20 May 2022 Sovereign and Public Sector

Federal Republic of Germany
Rating report

AAA STABLE OUTLOOK

Credit strengths

- Wealthy, large and diversified economy
- Strong fiscal framework and strong track record of fiscal discipline
- Highly competitive external sector

Credit challenges

- Transition risks for energy-intensive industries, and low levels of public and private sector investment
- Ageing population, resulting in rising pension liabilities and lower growth potential

Rating rationale

Wealthy, large and diversified economy: Germany's economy proved resilient during the Covid-19 pandemic. However, the country's high value-added economy has been impacted by global supply chain disruptions, which have resulted in a slower-than-expected recovery from the pandemic. Rising inflationary pressure will continue to weigh on the country's near-term growth outlook.

Strong fiscal framework: Germany's solid fiscal policy framework and strong record of fiscal discipline are well anchored through its constitutional debt brake. The debt brake is expected to be reinstated in 2023, although the increased use of off-balance sheet financing is reducing the transparency of the framework.

Highly competitive external sector: The economy's external strength is driven by its large and consistent current account surpluses. These have remained above 6% of GDP since 2011, and they neared their pre-pandemic level at 7.4% in 2021.

Rating challenges include: 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-term growth potential.

Germany's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aaa		-1/3	AAA
Public Finance Risk		25%	aa+		+1/3	
External Economic Risk		10%	aaa		+2/3	
Financial Stability Risk		10%	aaa		+1/3	
ESG Risk	Environmental Risk	5%	aaa		-1/3	
	Social Risk	5%	bbb		0	
	Governance Risk	10%	aaa		0	
Overall outcome		**aaa**		**+1**	**+1**	

Note: The sum of the qualitative adjustments, capped at one notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see the Sovereign Rating Methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

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

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Fiscal deterioration, resulting in a material increase in public debt
- Insufficient structural reform momentum, lowering growth potential

Ratings and Outlook

Local and foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: RESP SCOP

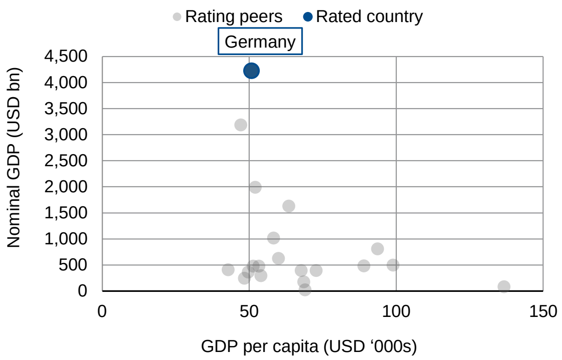
Domestic Economic Risks

- **Growth outlook**: Germany faced a shallower recession in 2020 (negative 4.6%) than other large European economies, such as France (negative 8%), Italy (negative 9%), the UK (negative 9%) and Spain (negative 11%). However, Germany's recovery since then has been slower than expected because supply chain disruptions driven by pent-up global demand, China's zero-Covid policy and the escalation of the Russia-Ukraine war have hampered industrial output and exports. Due to continued headwinds, we do not expect economic output to reach pre-pandemic levels until the second half of 2022. We expect economic growth of 2.3% this year and 3% in 2023. Further downside risks remain, especially if imports of Russian oil and gas stop suddenly. This would make a recession likely if gas storage facilities are not sufficiently filled before the winter. Germany's medium-term growth potential is estimated at 1%, and an ageing population is exerting downward pressure on this figure.
- **Inflation and monetary policy**: Inflationary pressures had been building before the escalation of the Russia-Ukraine war, and they have rapidly accelerated since then. Inflation reached 7.4% in April 2022, a level not seen since 1981. As in most advanced economies, the rise is driven by higher energy prices, although price pressures have become broad-based as core inflation reached its highest level in almost three decades at 4.3% in April. To prevent inflation from becoming entrenched, the ECB is likely to follow other major central banks by raising policy rates in the next few months.
- **Labour market**: Labour market conditions have continued to normalise, with employment exceeding its pre-pandemic level in March 2022 and the unemployment rate falling to 2.9%. Wage growth is likely to pick up gradually given that unions will negotiate pay increases for around 10 million workers this year. We expect the labour market to remain tight with an average unemployment rate of 3.2% this year.

