KfW Research
KfW Credit Market Outlook: July 2022

Credit market is reacting to interest turnaround

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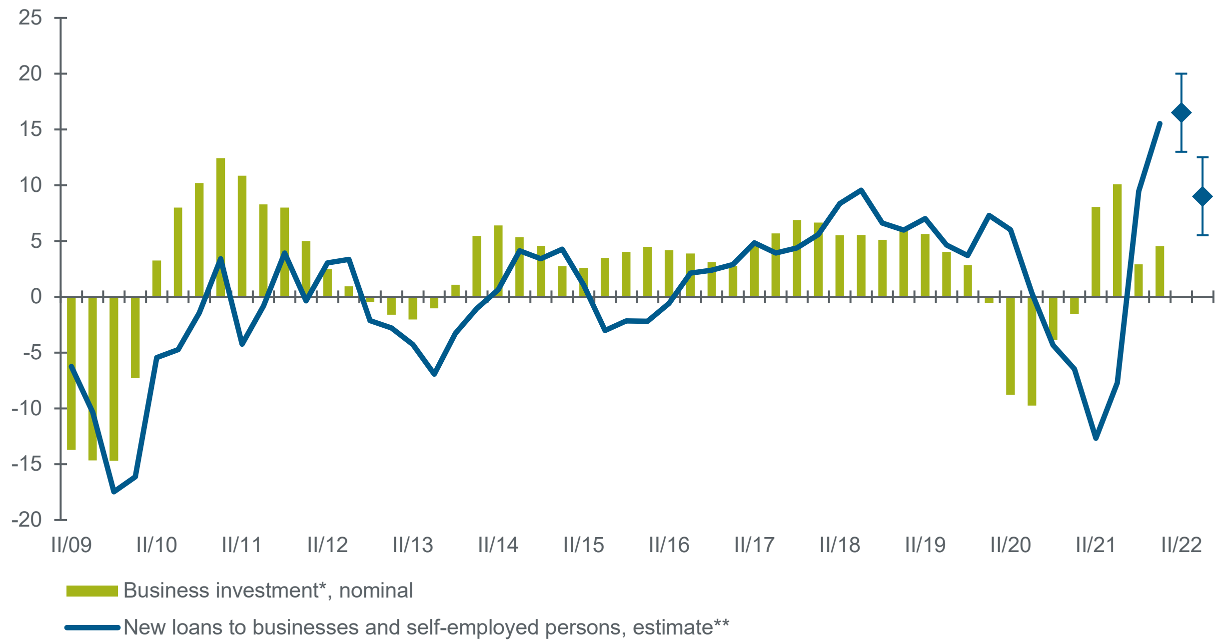
– KfW Research has calculated that new lending to enterprises and self-employed persons took another leap in the first quarter. New bank loans grew by 15.5% year on year.

– The strong credit growth is mainly attributable to short-term financing requirements to build up larger inventories as buffers for disrupted supply chains and the drive to secure interest rates against the background of monetary tightening.

– In the medium term, a looming economic downturn and higher interest rates, in particular, will likely reduce investor appetite and lead to slower growth in credit demand towards the end 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

Credit market is growing but momentum is set to slow in response to the interest turnaround

KfW Research has calculated that new lending to enterprises and self-employed persons took another leap in the first quarter. New bank loans grew by 15.5% on the first quarter of last year (Figure 1). That was a much stronger increase than at the start of the pandemic, when financing requirements were also high. One likely reason for the extremely dynamic credit growth is that business investment has increased at a faster rate than GDP. Favourable weather conditions (for the construction component) and catch-up effects after two negative quarters (adjusted for prices) spurred business investment.

In addition, the war in Ukraine and the strict zero-COVID policy of the Chinese government are driving demand in the credit market. In the medium term, the high uncertainty is set to have a rather dampening effect on businesses' investment appetite and thereby affect credit demand. In the short term, however, motives for interest rate hedging predominate, which increases financing needs. They are driven by larger stockpiling aimed at buffering against disrupted supply chains. Furthermore, the high inflation rates are creating cost pressures because consumables and capital goods are also becoming more expensive in nominal terms.

