

Morningstar DBRS Confirms Federal Republic of Germany at AAA, Stable Trend

SOVEREIGNS

DBRS Ratings GmbH (Morningstar DBRS) confirmed the Federal Republic of Germany's (Germany) Long-Term Foreign and Local Currency - Issuer Ratings at AAA. At the same time, Morningstar DBRS confirmed Germany's Short-Term Foreign and Local Currency - Issuer Ratings at R-1 (high). The trend on all ratings is Stable.

KEY CREDIT RATING CONSIDERATIONS

The Stable trend reflects Morningstar DBRS' view that Germany's credit fundamentals remain solid notwithstanding weak economic growth dynamics. Economic growth remained weak in recent months, weighed down by cyclical headwinds and structural factors. The German Council of Economic Experts (GCEE) forecasts real GDP to contract by 0.1% in 2024. While cyclical headwinds are likely to ease gradually next year, the economic outlook is exposed to downside risks such as rising global trade tensions and an escalation of geopolitical tensions. Budgetary pressures are now larger than in pre-pandemic years but Germany's fiscal deficit is much smaller than in most other major advanced economies. The GCEE forecasts the general government budget deficit at 2.1% of GDP in 2024. Moreover, the government's debt service capacity remains very strong, underpinned by a low interest burden, a moderate stock of public debt and the country's status as a safe haven. Germany's future fiscal policy is to be determined by a yet-to-be elected government, following the break-up of the "traffic light" coalition government in early November 2024 and the scheduling of snap elections for February 2025. In Morningstar DBRS' view, the next government is set to face tough budgetary choices as the fiscal policy space under the constitutional debt brake is narrow and spending pressures particularly on defense and investment are likely to increase.

Germany's AAA ratings are supported by its competitive and highly developed economy and high institutional quality. Furthermore, external finances are strong and resilient to potential shocks. However, the economy faces large challenges such as population ageing and structural changes within important manufacturing industries. Furthermore, contingent liabilities, emanating from state guarantees for domestic companies and fiscal burden sharing within the currency union could eventually weigh on public finances.

CREDIT RATING DRIVERS

Morningstar DBRS could downgrade the ratings if the country's growth and fiscal prospects deteriorate severely enough to place the public debt-to-GDP ratio on a persistent upward trajectory. Moreover, a materialisation of substantial contingent liabilities could put negative pressure on the ratings.

CREDIT RATING RATIONALE

Economic Growth is Likely to Recover Only Gradually and the Outlook is Exposed to Substantial Downside Risks

Economic growth dynamics remained weak in recent months. After contracting by 0.3% in 2023, real GDP contracted by 0.2% on a year-on-year basis in the first three quarters of 2024. Investment declined markedly on the back of tight monetary conditions and weak business sentiment. Furthermore, export activity was weighed down by sluggish external demand and German exporters'

declining global market shares in key industries such as automotives. Although households' purchasing power benefitted from a marked increase in real wages, private consumption remained sluggish not least as a result of still subdued consumer sentiment. The household saving rate increased moderately over the past year. Looking ahead, cyclical headwinds are projected to ease, albeit only in a gradual manner. The GCEE forecasts real GDP to expand by 0.4%, driven by a moderate strengthening in private consumption on the back of further, albeit moderating, real wage gains of households. Furthermore, investment in machinery and equipment is projected to recover modestly in 2025 from the large decline in the current year. The growth outlook is exposed to downside risks, including a potential increase in US tariffs on imports that would likely weaken Germany's export activity and weigh on domestic business sentiment. The US accounted for 10% of total German exports in 2023.

Over the medium-term, potential growth is projected to be dampened by unfavourable demographic trends. The size of the domestic labour force is expected to start shrinking over the next years, driven by the retirement of the large age cohorts of the baby boomer generation. Furthermore, important manufacturing industries face large structural challenges such as the global energy transition and the automotive industry's transformation towards electric vehicle production. Nevertheless, Germany's credit profile continues to be supported by its competitive and highly developed economy and its high level of labour productivity.

