Creditreform Sovereign Rating

Creditreform Rating
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Rating Object	Rating Information	
FEDERAL REPUBLIC OF GERMANY	Assigned Ratings/Outlook: **AAA /stable**	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	29-07-2016 30-06-2017 "Sovereign Ratings"

Rating Action

Neuss, 30 June 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "AAA" for the Federal Republic of Germany. Creditreform Rating has also affirmed Germany's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AAA". The outlook is stable.

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Key Rating Drivers

1. Due to the high quality and predictability of its institutional framework, Germany is among the most business-friendly countries in the world
2. Robust GDP growth in the recent past, complemented by a large domestic market, a wealthy population and a diversified economy
3. Strong track record of budget consolidation reflected by repeated budgetary surpluses and a sharply declining debt-to-GDP ratio
4. External risks due to high degree of openness mitigated by sustained and high current account surpluses and a growing net external asset position of the economy

Reasons for the Rating Decision

In the first place, we believe that Germany's very strong institutional set-up, together with its integration in the European Union and European Monetary Union, represent key credit strengths of the sovereign. Germany ranks in the first percentile on most of the World Bank's Governance Indicators, and well above the euro area average. In particular, the World Bank highlights the quality and effectiveness of government policy-making, extensive political participation rights, and the high quality of regulation. Also, its strong institutional framework translates into a favorable business environment. According to the World Economic Forum's 2016-17 Global Competitiveness Report, German competitiveness has held up well in recent years, being ranked 5th out of 138 countries world-wide and 2nd among EU-28 members (behind the Netherlands).

Our AAA rating for Germany is also underpinned by the country's proven track record of macroeconomic resilience and its growth performance in the recent past. Germany is the fourth largest economy in the world (measured in USD, current prices). We believe that the large size of its economy, which accounts for one third (29.2%) of the euro area's total output, coupled with high levels of wealth (2016 GDP p.c.: USD 48,111 PPP), and healthy private sector balance sheets act as macroeconomic stabilizers. In the same vein, we regard the country's diversified economy, which exhibits a strong industrial base (2016: 30.5% of GVA; 24.2% of employment) as credit positive. Furthermore, Germany's macroeconomic performance was underpinned by strong GDP growth in the recent past. With total output expanding at a rate of 1.9% last year (2015: 1.7%), Germany experienced the strongest GDP growth in five years. In 2016, growth was entirely driven by strong domestic demand. Both public and private consumption expenditures continued to grow at solid rates (4.0 and 2.1%, respectively), contributing 0.8 and 1.1 p.p. to total output expansion. While public consumption increased mainly due to higher costs related to accommodating the large inflow of refugees from 2015, private consumption spending continued to benefit from increasing real wages and buoyant labor market conditions. Throughout 2016, labor market indicators improved further. Standing at an already low 4.4% in Dec-15 (monthly average, s.a.), Germany's unemployment rate fell to 3.9% by the end of 2016 – the lowest reading within the euro area. At the same time, Germany reported the strongest rise in employment since 2012. After 0.9% in 2015, employment growth accelerated to 1.2% last year, adding more than half a million employed persons. As a result, the labor participation rate increased from 77.6 to 78.0% in 2015-16. Investment growth, which came in at 2.2%, was buttressed by strong construction activity, while investment in equipment remained subdued. According to latest data provided by Germany's National Statistics Office, the number of completed residential buildings amounted to 109.990 in 2016 – the highest figure since 2007. Meanwhile, net exports detracted 0.2 p.p. from GDP growth. Fostered by brisk domestic demand, imports increased more dynamically (+3.8%) than exports (+2.7%).

In our view, Germany's growth prospects for 2017 remain favorable. We believe that GDP is set to increase by 1.8%, with private consumption remaining the dominant growth driver. Private consumption expenditures should be somewhat muted against the backdrop of rising inflation and a slowdown in employment growth. At the same time, growth should be more broad-based, with exports growing vividly and investment activity turning the corner this year. Our baseline scenario is supported by recent Q1-17 data, which showed a notable improvement in external demand, in particular from the United States and the United Kingdom. Also, gross fixed capital formation rebounded strongly (+1.7% growth q-o-q) and we anticipate a further strengthening given a high and rising capacity utilization in manufacturing and favorable financing conditions.

