COUNTRY RISK ASSESSMENT FOR THE FEDERAL REPUBLIC OF GERMANY

Patrick Sebastian Oliver Ertelt

UNITAR International University

Abstract

This paper provides a country risk assessment analysis for the Federal Republic of Germany, with a particular focus on the sections about risk and vulnerabilities, banks, and real estate. The analysis highlights key data, such as Germany's primary export products and its trading partners. It discusses the impact of special military operation on German exports and the shift in gas imports from Russia to other countries. The paper also examines the response of companies and households to the natural gas shortage, including energy efficiency measures and reduced gas consumption. It discusses the pressure on businesses due to increased financing costs and wage increases. The analysis projects an increase in consumer prices in 2023 and discusses the impact of international commerce and the recovery of China on global commodity demand. The paper also addresses the German government's support measures in response to the energy crisis and the country's fiscal situation.

Keywords

Country risk assessment, Germany, risk and vulnerabilities, banks, real estate.

KEY DATA

In 2022, motor vehicles and their parts accounted for 15.6% of Germany's exports, making them the country's primary export product. Machinery (13.3%) and chemical products (10.4%) ranked second and third, respectively, among the most essential exports [1]. According to preliminary data, exports and imports between Germany and the People's Republic of China totaled 298.9 billion euros in 2022. The Federal Statistical Office (Destatis) reports that for the seventh consecutive year, the People's Republic of China was Germany's most significant trading partner in 2022. The United States came in second with a volume of 248.7 billion euros, followed by the Netherlands in third with a volume of 230.0 billion euros. Since the beginning of Russia's attack on Ukraine, German exports to the CIS countries (Commonwealth of Independent States, excluding Russia) have increased significantly. From January to April of 2023, goods worth 2,9 billion euros were exported to the CIS countries. The Federal Statistical Office (Destatis) reports that exports to these nations increased by 1.5 billion euros and more than doubled (+106.4%) compared to the same period in the pre-war year of 2021 (1.4 billion euros). In contrast, exports to the Russian Federation fell from 8.4 billion euros in the first quarter of 2021 to 3.5 billion euros in the first quarter of 2023. This represented a decrease of 58.3%, or 4,9 billion euros. Therefore, the increase in exports to the CIS countries was less than a third of the decline in exports to Russia [2].

Table 1

Key facts about Germany

GDP	4072 billion dollars (World Bank, 2022)
Population	84.4 (Destatis, 2023)
Form of State	Federal Republic
Head of State, Head of Government	Dr. Frank-Walter Steinmeier (Federal President), Olaf Scholz (Federal Chancellor)
Next elections	2025 (federal and legislative)

Sources: World Bank Open Data, available at: https://data.worldbank.org (Accessed 23 May 2023).
Federal Statistical Office. Current population, available at: https://www.destatis.de/EN/Themes/Society-Environment/Population/Current-Population/_node.html (Accessed 23 May 2023).

