# Companies respond to the corona crisis by adjusting labour costs

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The corona pandemic and the related lockdown measures have led to a strong contraction in business turnover and weakening of profitability, particularly in the service industries. If the profitability crisis persists, it will turn into a liquidity crisis and the risk of corporate bankruptcies will increase. Companies can, to some extent, adjust to the decline in turnover by cutting costs, for example by decreasing purchase volumes and by negotiating reductions to other cost items, such as rents. With the help of temporary lay-offs, companies can even adjust staff expenditure rapidly, if necessary.

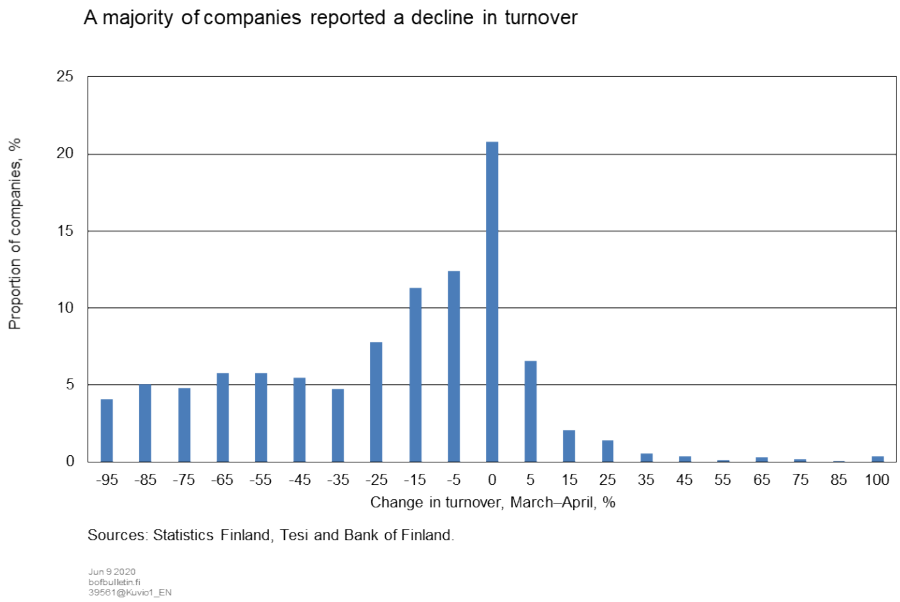
Many companies experienced a sharp contraction in turnover during the corona crisis, particularly in its early phases. If companies are unable to adjust their cost structures accordingly, their profitability will weaken and cash flow may turn negative. Rapid adjustments in labour costs play a significant role in companies' recovery from a sharp contraction in business volumes as experienced during the corona crisis. This article examines the significance of labour cost adjustments in the recovery of Finnish companies from the corona crisis.

This examination is based on data from Tesi (Finnish Industry Investment), which combines the results of a survey of some 1,600 SMEs, conducted in the period 3 April–5 May 2020, with business financial accounts data.[1]

## One-third of companies reported an over 30% decline in turnover

A large share of the companies that participated in the survey reported a decrease in turnover in March–April 2020. The results of the survey show that for 36% of the companies, turnover declined by more than 30% (Chart 1). Over 10% of the companies reported an increase in turnover, and slightly over 20% experienced no changes.

Chart 1




Business survey and financial accounts data enable a mechanical assessment of the proportion of companies that are threatened by a drying up of cash assets in the coming months, following the collapse in turnover. In the calculation, the largest expense items were deducted from the turnover, which shows the company's operating margin. If a company's turnover declines without a corresponding decrease in costs, its operating margin will fall or turn negative. In the short term, the company can use its cash assets for covering losses, but as the cash assets dry up, the company will face liquidity

1. In the survey by Finnish Industry Investment, companies were asked about the effects of the coronavirus pandemic on changes in turnover and profitability, as well as about cost adjustments after the onset of the crisis. The survey data combines companies' financial accounts data for the years 2017 and 2018 from the Orbis database. Following some delimitations, the data consists of 1,414 companies from the eight main industries: manufacturing; construction; wholesale and retail trade; transportation and storage; accommodation and food service activities; information and communication; professional, scientific and technical activities; and administrative activities.

