Finanzgruppe
Deutscher Sparkassen- und Giroverband

DIAGNOSE
MITTELSTAND

SME DIAGNOSIS 2022

German SMEs between hope and scepticism

Three out of four companies in Germany are customers of the Savings Banks Finance Group. Advising and financing small and medium-sized enterprises in Germany is the core business of the Savings Banks and Landesbanken. To this end they use their strengths; a detailed knowledge of their customers and their personal situation as well as a nationwide presence throughout Germany's regions.

With the SME Diagnosis 2022, the German Savings Banks Association (DSGV) presents the 22nd collection of representative data on the current situation of SMEs.

Integrated into this study for the first time is the S-Financial Climate Index of the DSGV and Deka. This is based on quarterly surveys on economic development conducted among the management boards of the German Savings Banks.

Content

HELMUT SCHLEWEIS
President of the German Savings Banks Association

“It is essential that temporary state aid quickly and directly reaches the companies affected by the enormous increases in natural gas and electricity prices.”

Berlin, November 2022

Ladies and Gentlemen,

SMEs are facing a multi-dimensional stress test: The combination of sharply rising energy costs, inflation and intensified supply bottlenecks as a result of the war in Ukraine is depressing both the mood and expectations.

The economic outlook received by the regional institutions of the Savings Banks Finance Group from their borrowers is now significantly worse than before the Corona winter of 2020/21. However, the corporate customer experts of the institutions consider the German SME sector as a whole to be flexible and stable enough to overcome the energy crisis.

> "Companies are currently saving energy to avoid a shortage in winter. This goes hand in hand with reduced production."

Problems are looming for the winter of 2022/23 as a result of the shortage of gas, according to estimates by the Savings Banks. However, with the announced gas price brake, the situation of sharply rising energy prices could ease somewhat.

After experiencing dynamic lending business in the first half of the year, companies are now expecting a decline in demand – also due to rising interest rates and the decreasing purchasing power of the population.

The budgets of many private households have reduced as a result of price increases for food, housing and energy. This leads to a declining savings rate as well as to consumption restraint. Sectors such as retail, tourism, culture and events and personal services, which had recovered from the effects of the Corona pandemic in recent months, have been particularly affected.

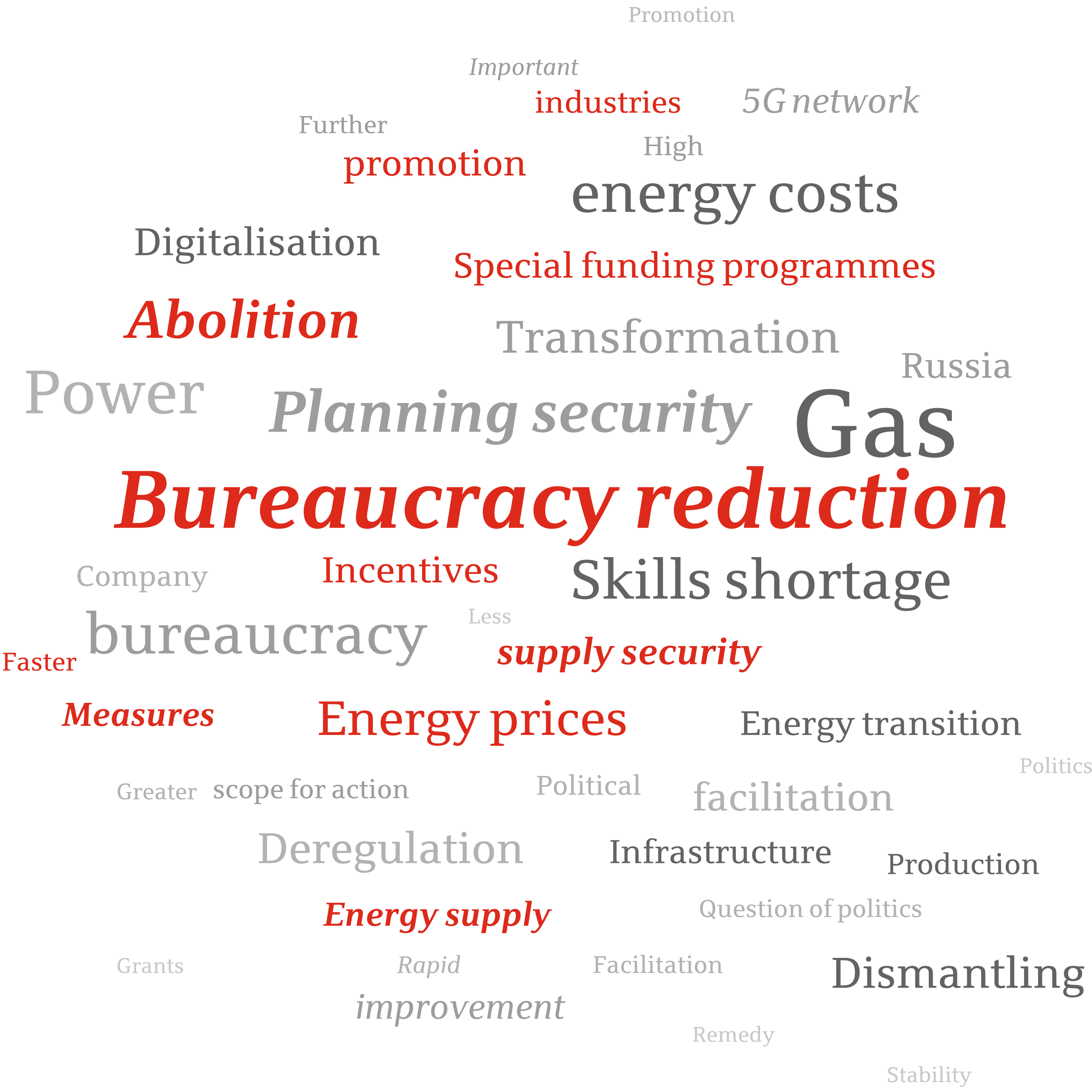
In the current transition phase, SMEs need reliable framework conditions under which they can develop freely. In many cases, however, companies fail in their efforts and planning due to bureaucratic requirements; for example, if they want to convert their production facilities to other energy sources. The lack of skilled workers also continues to be a major obstacle.

Politics and society should do everything they can to remove such obstacles, for example by promoting training, targeted immigration and reducing bureaucracy. Because right now Germany needs innovation and impetus from small and medium-sized enterprises.

This sector comprises around 99 percent of companies and is thus the backbone of the German economy in terms of value creation, employment and training. Entrepreneur-friendly framework conditions create the prerequisites for German SMEs to successfully manage the upcoming transformation process.

A strong SME sector also needs strong, regionally anchored credit institutions. The Savings Banks remain ready to provide companies with support in meeting the enormous challenges and investing in the future.

This “SME Diagnosis 2022” describes and evaluates the challenges for SMEs in an economic world threatened by crisis. For the first time, the S-Financial Climate Index of the DSGV and Deka is integrated into the study; it is based on quarterly surveys on economic development conducted among the management boards of the German Savings Banks. With the “SME Diagnosis”, Savings Banks and Landesbanken, as the most important financial partners of SMEs, make their knowledge available to the public.

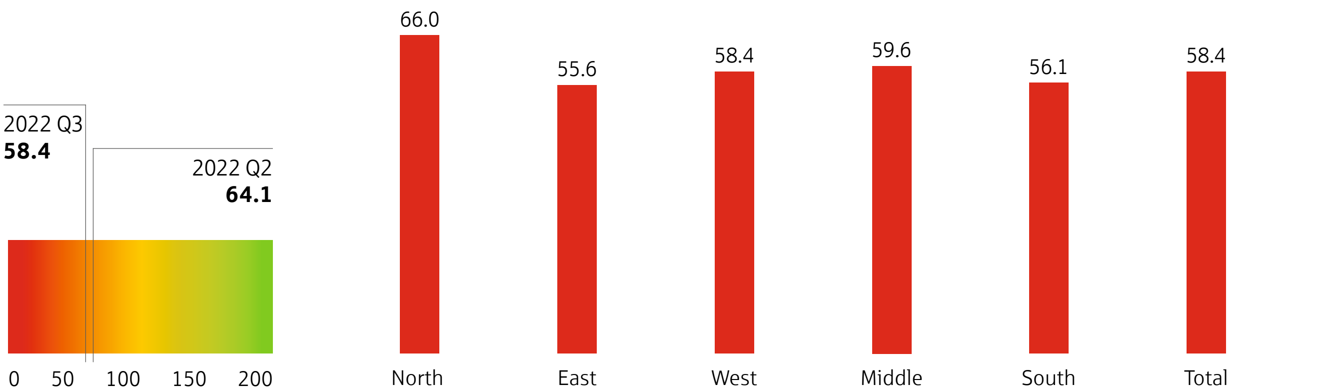

Promotion
Important
industries
5G network
Further
High
promotion
energy costs
Digitalisation
Special funding programmes
Abolition
Transformation
Russia
Power
Planning security
Gas
Bureaucracy reduction
Company
Incentives
Skills shortage
bureaucracy
Less
Faster
supply security
Measures
Energy prices
Energy transition
Politics
Greater
scope for action
Political
facilitation
Deregulation
Infrastructure
Production
Energy supply
Question of politics
Grants
Rapid
Facilitation
Dismantling
improvement
Remedy
Stability

2 DEKA S-FINANCIAL CLIMATE IN Q3 2022

A significant downturn but no drama

The Deka S-financial climate is a measure of the current environment for the economy and financial markets from the perspective of the regional credit institutions of the Savings Banks Finance Group. It is a Sentimet index that is produced quarterly from a survey of the management boards of the German Savings Banks, i.e. it relies deliberately on individual assessments. The indicator, which has been collected since mid-2020, fell to an all-time low in the third quarter of 2022. This was due to the further deterioration in the economic outlook for the German economy in view of uncertain prospects for energy supply and an environment of rising interest rates. Despite the expectation of a cyclical economic downturn in winter, the Savings Banks consider the companies in their business area to be mostly well prepared for the problematic energy environment in the coming months. Even the moderate rise in interest rates is, in the opinion of the regional credit institutions, manageable for the companies. The recent strong interest rate increases by the ECB meet with broad approval – the majority of the Savings Banks are in favour of further key interest rate increases into the neutral range of 1.5 to 2 percent and even beyond.

Deka S-Financial Climate, Q3 2022 chart 01



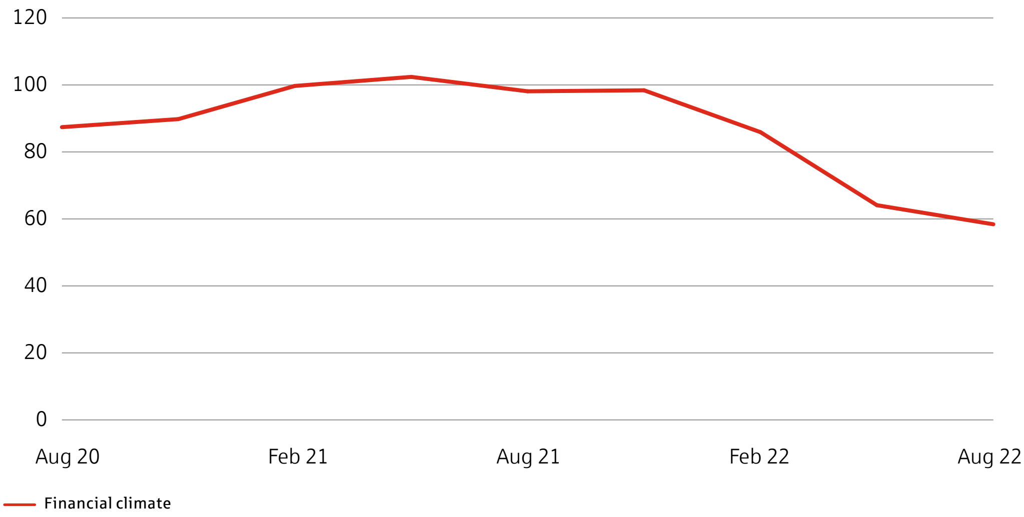
Sources: DekaBank, Research Centre for Savings Banks Development

Financial outlook: Deteriorating environment for the German economy

At 58.4 points, the S-financial climate continued to decline at the beginning of the second half of 2022. This is the third decline in succession and the lowest value for the S-financial climate index in its (still young) history (chart 02). The downturn is largely driven by declining economic expectations, which weakened again significantly in view of the winter energy supply. The current inflation and energy crisis are now considered to be as serious as the Corona crisis in 2020. So far, however, it is fears that are predominant rather than actual business slumps.