Snap Elections are Scheduled for February 2025

The 'traffic-light' coalition government (Social Democrats, Green Party, Free Democrats) broke up in November 2024 as the three parties failed to agree on a central government budget for 2025. Over the past year, the outgoing government's policymaking had been increasingly impeded by diverging policy priorities of the three coalition parties particularly on fiscal and economic policy. The snap elections are scheduled for 23 February 2025. The centre-right Christian Democratic Union is currently leading the election polls by a wide margin. While political polarization has increased in recent years, it continues to be less pronounced than in some other advanced economies. In terms of foreign affairs, policy continuity of the yet-to-be elected government is likely to remain high. Germany is a strong performer on the World Bank's Governance Indicators reflecting a high rule of law, low levels of corruption and stable political and economic institutions. Germany's high institutional quality is a key strength of its credit profile.

Government Budgetary Pressures are Moderate but the Next Government is Likely to Face Tough Fiscal Choices

Budgetary pressures are higher than in pre-pandemic years but still moderate. The GCEE forecasts the general government budget deficit to narrow to 2.1% of GDP in 2024 from 2.6% in 2023, driven by the phase-out of fiscal support measures such as the gas and price brakes by year-end 2023. While fiscal accounts in 2024 benefit from rising social security contributions and, to a lesser extent, personal income taxes on the back of high nominal wage growth, corporate income tax revenues have been weighed down by weak economic growth dynamics. Furthermore, budgetary pressures have been raised by a step-up in spending by the special fund for the military and rising investment in rail infrastructure. Total budgeted defence spending (core budget and special fund) amounts to 1.8% of GDP in 2024, up from 1.3% in 2022. In 2025, the GCEE forecasts the budget deficit to narrow to 1.9% of GDP. General government revenues are likely to be bolstered by the increase in the national carbon price and higher social security contribution rates for health and long-term care insurances. Central government budgetary operations next year will be guided by the principles of interim budget management until a new central government passes a budget for 2025. These principles confine central government spending to the fulfillment of contractual obligations and the continuation of already adopted fiscal measures.

While the size of current and projected budget deficits is smaller than those in most other advanced economies, the government's fiscal space has been narrowed by the reinstatement of the constitutional debt brake in 2024. The debt brake limits net structural borrowing of the central government at 0.35%. The central government 2024 budget fully utilized permissible net borrowing under the debt brake. Over the medium-term, rising ageing-related expenditure is projected to reduce the government's fiscal space under current policy settings. The government's Ageing Report projects annual public pension expenditure to increase by 0.6% of GDP between 2022 and 2030. Morningstar DBRS takes the view that the future government is set to face tough budgetary choices as the country faces large investment needs and defence spending pressures have risen markedly given the geopolitical uncertainties after

the US election. Making room for a potential step-up in investment and defence spending would require some flexibility around the debt brake, tax increases or cuts in other types of public spending. An alteration of debt brake regulations would require a two-thirds majority in the German parliament.

Debt Affordability Is High

Morningstar DBRS regards Germany's debt affordability as high due to moderate government debt levels, a low interest burden and Germany's status as a safe haven. General government gross debt declined to 61.9% of GDP in June 2024 from 65.0% in December 2022 underpinned by high, albeit decelerating, nominal GDP growth. Looking ahead, the debt-to-GDP ratio - under current policy settings - is likely to stabilize over the next year as nominal GDP growth is projected to continue to decelerate on the back of lower inflationary pressures and the general government budget deficit is likely to remain moderate. Risks to public finances emanate from a materialization of implicit or explicit contingent liabilities. This has been illustrated by support measures to the energy company Uniper and Siemens Energy in recent years. Nevertheless, while the increase in interest rates is projected to raise the government's interest burden moderately, it remains low and continues to compare favourably with European peers and in a historical perspective. The European Commission forecasts the general government's interest burden to rise to 1.1% of GDP in 2025 from 0.9% in 2023 compared to an average of 2.0% for Euro area countries in 2025 and an average annual interest burden of 1.6% for Germany during the years 2010-2019. Government financing benefits from the government's role as a benchmark issuer for the euro area. Germany's safe-haven status supports the "Debt and Liquidity" building block assessment.

