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Coronavirus and credit: an important building block to limit the economic fallout

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A quick look back

As expected, the growth of new lending to enterprises and self-employed persons (excluding commercial housing loans and excluding loans to other financial institutions and insurance industry) lost further momentum in the fourth quarter. Compared with the previous year, lending by German banks grew by just 3.1% (moving average across two quarters). That was the lowest rate since early 2017.

The causes for the slowdown in lending growth are most likely found on the demand side. The weak economic momentum, the industrial recession and a range of political uncertainties have probably dampened the appetite for new loans despite the low interest rate level. But there have also been growing signs that banks have become slightly more reluctant to provide credit. In the most recent ECB Bank Lending Survey, a majority of banks reported a growing percentage of denied loan applications for the second time in a row. The financing conditions for enterprises had also deteriorated slightly from an outstanding level.

The coronavirus outbreak in Europe has serious consequences for all areas of life and the outlook is changing fundamentally in the credit market as well

It was only a few weeks ago that a further slowdown in business lending became apparent. This may continue to be evident in the first quarter because the economic impact of the pandemic in Germany is only beginning to take on a new quality in the second half of March. Given the short-term liquidity needs of a large number of enterprises, we expect new lending to surge by the second quarter at the latest.

Providing a reliable estimate of growth rates is a significant challenge as we have no experience to draw on for a crisis of this nature. At the beginning of the global financial crisis, we temporarily observed an increase in new loan commitments of 10% on average. In the first quarter of 2008, the increase on the previous year was close to 20%. Currently we can assume that these percentages will even be exceeded while the measures aimed at containing the rate of infections are in place.

In order to ensure liquidity for enterprises and bring them through the crisis successfully, the entire German banking system has to come together in a joint effort. KfW, other promotional banks and the German credit industry are working together to live up to this responsibility. In order to more effectively position the required support, we discuss the particular characteristics of the economic aspect of the coronavirus crisis below.

The coronavirus outbreak has enormous economic impacts but the distortions it has triggered were not caused by economic imbalances

There are few certainties around the coronavirus crisis. What is certain, however, is that it will have serious consequences for the German, European and global economy this year. Given the rapid growth in infection rates, all major euro area countries have ordered far-reaching restrictions to public life as a containment strategy. The task of limiting the health impact of the pandemic rightly has absolute priority. Success in containing the spread of the virus directly correlates with its economic impact. The example of China gives reason to hope that case numbers can be stabilised within a limited amount of time. The current situation is therefore unlike the global financial crisis in three main aspects:

1. The coronavirus outbreak has hit all sectors of the economy. Whereas in 2009 the distortions in the financial sector primarily affected the internationally connected manufacturing sector, this time the services sector is being hit hard as well, as it is based on personal interaction. Besides the transport sector, this includes tourism, hospitality, entertainment and retail in particular. As there are many small companies operating in these sectors, the sheer number of materially affected firms is significantly higher than in the financial crisis.

2. Turnover losses are not gradual but abrupt and deeper. As a result, they directly create large liquidity shortages.

3. The third aspect is also a positive one. As the origin of the shock does not lie in economic imbalances which typically take time to unwind, a very fast recovery is possible once the infection rate has been stabilised and containment measures have been rolled back. In order for this to succeed, the support measures are designed to help fundamentally healthy businesses survive this difficult time. Tax relief, short-time work and extensive liquidity assistance in the form of loans are important steps in this approach and they may yet have to be supplemented.

Germany is entering the critical phase from a good starting position. Businesses, the government and banks are financially well-positioned.

The German economy is generally well equipped to get through tough times. Germany has sound public finances and, hence, broad fiscal policy scope which we now have to use given the challenges we are facing. Businesses and banks, however, can also be diagnosed as being financially healthy. The number of insolvency proceedings initiated for enterprises has been on the decline for years. It was fewer than 20,000 per year at the end of 2019. In 2003, more than twice as many enterprises were forced to declare insolvency. The financial crisis also interrupted this downward trend only briefly, with insolvencies temporarily rising by around ten per cent. Furthermore, SMEs are now benefiting from the strong equity base which they have been building up for years. Their average equity ratios exceed 30%.

Banks are also more crisis-resilient as a result of the regulatory reforms introduced since the financial crisis. The tightening of minimum equity requirements is paying off. According to the latest data, the Tier 1 equity ratio of Germany’s financial institutions stood at 15.3% in Q3 2019, compared with only 8.8% at the end of 2008. Restrictions to proprietary trading operations, lower interdependencies between banks and high liquidity are further factors that stabilise the system. Nevertheless, it must be stated that overcoming the coronavirus crisis is both a Herculean task and a stress test for German banks. The longer economic activity continues to be massively disrupted by the pandemic, the greater the increase in credit risks and defaults. That will reduce banks’ equity. Therefore, a package of measures has already been put together in order to credibly strengthen credit institutions’ lending capacity. First, European and national regulators have eased restrictions enabling the banking system to make use of the capital buffers that have been built to deal with a crisis. Second, the ECB is providing generous terms on funding for business loans and injecting liquidity into the financial system by expanding asset purchases. A third building block is the expanded granting of liability waivers to banks under KfW promotional loans. Overall, this is a convincing package that is suitable for bolstering the credit market and getting the real economy through the pandemic unharmed.