Research Report on Germany

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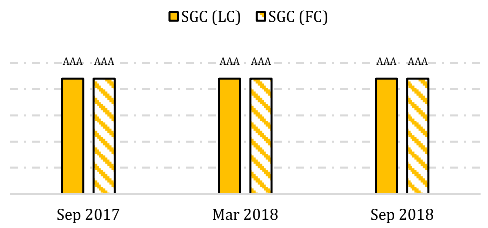
Ratings

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	2015	2016	2017
Gross gov. debt, EUR bn	2162	2145	2093
Nominal GDP, EUR bn	3044	3144	3263
Real GDP growth, %	1,5	1,9	2,5
Gross gov. debt/GDP, %	71,0	68,2	64,1
Deficit (surplus)/GDP, %	0,6	0,8	1,1
Inflation rate, %	0,2	1,6	1,6
Current Account Balance/GDP, %	-	-	8,0
External debt, USD bn	-	-	5727*

Development indicators	2017
Inequality adj. HDI	0,86
GDP per capita, USD th	50,4

Default indicator	07.09.2018
5-Year CDS spread, Bp	11,3
10Y Gov Bond Yield, %	0,39

Source: RAEX-Europe calculations based on data from the IMF, WB, Destatis, UN, Bloomberg.
* 1Q 2018

Summary

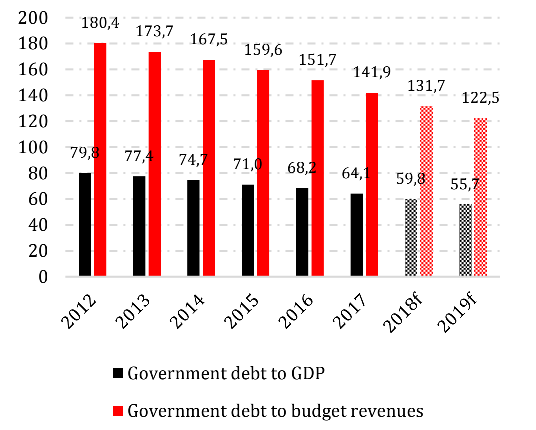
Germany's ratings at 'AAA' remain underpinned by a solid fiscal discipline, which has translated in lower debt levels and increasing budget surpluses, stable GDP growth combined with record employment levels, a strong external position and a healthy, albeit underperforming, banking sector. Moreover, Germany remains one of the most developed and competitive countries in the world.

Despite the extremely strong position of the economy, the government remains exposed to potential contingent liabilities as it owns around 26% of the banking sector. Additionally, ageing population remains a concern for the long-term stability of public finances. Finally, given the protectionist rhetoric of trading partners, as well as the recent emerging market issues, could create negative spillover effects for Germany as the country's economy and financial sector are highly interconnected worldwide.

Outstanding fiscal discipline: budget surpluses and declining debt. Gross government debt continues to be in a downward trend. As of the end of 2017, government debt was 64,1% of GDP and 142% of budget revenues, a decline of 4,1p.p. and 9,7p.p. respectively as compared to 2016. Moreover, as of 1Q 2018, debt levels dropped further as they were lower than EUR 2 tn in absolute terms posting a figure of EUR 1 948 tn. We do not expect additional debt issuance by the current administration (until at least 2022) given the fact that higher tax revenues and lower interest rates have caused financing needs in the country to ease. Also, slower but still solid economic growth and improving fiscal stance will keep debt metrics in a declining path. Thus, we anticipate government obligations to fall further in 2018 and to be around 60% and continue to go down to 55,7% of GDP by 2019 (see graph 1). These levels will help the government to fulfil one of the five convergence criteria of the Eurozone. Short-term debt is still moderate and represented 20,5% of total debt by 1Q 2018.

