

2020 insolvencies forecast to jump due to Covid-19

Atradius Economic Research – September 2020

Summary

- Global corporate insolvencies are forecast to increase by 26% in 2020 as the coronavirus pandemic pushes the world economy into recession
- Insolvencies are climbing in all markets, but the implementation of fiscal packages and a temporary suspension of insolvency proceedings in some countries keeps a lid on insolvency growth
- Hong Kong SAR, Turkey and the United States stand out as economies with a high annual increase of insolvencies in 2020. In Europe, Portugal and the Netherlands are among the countries with a strong rise in bankruptcies

With pressure eased around US-China trade talks and a bottoming out of the global manufacturing rut, the year started out relatively positively. However, the Covid-19 pandemic has snuffed out nascent hopes of a recovery. Global GDP is forecast to contract 4.5% year-on-year, which makes this recession worse in magnitude than the 2009 Great Recession. China is the only major market expected to escape a recession. Being ahead of the epidemic curve, China felt the largest economic impact in Q1 of 2020, while in Q2, the economic activity rebounded, by 3.2% year-on-year. For most other regions the brunt of the recession has been felt in Q2. A recovery can be expected in the second half of 2020 assuming lockdown measures are gradually unwound. This also creates a positive 'carryover effect' for 2021.¹ The recovery in 2021 is uncertain. It depends on the development and

administration of a vaccine or, alternatively, a state of the world in which the effects of social distancing on economic activities are largely overcome.

The depth of the economic contraction varies per country depending on various factors. First of all, the economic contraction is forecast to be highest in countries with longer and more stringent lockdown measures. These lockdowns prevent the production and consumption of products and services. On top of that, demand may fall as workers lose their income, and economic uncertainty increases the propensity to save. Italy, France and Spain are severely affected by the virus and have implemented long and stringent lockdowns. These countries are all seeing a strong GDP contraction in 2020.

¹ The carry-over effect is the advance contribution of the old year to growth in the new year. The carry-over effect is

positive if GDP was in an upward trend towards the end of the old year. Then this contributes positively to the GDP growth in the new year.

Second, sectoral composition matters. Countries in Southern Europe such as Spain, Italy, France, Portugal and Greece are more exposed to the current crisis, as their economic activity is highly dependent on tourism and service activities restricted by the coronavirus outbreak. Out of this group of countries, Greece exhibits the best outlook, as it has, until now, been more successful in containing the spread of the virus.

On the other hand, countries in Northern Europe are generally expected to have lower contractions. Germany, Denmark, Austria and the Netherlands are less dependent on tourism and have fared better in containing new infections, with their economies seeming to adapt better to social distancing restrictions.

Sweden has experienced the lowest GDP contraction of all the countries we analysed. This is because the government is steering for a policy of 'heard immunity' by letting the virus spread more freely. As a result, fewer economic activities are restricted. Despite the relatively light approach, the Swedish economy will still enter a recession this year. One reason is that people, especially those in risk groups such as elderly, voluntarily refrain from certain consumption. For instance, they choose not to go to cafes and restaurants, as this carries the risk of becoming infected. Another reason that Sweden has not been able to entirely avoid a recession is that it is exposed through trade and financial linkages to the negative shock coming from the rest of Europe.

The United Kingdom stands out as the country in Northern Europe with the highest GDP contraction. Like in Sweden, the UK government initially steered for a policy of 'heard immunity'. However, the economy was forced into a stringent lockdown as it became apparent that the medical system could not cope with the country's high infection rate. What further complicates the situation is that the economy suffers from high Brexit uncertainty. The UK and the European Union are trying to work out a deal on a future political and trade relationship before the end of this year, but it is highly uncertain if this can be attained.

Outside of Europe, the United States, Japan and Australia have a more positive outlook than most European countries. The United States, although severely affected by Covid-19 infections (with the number of new cases still rising in July), has restricted economic activity less. Moreover, the population is likely to have restricted consumption less than in Europe, as the US administration sent weaker signals regarding the severity of the crisis.