Financial Condition of the Banking Sector Is Sound but Pockets of Vulnerability Might Emerge from Commercial Real Estate Exposure

Financial stability is supported by the banking sector's good capital buffers. The average Tier 1 capital adequacy ratio rose to 18.1% in June 2024 from 17.2% in December 2022, driven by a temporary increase in profitability related to higher net interest income. Moreover, banks have so far weathered potential asset quality risks such as weak economic growth dynamics and the sharp increase in interest rates for corporate borrowers reasonably well. The average NPL ratio rose to a still low 1.6% in June 2024, up from 1.2% in December 2022. Pockets of vulnerability might arise from banks' exposure to the commercial real estate sector (15.5% of total domestic private loans in September 2024) and, to a lesser extent, to the manufacturing (4.5%) and the construction (3.3%) sectors. Commercial real estate borrowers face repricing risks over the next years and segments such as retail and office are exposed to structural challenges such as a rising importance of remote work and e-commerce. While commercial real estate prices have stabilized over recent months, transaction volumes continue to be low. In terms of household mortgages (37.4% of total domestic private loans in September 2024), the pass-through of higher interest rates has been contained by long interest rate fixation periods of most mortgages. Furthermore, households' repayment capacity is supported by the comparatively low level of household debt (51% of GDP in Q1 2024) and still low, albeit rising, unemployment.

External Finances Resilient to Potential Global Trade and Financial Shocks

Germany's external finances are strong and resilient to potential shocks. The economy commands over a structural current account surplus which amounted to 5.9% of GDP in 2023. The GCEE forecasts the current account surplus to widen to 6.7% in 2024 on the back of a modest increase in nominal exports and as weak domestic demand weighed on imports of goods and services. In 2025, the current account surplus is forecast to narrow to 6.4% of GDP as a moderate strengthening in domestic demand is projected to raise imports. Furthermore, Morningstar DBRS assesses the economy's external vulnerability to potential global trade and financial shocks as low given Germany's status as a safe haven and its large net external asset position. In Q2 2024, Germany's net international investment position amounted to a large 76% of GDP owing to substantial foreign assets held particularly by non-depository financial institutions and, to a lesser extent, the central bank. This strong net external creditor position supports the "Balance of Payments" building block assessment.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

There were no Environmental, Social or Governance factors that had a significant or relevant effect on the credit analysis.

A description of how Morningstar DBRS considers ESG factors within the Morningstar DBRS analytical framework can be found in the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (13 August, 2024) <https://dbrs.morningstar.com/research/437781>

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments. <https://dbrs.morningstar.com/research/443637>.

EURO AREA RISK CATEGORY: LOW

Notes:

All figures are in euros unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments (15 July, 2024) <https://dbrs.morningstar.com/research/436000>. In addition Morningstar DBRS uses the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings <https://dbrs.morningstar.com/research/437781> in its consideration of ESG factors.

The credit rating methodologies used in the analysis of this transaction can be found at: <https://dbrs.morningstar.com/about/methodologies>.

The sources of information used for these credit ratings include Germany's Federal Ministry of Finance (German Draft Budgetary Plan 2025, October 2024; Monthly Reports), German Finance Agency (Deutsche Finanzagentur), Deutsche Bundesbank (Monthly Reports; Financial Stability Review 2024, November 2024), Federal Ministry for Economic Affairs and Climate Action, Federal Statistical Office, Federal Financial Supervisory Authority (BaFin), European Banking Authority, German Council of Economic Experts (Annual Report 2024-25, November 2024), Ifo Institute, European Commission (European Economic Forecast Autumn 2024, November 2024), Statistical Office of the European Communities, European Central Bank (ECB), IMF (World Economic Outlook October 2024; International Financial Statistics; Germany: 2024 Article IV Consultation July 2024), OECD, BulwienGesa AG (Housing Price Index), European Environment Agency, German Environment Agency, Social Progress Index, World Bank, Bank for International Settlements, Macrobond and Haver Analytics. Morningstar DBRS considers the information available to it for the purposes of providing these credit ratings to be of satisfactory quality.

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With Rated Entity or Related Third Party Participation: YES

With Access to Internal Documents: NO

With Access to Management: NO

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The conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. Morningstar DBRS' outlooks and ratings are under regular surveillance.

For further information on Morningstar DBRS historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: <https://registers.esma.europa.eu/cerep-publication>. For further information on Morningstar DBRS historical default rates published by the Financial Conduct Authority (FCA) in a central repository, see <https://data.fca.org.uk/#/ceres/craStats>.

The sensitivity analysis of the relevant key credit rating assumptions can be found at: <https://dbrs.morningstar.com/research/443636>.

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Ratings

Germany, Federal Republic of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
29-Nov-24	Long-Term Foreign Currency - Issuer Rating	Confirmed	AAA	Stb	 
29-Nov-24	Long-Term Local Currency - Issuer Rating	Confirmed	AAA	Stb	 
29-Nov-24	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	 
29-Nov-24	Short-Term Local Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	 

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