ECONOMIC OVERVIEW AND TRENDS THE GERMAN ECONOMY IS STRUGGLING

In 2023, the German economy is expected to stagnate due to the fact that many hazards from 2022 have transferred into the current year. Supply chain chokepoints are one of these dangers. Even though these risks will have diminished significantly by the end of 2022, reciprocal sanctions between the EU and Russia will continue to impact on intra-European goods trade. In addition, the rapid spread of Covid-19 in China at the start of 2023 hampered supply chains. The energy supply, particularly natural gas, poses the greatest threat to the supply chain. Before the explosion at the Nord-Stream I and II pipelines at the end of September 2022, Russia held a 35 percent stake of German gas imports. Since then, the volume of total gas imports decreased by 38% in the spring of 2023 compared to the spring of 2022, and the distribution among supplier nations has shifted. The Czech Republic ceased gas exports to Germany, whereas the Netherlands, Belgium, and, to a lesser extent, Norway increased theirs. In Germany, the first three floating LNG terminals were constructed between late 2022 and early 2023, but their import capacity remained very low in spring 2023. Over the course of 2023, an additional three LNG terminals should be added, which, by the end of 2023, should provide up to half of the previous Russian gas supply, with total German gas imports remaining 16% below pre-war levels. Companies and households have responded to the natural gas shortage. After the price increase, businesses turned increasingly to energy efficiency and cost-cutting measures, while private households reduced their heating. The moderate temperatures, with the exception of a few isolated weeks, reduced gas consumption in December and January by nearly 20% compared to the average of the previous four years (Quelle: Bundesnetzagentur: Rückblick: Gasversorgung im Jahr 2022). This has assisted in maintaining very high gas storage levels (64% in late March 2023 compared to 26% at the same time in 2022), thereby preventing significant production cuts or even temporary shutdowns in German industry, such as the chemical and steel sectors [3]. In spite of this, pressure on businesses will remain elevated in 2023. Due to the change in European Central Bank (ECB) monetary policy, European companies face increased financing costs, which is a significant factor in this regard. The European Central Bank (ECB) raised its primary refinancing rate by 250 basis points to 2.50% in 2022 and another 100 basis points in early 2023 [4]. A further increase of 50 basis points is anticipated. In addition, monetary policymakers determined that, beginning in March 2023, the ECB balance sheet will be reduced by €15 billion per month.

In the third and fourth quarters of 2023, it is highly probable that these planned cuts will increase. Moreover, companies will be forced to pay greater wages. In 2023 and 2024, tariff-wage negotiations that concluded in late 2022 resulted in a 7% increase distributed in one or two stages [5]. Early in 2023, unions demanded approximately 10% wage increases for one year, which led to several disturbances in the public sector. While a portion of these additional company costs may be absorbed by margins, a sizeable portion will still result in price increases. While not as pronounced as in 2022, consumer prices are projected to increase in 2023 to levels above their long-term average. Therefore, the situation for households should continue to be difficult, but will be somewhat ameliorated by a persistently robust savings rate (11.2% in 2022, slightly above the pre-pandemic level) and a persistently robust labor market, where employees' bargaining power has increased due to the lack of skilled workers. This will promote personal consumption. At least in Western Europe, international commerce should remain subdued during the first six months of the year. Nonetheless, China should gradually recover in the latter half of 2023. Consequently, the global demand for commodities will increase, which will once again contribute to higher prices in this category, as well as an increase in the demand for German goods [6], [7], [8].

FOURTH CONSECUTIVE YEAR OF GENERAL FUND DEFICIT

In response to the energy crisis, the German government has enacted a number of support measures for private households and energy-intensive businesses through 2023. The primary initiative is a €200 billion package that went into effect in March 2023 and includes a gas and electricity price cap [9]. However, as a result of the decline in global energy prices, the ultimate cost of these measures may be significantly less than anticipated. In addition, rising inflation, sales, and incomes may result in increased state tax revenues. Consequently, the German public deficit should continue to be close to the Maastricht criteria objective.

The surplus of Germany's current account should increase slightly. Import prices, which are primarily influenced by energy costs, should fall on average, improving the trade surplus. It is anticipated that the balances of services (deficit), investment income (surplus), and current transfers (deficit) will experience only minor adjustments.

THE FIRST THREE-PARTY GOVERNING COALITION IN GERMAN HISTORY SCRAPES BY

Olaf Scholz (Social Democrat, SPD) is presiding over the first federal tripartite coalition in German history, which consists of the SPD (206 of 736 seats in Parliament), the Greens (118 seats), and the FDP (92 seats). The Russian military operation in Ukraine at the beginning of the coalition compelled the government parties to change their political posture, frequently in direct opposition to their ideology. In the 1980s, the Green Party, which grew out of the peace and anti-nuclear movements, supported military aid and opposed direct armament deliveries to Ukraine. Moreover, Minister of the Economy Robert Habeck (Greens) visited Middle Eastern countries such as Qatar to secure additional natural gas supplies for Germany (despite reservations regarding the country's human rights record). Habeck also agreed with Chancellor Scholz's decision to extend the lifetime of nuclear power facilities by a few months. On the other side of the political spectrum, liberal Finance Minister Christian Lindner (FDP) announced more support programs for the population to manage with higher energy prices, funded by an increase in public debt, as well as a cap on gas prices, thus interfering with the free market. In spite of their pragmatic approach to politics, coalition parties have lost support in the surveys. As a result of the fact that all parties are attempting to reach a compromise and there are no viable alternatives, the coalition appears stable and should last until the September 2025 election.