Third decline in succession

chart 02

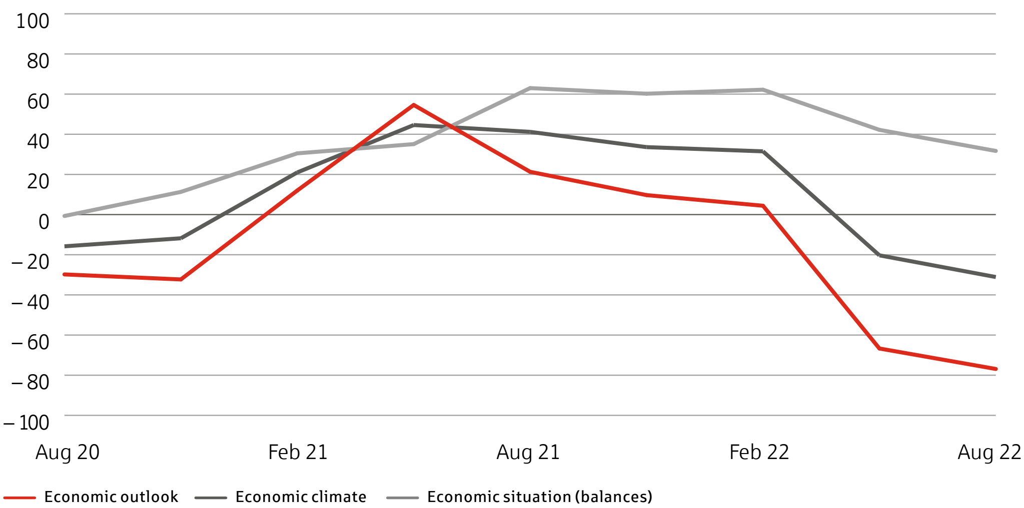


Source: Research Centre for Savings Banks Development, DekaBank

The Savings Banks managers' profitability expectations for their business also remain stable, and due to the renewed improvement in interest rate prospects, earnings expectations have even increased slightly on average. So far, the credit sector – at least as far as the Savings Banks in Germany are concerned – has shown itself to be robust in the face of the numerous problems in the economy. However, for the first time, the developments are also having an impact on financing conditions. In view of rising risks, the willingness to lend decreased somewhat at the beginning of the second half of the year, but is still at a high level.

Economic winter is coming

chart 03



Source: Research Centre for Savings Banks Development, DekaBank

Current economic climate: Worse than during Corona

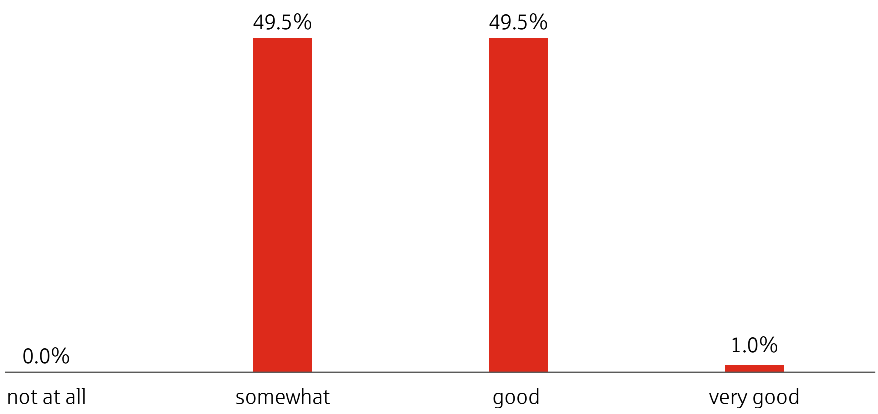
Economic pessimism also continued to rise in the Savings Banks Finance Group at the beginning of the second half of 2022. The business climate reached a new low in the relatively recent history of the survey (chart 03). Both the situation and expectations continued to decline. However, while the assessment of the current situation was still well above the previous low, economic expectations in particular have plummeted dramatically in the last two quarters and, at minus 76.9 points, are now not far from the absolute low (minus 100). This means that the economic outlook reflected by the regional institutions of the Savings Banks Finance Group from their borrowers in the corporate sector is even significantly worse than before the Corona winter of 2020/21.

Seemingly in contrast to these poor economic expectations is the fact that half of the experts see the companies in their business area as well prepared for the energy situation in the winter half-year (chart 04). However, this mainly reflects the considerable energy savings that industrial companies are currently making in Germany. This result also supports the current optimism that the so-called natural gas shortage (which would trigger rationing according to the 3rd stage of the gas emergency plan) can be avoided. If, in addition to industry, private households now also implement a reduction in consumption of a similar magnitude during the heating season that begins in September, a natural gas shortage will not in fact take place.

Although the experts in the Savings Banks are not unduly worried about the constitution of the companies in their business area, the concern about a recession remains well-founded: as the restrictions on industrial production associated with the energy-saving course of the companies, together with the ongoing consumer restraint, are likely to lead to a contraction of the gross domestic product from the 4th quarter of 2022 onwards.

How well are companies preparing for a natural gas shortage?

Preparations for energy shortages chart 04



Sources: DekaBank, Research Centre for Savings Banks Development

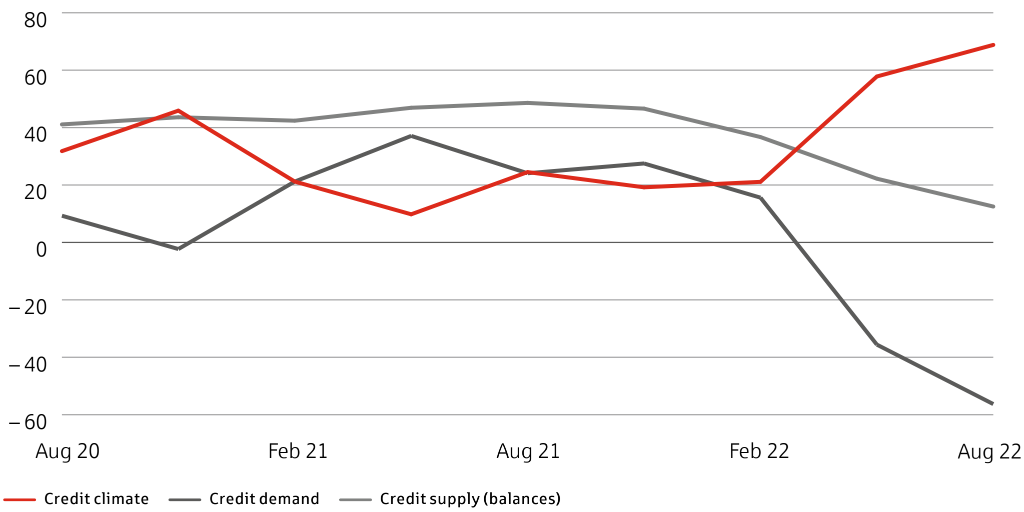
According to the Savings Banks, the most likely scenario for winter 2022/23 is thus not so much a natural gas shortage scenario, but a natural gas saving scenario.

Current credit climate: Prepared for further interest rate increases

The gloomy economic outlook is already leaving clear traces in the assessment of the credit situation. The credit supply balance deteriorated again at the beginning of autumn (chart 05) to only 12.5 balance points. Thus, the credit supply component declined after having remained very stable in the past quarters. On the demand side, however, there was an even sharper slump. Here, the responses of the regional credit experts showed the sharpest decline since the surveys began in mid-2020, at minus 56.3 balance points. The credit climate composed of credit supply and demand did improve to a high of 168.8 index points and 68.8 balance points, respectively. However, since this gap between supply and demand is mainly due to the slump in demand for loans, this development is not necessarily a positive message. Nevertheless, it does show that there is no credit crunch.

Credit climate

chart 05

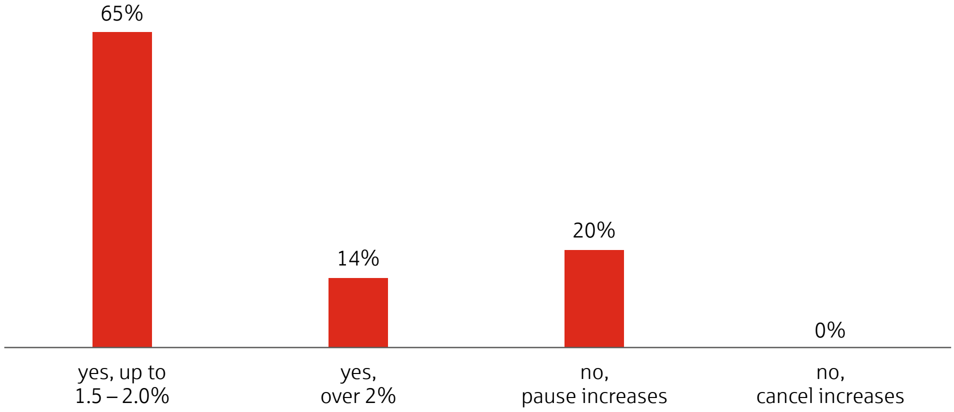


Sources: DekaBank, Research Centre for Savings Banks Development

Although rapidly rising interest rates are also a significant burden on the balance sheets of credit institutions, the top managers of the Savings Banks Finance Group are in favour of the monetary policy course now taken by the European Central Bank. Almost 80 percent of the experts are in favour of continuing the increases in key interest rates up to at least 1.5 to 2 percent for the deposit rate, including 14.4 percent who even consider interest rates of over 2 percent to be necessary (chart 06). In the meantime, the ECB has raised interest rates by 0.75 percentage points to 2 percent. Only a minority of a good 20 percent consider a pause in interest rate tightening necessary in view of the economic expectations. The ECB, which for a long time had been seen by the Savings Bank boards as too hesitant in fighting inflation, has thus regained some ground in the assessment of its monetary policy.

Should the ECB continue its monetary tightening course?

