FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Germany at 'AAA'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 15 Mar 2024: 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

Very Strong Fundamentals: Germany's 'AAA' rating reflects its diversified, high value-added economy and strong institutions. The rating is also supported by a record of fiscal prudence and very low government financing cost. 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. Notwithstanding these strengths, Germany is faced with several structural challenges, including a rapidly aging population that is starting to put pressure on the public finances and the labour market.

Economic Weakness: Germany's post-pandemic economic performance remains weak. The economy contracted by 0.3% in real terms in 4Q23, bringing output to only slightly higher than 4Q19. Growth underperformance since 2022 reflects a combination of external shocks and structural factors. We forecast only 0.1% growth in 2024 following a 0.3% decline in 2023, but a brighter cyclical outlook should drive acceleration in growth to 1.4% in 2025. We estimate that the energy shock reduced the level of Germany's potential output by 1% of GDP, but the output gap is large, indicating room to catch up.

Downside Risks to Growth: The risks to economic growth are on the downside. Germany's potential output may have suffered more as a consequence of the energy shock (for example, the Bundesbank estimated a 2% reduction in December 2022) or the recovery could be delayed. German export competitiveness could come under increased pressure if wages continue increasing at a pace higher than productivity growth or energy prices stabilise at higher levels than we currently assume. Also, further fiscal consolidation might be required to comply with the debt brake rule after 2024, which could directly impact growth.

Tight Labour Market: The tight labour market in Germany continues to put upward pressure on wages, which recently started growing more strongly than eurozone averages (6.1% vs 5.4% in 1H23). At 3.1%, unemployment remains around its historical lows. Labour shortages remain a significant obstacle to production, with 29.5% of companies in the industrial sector (the highest in the eurozone) reporting a lack of skilled labour as a factor limiting production capacity. Inflation has declined substantially, although core inflation remains significantly above the headline, at 3.5% in February, and could put additional pressure on wages.

Fiscal Trade-offs: The Federal Constitutional Court (FCC) ruling from 15 November clarified the operation of the debt brake rule. As a result of the ruling, the government will not be able to use up to EUR90 billion (2.1% of GDP) of planned spending, although the exact effect is difficult to measure given the high underspending from these funds in recent years. The ruling improved transparency and predictability of the federal budget process. However, the compliance with domestic fiscal rules creates important policy trade-offs, as the planned use of off-budget funds would have helped support investment spending.

Small Fiscal Deficits: The return to the application of the debt brake rule and the FCC ruling implies rapid narrowing of fiscal deficits. We expect the fiscal balance to decline to -1.5% of GDP in 2024 from -2.1% of GDP in 2023. However, there is high uncertainty for the fiscal path beyond 2024 as it is unclear how much consolidation the government will have to enact to comply with the debt brake rule, limiting the structural deficit to 0.35% at the central government level.

There is also a high political commitment to spend EUR100 billion (2.5% of GDP) from the Federal Armed Forces fund until 2027, but the initial take-up was small (EUR6 billion since the fund's establishment in 2022). This spending is excluded from the debt brake rule.

Debt Falling but at Slower Pace: Small fiscal deficits and moderate nominal economic growth mean that Germany's general government debt will continue declining as a share of GDP, but at a slower pace than in the post-pandemic period. We expect the debt/GDP to fall to 63.3% in 2025 from 64.2% of GDP estimated in 2023. Germany's debt ratio compares favourably with the eurozone average of 91.2% of GDP but is significantly above the 'AAA' rated median at 36.5% of GDP. However, the downward debt path is fairly resilient to shocks and we expect the debt burden to fall even if real GDP growth stabilises around 0.5%.

Aging Population: Germany faces significant demographic challenges, which are expected to materialise sooner than in other eurozone countries. According to updated projections from the European Commission, the labour force is expected to decline by 6.5% over the next 10 years compared with 2.1% for the eurozone. The Bundesbank expects that the government will have to inject an extra 0.8pp of GDP of funds into the statutory pension system and the contribution rate will have to be raised to 22.9% from 18.6% by 2035 to keep the replacement rate stable.

Resilient Banking Sector: The German banking sector's 'a' Banking System indicator reflects resilient asset quality and sound funding and liquidity. The sector also has sound capitalisation, with banks reporting substantial buffers over regulatory requirements. We expect increasing credit losses from commercial real estate (CRE) exposures to negatively impact German banks in 2024 and 2025, as the system's exposure to CRE, both domestic and foreign, is high compared with most other European sectors. However, the Outlooks on the ratings of all German banks are Stable, reflecting rating headroom to withstand weaker credit quality.

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. These 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 88.4, 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 significant loss of competitiveness, which would lead to a strong further revision in Germany's potential output.

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 a 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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.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, v2.0.1 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.14.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Germany	EU Issued, UK Endorsed

UNSOLICITED ISSUERS

Germany (Unsolicited)

With Rated Entity or Related Third Party Participation	Yes
With Access to Internal Documents	Yes
With Access to Management	Yes

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS

ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Germany	-	Short Term Issuer Default Rating	Unsolicited
Germany EUR 29.5 bln 2.4% bond/note 19-Oct-2028	DE000BU25018	Long Term Rating	Unsolicited
Germany EUR 17 bln Zero treasury bills/notes/bonds 19-Jun-2024	DE000BU0E063	Short Term Rating	Unsolicited

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