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.

Rating action

Scope Ratings GmbH (Scope) has today affirmed the Federal Republic of Germany’s long-term issuer and senior unsecured debt ratings at AAA in both local and foreign currency and maintained the Stable Outlook. The short-term issuer rating has been affirmed at S-1+ in both local and foreign currency with Stable Outlook.

Germany’s AAA/Stable ratings are underpinned by its wealthy, large, diversified economy, its robust fiscal policy framework and strong track record of fiscal discipline, and a highly competitive external sector. These factors supported the economy’s resilience in the past 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.

For the updated rating report, click here.

Key rating drivers

Wealthy, large and diversified economy supports resilience. Germany’s strong industrial base in the automotive, machine construction and chemicals industries, in addition to the diverse and competitive small and medium-sized companies, or “Mittelstand”, form the backbone of the export-oriented economy. The post-pandemic recovery has been weak when compared with peer countries as global supply chain disruptions and weaker demand held back industrial output, while sharply higher inflation slowed consumption growth. In Q2 2024, economic output stood at a similar level as before the pandemic in 2019, lagging behind the euro area average (+4.3%) and other highly rated sovereigns such as Sweden (+4.5%), the Netherlands (+7.6%), Switzerland (+7.9%) or Denmark (+10.7%). GDP contracted in 2023 by 0.3% as the economy faces a combination of cyclical challenges including weak global demand and high energy costs, as well as structural pressures related to an ageing population, persistent under-investment and the transition towards carbon neutrality. Scope expects GDP growth to stagnate in 2024, starting to recover during the second half of the year, and output to increase by 0.9% in 2025. The improving outlook is supported by rising real wages and falling interest rates leading to higher consumption and investment while exports recover driven by moderate growth in key trading partners including the eurozone, China and United States.

Robust fiscal framework and strong track record of fiscal discipline. Germany's constitutional court ruling[1] on the federal supplementary budget of 2021 and its strict interpretation of debt-brake borrowing limitations have reinforced the country's fiscal rules. This has led to challenging budget negotiations between the coalition parties to meet rising spending pressures while adhering to the debt brake. The result is a mix of policies that make use of all available flexibility within current limitations including off-balance sheet financing and financial transactions, such as a capital increase for the train operator Deutsche Bahn, which are excluded from debt-brake accounting. This allows the government to exceed the debt-brake limit of a structural deficit of 0.35% of GDP. Scope expects a fiscal deficit of 2.2% in 2024 and 1.8% in 2025.

The ruling by the constitutional court also intensified debate on possible reforms to the debt-brake. Changes that would encourage future governments to raise long-term investment would support Germany's competitiveness and its medium-term growth potential. However, near-term significant amendments to the debt brake appear unlikely as it would require cross-party political support for a change to German Basic Law. Meanwhile, Germany continues to have fiscal space to fund higher public spending to support the energy transition. Scope expects the debt-to-GDP ratio to decline from 62.7% in 2023 to 58.9% by 2029.

Highly competitive external sector. Germany's external strength is reflected in the country's very large, persistent current account surpluses, averaging 7.7% 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 (Germany's most important trading partner for the past eight years), exerted significant downward pressure on the trade balance in 2022. After falling to 4.4% in 2022, the current account balance recovered in 2023, and Scope expects it to reach around 6.5% in 2024. While it is expected to remain near this level in subsequent years, some volatility is likely to persist due to declining global demand and challenging outlooks for certain export sectors leading to structural changes in some industries.

Rating challenges: transition risks for energy-intensive industries and low levels of investment, an ageing population, and vulnerabilities related to global geopolitical risks.

Germany faces high transition risks among energy-intensive industries given carbon neutrality targets and low levels of investment relative to other countries with AAA ratings. Emission reduction targets are ambitious, with carbon emissions set to be cut by around 240m tonnes from 2023 levels by 2030[2]. Between 2010 and 2022, the annual carbon emission reduction averaged 1.8% with a much stronger reduction of 10% in 2023, placing 2030 targets within reach for the first time according to government projections[3]. The sharp drop in 2023 was due to lower use of fossil fuels for electricity production given a mild winter, a weak economy and high energy prices which lowered production in Germany's energy-intensive industries such as aluminum production. To meet the 2030 targets, annual reductions in carbon emissions will have to remain well above historical averages at around 6%. 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 country's 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, declined in Germany by 1% over the past two decades while increasing in the EU on average by +14%, and it remains well below other highly rated peer countries. To support future investments, the government is making use of any available flexibilities under the constitutionally anchored debt-brake law and continues to focus on reducing the administrative burden by improving planning and approval procedures.

