Research Report on Germany

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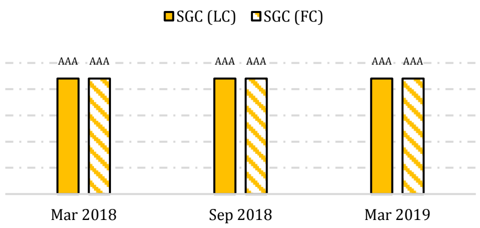
Ratings

Sovereign Government Credit (LC)	AAA
Sovereign Government Credit (FC)	AAA
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Germany

Macro indicators	2016	2017	2018
Gross gov. debt, EUR bn	2145	2093	2030*
Nominal GDP, EUR bn	3160	3277	3397
Real GDP growth, %	2,2	2,5	1,5
Gross gov. debt/GDP, %	67,9	63,9	59,8*
Deficit (surplus)/GDP, %	0,9	1,0	1,7
Inflation rate, %	1,6	1,6	1,7
Current Account Balance/GDP, %	-	-	8,4
External debt, USD bn	-	-	5656**

Development indicators	2018
Inequality adj. HDI	0,86
GDP per capita, USD th	52,9

Default indicator	01.03.2019
5-Year CDS spread, Bp	12
10Y Gov Bond Yield, %	0,19

Source: RAEX-Europe calculations based on data from the IMF, WB, Destatis, UN, Bloomberg. * Forecast for 2018 ** 3Q 2018

Summary

The ratings of Germany at ‘AAA’ reflect mainly the superb position of the government’s public finances, the extremely strong external stance as well as a resilient and solid economy. Moreover, the banking sector remains well capitalized and with a strong liquidity position, while unemployment levels remain low and stable.

However, there are some downside risks which we do not consider will threaten the country’s creditworthiness in the mid-term perspective. Factors such as, contingent liabilities from the banking system, ageing population and the global trade disputes could potentially hurt the strong position of Germany in the external sphere and create imbalances in its public finances.

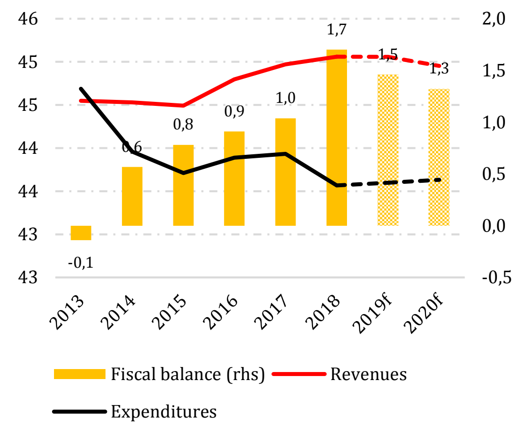
The fiscal position of the sovereign remains highly favorable. Public finances in Germany continue to be solid and are a key strength for the country’s creditworthiness. By the end of 2018, the budget posted a surplus of 1,7% of GDP driven by higher tax revenues. This is the fifth consecutive year that the public budget presents a positive balance (see graph 1) and it has already been translated in some tax benefits, as written in our previous report[1]. As a result of the constant surpluses and extremely low financing costs (10Y German Bund yield stands currently at around 0,19%) and needs, government obligations have continued to decline. Since the European Central Bank (ECB) decided to leave rates unchanged due to downside growth risks as a result of geopolitical concerns, we expect low financing costs to remain in the short-term. We also anticipate government debt to have decreased down to 59,8% of GDP and 132,6% of budget revenues as of 2018 (see graph 2).

Overall, we expect solid public finances to persist supported by a well-balanced budget with additional expenditures in social items, which represent 40% of budget expenditures. The fiscal space will be larger in the municipal and regional level starting in 2020, since a larger share of VAT will be kept by these governments; also, there will be higher federal grants.

However, if a worse than expected economic downturn were to materialize, public finances may come under strain and end the run of budget surpluses, while debt increases could resume. This could unfold as

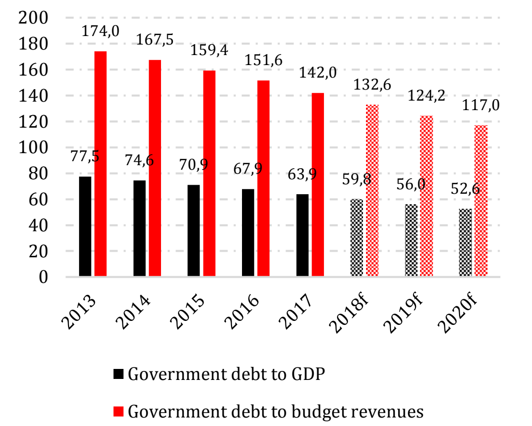
[1] Research report on Germany from 7 September 2018 (https://raexpert.eu/reports/Research_report_Germany_07.09.2018.pdf)

