

Can High Inflation Wipe Out the Zombies in the Economy?

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Against the background of the COVID-19 pandemic, and subsequently the Russian War in Ukraine and economic sanctions imposed by the West against Russia, high inflation has become a global economic problem (e.g. Baker, 2022; Papava, 2022; Rodrik, 2022). It is believed that it was high inflation that put an end to the financial “Dawn of the Dead,” referred to as “Zombies,” and it is supposed that the same high inflation contributes to the curtailment of ultra-loose fiscal, monetary,

and credit policies, which is the basis for the existence of zombie firms and zombie banks (Roubini, 2022).

In my opinion, the problem of ridding ourselves of zombies in the economy is not so simple as to be solved by exceptionally high inflation. It is necessary to consider the question in the context of what kind of economic zombies we are talking about, which is the subject of this analysis.

According to a common definition, zombie companies are generally considered to be companies that are insolvent, according to their declared negative profits, for a relatively long time, but which nevertheless continue to operate (e.g. Mohrman, Stuerke, 2014). Such a “relatively long time,” during the profit coverage ratio of debts below one, is considered as three consecutive years (GS, 2022).

A logical question arises – due to what do zombie companies and zombie banks exist?

As international experience of the functioning of the zombie economy shows, insolvent companies continue to exist due to extraordinary financial support from governments and central banks. In particular, the essence of this support is to provide these companies with government financial guarantees (through which these companies can take out new loans from banks), to provide direct support to firms through financial assistance programs, as well as to weaken the micro- and macro-prudential supervisory rules (e.g. Schepens, Schnabel, Laeven, 2020).

Of the various forms of state support for zombie companies, the provision of government financial guarantees to these companies should be highlighted. Historically, it was precisely this support that characterized the emergence of zombie companies during the financial crisis in Japan in the 1990s (Hoshi, 2006), seeing zombie companies receive loans from commercial banks through financial guarantees issued by the government (Hoshi, Kashyap, 2005). Banks are ready to lend to insolvent companies because they are insured by these government financial guarantees (Smith, 2003). Thus, zombie banks appear in the banking system, and they, together with zombie companies, create a zombie economy (Kane, 2000). In turn, the government provides financial guarantees to zombie companies based on the interest of preventing their bankruptcy, which would cause the loss of the votes in political elections of those voters who were unemployed due to this bankruptcy. This scheme for the formation and support of the zombie economy is, in some cases, still used today.

It was on the basis of this scheme that the zombie economy was born in its historical “homeland” – Japan. For greater clarity, this type of zombie economy, of so-called “Japanese origin” as the initial phenomenon, which is based on the existence of non-paying companies supported by government financial guarantees should, in my opinion, be named the **Orthodox Zombie Economy**.

During the global financial and economic crisis of 2008-2009, the process of zombification of economies was seen almost worldwide (Desjardins, Emerson, 2011; Harman, 2009; Onaran, 2012; Quiggin, 2010). The process of zombification of companies and banks not only failed to stop after this crisis, but gradually became one of the main challenges facing the global economy (Krugman, 2020).

During the COVID-19 pandemic, the problem of zombification of the economy became a heightened reality (Donnan, 2020; Lee, Contiliano, 2020; Schepens, Schnabel, Laeven, 2020; Zingales, 2021). Yet, this is not at all surprising, given that the government stimulus used to support the economy (Hoshi, Kawaguchi, Ueda, 2023; Stiglitz, Rashid, 2020), in the conditions of the economic crisis caused by the pandemic (Papava, 2020a), contributed to the emergence of a new wave of the process of zombification of the economy (Papava, 2020b).

Both under the global financial and economic crisis of 2008-2009 and after it (including the economic crisis caused by the COVID-19 pandemic), new tools have emerged to form and support the zombie economy. In particular, governments have begun to provide direct support (subsidizing) to firms through financial assistance programs (Song, Su, Wang, 2021). At the same time, central banks, along with the implementation of an accommodative monetary policy, have weakened the regulatory function in relation to banks (Lenzu, Wang, Acharya, 2021).

According to some studies, there is a direct link between low interest rates and the rise of zombie companies in the economy (Blažková, Chmelíková, 2022).

This mechanism also contributes to the emergence of zombies in the economy, but they are fundamentally different from the above-mentioned orthodox zombies. For the sake of clarity, the zombie economy that exists due to government programs of direct financial support, and/or low (and sometimes negative) bank interest rates, can in my opinion, be named the **Heterodox Zombie Economy**.

It should be noted that the fates of orthodox and heterodox zombie economies, under conditions of high inflation differ fundamentally from each other.

In order to overcome high inflation and restore price stability, central banks raise the interest rates, resulting in a sharp increase in debt-servicing costs, which should lead to the end of the zombie economy (Roubini, 2022).

Logically, this mechanism only works for those heterodox zombie banks and related zombie companies which exist solely due to low bank interest rates. Note that this judgment has a weak point, since the low interest rates of bank loans are also used by financially quite “healthy” companies that have a clear advantage in the competition with zombie companies (Schaaf, Bindseil, 2020).

At the same time, the question arises as to how high inflation can be sufficient to rid us of the orthodox zombie economy, as well as that part of the heterodox zombie economy that exists due to subsidizing from the national budget.

To answer this question, it is necessary to take into account the Oliver-Tanzi Effect (Olivera, 1967; Tanzi, 1978; Tanzi, ed., 1984).

The Oliver-Tanzi Effect manifests itself under high inflation, when taxpayers prefer to delay payments to the national budget. The reason for this is that under high-inflation, taxpayers hope that money will depreciate, as a result of which they benefit from the delay in paying tax liabilities. This is also supported by the tax legislation, which, in particular, provides that some taxes from the previous year are paid the following year. At the same time, tax liabilities for the previous year are fixed and are not subject to indexation. Thus, when inflation is high, the corresponding increase in tax revenues is characterized by a temporary delay. In other words, there is a time lag between rising prices and increasing tax revenues to the national budget.

Thus, due to the Oliver-Tanzi Effect, under high inflation, national budget revenues grow with a time lag. At the same time, the government, *ceteris paribus*, faces the problem of public procurement at higher prices. Therefore, it is precisely because of the Oliver-Tanzi Effect that high inflation puts the government in a difficult position to subsidize zombie companies.

One can conclude that high inflation is indeed a serious obstacle to the existence of a heterodox zombie economy, regardless of what (government subsidies or low bank lending rates) it exists through.

The situation is different with respect to the orthodox zombie economy. In particular, under high inflation due to the Oliver-Tanzi Effect, although national budget revenues grow with a temporary delay, the debts of zombie companies to zombie banks under government guarantees are also not covered immediately, but only after these companies become unable to fulfill their obligations to the banks.

Thus, under high inflation, it is fundamentally important for an orthodox zombie economy to compare the time lags of the Oliver-Tanzi Effect and the issuance of government guarantees, to the coverage of outstanding debts of zombie companies, to banks using these government guarantees.

As such, the orthodox zombie economy is far more resistant to high inflation than the heterodox zombie economy.

Based on the foregoing, one can conclude that the zombie economy, and, above all, when it is orthodox, is not a monetary phenomenon. The same conclusion, somewhat earlier, on the basis of arguments different from those presented in this analysis, was made by Schaaf and Bindseil (2020).

In other words, high inflation may only partially affect some zombie banks and zombie companies (not even all of them with heterodox origins), but it cannot, in principle, solve the problem of ridding the economy of zombies entirely.

Comprehensive measures are needed to dispense with the zombie economy (Schaaf, Bindseil, 2020), among which effective bankruptcy legislation will play a special role (Papava, 2020b).

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