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. The net present value of pension spending between 2023-50 is estimated at 24.5% of GDP, which is significantly higher than for the UK (9.6%) or France (-0.1%)[4]. In Germany's 2025 draft budget, EUR 132bn (27.2% of the total budget) is earmarked for pension spending and past studies have indicated that this share could double by 2050[5] with the old age dependency ratio rising to more than 50%. The introduction of a share-based pension fund with assets of at least EUR 200bn by 2036 can support future spending pressures, but additional reforms will be needed. The pension contribution rate is expected to climb from its current level of 18.6% of gross salaries to around 22.3% by 2045 (or 22.7% without the support of the fund). 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. The Federal Statistical Office estimates that the working age population (aged between 20 and 66 years) will decrease by between 7% and 11% by 2035. To compensate for this decline, average annual net immigration of 480,000 people of working age would be needed – average annual total net migration since the year 2000, and excluding the crisis years 2015 and 2022, amounted to 253,000 people. Policies to increase labour force participation and productivity, combined with substantial investments in the country's capital stock, can also help slow the declining growth 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. 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 2023 for the eighth consecutive year.

Outlook and rating sensitivities

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

Downside scenarios for the rating and Outlooks are if (individually or collectively):

1. 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

2. A severe macroeconomic or financial system shock resulted in a weaker growth outlook.

Sovereign Quantitative Model (SQM) and Qualitative Scorecard (QS)

Scope's SQM, which assesses core sovereign credit fundamentals, signals a first indicative credit rating of 'aa+' for Germany. Under Scope's methodology, this initial indicative rating receives a one-notch uplift from the SQM's reserve-currency adjustment and no negative adjustment from the political-risk adjustment. This results in a final SQM indicative credit rating of ‘aaa’ for Germany. On this basis, the final SQM quantitative rating of ‘aaa’ is reviewed by the Qualitative Scorecard (QS) and can be adjusted by up to three notches depending on Germany’s qualitative credit strengths or weaknesses compared against a peer group of sovereign states identified by the SQM.

Scope identified the following relative credit strengths of Germany via the QS: i) debt profile and market access; ii) current account resilience; iii) resilience to short-term external shocks; and iv) financial imbalances. The following relative credit weaknesses were identified: i) growth potential and outlook; and ii) environmental factors. Together these adjustments result in the final AAA long-term foreign- and local-currency ratings for Germany.

A rating committee has discussed and confirmed these results.

Environment, social and governance (ESG) factors

Scope explicitly factors in ESG issues in its ratings process via the sovereign-rating methodology’s stand-alone ESG sovereign-risk pillar, which holds a significant 25% weighting under the quantitative model (SQM) and 20% weight under the methodology’s qualitative overlay (QS).

With respect to environmental factors, Germany receives high SQM 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 75% of primary energy consumption in 2023 compared to around 68% 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 2024 Energy Transition Index[6] – in line with the previous year, but behind most other AAA rated sovereigns with only Luxembourg ranked lower than Germany. 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 SQM 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. The participation rate improved in 2022 and 2023 but remains below pre-pandemic levels. Despite some recent improvements, net wealth remains unevenly distributed in Germany reflected by a high Gini coefficient of 77.2 compared with France (70.3), the United Kingdom (70.2), Spain (68.3) and Italy (67.8). 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 but faces rising political fragmentation. Regional elections have seen strong support for the far-right Alternative für Deutschland (AfD) and the newly-established Sahra Wagenknecht Alliance (BSW) which split from the far-left party, die Linke. While the next general election will only take place in September 2025, the current coalition parties (centre-left Social Democratic Party, the Greens and the liberal Free Democratic Party) are polling at less than 30%. The fragmented political landscape may complicate coalition building after the election next year during a time when pressure to implement structural reforms continues to rise.

Rating committee

The main points discussed by the rating committee were: i) domestic economic risk; ii) public finances risk, including fiscal framework and debt dynamics; iii) external risks; iv) financial stability risks; v) ESG considerations; and vi) peer developments.

Rating driver references

1. Bundesverfassungsgericht, Second Supplementary Budget Act 2021 is void, November 2023
2. Umwelt Bundesamt, Climate emissions fall by 10.1 per cent in 2023, March 2024
3. Federal Ministry for Economic Affairs and Climate Action, Germany on track for 2030 climate targets for the first time, March 2024
4. IMF, Fiscal Monitor, April 2024
5. ifo Dresden, Stabile Finanzierung des Rentensystems: Was Deutschland von anderen europäischen Ländern lernen kann, June 2023
6. World Economic Forum, Fostering Effective Energy Transition 2024, June 2024

Methodology

The methodology used for these Credit Ratings and/or Outlooks, (Sovereign Rating Methodology, 29 January 2024), is available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The model used for these Credit Ratings and/or Outlooks is (Sovereign Quantitative Model Version 4.0), 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

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