NO RETURN TO THE 2% TARGET BY 2024

The inflation projections for 2022 and 2023 to 8.5% and 6.2% can be seen as increased respectively. The steep increase in inflation is primarily attributable to the rapid increase in energy and food commodity prices. However, core inflation appears likely to stabilize significantly above average. Over the forecast horizon, commodity-price increases and supply-chain constraints are anticipated to diminish. Nonetheless, labor cost pressure will remain high, and the green transition will incur additional expenses. Inflation will decline significantly overall, but both headline and core inflation will remain above 2% in 2024 [10].

OFF-BALANCE-SHEET EXPENDITURES ARE DEVELOPING RAPIDLY, ACCORDING TO THE ECONOMIC FORECAST

As a result of Russia's military operation in Ukraine, the German government announced significant fiscal measures to combat the energy crisis. In an effort to pursue a prudent underlying fiscal stance consistent with the domestic debt brake, the German government has amassed approximately

EUR400 billion in off-balance sheet spending (EUR100 billion for military upgrade, EUR200 billion to subsidize energy prices, and EUR100 billion for climate investments). In 2023, a robust increase in tax revenues will help ameliorate the fiscal situation. After reaching 3.6% in 2021, it is reasonable to anticipate the budget deficit to average around 3% over the forecast horizon. The ratio of government debt to GDP will likely stabilize just below 70% [10].

RISK AND VULNERABILITIES

The first table below highlights the results of small and medium-sized enterprises (SMEs) amidst the robust pre-pandemic performance of the NFC sector in Germany. In the 10 years between the Global Financial Crisis and the beginning of the pandemic in 2020, Germany's NFC (Nonfinancial Corporations) sector averaged slightly better results than in the 11 years prior to the GFC, which included the Asian financial crisis and the recession in advanced economies caused by the bursting of the dot-com stock bubble. During 2010-2019, the average financial performance of large companies was somewhat weaker than that of the SME sector in terms of sales percentage and return on assets. (KfW 2020) [11]. The German national development bank Kreditanstalt für Wiederaufbau (KfW) deems the period 2010-2019 a «bright decade for German SMEs.»

Table 2

Profitability of Nonfinancial Corporations, 1997 - 2019

	1997 - 2007	2010 - 2019
Annual result before taxes on income (percent of sales)	4.0	4.2
Large companies	3.8	3.4
Small and mid-sized companies (SMEs)	4.1	5.7
Return on assets (in percent, after tax)	4.2	4.5
Large companies	3.7	3.4
Small and mid-sized companies (SMEs)	5.0	6.9

Sources: IMF staff calculations, available at: https://www.imf.org/en/Publications/CR/Issues/2022/07/19/Germany-Selected-Issues-521023 (Accessed 09 July 2023).
Deutsche Bundesbank staff calculations. URL: https://www.bundesbank.de/resource/blob/885944/4ce9fac781237b852c07fd64f862c00a/mL/2021-annual-report-data.pdf (Accessed 11 July 2023).

In the years preceding the pandemic, the sustained improvement in SME profitability was primarily attributable to robust performance outside the manufacturing sector (Figure below). Since the Great Recession, the return on assets (RoA) of small and medium-sized enterprises (SMEs) has increased while the RoA of large corporations has fluctuated around the long-term average of 3.5 percent. The widening performance gap was most pronounced outside of the manufacturing industry. During the decade preceding the pandemic, small and medium-sized enterprises (SMEs) in the manufacturing sector attained a higher RoA than their larger counterparts, but the gap between the two remained relatively stable at 1.5 percentage points. Despite a slight decline in its proportion of sales and profits, the manufacturing sector continues to represent a significant portion of the NFC sector's total assets and a significant portion of the sector's liabilities to banks [12].

