Multiple shocks are driving record-high growth in new lending to businesses

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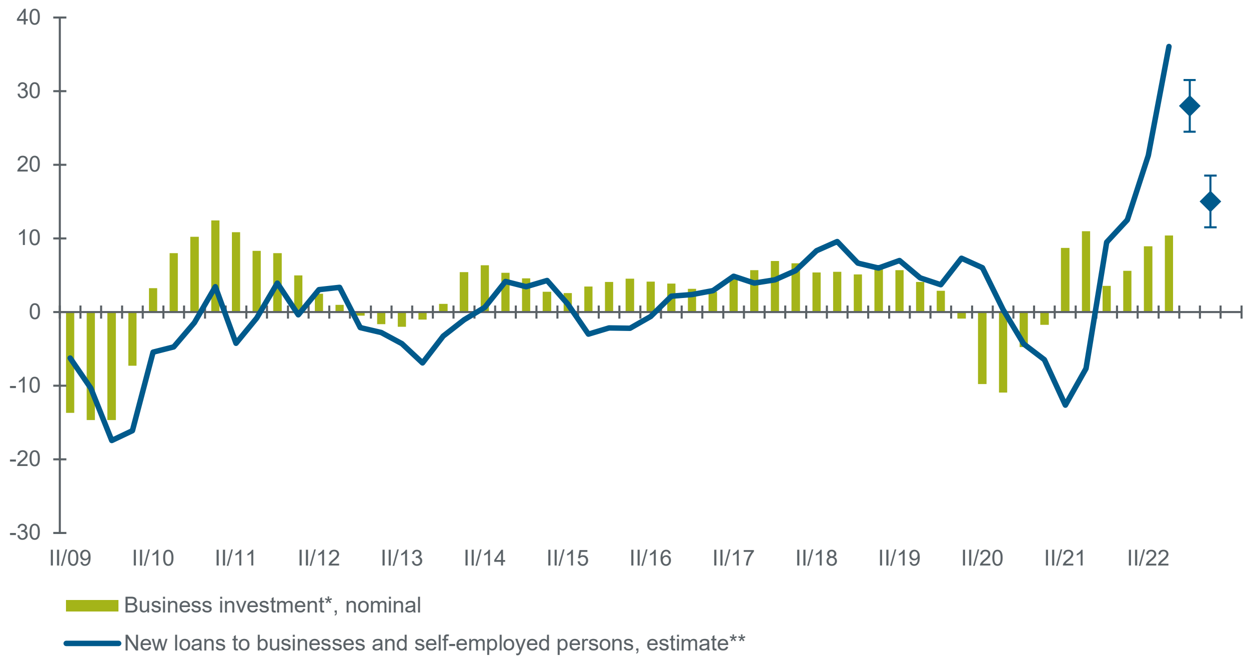
– In the third quarter of 2022, new lending from banks to businesses and self-employed persons reached a new record-high year-on-year growth rate of 36.1%. Higher procurement costs and the energy crisis in particular have resulted in increased financing requirements.

– Credit access appears to be intact despite multiple macroeconomic challenges. Energy companies benefited considerably from government guarantees.

– Further strong but slower growth of around 28 and 15% is to be expected for Q4 2022 and Q1 2023. Lower investment activity due to subdued economic conditions and higher financing costs will be the main factors dampening credit demand. Predictably tightening lending policies are likely to slow the growth in new lending on the supply side as well.

Figure 1: New lending by German banks and savings banks to domestic businesses and self-employed persons*

Variation on the previous year (moving two-quarter average), in per cent



* non-public investment in equipment, industrial buildings and other facilities

** excluding commercial housing loans and excluding loans to financing institutions and insurance industry

Multiple shocks are influencing credit demand in the **short term**

According to calculations by KfW Research, new lending to businesses and self-employed persons in Germany grew by a new record rate of 36.1% in the third quarter (see Figure 1). That was an increase of nearly 15 percentage points on the second quarter. Much of the strong growth in lending in 2022 was due to the high economic uncertainty that characterised the year. It was mainly driven by factors associated with high credit demand. For one thing, the need to accumulate higher stockpiles because of persistent supply chain issues is causing higher costs and creating increased financing requirements for many businesses. For another, the war in Ukraine in particular is causing severe disruptions. The Deutsche Bundesbank’s 2022 Financial Stability Report states that in the past, the cost of energy and raw materials as a proportion to production value was significant in only around 5% of German businesses. At present, however, these costs are a considerable burden on large parts of the business sector. In addition to direct cost increases from more expensive energy, indirect effects are also having an impact. Higher costs of inputs, for example, are driving prices. The sharp increase in producer prices in the course of the year reflects this clearly. Energy companies are particularly affected and therefore face enormous financing requirements as well. In order to ensure gas supplies, the Federal Government is providing guarantees for loans to these enterprises through KfW in substantial volumes. To be sure, the loans from KfW account for a tangible share in new lending business but that does not in any way change the basic observation of high financing requirements driven by multiple shocks. Loans aimed at mitigating cost-driven financing requirements, however, are only a temporary tool for businesses. The resulting credit demand can therefore be expected to decrease again in the foreseeable future.