Need for further interest rate increases chart 06

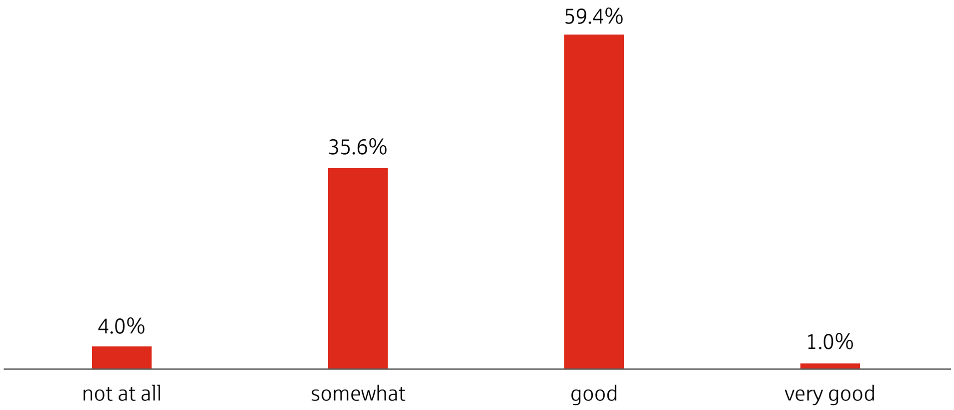


Sources: DekaBank, Research Centre for Savings Banks Development

Regional credit managers are also relaxed about their impact on the corporate landscape: 60 percent felt that companies in Germany were well to very well prepared for further increases in interest rates (chart 07). This underlines the observation, which can also be derived from balance sheet data, that German SMEs are entering the energy crisis with strong balance sheets across the board. However, this cannot hide the fact that for energy-intensive production the escalating prices for electricity and natural gas this winter are having a severe impact on profitability, at least temporarily.

How well prepared are companies for interest rates above 3 percent?

Ability to cope with interest rate increases chart 07



Sources: DekaBank, Research Centre for Savings Banks Development

Despite the foreseeable economic burdens from the geopolitically induced rise in energy prices, the Savings Banks continue to clearly support further interest rate tightening for the coming months. Together with the expectations observed on the financial markets, this consolidates an interest rate expectation on the money market of at least two percent in the course of the coming year. This expectation has now come to pass. However, there are slight discrepancies in the durability of this interest rate landscape: while participants in the S-financial climate assume that interest rates have come back to stay, the inversion of the yield curve currently taking place on the financial markets suggests that market players expect key interest rates to fall again relatively soon.

Significant economic indicators

	2022 Q3	2022 Q2	
S-financial climate	**58.4**	64.1	↓
S-business climate	**68.9**	79.7	↓
S-credit climate	**168.8**	157.8	↑
Economic situation	**131.7**	142.2	↓
Willingness to lend	**112.5**	122.2	↓
Regulatory framework	**23.1**	20.0	↑
Cost of capital	**36.9**	39.8	↓
Profitability	**98.1**	94.4	↑
Economic outlook	**23.1**	33.3	↓
Demand for credit (commercial)	**43.7**	64.4	↓
Demand for real estate loans	**18.4**	36.7	↓
Personnel planning	**67.3**	60.0	↑
Expectations for monetary policy	**26.9**	26.7	↑

Interpretation guide: The indicators can take values between 0 and 200. First, the balances are calculated from the proportions of positive and negative answers. These can be between – 100 (only negative answers) and + 100 (only positive answers). Then the value 100 is added. The financial climate of 58.4 therefore means that the balance was – 41.6, i.e. there were more negative answers.
For the additional question, the share of those who expect a later turnaround in interest rates was subtracted from the share who expect an earlier one. Neutral was normalised to 100.

Summary: Deka S-Financial Climate Q3 2022

The results of the autumn survey on the economic environment reveal a clear deterioration of economic expectations. Although the S-financial climate index does not have a recession threshold, the extent and speed of the decline as well as the level indicate that economic performance could decline in the coming quarters. At the same time, however, neither the assessments of the companies nor the indicators of their own business development indicate expectations of dramatic developments.

→ Information on the compilation of the Deka S-Financial Climate Index can be found on page 37.

3 FOCUS TOPIC

Inflation, supply bottlenecks, rising energy prices – A challenging combination for SMEs

Macroeconomic framework conditions and the situation facing small and medium-sized enterprises

The wind has changed. Instead of the expected economic recovery after overcoming the worst effects of the Corona pandemic, war broke out in Ukraine in early 2022. The consequences: rising food and energy prices worldwide as well as a further deterioration of the supply chain problems already caused by the Corona pandemic. The impact on the Savings Banks' SME customers is considerable. This became clear in a survey of the commercial customer advisors of the Savings Banks conducted by the DSGV.

More than half of SME clients are directly affected by supply chain issues. While last year about 51 percent of commercial SME clients expected their business situation to improve after the Corona pandemic subsided and more than 43 percent saw neither a change nor a deterioration, today more than 40 percent indicate that the actual economic situation has worsened within the last twelve months. The outlook has completely reversed. More than 80 percent of SMEs now expect their economic situation to deteriorate further by the end of 2023.

What are the causes of such a significant change?
The central issue for German SMEs is currently the unchecked rise in energy prices. Companies are usually affected faster and more severely than private households, as their energy supply contracts often include price adjustment mechanisms. In the event of a further military escalation in Ukraine and increasing disruptions in trade flows, inflation would receive new impetus. But even without new shocks, after a historically long phase of expansionary monetary policy with negative interest rates and purchase programmes for government and corporate bonds, it will be difficult for the ECB to effectively limit the price dynamics that have developed. An even rudimentary return to interest rate levels that were considered normal before the financial crisis of 2008/2009 would increase the interest expenses of SMEs many times over. A simultaneous sharp rise in expenses for energy supplies and interest on loans poses a real challenge for many businesses.

The commercial customers of the Savings Banks are aware of this danger. While last year two thirds of companies still saw the relatively favourable interest rates as an opportunity to finance investments, today almost all companies fear that further increases in interest rates pose a risk to their business development.

So far, the interest rate increases are still manageable for companies. The S-financial climate index shows that companies are well prepared for further increases in interest rates. This reflects the observation that SMEs have a solid balance sheet position despite the difficult overall economic policy situation. It should also be noted here that Savings Bank loans to SMEs are long-term loans with a term of more than five years and as a result interest rate increases have a delayed effect on the cost structure of SMEs. Interest expenses therefore still account for a relatively small share in the cost structure of SMEs.

Fueled inflation

Many commodities remain scarce. Exorbitant increases in energy prices and shortages also in goods and services for daily needs continue to keep prices high.

Nevertheless, rising interest rates are increasing the already very high cost pressure on SMEs, especially on energy-intensive companies and the real estate sector.

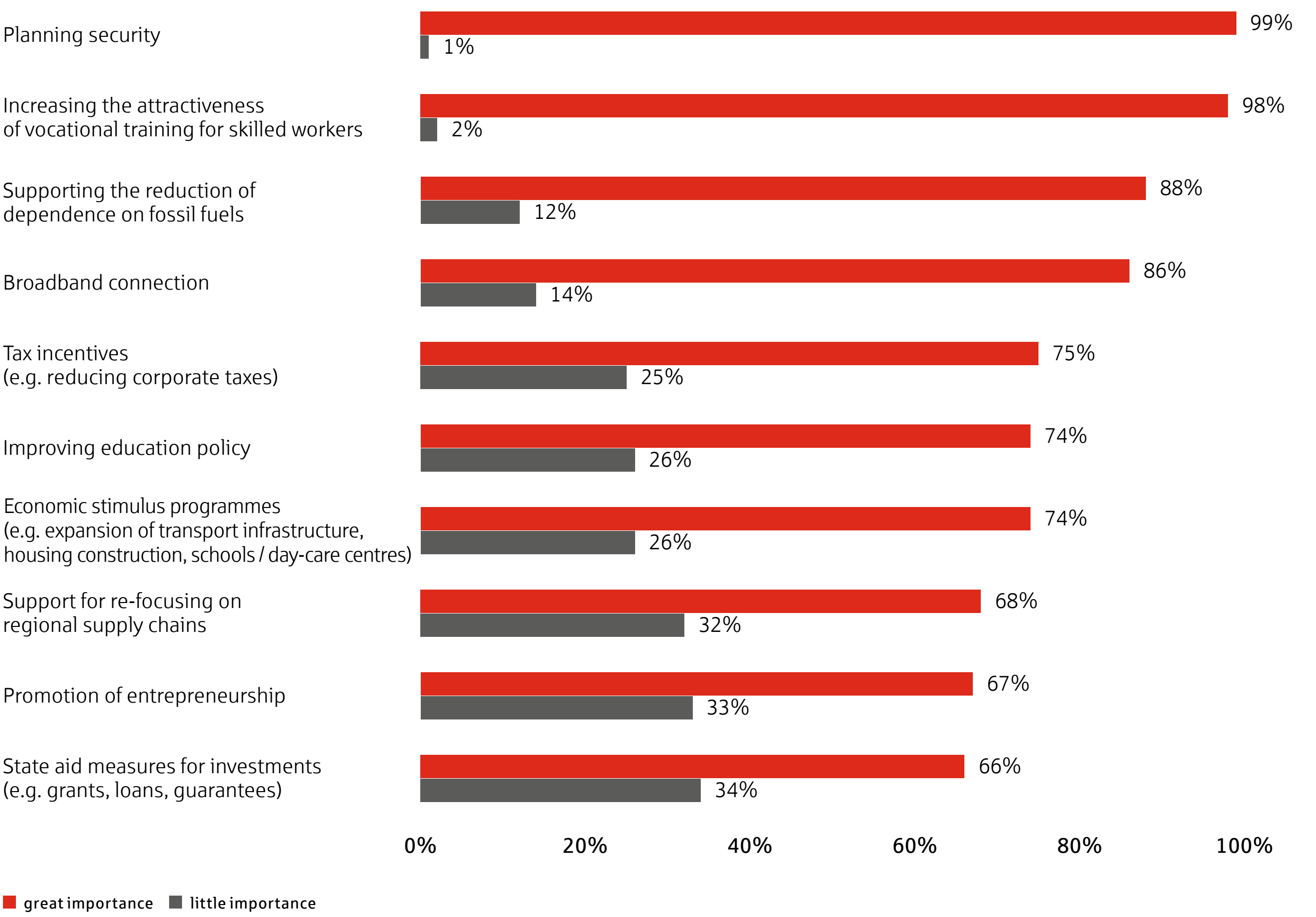
In the face of multiple crises and pressures, it is difficult to remain confident. “Uncertainty” is the keyword. Even the measurement and recording of economic events by the experts of the Federal Statistical Office are currently subject to uncertainty. For example, the actual real growth of 0.8 percent in the first quarter of 2022 was four times higher than the initial estimate, which was only 0.2 percent. Such uncertain forecasts do not make it easier for companies to prepare for the challenges ahead.

For this reason, almost all SME commercial customers of the Savings Banks would like to have greater planning security, which would enable them to react more quickly to the current challenges in order to avert greater damage or to be able to achieve a rapid business recovery (chart 08).

Which of the following framework conditions and policy measures do your corporate clients think are most important for economic recovery?

Necessary framework conditions

chart 08



Inflation as an economic phenomenon

“History repeats itself” is a universal wisdom, but one that is regularly ignored and just as readily derided. But the present times prove that this supposedly simple aphorism contains more than a grain of truth. The year 2022 painfully demonstrates the consequences of an overly unreflective approach to the past and at the same time stirs memories of less carefree times.

The Corona pandemic has not only disrupted Western societies and economies. The Russia-Ukraine war, which finally escalated in the spring of 2022, has plunged already battered economies around the globe into additional existential fear.

In privately organised economies, markets that are as freely accessible as possible play a prominent role. Supply and demand decisions are made on the basis of individual calculations; the much-invoked, almost mystical, invisible hand of the market ultimately answers allocation questions for the benefit of all and thus secures the welfare of an economy.

