››› Credit market shows surprising momentum

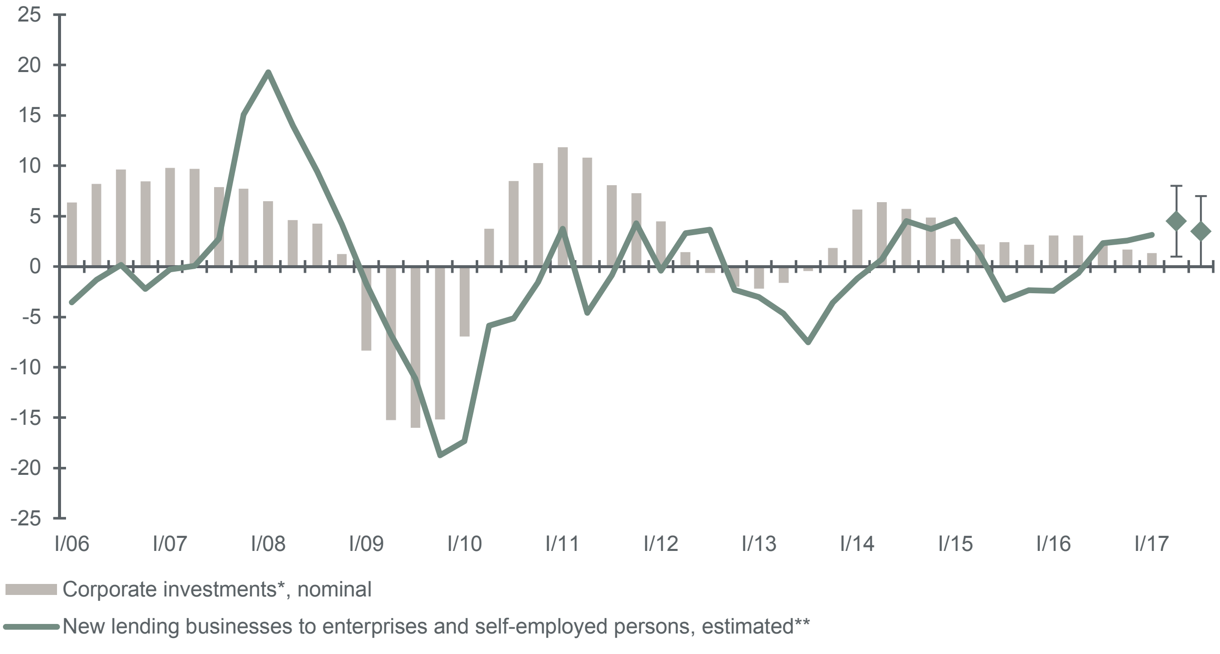
26 June 2017

Author: Dr Sebastian Wanke, phone +49 69 7431-9784, sebastian.wanke@kfw.de
Press contact: Christine Volk, phone +49 69 7431-3867, christine.volk@kfw.de

- The growth of new lending to enterprises and self-employed persons (as defined by KfW Research) continued to gain momentum in the first quarter of 2017, increasing by an impressive 3.1 % year-on-year.
- Three factors are currently driving new lending: the continuing strong business cycle, reduced political risks, and the increasing likelihood of borrowing costs rising in the future.
- Overall it appears that, for the time being, the credit market might pick up further momentum.

Figure 1: 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 has grown strongly again

KfW's estimates show that, surprisingly, new lending from banks to businesses and self-employed persons (excluding residential construction and finance institutions) increased noticeably once again at the start of the year. In the first quarter it was up 3.1 % on the same period last year (moving growth rate across two quarters), having risen by 2.6 % already at the end of 2016. This growth was backed by a 2.2 % rise in business investment (adjusted for seasonal variations) on the final quarter of 2016, an increase that ended the dry spell of three consecutive quarters of contraction.

However, because the momentum of investment last year was disappointing overall, business investment in the first quarter of 2017 grew at only a relatively meagre rate year-on-year (see Figure 1). Seen in isolation, this trend would hardly suggest such lively new lending activity. But probably at least one more factor has also been at play here.

A generally favourable mix for rising loan volumes

The yields on government bonds with longer-term maturities had already risen significantly prior to and immediately following the US presidential election last autumn. Since that time, inflation in Germany and across the euro area has also shown first signs of normalisation. Furthermore, the US Federal Reserve in the meantime has lifted key interest rates several times. And even if the yield increase has entered a consolidation phase since February, it seems highly probable that yields have bottomed out last summer. Borrowing costs, which hovered more or less around record-low levels in the first quarter, should therefore rise from now onwards. That will put pressure to act on businesses that are ready to invest – definitely a welcome development for the credit market.

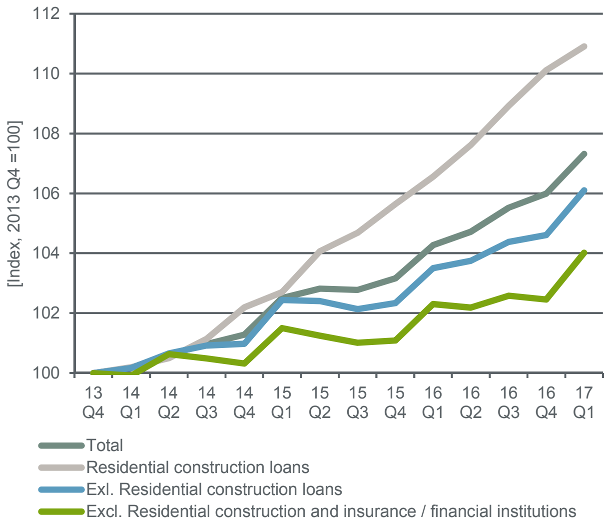
At the same time, much has changed for the better on the lenders' side. Banks have been helped by several trends since the second half of 2016. The first is the steeper yield curve and the second is the continuing cyclical upswing. Third, investors have become significantly more optimistic again for the sector, which is reflected in the strong performance of bank shares since they dropped to a temporary low at the beginning of July 2016 (shortly after the Brexit vote). Overall, that should have well improved banks' lending capacities recently. This view is supported by the fact that the latest Bank Lending Survey shows another loosening of lending conditions.

Outlook: political risks are also decreasing ...

In short: there is a good chance that the credit market has taken its momentum into spring and may even carry it over into summer. Another strong factor has just joined the reasons mentioned above: the political risks in Europe, which were deemed relatively high at the start of the year, are now decreasing noticeably. To start with, the disintegrative populist forces remained weaker than expected at the elections in Austria and the Netherlands. Then pro-European Emmanuel Macron won the presidential election in France with a clear mandate. His party is now set to take a majority in parliament as well. That is a very positive signal for Europe and for Germany. Even those who are not so euphoric about this outcome have to admit that the political risks have markedly faded in the past months. As a result, the uncertainty perceived by businesses should have decreased, and so should their reluctance to invest more. This, in turn, should further drive new lending business.

Figure 2: Loans to enterprises and self-employed persons

Indexed development of loan portfolio



Source: Deutsche Bundesbank, KfW Research

... and already strong residential construction lending remains well supported

While the situation in the just described core of new lending to enterprises and self-employed persons is improving visibly only at the current juncture, a remarkable upward trend has been underway in lending for commercial housing construction for six years now. That trend should continue for the time being. The reasons are mainly the same as for 'classic' business investment. So in the short term at least, the credit market outlook is better than it has been for a long time. ■

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.