Overview of Scope's qualitative assessments for Germany's *Domestic Economic Risks*

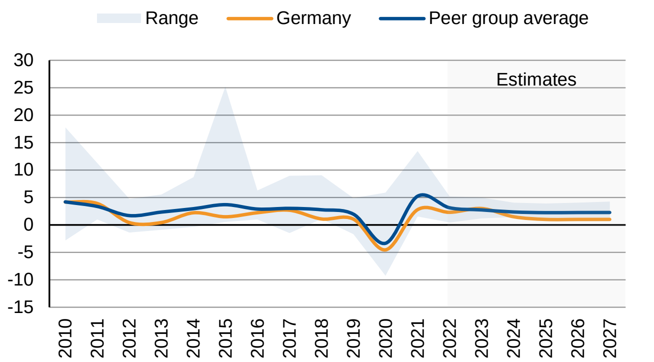
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Weak	-1/3	Weak growth potential, reflecting large investment gap and structural challenges in key industries
	Monetary policy framework	Neutral	0	ECB is a highly credible and effective central bank; effective policy framework and transmission over the cycle
	Macroeconomic stability and sustainability	Neutral	0	Competitive and diversified economy; but weaknesses in digitalisation; labour market challenges related to ageing

Nominal GDP and GDP per capita, USD '000s



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

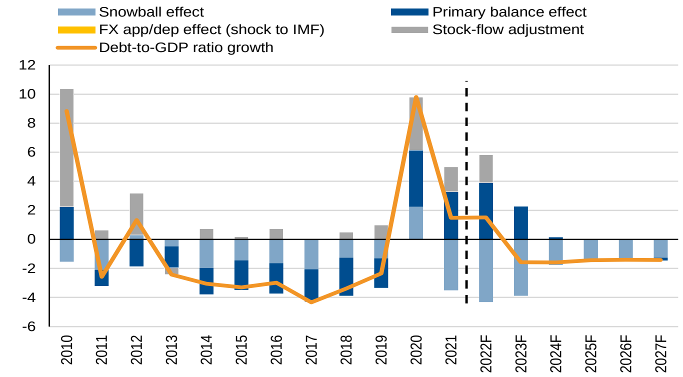
Public Finance Risks

- **Fiscal outlook**: 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 for the central government and 0% for state governments. The debt brake was suspended at the onset of the pandemic in 2020, which enabled the government to provide widescale fiscal support to households and firms. It also allowed the government to respond to the fallout from the Russia-Ukraine war with fiscal stimulus of around 1% of GDP, including tax cuts, compensation for higher energy prices and targeted support for lower income households. Additional borrowing of EUR 100bn (around 3% of GDP), structured as an extra-budgetary fund, was announced to boost military spending. While the government has committed itself to reimplementing the debt brake from 2023, the use of such off-budget financing reduces fiscal transparency.
- **Debt trajectory**: Germany maintained strict fiscal discipline during the decade leading up to the pandemic. Its strong fiscal framework helped put general government debt on a clear downward trajectory, reaching 59% in 2019 from 82% in 2010. Unprecedented fiscal support measures during the pandemic led to a sharp increase in debt levels, which are expected to hit 71.7% this year and then gradually fall to 64.3% by 2027. However, off-balance sheet financing for military spending and the green transition raises forecast uncertainty.
- **Market access**: Germany retains strong market access. In line with other advanced economies and amid rising inflationary pressure, its 10-year yield has increased to 1% for the first time since 2015. The average maturity of government debt has increased slightly over the past year to around 7.4 years. According to the Q2 2022 issuance plan published in March, annual borrowing will amount to EUR 409.2bn, including continued green bond issuance under the twin-bond framework.

Overview of Scope's qualitative assessments for Germany's *Public Finance Risks*

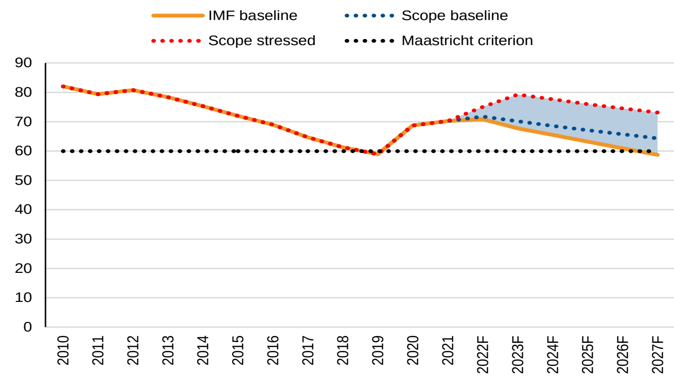
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Fiscal policy framework	Neutral	0	Strong policy response to Covid-19 crisis; constitutionally anchored debt brake on federal and regional level contributing to retention of fiscal space but weakening transparency of fiscal framework
	Debt sustainability	Neutral	0	Moderate public debt with high resilience to adverse scenarios; rising pension liabilities
	Debt profile and market access	Strong	+1/3	Primary benchmark issuer in euro area, reflected in low interest payments despite heightened debt levels

