Credit market has passed its trough

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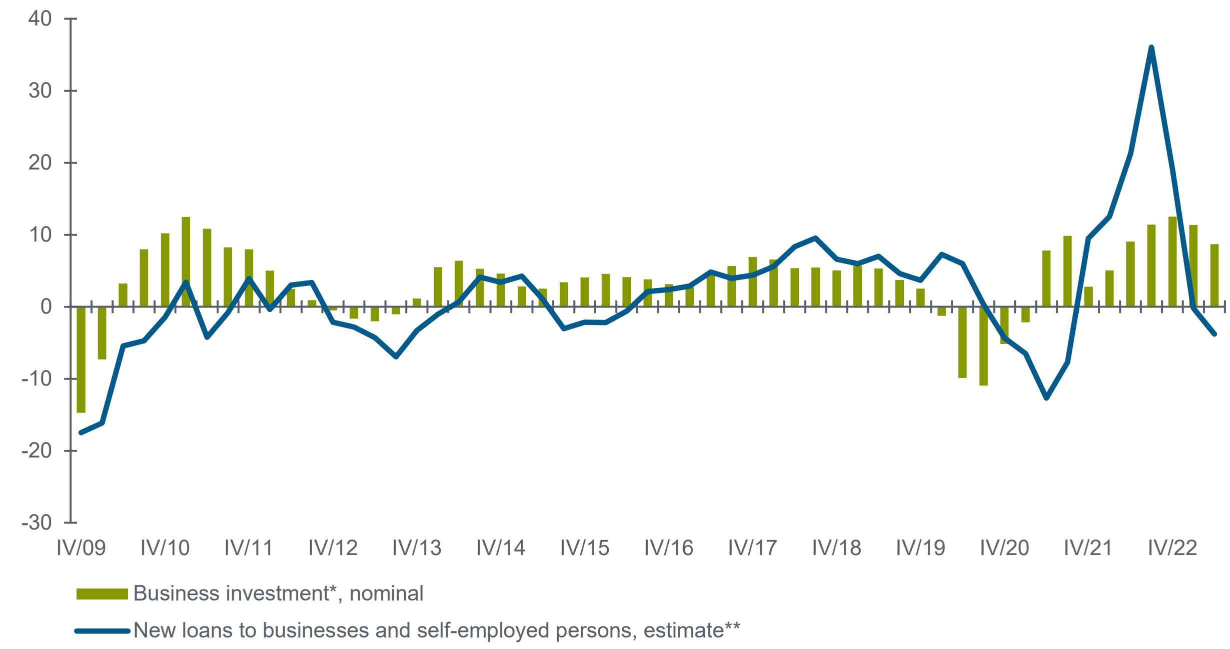
– KfW Research has calculated that the volume of new lending by German banks to businesses and self-employed persons tumbled in the third quarter of last year, taking it 15.7% below the high volume of the previous year. In the fourth quarter, the decline in new lending slowed to -12.5%. This shows that credit growth has bottomed out.

– Difficult financing conditions and falling demand are weighing on lending business.

– Business lending will continue to stall as companies remain reluctant to invest due to the weak economy. We expect lending to contract by 3% in the current quarter. With interest rates set to ease, new lending is likely to recover in the further course of the year.

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



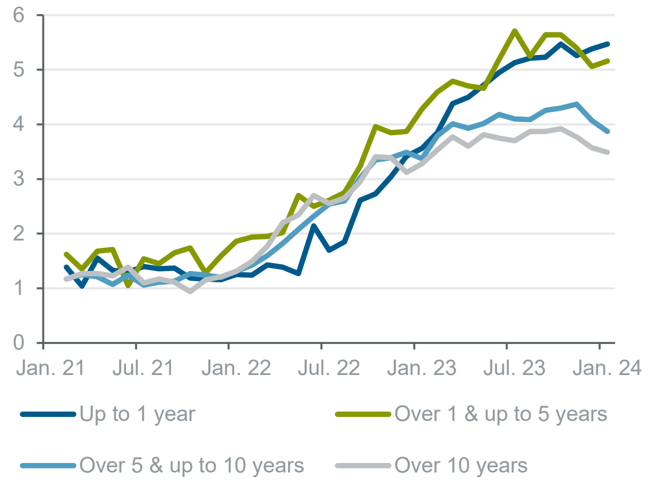
* non-public investment in equipment, industrial buildings and other facilities
** excluding commercial housing loans and excluding loans to financing institutions and insurance industry

