Research Report on Germany

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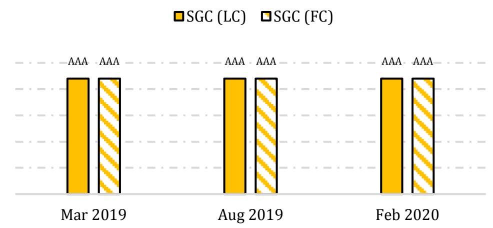
Ratings

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	2017	2018	2019
Gross gov. debt, EUR bn	2115	2063	2015*
Nominal GDP, EUR bn	3245	3344	3436
Real GDP growth, %	2,5	1,5	0,6
Gross gov. debt/GDP, %	65,2	61,7	58,6*
Deficit (surplus)/GDP, %	1,2	1,9	1,5
Inflation rate, %	1,5	1,8	1,5
Current Account Balance/GDP, %	-	-	7,7
External debt, USD bn	-	-	5623**

Development indicators	2019
Inequality adj. HDI	0,86
GDP per capita, USD th	53,6

Default indicator	28.02.2020
5-Year CDS spread, Bp	9,1
10Y Gov Bond Yield, %	-0,55

Source: RAEX-Europe calculations based on data from the IMF, WB, Destatis, UN, Bloomberg. * Forecast for 2019 ** 3Q 2019

Summary

The ratings of Germany at 'AAA' are supported by the excellent position of the government's public finances, the outstanding external stance as well as a still resilient and solid economy with low and stable levels of unemployment. Moreover, the banking sector remains well capitalized and with a strong liquidity position, as well as solid asset quality.

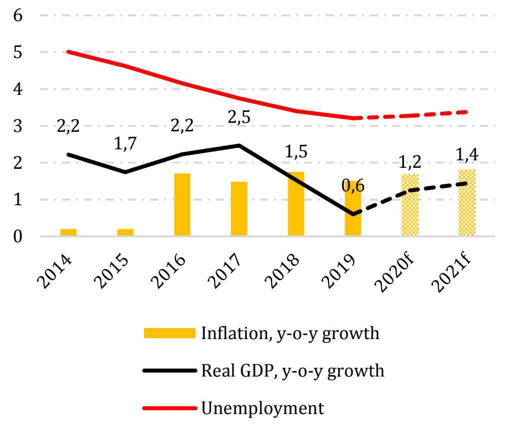
However, risks threatening the economic stance and the stability of the banking sector have built as of late, but we estimate these not to threaten the country's creditworthiness in the mid-term perspective as the government has enough buffers and tools to weather these uncertainties. Factors such as, contingent liabilities, profitability and the widening of the credit-to-GDP gap in the banking sector, ageing population and lower external demand could potentially hurt the strong position of Germany in the external sphere, negatively impact economic growth and create imbalances in its public finances.

The economy has shown resiliency to shocks, but risks linger. Germany remains one of the most developed and competitive countries in the world supported by the highly ambitious export-oriented economy and stable macroeconomic environment. GDP per capita in PPP terms is expected to stand at around USD 53,6 th, unemployment rate declined down to 3,2% and inflation remains stable as measured by the HCIP at 1,53% in 2019, remaining fairly stable as previously anticipated (see graph 1). Despite this, we have observed that the German economy has been challenged by several headwinds as of late.

Real output growth was stood at 0,6%, once again lower in 2019 as compared to an increase of 1,5% in 2018 (see graph 1). Moreover, there was no economic growth in 4Q 2019 alone. As a consequence of lower demand for German exports and issues in the automotive sector related to climate risks, manufacturing growth saw a steep fall declining by around 4% on a yearly basis. On the other hand, the services sector was solid as construction services remained strong growing at a pace of 2%, while services also increased led by information and communication services which posted a solid figure growing by 2,8%. Capital formation in construction also posted strong numbers growing at 2,7%.

