FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Germany at 'AAA'; Outlook Stable

Fri 13 Sep, 2024 - 5:03 PM ET

Fitch Ratings - Frankfurt am Main - 13 Sep 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. However, medium-term growth prospects are weak, reflecting long-standing structural challenges.

Economic Weakness: Germany's post-pandemic economic performance remains weak. The economy contracted by 0.1% in real terms in 2Q24, and the output level remains the same as two years ago. Growth underperformance relative to peers is mostly driven by investments and private consumption.

The manufacturing sector also continues to face challenges, with output 7% lower than two years ago. The worse-than-expected 2Q24 growth has contributed to a downward revision to the 2024 growth forecast to just 0.1%, following a 0.3% decline in 2023. We expect a more favourable cyclical outlook, brought by falling inflation and lower financing costs, and a recovery in global trade, to drive an acceleration in growth to 1.1% in 2025 and 1.4% in 2026.

Decline in Potential Growth: Germany's potential growth is likely to decline significantly, primarily due to an aging population and, to a lesser extent, the recent energy crisis. Forecasts from the Bundesbank, Ministry of Finance, German Council of Economic Experts, and the European Commission indicate that potential growth will drop to between 0.7% and 0.4% in the coming years from above 1% before pandemic (Fitch's last projection, from August 2023, is 1.1% on average in 2019-2027).

The government recently approved a reform package of 49 measures (Growth Initiative) designed to lift potential output. The Ministry of Finance says the reforms could increase potential output by 0.6% as early as next year. We expect a smaller positive effect, likely spread across two or more years.

Increasing Unemployment: Unemployment has gone up as the economy has slowed, although it remains low in absolute terms (3.4% in July, up from 3.2% at the end of 2023) and employment continues to grow. We expect the unemployment rate to remain around 3.5% in the medium term, reflective of cyclical weakness in demand but also structural changes; for example, the transition to electric vehicles will lead to fewer jobs in the auto industry. This situation coexists with skills shortages and vacancies in some other manufacturing sectors.

Fairly Small Fiscal Deficits: We continue to expect Germany to post fairly small fiscal deficits, at 1.7% of GDP in 2024 and 1.4% of GDP in 2025, in line with the country's very strict fiscal rules, which require the structural fiscal deficit to not exceed 0.35% of GDP (according to domestic accounting rules, which are based on cash flow accounting and exclude spending by off-budget funds). The narrowing of deficits is mostly driven by the expiry of emergency financial aid and expected pick-up in economic activity and employment, and wages supporting revenues.

Debt Falling but at Slower Pace: Small fiscal deficits and moderate nominal economic growth mean Germany's debt ratio will continue declining, but more slowly than in the post-pandemic period (and after the European debt crisis). We expect the debt-to-GDP ratio to fall to 61.5% in 2026, from 62.7% in 2023.

Germany's debt ratio compares favorably with the eurozone's at 101.4% of GDP but is significantly above the 'AAA' median at 39.9% of GDP. The sovereign also faces large spending pressures from aging and energy transformation. Further investments may be necessary to invigorate sluggish economic growth and transition the economy towards new growth drivers.

High Political Uncertainty: Germany faces political uncertainty as the coalition government (SPD, Greens, and FDP) has lost considerable public support. The coalition has delayed major reforms until after the September 2025 election due to diminished support and internal disagreements.

This erosion of confidence in the mainstream parties is reflected in the rising popularity of the hard-right Alternative for Germany (AfD) and the newly established hard-left Sahra Wagenknecht Alliance (BSW). Both parties together are receiving 26% of votes in polls. These parties are unlikely to be invited to form a coalition despite their strong support, which might complicate the formation of a stable government next year.

External Sector Strengths: Germany's external finances remain a key rating strength. We project the current account surplus (CAS) to increase this year, to 6.5% of GDP despite weaknesses in certain export sectors and declining global demand. We anticipate a modest rise in the CAS during 2024-2025, stabilizing close to 7% of GDP. This projection assumes a high domestic savings rate and resilience in most export sectors. Current measures of price competitiveness do not indicate a significant deterioration, but some industries are experiencing permanent shifts.

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. Banks have benefited from higher interest rates driving improving net interest margins, which have resulted in a significant improvement in profitability, traditionally the weak spot for the banking sector.

We expect asset quality to deteriorate modestly in 2024 and 2025 due to challenges to corporate lending, in particular to the commercial real estate sector, posed by the domestic economy. However, the Outlooks on the ratings of almost all German banks are Stable, reflecting rating headroom to withstand weaker credit quality.

High Macro-Prudential Risk Score: Germany's MPI 3 score (high vulnerability) in Fitch's Macro-Prudential Risk Model reflects the combination of a sharp increase in the credit/GDP ratio in 2020 and sustained strong house price inflation combined with economic contraction during Covid-19 pandemic. We expect the ratio to come down, given the recovery of the economy and the recent decline in real estate prices, and do not see it as a signal of heightened financial vulnerability.

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 large 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 'AAA' 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:

Fitch removed the +1 notch for macroeconomic performance, policies and prospects that was temporarily added to offset the deterioration in the SRM output driven by two consecutive external shocks, as the impact of these shocks on the model score has lessened sufficiently for it to return to 'AAA'.

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 too minimal to be considered. 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's 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 World Bank Governance Indicators (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/esg.

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-Local currency	LT AAA Affirmed	AAA
Senior Unsecured-Local currency	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, v2.0.2 (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
Germany	-	Short Term Issuer Default Rating	Unsolicited
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 04-Jul-2044	DE0001135481	Long Term Rating	Unsolicited

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