Research Report on Germany

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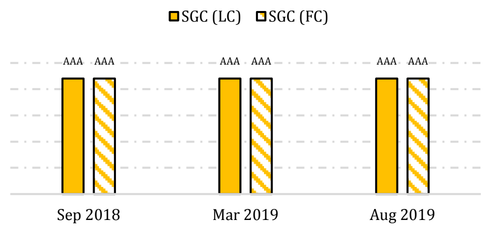
Ratings

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	2016	2017	2018
Gross gov. debt, EUR bn	2144	2093	2063
Nominal GDP, EUR bn	3160	3277	3386
Real GDP growth, %	2,2	2,1	1,4
Gross gov. debt/GDP, %	67,9	63,9	60,9
Deficit (surplus)/GDP, %	0,9	1,0	1,7
Inflation rate, %	1,7	1,5	1,7
Current Account Balance/GDP, %	-	-	7,4
External debt, USD bn	-	-	5611*

Development indicators	2018
Inequality adj. HDI	0,86
GDP per capita, USD th	52,5

Default indicator	30.08.2019
5-Year CDS spread, Bp	10,9
10Y Gov Bond Yield, %	-0,71

Source: RAEX-Europe calculations based on data from the IMF, WB, Destatis, UN, Bloomberg.
* 1Q 2019

Summary

The current confirmation of Germany's rating at 'AAA' with a stable outlook reflects a sustainable growth path of a highly diversified economy underpinned by the country's democratic and efficient institutions and deep integration into global value chains, which has contributed to a record low inflation, significant improvement in the external position along with an outstanding fiscal position and contracting public debt. Despite the low profitability of the banking sector, the country's financial system is reliable and one of the most developed in the world.

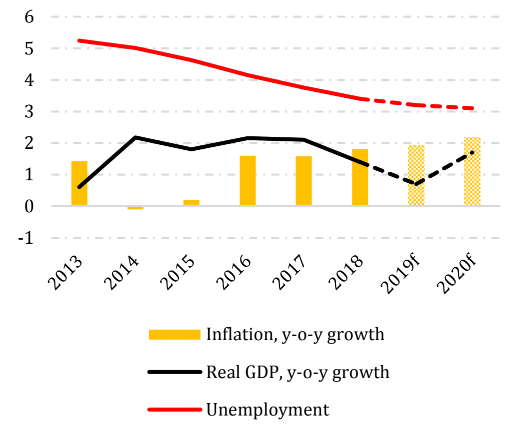
In the medium term, we believe the economy will be negatively affected by deteriorating global demand and trade conditions. Despite this, in our opinion, the government has more than enough fiscal buffers to partially mitigate these adverse conditions. Moreover, the country's creditworthiness will be under pressure from demographic and social factors in the long run without forcing a series of structural changes.

The growth of one of the world's strongest economies is decelerating. Germany's prosperity over the past decade has been underpinned by the high potential of a highly competitive export-oriented economy and stable macroeconomic environment. The progress resulted in one of the highest levels of real GDP per capita in PPP terms in the world at USD 52,9 th in 2018. In turn, subdued inflation persists and unemployment level slumped to a minimum 3,4% since the period of nation's reunification in 2018 (see graph 1).

The first signs of deterioration appeared in 2Q 2018 on the back of internal factors related to the shallowing of the main shipping lane - Rhine and issues in the automotive industry; furthermore, external demand for German exports weakened. However, the economy showed a still solid level of real GDP growth at 1,4% in 2018 due to robust domestic demand, construction and investments. In 2019, the economy continued to slow down gradually, reflecting weak external demand for manufacturing products. We estimate lower GDP growth at 0,7% for the year, while keeping the level of household consumption and government spending on infrastructure and social services.

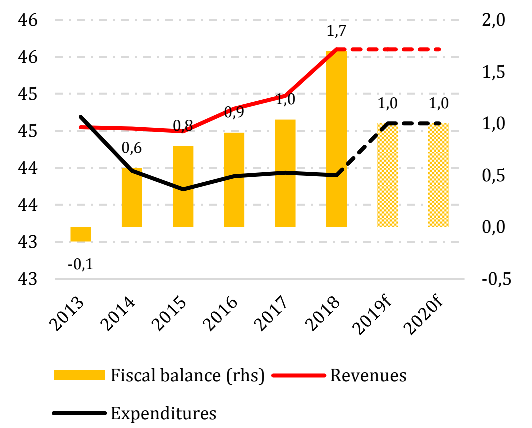
In the medium term, Germany faces critical demographic and social challenges, on which the dynamics of economic growth and resistance to external shocks largely depend. Above all, low birth rates, combined with

