INTERNATIONAL GROUP OF RATING AGENCIES
RAEX EXPERT RA RATING AGENTUR EUROPE
Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

Research Report on Germany

23 September 2016

Responsible Expert:

Gustavo Angel
Rating Associate

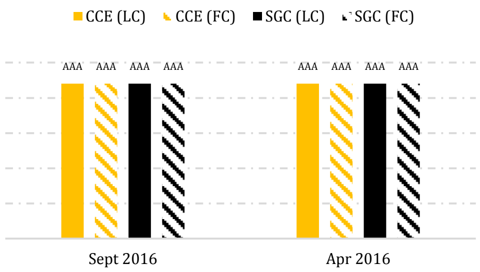
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Ratings

Sovereign Government Credit (LC)	AAA
Sovereign Government Credit (FC)	AAA
Country Credit Environment (LC)	AAA
Country Credit Environment (FC)	AAA

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Germany

Macro indicators	2013	2014	2015
Gross gov. debt, EUR bn	2182	2184	2152
Nominal GDP, EUR bn	2821	2916	3026
Real GDP growth, %	0,4	1,6	1,4
Gross gov. debt/GDP, %	77,4	74,9	71,1
Deficit (surplus)/GDP, %	0,1	0,3	0,6
Inflation rate, %	1,3	0,0	0,3
Current Account Balance/GDP, %	6,8	7,3	8,5
External debt, USD bn	-	-	-

Development indicators	2015
Inequality adj. HDI	0,85
GDP per capita, USD th	46,9

Default indicator	16.09.2016
5-Year CDS spread, Bp	17
10Y Gov Bond Yield, %	-0,003

Source: RAEX (Europe) calculations based on data from the IMF, CIA, Deutsche Bank

Summary

The Agency is confirming the ratings of Germany at 'AAA' based on the country's strong economic position and ability to show persistent twin surpluses despite the external shocks, as well as the high resilience of the banking sector to internal and regional risks.

Government debt metrics remain trending downward and the fiscal balance is still positive but narrow and has been consolidating over the past years. However, aging population and low birth rates introduce risks to the fiscal performance of the country.

The setback that the ruling party had in recent local and state elections, combined with UK-EU discussions over 'Brexit', could reshape some of the current policies regarding migration and taxation and encourage a policy shift after the September 2017 Federal elections.

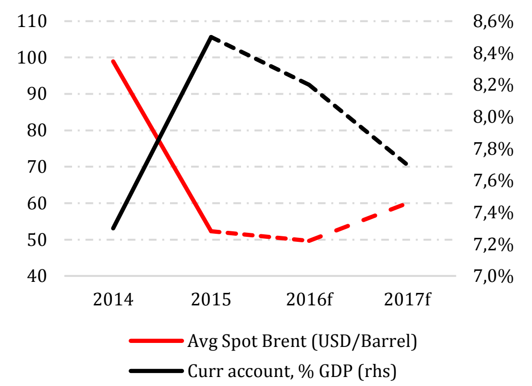
Strong macroeconomic position. Germany remains resilient to withstand external spill-overs. Recently released data by the IMF showed that the German economy grew by 1,4% in 2015 in real terms and is expected to grow around 1,7% by end-2016. These results are mainly rooted in higher internal and external demand which followed the lower interest rate environment and EUR devaluation in early-2015.

Supported by the positive net inflow of migrants, employment growth remained strong. Until now, the introduction of a statutory minimum wage in January 2015 has not affected the real wage growth and the employment trend. The unemployment rate declined further reaching 4,6% in 2015. We expect, in line with the IMF, this trend to remain in place in 2016 with an unemployment rate around 4,3% by the end of the year.

Debt metrics still declining. The German economy showed a solid economic performance over the past years, which was reflected in increasing growth rates of the real GDP as well as in higher private and public consumption. This, combined with a sustained consolidation of the fiscal balance, allowed the government to cut its debt down to EUR 2 167 bn as of 1Q 2016. Such decline represents a reduction of 3,3p.p. in the ratio of debt to 2015 GDP when compared with 1Q 2015, when it stood at 74,4%. With these metrics, the German federal government kept, for the second consecutive year, its commitment of not issuing new debt while keeping a balanced budget; the so called "black zero".

During 2015, short-term debt declined constantly, reaching 6% of GDP and 13,5% of budget revenues as of 4Q 2015. However, mainly driven by higher debt securities and loans, short-term debt increased during 1Q 2016 up to 7,1% of GDP and 16% of budget revenues. Despite such trend reversal we are keeping our view that short-term debt does not pose a material risk to the German economy on the basis that the currency and maturity structure remain favorable.

Graph 1: Current account vs Oil Price



Source: RAEX (Europe) calculations based on data from the IMF and EIA

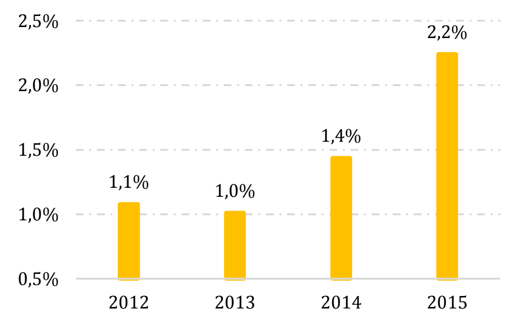
Twin balances remain positive but risks emerge. Driven by lower commodity prices and the devaluation of EUR against major world currencies, the German current account continued to widen in 2015 up to 8,5% of GDP (from 7,3% a year before).