The ECB's Bank Lending Survey (BLS) of April 2022 also suggests that the interest level in the first quarter again influenced credit demand more strongly than in the previous quarters. While the recent dramatic increases in interest rates were in line with an increase of the longer end of the interest curve in particular over the past months, the ECB's announcement of July 2022 to introduce a swift but moderate cycle of interest rate hikes will foreseeably lead to a flatter interest rate curve. In anticipation of this flattening and an environment of rising interest rates, interest rate hedging has likely been a motive as well.

In light of the factors outlined here, we estimate that new lending business also grew strongly in the second quarter but that growth momentum will start slowing from the next quarter (Figure 1). The strong increase in Q2 is probably linked to the especially weak Q2 2021 and the continuing need for short-term finance triggered by the war and inflation. From the next quarter, however, weakening economic momentum and the changing interest rate environment in the euro area will likely lead to a trend reversal.

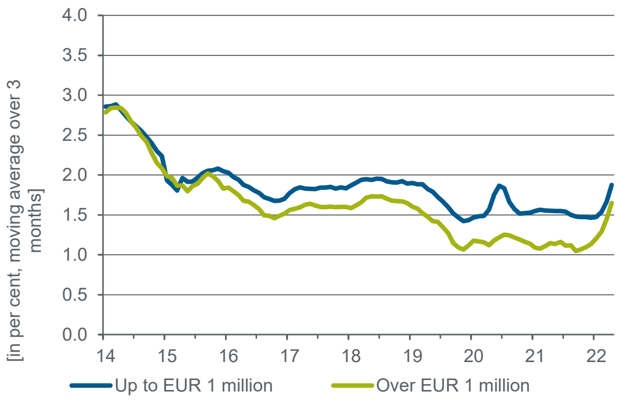
Higher credit costs are already reflected in the data

The interest turnaround of the ECB and the banks' more restrictive lending practices are already reflected in the ECB interest rate statistics, which contain data up to the month of April. Since January, the moving three-month average of interest rates for corporate loans with maturities of more than five years has increased from around 1.5 to 1.9% for loans of up to EUR 1 million and 1.65% for loans over EUR 1 million. What is also noteworthy is that the premium on lower-volume loans, which had increased during the pandemic, has fallen again. Given that interest rates have continued to rise significantly over the entire yield curve, actual credit interest rates negotiated in the current quarter are likely to be much higher. This is demonstrated by the monthly figures for April, which are already above 2 % (≤EUR 1 million) or just barely below that rate (>EUR 1 million).

The increase in the Credit Constraint Indicator prepared by KfW Group and the Ifo Institute also suggests that borrowing conditions are worsening. At the current margin, credit constraint is higher than the long-term average for both small and medium-sized as well as large enterprises.

Figure 2: Interest rates on loans with maturities over 5 years

New loans to non-financial corporations



Source: ECB interest rate statistics, KfW Research

After a strong first half-year, war, a weakening economy and credit costs will act as a brake in the second half

The development of new lending business in the further course of the year will likely hinge primarily on the performance of the economy. Restrictions on business activity caused by the pandemic are decreasing with the lifting of many public health measures, to be sure. At the same time, however, the German economy needs to brace for high costs as a result of Russia's invasion of Ukraine, which are likely to stop the momentum of the pandemic recovery dead in its tracks.

The banks surveyed under the BLS share this view. Against the backdrop of the high geopolitical and financial uncertainty in the euro area, they expect credit standards to be further tightened for businesses in Q2 and the ensuing quarters. The BLS also shows that disrupted supply chains and high prices for energy and inputs are the primary drivers of more restrictive lending standards. Financing conditions for businesses are also facing headwinds from the bond market. The ending of the asset purchase programme (APP) from July 2022 means that monetary policy will have a much less accommodating effect.

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.