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

SOVEREIGNS

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

KEY RATING CONSIDERATIONS

The Stable trend reflects DBRS Morningstar's view that Germany's credit fundamentals remain solid, despite the economic shocks from the COVID-19 pandemic and, more recently, Russia's invasion of Ukraine. While COVID-19 related fiscal measures are set to be gradually removed in 2022 and 2023, the invasion has raised spending pressures particularly with regard to energy and defence. Moreover, a potential prolonged cut-off in Russian gas supplies constitutes an important downside risk for public finances as it would most likely aggravate energy-related spending pressures. These risks, however, are balanced by Germany's substantial fiscal space for absorbing a temporary increase in budgetary pressures. This applies particularly to government spending that aims at strengthening the resilience of the economy. Fiscal space has been bolstered by recurring budgetary surpluses in the years prior to the Covid-19 shock. Furthermore, the government's interest burden is very low and government financing conditions continue to be very favourable due to Germany's status as a safe haven.

Germany's AAA ratings are supported by its competitive and highly developed economy, its sound public finances, high institutional quality and strong external finances. However, the country faces important challenges stemming from unfavourable demographic trends and contingent liabilities. The projected decline in the working-age population poses challenges to Germany's growth potential and the long-term sustainability of its public finances. Furthermore, contingent liabilities, emanating from state guarantees for domestic companies and fiscal burden sharing within the currency union could eventually weigh on public finances. DBRS Morningstar will continue to monitor potential financial risks from elevated housing prices in tandem with accelerated mortgage loan growth. Currently, we view these risks to be adequately mitigated by the sound financial condition of the domestic banking sector and still low levels of household debt.

RATING DRIVERS

Germany is strongly placed within the AAA category. DBRS Morningstar 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.

RATING RATIONALE

Economic Recovery From COVID-19 Shock Dampened By the Impact of Russia's Invasion of Ukraine

The German economy has so far recovered from the COVID-19 shock at a slower pace than most other EU economies and its near term economic outlook has deteriorated. Following a contraction of 4.6% in 2020, real GDP rebounded by only 2.9% in 2021 compared to an aggregate growth rate of 5.3% in the EU (2020: -5.9%). This comparatively slow rebound in Germany resulted from subdued private consumption on the back of stringent COVID-19 containment measures as well as supply-side bottlenecks which weighed down production in important industries, particularly automotive. While, by the end of last year, most observers had been predicting a marked acceleration of growth dynamics in 2022 due to the fading impact of the pandemic, Germany's economic outlook has deteriorated markedly over the past few months following Russia's invasion of Ukraine. During Q1 2022, real GDP grew by a mere 0.2% on a quarter-on-quarter basis. The weak growth dynamics in recent months can be ascribed to renewed supply chain disruptions particularly in construction and automotive industries. Furthermore, the invasion and the accompanying increase in energy prices have aggravated inflationary pressures which, in turn, contributed to a marked deterioration of business and consumer confidence. The annual inflation rate (HICP) rose to 7.8% in April 2022 driven by a spike in energy prices (+ 34.5%). In late March 2022, the German Council of Economic Experts cut its annual real GDP growth forecast for 2022 to just 1.8% from a 4.6% previously published in November 2021.

Germany's short-term economic growth outlook is clouded by significant downside risks. In particular, Russia's invasion of Ukraine has raised Germany's energy security risks given the still high dependence of the economy on Russian gas imports. A prolonged cut-off in Russian gas supplies would most likely curtail production in several energy-intensive manufacturing industries. However, DBRS Morningstar notes that the government has taken steps in recent months, including securing of alternative gas supplies and renting of floating LNG terminals, which should gradually reduce the economy's energy security risks over the next two years. Furthermore, a further weakening of global demand (particularly from the US and China) would weigh on economic activity in export-dependent manufacturing industries. Despite the risks, DBRS Morningstar expects growth to be supported by a gradual recovery of private consumption. The easing of COVID-containment measures is projected to foster private consumption, particularly of services, over the next two years, provided that no vaccine-resistant virus variants emerge. Furthermore, DBRS Morningstar expects domestic demand to be supported by higher (off-budget) public spending particularly on climate measures and a hike in the minimum wage in October 2022 in tandem with still tight labour markets. While DBRS Morningstar considers Germany's unfavourable demographic trends and potential scarring effects from high-for-longer energy prices on energy-intensive industries as important risk factors, Germany's credit profile continues to be supported by the competitive and highly developed nature of the economy and its high level of labour productivity.

