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PHENOMENON OF ZOMBIE ECONOMY: EVIDENCE AND POLITICAL SOLUTIONS

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Abstract. Zombie economy is a result of financial crisis. In the process, main players are zombie companies, zombie banks and a government. The term was first used by Edward Kane, the Professor of Boston University, during the savings and loan crisis of 1980s in America. In 2008, he used the term to refer to companies that would have fallen in a deep financial situation unless the government supported them through guarantees and loans (Papworth T., 2013, p.11). Under conditions of stagnation, the economy is characterised by low production and trade for a relatively long period of time which, in turn, gives rise to unemployment, a reduction in wages and salaries and the overall decline of living standards. During these times, governments, as a rule, are called to assist the economy to overcome such harsh conditions through the provision of bailouts and other attempts that could support the banking sector (in order to avoid a banking crisis) and the entire economy. When a financial crisis comes to an end, the economy receives its own lifeless portion as a legacy of the difficulties and continues to try to preserve the old system of the government's financial aid which was readily available to it during the crisis. (Papava V., 2010, p.17)

Introduction

Zombie economy is a topical issue both for Georgia and other developed or developing countries. The problem may be faced by economy of any state as it results from financial crisis.

Zombie economy is a result of financial crisis. In the process, main players are zombie companies, zombie banks and a government. The term was first used by Edward Kane, the Professor of Boston University, during the savings and loan crisis of 1980s in America. In 2008, he used the term to refer to companies that would have fallen in a deep financial situation unless the government supported them through guarantees and loans (Papworth T., 2013, p.11). Under conditions of stagnation, the economy is characterised by low production and trade for a relatively long period of time which, in turn, gives rise to unemployment, a reduction in wages and salaries and the overall decline of living standards. During these times, governments, as a rule, are called to assist the economy to overcome such harsh conditions through the provision of bailouts and other attempts that could support the banking sector (in order to avoid a banking crisis) and the entire economy. When a financial crisis comes to an end, the economy receives its own lifeless portion as a legacy of the difficulties and continues to try to preserve the old system of the government's financial aid which was readily available to it during the crisis. (Papava V., 2010, p.17)

A zombie economy is engined by insolvement companies being at the edge of bankruptcy, borrowing loans from zombie banks with lower interest rates than average interest rates at the market. Zombie banks operate through financial programmes. That means that a government is behind them. As for issueing such credits by banks, the logic is simple: these companies are backed by a government until it is in power. The government secures guarantees for such loans, so banks are in a safe side, in any case. The banks may be conscious of their actions but their main purpose is to gain profit and have a good relation with the government, being it the guarantee of stability. The situation is useful for zombie companies. They keep operating at the expense of tax payers. Zombie economy is resulted from combined actions of zombie companies, zombie banks and a government. Thus, it becomes a burden for a healthy part of economy. Compared to healthy companies, zombie companies are preveledged when credit resources are being distributed. Moreover, they can easily reduce prices and increase salaries, thus oppressing healthy companies and finally reducing efficiency of the whole economy.

Existence of Zombie Economy in different countries

In the purpose of analyzing a zombie economy, let's review the Japanese Crisis of the 1990s that began in 1992 and has not been finally overcome yet. It had a depressive nature. During the crisis, the economy suffered from the following problems:

- Japanese yen revaluated due to reduction of joint demand
- Japanese budget deficiency from 1991
- issuance of credits by banks with lower interest rates than those of balanced interest rates

In such a situation, the Government of Japan considered it necessary to support financial and non-financial sector. It:

- carried out expansive fiscal and monetary policy
- launched a fiscal investment and loan program (FILP) supporting weakened financial institutions and non-financial sector in the implemention of investments

During a certain period of time, it became necessary to issue such subsidies permanently that created an 'economic routine'.

