The Walking Dead: Zombie Firms Stifle Economic Recovery Prospects

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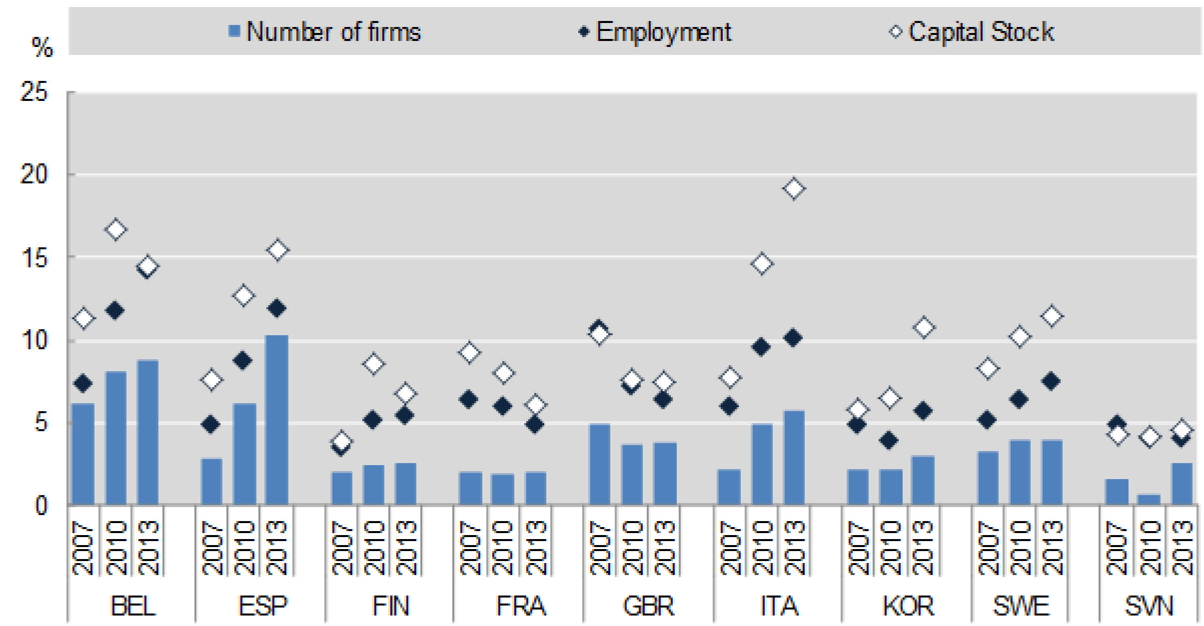
With the global economy stuck in a low growth trap, it is crucial to understand the factors behind the weak recovery in potential output growth, and particularly the barriers to productivity growth. New research shows that this dynamic can be partly understood in terms of the increasing survival of zombie firms – i.e. those firms that would typically exit in a competitive market but are being kept alive by creditors or policy weakness. Today, a key risk is that zombie firms may depress creative destruction, crowd-out growth opportunities for healthy firms and underpin a period of macroeconomic stagnation, just as they did in Japan in the 1990s (Caballero et al., 2008).

In a number of countries, the prevalence and productive resources sunk in "zombie" firms – defined as old firms that have persistent problems meeting their interest payments – has risen since the mid-2000s (Figure). In Italy, for example, the share of the industry capital stock sunk in zombie firms rose from 7% to 19% between 2007 and 2013. This is problematic because zombie firms can congest markets and reduce industry profitability – by inflating wages relative to productivity and depressing market prices – which deters the expansion of healthier firms, especially recent entrants.

Figure: The share and resources sunk in zombie firms have risen



Notes: Firms aged ≥10 years and with an interest coverage ratio<1 over three consecutive years. Capital stock and employment refer to the share of capital and labour sunk in zombie firms. The sample excludes firms that are larger than 100 times the 99th percentile of the size distribution in terms of capital stock or number of employees.

Source: Adalet McGowan, M., D. Andrews and V. Millot (2017), "The Walking Dead? Zombie Firms and Productivity Performance in OECD Countries", OECD Economics Department Working Paper No. 1372.

Econometric analysis shows that when more industry capital is sunk in zombie firms, the typical non-zombie firm undertakes less investment than otherwise. But the story does not end there because zombie congestion disproportionately crowds-out the growth of more productive firms, thus slowing productivity-enhancing capital reallocation and aggregate multi-factor productivity (MFP) growth.

The rise of zombie congestion can be connected to the collapse in OECD potential output via two key channels: weaker business investment and MFP growth. For example, simulations show that had the zombie capital share not risen from its pre-crisis levels:

- Investment of a typical non-zombie firm in Italy could have been around 6% higher in 2013. This can account for one-quarter of the actual decline in aggregate private non-residential business investment in Italy between 2008 and 2013.
- Aggregate MFP could have been 0.7% to 1% higher in Italy

and Spain respectively, owing to more efficient capital reallocation. This is significant given that in both countries, MFP subtracted significantly from potential growth over the past decade.

In some countries, these problems are likely to be symptomatic of weak insolvency regimes and a slowdown in the pace of product market reforms. But zombie firms may also be kept alive by bank forbearance and the persistence of crisis-induced SME support policy initiatives. While reforms in these areas may help revive productivity growth, it is crucial that they are flanked by well-designed active labour market policies, which have been shown to be effective at returning workers displaced by firm exit to work (see recent Ecoscope blog).

References

Adalet McGowan, M., D. Andrews and V. Millot (2017), "The Walking Dead? Zombie Firms and Productivity Performance in OECD Countries", OECD Economics Department Working Paper No. 1372.

Caballero, R., T. Hoshi and A.K. Kashyap (2008), "Zombie Lending and Depressed Restructuring in Japan", American Economic Review, 98(5), pp. 1943-1977.