Fiscal Space Sufficient to Absorb Temporary Increase in Budgetary Pressures

Public finances have been adversely impacted by COVID-19 and, more recently, Russia's invasion of Ukraine. In DBRS Morningstar's view, however, Germany has ample fiscal space to absorb a temporary increase in budgetary pressures. Germany's fiscal space has been bolstered by recurring budgetary surpluses in the years prior to the COVID-19 shock. Furthermore, government financing conditions continue to be very favourable due to Germany's status as a safe haven.

The general government budget deficit amounted to a high 3.7% of GDP in 2021, reflecting still large COVID-19 support measures (3.2% of GDP). While the latter measures are set to decline in 2022, Russia's invasion of Ukraine has raised budgetary pressures particularly on the spending side (energy and defence). As a result, the government currently expects the general government budget deficit to remain somewhat elevated at 3.7% of GDP in 2022. In spring 2022, the government adopted two relief packages totalling 0.7% of GDP which seek to shield households and businesses from the impact of higher energy prices. In addition, reducing the dependence on Russian gas supplies necessitates large investments in the build-up of a LNG infrastructure which have so far been partially borne by the government (e.g. renting of floating LNG terminals). In terms of defence spending, the government has proposed to set up a special fund ("Sondervermögen Bundeswehr") in March 2022. This special fund is planned to be exempt from the stipulations of the debt brake and projected to complement central government on-budget defence spending by an annual 0.5% of GDP during 2022-2026.

The government's current mid-term budgetary framework envisages a narrowing of the general government budget deficit to 2.0% of GDP in 2023 and 1.7% in 2024 (including operations of special funds). Narrowing the deficit is aided by an upswing in nominal tax revenues on the back of rising prices. Furthermore, mid-term budgetary figures are based on the assumption that energy-related spending pressures will subside markedly after 2022. In view of the latter, however, DBRS Morningstar notes that a potential prolonged cut-off in Russian gas supplies constitutes an import downside scenario for public finances as it would likely raise energy-related budgetary pressures beyond 2022. In terms of the national fiscal rule, the central government plans to return to the stipulations of the debt brake from 2023 onwards which limits the central government budget deficit at 0.35% of GDP. However, this presentation of very modest central government budget deficits from next year onwards masks a moderate increase in spending by the Climate and Transition Fund and the proposed special fund for defence spending as both funds are not included in central government accounts (according to debt brake stipulations). DBRS Morningstar understands that the combined off-budget annual expenditures of both funds will average around 1.5% of GDP during 2023-2026.

Government debt increased due to the COVID-19 shock. General government gross debt amounted to 69.3% of GDP at end 2021, up from 58.9% at end 2019. Looking ahead, the government's recently released stability programme projects a gradual decline in general government debt to 66.7% of GDP at end 2022 and to 65.0% at end 2025. The projected decline in 2022 partly results from the fact that the government has prefunded some funding needs for the ongoing fiscal year during 2021. Potential risks for public finances emanate from contingent liabilities (e.g. state guarantees for companies affected by COVID). The total stock of public guarantees stood at 17.5% of GDP at end 2020. Despite the increase in budgetary pressures over the past few years, Germany still benefits from very favourable financing conditions. The government's stability programme expects annual interest expenditures to amount to a very low 0.5% of GDP over the forecast horizon. In addition, government financing benefits from the government's role as a benchmark issuer for the euro area. The increase in nominal yields on German government bonds in recent months has been less pronounced than for other euro area governments. Germany's safe-haven status has a positive impact on the "Debt and Liquidity" building block assessment.

Risks from Elevated Housing Prices Mitigated by Sound Condition of Banks And Still Low Household Debt

DBRS Morningstar regards the overall financial condition of the German banking sector as sound. While the banking sector continues to be hampered by structural problems such as a low profitability, capitalization buffers have increased in recent years with the average capital adequacy ratio standing at a good 18.8% at end 2021. Furthermore, banks have so far weathered the COVID-19 shock well. Despite a large real GDP contraction in 2020, the NPL ratio of German banks (supervised by the EBA) declined to a low 1.1% at end 2021 from 1.3% at end 2019. This favourable dynamic in asset quality metrics can partly be ascribed to extensive government support measures for COVID-hit industries which have kept the number of insolvencies low even after the lifting of the insolvency moratorium in May 2021.

