

»»» Omicron is overshadowing the recovery in the credit market

30 December 2021

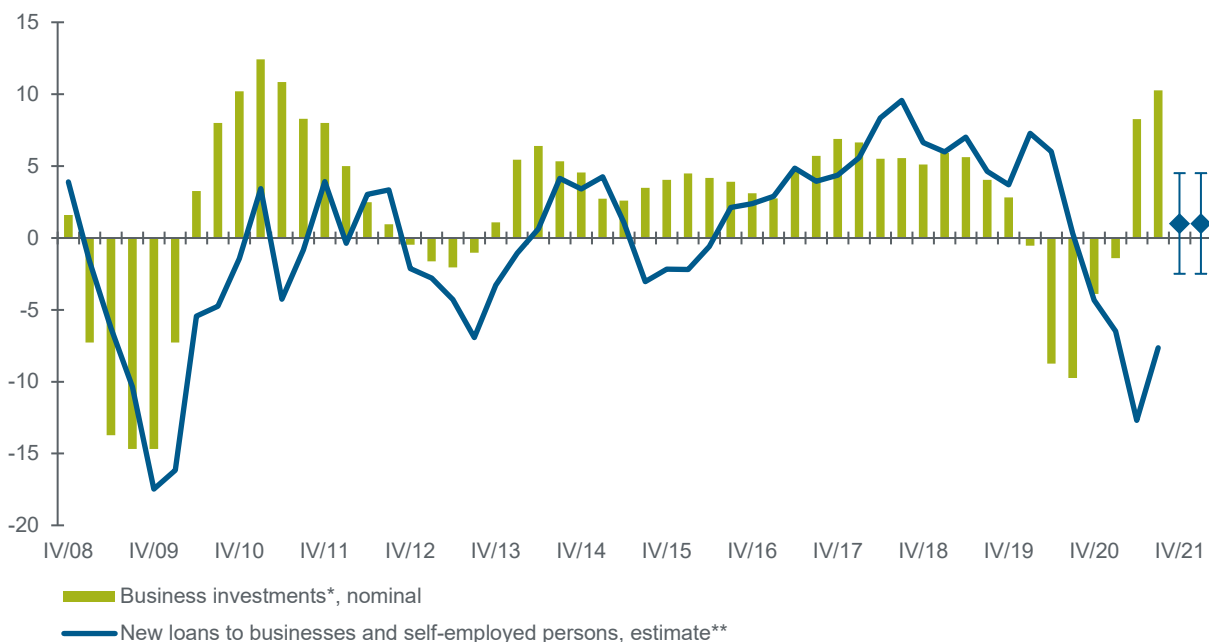
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- As we had expected, the growth of new lending to enterprises and self-employed persons rose from its low point in the third quarter. Nonetheless, new bank loans were still down 7.6% on the previous year.
- Demand for credit remained well below average overall as credit institutions hardly changed their lending policies. Long-term lending, which is particularly attractive because of the very low interest rate level, performed relatively well.
- We currently expect lending growth to turn positive at the end of the year. The jump is primarily due to the elimination of the negative base effect. Along with the improved economic situation, however, rising costs of operating supplies, intermediate products and investment projects are likely to increase credit demand as well.
- The emergence of the new virus variant has made the outlook for 2022 highly uncertain. The potential for more vigorous investment and lending activity exists in principle. Omicron will probably delay the recovery for now. Increased volatility in lending business should also be expected.

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

The slump in the credit market has bottomed out

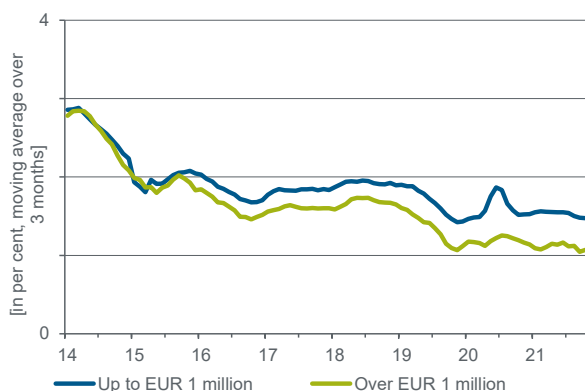
In the third quarter, banks and savings banks continued to extend fewer loans to business customers than in the previous year. The decline in new lending calculated by KfW Research was significant yet again, as we had

expected, at 7.6% (moving two-quarter average). Nonetheless, it is a cautious signal of a trend reversal in the business lending market. Compared with the historically weak previous quarter, the rate of contraction dropped by a notable 5.1 percentage points.

Still, credit demand remained decidedly weak. In the third quarter the share of businesses in loan negotiations with banks fell to unprecedented lows in all size classes since the beginning of the surveys. Only 17.7% of small and medium-sized enterprises still reported having applied for a bank loan.¹ At the same time, credit institutions made few changes to their lending policies over the summer months. Barriers to credit access remained steady on a moderately increased level overall. The KfW ifo Credit Constraint Indicator² showed a minor increase for SMEs after the sharp drop in the spring, to be sure, but larger enterprises reported being able to access bank loans slightly more easily again in the third quarter.

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

New loans to non-financial corporations



Source: ECB interest rate statistics, KfW Research

Interest rates remain extremely attractive

Despite rising inflation and an emerging debate about the right timing of the monetary policy turnaround, we continue to see record-low interest costs in the business lending market. Between July and September 2021, banks charged just

1.11% per annum on average for loans with terms of more than five years (see Figure 2). This fits with the relative strength of long-term lending, which is weaker than in 2020 but already exceeds the level of 2019.

Outlook: Credit growth is about to return to positive territory but Omicron brings new uncertainty

We now expect lending to businesses to grow again moderately in the final quarter compared with the previous year. However, much of the improvement is attributable to the elimination of the negative base effect, which had so far dampened credit growth at the beginning of the pandemic owing to high financing requirements.

Furthermore, businesses' need for external finance is also likely to increase slightly more strongly than anticipated. Persistent supply bottlenecks are currently disrupting economic activity through various impact channels. For one thing, they are generating a surge in prices in combination with developments in the energy market. Inputs, goods destined for sale and investment projects are becoming more expensive. This also increases the associated funding requirements. For another, scarcities have led to a considerable order backlog in the manufacturing sector. This is very likely to have delayed some investment projects. Initial data on fourth-quarter industrial output has now turned positive. It is therefore safe to assume that a (minor) catch-up recovery will set in towards the end of the year.

The emergence of Omicron has now significantly disrupted the economic conditions again. The investment environment is becoming cloudier, supply bottlenecks may continue for longer and new restrictions to contain the pandemic are likely. Forecasts for the development of the credit market in the year 2022 are therefore subject to great uncertainty. We currently expect increased volatility in lending business and do not anticipate a sustained strong recovery of the credit market until the second half of the year.

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.

¹ Schoenwald, S. (2021), Low SME credit demand – constraints remain higher than average, KfW ifo Credit Constraint Indicator: October 2021, KfW Research.

² Schoenwald, S., loc. cit.