From hibernation to reallocation: loan guarantees and their implications for post-COVID-19 productivity

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Many countries introduced or ramped-up guarantee schemes to bridge liquidity shortages as a key element of the policy response to the COVID-19 crisis. Governments raised the funding available for guarantee programmes (i.e. guaranteed loans more than doubled for the median OECD country), increased the level of the guarantee on credit, extended the coverage to a wider range of firms and simplified the administrative procedures to access the schemes.

Despite their relevance, empirical evidence on the role of loan guarantee programmes during the crisis in alleviating firm distress as well as their broader impact on productivity via reallocation is scarce. Our recent paper (Demmou and Franco, 2021) fills this gap by looking both at their potential short-term and medium-term effects.

Hibernation rather than zombification in the short-term, but reallocation may slow down in the medium-term

The crisis may have cleansing or scarring effects on productivity through the extensive margin. Depending on the type of firms "saved" over the productivity distribution, loan guarantees modify the market selection process and thereby aggregate productivity performance in the short-term. Based on i) a simulation model, ii) a large sample of SMEs located in 14 European countries, and iii) a detailed sector-specific shock to firms revenues, we show that loan guarantees played a critical role in bridging the large liquidity gaps associated to the COVID-19 shock and investigate the (pre-crisis) productivity profile of illiquid firms compared to that of the other firms in the sample.

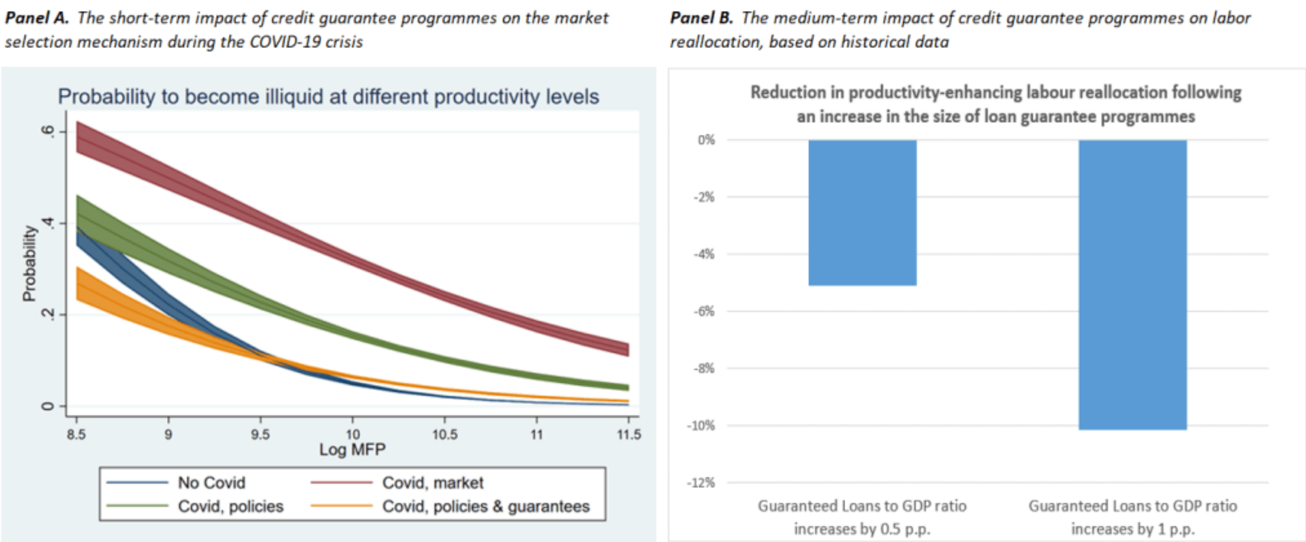
Our findings show that the COVID-19 crisis had the potential to seriously hamper the efficiency of market selection mechanism by pushing many high productivity firms out of the market. As shown in Figure 1, Panel A, COVID-19 substantially raised the probability of financial difficulties across the whole distribution of firm-level productivity – the red line (COVID-19 absent policy support scenario) is constantly above the blue line (normal times). However, the combination of standard policies and loan guarantee schemes counter-acted this process by hibernating the corporate sector and re-aligning the market selection mechanism closer to normal time standards (orange line), especially for medium and high productivity firms (top 75% of the productivity distribution).

This desirable outcome is achieved at the cost of slightly "over-reducing" the probability of illiquidity of low productivity firms (bottom 25% of the productivity distribution). Yet, back-of-the-envelope simulations hint that only a small share of the firms turning liquid owing to loan guarantees could be classified as zombies (between 4% to 8%) and thus that zombie lending has potentially been limited during the first year of the pandemic.