problems. Companies facing liquidity problems have a very high risk of going bankrupt if they are unable to obtain additional funding. For March–April, the assumptions on turnover used in the calculation are based on companies' own estimates. Some of the lockdown measures on businesses were lifted in June, and as a result, companies' turnover is assumed to gradually return to normal. Due to the unavailability of company-level estimates on developments in turnover after April, the calculation assumes that, starting in May, the companies' operating profit will remain at the level of April until the end of each review period (3 months/6 months). This assumption probably underestimates the developments in companies' turnover and liquidity position since May. This assumption is also gloomier than, for example, the assumption in the baseline scenario of the Bank of Finland's June 2020 forecast. This assumption was chosen because of the unavailability of company or even industry-level estimates of developments in turnover since the end of April. In addition to monthly cash flow, the calculation takes into account the amount of liquid assets at the beginning of the review period.[2] The estimate of the amount of liquid assets is based on financial accounts data for 2018.

According to the calculation, in three months after the onset of the corona crisis, i.e. at the end of May 2020, a total of 12% of the sample companies were facing liquidity problems. Liquid assets create a buffer that enables a company to continue even unprofitable business operations for some time, but not endlessly. As the time horizon of the review period extends, the proportion of companies facing liquidity problems thus increases significantly. Based on the calculation, in six months after the onset of the crisis, i.e. at the end of August, as many as 16% of the companies would have liquidity problems if the crisis had continued and the lockdown measures had not been lifted.

The persons employed by companies that will face liquidity problems already in three months account for some 8% of the persons employed in the sample, and the persons employed by companies that would have liquidity problems in 6 months account for some 16% of the persons employed in the sample. Thus, after three months, the majority of liquidity problems are found in smaller-than-average companies, but after six months, this difference is no longer observed. One possible interpretation is that larger companies are able to avoid a cash crisis for a longer period of time, but only for a couple of months longer.

The proportion of companies facing liquidity problems differs considerably between industries. The highest proportion of companies with liquidity problems is found in service industries where demand has collapsed, reflecting both the lockdown measures and the weakening of consumer confidence.

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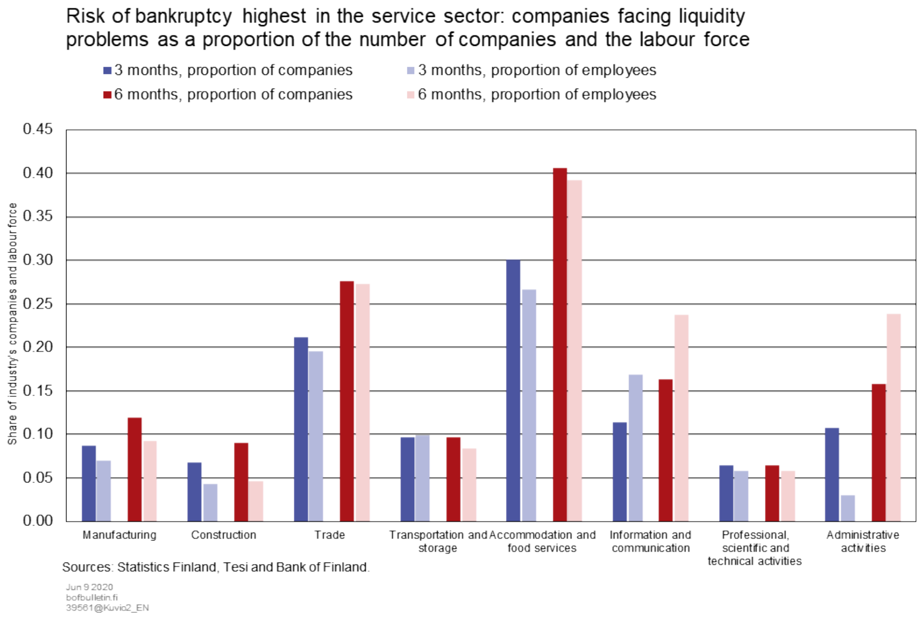
2. A company's cash position in n months is calculated as follows:  cash position in n months = company's liquid assets at the starting point, based on financial accounts data + operating profit in March + (n-1)*(operating profit in April).

