Research Report on Germany

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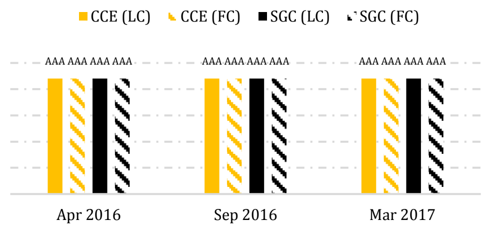
Ratings

Sovereign Government Credit (LC)	AAA
Sovereign Government Credit (FC)	AAA
Country Credit Environment (LC)	AAA
Country Credit Environment (FC)	AAA

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Germany

Macro indicators	2014	2015	2016
Gross gov. debt, LC bn	2178	2153	2171
Nominal GDP, LC bn	2924	3033	3132
Real GDP growth, %	1,6	1,5	1,9
Gross gov. debt/GDP, %	74,5	71,0	69,3
Deficit (surplus)/GDP, %	0,3	0,7	0,8
Inflation rate, %	0,0	0,3	1,7
Current Account Balance/GDP, %	-	-	8,3
External debt, USD bn	-	-	5,3

Development indicators	2015
Inequality adj. HDI	0,85
GDP per capita, USD th	48,2

Default indicator	15.03.2017
5-Year CDS spread, Bp	24
10Y Gov Bond Yield, %	0,4

Source: RAEX (Europe) calculations based on data from IMF, WB, Destatis, UN, Deutsche Bank.

Summary

The Agency confirms the ratings of Germany at 'AAA' on the basis of encouraging macroeconomic conditions, positive and persistent twin balances, resilience to external shocks and strong position of the banking sector.

Debt metrics remain on a downward trend driven by the reduced pressure on the fiscal balance. However, ageing population still poses a significant long-term risk on the fiscal sustainability of the country.

The unemployment rate declined significantly in 2016, while inflation rate jumped closer to the EU target. Despite remaining credit positive, this combined effect may only have a short-term impact.

In the current year, a number of elections will take place in Germany, whose outcome could re-shape the political landscape of the country. If after the elections political power is rebalanced towards parties with differing views from the one actually ruling, the fiscal policy could ultimately be affected in the mid and long term.

Bearable debt metrics. Even though the German government debt climbed during the first 3Q 2016 up to EUR 2,17 tn, debt metrics declined slightly driven by improved macroeconomic and fiscal conditions (see graph 1). When compared to GDP and fiscal revenues, the gross general government debt of Germany accounted for 69,3% and 153,8% respectively.

The yield on the 10Y government bond increased through 2H 2016 driven by higher inflation expectations. However, compared to its European and world peers, German bonds still present one of the lowest yields around 0,4% as of March 2017.

Short-term debt remained low at 6,7% and 15% of GDP and budget revenues as of 3Q 2016 respectively. In our view, these figures still do not pose a risk for the country's creditworthiness in the short run.

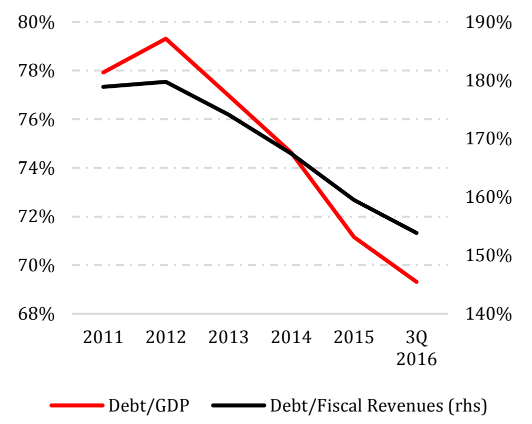
Twin balances still in place. Germany keeps showing strong positive results in terms of foreign trade. However, as predicted in our previous research report[1], the trade balance shrank by almost 1p.p. to 7,8% of GDP in 2016 mainly driven by higher energy prices. In spite of these risks, the

[1] Research report from 23 September 2016; http://raexpert.eu/reports/Research_report_Germany_23.09.2016.pdf

Agency considers that the external position of Germany will prevail in 2017 as a result of the country's highly competitive export sector.

The German government also keeps reporting increasing fiscal surpluses. In 2016, it reached its largest surplus figure since reunification as revenues grew 4% from a year before, due to a large increase in income and property tax payments (+6,5%) as well as social contributions (+4,6%). Despite these results, the fiscal balance trend for the following years will be clearer after the Bundestag elections this year. However, ageing population continues posing a significant long-term risk on the fiscal sustainability of the country.

Graph 1: German government debt metrics, %

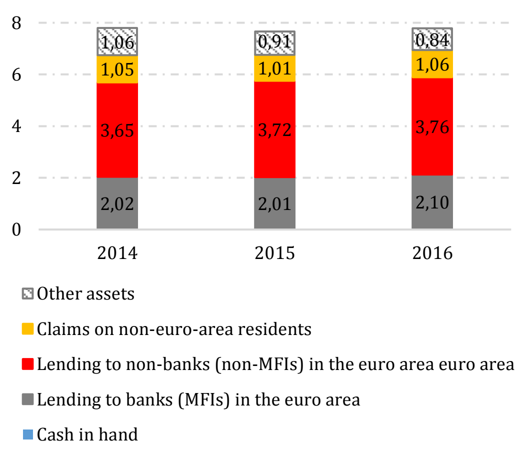


Source: RAEX (Europe) calculations based on data from the IMF, WB

Solid banking sector stance. The German banking sector remained solid with assets growing to EUR 7,8 tn or 249% of GDP in 2016. This increase was mainly driven by higher lending to non-financial corporations in the euro area and non-euro area residents (see graph 2). Likewise, the volume of private credit to GDP kept rising along 2016 to around 139%, fueled by the low and flat nominal interest rates and the negative real interest rates which prevail in the Eurozone.

