FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Germany at 'AAA'; Outlook Stable

Fri 21 Oct, 2022 - 5:03 PM ET

Fitch Ratings - Frankfurt am Main - 21 Oct 2022: Fitch Ratings has affirmed Germany's Long-Term Foreign-Currency Issuer Default Rating (LTFC IDR) at 'AAA' with a Stable Outlook.

A full list of rating actions is detailed below.

KEY RATING DRIVERS

Exceptional Credit Strength: The 'AAA' rating reflects Germany's diversified, high value-added economy, strong institutions and record of sound public finances. Germany's position as the primary benchmark issuer in the eurozone ensures significant financing flexibility. Its structural current account surplus (CAS) supports its net external creditor position.

Significant Hit from Energy Shock: We believe that Germany is likely to avoid widespread energy rationing over the coming winter months, due to swift diversification of energy sources and substantial cuts to domestic consumption. Nevertheless, we forecast economic contraction during the 2022/2023 winter due to the severe energy shock triggered by the war in Ukraine, while growth is further weakened by slower growth in China, Germany's second-largest export market.

Quarterly GDP growth slowed to 0.1% in 2Q22, well below the eurozone's 0.8% over the same period. The energy shock is not only a significant adverse supply and income shock to the German economy, but also has sizeable indirect effects through a fall in business and household confidence reinforced by the strong aversion of the German public to higher inflation.

Recession and Very High Inflation: Our annual GDP growth forecast is 1.4% in 2022, -0.5% in 2023 and 2.3% in 2024, a significant downward revision from the last rating review in April 2022. The very high inflation environment will be more prolonged than previously expected, despite the recession. Our HICP inflation forecast is 8.5% in 2022 and 6.4% in 2023. The GDP deflator inflation will be lower than HICP inflation, due to the imported energy price shock, but it will be above 4% in 2022 and 2023. The labour market is expected to remain resilient, preserving most of the gains of the previous years. We forecast the unemployment rate at below 4%. Further, we do not expect a persistent wage-price spiral to take hold in the German economy.

Large, Temporary Fiscal Stimulus: The German government has implemented various measures since February 2022 to mitigate the energy shock for the private sector, including a maximum EUR200 billion (5.3% of projected 2022 GDP) for energy subsidies until early 2024. It will be financed from the economic stabilisation fund that was set up in 2020 after the pandemic shock. The government strategy is to maintain a sound underlying fiscal position - consistent with its domestic fiscal rule - and to provide temporary stimulus through the economic stabilisation fund or the EUR100 billion military investment announced shortly after the war started in Ukraine.

Moderate but Persistent Budget Deficits: We forecast budget deficit, in European System of Accounts (ESA) terms, to be around 3% of GDP in 2022, versus 3.6% in 2021 and 4.3% in 2020. Despite the weak real economy, central government tax revenues grew 14% yoy in 8M22. We forecast the deficit will widen to 3.5% in 2023, assuming that less than half of the maximum EUR200 billion funds will be spent on energy subsidies, partly through a price cap up to 80% of gas consumption. Although Germany has under-spent previous support packages, the fiscal cost of the subsides is highly uncertain, not least as it will depend on the actual market gas price during next year. The risks around the baseline deficit projection are tilted to the downside.

Medium-term Fiscal Uncertainty: We expect the underlying general government deficit, on an ESA basis, to narrow only gradually and remain above 2% of GDP until 2025 due to expenditure pressures and their off-budget financing . In our view the debt-brake rule will be less binding for the underlying fiscal stance in the coming years and the large off-budget programmes erode the transparency of the public finance framework. In our assessment it could, over the medium run, also undermine Germany's outstanding fiscal credibility.

Higher Yields, Low Interest Cost: The upward shift of the yield curve has continued since our April rating review. The 10Y German yield reached 2.3% in October 2022, still the lowest among eurozone members. The higher yields will only lead to gradual increase in interest costs, given the almost seven -year average maturity of central government debt. Germany's interest expenditure declined to 0.6% of GDP in 2021 from 2.5% in 2010, due to a long period of ultra-low yields and falling debt/GDP until the pandemic. Interest expenditure/revenue is 1.1%, well below the 'AAA' median of 3.8%.

Stable Public Debt Ratio: General-government debt was 69% of GDP in 2021, compared with the pre-pandemic low of 59% reached in 2019. The German public debt level is above the 'AAA' median of 44% of GDP and, according to our baseline scenario, it will stabilise around 67% over the medium term.

Resilient External Position: Germany has a strong external position, which was resilient to the pandemic shock in 2020 and 2021, underpinned by its large, competitive and export-oriented manufacturing sector. Its trade surplus has narrowed more recently due to a surge in imported energy prices, thus the CAS is forecast to decline to below 4% of GDP in 2022 from 7.4% in 2021. We expect the CAS to stabilise at around 5% over the medium term. However, the longer-term adverse impact of the energy shock could be more significant to the large manufacturing sector, thus eroding further Germany's growth potential and CAS.

Sound Banking Sector: The German banking sector scores 'a' on Fitch's banking system indicator, reflecting resilient asset quality, sound capitalisation and funding and liquidity. This should limit the impact on German banks' credit profiles from the expected recession, which will also weaken loan demand, dampening business prospects for banks and leading to higher loan impairment charges.

In addition, temporary valuation losses on securities, driven by rising interest rates, are likely to lower 2022 profits and affect capital ratios. German banks should benefit from improving pre-impairment operating profitability in 2023. However, the improvements are likely to be gradual as a significant proportion of lending is fixed-rate, particularly for residential mortgages.

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. 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 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:

-Macro/Public finances: A more severe and persistent macroeconomic shock from the energy crisis resulting in failure to stabilise gross general government debt over the medium term, for example due to sustained expenditure pressures

-Structural: A material increase in fiscal risk-sharing at the EU level leading to a further marked increase in public debt to 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 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 SRM to arrive at the 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. 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 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 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 unsecured	LT	AAA	Affirmed	AAA
senior unsecured	ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 11 Jul 2022) (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, v3.13.1 (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	No
With Access to Management	Yes

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP	RATING TYPE	SOLICITATION STATUS
Germany EUR 18.5 bln 4.25% bond/note 04-Jul-2039	DE0001135325	Long Term Rating	Unsolicited
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 22.5 bln 1.5% bond/note	DE0001102317	Long Term Rating	Unsolicited

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Sovereigns Europe Germany