Chart 2




## Companies respond to changes in turnover

Companies may respond to a decline in turnover by adjusting their costs. Labour costs are a significant cost item for the whole Finnish corporate sector. In manufacturing, labour costs account for some 15% of a company's total production costs, and in other industries their share is about 30%.[3]

Companies can reduce labour costs by introducing temporary lay-offs, redundancies or shorter working hours. The decrease in labour costs during the corona pandemic is also due to the cuts in employers' social security contributions introduced by the government. In 2020, these contributions are reduced by over EUR 1 billion to alleviate the situation in the corporate sector. Companies' own tools for lowering labour costs have in practice turned out to be limited, which highlights the importance of the lay-off system.

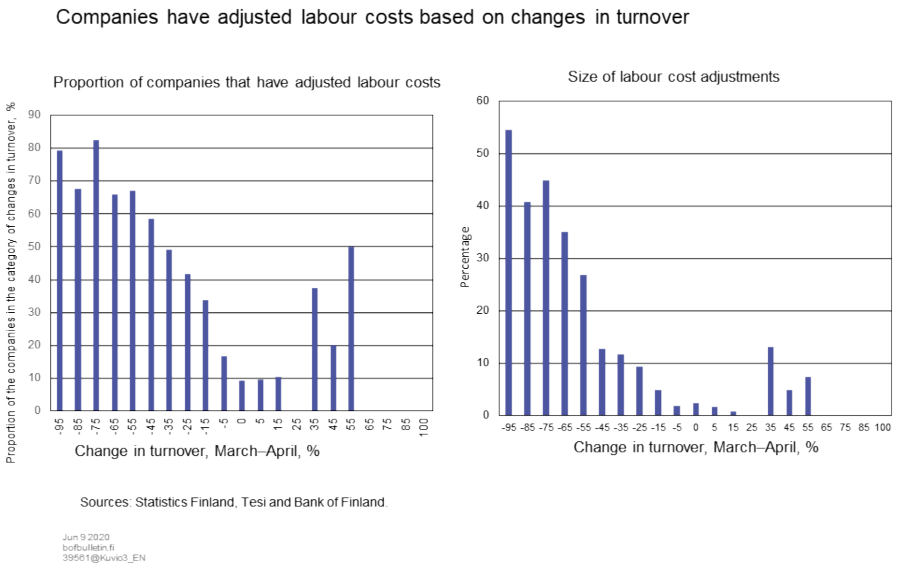
Cuts in labour costs by the companies in the survey sample clearly reflect the changes in turnover. In Chart 3, companies are divided into categories based on changes in turnover in March–April. The chart on the left shows the proportion of companies in each category that have adjusted labour costs. The chart on the right, in turn, shows the average size of the adjustments in each category. The larger the decline in turnover, the larger the share of companies in the industry that have adjusted their labour costs (Chart 3). The chart on the right shows labour cost adjustments relative to changes in turnover. Adjustments have usually been larger, the larger the decline in turnover.

Chart 3 shows that, for some companies, the downward adjustments in labour costs have been quite strong, while at the same time, their turnover has increased substantially. The proportion of companies that have experienced a strong increase in turnover is, however,

3. Silvo, A. (2019), Palkkojen nousun vaikutus kokonaiskustannuksiin eri toimialoilla. Bank of Finland Bulletin, Economic outlook, 17 May 2019.

very small. In the categories +35%–+55%, there are only a handful of companies.

