Credit Rating Announcement

11 November 2022

Scope affirms the Federal Republic of Germany's AAA rating with 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, diversified economy; ii) its robust 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 rising inflationary pressures following the escalation of the Russia-Ukraine war. They also provide the government with the required fiscal space to support the economy with countercyclical fiscal measures. Challenges relate to: i) transition risks for energy-intensive industries given 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 ratings/Outlooks could be downgraded if, individually or collectively: i) protracted fiscal deterioration and/or insufficient reforms on pension commitments resulted in a persistent increase in public debt; and/or ii) the country's growth potential and/or growth outlook deteriorated significantly.

Rating rationale

The first driver for the affirmation of Germany's AAA ratings is the country's wealthy, large, diversified economy. It is Europe's largest economy and benefits from a strong and well-diversified export industry. Following a relatively small decline in real GDP (negative 4.6%) in 2020, Germany's post-pandemic recovery of 2.6% in 2021 was slow compared with peers (averaging 4.9%) and the euro area (5.2%). The slow pace of its recovery was due in part to the impact of global supply chain disruptions on industrial output. Economic momentum remained subdued in the first half of 2022 amid a sharp drop in consumer confidence and a worsening export climate. While GDP growth surprised on the upside in Q3 2022 (up 0.3% QoQ), causing economic activity to edge above its end-2019 level, Scope expects a slowdown in the coming months as elevated inflation and tightening funding conditions result in lower consumption and investments. This is despite extensive government support measures as high nominal energy imports and weakening external demand weigh on the external balance.

Scope expects economic growth of 1.6% this year but a 0.3% contraction in GDP in 2023. This assumes that there will be no mandatory gas rationing enforced by authorities, which remains a significant downside risk. This risk has been mitigated thus far by relatively mild temperatures at the start of the winter and gas storage facilities being filled above the government's target at 98% as of early November. Rising interest rates will curb aggregate demand and the medium-term growth outlook will depend on the scale of the energy price shock and to what degree fiscal stimulus is able to counterbalance it. In the longer term, accelerated population ageing and persistently weak private sector investment constitute material headwinds for Germany's growth potential, which Scope estimates at 1%.

Inflationary pressures remain at very elevated levels historically, with headline inflation rising to 10.4% YoY in October 2022 (up from 10% in September), energy prices rising by 43% and food prices up by 20%. Price pressures have broadened as core and services inflation stand at 4.6% and 4.0% respectively, with core inflation at its highest level in almost 30 years. Like other major central banks, the ECB has been rapidly tightening its monetary policy to tame price pressures. Key ECB interest rates increased by 75 bps in both September and October 2022, with the deposit rate reaching 1.5%. This is the highest level since 2009, 200 bps higher than in 2019, and further interest rate increases are expected.

The German labour market has proved to be resilient despite slower economic momentum, with the unemployment rate remaining near historically low levels of around 3%. The employment rate is elevated at 77.3% as of Q2 2022, 0.3 pp above its end-2019 level. While wage negotiations have led to some salary increases for unionised workers, the rise in consumer prices has largely outpaced that of nominal wages, causing a dip in real incomes. Scope expects the labour market to remain tight in the medium term, with the unemployment rate averaging 3.1% this year and rising slightly to 3.2% in 2023. This is despite recent, more moderate employment gains and a gradual decline in unfilled vacancies.

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 for the federal government in 2009 and binding for state governments since 2020, limit structural deficits to 0.35% of GDP a year for the federal government and 0% for state governments. This helped place Germany's general government debt on a clear downward trajectory in the decade leading up to the pandemic, from 82% to 59% over 2010-19. Unprecedented fiscal support measures during the pandemic led to a sharp jump in debt levels, which are expected to increase to 71.1% of GDP this year. Scope expects the debt-to-GDP ratio to trend down starting from next year, declining from 69.4% in 2023 to around 63% by 2027.