Prices play a special role in this “model world”. They are the decisive indicators for the adjustment reactions of all participants. The market price balances the plans of suppliers and buyers in equilibrium: all potential buyers can purchase the desired quantity of a given item at the market price, all sellers are able to sell the products calculated for this price – the market is cleared.

As well as the market balancing function of the price, it also regularly acts as an indicator and source of information. Realised sales at a high market price indicate that the respective product is in great demand from the buyer’s side, i.e.: valuable in the broader sense and – measured by the willingness to pay – relatively scarce and vice versa.

In addition to the absolute level of individual prices on the respective markets, their movements over time are primarily of interest to the economy as a whole. In this context, macroeconomists speak of the change in price levels.

The economic phenomenon known as inflation refers to the percentage change in a predefined price index in relation to a previous period. It is important to distinguish carefully between the constancy of individual prices and the stability of the price level. Inflation does not refer to price flexibility in individual markets, but rather reflects the extent of co-directional price movements in a variety of markets. Opposing price fluctuations within the markets summarised in the respective price index can thus offset each other “on balance”, so that the price level may well remain constant. Ultimately, the discussion focuses on a “weighted average” of prices rather than on price movements in individual markets.

Inflation persists

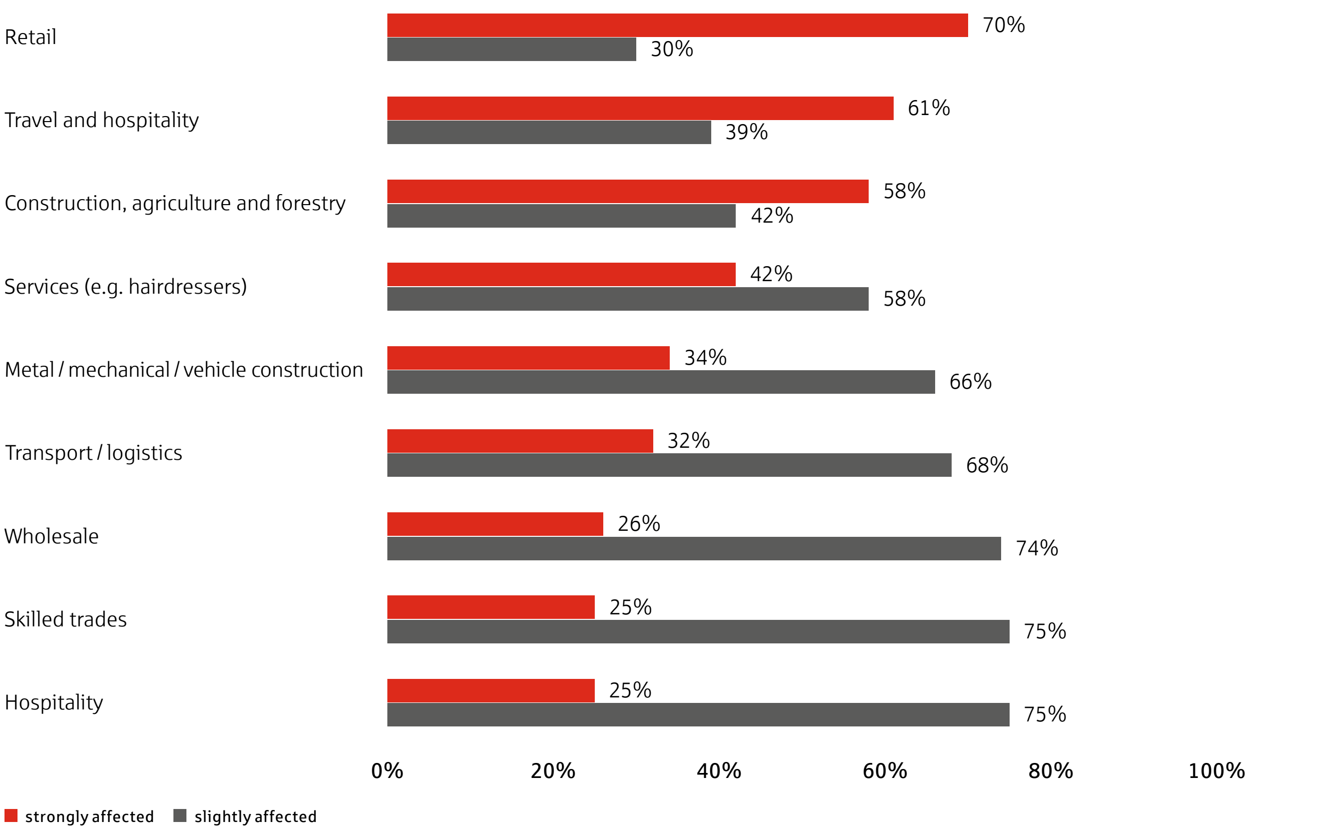
Even without the additional burden of the current risks, the upward pressure on prices will remain high, and in the event of a gas supply freeze it will presumably be even higher throughout 2023 and beyond.

Such a phase of inflation triggered by a shortage of supply of certain products is often much more damaging than the variant of increased demand for products. If, for example, the production bottlenecks affect physical goods or services of daily use (food, energy supply, transport), then those affected cannot always switch to possible alternatives, but are then forced, as it were, to pay the higher prices and, if possible, to put other consumption wishes on hold.

Additionally, increased costs for raw materials or energy also affect sectors that are only active at the next stage of production: Higher energy prices or more expensive food almost inevitably burden the retail trade, the hotel industry and gastronomic businesses, whose services, as experience shows, always fall victim to inflation-related budget constraints.

How would you assess the consequences of the Ukraine war for the following industries in your region?

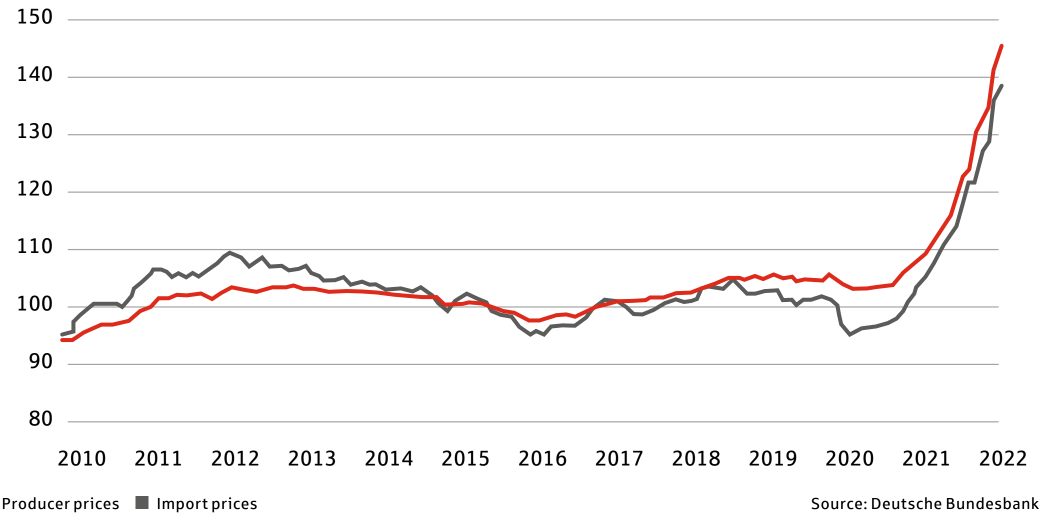
Consequences of the Ukraine war chart 09



These economic findings are only partially reflected in the results of the survey among the commercial customer advisors of the Savings Banks. When asked which sectors are suffering the most from the consequences of the Ukraine war and the associated price increases, the retail trade and the travel and hotel industry are named first, but the hospitality industry is overwhelmingly considered to be only slightly affected (chart 09). Certain catch-up effects from the Corona pandemic could play a role here. In any case, the results also illustrate the uncertainty of the individual sectors with regard to future impact.

For an internationally oriented economy like Germany's, causes of inflation that are not directly attributable to domestic market conditions are also relevant. The prices of all products imported from abroad are determined on international markets, and very often in foreign currency. Not only do the world market constellations relevant for the respective goods play an important role, but also the relevant exchange rates. The foreign trade component is particularly difficult to assess; moreover, even for systemically relevant import goods (e.g. raw materials, pharmaceuticals), suitable substitution alternatives are rarely available.

Price indices (2015: 100) chart 10



Source: Deutsche Bundesbank

Since the beginning of 2021 at the latest, there has been a rapid and largely parallel rise in the respective indices for both producer and import prices (chart 10). The consequences of the Corona pandemic are clearly visible: supply bottlenecks for raw materials, intermediate products or technology (especially electronic components) as well as closures of production facilities (not only abroad) have caught national and international markets completely unprepared. With the start of the Russia-Ukraine war, the general conditions have become even more acute, the upswing in the producer and import price indexes has been given new impetus, and the procurement problems in almost all relevant markets have once again grown noticeably.

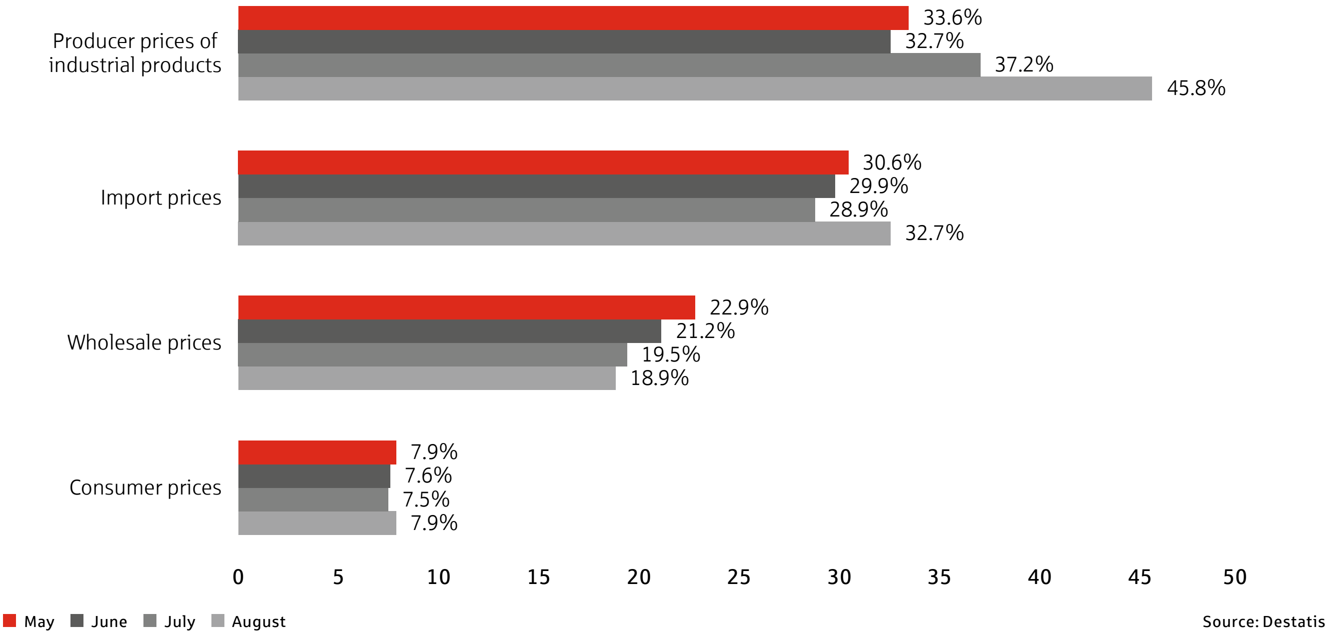
The price increases in the upstream value chains, which continue in the order of 30 percent at twelve-month intervals, show how great the pressure from import and production costs on price development continues to be. This is illustrated in chart 11 using the example of the German price indices.

