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THE THREAT OF THE FORMATION OF A POST-PANDEMIC ZOMBIE ECONOMY AND THE LEGAL CAPACITY OF BANKRUPTCY MECHANISMS

VLADIMER PAPAVA

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EXPERT OPINION

RONDELI FOUNDATION

საქართველოს სტრატეგიისა და საერთაშორისო ურთიერთობათა კვლევის ფონდი
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Introduction

The year 2020 was particularly marked by the large-scale COVID-19 pandemic (WHO 2020) which, in turn, precipitated the global economic crisis (e.g., Baldwin and di Mauro 2020). The most effective mechanism to stop the rapid spread of the coronavirus was to limit direct contacts between people which was achieved by halting a number of sectors of the economy (IMF 2020). The economic lockdown has led to an economic crisis of a global scale (Roach 2020). From this we can logically conclude that the COVID-19 pandemic has been transformed into an "economic pandemic" (Riley 2020).

Firms whose activities were locked now need to solve the problem of surviving and maintaining their places in the market. The government also understands the difficulties faced by these locked firms and tries to help them as much as possible vis-à-vis maintaining their ability to exist within the market. This type of assistance, in turn, may pose another threat related to the vitality of these firms which may, *caeteris paribus*, become a rather difficult economic problem in the post-pandemic period. This article seeks to discuss the aspects for the emergence of this problem and its possible solutions.

The Coronomic Crisis and Support for the Locked Firms

With the onset of the COVID-19 pandemic, it was clear that the economy would remain under the influence of this new reality for some time. In response, the economics found an appropriate term to label this phenomenon – "Coronomics," combining two terms – "corona" and "economics" (de Alwis 2020). Later, a similar term – "Coronanomics" – also emerged (Eichengreen 2020). Based on these new terms, the term "Coronomic Crisis" was formed (Papava 2020a).

It is impossible to make full use of the experience of the 2007-2009 global financial crisis in relation to the Coronomic Crisis because the global financial crisis was a typical type of economic crisis while the Coronomic Crisis is an atypical crisis by its nature (Papava 2020c). Nevertheless, governments employed the same anti-crisis measures (alleviating the social situation of the population and providing financial support to businesses) during the Coronomic Crisis that were actively used during the 2007-2009 crisis as well (Hatheway 2020).

Governments employ a variety of tools to financially support businesses. In particular, imposing tax breaks for firms, deferring bank debt repayments, the provision of budgetary subsidies and so on are among these tools. In other words, firms are provided with the type of assistance that will alleviate the problem of their declining solvency.

In a non-crisis situation, the question of whether or not it is possible to activate liquidation mechanisms provided by bankruptcy legislation for insolvent firms is always relevant. In the context of the Coronomic Crisis, solving this issue is not only difficult but practically impossible. The problem here is that the aforementioned financial assistance is required not only for firms that were fully or partially insolvent, even without this crisis, but also for those that were financially "healthy" or solvent before the crisis. While, during the crisis, it is practically impossible to group firms on the basis those which had a solvency problem before the crisis and those which did not.

The Threat of the Zombieing of the Economy

If it is not possible to differentiate between those firms that were financially "healthy" before the beginning of the crisis and those which were insolvent, then it is impossible to utilize bankruptcy legislation. There is another very important barrier; in particular, based on political expediency governments need to avoid the liquidation of insolvent firms through bankruptcy in order to prevent any increase in the number of dissatisfied voters. This, in turn, may even lead to a corresponding revision of bankruptcy legislation under the COVID-19 pandemic if necessary (Boon 2020).

Therefore, on the one hand, it is obvious that the Coronomic Crisis is leading to a significant reduction in the solvency of a significant number of firms while, on the other hand, governments prefer bankruptcy legislation that limits the possibility to liquidate these types of firms owing to political reason. As a result, it will be practically impossible to employ bankruptcy mechanisms to liquidate these insolvent firms even in the post-crisis period when the problem of economic recovery becomes even more urgent owing to the same political expediency.

Blocking the liquidation of insolvent firms under bankruptcy law and providing government financial support to businesses, including those aforementioned firms, are leading to the zombieing of the economy as a result of the anti-crisis measures (Stiglitz 2020).

