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The business insolvency paradox in Europe: miracle and mirage

Normally, insolvencies rise when the economy contracts. Yet, in 2020, and during its deepest recession, insolvencies fell in all major eurozone economies, notably by -38% in France, -32% in Italy, and -15% in Germany and Spain. It is safe to assume that government support is keeping many fragile firms alive – are we therefore seeing the "calm before the storm", with a wave of insolvencies around the corner?

The true impact of the Covid-19 crisis will remain unclear until companies release their financial reports. We have therefore simulated companies' financial health by calculating a sectorial solvency ratio (gross operating profit/net debt), taking into account both the negative revenue shock and the positive effect of government assistance. We ran these simulations on 6 sectors in the 4 largest eurozone economies[1] using data on turnover, furlough use, state-backed loans and, for France, the Solidarity Fund. We examined a sample of sectors typically accounting for ~80% of total insolvencies[2]. Sectoral granularity is a key element of our analysis: sectors have not all been equally hit by the crisis, nor benefited from the same government aid. Crucially, not all sectors contribute equally to overall insolvencies, due to overrepresentation in the aggregate figures (even in normal times).

Our simulation shows that, despite the stabilizing effect of government support, corporate financial health did deteriorate noticeably in 2020 – which would normally lead to a rise in insolvencies. According to our model, insolvencies in 2020 should have grown by 19% in Spain, 6% in France, 6% in Germany, and 7% in Italy (we call this number "simulated insolvencies"). That they instead decreased suggests that many insolvencies have been postponed rather than prevented, meaning 2020 has left us with a large number of "hidden insolvencies" that are taking much longer than usual to materialize. But how many?

If we take the 2020 insolvency numbers derived from our simulations (i.e. the "simulated insolvencies") and we subtract the officially reported 2020 insolvency figures (i.e. "observed insolvencies"), we can get an estimate. Simulated insolvencies reflect the underlying damage companies have suffered. Observed insolvency figures, on the other hand, still seem too low even after considering the effects of government measures. Therefore, we can read the difference between simulated insolvencies and observed insolvencies as an approximation of hidden insolvencies. We thus estimate the size of hidden insolvencies to be around 44% of 2019 insolvencies for France (22,500), 39% for Italy (4,100), 34% for Spain (1,600), and 21% for Germany (3,950). Without state intervention, insolvencies would be higher by an order of magnitude. In this sense, governments' success in saving firms is a small miracle of economic policy. But the 2020 insolvency figures are, to a large extent, a mirage.

1 Germany, France, Italy and Spain
2 Construction, retail, manufacturing, tourism, business services, and transport.