Furthermore, we expect higher government spending, which should be conducive to the economy's medium-term growth perspectives. According to European Commission data, the public sector in Germany constantly exhibited one of the lowest investment-to-GDP ratios in the EU over the last decade. To increase the scope for investment at the subnational level, which is responsible for the bulk of public investment in Germany, the federal government decided to fully reimburse asylum-related costs incurred at the level of the states and municipalities in 2016-18. While states will receive federal grants worth EUR 6bn, municipalities should receive additional funds in the amount of EUR 2.6bn over the three year stretch.

In the medium term, we believe that the comprehensive federalism reform passed by the Bundestag on 01 June 2017 could further strengthen the states' and municipalities' investment capacities. In the context of the reform, which will become effective in 2020, the current system of financial equalization (*Länderfinanzausgleich*) will be replaced by a new allocation mechanism. Under the new equalization scheme, the federal states will receive a larger share of VAT revenues and the amount of transfers will be more dependent on the financial situation of the municipalities in the respective states. Moreover, the new legislation also enables the federal government to finance investment projects (e.g. schools) at the municipal level, which is as yet outside of their constitutional competences. As a whole, state and local governments will be provided with additional funds worth EUR 9.4bn in the first year of the reform. In return for financial relief, the states agreed to transfer some competences to the federal government. Beyond 2020, funding, planning and construction of motorways will be concentrated at the central government level, which should speed up the completion of road construction.

At the general government level, Germany's fiscal and debt metrics gained further strength in 2016. Germany achieved a budget surplus for the third consecutive year. Standing at 0.8% of GDP in 2016, the actual budget outcome was significantly better than projected in the government's 2016 stability program (0.0% of GDP). Most of the outperformance can be attributed to the revenue side of the budget, which benefited from a strong increase in taxes on income and wealth (+6.6%) and in social security contributions (+4.5%), reflecting vivid output growth and favorable labor market conditions. In addition, further decreasing interest expenses had a positive impact on last year's government's budget.

Looking ahead, we expect Germany's fiscal policy stance to loosen somewhat. According to statements from fall 2016, the government envisages a moderate tax relief, in the amount of EUR 6.3bn. Besides an increase of the personal tax allowance and higher child benefits, the coalition agreed on an adjustment of income tax brackets to inflation in 2017 and 2018. As a result, Germany's headline balance should decrease to 0.5% of GDP this year.

Against the backdrop of a stronger-than-expected revenue forecast published by the working group for tax revenue estimates (*Arbeitskreis Steuerschätzung*) in May 2017 and the upcoming general elections (24 Sep 2017), there are voices within the governing Christian Democratic Party (CDU) calling for a comprehensive tax reform and a more significant relief for taxpayers in the aftermath of the elections. According to latest polls, chancellor Merkel's CDU could get between 37-40% of the votes, thus remaining the largest party in the next legislative period. However, even in the event of a somewhat larger tax relief we expect policy continuity, assuming that any new government will remain committed to debt consolidation. Thus, Germany's debt-GDP ratio, which stood at 68.3% of GDP in 2016, should remain on its downward trajectory and fall below the 60%-mark by 2020.

Risks pertaining to the reduction of government debt are mainly related to the materialization of contingent liability risks and a dynamic increase of age-related expenditures. Although reporting a decrease to 15.4% of GDP (2015) in its 2017 stability program, Germany's contingent liabilities remain sizeable. Taking into account that the country is the largest guarantor of the European Stability Mechanism (27.6% of EUR 705.8bn subscribed capital), contingent liabilities stand well above 20% of GDP. Government debt could also rise if the government fails to contain the projected increase of age-related spending. According to the Stability Program 2017, age-related expenditures could increase to 32.4% of GDP under an adverse scenario, up from 25.8% in 2015.