Going forward, DBRS Morningstar views a potential correction of housing prices in tandem with rising interest rates as a risk factor for banks' asset quality. Housing loans accounted for 53% of total domestic bank loans in March 2022, around 82% of which are secured by residential real estate. Housing prices (particularly residential real estate) have risen markedly over the past years, clearly exceeding the increases in rents and incomes. According to the OECD, the price-to-rent and the price-to-income ratios for residential mortgages in Germany rose by a comparatively large 45% and 35%, respectively between December 2015 and December 2021. In its latest financial stability review, the Bundesbank estimated the overvaluation in the residential real estate market at 10-30% in 2020. In DBRS Morningstar's view, risks from elevated housing prices are currently mitigated by the comparatively low, albeit rising, level of household debt (58% of GDP in Q3 2021) and long interest rate fixation periods of most mortgages. Furthermore, we expect future mortgage loan growth to be dampened by the gradual introduction of selected macroprudential measures until February 2023. These measures include an increase in banks' countercyclical capital buffer and the introduction of a sectoral systemic risk buffer for loans secured by residential real estate.

External Finances Robust to Potential Global Trade and Financial Shocks

Germany's external finances are strong and robust to potential shocks. The economy commands over a structural current account surplus which is likely to mitigate the potential impact of a global trade shock on external finances. In 2022, the German Council of Economic Experts forecasts the current account surplus to shrink to a still large 4.7% of GDP from 7.4% in 2021 as weakening global demand and supply side bottlenecks are expected to weigh on exports. In addition, the economy's import demand is projected to be raised by a partial rebound of private consumption in Germany. Furthermore, DBRS Morningstar assesses the economy's vulnerability to a potential global financial shock as low due to its status as a safe haven and its large net external asset position. At end 2021, Germany's net international investment position amounted to a large 68.4% of GDP due to high 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.

Germany's Rating Is Underpinned by High Institutional Quality

Germany's high institutional quality is a key strength of its credit profile. Germany is a strong performer on the World Bank's Governance Indicators as it is characterized by a high rule of law, low levels of corruption and stable political and economic institutions. Moreover, political polarization is less pronounced than in some other advanced economies. The federal election in September 2021 has led to the formation of a 'traffic-light' government coalition which comprises centre-left and centre-right parties (Social Democrats, Green Party, Free Democrats). The new coalition government aims to accelerate the green and the digital transitions of the economy by raising public investment moderately and streamlining regulatory frameworks. Despite this change of direction in certain policy areas, DBRS Morningstar assesses overall policy continuity as high particularly with regard to fiscal and foreign affairs.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

There were no Environmental/ Social/ Governance factor(s) that had a significant or relevant effect on the credit analysis.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings at https://www.dbrsmorningstar.com/research/396929/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments: https://www.dbrsmorningstar.com/research/397943.

EURO AREA RISK CATEGORY: LOW

Notes:
All figures are in EUR 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 (9 July 2021) https://www.dbrsmorningstar.com/research/381451/global-methodology-for-rating-sovereign-governments.
Other applicable methodologies include the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (17 May 2022) https://www.dbrsmorningstar.com/research/396929/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings.

The sources of information used for this rating include Germany's Federal Ministry of Finance (German Stability Programme 2022), German Finance Agency (Deutsche Finanzagentur), Deutsche Bundesbank (Monthly Report May 2022, Financial Stability Review

2021), Federal Ministry for Economic Affairs and Climate Action, Federal Statistical Office, Federal Financial Supervisory Authority (BaFin), European Banking Authority, German Council of Economic Experts (Updated Economic Outlook 2022 and 2023), IFO Institute, European Commission (2022 Spring Forecasts), Statistical Office of the European Communities, European Central Bank (ECB), IMF (World Economic Outlook April 2022), IMF (International Financial Statistics), OECD (Housing Prices), BulwienGesa AG (Housing Price Index), Germany Climate Action Plan, Climate Action Tracker, Social Progress Index, World Economic Forum Global Competitiveness Index, World Bank, BIS, Our World In Data, Haver Analytics. DBRS Morningstar considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

With respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, this is an unsolicited credit rating. This credit rating was not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES
With Access to Internal Documents: NO
With Access to Management: NO

DBRS Morningstar does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

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

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. DBRS Morningstar understands further information on DBRS Morningstar historical default rates may be published by the Financial Conduct Authority (FCA) on its webpage: https://www.fca.org.uk/firms/credit-rating-agencies.

The sensitivity analysis of the relevant key rating assumptions can be found at: https://www.dbrsmorningstar.com/research/397942.

This rating is endorsed by DBRS Ratings Limited for use in the United Kingdom.

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For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

Ratings

Germany, Federal Republic of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
03-Jun-22	Long-Term Foreign Currency - Issuer Rating	Confirmed	AAA	Stb	EU U
03-Jun-22	Long-Term Local Currency - Issuer Rating	Confirmed	AAA	Stb	EU U
03-Jun-22	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	EU U
03-Jun-22	Short-Term Local Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	EU U

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