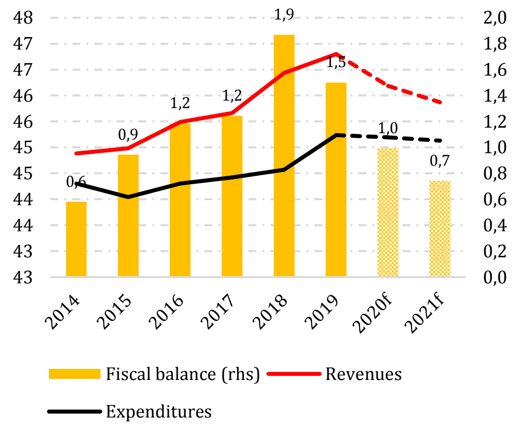
Despite domestic consumption being overall strong throughout 2019 hiking by 1,2%, it slowed down substantially in 4Q 2019, while government consumption grew meagerly. We expect real GDP growth to

Graph 1: Macroeconomic indicators, %



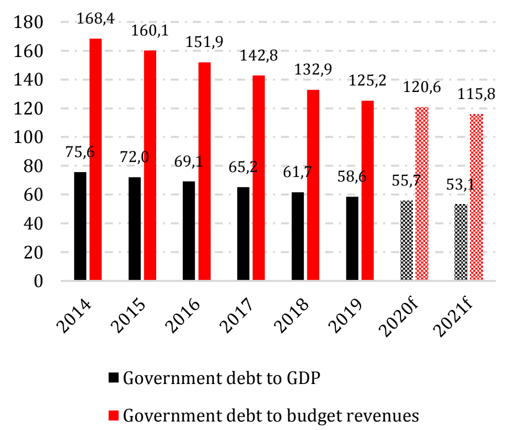
Source: RAEX-Europe calculations based on data from the IMF and Destatis

Graph 2 : Fiscal budget dynamics, % of GDP



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

Graph 3: Government debt dynamics, %



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

continue to struggle mainly as a result of negative external shocks continuing to affect manufacturing output. More recently, we also anticipate the outbreak of the coronavirus to weigh on the economy as plants from German firms operating in China have been temporarily closed with no resume of operations in sight.

The demographic developments in Germany continue to be a concern as these dynamics are expected to have a direct impact on economic growth and public finances, while the recent approval of the basic pension increases public spending while not solving the long-term pension conundrum.

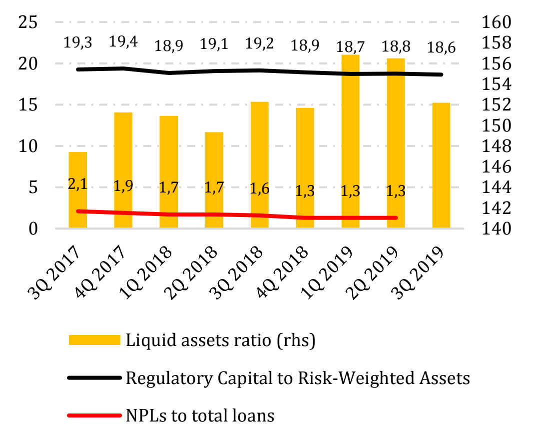
Finally, the political landscape in the country has recently taken a turn to uncertain territory as Annegret Kramp-Karrenbauer, Merkel's heir-apparent, resigned to the leadership of the CDU.

Fiscal position remains exceptional. The German budget balance remains outstandingly solid as it posted yet another surplus in 2019 at 1,5% of GDP (see graph 2). Expenditures outpaced revenues in terms of percentage growth led by spending in consumption and social security funds which together accounted for more than EUR 10 bn in 11M 2019 at the federal level. In terms of revenues, we saw a steady increase in tax income for the government in the same period. We anticipate budget surpluses at about 1% of GDP in 2020 and still positive in the mid-term view, but in a declining trend as the authorities' plan to cut taxes, increase investments and hike expenditure in social programs. In fact, the tax reduction already occurred with the income tax and will continue to happen in 2021 with the elimination of the solidarity surcharge. Also, the government already approved reforms to increase social spending in the form the introduction of the basic pension.

As of late, the finance minister Olaf Scholz has expressed his desire to lift the 10-year old debt cap in order to support German municipalities struggling to repay their debt. If this goes through, it will be a radical change of direction from the current fiscal policy aimed at reducing debt and maintaining a balanced budget. However, in order to do this, legislation must be passed and it is unlikely to happen given the current distribution in parliament.

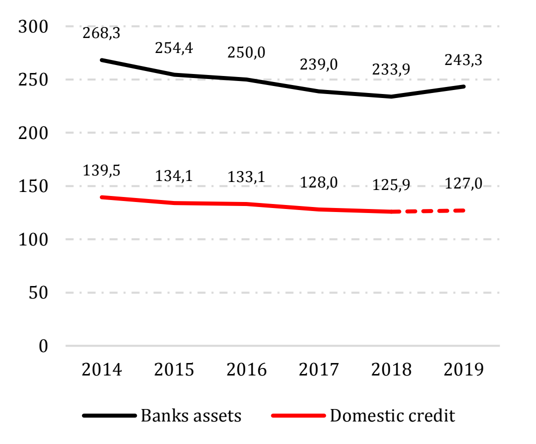
Government debt levels finally break the 60% threshold. Government debt to GDP is expected to have finished 2019 at around 58,6% of GDP, as we previously anticipated (see graph 3), resulting from carrying out a prudent fiscal policy for the past 10 years, as well as a persisting low and even negative interest rate environment for government obligations. This figure already breaks the threshold according to the Maastricht convergence criteria. Moreover, short-term debt remains quite low as by the end of 3Q 2019 it stood at about 12,6% of GDP.

