Credit Rating Announcement

03 December 2021

Scope affirms Germany's credit rating at AAA with a Stable Outlook

The ratings are supported by a wealthy, large and diversified economy, sound public finances and a strong external position. Transition risks and an ageing population are challenges.

For the updated report accompanying this review, click here.

Rating action

Scope Ratings GmbH (Scope) has today affirmed the Federal Republic of Germany's long-term local- and foreign-currency issuer and senior unsecured debt ratings at AAA. Scope has also affirmed the short-term issuer ratings at S-1+ in local and foreign currency. All Outlooks are Stable.

Summary and Outlook

Germany's AAA/Stable ratings are underpinned by the following credit strengths: i) its wealthy, large and diversified economy; ii) its solid fiscal policy framework and strong track record of fiscal discipline; and iii) a highly competitive external sector. These factors have increased the country's resilience to economic shocks, including from the Covid-19 pandemic, and provide the government with the required fiscal space to support the economy with countercyclical measures during the crisis. Challenges relate to: i) transition risks for energy-intensive industries related to carbon neutrality targets and low levels of public and private sector investment relative to peers; and ii) an ageing population resulting in rising pension liabilities and downward pressure on the country's medium-run growth potential.

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

The rating/Outlook could be downgraded if, individually or collectively: i) protracted fiscal deterioration and/or insufficient reforms on pension commitments result in a persistent increase of public debt; and/or ii) structural reforms are insufficient, weighing on the country's growth potential.

Rating rationale

The first driver for the affirmation of Germany's AAA ratings is the country's wealthy, large and diversified economy. It is Europe's largest economy and benefits from a strong and well-diversified export industry. The Covid-19 pandemic caused economic output to fall by 10% in Q2 2020. After a strong initial rebound of 9% in Q3, economic growth slowed after the increase in Covid-19 cases over the winter triggered further lockdowns. As global growth started to accelerate, Germany's high-value-added economy has suffered from global supply-chain disruptions, which will result in lower-than-expected growth during H2 2021. As of Q3 2021, economic output therefore remains around 1.3% below the pre-pandemic level. Scope has lowered its projection for economic growth in 2021 to around 2.4% due to the supply disruptions and a new wave of Covid-19 cases manifesting over the winter months. For 2022, stronger growth of 4.4% is expected once supply problems begin to subside, allowing the economy to return to pre-pandemic output levels during the first half of the year.

Headline inflation fell to 0.4% in 2020 due to lower commodity prices and a temporary reduction in VAT. The expiration of VAT rate cuts, along with higher energy prices and rising production costs due to the shortage of intermediary goods, is expected to raise inflation to around 3% in 2021. These factors are expected to fade in 2022, causing inflation to fall towards the 2% target, although the Bundesbank has noted that upside risks remain if inflation expectations result in increased wage growth[9]. While some central banks have started tapering their asset purchase programmes or indicated interest rate rises in the near term, the ECB has signalled it would maintain its accommodative monetary policy[1]. This includes continuing monthly purchases of EUR 20bn under the asset purchase programme and net asset purchases under the pandemic emergency purchase programme until at least March 2022.

In September 2021, employment was still 0.8% below the pre-pandemic level (end-2019). Labour market conditions have continued to normalise and real wages have increased over the past six months, although the Bundesbank estimates that only around half of the jobs lost during the coronavirus crisis have been re-staffed by Q3 2021[2]. The number of people on the Kurzarbeit unemployment support scheme decreased substantially from 2.6m in April 2021 to 93,000 at the end of October[3] and hiring expectations are back at pre-crisis levels. Scope expects a slight increase in the unemployment rate towards the end of 2021 in light of the rising Covid-19 cases although remaining at a low 3.6% in 2021 and falling to 3.4% in 2022.

The second driver supporting Germany's AAA rating relates to the country's solid fiscal policy framework and strong track record of fiscal discipline. Germany has maintained strict fiscal discipline since public sector debt rose in the wake of the Global Financial Crisis. Federal and state debt-brake laws, introduced in 2009 for the federal government and binding for the state governments since 2020, limit structural deficits to 0.35% of GDP a year and to 0% for state governments. This helped to place Germany's general government debt on a clear downward trajectory from 82.5% in 2010 to 59.2% in 2019.

In 2020, Germany activated the general escape clause of its debt brake in response to the pandemic. The European Commission estimates[4] that crisis-related temporary emergency measures will increase from 2.7% of GDP in 2020 to 4.3% in 2021 and then decrease to 0.3% in 2022. This is reflected in a sharp increase in debt levels and Scope expects public debt to reach 72.4% of GDP by the end of this year. The debt brake will remain suspended until 2022, with the budget deficit at 1.8% according to the government's draft federal budget, which includes net borrowing of EUR 99.7bn (2.3% of GDP). However, a combination of stronger economic growth and borrowing restraint in line with the debt brake is expected to return government debt on its downward trajectory to reach 62.5% by the end of 2026. The new coalition agreement is unlikely to result in a meaningful deviation from this downward debt trajectory.