Graph 1: Macroeconomic indicators, %



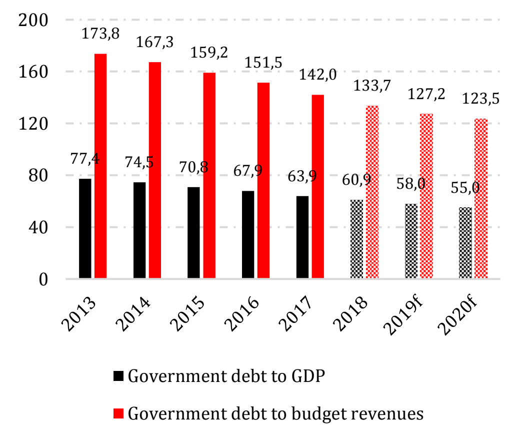
Source: RAEX-Europe calculations based on data from the IMF and Destatis

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

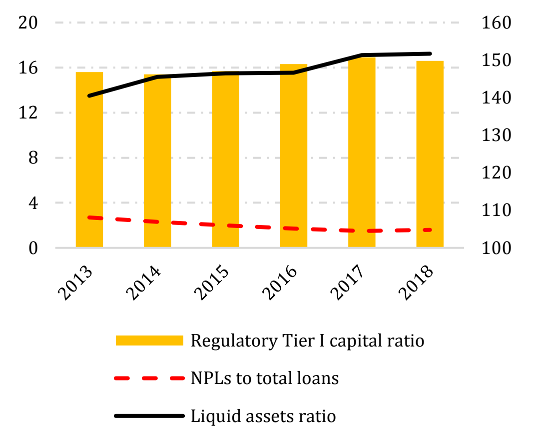
an ageing working population, will create a deficit in the skilled workforce and increase pension costs. Under the current dynamics, the able-bodied population may decline by 10% by 2035, which implies the need to stimulate birth rates and labor immigration. Another acute social challenge is the subdued disposable income of the middle and low classes, caused by the slow growth of wages over the past decade. Measures to reduce income inequality and activate purchasing power can support high consumer demand in the domestic market.

Outstanding fiscal stance and debt position. After a 5-year upward trend in 2018, the German budget surplus reached a record high of 1,7% of GDP, largely due to positive revenue trends and postponed government spending due to the lengthy process of forming a government coalition (see graph 2). Fiscal revenues to GDP rose to 45,6% in 2018, mainly driven by higher tax revenues, while a decrease in VAT proceeds amid weaker production exports was offset by a rise in domestic taxes. As a result, the fiscal policy was moderately conservative with allocation of surplus to the reserve funds.

2019 marks a transition to a moderately looser fiscal policy to stimulate a weakening economy, as well as investments in social services, new technologies and infrastructure. The political coalition reached consensus on measures to reduce the tax burden for low- and middle-income class with the aim of increasing the disposable income, such as child allowances and the basic tax allowances from 2019, as well as abolishing the solidarity tax for the majority payers from 2021. The projected mid-term fiscal stance allows the abovementioned initiatives to be implemented and the surplus to remain around 1% of GDP; moreover, the central and local governments have accumulated reserves. However, the authorities can limit the fiscal stimulus in the case of subdued tax revenue. In the long-term, the declining ratio of working to retired population will weigh on the government finances.

Prolonged public debt reduction, fostered by the favorable fiscal stance, culminated in a record low of 60,9% of GDP, slightly above the 60% threshold according to the Maastricht convergence criteria and the median of 58,9% for EU countries (see graph 3). An additional favorable factor for comfortable debt servicing is the current negative trend in government bond yields. Since the beginning of 2019, the yields on 10-year German bonds have been gradually declining and reached a low of -0,7% in August 2019, reflecting investors' increased expectations of ECB easing in the near term. As a result, the apparent average cost of debt[1] fell to 1,5% in 2018 and is one of the lowest in the EU.

