Growth expectations and the dynamics of firm entry

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Date:2022-08-24

Keyword:firm entry, exit, growth expectations, private and public investment

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Summary  
Focus  
Business turnover, the process by which entrepreneurs create new firms and dissolve old ones, is a key feature of modern economies. Structural factors, such as barriers to entry or an inefficient insolvency process, play a considerable role in either slowing down or speeding up the entry and exit of firms.  
Contribution  
In addition to structural factors, cyclical developments also matter. History would suggest that more firms are created in upturns and more liquidated in downturns. Yet the recent Covid-19 recession is somewhat at odds with this simple view. While most countries suffered a deep economic contraction, firm entry followed very different patterns across countries. In Europe for instance, Spain experienced a sudden stop in new firm creation while France had a boom, even if output fell by comparable amounts in both countries.  
Findings  
This paper argues that growth expectations are the key driver for firm entry. Based on a sample of euro area countries, it shows that more firms are created in response to past exits when the economy is expected to grow faster. Similarly, a drop in past entry weighs less on subsequent entry when the economy is expected to expand quickly. In addition, it finds that the economic outlook affects firm entry mainly through expectations of public and private investment. This suggests that policies focused on increasing private and public investment can often help to strengthen the economy's supply side, by increasing firm entry and business dynamism.  
  
Abstract  
How do aggregate conditions affect the dynamics of firm entry? Do recessions force more firms out, allowing for more firms to enter subsequently? Or does this process require other circumstances to thrive? I look into these questions using sectoral data on firm entry and exit for the main economies of the Euro Area over 2009-2019. My main finding is that expected, rather than current, GDP growth shapes the dynamics of firm entry. Specifically, I find that entry increases with past exits at the sector-level, but only when aggregate GDP growth is forecasted to be strong. Also, with strong growth forecasts, past entry developments weight less on the subsequent sectoral entry dynamics. Periods of low entry and high exit, can therefore be followed by strong entry subsequently, when the economy is expected to grow strongly. These findings are robust to the inclusion of several controls. This includes the quality of insolvency proceedings, firms' ability to obtain credit or the presence of barriers to entry. Finally, I show that expectations of private and public investment drive the impact of growth expectations on the dynamics of firm entry.  
JEL classification: D25, D84, E32, E62, H32, M13.   
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