

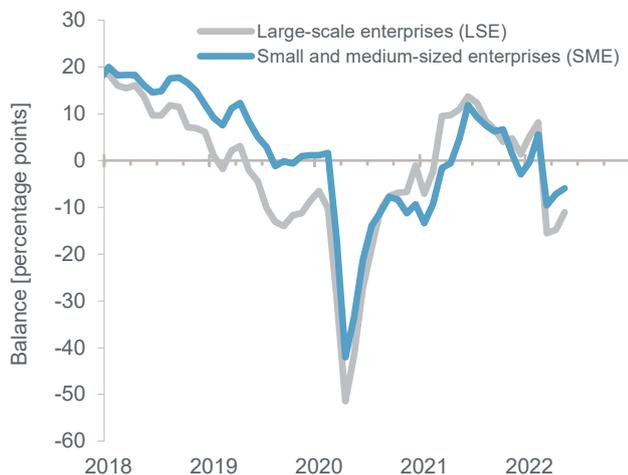
## »» Situation of SMEs is improving but fear of downturn is growing

7 June 2022

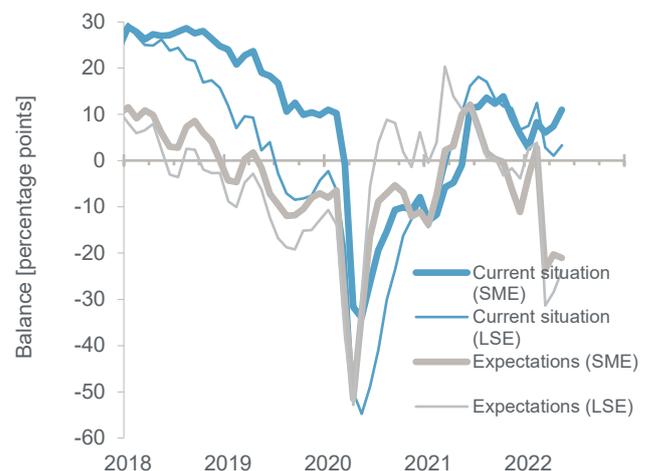
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- SME business climate improved for the second consecutive month
- Situation assessments are much better but expectations more pessimistic again
- Confidence among large enterprises is up slightly
- Hoped-for vigorous recovery is being choked off by the war

KfW ifo Business Climate Index



KfW ifo sentiment components



Source: KfW Research, ifo Institute

### SME business sentiment rises on the back of improved situation assessments

The slight improvement in sentiment among SMEs continued in May for the second consecutive month, after business confidence collapsed in March because of Russia's invasion of Ukraine. It now rose 1.2 points to -5.9 balance points but remains well below the pre-war level. Moreover, this time only the situation assessments improved:

- They gained a notable 3.6 points, climbing to 11.0 balance points. The last time SMEs rated their business situation more favourably was before the spread of the Omicron wave in October last year.
- The already very pessimistic business expectations, by contrast, fell by 0.7 points to -21.0 balance points. The current uncertainty simply leaves no room for new optimism. The war is driving up prices, leading to material shortages and reducing energy security, while in China even minor coronavirus outbreaks are triggering strict lockdowns and put added strain on global supply chains.

### Construction on a rollercoaster of emotions

Small and medium-sized construction firms reported the strongest improvement in business confidence in May (+4.7 points to -8.2 balance points), after sentiment there dropped sharply in April. But the current improvement offset only around half the decline in the previous month. Construction demand remains strong but is facing significant problems on the supply side, such as material shortages, rapidly rising costs of energy and building materials and a shortage of skilled workers. Higher interest rates are raising the costs of already expensive new building projects, as construction demand generally remains high. Construction firms are currently on a rollercoaster of emotions, as illustrated by the severe monthly mood swings.

### Service providers currently the most optimistic

Construction was closely followed by the services sector, where sentiment improved by 4.4 points. At now -1.4 balance points, sentiment is just below the zero line, which stands for the long-term average. That makes services the most

optimistic sector among all SMEs at this time. The current catch-up growth in social consumption is clearly visible. Besides services, trade was hit particularly hard by the contact restrictions and capacity limits imposed to contain the pandemic and wholesalers and retailers were also hoping for business to recover strongly with the end of almost all pandemic restrictions. But the war has thrown a spanner in the works, creating uncertainty and reducing real purchasing power by pushing energy prices and the cost of living sharply upward. After the immediate slump that followed the outbreak of the war in March, sentiment hardly improved in trade and even fell again slightly in May (retail: -0.1 to -4.6 balance points; wholesale: -1.7 points to -7.1 balance points). Inflation is eroding purchasing power but may now have peaked, at least on the basis of sales price expectations, which are falling from a historically high level (SMEs: -7.4 points to 46.6 balance points; large enterprises: -1.6 points to 51.2 balance points). The labour market continues to be robust and bolstering domestic demand and thus trade, with employment expectations in May rising further on a high level in both enterprise size classes (SMEs: +0.8 points to 10.6 balance points; large enterprises: +3.9 points to 15.3 balance points). Business sentiment among SME manufacturers again recovered only little after plunging in March (+0.7 points to -9.5 balance points), while their export expectations actually fell at the same time (-2.2 points to -9.2 balance points).