In the longer term, supply-side friction will slow lending

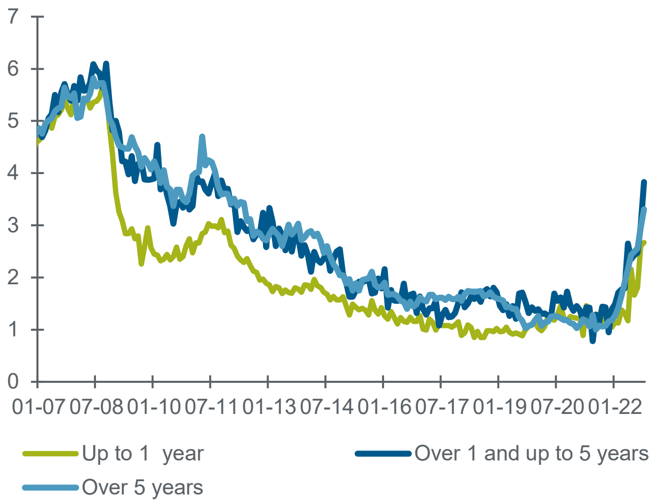
Despite the government's crisis response, the sharp increase in new lending indicates that credit access remains intact for the business sector. In the coming quarters, however, banks will focus even more on the quality of borrowers, which is dependent on various factors. What is crucial is how strongly the economic slowdown in 2023 will impact on the creditworthiness of the business sector. Furthermore, it must be expected that money market interest rates will rise to more than 3% this year as a result of continuing monetary tightening. This will also be mirrored in lending rates (see Figure 2). The trend reversal in the credit market is thus likely to emerge primarily from the supply side.

Current surveys already reflect this. The banks surveyed under the October Bank Lending Survey (BLS) indicated that increasing fear of recession, the sector- or company-specific situation and a generally decreasing risk tolerance have had a significant effect on credit standards. In a historical retrospective, the tightening of credit standards in Q3 2022 was even slightly above the level observed at the very start of the COVID-19 pandemic. Credit standards are still below the peak levels observed during the financial crisis in 2008 and the euro area sovereign debt crisis.

An increase in corporate defaults this year cannot be ruled out. To be sure, the number of insolvencies is on a historically low level despite a moderate rise since the end of 2021. However, it will take time for the massive cost increases of 2022 to filter through to company balance sheets. This affects not just energy-intensive businesses but also those that are grappling with high cost increases in a highly competitive environment. The potentially growing burdens in the business sector are therefore associated with a trend towards higher valuation adjustments and write-downs on the part of debt capital providers. Beyond the current crisis, the structural transformation might also contribute to higher loan defaults. The gas crisis highlights that certain business models would continue to be profitable only if prices of fossil fuels no longer had to be factored in in the future. State support measures cannot obscure this in the long term. Banks will take a closer look at these businesses in particular before renewing their loans to them.

Figure 2: Credit interest rates for non-financial corporations

Effective interest rates on new loans from banks by maturity



Source: MFI database, Deutsche Bundesbank

Credit demand weaker in Q4 and 2023

We expect that the peak of new lending to businesses and self-employed persons was reached in the third quarter. We predict growth rates of around 28 and 15% for Q4 2022 and Q1 2023. Lower investment activity due to subdued economic conditions and increased financing costs are likely to dampen credit demand. It must also be anticipated that banks' tightened lending policies will increasingly put the brakes on growth in new lending. A major risk for this forecast is the development of the COVID-19 pandemic in China, which may lead to a renewed worsening of supply chain problems.

The structure of the KfW Credit Market Outlook

New lending business is determined by adding to the quarterly variation of existing loans (data from the Deutsche Bundesbank on loans extended by German banks to domestic enterprises and self-employed professionals without housing construction loans and without loans to financial institutions and the insurance industry) a simulated on-schedule repayment behaviour (per quarter). The publication is presented in the form of the thus determined new lending business variation rate against the prior-year quarter, with the variation rate expressed as the moving two-quarter average. The forecast of new lending business is performed on the basis of the VAR model in which GDP, the twelve-month money market rate and business investments are taken into account as the most important explanatory variables. Business investments comprise all non-public investment in equipment, industrial buildings and other facilities. They are calculated by KfW quarterly on the basis of the national accounts data from the Federal Statistical Office and, using leading financial and economic indicators, are projected into the future with the aid of a vector autoregressive model.