It is noteworthy that the notion of the zombieing of the economy emerged as a result of the financial crisis in Japan in the 1990s (e.g., Hoshi 2006). A zombie-firm is one that still manages to continue operating despite its insolvency. The main tool for the existence of these firms is bank credit (Smith 2003) which zombie firms still manage to obtain despite their insolvency with a financial guarantee issued by their government (Hoshi and Kashyap 2005). As a result, zombie banks emerge next to zombie firms that are not relying on the repayment of loans because the bank does not incur losses if these loans are not repaid – possible losses are reimbursed at the expense of a government guarantee (Ahearne and Shinada 2005, 368). It is precisely the set of zombie firms and zombie banks that forms the zombie economy (Kane 2000).

In the context of the global financial crisis of 2007-2009, the zombieing of the economy has transcended the borders of Japan and taken on a global character. This was precipitated by the use of the abovementioned tools on the part of world governments to provide financial support to businesses in times of crisis (e.g., Desjardins and Emerson 2011, Harman 2009, Onaran 2012, Quiggin 2010).

The process of the zombieing of the economy continued even after the end of the global financial crisis of 2007-2009. The problem of the zombieing of economy was exacerbated even before the onset of the Coronomic Crisis (Krugman 2020) although it has increased the number of zombie firms and zombie banks (Papava 2020b, Zingales 2021).

In the early stages of the post-pandemic period, it is likely that governments will continue to employ the instruments of financial support to businesses for some time. Therefore, we can conclude that, *ceteris paribus*, the problem of overcoming the zombified economy in the post-crisis period will be even more acute.

Peculiarities of Bankruptcy Legislation

The elimination of the zombified sector of the economy is possible only with the liquidation of insolvent firms through the application of bankruptcy legislation. In this regard, however, quite serious problems have accumulated.

The US bankruptcy system is considered to be the best in the world which is why it is advisable to bring the bankruptcy legislation in various other countries closer to that of the US. In particular, bankruptcy proceedings in the US are considered to be quite effective as they focus on both paying off debts to creditors and successfully restructuring financially viable firms. For this reason, it is recognized that the EU should adopt the restructuring legislation which will be aligned as close as possible to the American model of bankruptcy (e.g., McCormack et al. 2016, Parikh 2020, Pochet 2002, Tilley 2005).

It is noteworthy that shortly before the COVID-19 pandemic, the EU initiated a new bankruptcy reform (e.g., Malakotipour, Perotti and de Weijs 2020). Providing entrepreneurs with a so-called "second chance" was identified as one of the goals of this reform; it implies deferring their bankruptcy caused by the non-payment of debts through preventive restructuring for a maximum of three years (Wallace and Pilkington 2019). This will significantly complicate the possibility of the elimination of the zombified economy through the liquidation process in the post-pandemic period.

In our view, it is not at all unlikely that the EU will further complicate the procedures for the liquidation of insolvent firms in the process of adopting a new regulation as a result of the Coronomic Crisis.

Georgia's experience in terms of the relation of insolvent firms to bankruptcy legislation is interesting.

For both Georgia and other post-Communist countries, the effectiveness of the bankruptcy mechanism vis-à-vis insolvent firms was of particular importance (e.g., Bufford 1996). This is understandable because this or that firm may even go bankrupt due to failure as a result of market competition. If we also take into account the fact that post-Communist countries inherited a necroeconomy from the command economy (Papava 2002, 2005), then the importance of bankruptcy law increases even more. Unfortunately, the enactment of bankruptcy legislation in post-Communist countries faced serious obstacles as a result of the underdevelopment of the existing institutional system and strong subjective factors (Bufford 1996).

The first bankruptcy law in Georgia was adopted in 1996. It was called the Law on Bankruptcy Proceedings. This law was replaced in 2007 by the Law on Insolvency Proceedings. Its purpose was, above all, to ensure the rapid liquidation of insolvent enterprises and the distribution of the remaining assets among debtors. It was later considered that this law was not in accordance with the so-called “best practice” of the internationally recognized standard according to which, in fact, bankrupt firms should be given a “second chance,” i.e., the opportunity to continue operating through debt restructuring (Janus 2016).