Specifically, two months after the September federal election, the coalition parties presented their draft coalition agreement[5]. This balances many of their key priorities, including no cuts to pensions or increases of the retirement age, an increase of the minimum wage to EUR 12/hour, an accelerated phasing-out of coal production by 2030 if feasible, increased investments in renewable energy, no major tax increases and a continued commitment to Germany's debt brake rule.

The spending priorities outlined in the coalition agreement cannot be met solely by re-shuffling the current budget. Since the debt brake rule is anchored in Germany's constitution, fundamental changes would require a two-thirds majority in both houses of parliament, which is unlikely in the near term. Scope expects that the government will not return to the pre-pandemic ‘Black Zero’ fiscal policy, which resulted in persistent budget surpluses. Some budgetary flexibility is available as Germany was running structural surpluses averaging 1% of potential output in the years before the pandemic and tax revenues have exceeded expectations thanks to the robust economic recovery. The new coalition is also planning a broad range of methods to raise public spending, including increasing its use of the federal development bank (KfW), stretching the repayment of pandemic-related borrowing from 20 years to 30 years and reconsidering the calculation of some elements of the debt brake (without constitutional changes) such as for the cyclical adjustment. Scope believes that while these measures may help to tackle the country’s investment gap, further private sector incentives to raise investments will be crucial.

The third driver underpinning Germany’s AAA rating is the country’s strong external position, which has remained stable during the pandemic. The sound net international investment position has been on a clear upward trend since 2011 and stood at 66% of GDP at the end of 2020. The economy’s external strength is driven by its large and consistent current account surpluses, which have remained above 6% of GDP since 2011, with the figure expected to reach 6.8% in 2021. The significant reduction in cross-border flows at the onset of the pandemic caused a large contraction in Germany’s goods trade balance. However, this was largely offset by a corresponding decline in the services deficit due to the reduction in tourism. While the current account balance fell briefly to 5.4% in Q2 2020, it recovered quickly, remaining above 7% until H1 2021 as exports were supported by buoyant external demand in key trading partners such as China and the US. Global supply shortages started to dampen Germany’s economic recovery and goods trade, resulting in a lower current account surplus of 6.1% in Q3 2021. The IMF expects the current account surplus to remain stable at around 7% over the next five years.[6]

Despite these credit strengths, Germany’s ratings face important medium-term credit challenges.

First, the country faces significant transition risks for energy-intensive industries related to carbon neutrality targets and low levels of public and private sector investment relative to other AAA rated countries. Germany’s emission reduction targets are ambitious, with CO_2 emissions to be cut by more than 300m tonnes between 2020 and 2030, more than in any preceding decade. The rapid shift towards a low-carbon economy exposes several industries to transition risks, including Germany’s large motor vehicle sector and energy sector, which remains heavily reliant on fossil fuels.

To meet the ambitious targets, large public and private sector investments will be needed. Historically, Germany’s public and private sectors have invested less than in other AAA rated peer countries. Since 2000, net *public* fixed capital formation in Germany averaged 0.1% of GDP compared with 0.9% in peer countries, while net *private* fixed capital formation averaged 2.5% of GDP in Germany compared with 4.1% in other AAA rated countries. Scope estimates the public sector investment gap in Germany at around EUR 410bn. Commitments concerning increased public investments outlined in the draft coalition deal of the new government are substantial and would help to reduce this gap. However, with the continued adherence to the debt brake curtailing significant public investments directly via the budget, appropriate policy reforms to incentivise increased private sector investment will be needed. This includes reform of existing planning and approval processes which can be relatively slow in Germany’s decentralised system of government.

Second, 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 new government intends to maintain existing pension benefits and does not intend to increase the retirement age. The gap between the demands of pension recipients and contributions will therefore continue to widen over the next 20 years as life expectancies of incoming retirees increase. This will result in a rising imbalance in Germany’s pay-as-you-go pension system, and in addition, result in meaningfully higher healthcare-related costs. Results from the Pension Projection Exercise 2021[7] show that annual public pension expenditure is on a rising trajectory and will increase from 10.3% of GDP in 2019 to 12.0% in 2030 if no changes to the retirement age are made.