Needle eye supply chain

It no longer works. The war in Ukraine has further exacerbated the supply bottlenecks caused by the Corona pandemic with no prospect of short-term improvement.

Price increases in Germany compared with the same month of the previous year

chart 11



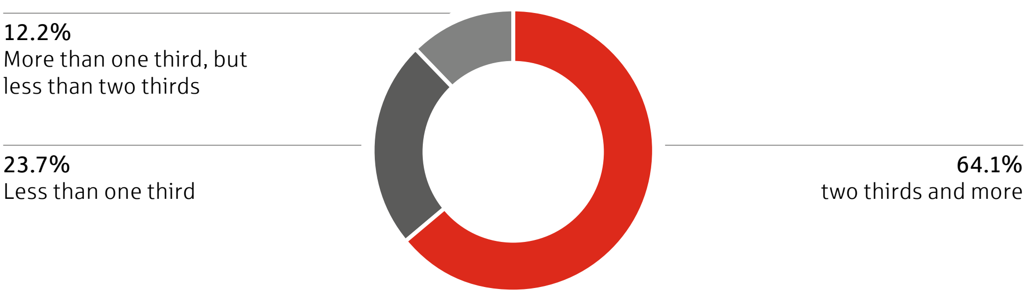
Source: Destatis

These price developments do not only affect the German SME sector. In over 60 percent of the Savings Bank areas, more than two thirds of commercial customers are directly affected by the increase in wholesale prices.

How many of your corporate clients are affected by the increase in wholesale commodity prices (e.g. oil, gas)?

Impact of wholesale prices on corporate customers

chart 12



SMEs, however, do not usually have the same opportunity as most large companies to relocate their production to countries with lower energy costs, such as the USA. A permanent rise in energy prices therefore means a significant competitive disadvantage for the commercial SME customers of the Savings Banks in globally operating product markets.

Companies that try to react to the changed framework conditions and, for example, convert their production facilities from gas to oil, are confronted with complicated approval procedures. Bureaucracy becomes an obstacle to necessary changes. It is therefore not surprising that the SME customers of the Savings Banks see the escalating bureaucracy as the third biggest risk for their further business development – immediately after the consequences of the Ukraine war and the shortage of skilled workers.

Cutting red tape, i.e. simplifying rules, procedures and regulations, is essential for SMEs to have more time for their actual tasks and to pave the way for innovation and investment.

Load-bearing SMEs

The burden on small and medium-sized enterprises is getting heavier and heavier: in addition to the consequences of war and the lack of skilled workers, there is also rampant bureaucracy. Here, too, we need to make changes.

Inflation takes its toll on purchasing power

Current price increases are taking their toll on purchasing power and cutting into household budgets. Both the savings rate and consumer demand are massively constrained by price increases. This is a major reason for slowing growth prospects.

Inflation is affecting individual income strata very differently. Experience shows that private households with low incomes have the highest consumption rate in relation to their income, especially for goods of daily use. Price increases on a broad front considerably restrict the consumption possibilities of these social groups, and can even trigger existential problems in the worst cases. Even if current incomes are still sufficient to finance essential daily consumption, the possibility of making suitable provisions for the future (old age, replacement of durable consumer goods, unforeseen events etc.) may be considerably restricted. Recipients of state social benefits (e.g. old-age pension, unemployment benefits) suffer particularly from longer periods of inflation, as such benefits are only adjusted after some delay.

Inflationary phases triggered by exogenous shocks regularly put a strain on even continuously cultivated customer relationships, as suddenly emerging relative market power opens up large pricing potentials. The steering functions of market prices are thus significantly restricted, as short-term alternatives for systemically relevant products are not sufficiently available. The current international markets for fossil fuels are a prime example of this. Global demand is very inflexible in the short term; if supply is suddenly reduced, prices rise extremely quickly and only the most solvent buyers are able to procure the desired quantities. In principle, more economically efficient players are thus squeezed out, because in times of crisis possibly state-subsidised solvency does not necessarily represent efficiency advantages. A state support action for domestic gas suppliers, keyword: gas levy, would have led to a considerable distortion of the original market conditions in favour of very large companies.

The fiscal effects of inflation are also significant. The higher the market prices, the greater the nominal revenues, which in turn can even lead to a permanent ad valorem tax such as value-added tax, which in turn leads to increasing revenues for the state. This places a disproportionate burden on low-income households in particular, because their consumption share of disposable income rises especially sharply, as already explained, and so does their tax burden.

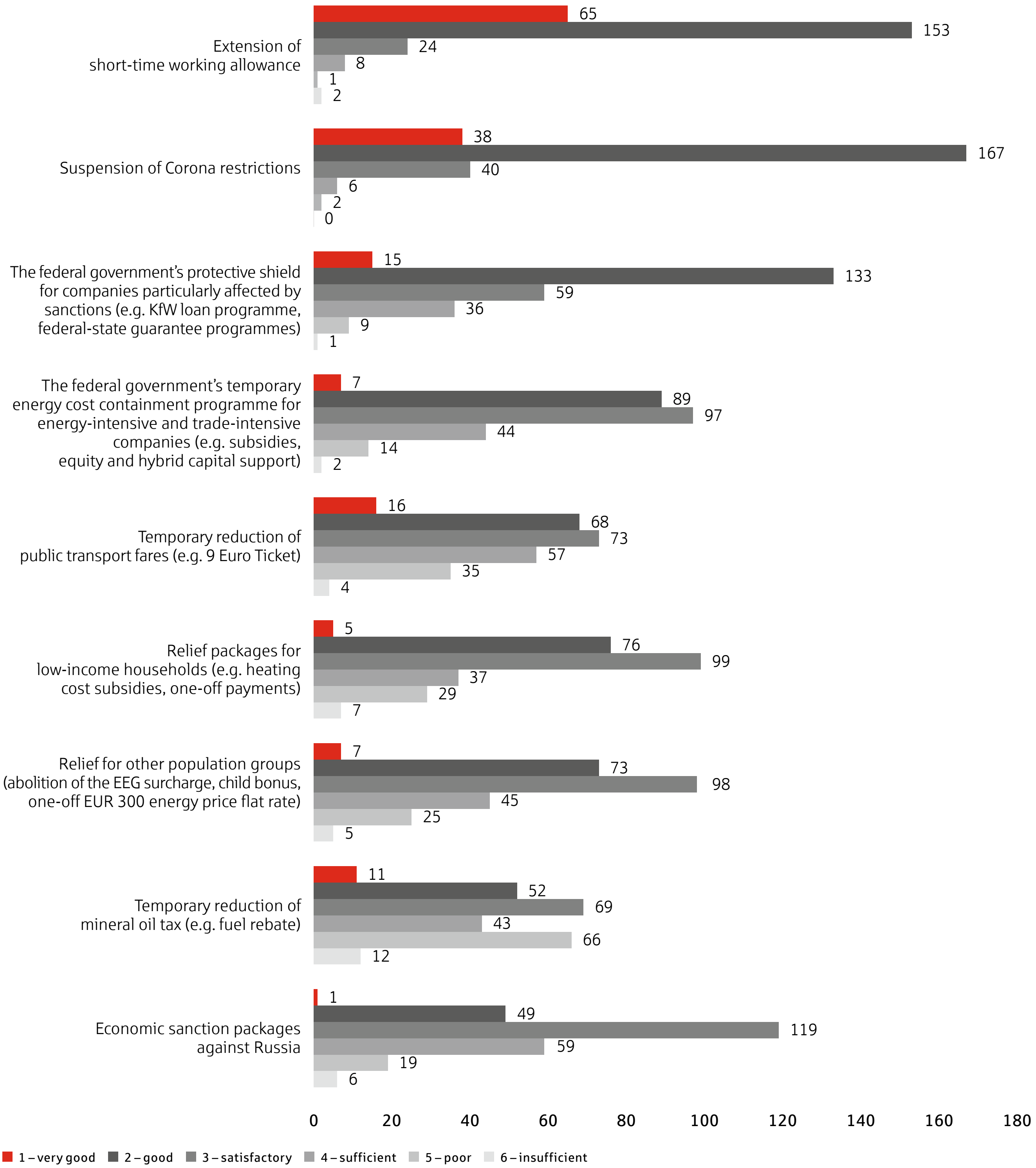
The federal government has identified this problem and reacted with a range of measures. Nevertheless, almost 90 percent of the commercial customer advisors of the Savings Banks expect that the increased consumer prices will have a negative impact on the earnings situation of their SME customers (see question 5, chapter 4, p. 31). The somewhat cautious assessment of the measures initiated by the state also supports this. Overall, only 45 percent of respondents rated the measures taken as positive (grades 1 and 2). Looking at the assessment of the individual measures, a very differentiated picture emerges (chart 13).

Although the suspension of the Corona restrictions, the extension of the short-time working allowance and the federal government's protective shield for companies particularly affected by sanctions are still largely rated positively by the respondents (58 to 86 percent), measures such as the fuel rebate or the economic sanctions receive mostly satisfactory and poor ratings (75 and 80 percent, respectively).

How do your corporate clients rate the following measures taken in connection with the Corona pandemic and the outbreak of the Ukraine war on a scale of 1 (very good) to 6 (insufficient)?

Evaluation of measures taken by the Federal Government

chart 13



Caution regarding “relief”

With all due understanding for the fact that people are looking for new intervention options and that relief packages are being adopted: the chances of doing so successfully are limited. Dampening certain prices also moderates the discipline and frugality practised there. Subsidising energy generates traffic, increases consumption, slows down substitution in heating and thus exacerbates scarcity.

It is important to acknowledge that supply shocks are accompanied by a deterioration in prosperity and consumption possibilities. Providing more money has never successfully slowed down and overcome inflation. This applies to economic and fiscal policy as well as to monetary policy. Putting a stop to rampant inflation, painful as it is, requires a restrictive monetary and economic policy.

Following the lead of the Federal Reserve Bank of the USA (Fed), the ECB has turned the corner in monetary policy. Several key interest rate hikes were signalled and implemented. However, the real interest rate (nominal interest rate minus inflation rate) has never been as strongly negative as it is today. The discrepancy between the average inflation rate and market interest rates also ensures negative real interest rates in the medium term. The resulting devaluation of large parts of the private accumulation of financial assets impairs in particular the savings activities of those on small and medium incomes as well as private old-age provision. The longer this constellation lasts, the greater the financial losses for investors. These losses affect not only future reserves, but also assets already saved in the past.

The return to a new price level stability requires time, as in many cases new real economic structures are necessary, which require product and process innovations. The flexibility of production factors is limited not least by long-term contracts, and new technologies also require periods of learning and experience. Start-up subsidies are often useful to overcome implementation hurdles, i.e. without accompanying fiscal policy measures, the macroeconomic adjustment costs cannot be shouldered. Inflation is painful, fighting it is costly, avoiding it as much as possible is therefore the best course.

Crisis as an opportunity

The ecological-economic transformation process must be set in motion. The prerequisite for this is a framework that enables small and medium-sized enterprises to develop freely.

Political framework conditions necessary for the economic recovery of SMEs

In summary, it can be stated that the mood in the German SME sector has deteriorated and that SMEs expect a further deterioration in their economic situation over the next twelve months. The extent and speed of the decline in economic performance with persistent inflation, continuing supply bottlenecks and rising energy prices is difficult to assess at present.

In Germany, more than 99 percent of companies belong to the SME sector. They are the backbone of the German economy in terms of value creation, employment and training.