Australia ranks among the best performing developed countries. It is a leading example for the

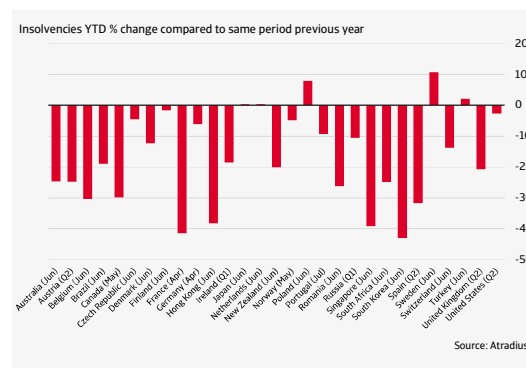
successful containment of new infections, but the Australian economy is still vulnerable due to high exposure of tourism and export services to South-East Asia.

Lastly, Japan is relatively more vulnerable than the previous two countries, as its mixed approach of strict restrictions at the beginning of the crisis followed by a premature relaxation and a second significant surge in infections will both take a toll on economic activity. GDP in Japan is expected to show a 6% contraction in 2020. We expect a partial recovery in 2021 (2.8% growth), as the resurgence of infections will weigh on domestic and overseas spending.

A surprising decrease in insolvencies in the first half of 2020

The insolvency figures recorded in the first half of 2020 exhibit a peculiar decreasing behaviour. Figure 1 shows that most countries experienced fewer insolvencies than in the same period of the previous year. Most notably, the UK, Spain and France exhibit Year-to-Date (YTD) figures ranging from -20% to -40%. These large declines are at odds with the depth of the recession, especially since these countries are among the hardest hit by the crisis.

Figure 1 Insolvencies in the first half of 2020 decline in most countries



Two types of policies in particular are responsible for the discrepancy between GDP and insolvency development in the first half of 2020.

Insolvency regime changes

First, most countries made changes to the insolvency regime to protect companies from going bankrupt. These measures include temporary suspensions of insolvency applications (making them inadmissible) in bankruptcy courts, preventing creditors from starting an insolvency procedure, or raising the debt threshold for a bankruptcy notice. These temporary relief measures vary in duration across countries, with

virtually all of them ending between May and December 2020, except a few that have no end date at all.

A number of countries including Belgium, Italy and Spain, have enacted laws that temporarily freeze insolvency proceedings or declare bankruptcies inadmissible. This means creditors are not allowed to appeal in court for the bankruptcy of a firm that is not able to honour its payment obligations.

Other countries, such as Singapore and Australia, have increased the debt threshold for companies to be declared bankrupt. A third group of countries including the Netherlands, Sweden, Denmark, Ireland, the United Kingdom and the United States have not made major changes to their insolvency regimes as a response to Covid-19. However, in the case of the Netherlands and the UK, the insolvency regime is subject to a larger overhaul that may affect the pattern of insolvencies going forward. In the Netherlands, for instance, it will be easier to force a company restructuring upon creditors, which may lead to fewer bankruptcies. But the changes to insolvency regimes in the Netherlands and the UK should be seen as separate from the coronavirus as they were initiated before the outbreak.

Governments are thus temporarily changing the insolvency framework to prevent a rise in insolvencies this early in the crisis. However, the measures are temporary, and in virtually all countries the relaxation measures end in Q2 or Q3 of 2020.

Fiscal measures

Second, governments and central banks across the world have taken measures to counteract the economic effects and to support small businesses. For instance, the Federal Reserve in the US and the Bank of England started lending programmes for Small and Medium Enterprises (SMEs). However, the most direct support for businesses has come from governments. These fiscal measures are aimed at providing companies breathing space after their liquidity position has come under pressure from a decline in revenues.

According to the IMF, the government support can be classified into three categories. First, the 'above the line' measures, which include wage subsidy schemes, temporary tax suspensions, social assistance, and direct grants made to small enterprises and self-employed. All of these immediately result in higher budget deficits. The second type of measure classified as 'below the line' generally involves the creation of assets, such as loans or equity injections to firms. These have little or no upfront impact on the deficit, but may

increase government debt. Lastly, government guarantees, which usually have no upfront impact on the deficit or debt, but create a contingent liability, with the government exposed to calls on guarantees.

We believe that the most effective measures in the short run are direct spending ('above the line') and tax break measures. These can be direct subsidies to cover the worker's wage bill and other fixed costs, such as rent and interest rate payments, or can involve a temporary suspension of corporate taxes. Several European countries such as Germany, the Netherlands, the UK, Denmark, and France, but also non-European countries such as Australia and Japan, have taken measures of this kind. Other European countries such as Austria, Belgium, Spain and Italy focused more on social assistance measures, such as unemployment benefits, short-term work compensation and benefits for temporary layoffs. Social assistance measures may have a positive effect on insolvencies, albeit a more indirect one, as they do not directly contribute to the firm's liquidity position, but underpin household spending.