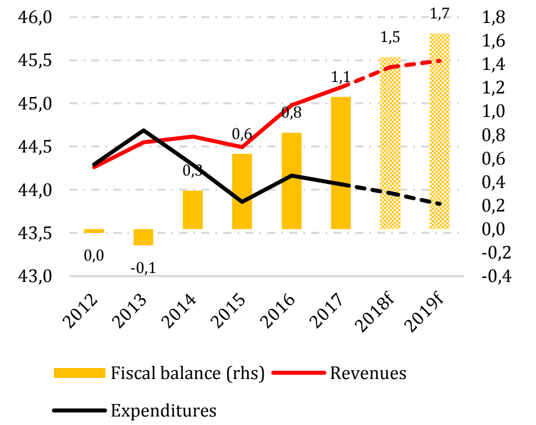
In regard to the fiscal budget, the surplus increased up to 1,2% of GDP in 2017 continuing to reflect the government's commitment to a balanced budget and remains with a comfortable fiscal space. As a result, the coalition partners recently decided to provide a fiscal stimulus to taxpayers by trimming unemployment insurance contributions by 0,5p.p. (the contribution rate was cut from 3% to 2,5% starting in 2019).

Graph 1: Government debt dynamics, %



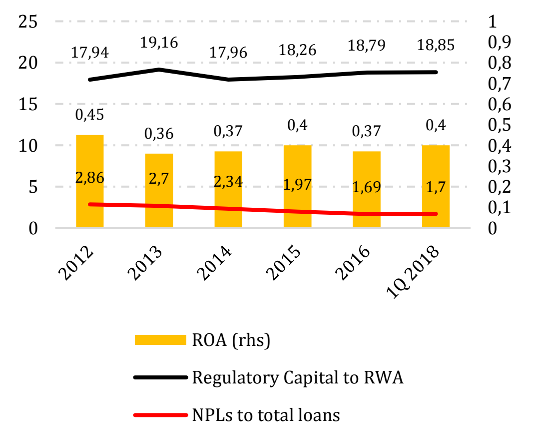
Source: RAEX-Europe calculations based on data from the IMF

Graph 2: Fiscal budget dynamics, % of GDP



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

Graph 3: Financial soundness indicators, %



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

We expect the surplus to continue to increase as the government expects to collect more revenues than those initially foreseen in the mid-term perspective. As of 2018, we expect the fiscal surplus to be around 1,5% of GDP. Thus, we anticipate Germany to continue to comply with the European stability growth pact with balances above -3% of GDP (see graph 2).

As a consequence of the financial plan for 2022, as previously mentioned, we do not anticipate the debt stance to change in the mid-term perspective; instead, we expect a well-balanced budget with additional expenditures in education, infrastructure and, mostly, in the social sphere. This last item accounts for around 40% of the 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.

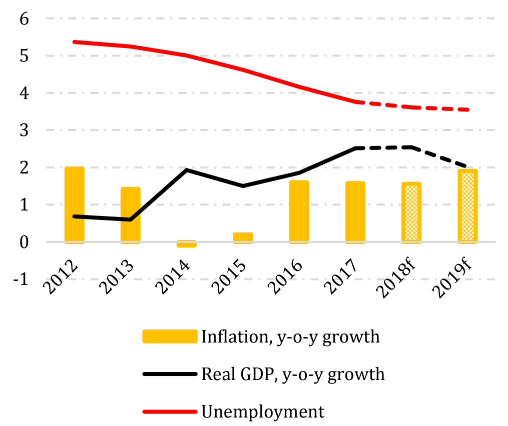
Sluggish profitability for banks, but sector remains solid. The banking sector profitability remains weak as compared to European peers on the back of, not only low interest rates, but also high operating costs and large provisions for compliance violations. Moreover, German banks are highly leveraged as compared to peers. However, even though the capital to assets ratio was low at around 6% in 2017, the Regulatory Capital to Risk-Weighted Assets ratio stood at 18,9% as of 1Q 2018. Also, the NPLs to total loans ratio remained low at 1,9% in 2017 and liquidity and funding levels are still favorable (see graph 3).