Graph 1: Fiscal budget dynamics, % of GDP



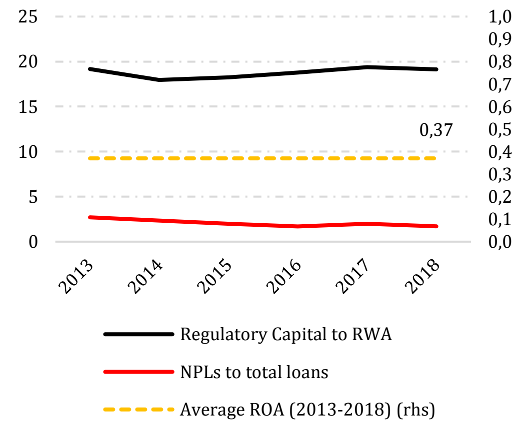
Source: RAEX-Europe calculations based on data from the IMF and Destatis

Graph 2: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the IMF

Graph 3: Financial soundness indicators, %



Source: RAEX-Europe calculations based on data from the IMF and Bundesbank

a result of a potential decline of the projected budget revenues and a turn to a loose fiscal policy. However, given the government's rhetoric, we do not anticipate the fiscal stance (currently moderately accommodative) to change even if economic developments turn negative. Moreover, additional pressures to public finances could arise as a result of the plan to phase out coal by 2038 and the government's intention to increase spending in defense.

The new budgetary policy for 2020-2023 will be discussed in May 2019 which will shed some more clear light on the government's fiscal plans depending on the state of the economy.

The government also has some contingent liabilities in the form of guarantees which are equivalent to around 14% of GDP. Despite this, in a scenario where the German government would have to intervene to cover potential contingent liabilities' materialization, we consider the authorities to have enough buffers to absorb the shock.

Demographic issues far from being resolved in the long-term. Ageing population and low birth rates remain one of the key long-term concerns for the authorities who have yet to introduce a structural reform to solve this issue. The problem is even deeper when we take into account that replacement rates are already very low compared to OECD countries and the European Union (EU)[2].

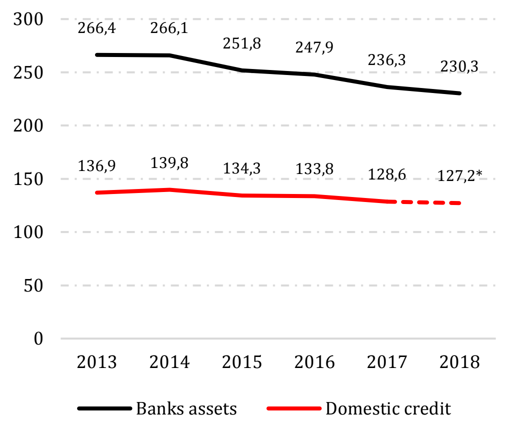
Moreover, as previously mentioned, pension and healthcare spending is projected to grow significantly. According to the 2018 Aging Report from the European Commission, age related spending is expected to increase by 4,2p.p. by 2070, well above the EU average of 1,7p.p. However, recent reforms, such as making it easier for employers to hire foreigners and the build-up of a special fund where EUR 2 bn per year will be added in order to guarantee the pension system, have slightly eased pressure on this topic temporarily.

The banking system remains solid but with low profitability. In general, figures of the banking system are robust. As of 3Q 2018, the Regulatory Capital to Risk-Weighted Assets ratio stood at 19,15%, NPLs to total loans ratio was low at 1,5% (see graph 3) and Liquid Assets to Short Term Liabilities was solid at 152% as of 3Q 2018. Despite these figures, there are concerns of underestimation of weights assigned to assets in order to calculate capital adequacy given the fact that most banks use the internal ratings-based approach. This approach has caused banks to consider lower weights for certain assets classes resulting from the

[2] According to OECD data from 2016, the gross pension replacement rate for men is 38,2% in Germany while the OECD average is 64,6% and the EU average is 69,6%. On the other hand, the same indicator for women shows that the gross pension replacement rate is 54,7% in Germany while the OECD average is 73,2% and the EU average is 79,7%.

favorable economic development in recent years. This means that an adverse economic situation will have a strong impact in terms of capital requirements. Moreover, as mentioned in our previous review, German banks' profitability keeps lagging that of European peers as a result of operating inefficiencies and legacy costs.