Chart 3

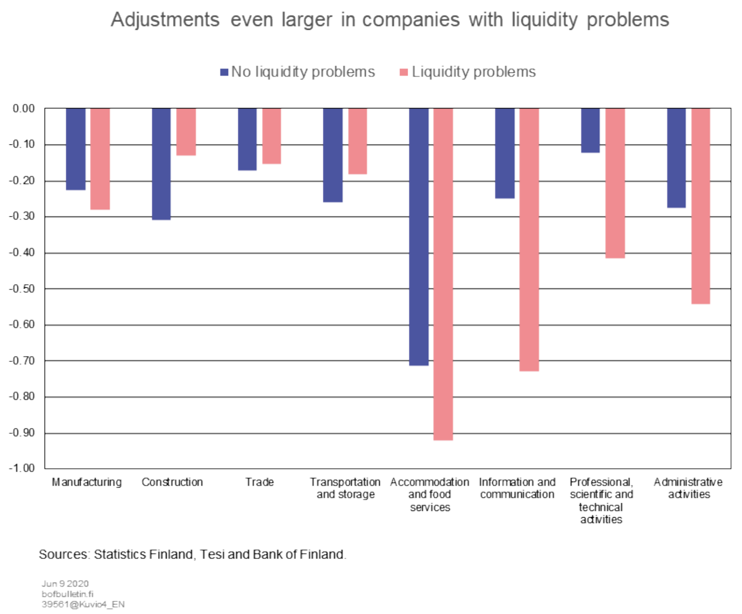



## Lay-offs will not be enough to save companies

As expected, the strongest adjustments in labour costs have been witnessed in accommodation and food services, which also reported the largest declines in turnover (Chart 4). Surprisingly, adjustments in both accommodation and food services and also in many other industries have been largest in the case of companies that have faced liquidity problems. Even the vigorous efforts by companies to cut costs via lay-offs, in addition to the reductions in social security contributions granted by the government, have in these cases not been sufficient to save companies from a cash crisis following a strong, sudden and unexpected contraction in business volumes. Smaller adjustments in companies that have avoided a cash crisis may be explained by the fact that these companies have considered cuts in labour costs as a last resort.[4]

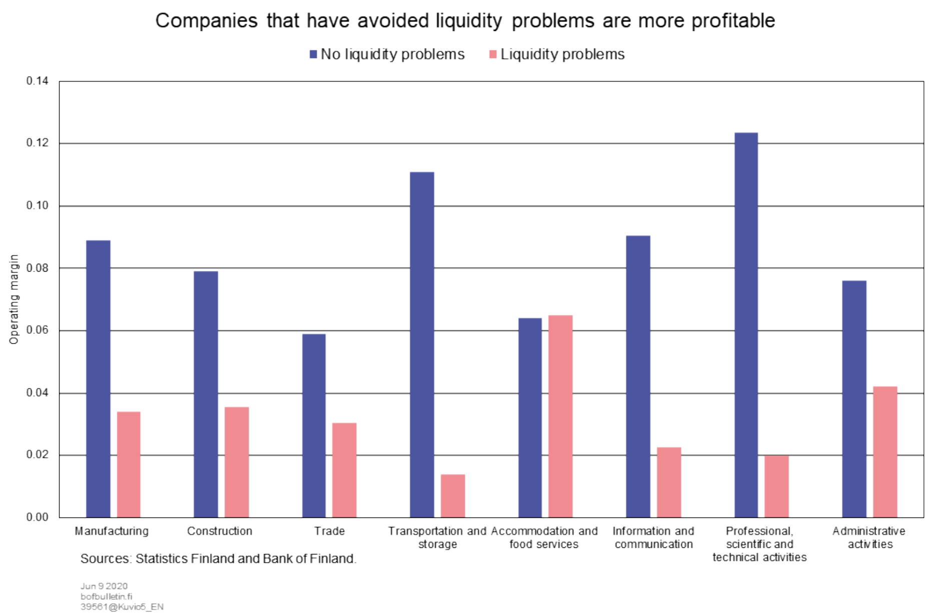
4. For example, studies on wage rigidity (for example the survey of firms conducted by the ESCB Wage Rigidity Network and comprising many European countries) show that companies are typically fairly unwilling to cut wages, because they fear a weakening in employee motivation.

