PRESS RELEASE

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Morningstar DBRS Confirms Federal Republic of Germany at AAA, Stable Trend

SOVEREIGNS

DBRS Ratings GmbH (Morningstar DBRS) confirmed the Federal Republic of Germany's (Germany) Long-Term Foreign and Local Currency – Issuer Ratings at AAA. At the same time, Morningstar DBRS confirmed Germany's Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (high). The trend on all ratings is Stable.

KEY CREDIT RATING CONSIDERATIONS

The Stable trend reflects Morningstar DBRS' view that Germany's credit fundamentals remain solid notwithstanding weak economic growth dynamics. Real GDP contracted by 0.2% in 2023 related to weak domestic demand and is forecast to increase by just 0.2% in 2024 and by 0.9% in 2025. While cyclical headwinds are projected to fade gradually over the next two years, the economy's medium-term growth potential is dampened by unfavourable demographic trends. The fiscal accounts are set to benefit from the planned phase-out of energy support measures with the general government budget deficit forecast to narrow from 2.5% of GDP in 2023 to 1.5% in 2024 and to 1.0% in 2025. While fiscal performance is likely to remain weaker than in pre-COVID years, the relative size of projected budget deficits is lower than those of most other major advanced economies and Euro area peers. General government gross debt is forecast to decrease marginally to 63.0% of GDP in 2025 from 63.6% in 2023 due to a narrowing budget deficit and still favourable debt dynamics. At the same time, the government's fiscal leeway has been constrained by the reinstatement of the constitutional debt brake which is currently exerting pressure on the central government to bring its 2025 budget in line with its stipulations.

Germany's AAA ratings are supported by its competitive and highly developed economy, high institutional quality and strong external finances. Furthermore, the government's debt affordability is high, underpinned by a low interest burden, a moderate stock of public debt and the country's status as a safe haven. However, the economy faces large challenges such as population ageing and structural changes within important manufacturing industries. Furthermore, contingent liabilities, emanating from state guarantees for domestic companies and fiscal burden sharing within the currency union could eventually weigh on public finances.

CREDIT RATING DRIVERS

Morningstar DBRS could downgrade the ratings if the country's growth and fiscal prospects deteriorate severely enough to place the public debt-to-GDP ratio on a persistent upward trajectory. Moreover, a materialisation of substantial contingent liabilities could put negative pressure on the ratings.

CREDIT RATING RATIONALE

Economic Growth is Likely to Recover Only Gradually and Medium-Term Potential Growth is Low

Economic growth has been weak over the past year. Germany's real GDP contracted by 0.2% in 2023, whereas Euro area real GDP increased by a modest 0.4%. Economic activity in Germany was held back by cyclical headwinds and structural factors such as labour shortages in certain industries and also by sluggish growth dynamics in important manufacturing industries which has been ongoing for the past five years. Private consumption declined by 0.7% in 2023 as households' purchasing power continued to be weighed down by higher consumer prices. Average real wages in 2023 were around 4% below their 2021 levels. Furthermore, investment activity was dragged down by tighter financial conditions and weakening external demand for German exports. Over the next two years, cyclical headwinds are projected to fade, albeit only in a gradual manner. The German Council of Economic Experts (GCEE) forecasts real GDP growth at a mere 0.2% in 2024 before accelerating to 0.9% in 2025. Private consumption is projected to benefit from a rebound in households' purchasing power related to a decrease in consumer price inflation and a catch-up in nominal wages. Investment activity is likely to remain weak in 2024 and to recover only gradually thereafter. Downside risks to the economic outlook include a potential escalation of geopolitical or global trade tensions.

Over the medium-term, potential growth is projected to be dampened by unfavourable demographic trends with the size of the domestic labour force expected to start shrinking from 2026 onwards. As a result, the GCEE projects the potential real GDP growth rate to average 0.4% over the next ten years compared to an average of 1.4% during the period 2010-2019. Furthermore, important manufacturing industries face large structural challenges such as the global energy transition and the automotive industry's transformation towards electric vehicle production. Nevertheless, Germany's credit profile continues to be supported by its competitive and highly developed economy and its high level of labour productivity. Moreover, Morningstar DBRS notes that most, though not all, industries demonstrated a strong resilience to the energy price shock in 2022.

Government Budget Benefits from Phase-Out of Energy Measures but Future Fiscal Leeway is Likely to Be Narrow

Fiscal accounts in 2023 were impacted by still large energy support measures for households and companies such as the price brakes for electricity and gas and temporary VAT and energy tax cuts. The total fiscal cost of energy measures amounted to 1.7% of GDP in 2023. The general government budget deficit stood at 2.5% of GDP in 2023. Looking ahead, the GCEE forecasts the general government budget deficit to narrow to 1.5% of GDP in 2024 and 1.0% in 2025, underpinned by the planned phase-out of energy support measures. The latter savings clearly offset the impact of higher projected spending by the central government's Climate and Transformation Fund and the special fund for defence. While fiscal performance is likely to remain weaker than in pre-COVID years, projected fiscal balances compare favourably with those of most other major advanced economies and Euro area peers. The IMF forecasts the average fiscal deficit among other Euro area countries at 2.5% of GDP in 2024.