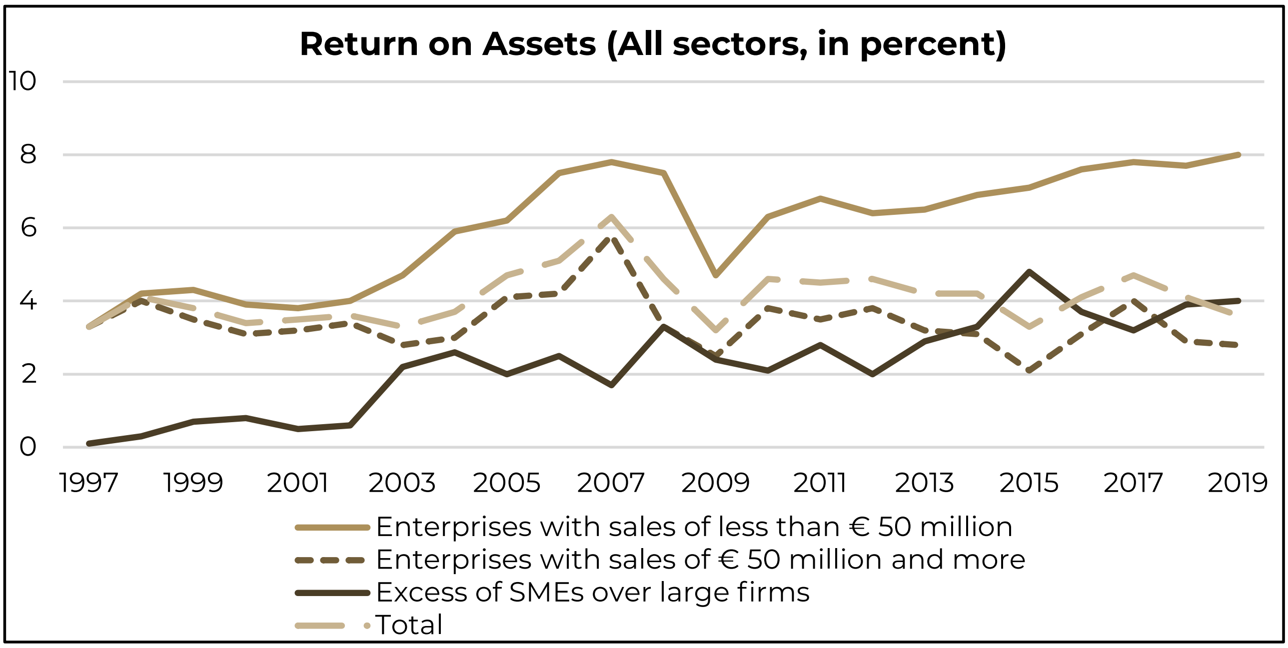

Fig. 1. Return on Assets (All sectors, in percent).

Source: Deutsche Bundesbank, available at: https://www.bundesbank.de/resource/blob/885944/4ce9fac781237b852c07fd64f862c00a/mL/2021-annual-report-data.pdf (Accessed 09 July 2023).

The resilience of the NFC sector combined with the various support measures instituted by the government helped the sector weather the pandemic relatively well.

· According to data for 2020 presented in Deutsche Bundesbank (2021), the total income of NFCs decreased by €220 billion, or 3.1%. However, enterprises' total expenses prior to income taxes decreased by the same amount. The annual result before taxes on income remained essentially unchanged at 4.1 percent of sales despite a decrease in profits before taxes of 3.8%. In accordance with this, data from KfW's SME panel of 9,889 enterprises with an annual turnover of less than €500 million suggests that, on average, the return on sales of SMEs has remained largely unchanged. However, the tiniest SMEs appear to have experienced the most difficulty. They have exhausted their reserves. Insofar as they operate in industries for which 2021 was also a problematic year, buffers may have shrunk.