The level of capitalization of German banks grew further in 2016 as shown by the capital to assets ratio which stood at 5,9% in that year. However, Germany remains well below its European peers, as Switzerland, the UK and Italy recorded a ratio of 6,9%, 6,8% and 6,1% respectively in 2016. The growing capitalization of the German banking sector was considered credit-positive for our rating assessment, given the constant increase of NPLs reported in the sector over the past years.

Graph 2: Banks assets, EUR tn



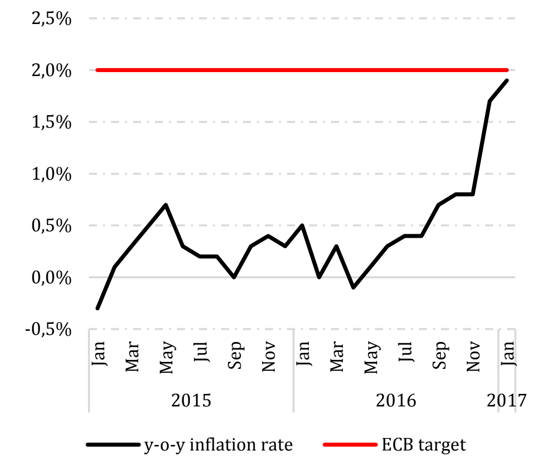
Source: RAEX (Europe) calculations based on data from the Bundesbank

Increasing inflation. The inflation rate hiked during 2H 2016 in Germany mainly fueled by higher energy and food prices, reaching 1,9% by January 2017. This figure was close to the 1,8% average recorded in the Euro Area and the 2% target of the European Central Bank (see graph 3).

With such an increase, the inflation rate reached a record high since August 2012, when it stood at 1,7%. Despite the significant recovery, since there are still no convincing signs that underlying inflation is on an upward trend, the ECB decided on 9 March 2017 that the loose monetary policy will remain in place. The Bank decided to keep its assets purchase program unchanged at EUR 60 bn per month and interest rates constant at current levels.

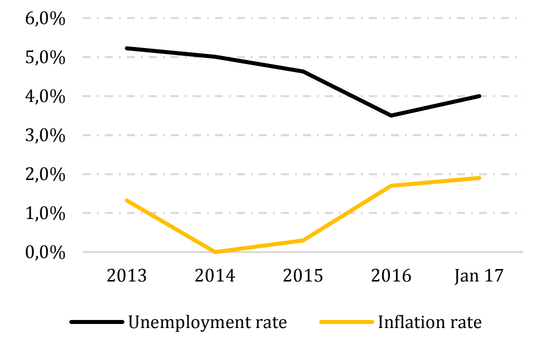
In line with the German Statistical Office (Destatis), we expect the y-o-y inflation rate to accelerate to 2,2% in February mainly driven by further increase in household energy and motor fuel prices. In our view, however, inflation is likely to peak in the coming months, as energy prices are

Graph 3: Inflation rate in Germany, %



Source: RAEX (Europe) calculations based on data from Eurostat

Graph 4: Unemployment vs Inflation, y-o-y %



Source: RAEX (Europe) calculations based on data from Destatis

expected to remain relatively stable and the ECB is not intending to change its monetary policy in the near future.

Strong economic position. Germany keeps showing high resilience to external imbalances as real GDP increased by 1,2% in 2016. Such increase was mainly driven by internal consumption expenditure and exports which increased by 1,9% and 3,3% respectively in that year. Germany's sustained growth rate has had a direct impact on the unemployment rate in recent years. Despite following the same trend in 2016, unemployment rate dropped relatively more than in previous years, reaching a historical low rate of 3,5% by December. In our view, such a decline could be associated with a short-term effect which took place alongside higher inflation rates. In January 2017, the rate was reported at 4%, which could be reinforcing this view (see graph 4).

Fiscal policy could shift. Germany enjoys a strong institutional framework and, in contrast to many of its European peers, a relatively stable political system. The country has a long record of party coalitions and political agreements between the Federal and State governments. This was evidenced by the recent reform of the fiscal equalization scheme[2], under which the state governments will cede infrastructure responsibility to the Federal branch in exchange of a stronger role of the federal government in the monitoring of state finances.

Despite having such a strong level of political and institutional development, Germany is facing potential fiscal risks as elections planned for 2017 at a Federal and State levels could potentially change the country's political landscape. Currently, polls results are showing that the two main parties (CDU and SPD) have similar support from population. SPD leaders have already unveiled that the party's policies will be aimed at increasing spending for social benefits and education, which will likely have a negative impact on public finances.

Even though polls are showing that the support for the Eurosceptic party Alternative fuer Deutschland (AfD) is falling, the party will likely reach a number of seats in the Bundestag (legislative branch) for the first time in history. In our view, this would make the composition of the Bundestag more heterogeneous, and with it, the coalition building more challenging.

[2] The fiscal equalization scheme is intended to create and maintain equal living conditions for the entire population in the whole Germany through a vertical and horizontal distribution of tax revenues among the different levels of government.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://www.raexpert.eu/reports/Press_release_Germany_17.03.2017.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.