Graph 4: Financial soundness indicators, %



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

Graph 5: Credit to the economy dynamics, % of GDP



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

Going forward, we expect the level of debt to continue in a declining trend as fiscal buffers remain vast and financing rates will remain depressed. However, recent plans from minister Scholz as well as a prolonged economic downturn could reverse the trend of this metric.

Contingent liabilities remain a latent issue in Germany as the level is one of the highest in the EU due to the large amount of government guarantees at 12,8% of GDP and liabilities of public corporations at about 90,5% (mostly related to *Landesbanken* and *Sparkassen*) at the end of 2018. Both metrics are in the top-5 among countries in the EU. In the event of materialization of such liabilities, the government would have to meet obligations and endure unanticipated pressures on the budget. Nonetheless, we consider the risk of realization to be negligible in the medium term.

The banking system remains solid, but risks are looming. The current state of the banking system appears to be solid as shown by strong financial soundness metrics such as liquidity, capitalization and asset quality. The capital adequacy ratio stood at 18,6% by 3Q 2019, while the liquid assets to total short-term liabilities ratio was 152% as of the same date. Furthermore, the NPLs to total loans ratio remained at a very depressed level posting a reading of 1,3% as of 1H 2019 (see graph 4).

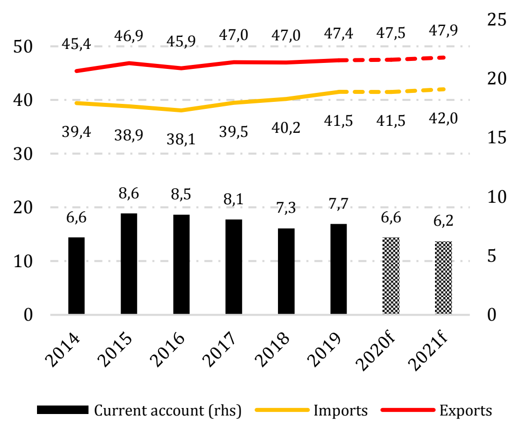
Despite this, there has been evidence that risks in the system could mount as a result of a couple of factors. The credit-to-GDP gap has gradually increased potentially showing some overheating of the credit market, while, at the same time lending to riskier corporates in order to chase profits has hiked. Also, the perception of a continued increase in asset prices, especially those related to mortgages, could reflect an overvaluation of collateral. All of this, combined with an adverse economic situation, could increase defaults and decrease banks capitalization.

On a positive note, we have observed that BaFin already acted in order to mitigate potential cyclical systemic risks by activating the countercyclical capital buffer[1]. However, we believe this measure will cause banks to continue to struggle in terms of profitability as, besides the increase in capital requirements, interest rates remain extremely low and operating profit remains narrow.

Regarding the development of activity in the banking sector, banks' assets to GDP as increased up to 243,3% in 2019, after posting a decline in 2018, mostly propelled by a hike in portfolio derivatives as loans to non-banks increased by 3,9% due to solid credit growth to domestic enterprises and households (see graph 5).

[1] The countercyclical capital buffer is intended to make the banking system more resilient to cyclical systemic risks. BaFin raised the buffer to 0,25% of risk-weighted domestic exposures with effect from the third quarter of 2019 with a 12-month phase-in period.

Graph 6: External sector indicators, % of GDP



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

The external stance remains sound while threats persist. The external position of Germany remains outstanding. The current account surplus posted a figure of 7,7% of GDP, 0,4p.p. higher than in 2018, as primary income saw a solid uptick. On the other hand, the trade balance stood at 5,9% of GDP, lower than in 2018 as we previously anticipated, as a result of a exports of good increasing meagerly (see graph 6).

As a result of continued weak external demand and the disruption of global commerce due to the coronavirus outbreak, we expect exports to continue to struggle. However, we anticipate the external position to remain solid going forward as the country has sufficient buffers and the risk of a no-deal Brexit has eased.

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_28.02.2020.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.