· The distribution of RoA for listed NFCs fell to levels last seen during the Great Recession. But the decline in RoA in 2020 is less severe than during the recessions caused by the bursting of the dot-com mania in 2000/01 and the Great Financial Crisis in 2008/09. The downward trend exacerbated a decline that began in 2018, when many export-oriented companies were affected by China's weakening demand. Profits for listed nonfinancial organizations monitored by the Bundesbank declined [13].

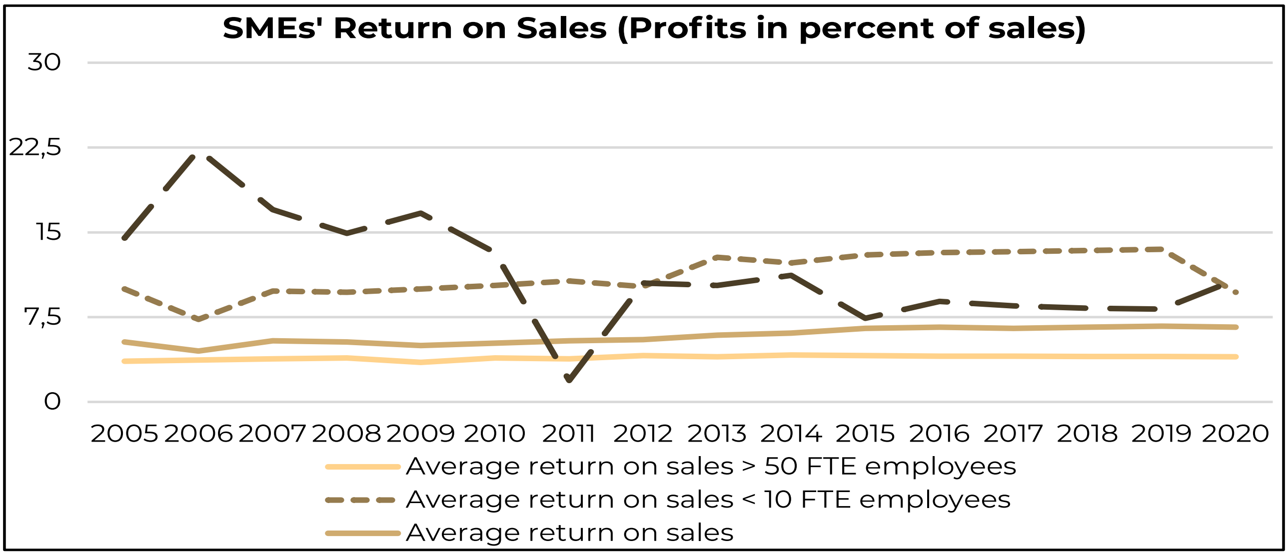

Fig. 2. SMEs' Return on Sales (Profits in percent of sales).

Source: KfW SME panel (enterprises with turnover < € 500 million), available at: https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-KfW-Mittelstandspanel/PDF-Dateien-Mittelstandspanel-(EN)/KfW-SME-Panel-2020_en.pdf (Accessed 08 July 2023).

On the eve of the pandemic, the overall ICR (interest coverage ratio) distribution of publicly traded companies was greater than in the preceding two decades. Despite the fact that the 25th percentile of firms has already turned negative in 2019, as a number of firms' fiscal years begin in the previous calendar year. Additionally, it should be noted that not all news regarding NFC operations in 2020 was negative. Of the 57 listed firms with an ICR below 1 in 2019 that were also included in our 2020 sample, 17 firms with a total debt of €17.5bn saw their earnings increase in 2020, pushing their ICR above 1. These companies operate in novel or more recession- resistant industries, such as (solar) energy, telecommunications, food, pharmaceuticals, e-commerce, construction, and the production of salt and sugar. Utilizing the generally lax domestic and international financing conditions, businesses have improved the maturity profile of their debt. At the aggregate level, rollover risks have become more contained as the proportion of short-term debt has decreased.