Contributions to changes in debt levels, pp of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

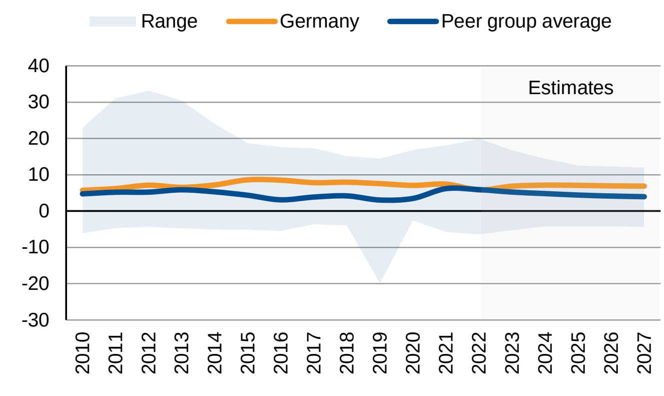
External Economic Risks

- **Current account**: The economy's external strength is driven by its large and consistent current account surpluses, which have remained above 6% of GDP since 2011. While the current account surplus was near its pre-pandemic level at 7.4% in 2021, we expect this to fall to below 6% in 2022. Given that Germany is a net energy importer, this drop mainly reflects a significant terms-of-trade shock due to the sharp increase in energy prices following the escalation of the Russia-Ukraine war. It also reflects ongoing supply chain disruptions, which have already significantly lowered goods exports during Q1 2022.
- **External position**: Germany's net international investment position (NIIP) amounted to EUR 2.4trn in 2021. Persistent current account surpluses have supported the NIIP, which has continued a gradual upward trend in line with other peer countries, rising from 17.3% of GDP in 2011 to 65.4% of GDP at the end of 2021. Portfolio investment accounts for a rising share of net external assets and has now increased to around 25% after the balance turned positive in 2017. The level of external debt has remained moderate at about 172% of GDP in 2021.
- **Resilience to shocks**: Like all euro area members, Germany benefits from the euro's status as a global reserve currency, significantly mitigating risks to external shocks.

Overview of Scope's qualitative assessments for Germany's *External Economic Risks*

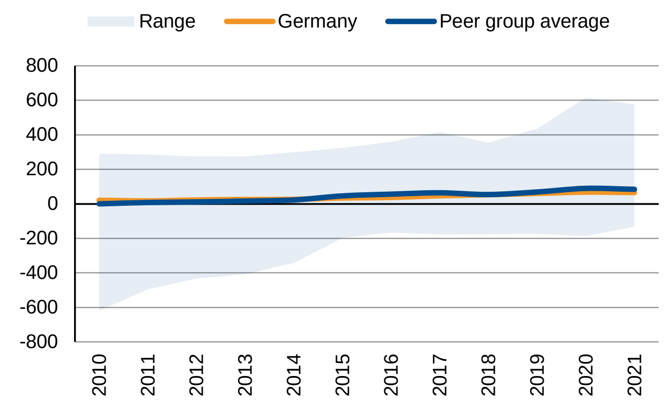
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Diversified and competitive export base; strong track record of current account surpluses
	External debt structure	Neutral	0	Moderate external debt
	Resilience to short-term shocks	Strong	+1/3	Benefits from euro area membership; large external creditor position