At the same time, the government's fiscal leeway has been constrained by the reinstatement of the debt brake in 2024 and the November 2023 Constitutional Court Ruling which strengthened the applicability of the debt brake for the operations of off-budget entities. The debt brake limits the central government's structural net borrowing at 0.35% of GDP which is currently exerting consolidation pressure on the central government. This is illustrated by the ongoing discussions among the three government coalition parties on required fiscal consolidation measures in the 2025 budget. The government's fiscal leeway might be further narrowed in case the Constitutional Court rules the remaining solidarity surcharge on corporate incomes and high personal incomes unconstitutional with a ruling expected in late 2024 or early 2025. Morningstar DBRS takes the view that the stipulations of the debt brake are unlikely to be altered prior to the next federal election in autumn 2025 as such a change is currently opposed by the Free Democrats, a government coalition party, and most senior members of the Christian Democrats, the largest opposition party. Changes to the constitutional debt brake would require a two-thirds majority in the parliament. Over the medium-term, the government's fiscal leeway under current policy settings is likely to decrease further, see Morningstar DBRS's recent commentary "Germany: Tough Budgetary Choices Ahead" at https://www.dbrsmorningstar.com/research/430023. Public ageing expenditure is projected to increase with the retirement of the baby boomer generation during the next decade. In addition, the government is likely to face rising on-budget spending pressures for investment and defence whereas the decrease in the economy's growth potential weighs on tax revenues.

Debt Affordability Is High

Morningstar DBRS regards Germany's debt affordability as high due to moderate government debt levels, a low interest burden and Germany's status as a safe haven. The GCEE forecasts general government debt to decrease marginally to 63.0% of GDP in 2025 from 63.6% in 2023 underpinned by a narrowing budget deficit and still favourable debt dynamics. Moreover, despite the recent increase in interest rates, the government's interest burden is projected to remain low both when compared to European peers and from a historical perspective. The European Commission forecasts the general government's interest burden at 0.9% of GDP in 2024 compared to an average of 1.9% for Euro area countries and an average annual interest burden of 1.6% for Germany during the years 2010-2019. Risks to public finances emanate from a materialization of implicit or explicit contingent liabilities. This has been illustrated by support measures to the energy company Uniper and Siemens Energy in recent years. In general, government financing benefits from the government's role as a benchmark issuer for the euro area. Germany's safe-haven status supports the "Debt and Liquidity" building block assessment.

Financial Condition of the Banking Sector Is Sound but Asset Quality Risks Are Likely to Rise

Financial stability is supported by the banking sector's sound capital and liquidity buffers. Furthermore, banks benefitted from a temporary increase in profitability related to higher net interest income over the past year. The current stock of non-performing loans is low. Looking ahead, however, asset quality risks are likely to rise particularly for corporate loans given weak economic activity in certain industries and as higher interest rates strain the repayment capacity of some borrowers. The average interest rate on outstanding loans to non-financial corporates rose to 3.4% in March 2024, up from just 1.6% two years earlier. In particular, pockets of vulnerability might arise from banks' exposure to the commercial real estate sector (15.5% of total domestic loans in March 2024) and, to a lesser extent, to the manufacturing (4.6%) and the construction (3.3%) sectors. A potential prolonged decline in real estate valuations and transactions volumes might raise refinancing risks for some commercial real estate borrowers, particularly across the office and retail segments. In terms of household mortgages (37.4% of total domestic loans in March 2024), the pass-through of higher interest rates has been contained by long interest rate fixation periods of most mortgages. The average interest rate of outstanding mortgages to households increased only moderately to 2.0% in March 2024 from 1.7% in March 2022. Furthermore, households' repayment capacity is supported by the comparatively low level of household debt (53% of GDP in Q3 2023) and still low unemployment.

External Finances Resilient to Potential Global Trade and Financial Shocks

Germany's external finances are strong and resilient to potential shocks. The economy commands over a structural current account surplus which has mitigated the impact of the energy price shock on external finances. After narrowing to 4.2% of GDP in 2022, the current account surplus rebounded to 5.9% in 2023 as the terms of trade shock partially reversed. The GCEE forecasts a further increase of the current account surplus to 6.7% of GDP both in 2024 and 2025 on the back of strengthening external demand for German exports. Furthermore, Morningstar DBRS assesses the economy's vulnerability to potential global financial shocks as low given Germany's status as a safe haven and its large net external asset position. In Q4 2023, Germany's net international investment position amounted to a large 70% of GDP owing to substantial foreign assets held particularly by non-depository financial institutions and, to a lesser extent, the central bank. This strong net external creditor position supports the "Balance of Payments" building block assessment.

