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Crises and insolvencies: did the relationship disappear?

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Abstract

In 2020 for the first time there was an economic crisis accompanied with a decrease in the number of insolvencies. Why was it different?

Zusammenfassung

Im Jahr 2020 gab es zum ersten Mal eine Wirtschaftskrise, die mit einem Rückgang der Insolvenzen einherging. Warum war es anders?

The outbreak of the coronavirus pandemic was followed by the worst economic crisis of the postwar era, and yet the number of corporate insolvencies has fallen as sharply as it has not since insolvency statistics have been collected. Why was it different in the 2020 pandemic year?

Crises and insolvencies

A company becomes insolvent when it can no longer meet its payment obligations, even if the specific application of the insolvency rules and the restructuring options vary from country to country.

A company may face payment difficulties during a crisis if the business model is impaired or if credit conditions deteriorate. Insolvent companies must restructure their business or give up, which allows new business models to emerge. This creative destruction creates the basis for a new upswing. One should therefore expect a negative correlation between the number of corporate insolvencies and a country's gross domestic product (GDP).

Numerous business lines were affected during the Corona crisis. Governments everywhere responded to the Corona pandemic mainly with lockdown measures, causing a drop in supply and demand. In particular, industries that rely on personal contacts, such as tourism, restaurants, trade fairs, concerts, etc., were affected. But why were there still only a few insolvencies?

An immediate explanation lies in the governmental business support measures. Because not only insolvencies but also a rise in unemployment were undesirable for governments, they responded to the consequences of their lockdown measures with extensive aid packages. Short-time working compensation schemes, direct transfers ("stimulus checks") and changes in insolvency rules were intended to prevent companies from running into payment difficulties.[1]

Government aid, however, explains only part of the story. Rather, the link between insolvencies and crises had already disappeared before the coronavirus pandemic started.

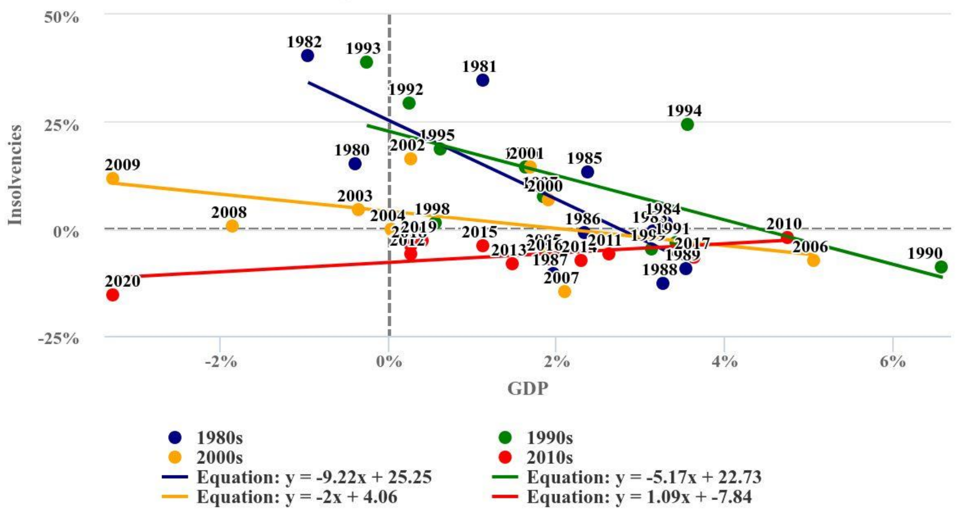
Insolvencies and growth

Figures 1 and 2 show the relationship between annual GDP growth and the annual percentage change in insolvencies between 1980 and 2021 in Germany and the USA. In general, there is a negative correlation in both countries. Upswing years were accompanied by a decline in insolvencies and crisis years by an increase. A simple linear regression shows that, on average, additional GDP growth of one percentage point per year was accompanied by an additional decline in insolvencies of 3.3 percentage points in Germany and 5.5 percentage points in the USA.

[1] See Duarte and Gehringer (2021) „The missing insolvencies“, Flossbach von Storch Research Institute.