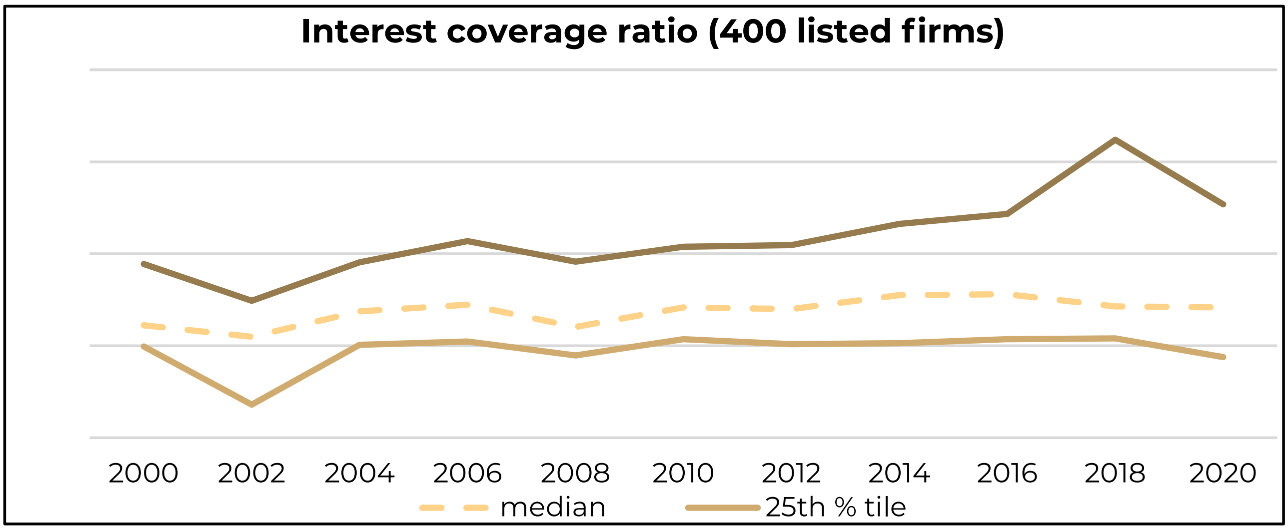

Fig. 3. Interest coverage ratio (400 listed firms).

Source: IMF Corporate Vulnerability Utility, available at: https://www.elibrary.imf.org/downloadpdf/book/9781616352028/ch007.pdf (Accessed 11 July 2023).

BANKS

In international comparison, the profitability of the German finance system is relatively low. In 2020, German banks reported lower returns on total assets, risk-adjusted assets, and equity (ROE) than EU averages. In 2020, the aggregate ROE of German banks fell short of the estimated cost of capital by European banks, which ranged from 8 to 12 percent. This is the result of both cyclical and structural factors. Low interest rates have reduced the net interest incomes of German retail banks, while efforts to increase fee and commission income have been hampered by customer risk aversion, a preference for savings products over asset management products, limited customer experience with fee-based products, and intense bank competition.

The aggregate profitability figures conceal significant heterogeneity among the various categories of banks. Savings banks and cooperatives have performed better than private banks, but the profitability of all bank groups has declined over time due to the effects of low interest rates. This is due in part to the difficulty and protracted implementation periods of private banks' restructuring plans to address the effects of the global financial crisis. The higher profitability of savings and cooperative banks is largely attributable to increased lending volumes (including to real estate) and a regional focus that shields them from intense competition, resulting in a substantial increase in their market share in lending to households and businesses (especially SMEs) [14].

Rising risks and vulnerabilities threaten the business models of savings and cooperative banks and necessitate ongoing risk monitoring. Until now, increased lending, particularly for residential and commercial real estate, has helped cooperative and savings banks increase revenues and partially counterbalance declining interest rates. In the future, however, rising risks and vulnerabilities in the German banking sector, especially in real estate, threaten the viability of such business models and the ability of banks to continue to generate profits. Despite this, BaFin has implemented a macroprudential policy package, which includes a sectoral systemic risk buffer for RRE exposures. Other hazards, such as those resulting from changes in interest rates, slow digitalization, cyber threats, and geopolitical developments, are also on the rise. Therefore, efforts should be accelerated to acquire data on bank exposures to various risks.