Especially in the current times of upheaval, Germany needs innovation and impetus. They are the prerequisite for the ecological-economic transformation process. In order for German SMEs to be able to overcome the current multiple crises and the future transformation process, they must find framework conditions that allow them to develop freely.

> The war in Ukraine clearly shows that we must become less dependent on fossil energy imports. This requires massive investment. The German Savings Banks are ready to work alongside companies in this process.

Helmut Schleweis

Great challenges and crises always bring great opportunities. Planning security, bureaucracy reduction, education, skilled workers, entrepreneurship and investment support are the most important and central building blocks for a future economic recovery and a robust SME sector.

A robust SME sector also needs strong, regionally anchored credit institutions. The German Savings Banks stand ready to actively support SMEs in facing the enormous challenges and investing in the future. Policymakers must create the right framework conditions for this – both for the real economy and for the financial sector.

4 SURVEY OF SAVINGS BANKS EXPERTS

The survey of Savings Banks experts complements the results of the S-Financial Climate Index of the DSGV and Deka as well as the focus topic of the SME Diagnosis. For this purpose, a total of 275 corporate customer advisors from Savings Banks across Germany were surveyed in the period from August to September 2022. They not only have a very sound knowledge of the small and medium-sized enterprise sector, but also regularly hold a large number of discussions with their SME customers. This enables them to provide a professionally sound and up-to-date assessment of the economic situation and the views and plans of their more than two million commercial customers.

German SMEs between hope and scepticism

After almost two years of the Corona pandemic, hopes were high for economic recovery from spring 2022. But since February 2022, the Ukraine war has dealt another heavy blow to German SMEs. The combination of sharply rising energy costs, inflation, dwindling purchasing power, major uncertainties regarding energy supply, the ongoing war and global geopolitical tensions that has prevailed since then has greatly dampened the mood among German SMEs. Well over three quarters of respondents expect the business situation of SMEs to deteriorate over the next twelve months. This is a clear reversal of the cautiously optimistic mood of last year to the current state of concern.

In addition to the resolution of geopolitical conflicts and economic imponderables, the reduction of bureaucracy and the training of skilled workers remain the decisive criteria for the future positive development of SMEs in the view of almost 100 percent of the Savings Banks experts.

The current critical situation is exacerbated by the challenges of a sustainable transformation of the German economy. For this to succeed, financial stability, the ability to plan and the promotion of entrepreneurship and innovation are imperative.

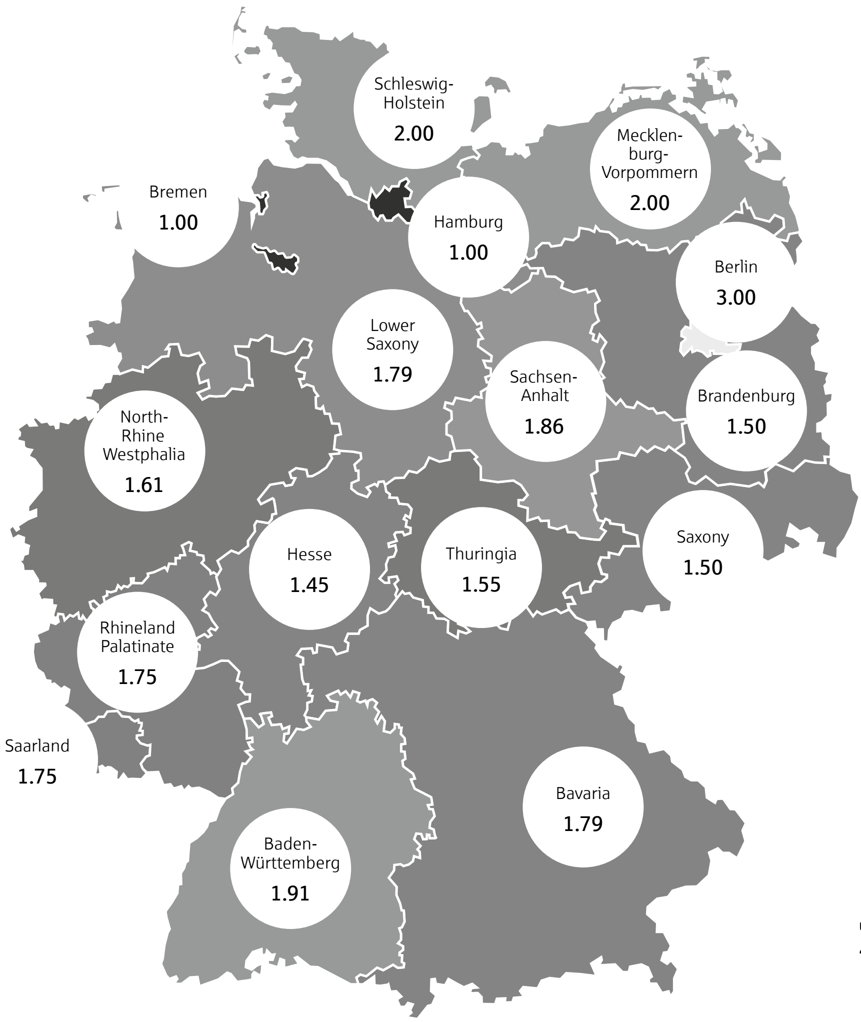
Accordingly, the political and economic framework conditions will be decisive for mastering the future economic development of German SMEs. A prudent foreign, economic, education and investment policy from the federal government will provide German SMEs with a reliable framework to master the major challenges of today and the changes of the future.

Part 1: Current business performance, outlook and economic environment

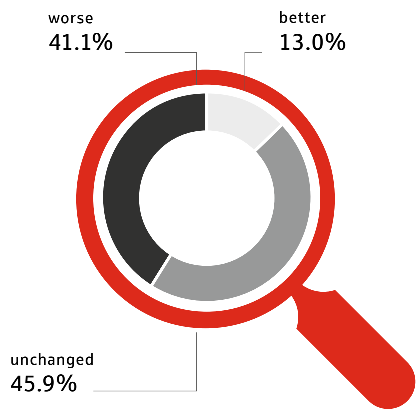
Question 1: How would you assess the current business situation (orders, turnover, earnings situation) of your SME business customers compared with the previous year?

At just under 46 percent, almost half of the respondents do not perceive any change in the current business situation. Approximately 41 percent of respondents see a deterioration in the current business situation of their customers. Opinions differ here, which is partly due to the fact that in the current situation particularly energy-intensive and export-dependent sectors have already been hit hard by the effects of the Ukraine war, while other sectors such as the hospitality and cultural industries and personal services have so far been hit less hard. The latter have even been able to recover their sales downturn from the previous two years since April 2022 with the lifting of Corona measures. The growth in turnover is also reflected in GDP in Q2 2022. Private consumption increased significantly by approx. 7 percent compared with the same quarter of the previous year.

However, the hospitality and cultural industries are facing hard times, as the combination of sharply rising energy costs, the declining purchasing power of end consumers and the considerable uncertainty regarding energy supply will also affect these industries.

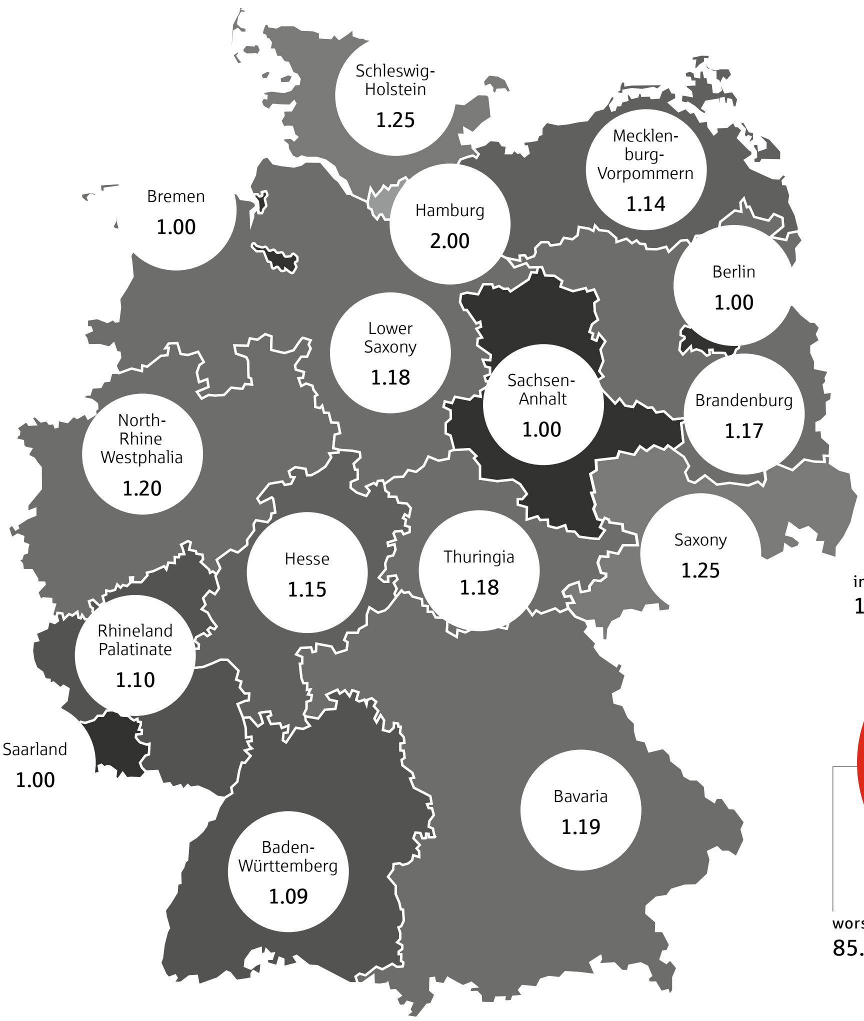


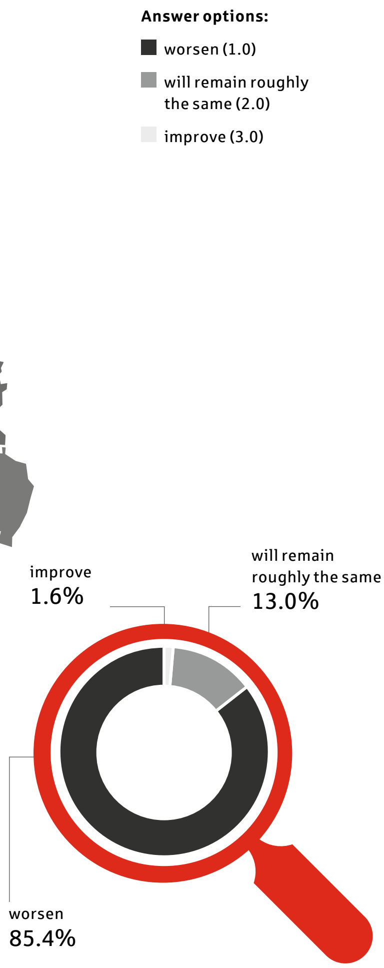
Answer options:
- worse (1.0)
- unchanged (2.0)
- better (3.0)



Question 2: For the next twelve months, do your SME corporate clients on average expect that the business situation will: remain roughly the same, improve or worsen?

