The trend reversal is here: New lending has cooled considerably

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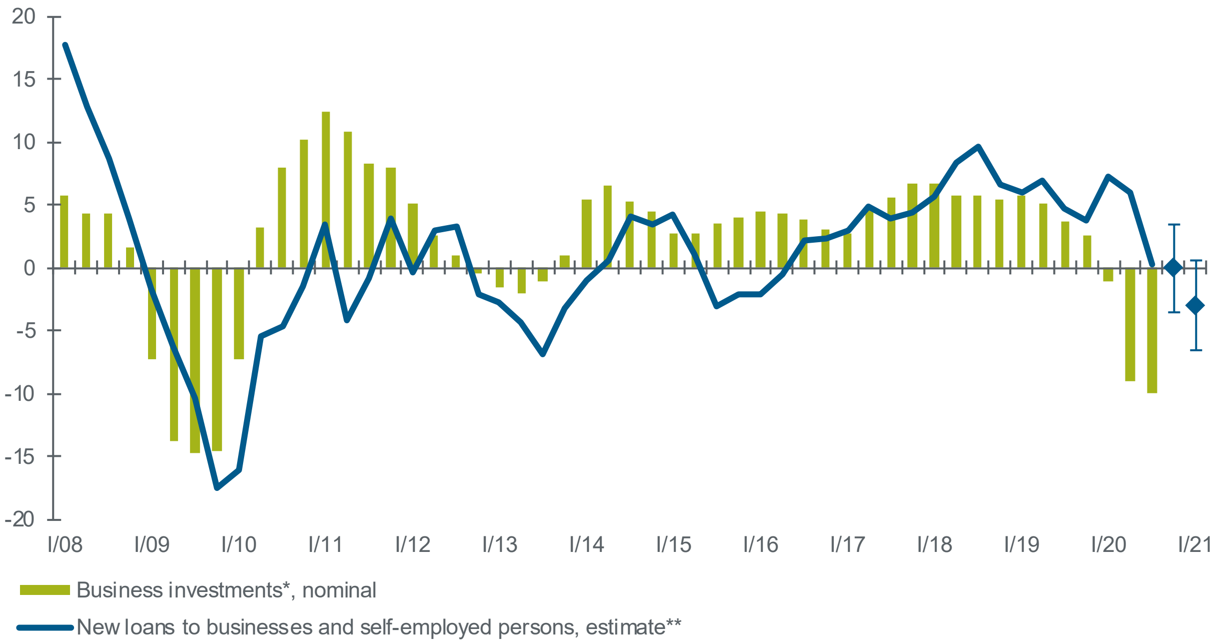
– As expected, new lending to businesses and self-employed persons slackened in the third quarter. At 0.3%, the growth rate was just barely positive compared with the previous year. Thus, after the pandemic-driven surge in the first half-year, the drop was steeper than forecast.

– The causes lie mostly on the demand side. Companies have built up liquidity buffers and the economy recovered over the summer amid weak investment activity, all of which dampened demand for additional loans. At the same time, banks remained moderate in tightening their lending policies. The decline in lending momentum will continue and accelerate. The direct financial support paid to affected sectors is limiting liquidity shortages in the second wave. We do not expect business investment to pick up significantly until mid-2021, when the pandemic-induced uncertainty is likely to have largely disappeared.