The key to understanding a zombie economy's routine may be found in the theory of public choice by James Buchanan in which politics is interpreted as a special type of a market. During a financial crisis, a type of economic policy develops that proposes the government's interference in the economy with its uppermost goal of rescuing it from a critical state, on the one hand, and encourages the addressing of the private interests of those economic agents who have found themselves on the verge of bankruptcy as a result of the said crisis, on the other hand. A zombie-economy's routine is the product of a market economy in a state of crisis. Consequently, it is not a simple homo economicus who is the carrier of this routine but, rather said, a mutation which was formed in the process of his adaptation to the deformed conditions of the market economy as a result of the financial crisis. Conventionally, a homo economicus mutant may be called zombie economicus in that he is the carrier of a zombie-economy's routine. From zombie economicus, as an already accomplished phenomenon, homo transformaticus (for post-communist countries) differs by the fact that he is still in the process of adaptation to a market economy and, as such, he has not yet been established as a type of human being. Because homo transformaticus is still developing, one may ask whether or not it is possible for a homo transformaticus to grow into a zombie economicus in the context of the ongoing global financial crisis. (Papava V., 2010)

There was set up a group of companies and banks, which was unable to exist without support. So, these were zombie companies and banks. In the opinion of Richard Koo, the economist, it happened in the 1990s when a bubble burst up producing a massive price fall. This resulted in changes in priorities of corporations: a bulk number of companies decided to operate differently. The improvement of balance became the priority over profit maximization. Temporary though, such a change hindered a normal functioning of economy as a business sector no longer got loans saved up by domestic economies, even with low interest rates. The reduction of demand on loans, non-usage of savings kept idle in banks created a deflationary hole, in addition to increasing indebtedness of the business sector. Such change in priorities of a business sector occurs when companies see that values of their assets sharply fall. Hushing up the problem ruined tranquility of politicians. After falling prices on assets, companies were obliged to claim reduction of loans. They used revenues for discharging loans. Consequently, the business sector of Japan became supplier of monetary resources to the bank system and the capital market. It made up approximately 20 trillion yens annually. This created a deflationary hole of economy making up about 8% of gross domestic product of Japan. In such a situation, monetary policy was ineffective, as all players reduced debts and did not borrow loans. Thus, money delivery reduced. There was only way out for the government – to borrow and spend money saved up by domestic economies and not borrowed by business sector. When a large number of companies shift their priorities from profit maximization to debt minimization all at the same time, a fallacy of composition problem is created where Adam Smith's invisible hand works in the opposite direction by shrinking both the economy and the money supply. In this unusual situation, the government—the only player outside the fallacy of composition—must have the courage to do the opposite of the private sector by borrowing and using the excess savings of the private sector if a major economic disaster is to be avoided. This was necessary to maintain sustainability of economy and delivery of money. Japan has managed to stay afloat in spite of a loss of wealth comparable to what the United States suffered during the Great Depression in the 1930s. Instead of losing half its GDP and 40 percent of its money supply as the United States did under President Herbert Hoover seventy years ago, Japan has managed to maintain stability for both because of the prompt fiscal response that filled the deflationary gap each year before the vicious cycle was allowed to start. (Koo R.C., Fall, 2003).

