New lending stages a strong comeback as Ukraine war weighs on outlook

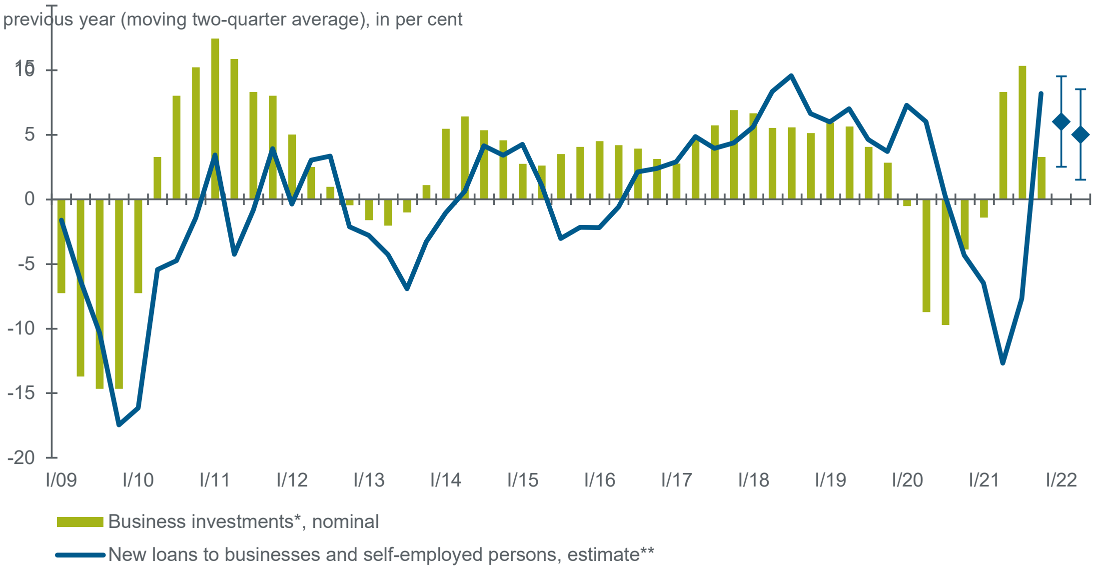
5 May 2022

Author: Stephanie Schoenwald, phone +49 69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Christine Volk, +49 69 7431-3867, christine.volk@kfw.de

- Lending to German businesses surged towards the end of the year. Growth in new lending soared to 8.2% year on year in Q4/2021 after a significant drop of 7.7% last summer.
- The sharp acceleration of credit growth is also due to strong incentives provided by an important reference date under the ECB's targeted longer-term refinancing operations. After all, the very favourable special interest rate was only available to banks who reached the lending performance threshold set by the ECB by 31 December 2021.
- The Ukraine war has led to a massive increase in energy prices as new disruptions plague the already tense supply chains. While this is sure to affect investment appetite, unexpected borrowing needs are growing. Surveys among banks and businesses generally point to growing credit demand in the first half of the year.
- The unpredictable impact of the war makes the further outlook for the credit market highly uncertain. A tightening of financing conditions is already becoming apparent, however. Banks are reassessing default risks against the backdrop of the war and interest costs have been rising again noticeably for a long time as a result of the gradual tightening of monetary policy.

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

Business lending market turned clearly positive

KfW Research has calculated that new lending to enterprises and self-employed persons literally soared in the fourth quarter. New bank loans grew 8.2% year on year after shrinking considerably in the summer quarter. This development was mainly due to short- and medium-term loans with maturities of up to five years.

Two main factors contributed to the dramatic trend reversal: First, the quarters with strong lending activity at the beginning of the pandemic are now completely eliminated from the annual comparison, so that the associated dampening base effect is gone. Second, the special reference period for the ECB's targeted longer-term refinancing operations (TLTRO III) ended on 31 December 2021. Banks were eligible to receive the special interest rate only if their net lending performance met the eligibility criteria on this reference date. Credit institutions thus had great incentive to step up their lending operations. Large enterprises were able to benefit most from this. The Credit constraint indicator[1] fell sharply for large firms in the fourth quarter and dropped below the longer-term average. This is also consistent with the fact that according to the ECB, banks extended short-term loans of more than EUR 1 million with maturities of up to a year at conspicuously favourable interest rates of around 1% in December.