Graph 4: Credit to the economy dynamics, % of GDP



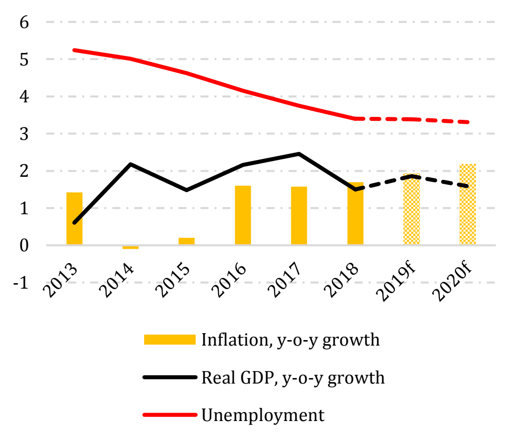
Source: RAEX-Europe calculations based on data from the WB and Bundesbank
* Forecast for 2018

In terms of credit to the economy, we anticipate it to have declined further in 2018. According to our estimate, domestic credit and bank assets to GDP are expected to be around 126% and 230% respectively, a decrease of about 1p.p. and 6p.p. accordingly (see graph 4). Despite the declines, household and corporate credit have maintained a consistent annual growth pace. As of end-2018, both loan segments together grew by 4,5%.

In addition, the concentration of government owned banks remains substantial. As of end-2018, assets from *Landesbanken* and *Sparkassen* accounted for around 27,6% of the total sector. As the size of the assets of these types of banks is quite high, so are their liabilities for which the government is responsible, which creates contingent liabilities for the government. Nonetheless, we consider the risk of the materialization of these contingent liabilities to be quite low as the banking sector is well-capitalized and with strong soundness figures.

Economy still solid but with downside risks. Germany is one of the most developed nations in the world with a GDP per capita in PPP terms of USD 50,2 th in 2018 and an HDI index (adjusted for inequality) of 0,86; both figures are substantially high. In addition, the country has enjoyed strong and solid levels of economic growth, low inflation and very depressed levels of unemployment.

Graph 5: Macroeconomic indicators, %

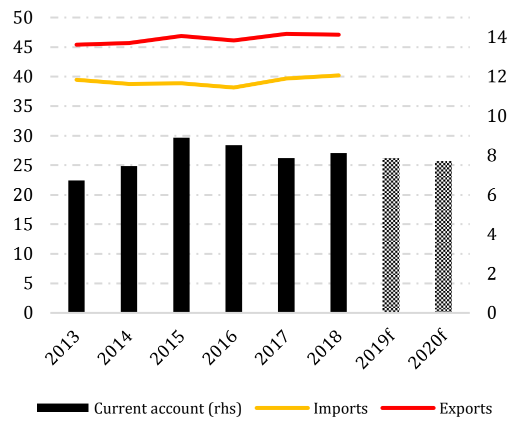


Source: RAEX-Europe calculations based on data from the IMF and Destatis

As of 2018, we expect the German real economy to have grown at a pace of around 1,5% (see graph 5), slower than initially anticipated as result of lower exports and struggles in the automotive sector due to troubles complying with the new emission standards. Despite this, domestic consumption in terms of public spending and fixed investment were strong and private consumption was positive.

In the mid-term perspective we expect the economy to be solid but with many downside risks such as Brexit and international trade tensions. In fact, the expected real output for 2019 has already been cut by a substantial margin by many international institutions. A return to previous growth levels or even worse economic performance will mainly depend on the resolution of trade tensions and the developments of the Brexit negotiations. In the long-term perspective we continue to see a declining growth due to the lack of skilled labor and aging population.

Graph 6: External sector indicators, % of GDP



Source: RAEX-Europe calculations based on data from the IMF, Bundesbank and Destatis

In terms of inflation and unemployment, we anticipate the figures to remain well-balanced and in optimal levels. The Harmonized Index of Consumer Prices (HICP) stood at 1,7% in 2018 and the unemployment level at 3,4% in 2018 (see graph 5).

External position remains outstanding. The external stance is another key strength and shock absorber for the German economy. The trade and current account balances remain substantially positive and wide as these stood at 6,6% and 8,4% of GDP respectively. The slight decline in the trade balance can be attributed to a decline in the demand of exports which grew by 3,1% y-o-y while imports increased by and 5,4% y-o-y (see graph 6).

As mentioned in our previous review, the high interconnectedness of Germany makes the economy highly vulnerable to external developments. Thus, as previously stated, trade tensions and the Brexit puzzle will have an impact on the economic dynamics in the country. Despite this, Germany has enough tools and buffers to weather adverse external conditions to a certain extent.

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:

https://raexpert.eu/reports/Press_release_Germany_01.03.2019.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.