FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Germany at 'AAA'; Outlook Stable

Fri 29 Oct, 2021 - 5:03 PM ET

Fitch Ratings - Frankfurt am Main - 29 Oct 2021: Fitch Ratings has affirmed Germany's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'AAA' with a Stable Outlook.

A full list of rating actions is detailed below.

KEY RATING DRIVERS

The 'AAA' rating reflects Germany's diversified, high value-added economy, strong institutions and record of sound public finances that have enabled a robust policy response to the pandemic shock. The combination of Germany's position as the primary benchmark issuer for the eurozone and the ECB's ultra-loose monetary policy stance ensure significant financing flexibility. Its structural current-account surplus (CAS) supports its net external creditor position.

The recovery of the German economy from the pandemic shock has slowed in 2021, after a strong initial quarterly 9% rebound in 3Q20. The level of GDP in 2Q21 was still 3% below the pre-pandemic level as a 2% quarterly contraction in 1Q21, due to renewed lockdown measures in response to the winter waves of the pandemic, was followed by only a 1.6% growth in 2Q21. The recovery more recently has been hindered by supply-side constraints affecting the large manufacturing sector of the trade-oriented German economy. Fitch forecasts 3.6% GDP growth in 2021 and 4.2% in 2022, but in light of recent developments, risks are on the downside. The 'AAA' median GDP growth is 4.5% in 2021 and 4% in 2022, while Fitch's latest growth forecast for the eurozone is 5.2% and 4.5%, respectively.

Coalition talks have proceeded quickly after the September general elections and most likely will lead to a three-member, 'traffic light' coalition of the SPD, winner of the election with 25.7% of the votes, the Greens (14.8%) and the Liberals (11.3%). In line with our previous views we expect broad continuity on economic policy and major EU issues, based on the preliminary agreement of the three parties published on 15 October.

In particular, we expect that the new government will run sound fiscal policies over its four-year-mandate as it remains committed to the constitutional debt brake, which requires a very small structural budget deficit (0.35% of GDP) at the central government level over the medium term. The parties have also expressed their commitment to the rules of the European fiscal framework.

At the same time, we do not expect a rapid return to the pre-pandemic fiscal stance of persistent budget surpluses, as fiscal tightening will likely be gradual, in line with the general EU Commission guidance to support the post-pandemic recovery. Green and digital investment will likely increase in the coming years.

Based on all these considerations we expect a fiscal deficit at 5.4% of GDP in 2021, well below the original government target of 9% set in the spring Stability programme. As the economic recovery strengthens the budget deficit is forecast to shrink to 3.5% in 2022 and 2.8% in 2023. This path implies that the German budget deficit would narrow to below the 3% threshold of the Stability and Growth Pact in 2023, when the EU fiscal rules will return, but it would remain for the fourth year above the level consistent with the domestic debt brake rule.

General-government debt is forecast to increase to 71% of GDP in 2021, compared with 69% in 2020 and the pre-pandemic low of 59% reached in 2019. The German public debt level is above the current 'AAA' median of 48% of GDP and, according to our baseline scenario, is unlikely to decline meaningfully until 2025. Although the deficit will continue to shrink, GDP growth is expected to slow towards the 1% medium-term potential rate and inflation rate to fall back after the temporary spike in 2021, slightly below the ECB's revised target of 2%.

We no longer expect additional debt increase from one-off adjustments beyond the programmes that are already reflected in public debt. As part of the initial response to the pandemic the German government announced capital-injection programmes aimed at the private sector with existing and new guarantee schemes totalling EUR820 billion, 21% of GDP. These included a new EUR200 billion economic stabilisation fund for capital injections and refinancing programmes through the state-owned development bank (KfW).

The German sovereign debt market has continued to enjoy very benign financing conditions. As part of the ECB's quantitative easing programmes, purchases of German sovereign bonds were close to an estimated EUR600 billion by September 2021, around 17% of GDP. The average issuing yield has been negative since 2016. The average maturity of central-government debt is 6.9 years. As the negative yields have been locked in for an extended period, the risks from interest-rate increases is limited, even if the entire yield curve shifts substantially upwards in the near future. The 10-year yield has increased to close to -0.1% in October from -0.6% at the beginning of 2021, due to global trends and a gradual increase in previously below-target longer-term inflation expectations in the eurozone, following the ECB's strategy review that concluded in summer 2021.