Chart 4




Companies' need to introduce lay-offs depends on many factors, in addition to a decline in turnover. Companies are fairly heterogeneous in terms of, for example, profitability, cost structure and cash position. Some companies have in principle weaker possibilities of coping with sudden unexpected difficulties like the corona crisis. Chart 5 shows that, irrespective of industry, the profitability of companies that will encounter liquidity problems was weaker than in the other companies even prior to the drop in turnover.[5]

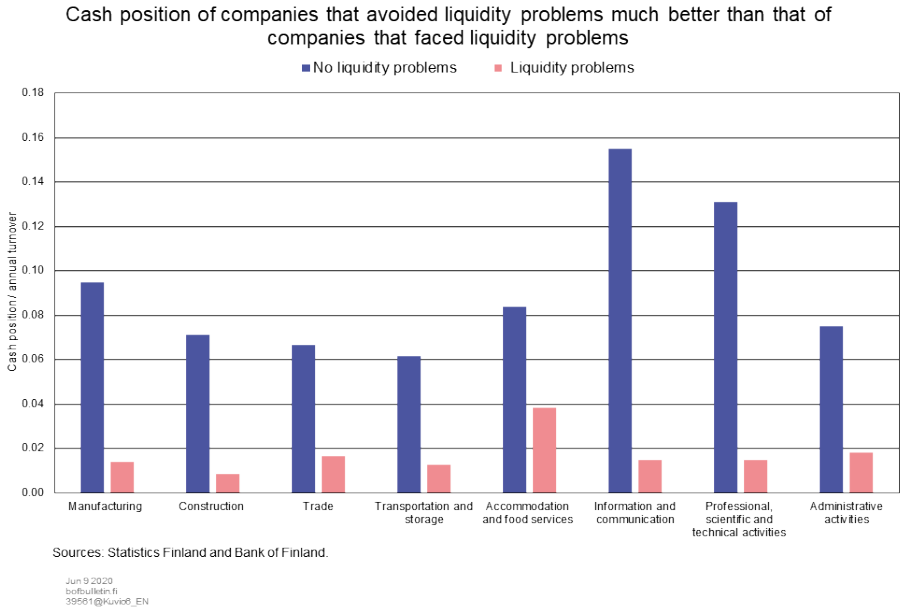
Chart 5




5. The profitability measure is operating profit as a percentage of turnover before depreciations and amortisations (EBITDA margin, %).

As expected, a company's cash situation prior to the crisis has played an important role in how they have coped with the crisis. The cash position of the companies that faced liquidity problems was just before the crisis significantly weaker than in the case of companies that avoided liquidity problems (Chart 6).

Chart 6




## Adjustments in labour costs have saved jobs

Cost adjustments introduced in March–April 2020 are helping many companies cope with a decline in turnover of at least a couple of months. Next, we examine more closely the importance of cost adjustments to companies that reported a considerable (at least 30%) decline in turnover in March–April.[6] Based on a mechanical calculation, approximately one in every four companies in the sample would face cash problems in three months after the onset of the corona crisis. Correspondingly, approximately three-quarters of the companies would survive at least three months. For many companies that will avoid bankruptcy, the possibility to introduce downward adjustments in labour costs is of key importance for coping with the crisis. Approximately one in ten of the companies that will avoid liquidity problems would go bankrupt without the costs adjustments made in March–April (Chart 7).

If the weak economic conjuncture continues, a growing number of companies will face liquidity problems.[7] The calculation shows that in six months, only some two-thirds of the sample companies would be able to avoid a drying up of cash. Of those companies that will avoid liquidity problems, for every five the cost adjustments introduced in March–April are essential to survival.