Finally, Germany's growth potential is currently estimated at 1.1%, the weakest among AAA rated peer countries. Over the coming years, the country's challenging demographics will exert increasing pressure on its growth potential. The Federal Statistical Office estimates that between 2020 and 2035, the number of people aged 67 or over will rise by 22% from 16m to around 20m. Falls in productivity and the labour force are likely to set the country's potential output on a downward trend. Scope estimates that the decline in potential output could amount to around 0.1 pp yearly, falling to a medium-run growth potential of around 0.7%. Policies to increase labour-force participation and productivity, combined with substantial investments in the country's capital stock, can help to slow this trend.

Core Variable Scorecard (CVS) and Qualitative Scorecard (QS)

Scope's Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, provides an indicative rating of 'aaa' for the Federal Republic of Germany. This indicative rating can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative qualitative credit strengths or weaknesses against a peer group of countries.

For the Federal Republic of Germany, the following relative credit strengths have been identified: i) strong fiscal policy framework; ii) debt sustainability; iii) stable debt profile and market access; iv) current account resilience; v) resilience to short-term shocks; and vi) low financial imbalances. Relative credit weaknesses are: i) the low growth potential; and ii) elevated environmental risks.

The combined relative credit strengths and weaknesses indicate a sovereign rating of AAA for the Federal Republic of Germany.

A rating committee has discussed and confirmed these results.

Factoring of Environment, Social and Governance (ESG)

Scope explicitly factors in ESG sustainability issues during its rating process via the sovereign methodology's stand-alone ESG sovereign risk pillar, with a 20% weighting under the quantitative model (CVS) as well as in the qualitative overlay (QS).

With respect to environmental risks, Germany receives high CVS scores for having low natural disaster risk. However, compared with peers, the country receives lower scores for carbon emissions per unit of GDP and on the ecological footprint of consumption compared with available biocapacity. Scope assesses Germany's QS adjustment for 'environmental risks' as 'weak'. The ruling of Germany's Constitutional Court to enhance carbon emission reduction plans, especially until 2030, has prompted the government to bring forward its climate neutrality goal to 2045 from 2050. Germany also published its Sustainable Finance Strategy in May 2021, which aims to shift federal investments towards sustainable investments, introduce sustainability reporting for non-financial firms and support sustainable investments via KfW[8]. However, Germany remains heavily reliant on fossil fuels, which accounted for 76% of primary energy consumption in 2020 compared to around 62% for peer countries. The Paris climate target of a 40% carbon emission reduction from 1990 levels by 2020 was met, although helped by widespread pandemic-related economic shutdowns in the spring of 2020. The ambitious targets until 2030 and 2045 will require continued, rapid structural changes to keep up with other highly rated economies. Germany ranks 18th within the World Economic Forum's Energy Transition Index and thereby remains well behind other AAA rated sovereigns, all of which rank within the top five, and other advanced economies such as the United Kingdom (7th) and France (9th).

Regarding social risks, Germany scores high in the CVS 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 outbreak of the pandemic but mostly in favour of the relatively large low-paid sector. Most (around 9 out of 10) who benefited from the Kurzarbeit scheme are expected to be able to return to their original employment. Income and wealth inequality was already increasing in Germany before the pandemic and is likely being exacerbated by the strong rise in asset prices during the pandemic. Of the OECD economies, Germany is among the least able to guarantee equal opportunities for students, partly due to insufficient digitalisation and investment in schooling.

Germany benefits from the high quality of its institutions and a stable political environment. While the latest elections delivered a highly fragmented parliament, a three-way coalition consisting of the centre-left Social Democratic Party, the Greens and the liberal Free Democratic Party – a first for the country's history – was quickly established.

Rating Committee

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

Rating driver references

1. ECB, Monetary policy announcement, 28 October 2021
2. Bundesbank, Monthly report: November 2021
3. German Statistical Office: Monthly update: October 2021
4. European Commission: Commission opinion on the Draft Budgetary Plan of Germany, November 2021
5. Draft coalition deal between SPD, Greens, FDP, November 2021
6. IMF, Germany: Article IV announcement, July 2021
7. European Commission, The 2021 Ageing Report: Economic & Budgetary Projections for the EU Member States (2019-2070), May 2021
8. The Federal Government, German Sustainable Finance Strategy, May 2021
9. Bundesbank, Financial Stability Review 2021, November 2021

Methodology

The methodology used for these Credit Ratings and/or Outlooks, (Rating Methodology: Sovereign Ratings, 8 October 2021), is available on https://www.scoperatings.com/#!methodology/list.

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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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Lead analyst: Eiko Sievert, Director
Person responsible for approval of the Credit Ratings: Alvise Lennkh, Executive Director
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Contact

Analyst	Eiko Sievert	e.sievert@scoperatings.com
Team leader	Giacomo Barisone	g.barisone@scoperatings.com

Scope Ratings GmbH • Lennéstraße 5 • D-10785 Berlin • Phone: +49 30 27891-0 • Fax: +49 30 27891-0
www.scoperatings.com