Methodology, 27 September 2023), is available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

The model used for these Credit Ratings and Outlooks is (CVS Model Version 2.1), available in Scope Ratings' list of models, published under https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.

The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The Credit Ratings were not requested by the Rated Entity or its Related Third Parties. The Credit Rating process was conducted:

With Rated Entity or Related Third Party participation YES
With access to internal documents NO
With access to management YES

The following substantially material sources of information were used to prepare the Credit Ratings: public domain, the Rated Entity.

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Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and Outlooks and the principal grounds on which the Credit Ratings and Outlooks are based. Following that review, the Credit Ratings were not amended before being issued.

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The Credit Ratings/Outlooks were first released by Scope Ratings on 30 June 2017. The Credit Ratings/Outlooks were last updated on 11 November 2022.

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