Graph 4: Financial soundness indicators, %

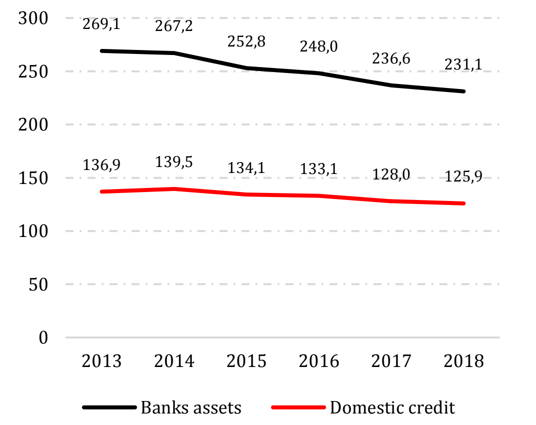


Source: RAEX-Europe calculations based on data from the IMF and Bundesbank

We anticipate that under the current macroeconomic environment, Germany's public debt will decline to less than 60% of GDP in the next few years, especially as the government does not intend to take new debt in line with its financial plan until 2023. The potential factor that could weigh negatively on public finances is the country's contingent liabilities, as the volume of state guarantees is one of the highest in the EU, about 13% of GDP, and the liabilities of state corporations - about 90% of GDP. However, IMF stress scenarios show that even in the event of macroeconomic shocks, the debt burden will not exceed the current level. In addition, the government's short-term obligations stand maintained at a comfortable 12% of GDP and 27% of budget revenues as of the end 2018.

In the medium term, the position of the country, where exports form almost half of the GDP, is under threat of increased foreign trade tensions, both due to the global recession and the possible consequences of Brexit and the increase in U.S. tariffs for European car products.

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



Source: RAEX-Europe calculations based on data from the WB and Bundesbank
* Forecast for 2018

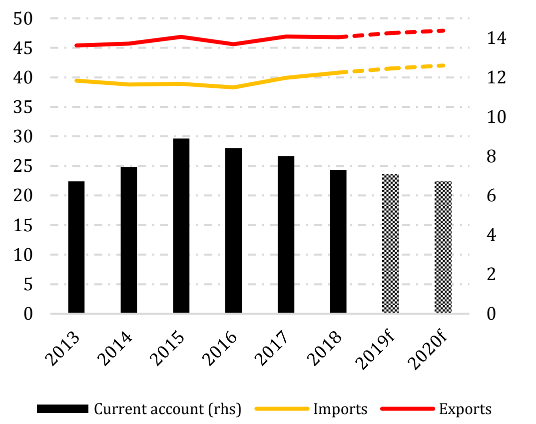
The banking system requires structural changes to raise profitability. Overall, Germany's banking system demonstrates strong liquidity, sufficient capital adequacy and sustainable funding. Tier I capital to risk-weighted assets ratio stood at 16,6% compared to 16,1% in the EU and the ratio of Liquid assets to total short-term liabilities was robust at 152% as of the end 2018 (see graph 4). The ratio of NPLs to total loans was half the Euro area average at 1,6% as of the 3Q 2018 and despite the increase in house prices, there are no signals of housing bubbles and deterioration of the quality of mortgages in the medium term.

The banking system continues to be constrained by low profitability, a lack of dynamism in the business models and outdated technologies that make it tough to compete with the growing Fintech and BigTech companies. ROA has been stable and positive fluctuating around 0,13% over the past 5 years; however, strong interest income dependency combined with excessive operating costs makes banks more vulnerable and provides little room for organic capital growth. At the same time, potential risks of contingent liabilities realization stem from the regional state-owned banks[2], which represent a quarter of the banking system's assets.

Although corporations' lending and mortgages growth accelerated last several years, the ratio of domestic loans to GDP continued in a long downward run, reaching 126% in 2018, compared to 165% at its peak in

[1] Accrued interest payable over the period as a percentage of the average outstanding debt
[2] *Landesbanken* and *Sparkassen*

Graph 6: External sector indicators, % of GDP



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

2010 (see graph 5). In addition, successful survival and further development will depend largely on the ability to consolidate small cooperative and saving banks, review existing business models, digitalization and increases in fee income.

On the background of export weakening, the external position remains confident. The current account surplus declined down to 7,3% of GDP in 2018 as a result of the exports' contraction and appreciation of the EUR against the currencies of the main trading partners, as well as increase in private investment; moreover, imports driven by domestic consumption grew confidently. Despite a downward trend of the current account surplus from 2015, the external position remains a key strength for the German economy with strong net foreign assets at 51% of GDP in 2018 (see graph 6).

In 2019, we anticipate further deterioration of the trade balance as manufacturing exports are likely to decline, both due to weakened global demand and under threat of worsening of the terms of trade caused by the possible 25% hike of car imports from U.S. and the disruption of long-standing relationships caused by Brexit. Nevertheless, the country has sound safety buffers and we assume that in the medium term the threshold of 6% of GDP set by the European Commission under the procedure of prevention and correction of macroeconomic imbalances will be further exceeded.

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_30.08.2019.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.