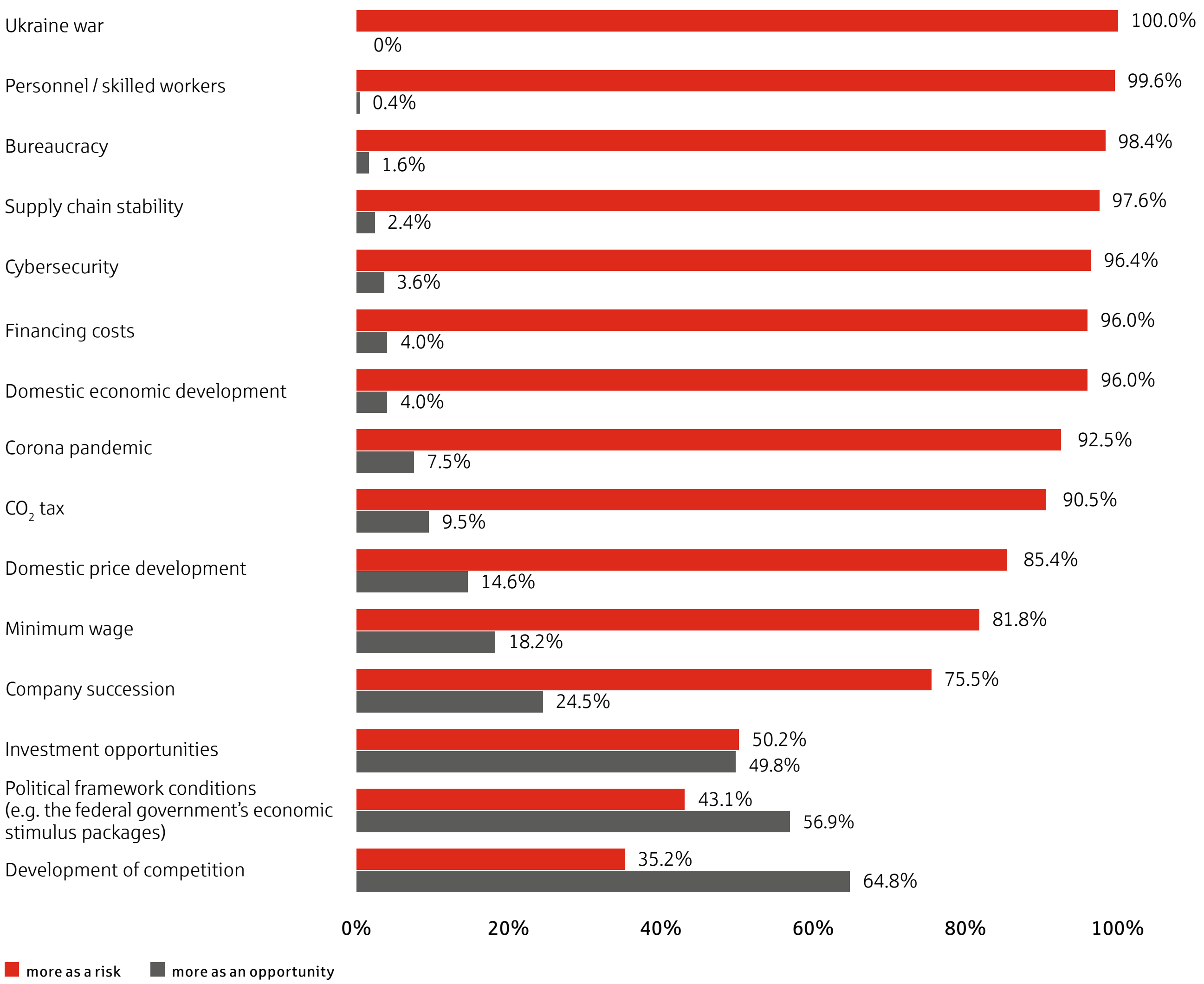
In view of the multi-layered crises and uncertainties, it is not surprising that approx. 85 percent of SME experts expect the economic situation of their business customers to deteriorate, thus reflecting the negative mood in the SME sector. The heavy burdens on private households will have an additional negative impact on consumer-related sectors. Due to the high price increases, especially for essential goods such as food, housing and energy, household budgets are shrinking and forcing people to cut back on consumption. Changing customer behaviour will hit retail, tourism, the culture and event industry and personal services particularly hard. This is reflected in the weak growth forecasts of the chief economists in the joint forecast for Germany for 2023.





Question 3: How do the majority of your SME business customers assess the following factors in terms of the future development of their companies?

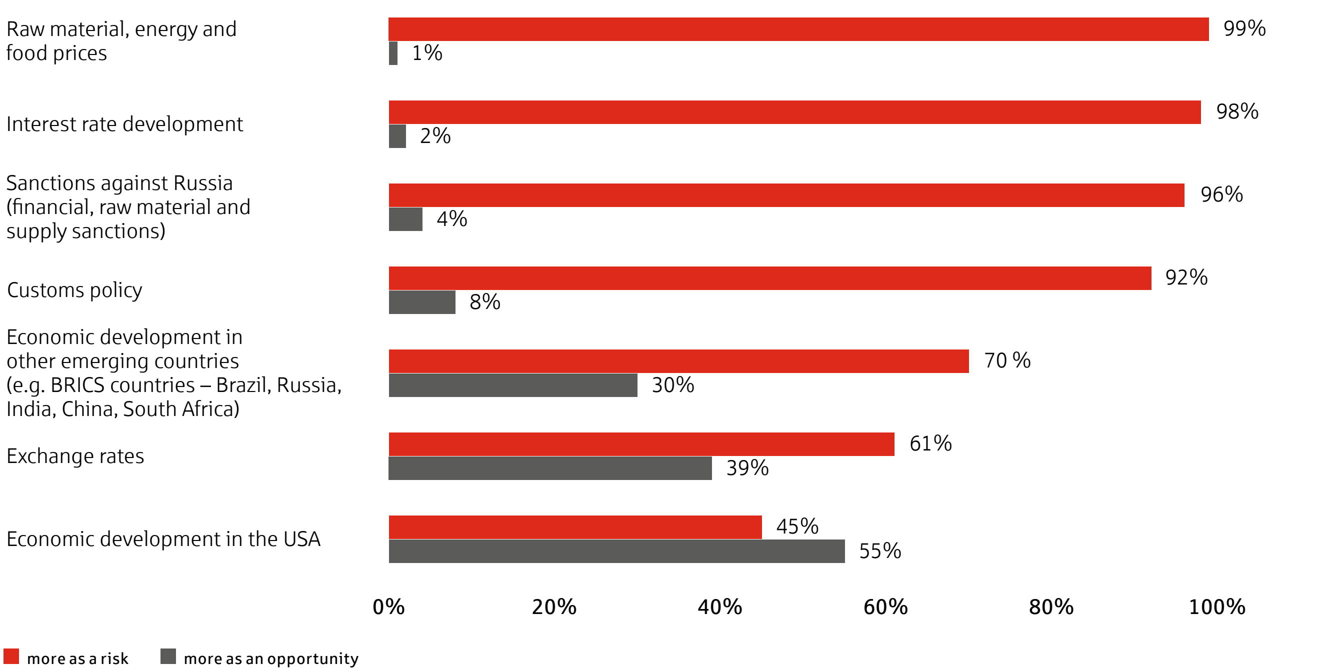
The experts unanimously consider the Ukraine war to be the greatest risk to successful business development. This is understandable, as since the outbreak of the war not only the rapid rise in raw material and energy prices, but also the energy shortage have led to major uncertainties and a lack of perspective and planning security, threatening the existence of some companies. The current situation continues to be exacerbated by the shortage of staff and skilled workers and the high bureaucratic hurdles, which are rated to be even worse than last year at 99.6 percent (previous year 98.1 percent) and 98.4 percent (previous year 97.6 percent) respectively. More than 95 percent of the Savings Banks experts also rate the stability of supply chains, cyber security, economic development in Germany and financing costs as risks for the future development of SMEs. Last year, the latter was still seen as an opportunity by 81 percent of those surveyed. In the meantime, an overwhelming majority (96 percent) sees financing costs as a risk. One reason for this will be the about-turn in ECB monetary policy after years of zero and negative interest rates and the accompanying rise in interest rates to 1.25 percent, which will increase SMEs' financing costs in the medium to long term.



Question 4: How do the majority of your SME business customers assess the following global economic factors with regard to the future development of their companies?

The ongoing steep increase in commodity, energy and food prices is seen as the main burdening factor for future development, at 99 percent, the same as last year (99 percent). This is perfectly understandable due to the distortions on the commodity and energy markets and the sharp increase in food prices.

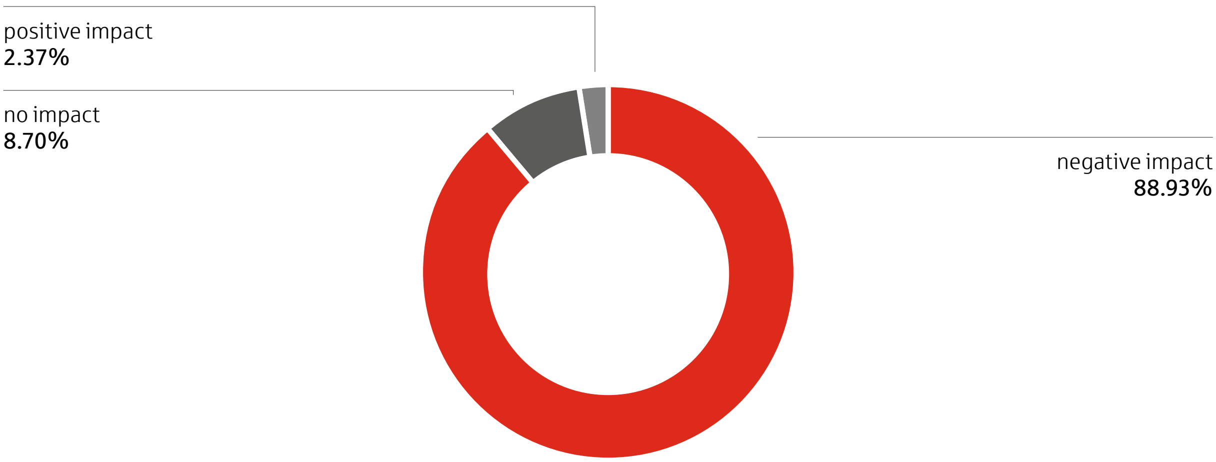
Furthermore, the current interest rate development (98 percent, previous year 35 percent) and the sanctions against Russia (96 percent) have been added as risk factors alongside customs policy (92 percent, previous year 76 percent). This high-risk assessment by the Savings Banks experts is also understandable, as the rising interest rates additionally increase the already existing cost pressure on SMEs and the sanctions against Russia not only inhibit SMEs' trade, but they are also already directly affected by the sharp rise in energy prices. It is interesting in this context that 70 percent (previous year 58 percent) of the respondents rate the economic development in emerging countries such as the BRICS countries as a risk. This could be due, among other things, to the more intensive cooperation within the BRICS countries and also with other emerging countries (keywords: Shanghai Cooperation Organisation, new Silk Road "One belt, one Road" initiative), which could lead to Germany being relegated as an export nation. This would have a negative impact on Germany's small and medium-sized enterprises. Since these countries can stock up on raw materials and energy sources cheaply, they gain a clear competitive advantage over export-oriented German SMEs.