Germany's strong net external position has been maintained in 2021, amid the global impact of the pandemic shock and the recent supply-side disruptions. Its net external creditor position stabilised at around 20% of GDP and the large pre-pandemic CAS of 7.4% of GDP in 2019 has narrowed marginally to 7% in 2020. We forecast the CAS to average 5% of GDP in 2021 to 2023, in line with the current 'AAA' median.

The comprehensive state support to the economy since the start of the pandemic has protected banks' asset quality well beyond our initial expectations, stabilising the sector's non-performing loan (NPL) ratio at an estimated 1.6% at end-1H21, in line with pre-pandemic levels. The average Viability Rating (VR) of the German banking sector is 'a', in line with most European peers'. However, most large banks' VRs are in the 'bbb' category. Since the beginning of 2021, Fitch has revised to Stable the Outlooks on the Long-Term IDRs of most large commercial banks, which had been Negative since the start of the pandemic. We also upgraded Deutsche Bank, whose Long-Term IDR remains on Positive Outlook. The sector's capitalisation, funding and liquidity are robust, but the lack of consolidation and pricing discipline as well as insufficiently diversified business models result in weak pre-impairment operating profitability in the very low interest-rate environment.

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. The drivers of the credit/GDP ratio rise were similar to other developed markets': real credit growth was supported by monetary- and fiscal-policy measures and demand for liquidity from business, while GDP contracted sharply. We expect the credit/GDP ratio to fall back in 2021, as the economy rebounds. Therefore, the recent increase in credit/GDP ratios is unlikely to be a meaningful signal of heightened financial vulnerability.

Strong price increases in the housing market have also contributed to the MPI 3 score. Fitch's macro-prudential indicator shows that the real house price level is 19% above its long-term trend. House price inflation has been driven by significant demand-and-supply imbalances, which are likely to persist over the medium term, due to limited construction, but price levels are moderate on a cross-country and historical basis.

ESG - Governance: Germany has an ESG Relevance Score (RS) of '5[+]', respectively, for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. Theses 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 89, reflecting 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:

-Public finances: Following the sharp increase in GGGD (general government gross debt)/GDP in 2020 as a result of the pandemic, failure to stabilise debt over the medium term, for example, due to persistently large budget deficits, growth under-performance or crystallisation of substantial contingent liabilities.

-Structural: A material increase in fiscal risk-sharing at the EU level leading to a further marked increase in GGGD/GDP, without offsetting benefits from greater eurozone resilience and institutional strength. As a core member of the monetary union, Germany is financially exposed to the broader liabilities of the eurozone.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The ratings are at the highest level on Fitch's scale and therefore 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 LTFC IDR scale.

Fitch's sovereign rating committee adjusted the output from the 'AA+' to arrive at the final LTFC 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 shock, including on GDP growth. The deterioration of the GDP growth and volatility variables reflects a very substantial and unprecedented exogenous shock that has hit the vast majority of sovereigns, and 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 LTFC 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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

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 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 track 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.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). 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	LT	AAA	Affirmed	AAA

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

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

Sovereign Rating Model, v3.12.2 (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	No
With Access to Management	Yes

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Germany EUR 11.2 bln Zero Coupon local currency gov bonds 4 Jul 2027	DE0001142032	Long Term Rating	Unsolicited
Germany EUR 16.5 bln bond/note 15-Apr-2023	DE0001030542	Long Term Rating	Unsolicited
Germany EUR 28.5 bln 2.5% bond/note 04-Jun-2044	DE0001135481	Long Term Rating	Unsolicited
Germany EUR 22.5 bln 1.5% bond/note 15-May-2023	DE0001102317	Long Term Rating	Unsolicited

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Sovereigns Europe Germany