#### **Confidence improved sharply among large manufacturers**

The nearly unchanged low confidence level of SME manufacturers is in striking contrast to the strong rise in confidence among large industrial firms. Business sentiment there rose by more than two and a half times a typical monthly variation: +9.6 points to 1.1 balance points. That means the confidence level there has basically returned to the historical average, even though it is still much lower than it was just before the outbreak of the war in February (15.6 balance points). At the same time, large industrial enterprises' export expectations increased noticeably by 5.5 points to -1.6 balance points. Whether the striking improvement in sentiment among large industrial firms is more than a flash in the pan remains to be seen, given the near impossibility of predicting economic and foreign trade developments, disruptions to supply chains, rapidly rising input prices and concern over energy security. But the improved sentiment might be an indication that businesses are increasingly managing to adapt to the changed situation.

Sentiment also improved in the other sectors, although not as much as in large manufacturing. Overall, confidence levels of large enterprises improved slightly more than among SMEs in May, rising by 3.7 points to -11.1 balance points, but still remained well below the comparison value for the SME sector. The situation assessments of large enterprises were only slightly positive (+2.3 points to 3.3 balance points) and, despite improving noticeably, their expectations remained more pessimistic than those of small and medium-sized enterprises (+4.7 points to -23.7 balance points).

#### **The war has choked off the hoped-for strong recovery**

Despite all the burdens posed by the war and the pandemic, current business is still relatively good but companies are very fearful of a downturn. That sums up the key message of the KfW-ifo SME Barometer for May. Never before was the discrepancy so high – among both SMEs and large enterprises – between the continuing positive assessments of the current business situation and the very gloomy business outlook since the outbreak of the war. That shows the abyss into which enterprises are staring. How deep they will fall is a different matter, however. It will essentially depend on how long the spiral of sanctions and escalation will continue to turn but also on the duration of the war. What is particularly relevant for the economy is whether gas imports from Russia will stop. Two fundamentally opposing forces are currently acting on the business cycle: While the dampening effects of the pandemic are waning and contact-intensive services are recovering, Russia's war of aggression is prolonging and exacerbating global supply chain problems, sending energy costs soaring and weighing on purchasing power. Consumption will therefore pick up in the summer half-year but likely at a slow pace. In the winter half of 2022/2023 the economy will even almost stagnate because by that time the moderate momentum from the recovery of services consumption will have subsided, so that supply-side problems in manufacturing and construction such as material shortages and high costs for energy and other important inputs will impact the overall economy more noticeably again. Assuming a stop of Russian gas supplies can be avoided, against this backdrop we expect that the German economy can still grow by 1.6% in 2022. By contrast, before the war broke out we had predicted that the economy would grow at twice that rate under more favourable circumstances. But that hoped-for vigorous recovery is now being choked off by the war.

