In countries with poorly functioning business bankruptcy institutions, business credit booms are followed by severe declines in output, investment, and consumption. In countries with well-functioning business bankruptcy institutions, credit booms are followed by only moderate changes in economic activities.

**Figure 1 · Change in Business Credit to GDP Following Credit Booms**

Note: This figure shows the GDP trajectory following a 10-percentage-point increase in the business-credit-to-GDP ratio over the past 5 years, in countries with low- and high-bankruptcy efficiency. Shaded areas mark 90% confidence intervals.

Recent research, including from UChicago economists, shows that periods of rapid borrowing can lead to economic problems such as reduced output, investment, and consumption. As a result, policymakers often pass rules aimed at curbing such credit booms. These policies can also have downsides, however, such as adding extra regulatory burden and causing the inefficient allocation of resources.
In this paper, the authors identify settings where credit booms are likely to harm the economy. They focus on the role of the legal institutions that govern business bankruptcy. The authors use existing measures of bankruptcy efficiency and business credit to GDP across 39 countries, along with economic indicators including GDP, investment, unemployment rate, and consumption to study how the macroeconomic dynamics following credit booms vary with business bankruptcy institutions. They find the following:

- Among countries in the bottom quartile of bankruptcy efficiency, a ten-percentage-point increase in the business-credit-to-GDP ratio in the past five years is followed by a decline in output of roughly three percentage points over the subsequent five years. There are also substantial declines in investment and consumption, and increases in unemployment.

- In contrast, these impacts are negligible among countries in the top quartile of bankruptcy efficiency.

The authors conduct extensive robustness checks to ensure their results are not influenced by a correlation between bankruptcy efficiency and other factors affecting macroeconomic stability, such as development status, exchange rate pegging, the countercyclicity of monetary and fiscal policies, or the general rule of law.

Building on this results, the authors use a model to illustrate how efficient bankruptcy systems mitigate the negative consequences of credit booms. They distinguish between fundamental credit booms, which are driven by increases in productivity, and nonfundamental credit booms, which are driven by speculation. They draw the following conclusions:

- Efficient bankruptcy systems mitigate the negative consequences of nonfundamental credit booms by reducing inefficient liquidation and improving the resolution of financial distress.

- Efficient bankruptcy systems can also reduce the positive impacts of fundamental credit booms, however, by limiting the room for improvement when higher productivity reduces defaults.

- In the data, nonfundamental credit booms appear more prevalent, and making the authors’ first finding especially relevant.

This research demonstrates the importance of accounting for bankruptcy systems in the design of policies aimed at stabilizing financial systems, a point vividly illustrated by the experience of Japan in the last two decades of the 20th century. Business bankruptcy institutions in Japan were underdeveloped until the late 1990s. When a real estate boom in the late 1980s ended with the collapse of the industry, Japan’s economy suffered substantially. Given these challenges, Japanese policymakers recognized the importance of bankruptcy institutions and embarked on a major bankruptcy reform that lasted from 1996 to 2005.

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**Bankruptcy efficiency**: designed by Djankov et al. (2008) and extended by World Bank (2020), this measure captures the fraction of enterprise value that can be preserved in bankruptcy.

**Business credit to GDP**: a financial metric that measures the total amount of credit extended to businesses as a percentage of a country’s gross domestic product, or GDP.

**Quartile**: a statistical term that refers to one of the three values that divide a data set into four equal parts, each containing 25% of the data points.

**Exchange rate pegging**: a monetary policy where a country’s currency value is fixed to another currency, a basket of currencies, or a commodity like gold to provide exchange rate stability.

**Fundamental credit boom**: an increase in lending driven by strong economic growth and sound financial conditions.

**Nonfundamental credit boom**: an increase in lending driven by speculation and unsound financial conditions, not supported by sustainable growth.

**Inefficient liquidation**: the process of selling a company’s assets for less than their optimal value.

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