Prospects

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The point of view

How is the crisis affecting business?

In its latest Financial Stability Review, the ECB wonders about the risks borne by eurozone businesses as a result of the crisis.

The drop in economic activity had an immediate negative impact on business profitability. In the eurozone, profit margins fell 6% in the first quarter of 2020 and 18% in the second quarter. However, on average business bankruptcy declarations were down 41.7% year-on-year in the second quarter. Meanwhile, the failure rate among the self-employed rose, though remaining close to its long-term average. However, the 28.5% drop in the number of new businesses registered in the spring should set alarm bells ringing.

Optical illusion or effective government support?

While the suspension of bankruptcy filings certainly goes some way towards explaining these trends, they are also largely a product of preventive measures designed to mitigate liquidity risk linked to cash flow needs, for want of being able to mitigate the drop in sales. These support measures have enabled non-financial corporations (NFCs) to increase their liquidity reserves and improve their cash positions. Their liquid assets increased 9.6% in the first quarter and 18% in the second quarter.

Furlough schemes and the option to defer tax and social security contributions have helped limit the costs incurred by the temporary decline in activity. Government guarantees on loans have enabled businesses to lengthen their loan maturities, meet interest payments, cover operating expenses and adjust output in line with the new environment. In the second quarter of 2020, government-guaranteed loans accounted for 1.6% of all new loans in Germany, 4.8% in France, 5.6% in Italy and 9.2% in Spain. For large corporates, government-guaranteed loans on average accounted for 3.8% of total new loans in the eurozone; the equivalent figure for SMEs is 14.3%. Moratoria on loans to NFCs have also played a part, applying to 2.6% of total loans in Germany, 7.7% in France, 13.9% in Italy and 0.2% in Spain.

These policies have had a greater impact in Italy and Spain, where liquidity stress seems to have arisen more quickly than in France or Germany. According to the ECB, these measures reduced the probability of NFCs experiencing a liquidity crisis during the first two months of the crisis by three quarters in Spain, two thirds in France and Germany and half in Italy. They thus enabled businesses to extend the period over which they would be able to meet their liabilities before business picked up again.

All these measures are temporary, and have simply deferred financing requirements and encouraged higher borrowing. Consequently, a number of corporate issuers have had their credit ratings or outlooks downgraded. The probability of default on loans to NFCs rose from 2% at end 2019 to 2.6% in September 2020; the increase was four times greater among SMEs than large corporates (source: AnaCredit).

What the ECB is worried about

During the initial phase of the pandemic, businesses borrowed more from banks mainly to cover ongoing operating expenses, taking out loans with terms of less than one year. Bank borrowing remained high in the second quarter, while market-based corporate debt rose to record levels thanks to ECB intervention to stabilise markets. As activity bounced back over the summer, corporate bond issues and bank borrowing slowed, though continuing at a sustained pace. Meanwhile, NFCs lengthened the average maturity of their borrowings (with the average proportion of net new loans with maturities over five years up from 57% in 2019 to 100% in September 2020), thus reducing their immediate refinancing requirements and locking in prevailing highly favourable financing terms for a longer period. The volume of government-backed loans exceeded the net amount of new lending, suggesting that existing loans were converted into government-backed loans, particularly in Italy and Spain.

Despite an increase in underlying risk, credit conditions remain favourable. Government guarantees have lowered the risk of loss and kept a lid on upward pressure on interest rates driven by higher probabilities of default.

However, the ECB is worried that credit conditions could rapidly tighten when these measures are withdrawn. It is less worried about the increase in debt carried by the largest corporates. Indeed, more than half of the increase in the debt-to-GDP ratio is thought to result from the drop in GDP. The gradual resumption of economic activity would thus automatically lower the ratio. And above all, the increase in debt has been accompanied by a similar increase in liquidity, keeping net debt stable. Nevertheless, while this stability can be seen when looking at the average of all NFCs, there is substantial divergence between sectors, with significant vulnerabilities appearing in those hit hardest by the crisis, where net debt has increased and refinancing risk has risen sharply.

No rerun of 2009

The ECB has published a composite indicator of corporate vulnerabilities based on multiple factors: activity, profitability, indebtedness, refinancing risk and debt service capacity. According to this indicator, the level of vulnerability is the same as it was in the 2012 sovereign debt crisis but lower than in the great financial and economic crisis of 2009. The rise in the indicator in 2020 is mainly down to the decline in activity, the observed and expected deterioration in profitability and the increase in indebtedness; however, refinancing risk and debt service capacity have tended to mitigate vulnerabilities, whereas they significantly fuelled them in 2009. The difference this time around is explained by favourable financing conditions and long maturities. Government-backed loans, repayment holidays and the suspension of bankruptcy filings have thus helped significantly contain vulnerabilities.

These support measures have obviously been very effective in limiting corporate vulnerability. The recent extension of furlough schemes will enable businesses to maintain production capacity at lower cost as long as activity is suspended or restricted. However, government-backed loans and the option to defer tax and social security contributions have not been extended beyond the end of 2020 in some countries. The ECB has highlighted the risk of withdrawing these measures too quickly: not only would this shut off the supply of liquidity to businesses, it would also trigger the payment of amounts for which temporary exemptions had been granted. This applies not only to repayment holidays and deferred tax and social security contributions but also to shorter-term government-backed loans. The simultaneous withdrawal of these political measures could knock the recovery trajectory off course. The risk of a “cliff-edge effect” would be concentrated in the first half of 2021.

The ECB is once again calling on governments to take supportive action to supplement monetary measures like the PEPP and TLTRO programmes. This call not to be too quick to withdraw fiscal support for the economy has been reiterated by European authorities. To boost more sluggish growth in early 2021, it will thus be necessary either to roll out a fresh suite of support measures or to withdraw those measures already implemented later than assumed in draft 2021 budgets[1]. ■

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[1] Eurozone – Lowering the deficit while maintaining economic support: the 2021 budget challenge, Perspectives, issue 20/302, 24 November 2021.

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