Domestic credit and assets to GDP declined for the third year in a row as these ratios posted figures of 127,3% of GDP and 236,3% of GDP respectively at the end of 2017. However, there was a pick up in credit to corporates as a result of favorable financing conditions and increased investment. On the same line, domestic household credit also continued to increase at a stable pace. As of April 2018, y-o-y credit growth of household and corporations was around 5% and 2% respectively.

The share of state owned banks in Germany remains quite high (assets from *Landesbanken* and *Sparkassen* account for around 26,6% of the total sector) augmenting the contingent liabilities of the government. However, in a scenario where the German government would have to intervene to cover potential liabilities, we consider the authorities to have enough buffers to absorb the shock.

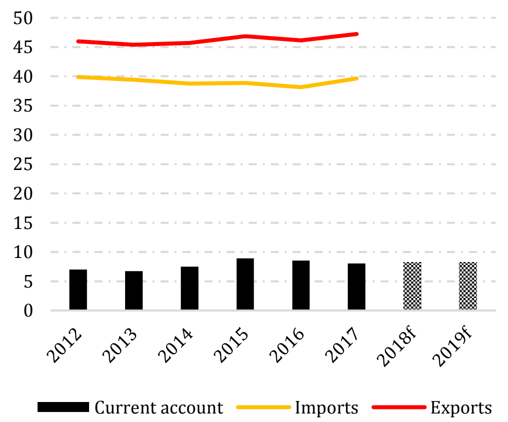
Demographics remain a moderate concern. A long-standing issue for the German authorities is the aging population and low birth rates in Germany as pension and healthcare spending are forecast to grow significantly. According to the 2018 Aging Report from the European Commission, age related spending is expected to increase by 4,2p.p. by 2070, well above the average of 1,7p.p. from the European Union.

Graph 4: Macroeconomic indicators, %



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

Graph 5: External sector indicators, % of GDP



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

Moreover, according to the report, most of the spending will come in the next 20 years as the so-called "baby boomers" generation starts to retire.

However, recent reforms have slightly eased pressure on this subject, especially when it relates to pension expenditure growth. The government announced that starting in 2021, the fiscal budget will have a special fund where EUR 2 bn per year will be added in order to guarantee the pension system. Nevertheless, there have not been any structural plans to mitigate this risk. We believe that this decision, without a structural solution, could increase the fiscal burden of the taxpayers in case government revenues start to fall in the event of potential adverse economic conditions.

The economy remains strong and stable. The economy grew at a rate of 2,5% in 2017 due to a pick up in investment as exports continued to increase and domestic consumption was high. Increase in consumption is also a reflection of record low levels of unemployment at 3,4% as of July 2018, 0,4p.p. lower than at the end of 2017. As of the 2Q 2018, growth continued to be solid at 2,3% again propelled by domestic demand to which government expenditure contributed. Going forward, we expect this rate to remain stable as capacity utilization remains high. All these dynamics have also translated in higher inflation; the Harmonized Index of Consumer Prices (HICP) has been picking up posting a figure of 1,5% in 2017 and increasing to around 2,1% as of July 2018 while wages have continued to grow (see graph 4).

In the long-term perspective we anticipate growth to decline as a result of skilled labor scarcity and a positive output gap, meaning the economy is working at full capacity. We also expect these factors to cause wages to increase further contributing to higher price levels.

External environment solid but exposed to shocks. The external position of the German economy remains outstanding. The trade balance posted a surplus of 7,6% of GDP and the current account was as high as 8% of GDP in 2017 reflecting the high dynamism of the economy. We expect these figures to remain dominant in the long term (see graph 5).

However, the high global interconnectedness of Germany, in terms of finance and trade, makes the economy vulnerable to developments in other countries. We believe Germany's exports and banking system could suffer from potential geopolitical stress and protectionist measures from their trade partners. For instance, potential tariffs from the U.S. or diverse effect of the banking system given its links with the Turkish economy. In fact, overseas demand is already showing signs of dropping as international new orders decreased by around 3% as of June 2018.

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_07.09.2018.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.