Based on the aforementioned European tradition, a new Law on Rehabilitation and the Collective Satisfaction of Creditors was adopted in Georgia in 2020, entering into force on April 1, 2021. The purpose of this law is to keep a de facto insolvent firm in the market for at least three years. Transferring such a firm to the bankruptcy mode is possible only if the rehabilitation process reveals that the firm is not able to become solvent.

Therefore, it becomes almost impossible to get rid of insolvent companies in Georgia due to this new bankruptcy law. This is also indicated by the fact that widespread international experience shows that there is always a political lobbyist who can “prove” in every possible way that virtually any insolvent firm has potential and that liquidating it through bankruptcy is completely unjustified (Anderson 2004, 199). The arsenal of arguments will be further reinforced by the notion that even an insolvent but still working firm increases the gross domestic product (GDP), employs the population and so on (e.g., Janus 2016).

The increase of the GDP and employment at the expense of insolvent firms can only be achieved in the short term and this is usually only the case if strong protectionist measures are used to insulate the national market in the country’s foreign trade. Maintaining insolvent firms is known to hurt both the consumer and the national budget of a given country and, ultimately, the economy of the country as a whole (e.g., Krugman, Obstfeld and Melitz 2018).

Unfortunately, it is obvious that Georgia’s bankruptcy legislation, like that of the EU, reinforces the tendency of artificially prolonging the presence of insolvent enterprises in the market and not so much healing the economy. This difficult situation is exacerbated by the Coronomic Crisis.

The main principle of the current bankruptcy legislation, according to which it is necessary to maintain a balance between the interests of creditors and the avoidance of the early liquidation of potentially viable firms (Stiglitz 2001), must be substantially changed as it effectively blocks the liquidation of an insolvent firm through bankruptcy law. Therefore, if we want the economy to consist only of financially sound firms, then the main principle of bankruptcy law must be to maintain a balance between the interests of creditors and the timely liquidation of non-viable firms (Papava 2017, 460). Only then will it be possible to eliminate a zombified economy in the post-pandemic period.

Conclusion

The COVID-19 pandemic in 2020 caused a global economic crisis owing to the temporary lockdown of the activities of certain sectors of the economy and firms operating within. This lockdown proved to be an effective mechanism for halting the spread of the virus by restricting contacts between humans.

The relatively prolonged period of this economic condition has led to an economic crisis caused by the coronavirus; in other words, the Coronomic Crisis.

Due to the lack of better ideas, governments employed the same anti-crisis measures to tackle the Coronomic Crisis as were used during the global financial crisis of 2007-2009. In particular, these measures are aimed at alleviating the social situation of the population and supporting business.

The firms with problems of solvency were clearly exposed during the Coronomic Crisis. This included those firms that already had this problem, at least in part, even before the beginning of the COVID-19 pandemic.

In general, government support to business in times of an economic crisis leads to the zombieing of insolvent firms. The first precedent of a zombie economy emerged in Japan in the 1990s. During the global financial crisis of 2007-2009, the zombieing of the economy had already taken on a global character and this process, unfortunately, continued even after the end of that crisis.

Insolvent firms, or zombie firms, are a heavy burden for the financially healthy part of the economy and the only way to solve this problem is to liquidate zombie firms which must proceed through the enforcement of a relevant bankruptcy legislation.

The modern trend in bankruptcy legislation is to provide a so-called “second chance” to the bankrupt firms, achieved by avoiding their liquidation. When deciding on a firm's form of bankruptcy, preference is usually given to reorganization and not liquidation. In many cases, various groups with political and public influence are behind the insolvent firms. They use political tools to try and artificially maintain these firms in the market.

The main principle of bankruptcy should be to find the balance between creditor interests and the timely liquidation of non-viable firms in order to heal the economy by forcing non-viable firms out of the market.

One of the most important aspects of the economic development in the post-pandemic period will be the elimination of the zombie economy. This cannot be achieved without employing an effective bankruptcy mechanism.

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