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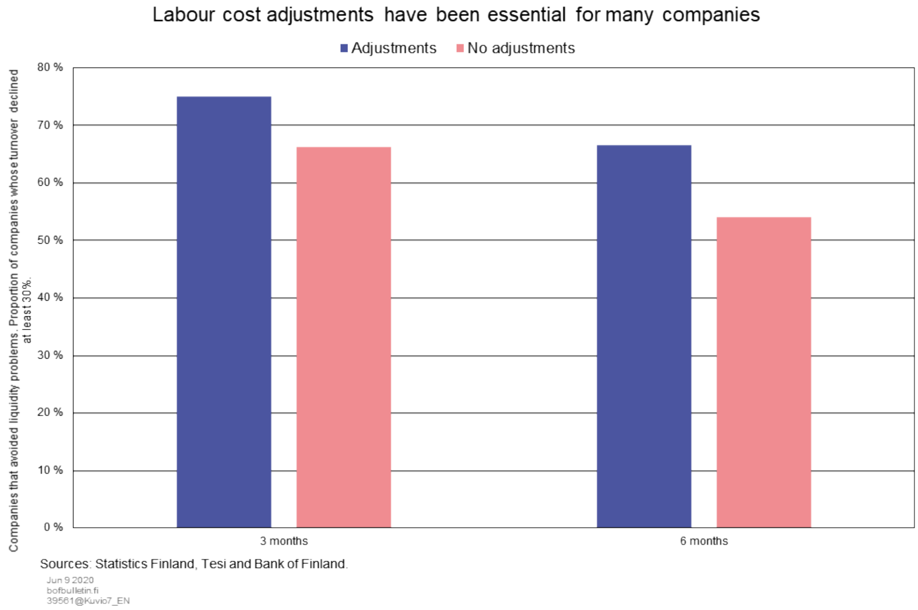
6. A 30% decline in turnover was strongly proposed as a criterion for general support to companies.
7. We wish to point out that this scenario is based on weaker economic developments than assumed in the Bank of Finland's June 2020 forecast for the Finnish economy; this is due to restrictions regarding the data available.

Chart 7




Companies reporting payment difficulties. Proportion of companies that reported a minimum 30% decline in turnover in March–April.

Job losses will be permanent in respect of companies that face liquidity problems and go bankrupt. The number of these permanent job losses can be estimated based on the number of bankruptcies avoided with the help of lay-offs. Jobs may be lost permanently not only in connection with bankruptcies but also in a situation in which the company survives but is forced to make some of its employees redundant because of shrinking business volumes.[8] Based on the data available, it was not possible to examine the significance of lay-offs due just to the decrease in companies' turnover.[9]

Chart 8 shows the number of job losses prevented in the economy as a whole with the help of lay-offs. The number of bankruptcies in the economy as a whole is estimated based on the number of bankruptcies per industry in the sample. The industry-specific weighting coefficient is the number of persons employed in the industry.

Based on this rough estimate, lay-offs have a fairly large impact on employment. In a review horizon of three months, lay-offs help save slightly under 70,000 jobs, which corresponds to roughly 2% of the persons employed. In this estimate, we should however take into account the fact that restrictions in data availability mean the calculation probably underestimates developments in companies' turnover and cash position and is thus gloomier than, for example, the baseline scenario in the Bank of Finland's June 2020 forecast.