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

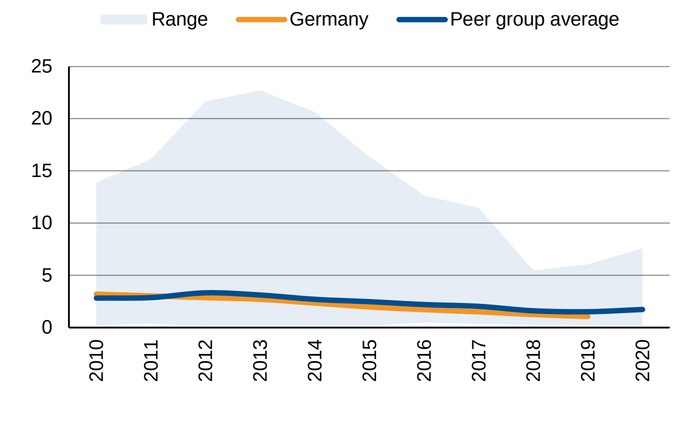
Financial Stability Risks

- **Banking sector**: Germany's banking sector is medium-sized and adequately capitalised, but it suffers from structurally weak profitability. Tier 1 capital has remained stable in recent years and stood at 17.0% of risk-weighted assets in Q3 2021. The banking sector did not suffer significant losses during the pandemic thanks to fiscal support provided to households and firms. This kept non-performing loans low. While banking sector risks are expected to remain manageable, improved earnings performance during 2021 is likely to weaken in 2022 as inflationary pressures increase costs and the fallout from the war in Ukraine weighs on the growth outlook.
- **Private debt**: Private sector debt levels in Germany are modest compared to those of peer countries with AAA ratings. Corporate insolvencies remained below pre-pandemic levels as of April 2022, supported by the extraordinary fiscal support measures mentioned above. Non-financial corporate debt stood at 116% of GDP in Q4 2021 after peaking at 117% in Q1 2021. Household debt levels also fell slightly by 1 pp to 58% of GDP over the same period.
- **Financial imbalances**: House prices have increased sharply since the start of the pandemic in early 2020, rising by 21% as of Q4 2021. The increase in prices has been broad-based in urban areas and the countryside, hinting at structural demand pressures as well as supply shortages. The Bundesbank has highlighted the risk of overvalued property prices on multiple occasions. Yet risks to financial stability caused by lending to households appear contained given high amortisation rates, the prevalence of fixed-rate mortgages and the high proportion of renters compared to other countries. The Federal Financial Supervisory Authority decided raise the countercyclical capital buffer rate to 0.75%, effective 1 February 2023.

Overview of Scope's qualitative assessments for Germany's *Financial Stability Risks*

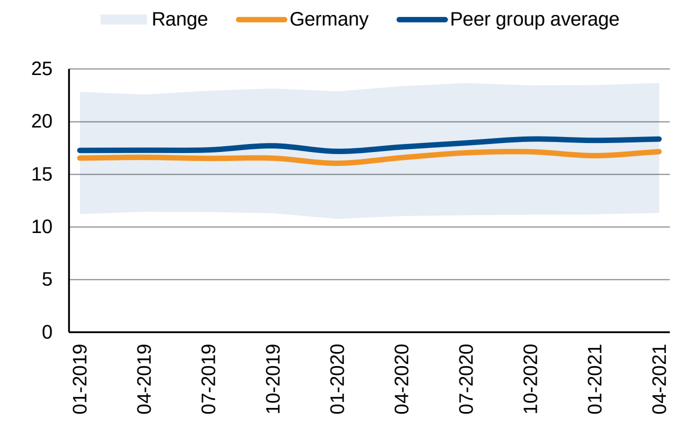
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Low profitability and unfavourable cost structure of banking sector balanced by adequate capitalisation and moderate exposure risk to non-financial corporate debt
	Banking sector oversight	Neutral	0	Oversight under National Supervisory Authority and ECB as part of Banking Union
	Financial imbalances	Strong	+1/3	Moderate household and private sector indebtedness; closely monitored systemic risks in financial system