## KfW-ifo SME Barometer in figures

Balance [Percentage points]*		Month/Year							m-o-m	y-o-y	3m-o-3m
		May 2021	Dec 2021	Jan 2022	Feb 2022	Mar 2022	Apr 2022	May 2022			
<b>Business climate</b>											
Manufacturing	SME	13.4	3.5	3.9	10.1	-10.5	-10.2	-9.5	0.7	-22.9	-15.9
	LSE	21.2	7.7	9.6	15.6	-12.4	-8.5	1.1	9.6	-20.1	-17.6
Construction	SME	11.3	13.3	11.0	11.0	-4.3	-12.9	-8.2	4.7	-19.5	-20.2
	LSE	1.4	9.7	13.1	14.4	-23.8	-19.2	-11.6	7.6	-13.0	-30.6
Retail trade	SME	10.0	-10.8	-1.7	9.5	-6.6	-4.5	-4.6	-0.1	-14.6	-4.2
	LSE	1.4	-17.6	-2.3	-4.8	-14.7	-28.1	-26.4	1.7	-27.8	-14.8
Wholesale trade	SME	13.5	-4.3	-1.7	5.9	-9.2	-5.4	-7.1	-1.7	-20.6	-7.2
	LSE	14.7	0.1	2.6	11.9	-11.0	-9.1	-7.2	1.9	-21.9	-14.0
Services	SME	-3.0	-11.5	-7.9	-0.5	-10.3	-5.8	-1.4	4.4	1.6	0.8
	LSE	4.3	-9.9	-2.6	0.1	-16.7	-19.5	-18.4	1.1	-22.7	-14.1
<b>Germany</b>	<b>SME</b>	<b>4.7</b>	<b>-2.9</b>	<b>-0.3</b>	<b>5.6</b>	<b>-9.5</b>	<b>-7.1</b>	<b>-5.9</b>	<b>1.2</b>	<b>-10.6</b>	<b>-8.3</b>
	<b>LSE</b>	<b>10.9</b>	<b>1.3</b>	<b>5.1</b>	<b>8.1</b>	<b>-15.6</b>	<b>-14.8</b>	<b>-11.1</b>	<b>3.7</b>	<b>-22.0</b>	<b>-18.7</b>
Current situation	SME	-1.0	5.8	2.8	8.3	6.0	7.4	11.0	3.6	12.0	2.5
	LSE	10.2	6.7	7.5	12.5	2.8	1.0	3.3	2.3	-6.9	-6.5
Expectations	SME	10.0	-11.1	-3.5	2.8	-23.5	-20.3	-21.0	-0.7	-31.0	-17.7
	LSE	11.3	-3.8	2.7	3.9	-31.3	-28.4	-23.7	4.7	-35.0	-28.7
<b>Employment expectations</b>	SME	7.7	8.0	8.5	13.2	9.2	9.8	10.6	0.8	2.9	0.0
	LSE	3.1	15.0	15.4	19.2	11.8	11.4	15.3	3.9	12.2	-3.7
<b>Sales price expectations</b>	SME	21.5	34.7	36.1	35.8	47.5	54.0	46.6	-7.4	25.1	13.8
	LSE	19.1	34.5	34.6	39.9	47.3	52.8	51.2	-1.6	32.1	14.1
<b>Export expectations of manufacturing</b>	SME	10.5	-1.2	0.3	3.6	-13.9	-7.0	-9.2	-2.2	-19.7	-10.9
	LSE	14.6	6.5	9.3	6.1	-9.7	-7.1	-1.6	5.5	-16.2	-13.4

Source: KfW Research, ifo Institute

Explanations and abbreviations:

\*Seasonally and mean adjusted (long-term mean since January 2005 = 0)

S(mall and) M(edium-sized) E(nterprises).

L(arge-)Scale E(nterprises).

Change in percentage points m(onth)-o(ver)-m(onth).

Change in percentage points y(ear)-o(ver)-y(ear).

Change in percentage points 3 m(onths period)-o(ver)-3 m(onths period).

Revisions relative to previous publications may occur due to seasonal and mean adjustments as well as rounding. The KfW-ifo SME Barometer was fundamentally revised for the reporting month of April 2018 (new aggregation process, inclusion of services, start of time series now 2005 instead of 1991, consideration of export expectations, discontinuation of regional indicators for western and eastern Germany). Publications prior to and from April 2018 are therefore comparable to a limited extent only.

### Construction and interpretation of the KfW-ifo SME Barometer

The KfW-ifo SME Barometer indicator family is based on a scale-of-enterprise evaluation of the ifo economic surveys which are used to calculate, among other things, the well-known ifo Business Climate Index. Each month about 9,500 enterprises from trade and industry, construction, wholesale, retail and services (without the banking and insurance sectors or the state) are polled on their business situation, among them some 8,000 SMEs. Enterprises are generally classed as small to medium-sized if they employ a workforce of not more than 500 and record an annual turnover not exceeding EUR 50 million. For a more accurate analysis, however, these quantitative distinctions have to be drawn more narrowly for retail trade (maximum annual turnover of EUR 12.5 million), the building and the construction industry (up to 200 employees) and services (maximum annual turnover of EUR 25 million). All enterprises that exceed at least one of these thresholds are classed as large-scale enterprises. The KfW-ifo SME Barometer reports the balance of current business assessments (percentage of positive answers less percentage of negative answers), the balance of business expectations for the next six months, ascertained in a similar way, and the inferred mean average value for the business climate. Moreover, the enterprises' employment and domestic sales price expectations and – exclusively for manufacturing – export expectations are also captured as balance figures for the next three months. All time series are seasonally and mean adjusted. The zero line therefore marks the long-term 'cycle-neutral' average since January 2005. Indicators above (or below) zero point to an above average or favourable (below average or negative) business situation.