Figure 1: Germany, Insolvencies and GDP, YoY%

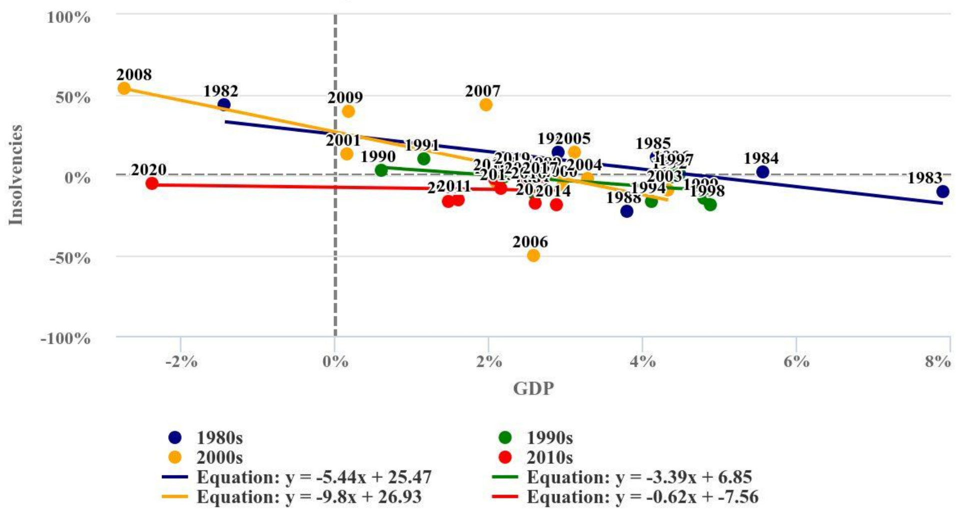
Click on the legends to show and hide the individual decades



Source: Flossbach von Storch Research Institute, Macrobond.

Figure 2: USA, Insolvencies and GDP, YoY%

Click on the legends to show and hide the individual decades



Source: Flossbach von Storch Research Institute, Macrobond.

Looking at the decades one by one, we see that the relationship between insolvencies and economic growth has become weaker over time. The sharper the lines drop from left to right in the figures, the stronger the relationship. In Germany, the relationship was strongest in the 1980s, and in the U.S. it was in the 2000s. In both countries, GDP reductions (points to the left of the zero line) were always accompanied by an increase in insolvencies (points above the zero line) until 2019.

The red line indicating the relationship in the 2010s is almost flat in the U.S. and in Germany the slope is even slightly positive. In this decade, insolvencies and economic growth seemed to run independently from each other. Low interest rate policies, which began as a response by central banks to the financial crisis of 2007/08 and continue to this day, have broken the link between growth and insolvencies. With financing conditions greatly relaxed by central banks, companies were able to avoid payment difficulties without improving their business structure via innovation and increased productivity. Companies that would have had no chance of survival without the very favorable financing conditions were able to stay afloat.[2]

Until the end of 2019, the macroeconomic environment in the major industrialized countries was characterized by low productivity, weak growth, and high debt.[3] This was accompanied by falling interest rates. When the Corona crisis erupted, central banks created even more money, enabling record-high government debt. Corporate insolvencies were successfully avoided. Government aid thus secured the disconnect between insolvencies and growth.

If this pattern of crisis, insolvency avoidance, zombification and weak growth repeats itself, the most important driver of long-term growth, namely innovation, could also be undermined step by step. Meanwhile, some will continue to dream of achieving sustainable growth and progress through money creation and central bank-financed government debt. This strategy has never worked before.

[2] See Tofall (2017) „Zombification and monetary policy“, Flossbach von Storch Research Institute. The share of firms listed on stock markets in 14 developed countries is estimated at 15 percent in 2017. See Ryan Banerjee and Boris Hofmann. "Corporate zombies: anatomy and life cycle." BIS Working Papers No 882 (September 2020).

[3] See Schnabl, G. and Mayer, Thomas (2021) "Hayek contra Keynes," Ludwig von Mises Institute Germany.

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