Financing recovery and growth

Christian Keuschnigg, Professor of Economics at the University of St. Gallen, explains how credit reallocation of banks boosts innovation and growth by steering capital to more productive use

Innovation driven growth rests on creative destruction. The creation of new firms and the expansion of the best companies on world markets requires resources that are released by the downsizing of old industries with low productivity. Capital and labour must flow from unprofitable firms to their more innovative rivals. Wages and career prospects are not good when employees are locked up in companies that are no longer competitive. Similarly, unprofitable firms can barely generate a return on capital while innovative firms yield "excess returns." Productivity growth depends on a country's ability to reallocate capital and labour to their best uses where they yield the highest income.

How banks reallocate credit

Our research (funded by the Swiss National Science Fund) focusses on the role of banks in credit reallocation. Which firms should receive credit, and when is it necessary to terminate credit lines? Before extending a loan, banks must assess the debt capacity, e.g., the ability to fully repay with interest. Creditworthiness depends on a firm's earnings potential and endowment with loss absorbing equity capital. However, many things can go wrong after receiving a credit. New rivals may wipe out sales, and a severe recession could do the same. A good credit may turn into a non-performing loan and create losses.

To protect depositors and shareholders, banks must carefully monitor outstanding credit and terminate non-performing loans before the situation escalates and losses multiply. If difficulties are temporary, banks will continue credit lines to keep firms going. However, when the business model becomes outdated so that equipment and the workforce are no longer profitably used, banks should terminate credit and initiate bankruptcy procedures. More successful rivals can generate higher income by making better use of resources that are released by non-viable firms. When liquidating assets, banks can typically extract about 70% of the value of bad loans. The remainder creates losses due to credit write-offs. However, banks can use liquidation revenues for new lending to other firms with better prospects. That is why efficient bankruptcy procedures are essential for productivity gains by facilitating a smooth reallocation of resources.

Reallocation boosts productivity

Our analysis points to policies that can improve credit reallocation. For example, strengthening equity capital helps banks to digest liquidation losses without violating their own stability. Well capitalised banks are better able to reallocate credit. Ending the tax discrimination of equity or strengthening investor protection to facilitate external equity financing would help. Bankruptcy reform could render liquidation procedures more efficient, allowing banks to extract a larger share of non-performing loans for lending to new firms.

In removing barriers to credit reallocation, such policies are conducive to the expansion of innovative industries which tend to have shorter product cycle and faster firm turnover. Innovative sectors thus have a larger need for reallocating resources from downsizing to more profitable, expanding firms. The upshot is that a healthy banking sector can facilitate the reallocation of resources, thereby contributing to productivity gains and reinforcing a country's competitiveness in innovative sectors.

The role of equity financing

Banks and markets perform complementary roles. The efficiency of bank lending depends on the existence of viable capital markets. Private equity and venture capital are a source of external equity financing. Since creditworthiness depends on a strong equity base, bank credit and equity financing are necessarily interdependent. In Europe, most of equity capital stems from retained earnings for internal accumulation of equity capital. However, this tends to be a very slow process since firms need to pay steady dividends to satisfy shareholders and are thus limited to increase retained earnings.

Innovative start-ups and fast-growing firms need big chunks of equity in noticeably short time. These equity investments create access to additional bank credit and help firms to scale up rapidly. If they relied on retained earnings only, they would be extremely slow to accumulate equity and could not scale up fast enough to capture a dominant market share. If scaling up is prevented by an equity shortage, rival firms will take the lion's share of new markets. Availability of external equity financing by private equity and venture capital firms is thus crucial to benefit from the growth potential of new innovative firms. Apart from giving money, venture capitalists also add value by supporting the managerial professionalisation. They increase the chances that start-ups will grow to truly large corporations with thousands of new jobs.

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The COVID-19 Recovery

Bank credit and equity financing are thus tightly connected and together drive economic rejuvenation by reallocation of capital and labour from downsizing to expanding companies. They also play together in determining crisis resilience. Bank credit is needed to leverage up equity capital for financing more investment. A shortage of equity not only constrains growth but also makes firms vulnerable. Overindebted firms are the first to go bankrupt in a severe recession.

The COVID-19 crisis has severely hit the earnings of many companies and, despite public relief measures, has reduced equity capital by large amounts. A shortage of equity means excessive debt which might lead to large increases in bad loans and a surge of insolvencies when public guarantees end. Waiting for firms to rebuild their equity base by retaining profits takes a long time and is a prescription for a prolonged slump. To speed up the post-COVID-19 recovery, firms must be much faster to rebuild their equity base and restore their full creditworthiness. Large firms have better access to stock markets or capital markets for external equity financing. Policy initiatives to facilitate private equity and venture capital for small and medium sized companies would provide new equity in big chunks, improve the debt capacity of profitable firms, and speed up the recovery.

References

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University of St.Gallen

Christian Keuschnigg
Professor
University of St. Gallen
Tel: +41 71 224 3085
Christian.Keuschnigg@unisg.ch
www.fgn.unisg.ch/keuschnigg