Fiscal measures had their biggest impact in the second quarter of 2020, when the lockdowns were most stringent. Governments in Germany, the Netherlands, France and Australia have explicitly mentioned that measures will be extended beyond the second quarter. In the European Union, there is also a common EUR 750 billion recovery fund that redistributes funds from countries that fared better through the pandemic to the ones that fared worse. All of this signals that the economic relief packages are likely to be extended throughout 2020.

The United States has opted for a mix of policies, including a form of wage subsidies to companies committing to keep their employees for a given period through the Paycheck Protection Program (PPP). A separate government scheme is aimed at providing loans and guarantees to companies. These measures could explain why there were relatively few insolvencies in the US in the first half of 2020, despite bankruptcy courts that were still largely functioning. At the moment of the writing of this report, the United States Congress was debating extension of the PPP relief package.

While effective in the short run, direct spending and tax reduction measures ('above the line' measures) are unlikely to prevent a rise in insolvencies in the longer term. Even if these packages cover costs incurred by companies, they will not cover persistent losses of profits. Capital owners of affected sectors will ultimately have no choice but to file for insolvency and reallocate their remaining capital to more promising sectors. The fiscal packages related to the coronavirus crisis

also weigh heavily on the government budget, which may threaten to become unsustainable if continued too long. Some Southern European countries, most notably Italy and Greece, already have a high government debt. The budgetary space there to continue stimulus packages of this magnitude is limited.

A surge in insolvencies in H2 of 2020

We expect to see much higher bankruptcy figures in the second half of 2020. Figure 2 reproduces our insolvency forecasts for the full-year 2020. We forecast a 26% rise in global insolvencies. This forecast is based on the assumption of a gradual phasing out of the fiscal stimulus measures and a reopening of bankruptcy courts and proceedings. As mentioned before, temporary relaxation of insolvency laws ends in either Q2 or Q3 of 2020 for most countries. Fiscal measures may be extended throughout 2020 and even well into 2021, but are likely to be phased out, as they weigh heavily on the government budget.

All major regions will be confronted with an increase in insolvencies. Across countries there is a wide range of insolvency projections, depending on the severity of the economic contraction and the insolvency elasticity - the percent responsiveness of insolvencies to a one percent GDP change. This varies across countries due to differences in economic structure and institutional factors, such as type of insolvency regime.

The lowest increases in insolvencies are all found in Europe. In Germany, France, Austria, Belgium, Switzerland and Italy, insolvencies are likely to go up by percentages ranging from 6% to 20%. The economic contraction in these countries is generally lower - Belgium and Italy are exceptions - and they have a lower responsiveness of insolvencies to GDP. As mentioned before, there are often institutional reasons behind a lower insolvency elasticity. In Germany, for instance, legislation does not encourage struggling companies to file for insolvency, but instead encourages restructuring. On the other hand, Italy also has a relatively low historical elasticity of insolvencies to economic cycles, but for different reasons: the insolvency procedures are lengthy and costly, and thus most struggling firms prefer to liquidate outside the court through the so-called pre-bankruptcy composition agreements with creditors.

Among the economies with large increases in insolvencies are Turkey, the United States, Hong Kong SAR, and in Europe, Portugal, the Netherlands and Spain. For all of these countries, we expect a sizeable economic contraction that mostly explains the large increase in insolvencies.

However, there are also country specific factors that matter. In Turkey and Portugal, we give a lower weight to the effectiveness of the fiscal response in preventing insolvencies, as this has limited focus on providing liquidity to firms. In the United States, although the recession is not expected to be as deep as in the Southern European countries, insolvencies are highly responsive to fluctuations in economic activity. Moreover, the effectiveness and the scale of the PPP program are likely to remain lower than in the European countries which provided generous liquidity assistance through wage subsidies.

