KfW Research

KfW Credit Market Outlook: April 2017

››› Credit market ended the year on a conciliatory note

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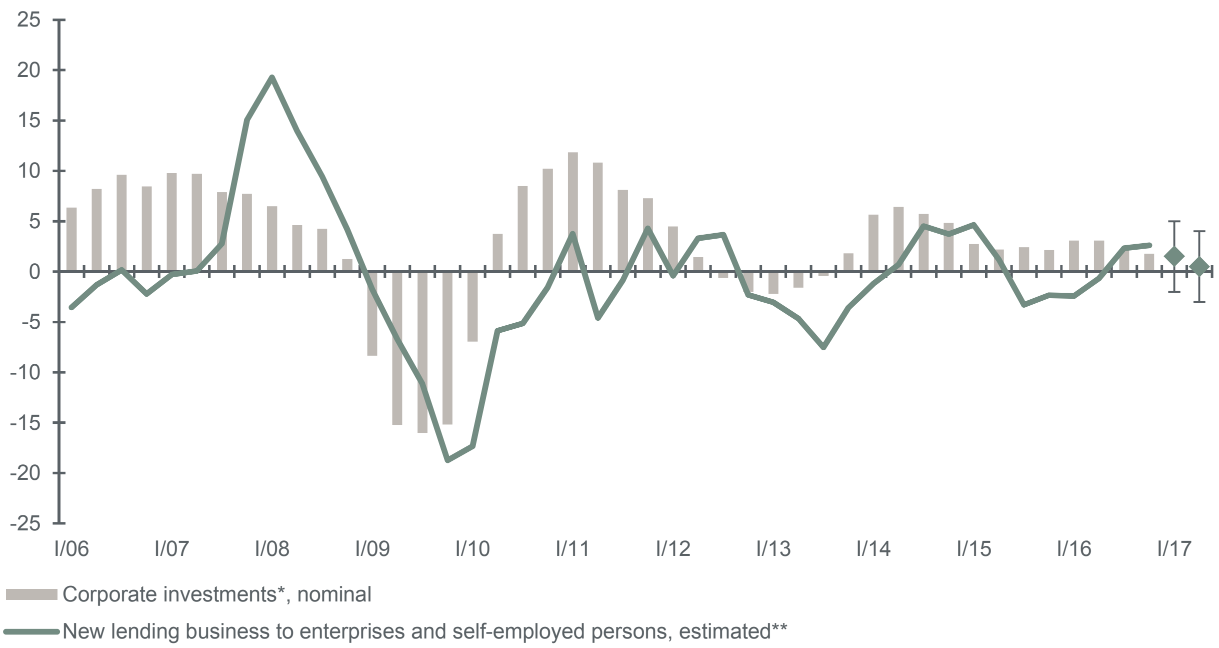
- Towards the end of the year, new lending to enterprises and self-employed persons (as defined by KfW Research) gained momentum, growing by 2.6 % year-on-year in the final quarter of 2016.
- The intensified debate over rising borrowing costs boosted credit demand temporarily. This was built on the interest rate reversal in the USA, economic optimism, and the gradual normalisation of inflation.
- The credit market should be able to take this momentum into the first half of 2017 as well. However, we do not expect a sustained, strong recovery. Given the unusual political risks, businesses will likely remain reluctant to make decisions on investments.

New lending by German banks to domestic businesses and self-employed persons*

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



* non-governmental investments in equipment, commercial buildings and other products
** excludes commercial housing loans and loans to insurance and financial institutions

New lending business grew in the final quarter

KfW's estimates indicate that new lending from banks to businesses and self-employed persons (excluding residential construction and financial institutions) rose by 2.6 % in the final quarter of 2016 compared with the same period last year (moving growth rate across two quarters). Businesses' stronger appetite for debt was not accompanied by increased investment momentum, however. On the contrary: adjusted for prices, fourth-quarter business investment declined for the third quarter in a row. That corroborates our view that the improvement in the credit market is a temporary phenomenon that is primarily due to expectations of a renewed rise in borrowing costs further ahead.

Businesses no longer rule out rising interest rates

Even before the US elections, the Federal Reserve was expected to continue the ongoing normalisation of monetary policy on the back of the strong labour market. These expectations were confirmed by the two benchmark interest rate increases in December and March. At the same time, the hope for a growth-friendly economic policy by the new US administration nurtured economic optimism also in Europe. Since then, the yields on long-term government bonds in Europe have recovered significantly from their lows of late summer 2016. In addition, the threat of deflation in the euro area has decreased noticeably. As a result, public speculation over a monetary policy trend reversal in the monetary union has picked up as well. These developments may have encouraged businesses to meet foreseeable funding needs sooner rather than later.

Borrowing conditions remain excellent

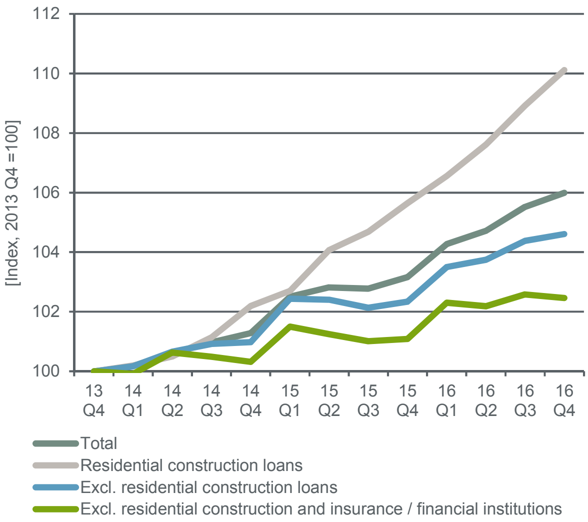
This is all the more true as actual average borrowing costs have continued trending downwards thus far. They reached a new record low of just 1.7 % in January. According to the 'Bank Lending Survey', the remaining borrowing conditions also developed favourably for German businesses in the final quarter. This was particularly true of the loan covenants.

Outlook: Investments remain the Achilles heel of new lending business

Business investment levels have already disappointed in the past two years. Despite the positive economic situation, businesses borrowed little to future-proof their operations. This cautious approach will probably change little in 2017 as well. Business confidence levels are very high, the economy is on track and capacity utilisation is rising. Nevertheless, the unusual political risks that emerged some time ago have not diminished and are making long-term planning difficult. They include, in particular, uncertainty over the shape of future economic relations with the USA and the UK, which both are important partners of Germany. This environment and German businesses' high internal funding capacity give us no reason to expect the credit market to eventually break out of the sideways movement that has been observable since 2011. Rather, the new lending growth will likely weaken again towards the middle of the year.

New lending to enterprises and self-employed persons

Indexed development of loan portfolio



Source: Deutsche Bundesbank, KfW Research

Residential mortgage lending is the bright spot

Banks should be all the more pleased with the strong growth of residential construction. Thanks to high needs and low unemployment, there is no end in sight to the upswing in this sector. The strong growth of loan portfolios for this purpose reflects this trend in the real economy. ■

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 a VAR model in which the 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.