Research Report on Germany

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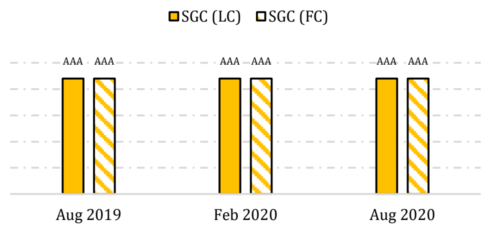
Ratings

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	2053
Nominal GDP, EUR bn	3245	3344	3449
Real GDP growth, %	2,5	1,5	0,6
Gross gov. debt/GDP, %	65,2	61,7	59,5
Deficit (surplus)/GDP, %	1,2	1,9	1,4
Inflation rate, %	1,5	1,8	1,5
Current Account Balance/GDP, %	-	-	7,1
External debt, USD bn	-	-	5588,0

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

Default indicator	28.08.2020
5-Year CDS spread, Bp	11,1
10Y Gov Bond Yield, %	-0,39

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

Summary

The confirmation of Germany's credit ratings at 'AAA' reflect mainly the vast fiscal buffers the government has to confront the pandemic and also, the ability to use these funds in an efficient way. In addition to this, Germany's economy remains solid and highly diversified, its external stance is still strong and, despite unprofitable, the banking system is liquid and has an adequate level of capitalization.

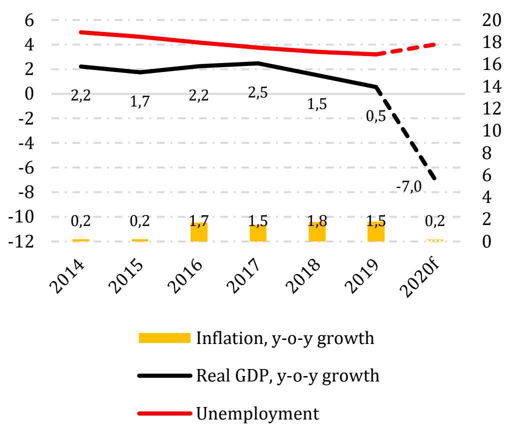
However, even though we do not consider this as a likely scenario, the fact that the development of the pandemic is hard to predict, the country is still highly exposed to further economic deterioration, which could lead to additional fiscal support and higher debt levels for years to come. Moreover, the banking system profitability remains quite low and the whole sector will be tested as the coronavirus crisis will most certainly lead to an increase in the level of low quality assets. Also, contingent liabilities remain a latent risk of materialization. Despite all this, we do not anticipate the creditworthiness to be threatened in the mid-term view.

Economy set to shrink substantially in 2020. The German economy grew in 2019 at a rate of 0,56% resulting from a decline in exports and issues in the automotive sector. However, as a consequence of the coronavirus crisis, the economy shrank by 11,3% y-o-y as of 2Q 2020. This was mainly driven by lower domestic demand as a result of semi-lockdown measures across the country to prevent the spread of the pandemic which caused a strong fall in household spending, while external demand also dipped sharply. The overall negative consumer and investment sentiment most likely took a toll in household consumption as well as business investments respectively. However, government consumption increased by 1,5% q-o-q.

Even though we anticipate the economy to have a negative growth of around 7% by year-end 2020 as a result of the pandemic (see graph 1), we have already seen an increase in German business confidence. The Ifo institute reported that the business climate index rose to 92,6 from 90,4 in July. Nevertheless, the direction of the economy and any expectations of recovery have a high margin of error as all will revolve around how the resurgence of COVID-19 cases is managed as, if cases continue to increase, we anticipate further restrictive measures to be implemented, which would negatively change our base scenario for the economy.

Overall, Germany remains one of the most developed and competitive countries in the world supported by the highly ambitious export-oriented economy and still stable macroeconomic environment. GDP per capita in PPP terms stood at around USD 53,6 th and the inequality adjusted HDI was 0,86, reflecting a high level of development. Even though unemployment remained low at 3,2% in 2019, the rate increased up to 4,5% as of the end of 2Q 2020 as a consequence of the coronavirus crisis. Nonetheless, the level of job losses has remained balanced resulting from the short-term work program ("Kurzarbeit") where employers, instead of laying off employees, only reduce their working hours and the government pays 60% of the salary. This program has smoothed the unemployment levels, unlike in other developed economies where the rate has spiked dramatically. Regardless, we anticipate the unemployment rate to increase if the coronavirus crisis were to lignin well into 2021.

