The effect of Zombie Firms on the Global Economy

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What is a Zombie Firm?

Zombie firms are highly debt ridden inefficient firms which are kept alive artificially by banks or tax payer’s money. In a traditional sense Zombie means a dead man walking, it also means neither dead nor alive.

Such firms lock in capital and labor resources which could have been more efficiently used by other firms, especially efficient small businesses with innovative ideas. Zombie firms’ slowdown the productivity and this has a downward spiraling effect on the economy.

Zombie firms can be identified as those firms which are only paying interest on their loans and are not able to repay the principal. Some zombie firms generate enough profits to meet the operational expenses but are not able to expand or invest in new ideas.

Why are these firms kept alive?

Banks keep zombie firms alive in the hope that they will be able to recover their loans in the future. In the case of huge loans, writing off the loans may be the difficult process having adverse affect on the financial statements of the bank in the short run.

The governments keep zombie firms alive in order to reduce unemployment and also due to lack of concrete legislation with respect to liquidation of bankrupt firms.
Countries impacted by zombie firms

Good examples of the adverse effect of zombie firms on their nations’ economies are the Japanese Economy, UK and China.

Even the Indian economy is facing the adverse effects of maintaining zombie firms. This is especially true with respect to the aviation sector, construction sector and certain loss making public sector firms.

Japan

Japanese economy suffered slowdown and stagnation for approximately two decades, since the early 1990’s due to the banking system’s financial support for zombie firms.

Japan has faced the problem of aging workforce since past two decades; this has led to the reduction in productivity. The demand for labor decreased since 1990’s due to lower consumer spending. Construction, real estate and retail which grew rapidly in the 1980’s slowed down drastically post the peak in mid 1990’s.

However banks supported these loss making sectors throughout which in turn led to the drastic slowdown in the economic growth rate. In the case of construction sector, the value of land which was used as collateral has fallen sharply but the outstanding loan remains the same.

0.8% Japan’s GDP growth in 2015
UK’s record low interest rates are the prime reason for the survival of zombie firms which are currently increasing in numbers.

The construction and real estate sector in the UK took a massive hit during the recent European financial crisis. Property values have reduced less than one third as compared to the peak value but banks are unwilling to take action as this would result in massive short term losses.

The near 70% reduction in global oil prices has hit UK companies in the oil and gas sector. Labour shortages and inflation in price of building materials has weakened the construction sector. Some economists suggest that effective solution to UK’s economic woes is to increase the interest rates which in turn will kill zombie firms.

2.4% The UK’s GDP growth in 2015
China’s economic woes are caused mainly due to overcapacity and high government subsidies especially post 2008 global financial crisis.

Local provincial governments in China are keeping zombie companies alive in order to achieve self sufficiency at the provincial level and to get more subsidies. One remedy to this problem would be effective collection of VAT, so that the focus shifts to consumer demand in generating tax revenues rather than the current model where the provincial governments depend on local industries for tax generation.

The Central Chinese government’s solution to this problem is flawed, whereby they are focusing on mergers of loss making firms with the aim of creating giant enterprises. The logic behind this approach is to avoid competition among rival Chinese firms and to protect jobs of those employed in loss making state owned enterprises (SOE’s).

This approach is just delaying the problem is not a solution to the problem. Yin Weimin, China’s labour minister made an announcement in February, 2016 that that he expects 1.3m coal workers and 500,000 steelworkers to lose their jobs as part of efforts to deal with overcapacity.

6.9% China’s GDP growth in 2015
The Solution

The solution to problem of zombie firms’ is to put them out of their misery by easing the process of liquidation and having effective bankruptcy regulation.

The central banks should push banks to write off bad loans and declare their nonperforming assets (NPA’s). The banks should pull off the plug from zombie companies’ and let them die rather than keeping them alive artificially through financial life support system.

The central banks need to increase the interest rates whenever faced with the problem arising from zombie firms.

The solutions may be painful in the short term and result in loss of jobs but in the long run will unlock capital and labour resources, which can be used by more efficient and nimble firms.

References


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