Non-performing loans, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

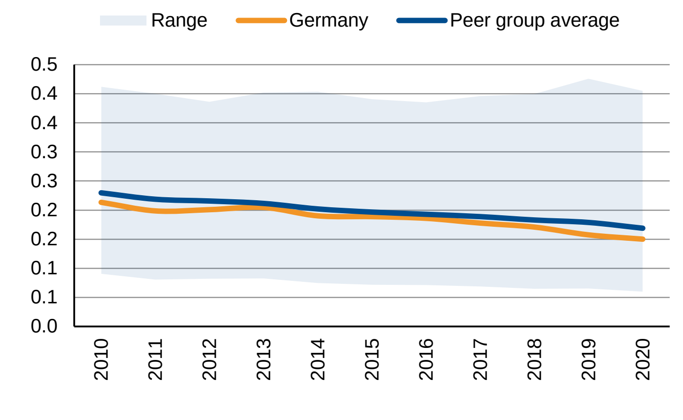
ESG Risks

- **Environment**: The Federal Constitutional Court's ruling to enhance carbon emission reduction plans, especially the plan for 2030, has prompted the government to bring forward its climate neutrality goal to 2045 from 2050. The government is now planning to give up coal entirely by 2030, eight years earlier than the target set by the previous government. The update also aims for Germany to get 80% of its electricity from renewable energy by then, up from the previous target of 65%. To date, Germany remains heavily reliant on fossil fuels, which accounted for 77% of primary energy consumption in 2020 compared to around 62% in peer countries. The ambitious targets will require continued, rapid structural changes – likely accelerated by the Russia-Ukraine war – to keep up with other highly rated economies. Still, Germany ranks only 18th within the World Economic Forum's Energy Transition Index – well behind other AAA rated sovereigns, all of which rank within the top five.
- **Social**: Germany managed to raise its 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.
- **Governance**: Germany benefits from high-quality institutions and a stable political environment. Although the last election delivered a highly fragmented parliament, the centre-left Social Democratic Party, the Greens and the liberal Free Democratic Party quickly established a three-way coalition.

Overview of Scope's qualitative assessments for Germany's *ESG Risks*

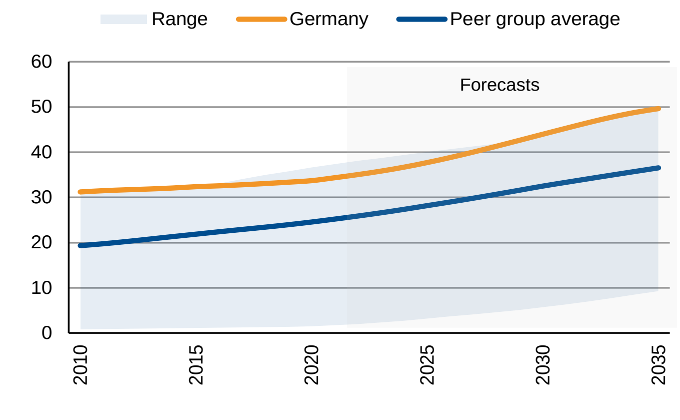
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Environmental risks	Weak	-1/3	Structural challenges related to transition risk in view of carbon neutrality targets and economic importance of energy-intensive key industries
	Social risks	Neutral	0	Weak demographics in form of ageing workforce balanced by high social inclusion and improving labour force participation; rising inequality risks, reinforced by the Covid-19 crisis
	Institutional and political risks	Neutral	0	High-quality institutions and stable political environment