Graph 1: Macroeconomic indicators, %

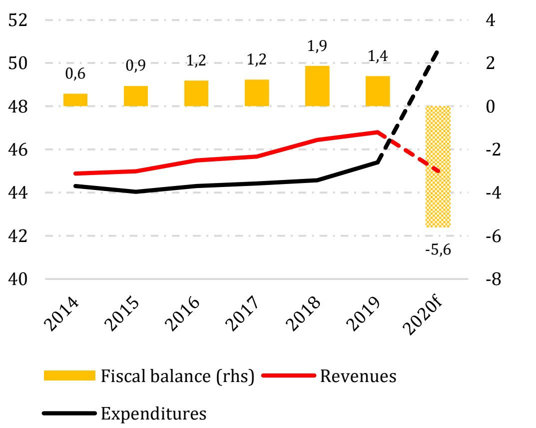


Source: RAEX-Europe calculations based on data from the IMF and Destatis

Finally, the inflation rate was 0% y-o-y as of July 2020 as a result of lower energy prices, a dip in consumption due to the lockdown measures and, as of late, the reduction of the VAT. We expect consumer prices to remain quite low and the HCIP growth to post a figure of around 0,2% by end-2020 (see graph 1).

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 approval of the basic pension increases public spending while not solving the long-term pension conundrum.

Graph 2: Fiscal budget dynamics, % of GDP

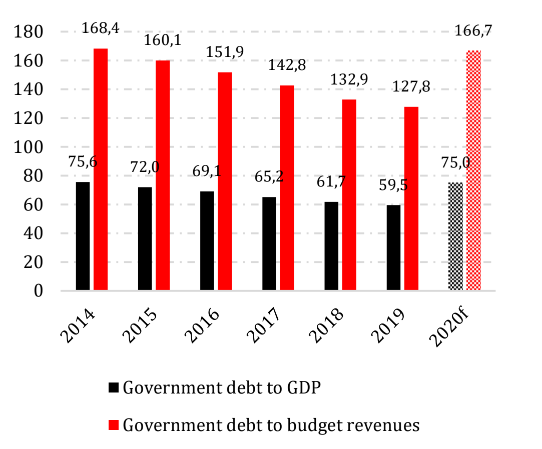


Source: RAEX-Europe calculations based on data from the IMF and Bundesbank

Fiscal balance to turn negative due to anti-pandemic expenditure. Germany posted a surplus of 1,45% of GDP in 2019 (see graph 2) marking another year of a positive balance for the government and solidifying the so-called "black zero" policy, which relies on the premise of maintaining a balanced budget and no further debt. However, the current pandemic situation has brought this controversial policy to an end as the government has rushed to increase debt and spending in order to cushion the effects of the crisis.

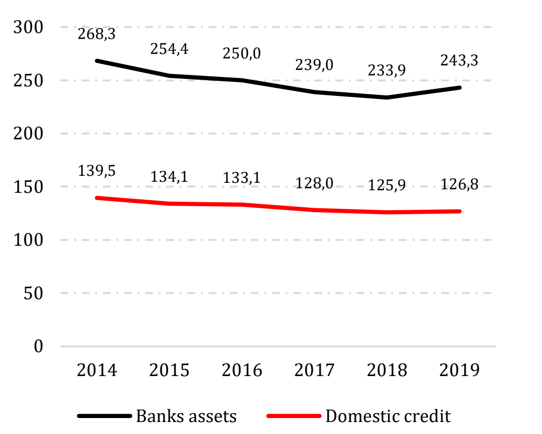
The government has approved supplementary budgets for around EUR 285 bn so far, while local governments have announced support of around EUR 140 bn. Measures to weather the crisis include expenditures on healthcare, subsidies to support the aforementioned "Kurzarbeit" program (which has been recently extended until 2021), as well as additional child care benefits, grants to SMEs, tax-deferrals, VAT reduction and extended credit guarantees for the international trade sector. As of 25 August 2020, EUR 69,3 bn had already been approved under the protective shield to manage the coronavirus pandemic.

Graph 3: Government debt dynamics, % of GDP



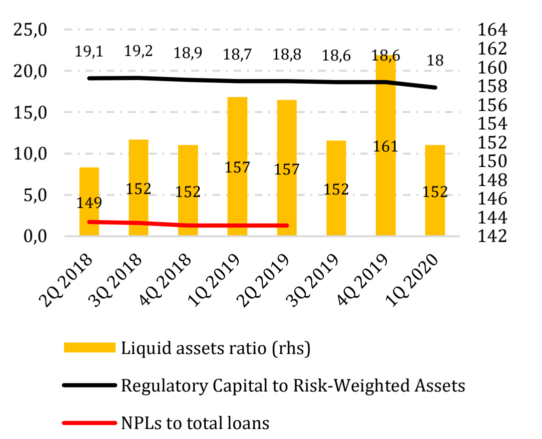
Source: RAEX-Europe calculations based on data from the IMF and Bundesbank

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



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

Graph 5: Financial soundness indicators, %



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

As a result of the aforementioned measures, the government recorded a deficit of 3,2% of GDP in 1H 2020 and we anticipate the budget deficit to stand around 5,6% of GDP in 2020 and to remain on negative territory in 2021 as well.

