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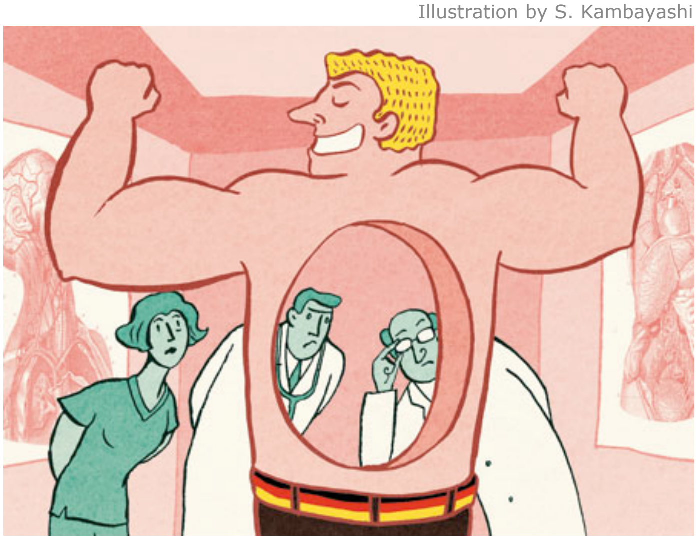
Germany's looming credit crunch

A reluctant patient

Jul 23rd 2009 | BERLIN
From *The Economist* print edition

Europe's biggest economy has largely escaped the squeeze. Not for much longer

Illustration by S. Kambayashi



ONE of the hardest tasks doctors face is convincing an outwardly well patient that he needs drastic treatment. So too with Germany's financial system. By most measures, the flow of credit has held up pretty well in Germany, even as it has fallen elsewhere. Yet without painful surgery, there is a real danger that the arteries of finance may soon clog.

There is no obvious need to panic. According to ZEW, a research institute, the total volume of loans outstanding in Germany was almost 3% higher in May than a year earlier, compared with loan growth of under 2% in the rest of the euro area. Surveys of businesses and banks have shown no pervasive tightening of credit. A monthly survey by the IFO institute for economic research at Munich University found that in June more than half of German firms thought credit no harder to come by than usual. A similar study by the German chambers of industry and commerce (DIHK) found that almost two-thirds of firms had experienced no tightening of credit conditions.

Bankers say that they have got tougher but they have still tightened lending standards less markedly than their counterparts in the euro area as a whole. Not even the notoriously pessimistic

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Bundesbank expected Germany to experience a credit squeeze when it produced its latest forecasts in June. "Overall what you see right now is not a credit crunch," says Carola Schuler of Moody's, a rating agency.

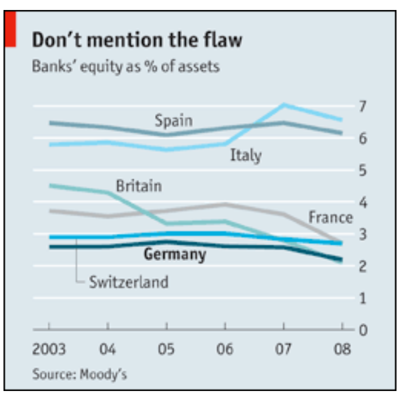
Yet many in Germany are increasingly concerned that a looming credit crunch will squeeze lending to the country's middle-sized firms, throttling any hope of a rebound in growth next year. "There is a real danger for the second half of the year" that credit conditions will tighten sharply, says a senior government official.

The first reason for worry, oddly, is that Germany's legion of small and medium-sized firms entered this downturn with balance-sheets stuffed with cash. Most say that they are not having trouble raising loans because many have not yet tried. But the sharp contraction in German export orders, with sales in some industries such as machine tools falling by 60%, means that many firms are now burning cash and will soon need to replenish reserves, says Alexandra Böhne of the DIHK.

Being very small will afford some protection. Germany's locally owned savings banks (or *Sparkassen*), co-operative banks and small regional banks seem still to be lending furiously to their local clients. Alongside dedicated mortgage banks, such institutions account for about two-thirds of all lending in Germany, although most of this is to (thrifty) households and very small businesses. Being very big may also help. Germany's largest firms have successfully sold bonds in recent months.

That leaves the *Mittelstand*, the mid-sized firms that are the backbone of Germany's export-driven economy, most exposed to a credit squeeze. Sheltering these firms will be tricky because there are many reasons for the expected contraction in lending. The first is that they were keenly courted before the crisis by foreign banks that have since pulled back. Stories abound of clients of these banks desperately knocking on the doors of domestic lenders. "Foreign banks have more or less retreated from Germany," says Matthias Wissmann of the German Association of the Automotive Industry (VDA).

A second reason is that the merger of two of the country's big domestic banks, Commerzbank and Dresdner Bank, is leading to a sharp withdrawal of credit from the *Mittelstand*. This is partly because the combined bank is obliged under European state-aid rules to shrink its balance-sheet in return for the help it has received from the government. But it is mainly because many middle-sized companies were clients of both banks. Now that they have merged, credit lines are being amalgamated and cut back.



Don't mention the flaw

Underlying these risks is a deeper weakness. German banks are thinly capitalised, with little more than 2% of equity supporting their assets (see chart). Loan losses from a prolonged downturn could quickly deflate that cushion; so too could losses on the banks' hoard of toxic securities, estimated in some quarters to exceed $1 trillion.

German banks also fear the effects of credit downgrades among their corporate clients. Under Basel 2 rules banks would then have to set aside more capital relative to their assets. The head of corporate banking at one large German bank anticipates an average downgrade of three notches among its clients, which in theory could force the bank to increase its capital reserves by as much as a quarter. Others expect more modest downgrades of one to two notches on average, but few can afford even that sort of deterioration. Many are likely to cut back on lending rather than try to raise more capital.

Such problems are not unique to Germany, but they are being handled in a uniquely short-sighted way. Germany's bad-bank plan, which passed into law this month, seems determined to deter banks from using it by imposing unnecessarily onerous conditions. Only two banks look likely to take it up. The scheme's main aim is to protect taxpayers from bearing losses. In that it will be a remarkable success. But it will do little to protect the economy from a prolonged credit squeeze.

Symptomatic of Germany's reluctance to peer into the state of its banks is its steadfast refusal to force them to conduct stress tests against published criteria. "Why were we reluctant to stress-test the banks?" says an official. "Because we were worried about what we would find." With doctors like these, pray for the patient.

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