Survey data collected after the outbreak of the war suggest credit growth will continue in the first half-year

While the economic disruptions from the pandemic are abating, Russia's shocking attack on Ukraine has brought enormous setbacks and uncertainties for the development of the economy and its overall environment. What is certain is that the war has weakened the momentum of the economic recovery. Businesses' expectations have fallen significantly.[2] It can therefore be assumed that enterprises will be more cautious in undertaking investment projects from the spring onwards and that demand for investment finance will be dampened. On the other hand, there is a growing likelihood that more loans will be required to mitigate unexpected borrowing needs because businesses will be facing rapidly growing cost pressures. The costs of energy and commodities have increased sharply as a consequence of the war and the already tense supply chains are suffering additional disruptions. This is also being exacerbated by the escalation of the pandemic situation in China, which has triggered sometimes drastic restrictions there.

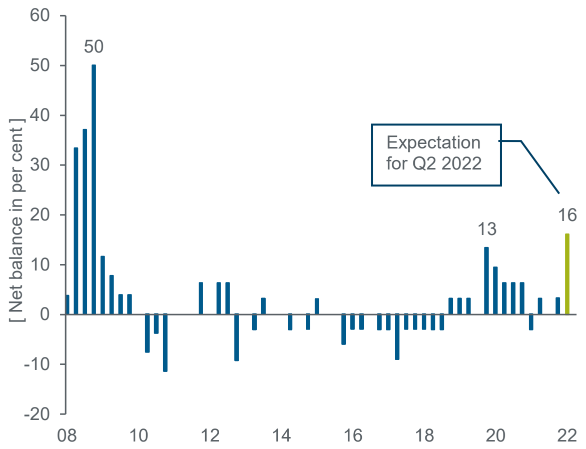
In assessing which of the opposing forces acting upon credit demand is stronger, it is helpful to look at the surveys among banks and businesses conducted in March, that is, after the war broke out. In the current ECB Bank Lending Survey (BLS) a clear and growing majority of credit institutions reported increased credit demand from businesses in the first quarter. Banks expect demand to grow further in the spring as well. The most recent survey conducted among businesses for the KfW ifo Credit Constraint Indicator yielded slightly less clear but similar findings.[3] A growing share of SMEs reported having spoken to their bank about loans. The large enterprises surveyed continued to show very little interest in loan negotiations. But they can probably also draw on existing credit lines to a greater extent.

Financing conditions are set to tighten

First, for the credit supply of the economy it is good news that Germany's banking sector has a modest exposure to Russia of around EUR 4.5 billion. That will not hamper the banking system's lending capacity. Nevertheless, the weakening of economic activity and the elevated risk environment will make banks more cautious in their lending practices. This is reflected in the responses given by banks under the BLS, with the majority expecting credit standards to tighten already in the second quarter (see Figure 2).

Figure 2: Development of credit standards

Net balance (tightening – loosening) of banks' responses, in per cent



Sources: ECB Bank Lending Survey, KfW Research

In addition, the ECB is responding to the high inflation with a policy of monetary tightening. After the end of the asset purchases, a first interest rate increase could happen before the end of this year. Capital market interest rates have already been rising for some time now and credit interest rates are also edging upward slowly. The prospect of higher borrowing costs is also an incentive for businesses to pull financing arrangements forward. The interplay of these factors will probably cause new lending to lose steam from the summer after solid growth in the first half-year. It remains to be noted that the hardly predictable course of the war will also significantly influence developments in the credit market. All forecasts should therefore be treated with caution.

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.

[1] Schoenwald, S. (2022), Credit constraints are easing – large enterprises are benefiting the most, KfW-ifo Credit Constraint Indicator: February 2022, KfW Research

[2] Scheuermeyer, P. (2022), Attack on Ukraine has sent business expectations into a tailspin, KfW-ifo SME Barometer: March 2022, KfW Research

[3] Schoenwald, S. (2022), Banks ease credit access for SMEs again, KfW-ifo Credit Constraint Indicator: April 2022, KfW Research