The narrowing of the oil and gas trade deficit, following the decline of world oil prices, amounted to 62% of the increase in the trade balance which reached 8,7% of GDP in 2015 according to the IMF (see graph 1). Furthermore, lower world oil prices prompted global demand for automobiles, one of Germany's main export goods.

In our opinion, external conditions will remain strong for Germany in 2016. However, the recovery of oil prices and EUR appreciation against GBP that are likely to meager exports and further growth of real wages (see graph 2) which might boost imports, could ultimately narrow the trade balance.

Additionally, the German government was able to continue consolidating the fiscal balance in 2015 as the country faced favorable internal and external conditions. In spite of the increase in social expenditure, which was triggered by the large inflow of asylum seekers in 2015, the fiscal budget balance stood at 0,6% of GDP; 0,3p.p. higher than in 2014.

Graph 2: Real wage growth, % y-o-y

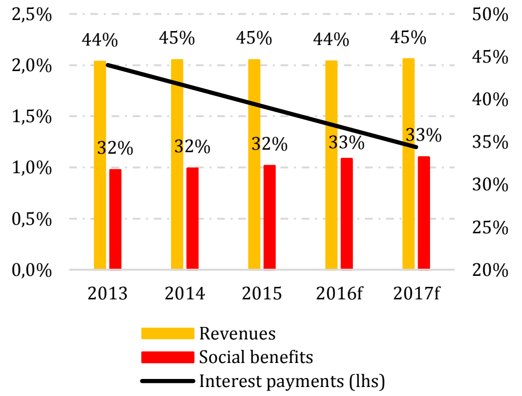


Source: RAEX (Europe) calculations based on data from OECD

In early September 2016, Germany's finance minister stated that Germany has the scope to cut taxes by EUR 15 bn after next year's federal election despite increasing fiscal expenses. We expect, in line with the IMF, that this will create a marginal fiscal deficit in 2016 driven by lower tax revenues and higher social and pension expenses. However, the fiscal balance is likely to turn positive again in 2017 as interest payments will keep declining following low interest rates, social expenses will stabilize and tax revenues will increase in our view (see graph 3).

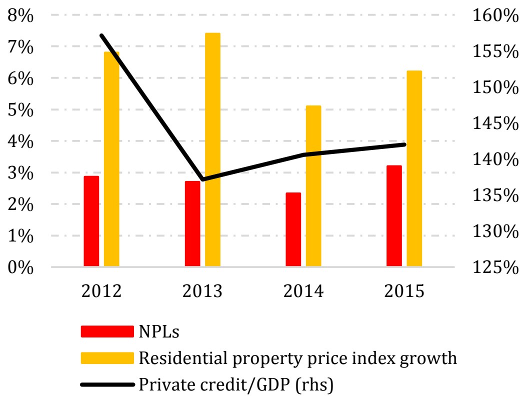
Ageing population and growing pension expenses remain the main long-term risks to the sustainability of the German fiscal budget. According to the IMF, the German population will begin to decline from 2020 and is likely to have a weighty impact on the country's output despite total-factor productivity (TPF) and capital growth remaining positive.

Graph 3: Components of the fiscal balance, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF

Graph 4: Banking and real estate performance metrics



Source: RAEX (Europe) calculations based on data from OECD

The inclusion of a larger number of women in the labor market, as well as the extension of the retirement age and the improvement and faster integration and training facilities for immigrants are among the policies proposed to mitigate the aforementioned risk.

However, none of these policies are expected to be implemented in the short and mid run. Additionally, the possibility that inclusion and integration policies do not foster the right skills that the German labor market needs, could derive in poor employment prospects, lower salaries and ultimately lesser contribution to the social system.

Resilient banking sector with downside risks. The German banking sector remains strong with assets at 261% of 2015 GDP as of August 2016. Private credit to GDP stood at 142% in 2015 fueled by a 2,4% increase of total credit to the private sector. In early 2016, this ratio continued to increase mainly driven by an increase in mortgage and corporate loans as borrowers took advantage of record-low interest rates.

The overall increase in private credit, which in part was the combined result of low interest rates and loose bank lending standards, has accelerated the housing price growth rate. While still low, non-performing loans to total loans ratio resumed growth reaching 3,2% in 2015 (see graph 4). Even though this figure does not introduce risks in the short run, further increase of this metric could cause a decline in banks' profits and assets in the long term.

Possible shift in policies. Growing support to the right-wing AfD party on this year's local and state elections in Germany could signal certain political risks, as the next-year Bundestag elections approach. Chancellor Merkel and her ruling party CDU, are under pressure from coalition partners, opposition and some sectors of the public to redefine policies, especially the ones dealing with refugees and migration. These pressures, together with awaited 'Brexit' talks and the upcoming election could lead to a noteworthy shift in polices in the areas of immigration, security and taxation.

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:

http://www.raexpert.eu/reports/Press_release_Germany_23.09.2016.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.