Government debt set to hike in order to finance the assistance package. Government debt to GDP stood at 59,5% and the ratio of debt to budget revenues was 127,8%, both showing a smooth decline before the pandemic started. Now, we anticipate the government o issue around EUR 218,5 bn in debt this year in order to finance the historic assistance package announced by the authorities. Thus we expect the government debt level to increase up to 75% of GDP in 2020 (see graph 3); however, debt levels will most likely resume a declining trend in 2021.

Moreover, the level of short-term debt hiked to around 18% of overall debt and 16% of GDP as of 2Q 2020 also as a consequence of financing measures to overcome the adverse economic effects from the pandemic. Despite this, we consider that the level of short-term debt remains well covered by budget revenues.

The materialization of contingent liabilities risk still lingers for the government. Germany is still the most exposed country in EU to these types of liabilities, as government guarantees are equivalent to around 12,8% of GDP at the end of 2018; while liabilities of public corporations were about 90,5% (mostly related to Landesbanken and Sparkassen). Both figures put Germany among the top-5 countries in the EU in terms of contingent liabilities. Despite this, the risk of these obligations transferring to the balance sheet of the government is fairly negligible.

Banking sector to deteriorate but will remain stable. In 2019, banks' assets and domestic lending to GDP hiked by 9p.p. y-o-y and 2p.p. respectively (see graph 4). Nonetheless, as of June 2020 loans have dropped due to lower demand; from May to June 2020, the absolute value of loans to non-MFIs declined by 0,2%. We anticipate an increase in the level of credit to the economy as the reduction of the countercyclical capital buffer from 0,25% to 0% provides additional room to the sector and facilitates credit growth. Moreover, the assistance program set up at KfW will also aid to inject financing into the economy.

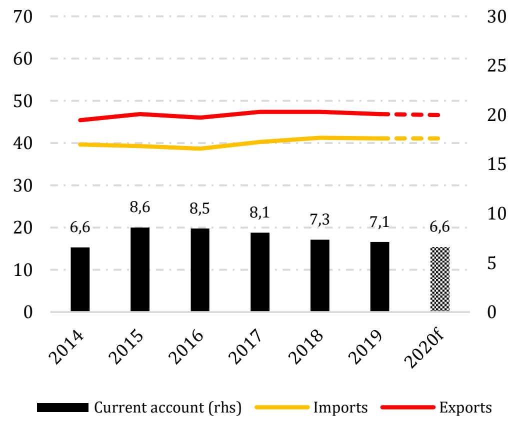
The financial soundness indicators of the banking system remain fairly solid. The NPLs to total loans ratio remains below 2%, the capital adequacy ratio is still quite strong at 18% and the liquid assets to total short-term liabilities ratio was solid at 152% (see graph 5) as of 1Q 2020. Despite anticipating the coronavirus crisis to take a toll on some of these metrics, we do not believe any extraordinary changes in the soundness of the financial institutions.

However, the profitability of the sector continues to be depressed as compared to EU peers. This is a reflection of the high competitiveness in the sector as the government-related banks do not have as high profit-generating incentives as commercial banks. Moreover, low interest rates and high operating costs have also hurt the bottom line.

In our previous revision we mentioned that credit-to-GDP gap had gradually increased potentially showing some overheating of the credit market, while at the same time lending to riskier corporates had increased in order to chase profits. All of this, combined with the negative effects of the coronavirus crisis, will cause banks margins to continue to shrink (also as a result of lower rates), NPLs are expected to climb and capitalization to deteriorate.

External stance will continue to be a strength for Germany. Despite the staggering negative effects from the pandemic, The external position of Germany remains solid. The current account recorded a surplus of 7,1 of GDP in 2019 (see graph 6), but in May 2020, it recorded a surplus of EUR 6,5 bn, EUR 2,6 bn lower than the figure recorded in April as a result of a negative balance of the secondary income, while the surplus in the goods balance increased. We anticipate the current account to remain at a surplus going forward.

Graph 6: External sector indicators, % of GDP



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

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_28.08.2020.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.