In the case of Portugal, Spain and the UK, the large increase in insolvencies is largely attributed to the severe economic contraction. But, notably for Spain and the UK, insolvencies are forecast to increase less than during the Great Recession of 2009. We believe that this outcome is more likely to materialize, given some important changes in the insolvency procedure implemented since then. In the UK, the recent insolvency reform from June includes the temporary suspension of the wrongful trade provision that could result in accounting company directors being charged with a civil offence when a firm enters into financial difficulty. In Spain the reforms enacted in 2014 were designed to incentivize companies experiencing difficulties to apply for a restructuring plan as opposed to opting for liquidation. Before this reform, the insolvency procedure was generally unattractive to both debtors and creditors because it was lengthy and costly. Moreover, there is evidence that in order to avoid insolvencies, companies preferred to take on additional debt through mortgages, a practice that most likely contributed to the amplification of the increase in the insolvency numbers during the Great Recession when the housing market collapsed. We think that the current changes in legislation will weaken the link between the housing market and insolvencies, as attractive restructuring options will limit the need to finance liquidity through mortgages. Additionally, there are not yet signs of a severe downturn in the housing market in Spain. This further limits the stress on companies that may still depend on this form of financing.

Finally, the Netherlands is expected to experience a large increase in insolvencies, even though the economic contraction is smaller than in most other countries. The high sensitivity of insolvencies to

Figure 2 Insolvency outlook 2020

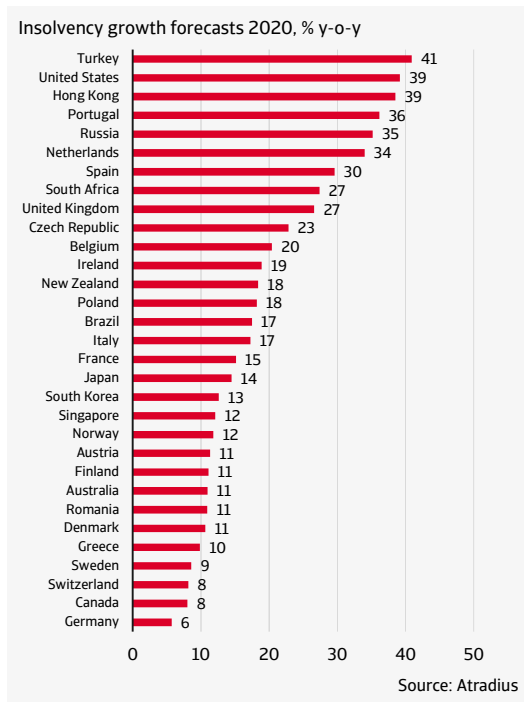
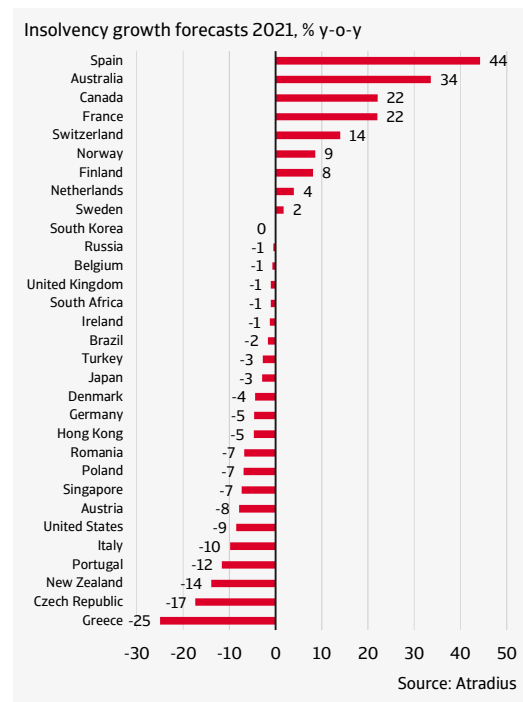


Figure 3 Insolvency outlook 2021



economic conditions explains why insolvencies are expected to experience a considerable jump. This high insolvency elasticity has its roots in the legal framework. Companies with financial difficulties often prefer to apply for insolvency and re-start activity under another entity. Restructuring options cannot be enforced upon creditors and therefore are used less frequently.²

A mixed picture in 2021

Our baseline forecast assumes that the global lockdown measures are gradually eased throughout the second half of 2020. Economic recovery is further boosted, as a vaccine becomes available in Q1 of 2021 or, alternatively, a state of the world emerges in which the effects of social distancing on economic activities are largely overcome. Our baseline scenario is that of a GDP recovery in all countries in 2021. This implies that monetary policy and fiscal policy can be gradually tightened in 2021. The assumption that the pandemic will be successfully countered is an important one, but also a very uncertain one. This is due to the fact that starting in July, many countries started experiencing a renewed rise in Covid-19 cases. This may necessitate more