In one of his articles, Richard Koo says: ''Japanese companies are mainly engaged in discharging loans rather than maximizing profit''. 'This only explains why existing companies did not expand' – Hoshi says. 'There must be new companies which have no arrears and can create value and support economic growth. Such companies were very few in Japan' – he says. The reason to obstruct these new companies to develop was zombieing. Hoshi and his collegue Anil kashyao from Chicago University describe unprofitable, 'dead' companies existing by means of preferential credits. From 2000, about 30% of public companies of Japan engaged in construction, service providing and production spheres were unprofitable and breathed only thanks to bank loans. In Japan, Sogo is an example of a gigantic zombie company. It bankrupted in 2000 and its debt was 1.9 trillion yens. Banks made two devastating errors: first, they obstructed financing of new, profitable companies and second, they financed rivals of profitable companies – zombie companies giving them opportunity to maintain low prices and high salaries. 'By recirculation of loans, banks doubled and tripled stakes on zombie companies. If banks acknowledged the problem before 1997, the situation would not have worthened so' – says AnilKashyap (Guilford G., 2014). It was the government behind them, which somehow forced them to do so, in order to prevent massive unemployment. That's why banks keep on issuing credits to zombie companies. Theorem of public choice explains that. Persons in the government did not desire to stir up public discontent and loose electorate votes in elections. The example of Japan showed us that the government had a choice wheather or not to save companies. Due to a wrong decision, an improper 'treatment' the economy fell ill. This is one reason confirming that zombieing is a local problem. As for China, 'backwardness of stock exchange market is one of the signs of what happened to real estate market in Japan. China must carry out double investment to have the same growth of GDP as it had in 2008' – Wei Yao, the journalist of Societe Generale says (Guilford G., 2014). In China, state-owned enterprises (SOEs) are much less profitable than private companies, and large banks are in the state ownership. As China's credit system depends on political rather than market risks, large state-owned banks provide for small companies (SOEs) with loans. Hoshi says: ''this system is familiar to him as the situation was similar in Japan. SOE does the same. Unprofitable companies stay at the market as they are state-owned and are protected automatically. It seems, China is in a similar situation as Japan. The longer they postpone financial reforms the harder will be for them to defeat the zombie economy''. (Guilford G., 2014).

In Britain, there are hundred of thousands of zombie firms: companies that may satisfy requirements of borrowing loans but hoping to discharge loans through the law interest rate policy carried out by the Bank of England and the tolerance of financial institutions they continue to operate. The consequences of this policy were reflected in a real economy. Unemployment level was maintained at a low point, though profitability reduced: production per hour was 2.6% less in the third quarter of 2012 than four years ago. Over 108,000 zombie companies create hazard of getting a lost decade of inactive growth and profitability. As never before, variuos corporations are left without finances when capital and labour force are accumulated in zombie companies, though they may be used effectively elsewhere. The low interest rate and banks' tolerance towards unprofitable companies damage profitability and undermine competitiveness, hinder distribution of financial resources and labour force.

Beside this it's interesting to find out if zombie economy is local or global problem. From above example the problem emerged in China and Britain has not been spread from Japan but was a result of governments' actions. Once again, this proves that the problem is more local. In order to comprehend the essence of the global problem, let's review the financial-economic crisis of the XXI century. This crisis began in the USA in 2007. The main characteristic is a redundant issuance of credits in a short-term period and a redundant production in a long-term period. A starting point of the crisis is considered to be the mortgage (hypothecary) crisis of the USA that paralyzed the bank sector, as it was easy to issue mortgage credits without solid guarantees. Consequently, indebtedness towards banks sharply increased. That led to the edge of bankruptcy not only most banks but also the largest players of the insurance sector. The collapse of the largest bank of Lehman Brothers is an example to that.

In the XX century, almost every economic crisis started in the USA and many of them spread over the world. The current crisis is not an exception. It happens due to the role of the USA in the world economy. The USA produces over 20% and consumes about 40% of the world GDP. The USA is the largest trading and economic partner of the EU, Japan, China and a number of developing or post-communist countries. Hence, naturally, the financial-economic crisis emerged in the USA spread over other countries which were unable even to resist it. For example, the volume of industrial production of the EU countries reduced by 20.6% in April of 2009 comperaed to the same period of the previous year. In Europe, the first victim of the financial-economic crisis was the Island bank system. Islandish banks massively went bankrupt. Those banks were bought by large European banks, mostly, by British banks. In EU countries (except for Germany), unemployment level significantly increased. It reached the highest point of 9.2% for the last 25 years. Central and Eastern European countries, as well as Baltic States were especially damaged by the global crisis (Mekvabishvili E., 2009). Hence, we may conclude that financial crisis is a global problem that spreads over economies of other countries like a virus. Therefore, zombie economy has only a global 'effect' and, as mentioned above, depends on a person's decision.