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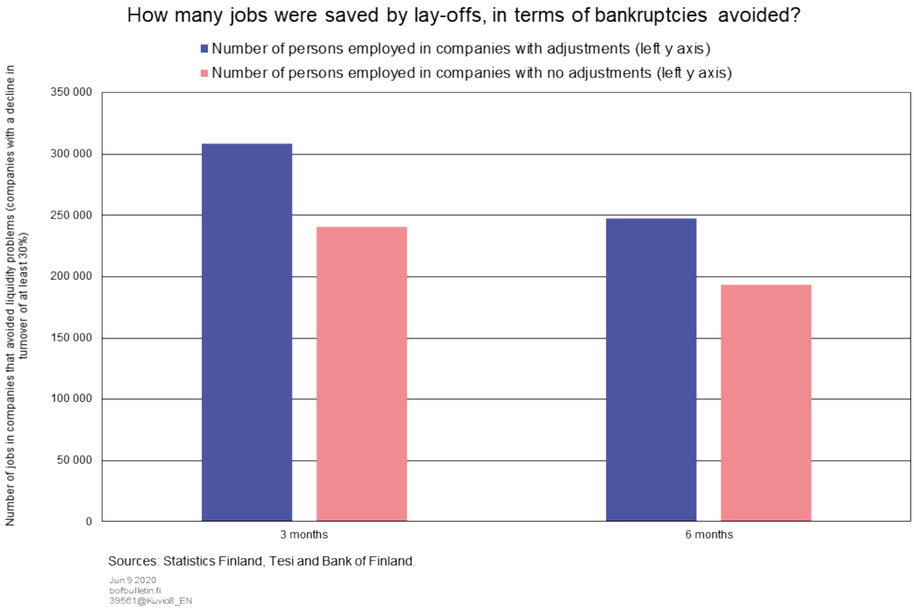
8. Nir Jaimovich & Henry E. Siu, 2020. 'Job Polarization and Jobless Recoveries', Review of Economics and Statistics, vol. 102(1), 129–147.
9. The number of jobs saved in the sample companies was scaled to the level of the economy as a whole, industry by industry, using as the scale factor the combined turnover of the companies in each industry relative to the turnover of the companies in the sample.

At least based on the figures calculated from the sample, the significance of lay-offs is smaller after six months than after three months from the drop in turnover. The calculation shows that six months after the onset of the corona crisis the number of jobs saved with the help of lay-offs has fallen to only 50,000. This is the case despite the fact that the impact of lay-offs on the number of companies that have avoided bankruptcy is larger after six months than after three.

Without lay-offs, many companies would not have survived even three months following the drop in turnover in March. If the crisis continues, an increasing number of companies will be driven close to the profitability margin and eventually below it. After six months, the number of job losses avoided via lay-offs is smaller than after three months. This indicates that more bankruptcies than before has been avoided in smaller companies.

