



# Insolvency moratorium

August 13, 2020

## The worst is yet to come

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The impact of the coronavirus pandemic on growth in the second quarter was dramatic, no doubt about it. But economic data, as well as the daily and weekly real-time indicators that are now being watched meticulously, show that most countries began to reemerge from the slump back in May. In Germany, production was down by “just” 11.5% year over year in June, after a drop of nearly 25% in April.

This yoy gap is likely to continue to shrink as the summer goes on. However, the overall economy is not expected to return to pre-crisis levels within the next 12 months, even if the current rise in infections does not lead to a “second wave” and the increase in infections that is feared for the winter does not overwhelm our healthcare system. In a survey conducted by the ifo Institute, German companies expected to see restrictions in public life continue until April 2021 on average. We believe it could be mid-2021 before a vaccine that would make it possible to lift these kinds of restrictions after a certain period becomes widely available.

With activity across many industries paused in April, the temporary suspension of the obligation to file for insolvency that was introduced retroactively with effect from 1 March was an important step in mitigating adverse impacts. The moratorium applies explicitly only to cases in which the company in question has become insolvent or overindebted due to the COVID-19 pandemic. However, the fact that corporate insolvencies were down by a whopping 9.9% year over year in May despite the tough economic situation already in place before the coronavirus crisis broke out seems to suggest that some businesses may be interpreting the economic impact of the pandemic very broadly. This is probably one of the factors behind the increasing warnings of a wave of bankruptcies to come starting in October. With all this in mind, it comes as no great surprise that Germany’s ministry of justice is considering postponing the day of reckoning by extending the moratorium until March 2021. Of course, the question remains of why a company that has not managed to adapt to the new environment brought on by the coronavirus by the end of September should be able to do so by March 2021 – especially as there is concern that the impact of the pandemic will tend to increase again over the winter.



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If policymakers suspend insolvency proceedings for a full year, healthy businesses will likely feel the bite. There will be more and more zombie companies with aggressive pricing practices that weigh on profit margins at healthy businesses and impede structural change overall. While it is true that the number of zombie companies has been on the rise for some time now due to the ECB's zero-interest policy, the new type created by the moratorium is much more dangerous. Since the ECB is unlikely to change course on interest rates for years to come, the "interest-rate zombies" are here to stay. The new group, though, will probably spend only a short time among the undead, causing risks to banks and to healthy firms that do business with them. Should the moratorium expire at the end of March, the number of insolvency proceedings could be expected to rise sharply – and certainly by more than if the moratorium were to expire at the end of September. But that is not all: there could also be a domino effect as even healthy companies are brought to their knees by mounting defaults of their clients and business partners.

Would the government be willing to take that kind of risk six months before the Bundestag elections? In light of such questions, which are already relevant today, there are both regulatory considerations and factors relating to political economy that argue against extending the moratorium beyond September. Still, any extension despite the warning signs will probably not be the last, taking us one giant step closer to state capitalism.

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