Georgia is not an exception, as a zombie economy is acute problem both in developed, developing and post-communist countries. Among the members of our government, the theorem of public choice plays a key role. In Georgia, zombieing was applied mostly to construction sector. Here we may talk about several state programmes that aimed at 'encouraging' construction business. Such a project was 'A New Life of Old Tbilisi'. Within this project, the City Hall of Tbilisi financed construction companies that had to complete constructions (construction companies operating on the basis of 'financial pyramids'). These companies were also used in the rehabilitation project of old Tbilisi. In this case, the essence of the problem is: most of residential constructions are carried out by fellowships of flat owners organized by construction companies. The fellowship of flat owners is a union of persons who are interested in developing their own immovable property, without any commercial interest. This is carried out based on an agreement. The agreement defines shares. That is how the property should be distributed among members after completion of the construction.

As a rule, a company undertakes services such as obtaining a construction permit, designing a project and other activities not costing much. During construction, construction companies mainly do not use their own financial resources. The construction is financed from the money paid in advance by fellowship members for purchasing their future property.

This was the practice before the Russian-Georgian war of 2008 and the world financial crisis. Moreover, construction companies organized several constructions at the same time, though they had no adequate financial resources. They expected to sell virtual shares of a fellowship to future members of the fellowship before starting the construction, after obtaining a construction permit. Though, demand on flats being under construction was unexpectedly stopped and the system failed functioning. There were no new flat owners to finance constructions. In addition, construction companies unreasonably spent revenues received from selling shares of fellowships. Consequently, many constructions were suspended for an indefinite time.

Tbilisi City Hall decided to solve the problem of unfinished constructions and offered to construction companies the programme 'A New Life of Old Tbilisi'. Within the programme, banks issued credits to 'developpers', and the City hall was a guarantor. Construction companies had to complete started constructions and provide Tbilisi citizens living in dangerous structures with flats. According to the project, the City Hall would become the owner of empted old houses. It was going to destroy them and offer vacant parcels of land to investors. Hence, companies solved both problems of unfinished constructions and selling of flats. As for the City Hall, it acquired the best territories in the city.

The City Hall involvement is justified in this case. First, because the population was deceived (despite paid money they got nothing) and second, unfinished constructions spoil the appearance of the city and create dangeours zones around construction sites. Though, it would be better to help fellowships with 'developpers' playing a leading role, rather than supporting unorganized and irresponsible companies. The followships would have hired construction groups to complete constructions and this would have encouraged new construction companies to emerge. The action of the City Hall made the society to think that it were the members of the government who stood behind the financed construction companies.

Policy to defeat Zombie Economy

Legal instruments solve the problem of zombie economy more effectively than economic ones. None of the countries in the world has a comprehensive legislation against bankruptcy. The only way to get rid of zombie economy is to substitute zombie companies and zombie banks with healthy elements. It will be possible if an effective legislation against bankruptcy enters into force. In this case, bankruptcy does not mean liquidation but changing of company’s management. Putting into force legislation against bankruptcy is just a political will, though not ‘profitable’ for politicians.

However, putting legislation against bankruptcy into force is not sufficient for putting an end to a global financial crisis. Legislation against bankruptcy only relieves a country from the heritage of crisis. While analysing an existing financial model of the world, we see that it can not function without a credit system. The current financial market produces diverse and bulk number of products causing delivery of redundant credits, finally, this becoming the reason of financial crisis. Therefore, the problem is caused from a wrong organization of a financial system. It enables entities having large financial resources to have great profit without producing any real value for the society. In the nowaday world, everything that is valuable does not gain profit and everything that gains profit is not valuable.

In the world, governments use the amount accumulated by societies for financing organizations not producing any value. The government continues investing money in zombie economy instead of real one. They established a system of social values that awards harmful activities. In order to solve the financial crisis in Georgia, it is necessary to:

- get rid of post-crisis heritage
- change financial ‘structure’

The first problem is easier to solve. This task needs a political will and courage to take right steps. As for the second problem, it is harder to solve. Here, it is necessary to create a relatively comprehensive financial model that will not generate extra financial resourse in one hand, and will not provide for the possibility of ‘accumulating wealth therough wealth’ in the other hand. In addition, the second task requires not only a political will but alteration of a financial system, but this does not always match the interests of decision makers. The problem of financial crisis must be solved at a global level. This will automatically exclude the probability of emerging a zombie economy locally.