On the other hand, budgetary risks related to the banking sector seem limited at present. While asset quality is generally high (Q4-16 NPL-ratio: 2.5%) and capital buffers are sufficient (CET1-ratio: 15.0%), the profitability of the German banking sector remains challenged by low interest rates and a competitive domestic market. Consolidation within sector is advancing only gradually. Notwithstanding that the number of MFIs residing in Germany decreased by 4.3% in 2016, the number of banks was still double the number in France and the cost-to-income ratio of German banks further deteriorated in 2016, posting at 80.9% in Q4-16 – the highest figure of all EU members.

Meanwhile, house price growth further accelerated in 2016. Driven by a growing population and low interest rates, residential real estate recorded y-o-y growth rates in the 5-7% range in each quarter. However, apart from the country's largest cities, where the Bundesbank sees signs of an overvaluation, we believe that price developments are generally in line with fundamentals. Additionally, indebtedness of private households as well as recent developments in the mortgage market do not indicate a credit-fueled housing boom. While lending for house purchases expands modestly and a large share of new mortgages (approx. 45%) carries fixed interest rates for long periods (>10 years), German private households continued to deleverage during the last year, with debt-to-GDP posting at a moderate 53.8% of GDP (Q4-16). Thus, risks to financial stability seem limited at the moment. What is more, the Bundestag passed a legislative amendment (*Finanzaufsichtsrechtsergänzungsgesetz*) empowering the Federal Financial Supervisory Authority (*BaFin*) to introduce minimum requirements (e.g. LTV- and DTI-ratios, amortization requirements) for housing loans, in case of a credit-fueled boom of house prices.

In assessing Germany's external vulnerability, it has to be noted that the country's economy is more sensitive to global growth and trade dynamics than other large economies. Germany's deep integration in global value chains is mirrored by its trade-to-GDP ratio, which stood at 84.4% of GDP in 2016 – by far the highest reading of all G7 economies. However, external risks are largely tempered by the country's persistently high current account surpluses, which came in at 8.3% and 8.6% of GDP in 2016 and 2015, respectively, and its strong net international investment position (NIIP). Germany's NIIP reached 54.4% of GDP in 2016 (2015: 49.7% of GDP), with households, NFCs and MFIs each contributing positively to the economy's net external asset position.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of AAA is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

We could consider a downgrade if medium-term growth turns out to be significantly lower than in our baseline scenario. In our opinion, Germany would be disproportionately affected by a prolonged period of subdued global growth or a rise of protectionist policies, given the country's high degree of openness. Generally, we believe that German exports are well-diversified across industries and regions, however the country's main exports are relatively sensitive to changes in global investment activities, as cyclical industries (machinery, electrical equipment, chemicals, and automotive sector) accounted for 38.6% of total exports in 2016.

Our AAA rating could also be lowered if we observed a material deterioration of fiscal metrics in the years to come. Such a scenario could emerge if some of the governments' contingent liabilities materialize and/or age-related spending cannot be contained at sustainable levels.

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Ratings*

Long-term sovereign rating	AAA /stable
Foreign currency senior unsecured long-term debt	AAA /stable
Local currency senior unsecured long-term debt	AAA /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	3.7	0.5	0.5	1.6	1.7	1.9	1.8
GDP per capita (PPP, USD)	43,249	44,265	45,123	46,470	47,255	48,111	49,815
Inflation rate, y-o-y change	2.5	2.1	1.6	0.8	0.1	0.4	1.6
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.4	80.5	80.5	81.1	81.1	n.a.	n.a.
Fiscal balance/GDP	-1.0	0.0	-0.2	0.3	0.7	0.8	0.5
Current account balance/GDP	6.1	7.0	6.7	7.5	8.6	8.3	n.a.
External debt/GDP	151.1	169.8	156.2	140.5	145.4	141.1	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of Creditreform Rating´s “Sovereign Ratings” methodology. Creditreform Rating AG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of Creditreform Rating´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in Creditreform Rating´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

Disclaimer

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When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

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