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

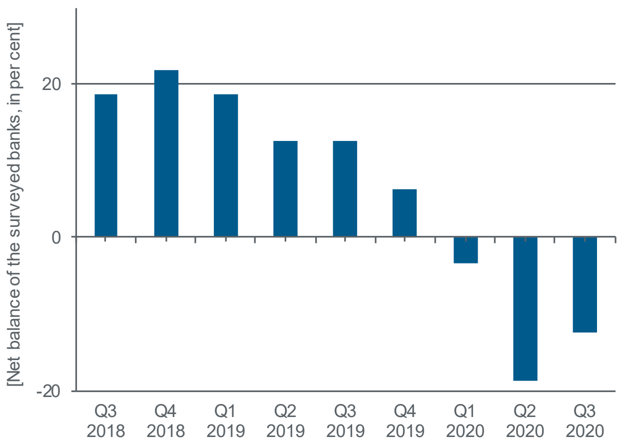
New corporate lending is hardly growing

New lending to enterprises in Germany saw very strong dynamics in the first half of the year, mostly resulting from businesses' very high liquidity needs caused by turnover losses due to the pandemic. The broad relaxation of restrictions was accompanied by a swift recovery over the summer. In the third quarter, economic output thus returned to 96% of the pre-crisis level. KfW Research found that increases in new bank loans to domestic enterprises and self-employed persons fell significantly in this environment, posting hardly any gains at all with growth of just 0.3% on the previous year. Lending was still 6% higher in the previous quarter.

High reluctance to invest and improved liquidity situation have reduced demand for credit

The reasons for the downturn in lending can be traced back to demand factors in particular. Businesses remain in a difficult situation as a result of the coronavirus crisis. There is also extremely high uncertainty about future economic conditions. Many companies are therefore revising their investment projects. A supplementary survey conducted as part of the KfW SME Panel has revealed that by September only 47% of SMEs realised the investment plans they had at the start of the year.[1] This is reflected in the slump in business investment across the aggregate economy, which was more than 10% below the previous year's level in nominal terms – averaged over the second and third quarter. Accordingly, credit demand for investment purposes was muted (see Figure 2).

Figure 2: Credit demand – influence of investment



Source: Bank Lending Survey, Bundesbank

At the same time, the acute financial distress brought on by the pandemic should now have passed its peak. Thus, the share of SMEs affected by reduced liquidity dropped from 44 to 31% from April to September.[2] In addition to government assistance, the swift economic recovery in the summer months is sure to have brought relief as well. Furthermore, enterprises have now had opportunity to adapt to the pandemic conditions by cutting costs, reducing turnover expectations and innovating. Even as lending rose sharply in the first half of the year, most businesses are likely to have planned ahead and built up liquidity buffers that sustain them over an extended period of time. This is also consistent with our observation that loan applications under the KfW coronavirus assistance programmes have increased at a declining rate.

Banks' willingness to lend is hardly affected so far

Greater caution on the part of banks may have played a role in the weaker new lending dynamics, albeit a secondary one. Banks continue to tighten their lending policies within limits. Thus, the KfW ifo Credit Constraint Indicator[3] rose only slightly by 1.3 PP to 21.7% for SMEs in the third quarter, remaining well below the level during the financial crisis. This is consistent with the data reported by financial institutions under the BLS: Only a very small majority of 6.25% of banks reported having tightened their lending standards again.

Outlook: Downward trend in new lending will continue

We expect activity on the corporate lending market to continue weakening far into the next year. After stagnating in the final quarter of this year, we predict a decline of -3% in the first quarter. To be sure, the second wave of infections is likely to sporadically aggravate the liquidity situation. But that should remain limited owing to the generous financial assistance being offered to directly affected sectors. In addition, investment activity cannot be expected to pick up significantly until the pandemic-induced uncertainty has largely disappeared. Despite good news on vaccines, that will take some time yet. It is therefore all the more important to keep access to credit open for companies that want to invest now in order to be prepared for future challenges and opportunities.

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.

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[1] Schwartz, M. et al. (2020), **SMEs between financial resilience and a digital and green investment rally – A target conflict that should not be**, Focus on Economics No. 306, KfW Research. (available in English soon)

[2] Gerstenberger, J. and Schwartz, M. (2020), **KfW SME Panel 2020: Coronavirus pandemic has dampened expectations for 2020 – SMEs entered the crisis from a strong position**, KfW Research.

[3] Schoenwald, S. (2020), **Small and medium-sized enterprises face growing barriers in accessing credit**, KfW ifo Credit Constraint Indicator: October 2020, KfW Research.