Tom Papworth, the economist, offers classification of zombie companies, according to the example of British zombie companies:

- companies that are at the edge of bankruptcy, but current low interest rates prevent the process
- companies at initial stage that use current low interest rates for expansion
- companies suffering a cyclic crisis
- Companies having problems in management and corporative structure despite their ability to produce demanding goods or services.

The only companies that can be recovered are those of the fourth category. The recovery of the first category companies may be desirable, but there is no longer the demand on their production at the market. It will be better for the economy and the society if a labour force and capital accumulated in those companies are used for profitable purposes. The second category companies have owner-managers or investors who look at the company as a lifestyle obligation and do not expect their recovery in a short-term period. In this case, stricter credit conditions will entail increase of demand on production of those companies. To the fourth category there belong the companies that could not develop due to problems in management and corporative structure. Those are companies that may be recovered (Papworth T., 2013, pp.44-45).

According to the approach of Hoshi and Kashyap, the programme for maintaining zombie companies is ineffective and serves keeping employment level only (Papworth T., 2013, p. 39). Zombie companies cause reduction of investments in healthy companies. When banks have issued many ‘bad’ loans they can not provide for sufficient ‘good’ loans. Financial institutions must be given regulatory encouragements, in order they liquidate bad loans. In any case, the government should not decide which company is saved and which is not. First, the government is unable to gather information necessary for making such a decision. Second, such a decision will be based on political rather than economic reasons. Third, the government may take actions and risks only by the money of tax payers. In the opinion of Tom Papworth, the tools of companies to fight at the free market must be industrial activities, investors, individual and tactical knowledge, free from political opinions. Private Entrepreuners will defeat zombie virus by risking monetary resources of investors. They must decide which company deserves to be saved and which one should be liquidated quickly and effectively. There are two reasons why this role is upon entrepreuners to be played by: first, they know which company should be saved and which not. Second, only entrepreuners risk their assets by buying rival companies. As for the risk taken by the state when supporting companies, it is a public risk. Despite it’s not a novelty for politicians, it’s important to change approach of the government, journalists and society (Papworth T., 2013, pp.53-54). On the background of the bank crisis of 2008, politicians made the following decision: to privatize profit and to socialize risks. Therefore, it will be more reasonable and moral if politicians give opportunity to individuals to undertake risks. Capital and labour force must be distributed, in order to create value for both investors and society. This will increase productivity and employment, and generally, recover the economy, as it is the best way to get rid of a zombie economy.

It will be better if the government is intolerable and let companies go bankrupt. In this case, the government will be able to use money for the compensation of workers supporting them during the period of unemployment, assist them in professional retraining so that they are able to be employed in the industry where there is a real demand.

Conclusions

Zombie economy is a result of improper 'treatment' of economy. As the ground of zombie economy is a financial crisis, and as the latter is a global problem, it is spread from one country to another and rapidly damages healthy economies, as economies of different countries in the world are closely interrelated. It's also interesting to find out wheather zombie economy is local or global. The problem seems local if it does not go beyond the economy system of a single country. The global problem may prevail over other economies. When a government has to make decision, according to the theorem of public choice, it always takes the way convenient and safe for itself. Therefore, it becomes a guarantor and helps companies to get finances through cheap credits. By doing this, the government enjoys sympathy of society and keeps in power longer. But this is the way leading us to zombie economy. As it depends on choice, I think the problem is more local than global. There is one more aspect that confirms the same – this is a period of time during which a routine is formed. A local problem needs a basic period of time to be formed. And we have such a period of time in the case of a zombie economy. The opportunity of choosing either recovery or liquidation of a zombie economy also indicates to the local nature of the problem. One more aspect should be reviewed – it's human factor. Some post-Communist countries received dead companies and economic system which is far from European capitalism. It's very dangerous for such countries to transform homo-transformaticus into homo-zombicus instead of homo economicus. Maybe one day policy makers will make decision in favour of the country and not of their own interests (based on the theorem of public choice).

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