Lending to businesses is up sharply

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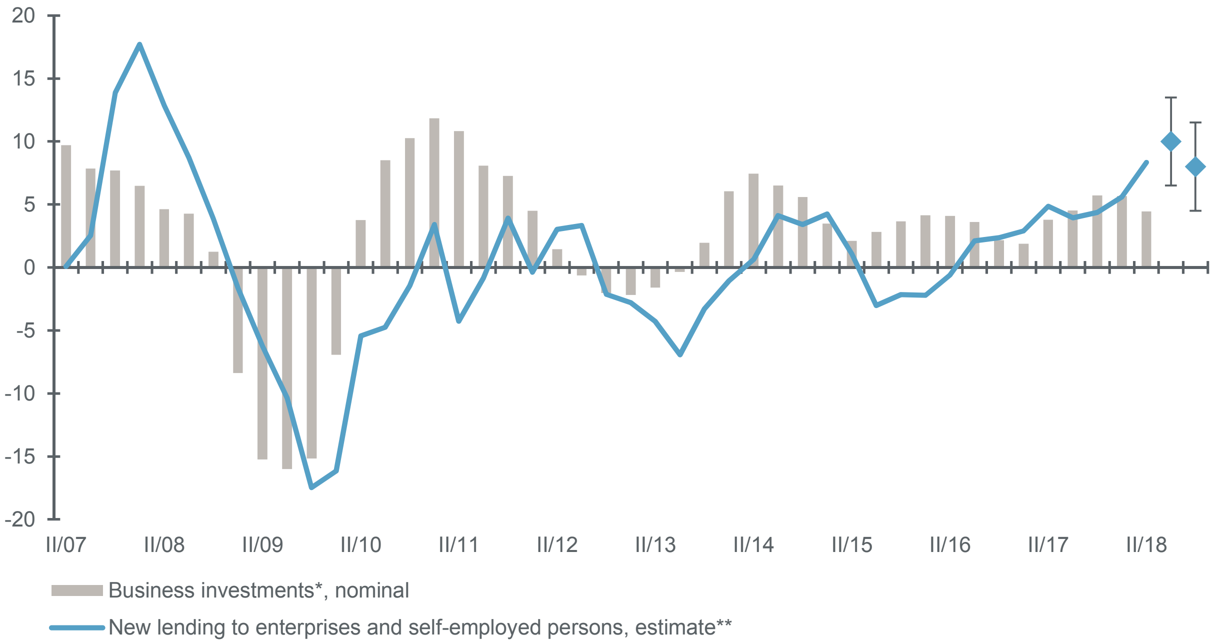
- New lending to businesses and self-employed persons grew at an unusually fast pace in the second quarter, up 8.3 % on the previous year; banks' interest margins remain under pressure.
- Lending accelerated despite a minor drop in investment momentum.
- Among the factors explaining this trend are increased interim financings because of higher stockpiles and the formation of financial reserves amid increased cyclical risks and favourable borrowing terms.
- As the overall framework remains unchanged, we expect strong growth in corporate lending to continue in the second half of the year.

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

Credit dynamics exceed expectations

The upswing in the German corporate lending market continues. Lending has now grown for the past eight consecutive quarters. There has not been a longer expansion phase since the turn of the millennium. More remarkable, however, is the strength of credit growth. According to KfW's estimates for Germany, new lending from banks to businesses and self-employed persons (excluding residential construction and finance institutions) gained momentum once again in the second quarter. Year-on-year, the growth rate increased to 8.3 % (moving average over two quarters). For the German corporate lending market, which has been on the decline over vast stretches of the past 20 years (see also Figure 2), this is a value that merits attention. We had expected continuous growth but no further acceleration, given the gradual cyclical slowdown.

Corporate investment alone does not explain strong credit growth

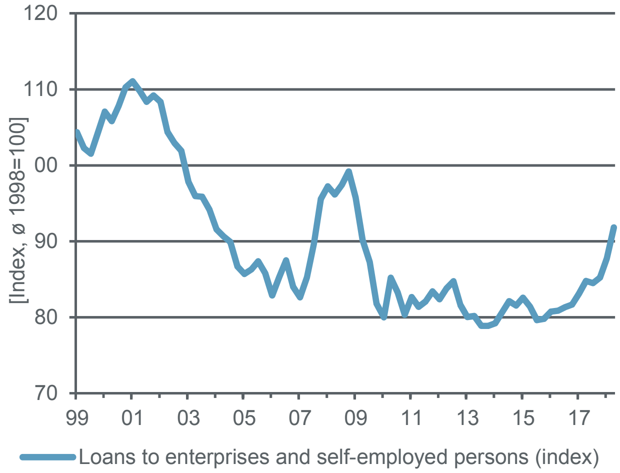
Businesses' investment expenditure is one of the most important factors influencing the development of corporate loans on the demand side. But it would be too simplistic to read strong credit growth as a sign of an imminent investment boom. There are always phases in which a (temporary) decoupling takes place between credit growth and investment growth (see also Figure 1) and this is currently the case. Although businesses are continuing to expand investment expenditure amid increasingly tight capacities, the pace is slowing down moderately in line with lower business expectations. Thus, growth in nominal business investment was 4.5 % year-on-year in the second quarter, one percentage point lower than at the beginning of the year. It is true that the share of investment expenditure financed by credit typically grows after the cyclical peak has been surpassed. The substitution of capital market financings with bank loans has probably contributed to rising credit dynamics as well, since the growth of the outstanding bond volume has been falling noticeably since the beginning of the year. Nonetheless, this does not explain the clearly disproportionately high growth in corporate lending.

Strong credit growth may also reflect risks of cyclical downturn

Business expectations received a significant dampener compared with the unusually high values at the beginning of the year and the list of cyclical risks is long. Global trade conflicts, difficult Brexit negotiations and Italy's fiscal policy stance are the flashpoints that might weigh on the so far robust economic growth. Moreover, the second quarter has seen a significant accumulation of stock. This confluence of factors is likely to have prompted enterprises to secure interim financings and financial reserves at what are still excellent borrowing conditions before the imminent monetary policy reversal leads to rising interest rates in the credit market as well. This is consistent with the fact that the current acceleration of credit growth is coming from short and medium maturities up to five years, while growth in long-term loans is steadily trending upward.

Figure 2: Loans to enterprises and self-employed persons

Indexed development of new loan commitments



Sources: Deutsche Bundesbank, KfW Research

Looking ahead: second half-year will remain strong

The second half-year will continue to be marked by steady investment activity in an environment shaped by high risks and looming interest rate increases. We therefore expect corporate lending to continue evolving very dynamically. Since Germany's enterprises have healthy balance sheets, we are not concerned. German businesses have given priority to optimising their balance sheets and strengthening their equity base for a long time. As a result, they now have scope to invest on a sound basis, even in times of high uncertainty and temporary weaknesses. This not only reduces cyclical volatility but strengthens the growth prospects of tomorrow. ■

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 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.