At the same time, however, large loan guarantee programmes do not come without risks for future productivity. Exploring the historical relationship between the size of loan guarantee programmes and dynamic allocative efficiency in 10 OECD countries, we show that these schemes may favour the build-up of misallocation in the medium-term, as sizeable programmes are correlated with a slowdown in the ability of most productive firms to attract more labour and grow faster (Figure 1, Panel B).[1] For instance, while our results do not imply causation, a large increase in the loan guarantees to GDP ratio of 1 p.p. appears associated with a decline in the efficiency of labour reallocation of one tenth.

Noteworthy, this average relationship masks relevant heterogeneities. The effects of loan guarantees on reallocation were found to be more benign in intangible-intensive sectors and even positive for smaller scale programmes, underscoring their potential to ease financial constraints and raising the prospect that delimited guaranteed credit programmes may help foster the growth of productive firms.

Figure 1. Credit guarantees have contributed decisively to repair COVID-19-induced inefficiency in market selection, but large programmes may hamper allocative efficiency in the medium-term



Note: Panel A shows the predicted probability to turn illiquid at different productivity levels in four different scenarios: No-COVID (blue line); COVID-19 without policy intervention (red line); COVID-19 with job retention schemes, debt moratorium and tax moratorium (green line); COVID-19 with loan guarantees in addition to the other policies (orange line). The shaded areas around the lines represent 95% confidence intervals. Productivity is measured as the log of pre-crisis firm-level multi-factor productivity. Based on an analysis covering the 2007-2018 period, Panel B shows the impact of an increase of the guaranteed loans to GDP ratio on the correlation between productivity and employment growth.
Source: OECD calculations based on Orbis® and OECD data.

Policy implications

At a glance, the empirical analysis shows that the cost of withdrawing support may outweigh the benefits in the short-term, while the reverse may hold when the economy will turn back to its pre-crisis levels. We argue that an effective exit strategy could aim at preserving the benefits achieved through support packages while reducing their drawbacks.

To reduce concerns of a potential collapse of credit flows following a premature withdrawal, policy makers could consider a gradual and state-contingent approach to phasing out loan guarantee schemes and other pandemic-related support:

- Viable firms in hard-hit sectors and SMEs not directly benefitting from the international recovery may need continued liquidity support. Loan guarantee schemes could also be temporarily frozen once liquidity needs diminish, but specific arrangements to ease their reactivation could help to avoid cumbersome legislative processes or sunk operational costs if the scheme needs to be restarted later on.
- Yet, to ensure that the additional support does not induce a material misallocation of resources over the medium-to-longer run, loan guarantee schemes may need to be fine-tuned and further targeted. For instance, re-designing the main covenants of the loans (e.g., portion of the loan backed by the government guarantee; fee to access the programmes) would diminish the risk of moral hazard and adverse selection.

The shock could still translate into a wave of corporate insolvencies and the reliance on credit guarantees could have increased firms indebtedness, leading to debt overhang. To countervail these risks, it is important to:

- Privilege grants and quasi-equity type of instruments to support the corporate sector, e.g. linking loans

repayment to businesses' returns or converting government loans into grants (up to a ceiling and for specific operational costs).
- Establish the conditions to promote early debt restructuring, e.g. through a reinforced network of consultations involving stakeholders or incentives for banks to restructure.

Finally, as pandemic-related support is phased-out, dynamism-enhancing structural reforms could be prioritised. In particular:

- Boosting firms' entry is a major challenge for absorbing displaced workers from upcoming bankruptcies, as it would allow harnessing the benefits of the creative-destruction process while reducing its social costs.
- It is key to ensure the diffusion and uptake of digital technologies across all layers of the corporate sector, as digitalisation became a matter of survival for many firms in COVID-19 times, shaping not only productivity but also macroeconomic resilience.

Reference

Demmou, L. and G. Franco (2021), "From hibernation to reallocation: Loan guarantees and their implications for post-COVID-19 productivity", *OECD Economics Department Working Papers*, No. 1687, OECD Publishing, Paris, https://doi.org/10.1787/2f4a4c20-en.

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[1] It is worth stressing again that the analysis focuses on the productivity impacts via reallocation. Large programmes may also be performance enhancing through channels other than reallocation which are not investigated in this study – for instance by spurring within firm productivity, if loan guarantees provide additional resources (not available otherwise) that foster firms' investment.