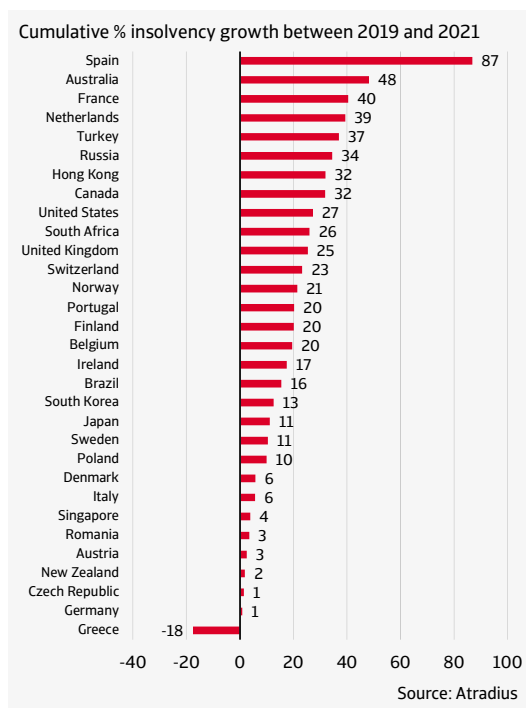
stringent social distancing measures, which could change the outlook dramatically.

Figure 3 shows the insolvency forecasts for 2021. Again, there is a wide range of insolvency projections. In some countries there is an increase in the level of insolvencies coming from a delay of registrations caused by the temporary suspension of court proceedings in 2020. This is the case for Spain, Australia, Canada, France, Switzerland, Norway and Finland – countries that are forecast to experience the highest increases in 2021. For Sweden and the Netherlands, the relatively weaker economic growth in 2021 following the milder contraction in 2020, coupled with the withdrawal of the fiscal support packages, leads to a slight increase in insolvencies in 2021.

² The new insolvency law that is under discussion is going to change this practice. A bankruptcy court can enforce a

restructuring upon all creditors. The new law is currently under discussion at the First Chamber of parliament. Implementation is expected in the coming months.

Figure 4 Cumulative insolvency growth 2021/2019



Among the countries with the strongest decline in insolvencies in 2021 are Southern European countries, including Greece, Portugal and Italy. All benefit from a relatively strong economic recovery. Greece is a special case, as it has registered a downward trend in insolvencies in recent years, likely caused by reforms that make it easier to restructure a company without involvement of a bankruptcy court. We consider the 2020 increase

in insolvencies in Greece a temporary deviation from this trend, and expect the previous downward trend to resume in 2021. Greece is also the only country with a cumulative decrease in insolvencies between 2019 and 2021 (Figure 4). Not only in Southern Europe, but also outside this region a number of countries display a strong percentual decline in insolvencies in 2021. Examples are New Zealand and the Czech Republic. These countries are also expected to benefit from a relatively strong economic recovery in 2021, which pushes down the insolvency level compared to 2020.

Despite the fact that globally on average we see a slight decline in insolvencies in 2021, we emphasize that this is relative to the average level of insolvencies in 2020. Comparing the insolvency level in 2021 to the level before the Covid-19 recession (2019), we still see 2021 insolvencies are 25% higher. Thus, we caution that the level of insolvency risk will still remain more elevated than before the coronavirus crisis as a result of only a minor economic recovery in 2021.

