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Germany's AAA: for how much longer?

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How vulnerable Germany's top credit rating really is

After markets close tonight, Moody's, the credit-rating agency, will update its periodic assessment of Germany. S&P Global, previously known as Standard & Poor's, follows on October 23rd and Fitch on November 13th. Germany currently enjoys the best possible rating: AAA. In terms of school grades it is rather like an A+ with a gold star – and correspondingly rare. Since the financial crisis, the number of sovereigns rated AAA has nearly halved (see fig. 1).

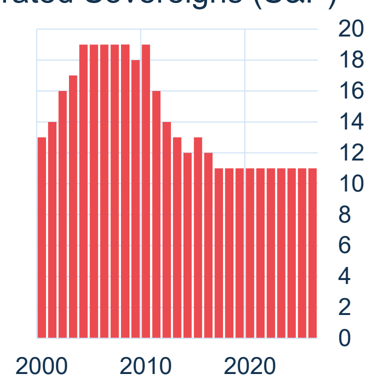
As Germany's deficits and debt mount and growth remains sluggish, financial markets are watching the agencies' assessments closely. I cannot remember a time when Germany's AAA rating has faced so much scrutiny. I should know: before joining LBBW, I spent almost 20 years overseeing sovereign ratings at S&P, most recently as its global chief sovereign ratings officer.

What exactly is a credit rating?

First, allow me to dispel a common misconception. Credit ratings are often seen as recommendations on whether a security is a sound investment, or whether its risk-return profile is favorable. They are not. A rating is solely an opinion on the likelihood that a borrower will default – that is, fail to repay its obligations in full, on time and in the agreed currency. Ratings merely establish a ranking rather than outright numerical probabilities: the lower the rating, the greater the probability of default. The rating scale ranges from AAA to CCC. In the latter category, default is, in effect, only a matter of time. Ratings are assigned by committees, usually comprising five analysts or more, taking decisions on the basis of a published methodology. In the committee the majority of votes decides the outcome.

Germany's AAA rating is facing growing scrutiny

Fig. 1: Number of AAA-rated Sovereigns (S&P)



Source: S&P Global, LBBW-Research.

The remaining AAA-rated sovereigns are Australia, Canada, Denmark, Germany, Liechtenstein, Luxembourg, the Netherlands, Norway, Singapore, Sweden and Switzerland.

The pillars of Germany's AAA rating

Germany's AAA rating has traditionally rested on three strengths:

1. The sustainability of its public finances;
2. Solid, export-led growth; and
3. The ability to master major economic-policy challenges – most notably the economic and fiscal consequences of reunification after 1990.

It is hardly surprising that ballooning budget deficits and lackluster economic momentum have raised questions about the rating. Germany's capacity for reform also appears to have diminished amid growing social polarization. Germany is not alone in this, but concerns over the AAA are not pulled out of thin air.

Germany's strengths are waning

What could spell the end of the AAA

The agencies are fairly transparent in identifying the risks that could trigger a downgrade. One such trigger would be if the fiscal push failed to generate stronger economic momentum. In late April, S&P wrote that Germany's rating would come under pressure if economic performance fell "significantly" short of expectations.

Growth will be decisive

If reforms and investment fail to kick-start growth, the risk of a downgrade will rise. It is worth noting that S&P assumes growth of 1.4% for each of the next two years. Moody's expects as much as 1.5% in 2027. That is ambitious. LBBW Research is markedly more cautious, forecasting growth of less than 1% for 2027.

A negative outlook would probably come first

The rating is likely to hold in 2026

In my experience, a downgrade is not imminent. Agencies would typically first revise the outlook on a rating to negative – a formal warning that can remain in place for up to two years. Historically, at S&P Global, a negative outlook led to an actual downgrade in nearly 60% of cases.

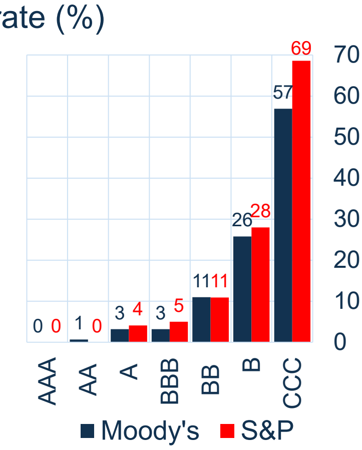
As Germany's recent economic data have surprised on the upside, I do not expect the agencies to revise Germany's outlook to negative in 2026, let alone downgrade the rating. But should the economic outlook weaken again, it will become increasingly difficult for them to justify the AAA.

The political and financial consequences of a downgrade

Losing the top rating would above all be a political embarrassment. A downgrade by the agencies would likely play further into the hands of parties on the political fringes that claim they could do better. Yet capital markets offer life after AAA.

Investors understand that the default probabilities implied by AAA and AA ratings are barely distinguishable and have historically been close to zero (fig. 2). The adverse effects on Germany's borrowing costs should therefore remain manageable.

Fig. 2: 10-year default rate (%)



Source: S&P, Moody's, LBBW-Research
Default rates up to ten years after the rating was assigned.

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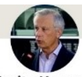

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