REAL ESTATE

Since the beginning of the present upswing in the German RRE market in 2010, RRE prices have increased by approximately 91% by the end of 2021, a rate faster than in many other OECD countries. Prior to 2009, nominal RRE prices in Germany increased by approximately 25 percent between 1990 and 2009. The current upswing in the RRE market began in 2010 and persisted throughout the COVID-19 pandemic, with nominal (real) house prices increasing by approximately 91 (63%) percent between 2010 and 2021 [15]. In the seven largest cities, RRE prices increased by approximately 144 percent between 2010 and 2021, outpacing most other cities in the world. The most rapid price growth in the German RRE market was observed in the most populous cities. Specifically, residential property prices in the seven greatest cities increased by 144 (109) percent nominally (real) from 2010 to 21 [16]. The COVID-19 pandemic caused divergent dynamics in the RRE and CRE markets, with some CRE subsector price declines [17]. While RRE prices in Germany continued to rise through the end of 2021, CRE prices declined significantly since the onset of the COVID-19 pandemic, albeit with significant heterogeneity across property types [18]. In 2021, CRE prices will decrease by 0.8%, compared to an increase of 6.4% in 2019. After declining in 2021H1, average office prices increased by 0.2 percent in

2021 (9.6 percent in 2019), whereas retail property prices (mostly nonfood) have continued to decline (-3.1 percent in 2021) since late 2018 due to competition from e-commerce, which was exacerbated by the COVID-19 pandemic [14]. The performance of CRE sub-sectors also varies by location, with prices increasing the most in prominent locations in larger cities. There is significant heterogeneity not only between subsectors but also by location within the CRE industry. For example, office properties in prominent locations in larger cities performed better – even after the COVID-19 outbreak – than properties in less populous areas, which experienced stagnation or outright price decline. Food-related properties, especially in prime locations, have been in greater demand than non-food-related properties, such as shopping malls, which have been struggling for several years due to the shift in consumer preferences toward online shopping. The COVID-19 pandemic further exacerbated this trend.

CONCLUDING REMARKS AND RECOMMENDATIONS

1. Economic Stability: Germany's economy, the largest in Europe, is widely robust and secure. This makes it a desirable location for international investors. However, the analysis identifies potential hazards, such as chokepoints in the supply chain and reciprocal sanctions between the EU and Russia. Businesses should be advised to closely monitor these risks and develop contingency plans to mitigate their effects.
2. The analysis focuses on the financial performance of German small and medium-sized enterprises (SMEs). While SME profitability has improved, there are still vulnerabilities, particularly in the manufacturing sector. To mitigate risks, it is recommended that small and medium-sized enterprises diversify their operations and investigate opportunities outside the manufacturing sector.
3. The analysis also reveals that the profitability of the German financial sector is relatively low in comparison to international norms. Profitability is affected by a number of factors, including low interest rates and fierce competition. It is suggested that banks investigate innovative strategies to increase fee and commission income and enhance efficiency in order to increase profitability.
4. The analysis furthermore points to a significant price growth in the residential real estate (RRE) market in Germany, especially in the largest cities. However, the commercial real estate (CRE) market exhibits divergent dynamics, with some subsectors experiencing price declines. It is recommended that investors and market participants thoroughly evaluate the risks and opportunities in various sectors and locations.
5. In conclusion, despite the fact that Germany provides a stable and alluring business environment, risks and vulnerabilities must be considered. To mitigate risks and maximize opportunities across multiple sectors, thorough risk assessments, diversification strategies, and innovative approaches are advised. Businesses and policymakers must continuously monitor economic trends and potential hazards in order to make informed decisions and adapt to changing conditions.

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About the author:

Patrick Sebastian Oliver Ertelt – independent consultant, UNITAR International University, Germany.

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