Theo Smid, economist
theo.smid@atradius.com
 +31 20 553 2169

Iulian Ciobica, economist
iulian.ciobica@atradius.com
 +31 20 553 2121

Table 1 Total insolvencies - annual percentage change

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020f	2021f
Australia	-3	21	4	2	9	1	2	-19	16	-16	-8	3	3	11	34
Austria	-6	0	9	-8	-8	3	-10	-1	-5	1	-3	-2	1	11	-8
Belgium	1	10	11	2	7	4	11	-9	-9	-6	9	-1	7	20	-1
Brazil	-25	-34	-6	-19	-12	7	8	-1	12	-13	29	0	-1	17	-2
Canada	10	-2	-41	-11	13	-11	-2	-2	-1	-7	-6	-1	3	8	22
Denmark	21	54	-10	-3	-22	4	-15	-21	15	18	-4	7	6	11	-4
Finland	-1	16	25	-13	3	0	6	-5	-14	-6	-10	17	3	11	8
France	7	7	14	-5	-1	3	3	0	0	-8	-6	-1	-4	15	22
Germany	-15	0	12	-2	-6	-6	-8	-7	-4	-7	-7	-4	-3	6	-5
Greece	-3	-35	68	-35	-4	19	31	-16	-43	-43	14	-32	27	10	-25
Hong Kong	7	-3	50	-43	-13	2	15	3	1	-9	-14	-6	9	39	-5
Japan	6	11	-1	-14	-4	-5	-10	-10	-8	-6	0	-2	2	14	-3
Netherlands	-13	-14	53	-9	0	19	10	-22	-24	-19	-22	-9	4	34	4
New Zealand	-5	-35	45	-5	-12	-7	-13	-7	4	3	-22	-7	-18	18	-14
Norway	-6	41	47	-17	0	-13	18	6	-3	-1	4	12	3	12	9
Portugal	-12	39	28	21	-5	46	1	-13	12	-6	-16	-4	-8	36	-12
Singapore	-7	-16	-12	-25	-1	14	14	-12	1	1	-9	1	-1	12	-7
South Africa	4	5	25	-3	-11	-24	-13	-13	-5	-1	-3	-1	11	27	-1
South Korea	-9	19	-27	-21	-13	-10	-18	-16	-14	-23	-11	-5	-12	13	0
Spain	18	188	88	-4	15	32	10	-27	-21	-9	10	11	12	30	44
Sweden	-5	7	20	-4	-4	7	4	-6	-11	-5	6	13	2	9	2
Switzerland	0	-7	24	20	6	3	-5	-10	4	7	3	3	-1	8	14
United Kingdom	-11	35	14	-18	4	-4	-9	-8	-10	1	-1	10	7	27	-1
United States	42	52	41	-7	-15	-16	-17	-19	-8	-2	-4	-4	3	39	-9

Sources: Atradius, Macrobond, national sources

Table 2 Total insolvencies - index, 2007 = 100

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020f	2021f
Australia	100	121	125	128	139	141	144	117	135	113	104	107	111	123	164
Austria	100	100	110	101	93	96	87	86	82	83	81	79	80	89	82
Belgium	100	110	123	125	133	138	153	140	127	119	130	129	138	166	165
Brazil	100	66	61	49	43	47	50	50	56	49	63	63	62	73	72
Canada	100	98	70	62	70	62	61	59	59	55	52	51	52	57	69
Denmark	100	220	200	193	151	156	134	105	120	141	136	146	155	171	164
Finland	100	116	145	127	131	131	139	132	114	107	96	113	116	129	140
France	100	107	123	117	115	118	122	121	122	112	106	105	100	115	140
Germany	100	100	112	110	103	97	89	83	79	74	69	66	64	68	65
Greece	100	65	109	71	68	81	106	89	51	29	33	23	29	32	24
Hong Kong	100	97	146	83	72	74	85	87	88	81	69	65	70	97	93
Japan	100	111	110	95	90	86	77	69	64	60	60	58	59	68	66
Netherlands	100	86	132	119	120	143	157	122	92	75	58	53	55	74	77
New Zealand	100	65	95	89	79	73	64	59	61	63	49	46	38	45	38
Norway	100	141	207	171	172	150	176	186	180	179	187	211	217	243	263
Portugal	100	139	179	216	205	300	303	262	294	277	233	224	207	282	249
Singapore	100	84	74	56	55	63	72	64	64	65	59	60	59	67	62
South Africa	100	105	131	127	113	86	75	66	62	61	59	59	65	83	82
South Korea	100	119	87	68	59	54	44	37	31	24	22	20	18	20	20
Spain	100	288	540	520	598	791	866	635	501	458	502	558	627	812	1,171
Sweden	100	107	128	123	118	126	130	122	108	103	109	124	126	137	140
Switzerland	100	93	115	138	147	151	143	130	135	144	148	152	151	163	186
United Kingdom	100	135	153	125	130	124	113	104	93	94	93	103	110	139	138
United States	100	152	215	199	169	142	118	95	88	85	82	79	81	112	103

Sources: Atradius, Macrobond, national sources

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Atradius N.V.
David Ricardostraat 1 – 1066 JS Amsterdam
Postbus 8982 – 1006 JD Amsterdam
The Netherlands
Phone: +31 20 553 9111

info@atradius.com
www.atradius.com