New lending has reached the end of the slump

The predicted decline in new lending from German banks to businesses and self-employed persons took place in the second half of 2023. According to KfW Research, new lending declined in the third quarter by 15.7% compared to the previous year. In addition to economic stress factors due to the high interest rates and a subdued economic situation, the sharp drop was driven by a base effect in the reference period. In the summer of 2022, the energy crisis had created high borrowing needs for businesses and led to exceptionally high new lending volumes.[1] In the fourth quarter, lending business declined at a slightly slower pace as a result of the weakening base effect, although economic factors remained equally challenging. Lending to businesses and self-employed persons fell by 12.5% on the previous year. Despite this steep decline, the indexed development of new lending business demonstrates that new lending currently remains above the pre-crisis level. Credit supply for businesses is generally intact. Positive signs on the credit demand and supply sides indicate that the rate of contraction in new business lending is slowing. This suggests that credit growth has bottomed out.

Figure 2: Credit interest rates for non-financial corporations

Effective interest rates on different maturities, in per cent



Source: ECB.

Slump in demand is weakening

According to the Bank Lending Survey (BLS) in January 2024, the weakness in demand from businesses waned significantly towards the end of the year. Whereas 23% of banks (net responses) surveyed in October still recorded a decline in demand, that share dropped to 16% in January. The December survey of businesses conducted under the KfW ifo Credit Constraint Indicator was slightly less positive but at least confirmed that sluggish demand had stabilised.[2] Appetite for loans from large scale enterprises stagnated compared with the preceding quarter. Although demand by small and medium-sized enterprises slipped to the level of early 2023, it thus remained relatively steady in light of the macroeconomic challenges faced since early 2023.

Bank interest rates for loans eased slightly

After businesses shied away from loans primarily because of higher interest rates up until autumn of 2023, this motive is now less relevant, according to findings from the BLS. The diminished importance of interest rates in borrowing decisions must be seen against the backdrop of current interest rate movements. After rising sharply up until October 2023, interest rates have since begun to ease, particularly on loans with longer maturities (Figure 2). This trend reversal marks the end of the interest tightening cycle which the market anticipates. Banks explained the decline in demand with the fact that not only do interest rates remain high despite having recently eased (19% of net responses) but companies also have lower financing requirements for fixed capital formation (23% of net responses). Business investment had stabilised new lending business with noticeable quarterly growth up to the summer of the year 2023. As investment expenditure dropped in both nominal (-2.2%) and real terms (-1.9%) at the end of the year on the previous quarter, this effect was over.[3] The propensity of businesses to invest is being constrained not just by high financing costs but also by weak demand, high uncertainty and pessimistic economic prospects. We predict that investment will decline again in the current quarter but expect it to recover again slightly in the later part of the year on the back of falling key interest rates and a revival in domestic and international demand. Overall, we expect real business investment to grow only moderately in 2024. The supportive effect of business investment for new lending should thus weaken temporarily before picking up again later in the year.

Banks tightened their lending criteria only slightly

In the Bank Lending Survey, German banks indicated that they tightened their lending requirements for businesses only slightly in the final quarter of 2023, leaving their lending criteria for housing loans unchanged. In the preceding months, banks had still tightened their lending rules significantly across all segments. The situation illustrates that the uncertainty caused by the weak German economy is straining the lending relationship between banks and companies. Credit and market price risks are the main factors. Given the poor economic sentiment and dim business expectations[4], it is understandable that banks have announced they will slightly tighten their lending criteria again in the first quarter of 2024.

Lending business will be treading water before improving

First signs give hope that the downturn in the credit market is coming to an end. But in order for the credit market to achieve a sustained turnaround, economic activity must pick up noticeably and there needs to be more planning certainty for businesses again. A critical factor will be the continued easing of price pressure. This is also likely to boost expectations for a trend reversal in monetary policy later in the year, which would positively impact borrowing costs. For the current quarter, KfW Research expects a 3% decline in new lending as a result of the base effect described above and continuing subdued credit supply amid slowly growing demand. Credit demand is likely to gain momentum in the second quarter as the economy brightens. Lending will likely pick up and remain only slightly below the previous year's level. In all probability, we will not see the annual growth rate turn positive again until the summer.

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] Herold Estevez, J. (2022), Multiple shocks are driving record-high growth in new lending to businesses, KfW Credit Market Outlook December 2022, KfW Research.

[2] Körner, J. (2024), Access to credit remains difficult for businesses, KfW ifo Credit Constraint Indicator January 2024, KfW Research

[3] Schoenwald, S. (2023), Businesses are borrowing less, KfW Credit Market Outlook December 2023, KfW Research.

[4] Borger, K. (2024), SMEs start the new year with subdued sentiment, KfW-ifo SME Barometer January 2024, KfW Research.