Part 2: SMEs in the midst of inflation, sanctions, supply shortages and energy crisis

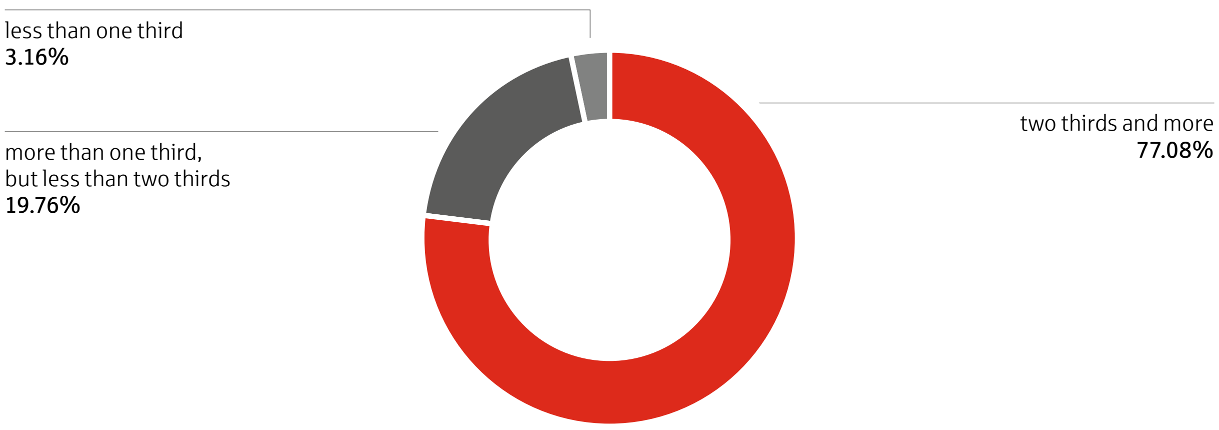
Question 5: Are the majority of your business customers seeing an impact from the current high inflation on the business models or earnings situation of their companies?

89 percent of respondents see the rapid rise in inflation in recent months as a threat to the earnings situation of their business customers and to their business model. The extreme price increases for electricity and raw materials are causing acute distress for many SMEs. There is also considerable concern about production stoppages. The relief measures so far taken by the federal government, such as the abolition of the EEG levy and the temporary reduction of the mineral oil tax, have somewhat alleviated the difficult situation for the companies. In addition, further relief such as reductions in electricity-related taxes and levies would be desirable.



Question 6: How many of your business customers are planning price increases for their products in the near future or have already implemented price increases due to the current high inflation?

More than three quarters of the Savings Banks experts state that 66 percent or more of their business customers have already implemented or are planning price increases for their products. Less than a third of their business customers have not yet taken any action in this regard. Since consumer prices, especially for essential goods such as energy and food, have risen sharply and further energy price increases cannot be ruled out, many households with low and medium incomes have already reached their pain threshold. Producer prices in Germany rose by 45.8 percent year-on-year in August. The magnitude of the increase is unprecedented since data was first collected in 1949. In addition to energy, many intermediate goods also became significantly more expensive. Many companies will no longer be able to pass these price increases on to customers.



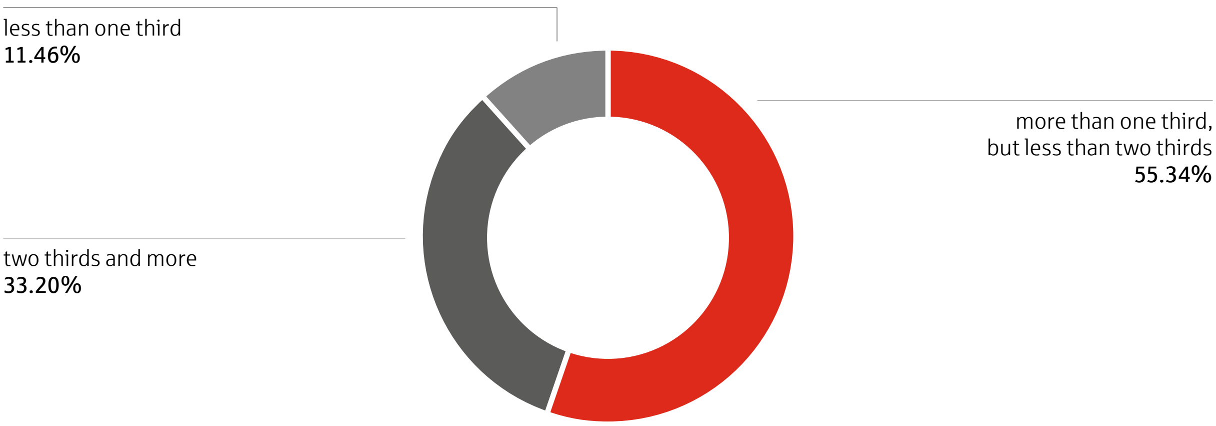
Question 7: How many of your business customers are affected by problems with punctual delivery of intermediate products?

Over 55 percent of the respondents state that between one and two thirds of their business customers are affected by delivery problems. Over 33 percent of them state that more than two thirds of their business customers are affected by delivery bottlenecks. For only 11 percent of the respondents it is less than one third.

It is not only the high energy and raw material prices and the scarce raw material supplies that are causing problems for German SMEs. Supply bottlenecks and faltering logistics chains are also disastrous for SMEs. Disrupted supply chains cost SMEs a great deal of money and time, and even lead to production stoppages and delayed delivery of goods. The situation in the retail sector is particularly tense for bicycle dealers, household appliance dealers and consumer electronics dealers.

It is especially difficult for SMEs to react to this compared with large internationally positioned companies. Large companies have the opportunity to influence logistics chains due to the high volume of goods they transport.

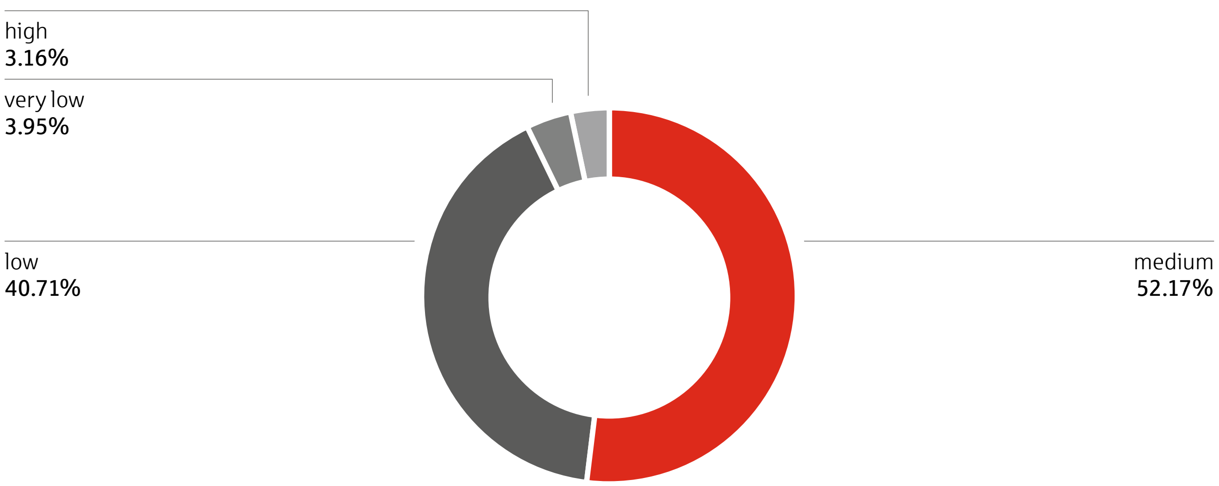
But the construction industry, which was still the "winner" during the Corona pandemic, is also suffering from material shortages. The price of building materials is rising as a result of the shortages and, in combination with the high energy costs and higher financing interest rates, this is making projects unprofitable.



Question 8: How high is the willingness of your business customers to invest at present?

According to 52 percent of the Savings Banks experts, the willingness of business customers to invest is medium. Just under 45 percent of the respondents state that the willingness to invest is rather low to very low.

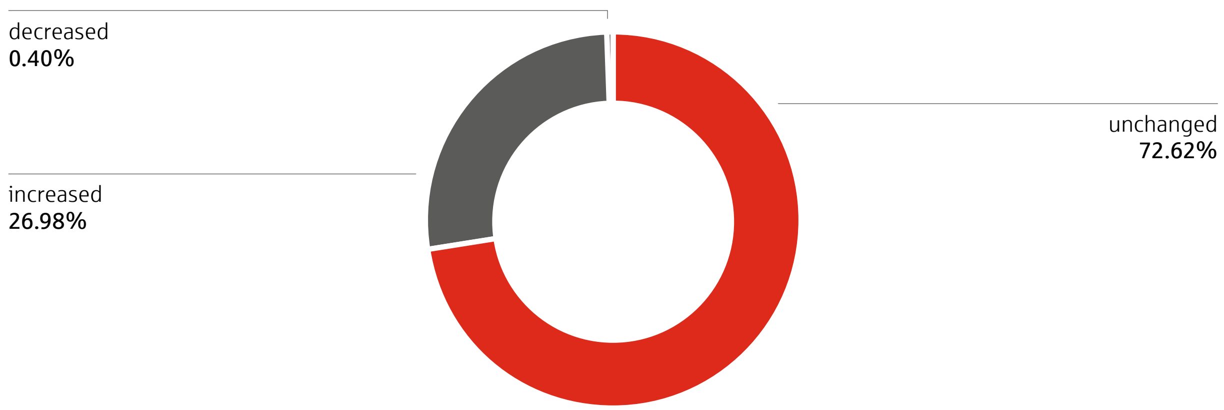
The reluctance to invest in times of crisis is understandable, as crises always trigger risks, dangers and uncertainties. Nevertheless, EUR 6 billion more investment loans were committed in the first half of 2022 than in the first half of 2021 and around EUR 3 billion more commercial housing loans than in the same period last year (source: DSGV industry service). These figures offer hope that SMEs will continue to be willing to invest despite the current difficult situation. Investments in transport infrastructure, schools and daycare centres, housing construction as well as education, research and development are essential for the sustainable transformation of the German economy.



Question 9: How has the intensity of cooperation with your business customers changed since the outbreak of the Ukraine war?

The Corona pandemic has already shown the importance of stable banking relationships for businesses – especially in times of increased stress. 67 percent of the Savings Banks' business customer advisors said that cooperation with their business customers had strengthened during the Corona pandemic. This statement was confirmed in this year's survey. Almost 73 percent of the account managers still rate the cooperation with their customers as good. Almost 27 percent of the respondents think that the intensity of the cooperation has even increased.

This encouraging result highlights the importance of the Savings Banks as regional, real-economy credit institutions for crisis management and the stability of the German economy, and it also reflects the trust of customers in the Savings Banks.



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The SME Diagnosis 2022 is available in German and English.
Both versions are available on the internet for download and online at:

↘ dsgv.de/sparkassen-finanzgruppe/publications/diagnose-mittelstand.html

In case of discrepancies, the German version is definitive.

A note on the use of the generic masculine of persons in our SME Diagnosis: In order to facilitate easier reading, the generic masculine is used – as is predominantly the case – although female and diverse persons are of course also included.

Compilation of the Deka-S Financial Climate Index

The Deka-S Financial Climate Index was developed in a cooperation between the Research Centre for Savings Banks Development at the University of Magdeburg, headed by Professor Horst Gischer, and DekaBank. The index is calculated from the results of a quarterly survey of 361 Savings Banks. It consists of ten topic areas, each of which can be subdivided into the perspective on the current situation and on future expectations.

In addition, there are varying special questions relating to the current economic or monetary situation.

The evaluation algorithm is based on the balances of positive and negative answers to each question. A completely neutral result yields in an index value of 100. A completely positive assessment in all questions by all participants signifies an index value of 200 points; in the opposite negative variant, the index value is zero.

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