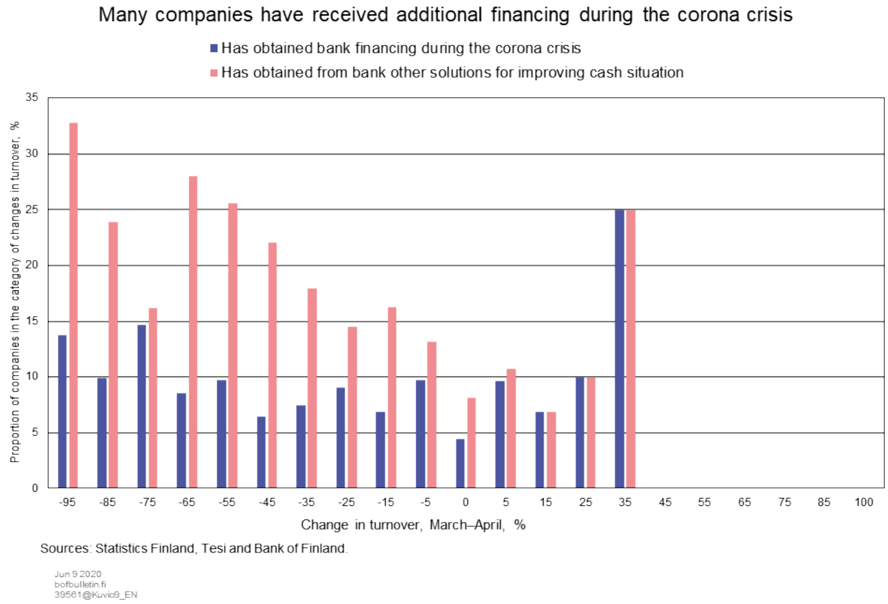
Chart 8




## Additional financing by banks has helped avoid a cash crisis

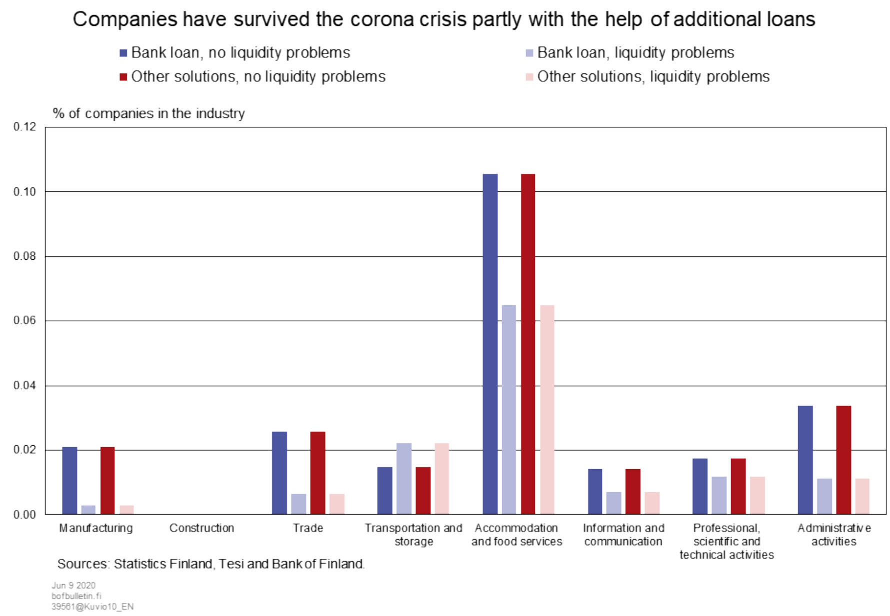
In addition to labour costs, additional financing has played a role in avoiding a cash crisis. Companies that have experienced losses in turnover have been granted bank loans during the corona crisis. Banks have also granted interest-only periods (Chart 9).

Chart 9




Companies have been able to avoid a cash crisis partly by taking on more debt. Debt accumulation will, however, hamper their future business activities and slow their recovery from the crisis. Additional bank financing is more common particularly in the group of companies that, based on the calculation, are likely to avoid liquidity problems (Chart 10). These companies have also been granted interest-only periods more easily than other companies. This observation applies to nearly all the industries surveyed.

Chart 10




## More measures needed to save companies

The possibility of introducing labour market adjustments via lay-offs has traditionally been an important tool on the Finnish labour market when the economy has been hit with a sudden shock. In the early phase of the corona crisis, a quarter of the sample companies experienced an over 30% decline in turnover. Particularly those companies that were hit hardest by the corona crisis reacted rapidly to shrinking turnover by cutting labour costs, mainly via lay-offs. These helped avoid bankruptcies, and based on the calculation some 70,000 jobs have been saved. In this estimate, we should however take into account that restrictions in data availability mean the calculation probably underestimates the developments in companies' turnover and cash position and is thus gloomier than, for example, the baseline scenario of the Bank of Finland's June 2020 forecast.

However, lay-offs are an effective tool for adjustment only in the short term. Labour costs are adjusted in Finland typically via the size of the labour force, and not its price. In the short term, lay-offs can help avoid bankruptcies and save jobs. If wages do not have to be flexible in Finland, in contrast to our competitors, the competitiveness of our companies will be eroded, which will weaken their operating prospects and opportunities for employment going forward.

The smooth functioning of financial intermediation has also played a role during the corona crisis. Banks have granted companies that have suffered from the corona crisis additional financing and also interest-only periods that will help them through the acute phase of the crisis. By increasing borrowing, companies have been able to tackle their worst short-term financing problems, but debt accumulation will erode profitability and slow recovery from the crisis.

Lay-offs and increased borrowing are not sufficient to save all companies, not even the healthiest. We also need other solutions, for example financial support to help the companies through the worst period. New labour market flexibilities would also be welcome. However, ultimately companies will survive only if demand recovers and labour market structures are appropriate.

## Tags

COVID-19, profitability companies, lay-offs, bankruptcies, financing conditions