The debt brake was suspended at the onset of the Covid-19 crisis and again after the escalation of the Russia-Ukraine war, enabling the government to fund large budgetary measures. Public funds allocated to mitigate the energy crisis' impact on the private sector are estimated at EUR 264bn (6.9% of estimated 2022 GDP) between September 2021 and October 2022. This represents one of the largest amounts when compared with other European countries. Scope expects Germany's headline budget deficit, including extra-budgetary spending, to remain elevated at 3.3% of GDP in 2022 and 3.5% in 2023, down from 3.7% last year, before gradually falling to around 0.8% by 2027. There is an unusually high degree of uncertainty concerning budget deficit estimates. While the government is committed to reimplementing the debt brake from 2023, the use of special funds, with spending spread over several years, increases expected general government deficits. This includes additional planned borrowing of EUR 100bn to boost military spending and EUR 200bn to cushion the impact of rising energy prices on households and businesses. The energy support package would encompass state support for energy company Uniper and a 'gas price brake' that is intended to reduce average gas prices to around EUR 0.12 per KWh for consumers and EUR 0.07 per KWh for industry members. The announcement caused some concern in other European capitals that it could distort competition as other countries may lack the fiscal space to implement similar large support packages.

The third driver underpinning Germany's AAA rating is the country's strong external position, which has remained stable during the pandemic. This external strength is reflected in the country's very large, persistent current account surpluses, averaging 7.6% of GDP in the decade up to 2021. The escalation of the Russia-Ukraine war and the associated sharp rise in energy import prices, as well as weaker external demand from key trading partners including China, exerted significant downward pressure on the trade balance in 2022. China is Germany's biggest single source of imports (12% of total in 2021) and second biggest export destination (8% of total in 2021). The current account surplus narrowed to only EUR 0.6bn (0.2% of GDP) in August after briefly turning into a deficit of 0.1% of GDP in May for the first time since 2003. Scope expects these headwinds to weigh on Germany's current account balance in the medium term, allowing for only a gradual and partial recovery to pre-pandemic surpluses, but still above the peer group average. In line with IMF estimates, Scope expects the current account surplus to narrow to 4.2% in 2022 and stabilise below the previous long-term average at around 6% due to reduced competitiveness and revived domestic demand.

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

First, the country faces significant transition risks among energy-intensive industries given carbon neutrality targets and low levels of investment relative to other countries with AAA ratings. Germany's emissions reduction targets are ambitious, with carbon emissions set to be cut by more than 300m tonnes between 2020 and 2030, more than in any preceding decade. The Council of Experts on Climate Change has noted that Germany is currently not on track to meet its emission reduction targets specified in the 2019 Federal Climate Change Act. As Germany shifts away from Russian gas supplies, an important challenge remains establishing new and reliable supply agreements, while diversifying the country's energy mix. 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 remain heavily reliant on fossil fuels.

Large public and private sector investments will be needed to meet these ambitious targets. Historically, Germany's public and private sectors have invested less than those in other AAA rated peer countries. Since 2000, net public fixed capital formation in Germany has averaged 0.1% of GDP compared with 0.9% in peer countries. Net private fixed capital formation has averaged 2.5% of GDP in Germany compared with 4.1% in other AAA rated countries. The escalation of the Russia-Ukraine war has prompted the government to present measures aimed at accelerating the country's transition away from fossil fuels and strengthening its energy security, including additional investments and relaxed planning rules.

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. Since the current government has maintained pension benefits and has not increased the retirement age, the gap between payments to pension recipients and contributions will continue to widen in the years to come as life expectancies of incoming retirees increase. This will result in a rising imbalance in Germany's pay-as-you-go pension system and will result in meaningfully higher healthcare-related costs. The IMF estimates that the net present value of pension spending between 2021-50 will amount to 29% of GDP, which is far higher than for the UK (12.6%) and France (4.9%). In Germany's 2022 budget, EUR 117bn (23.6% of the total budget) is earmarked for pension spending. According to projections by the Ifo Institute, future spending on pensions could rise to 60% of the annual budget by 2050 if no reforms were undertaken. The planned introduction of a share-based pension fund can be an important reform pillar, but additional reforms are likely to be needed.

Finally, Germany's growth potential is currently estimated at 1%, the weakest among peer countries with AAA ratings. Over the coming years, the country's challenging demographics will exert more and more pressure on its growth potential. The Federal Statistical Office estimates that between 2020 and 2035, the number of people aged 67 and over will rise by 22% from 16m to around 20m. Lower productivity and a shrinking labour force are likely to put the country's potential output on a downward trajectory. Policies to increase labour force participation and productivity, combined with substantial investments in the country's capital stock, can help 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. The qualitative scorecard (QS) can adjust this indicative rating by up to three notches depending on the size of relative qualitative credit strengths or weaknesses versus a peer group of countries.