Germany's Rating Is Underpinned by High Institutional Quality

Germany's high institutional quality is a key strength of its credit profile. Germany is a strong performer on the World Bank's Governance Indicators reflecting a high rule of law, low levels of corruption and stable political and economic institutions. Moreover, political polarization is less pronounced than in some other advanced economies. The current 'traffic-light' coalition government (Social Democrats, Green Party, Free Democrats) places a greater emphasis on fostering the green transition of the economy compared with the previous government whereas policy continuity is very high for other areas, most notably foreign affairs. At the same time, Morningstar DBRS notes that policymaking in the current coalition government has been complicated by programmatic differences between the three coalition parties particularly on energy and fiscal policies. Looking ahead, cohesion within the coalition might be further strained by ongoing discussions on required fiscal consolidation measures in the 2025 government budget given the parties' diverging fiscal priorities.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

Environmental (E) Factors
There were no Environmental factors that had a relevant or significant effect on the credit analysis.

Social (S) Factors
There were no Social factors that had a relevant or significant effect on the credit analysis.

Governance (G) Factors
There were no Governance factors that had a relevant or significant effect on the credit analysis.

A description of how Morningstar DBRS considers ESG factors within the Morningstar DBRS analytical framework can be found in the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (23 January 2024) https://dbrs.morningstar.com/research/427030/morningstar-dbrs-criteria:-approach-to-environmental,-social,-and-governance-risk-factors-in-credit-ratings.

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments. https://www.dbrsmorningstar.com/research/433840.

EURO AREA RISK CATEGORY: LOW

Notes:
All figures are in euros unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments (06 October 2023) https://dbrs.morningstar.com/research/421590/global-methodology-for-rating-sovereign-governments. In addition Morningstar DBRS uses the Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings https://dbrs.morningstar.com/research/427030/morningstar-dbrs-criteria:-approach-to-environmental,-social,-and-governance-risk-factors-in-credit-ratings in its consideration of ESG factors.

The credit rating methodologies used in the analysis of this transaction can be found at: https://dbrs.morningstar.com/about/methodologies.

The sources of information used for these credit ratings include Germany's Federal Ministry of Finance (Stability Programme 2024, April 2024; Monthly Reports), German Finance Agency (Deutsche Finanzagentur), Deutsche Bundesbank (Monthly Reports; Financial Stability Review 2023, November 2023), Federal Ministry for Economic Affairs and Climate Action, Federal Statistical Office, Federal Financial Supervisory Authority (BaFin), European Banking Authority, German Council of Economic Experts (Spring Report 2024, May 2024; Annual Report 2023-24, November 2023), Ifo Institute, European Commission (European Economic Forecast Spring 2024, May 2024), Statistical Office of the European Communities, European Central Bank (ECB), IMF (World Economic Outlook Spring 2024; International Financial Statistics; Germany: 2023 Article IV Consultation July 2023), OECD, BulwienGesa AG (Housing Price Index), European Environment Agency, German Environment Agency, Social Progress Index, World Bank, Bank for International Settlements, Haver Analytics. Morningstar DBRS considers the information available to it for the purposes of providing these credit ratings to be of satisfactory quality.

With respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, this is an unsolicited credit rating. This credit rating was not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES
With Access to Internal Documents: NO
With Access to Management: NO

Morningstar DBRS does not audit the information it receives in connection with the credit rating process, and it does not and cannot independently verify that information in every instance.

The conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. Morningstar DBRS' outlooks and credit ratings are under regular surveillance.

For further information on Morningstar DBRS historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: https://registers.esma.europa.eu/cerep-publication. For further information on Morningstar DBRS historical default rates published by the Financial Conduct Authority (FCA) in a central repository, see https://data.fca.org.uk/#/ceres/craStats.

The sensitivity analysis of the relevant key credit rating assumptions can be found at: https://www.dbrsmorningstar.com/research/433839.

This credit rating is endorsed by DBRS Ratings Limited for use in the United Kingdom.

Lead Analyst: Yesenn El-Radhi, Vice President, Global Sovereign Ratings
Rating Committee Chair: Nichola James, Managing Director, Global Sovereign Ratings
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DBRS Ratings GmbH
Neue Mainzer Straße 75
60311 Frankfurt am Main Deutschland
Tel. +49 (69) 8088 3500
Geschäftsführer: Detlef Scholz
Amtsgericht Frankfurt am Main, HRB 110259

For more information on this credit or on this industry, visit dbrs.morningstar.com.

Ratings

Germany, Federal Republic of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
31-May-24	Long-Term Foreign Currency - Issuer Rating	Confirmed	AAA	Stb	EU U

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
31-May-24	Long-Term Local Currency - Issuer Rating	Confirmed	AAA	Stb	EU U
31-May-24	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	EU U
31-May-24	Short-Term Local Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	EU U

Contacts

Yesenn El-Radhi
Vice President - Global Sovereign Ratings
+(49) 69 8088 3517
yesenn.el-radhi@morningstar.com

Nichola James
Managing Director - Global Sovereign Ratings
+(49) 69 8088 3689
nichola.james@morningstar.com