Carbon emissions per unit of GDP, mtCO2e



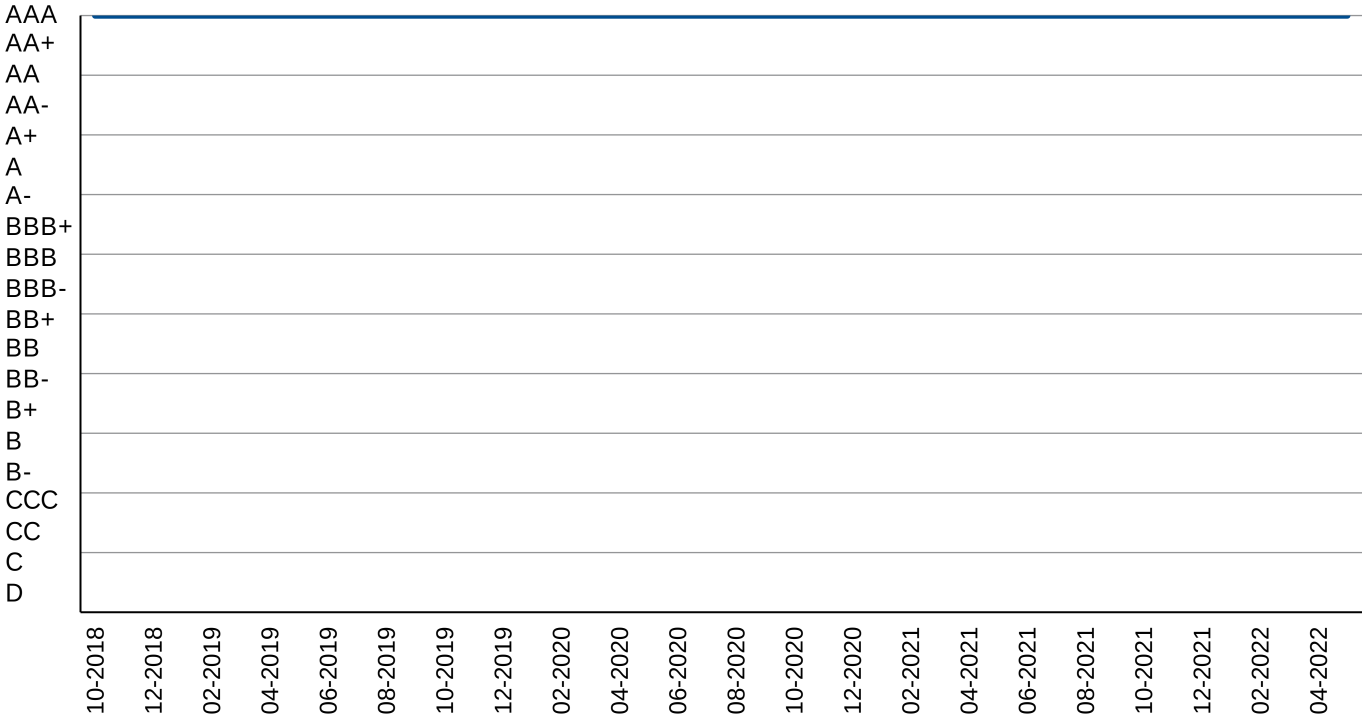
Source: European Commission, Scope Ratings GmbH

Old-age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or adjacent categories according to our core variable scorecard (CVS).

Peer group*
Austria
Denmark
Finland
Germany
Ireland
Luxembourg
Netherlands
Norway
Sweden
Switzerland
United Kingdom

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators[1]

	2016	2017	2018	2019	2020	2021	2022E	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	42.1	44.6	48.0	46.8	46.2	50.8	51.1	54.8
Nominal GDP, USD bn	3468.9	3689.5	3979.1	3888.8	3843.3	4225.9	4256.5	4564.8
Real growth, %[1]	2.2	2.7	1.1	1.1	-4.6	2.8	2.3	3.0
CPI inflation, %	0.4	1.7	1.9	1.4	0.4	3.2	5.5	2.9
Unemployment rate, %[1]	4.1	3.8	3.4	3.2	3.8	3.5	3.2	3.3
Public Finance Risk								
Public debt, % of GDP[1]	69.0	64.7	61.3	58.9	68.7	70.2	71.7	70.1
Interest payment, % of government revenue	2.1	1.8	1.6	1.2	0.9	0.9	0.9	0.8
Primary balance, % of GDP[1]	2.1	2.2	2.6	2.0	-3.9	-3.3	-3.9	-2.3
External Economic Risk								
Current account balance, % of GDP	8.5	7.8	8.0	7.6	7.1	7.4	5.9	6.9
Total reserves, months of imports	1.5	1.5	1.3	1.6	2.0	-	-	-
NIIP, % of GDP	37.3	47.0	53.1	60.5	68.1	65.4	-	-
Financial Stability Risk								
NPL ratio, % of total loans	1.7	1.5	1.2	1.1	-	-	-	-
Tier 1 ratio, % of risk-weighted assets	16.3	16.9	16.6	16.5	17.2	17.0	-	-
Credit to private sector, % of GDP	77.5	77.6	78.1	79.6	85.7	-	-	-
ESG Risk								
CO_2 per EUR 1,000 of GDP, mtCO2e	185.8	177.7	170.9	157.5	150.2	-	-	-
Income quintile share ratio (S80/S20), x	5.0	5.0	5.1	-	-	-	-	-
Labour force participation rate, %	77.8	78.1	78.5	79.1	-	-	-	-
Old-age dependency ratio, %	32.6	32.8	33.1	33.4	33.7	34.3	35.0	35.8
Composite governance indicator[2]	1.5	1.5	1.5	1.5	1.4	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections.
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, UN, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 20 May 2022	12.8

[1] This table presents a selection of the indicators (24 out of 29) used in our quantitative model, the core variable scorecard.

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