For the Federal Republic of Germany, the following relative credit strengths have been identified: i) debt profile and market access; ii) current account resilience; iii) resilience to short-term shocks; and iv) low financial imbalances. Relative credit weaknesses are: i) 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 ratings process via the sovereign methodology's standalone ESG sovereign risk pillar, with a 25% weighting under the quantitative model (CVS) and in the qualitative overlay (QS).

With respect to environmental factors, 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, greenhouse gas emissions per capita, and the ecological footprint of consumption compared with available biocapacity. Scope assesses Germany's QS adjustment for 'environmental factors' as 'weak'. Despite having achieved material progress in developing renewable energy production capacities over recent decades, Germany remains largely reliant on fossil fuels, which accounted for 78% of primary energy consumption in 2021 compared to around 70% in the EU. The government aims to reach climate neutrality by 2045 through an accelerated phase-out of coal and a rapid scale-up of renewable sources of energy, which are to cover 80% of the country's electricity needs by 2030. Meeting these ambitious targets 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 – 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). Progress towards the government's emission reduction targets is monitored by the Council of Experts on Climate Change.

Regarding social factors, 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 pandemic but mostly in favour of the lower-paid sector. Income and wealth inequality was already on the rise in Germany before the pandemic and has likely been exacerbated by the strong rise in asset prices during the pandemic. Among OECD economies, Germany is one of the least capable of guaranteeing equal opportunities for students, partly due to insufficient digitalisation and investment in schooling. Demographic pressures are rising and are more adverse compared to peers.

Germany benefits from high-quality institutions and a stable political environment. Although the last election delivered a fragmented parliament, the centre-left Social Democratic Party, the Greens and the liberal Free Democratic Party quickly established a three-way coalition and have effectively reached compromises in key policy areas.

Rating Committee

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

Methodology

The methodology used for these Credit Ratings and/or Outlooks, (Sovereign Rating Methodology, 27 September 2022), is available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The model used for these Credit Ratings and Outlooks is (Sovereign CVS model version 2.1), available in Scope Ratings' list of models, published under https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
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	NO

The following substantially material sources of information were used to prepare the Credit Ratings: The Rated Entity, and public domain.
Scope Ratings considers the quality of information available to Scope Ratings on the Rated Entity or instrument to be satisfactory. The information and data supporting these Credit Ratings originate from sources Scope Ratings considers to be reliable and accurate. Scope Ratings does not, however, independently verify the reliability and accuracy of the information and data.
Prior to the issuance of the Credit Rating action, the Rated Entity was given the opportunity to review the Credit Ratings and/or Outlooks and the principal grounds on which the Credit Ratings and/or Outlooks are based. Following that review, the Credit Ratings were not amended before being issued.

Regulatory disclosures

These Credit Ratings and/or Outlooks are issued by Scope Ratings GmbH, Lennéstraße 5, D-10785 Berlin, Tel +49 30 27891-0. The Credit Ratings and/or Outlooks are UK-endorsed.
Lead analyst: Eiko Sievert, Director
Person responsible for approval of the Credit Ratings: Alvise Lennkh-Yunus, Executive Director
The Credit Ratings/Outlooks were first released by Scope Ratings on 30 June 2017. The Credit Ratings/Outlooks were last updated on 3 December 2021.

Potential conflicts

See www.scoperatings.com under Governance & Policies/EU Regulation/Disclosures for a list of potential conflicts of interest related to the issuance of Credit Ratings.

About Scope Group

With more than 250 employees operating from offices in Berlin, Frankfurt, Hamburg, London, Madrid, Milan, Oslo and Paris, Scope Group is the leading European provider of independent credit ratings, ESG and fund analysis. Based on forward-looking and innovative methodologies, Scope offers a European perspective that contributes to greater diversity of opinion for institutional investors worldwide. **Scope Ratings** is the largest European credit rating agency, registered in accordance with EU and UK rating agency regulation, offering opinion-driven and non-mechanistic credit risk analysis. **Scope ESG Analysis** provides tools for analysing and reporting on ESG impact and risk, as well as second-party opinions on green, social and sustainable bonds. **Scope Fund Analysis** rates more than 10,000 funds and asset managers across all major asset classes. The shareholders of Scope Group include CEO and founder Florian Schoeller and anchor shareholder Stefan Quandt, numerous senior personalities in European finance and industry as well as institutional investors from several European countries. More on www.scopegroup.com

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

Executive Board: Guillaume Jolivet, Matthias Böhm • District Court: Berlin: HRB 192993 B • VAT identification number: DE226486027