Corporate lending: slower growth, more caution

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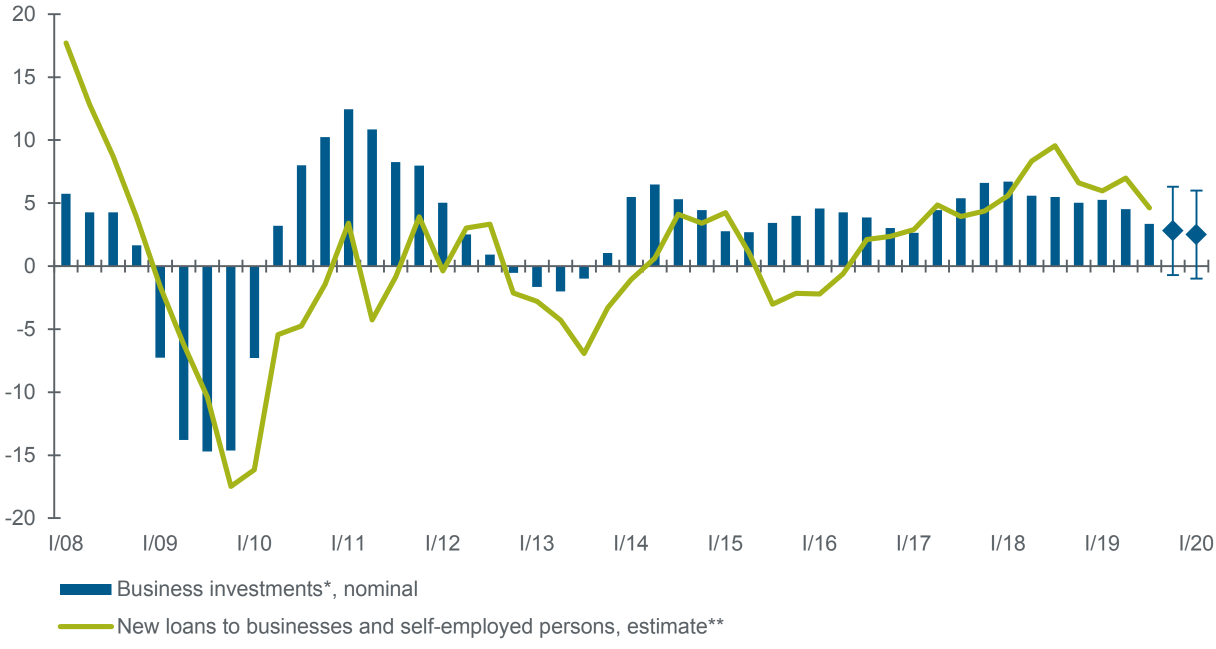
- The growth of new lending to enterprises and self-employed persons slowed in the third quarter. Banks extended 4.6% more loans year-on-year, following a 7.0% increase between April and June.
- Thus, after only a brief interruption, corporate lending resumed the downward trend that had set in at the end of 2018. Nevertheless, the growth of new commitments can still be regarded as strong.
- We expect the decline in the growth of corporate lending business to continue into the new year. Despite the low interest rate level, the weak economic momentum, the industrial recession and multiple political uncertainties appear to have dampened the appetite for new loans – among both banks and businesses.

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

New lending has slowed

According to KfW Research, new lending to businesses and self-employed persons in Germany (without residential construction and finance institutions) lost momentum in the summer months. New lending to corporate borrowers grew by a vigorous 4.6% in the third quarter but at a much slower rate than the strong 7.0% that was still recorded in the preceding quarter. As we had expected, the acceleration in spring has thus shown to be unsustainable. At the time, short-term loans in particular provided a surge in corporate lending. This has now reversed, and new lending has resumed the downward trend that set in at the end of 2018. Such volatility is characteristic of phases of cyclical weakness, as businesses have to fund more liquidity bottlenecks or a previously unanticipated buildup of inventories before they adjust production. Moreover, side effects of the Brexit poker are likely to have helped companies clear inventories in the third quarter. As the detailed data on the development of gross domestic product illustrate, Germany's exports grew notably despite weak global trade, while inventories decreased substantially at the same time. It can be assumed that this was due to pull-forward effects from the drive to cushion the blow of a hard Brexit that appeared to loom on 31 October.[1]

Despite expansionary monetary policy: Weak business cycle is increasingly hampering investment

Let us first look at the positives: In the third quarter as well, companies again invested more than in the previous year – even without taking residential construction into account. At the same time, new commitments for longer-term loans also rose, although at an increasingly slower pace. The ECB's expansionary monetary policy appears to have made a significant contribution to what has been remarkably stable investment activity in the face of the weaker economy and to the resulting funding requirements. In the most recent Bank Lending Survey (BLS), banks mentioned the low interest level as the most important factor supporting credit demand. However, the scope for monetary policy has been largely exhausted and there is little potential for further interest reductions. This increases the likelihood that factors which weigh on investment activity and credit demand will gain the upper hand. Industrial capacity utilisation has been declining for nearly two years already. That has reduced borrowing requirements for new plant and equipment. The strongest signal for declining investment activity in Germany recently came from incoming domestic capital goods orders, which dropped unexpectedly sharply by more than 5% in October compared with the previous month. Banks share our sceptical view of how credit demand will develop. For the first time in five years, a slim majority of credit institutions expect credit demand to decrease.

Growing credit risks are making banks more cautious

Overall, financing conditions for businesses still remain exceptionally good. Credit costs once again dropped to new lows on average across the third quarter. Nonetheless, the results of the BLS indicate that Germany's banks are responding to the growing credit risks in the downturn with increasing caution. First, the long-standing period of looser lending criteria is over. Driven by intense competition, banks had accommodated their corporate customers more and more since 2014 until this development petered out at the beginning of the year. All the same, after two consecutive increases, credit institutions refrained from tightening lending conditions further in the third quarter. Second, a clear majority of banks have reported a rising credit rejection rate for the first time since the survey began (Q1 2015). And third, the net percentage of reporting banks that have raised interest premiums on riskier loans has reached the highest level in more than six years.

Outlook: Dynamic of new lending is waning

The forces on both sides of the credit market are currently pulling in the same direction. Both on the supply side and on the demand side, there are growing signs that the credit market will not be able to durably escape the cyclical weakness and the high level of political uncertainty. KfW Research forecasts a further drop in new lending growth down to around 2.5% in the first quarter of 2020. Nonetheless, thanks to the healthy balance sheets of German enterprises, banks should continue to be ready to bridge liquidity bottlenecks that may occur in the event of unexpected developments. Sharp increases in short-term lending thus remain within the realm of possibility. But in order for a trend reversal in the credit market to be sustainable, economic growth will have to pick up noticeably and the political disruptions that are making it hard for businesses to plan will have to at least decrease. That is unlikely to occur before the middle of next year.

[1] Cf. Borger, Klaus; **KfW Business Cycle Compass Germany, Nov. 2019**; KfW Research

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.