The Costs of Zombification in Europe: Why Austrian Economics fails and the Empirical Findings for Japan are a Misleading Guide.

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Abstract

Supporters of the Austrian School of Economics and a number of empirical studies have claimed that the increasing number of "zombie" companies is a supply-side reason for the low growth rates in Europe. Often, these studies cite empirical findings for Japan to justify their claims, and conclude that in order to overcome the stagnation phase, bad investments and thus zombie companies should be eliminated from the production process. However, such creative destruction can only prove beneficial if innovative and highly productive companies replace these zombies under full utilization of resources. We ask whether findings on the zombie problem from empirical studies on Japan can be applied directly to the current European situation. We present facts contradicting the idea that productive companies would not have been able to exploit their growth potential in (southern) Europe, allegedly because they could not have found suitable employees since these were tied up in zombie companies on a massive scale. Even under the false assumption of full employment in Europe, existing empirical work shows that the losses due to zombification are only around 3.6% of GDP over 10 years. In our calculation, that would be 100 euros per capita, currently far too little to call for a drastic change in ECB monetary policy towards past long-run average short-term rates.

Keywords: Zombie Companies, Japan, Austrian School of Economics, Schumpeter, Creative Destruction, Monetary Policy, Costs of Zombification of Europe, Balance Sheet Recession, Secular Stagnation.

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I. Introduction

Supporters of the Austrian School and a number of empirical economists have claimed that the increasing number of "zombie" companies is a supply-side reason for the permanent low growth phase in Europe. They cite findings for Japan to justify these claims. Zombie companies are highly indebted companies whose operating business does not generate sufficient earnings to guarantee the fulfilment of their payment obligations. Starbatty and Stark have demanded that more attention be paid to Austrian Economics in light of the continuing weak economic growth across Europe. Their recipe for overcoming the current post-crisis phase criticizes Keynesian demand management financed by increasing government debt and refers to Schumpeter's *Theory of Economic Development* as a remedy. According to Schumpeter, during a lasting phase of prosperity, exaggerations occur that cause undesirable developments in the overall economic production structure. In the event of an unavoidable economic downturn, such bad investments would have to

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be eliminated from the production process. The production factors released in this way are necessary raw materials for subsequent phases of prosperity.[1]

In our current post-crisis world, Austrian economists claim that banks around the world have halted the creative destruction that Schumpeter sees as inevitable in an economic downturn, firstly because the commercial banks, some of which are themselves only weakly capitalized, regularly extend loans to zombie companies as they fear the write-downs associated with the expiration of such loans. Secondly, due to the low refinancing costs of the commercial banks given the extremely low central bank interest rates, banks would additionally finance corporate investments, which generate only very low returns.[2] Zombie companies would therefore currently consume resources that would not be available to other, more productive companies. In a nutshell, the extremely expansive monetary policy of the central banks, in conjunction with the commercial banks' credit policy, has been cementing the undesirable developments in the production structure for years and thus reinforcing economic stagnation. However, those who cite Austrian and in particular Schumpeter's explanations for today's economic cycles and continuing weakness of growth in industrialized countries must first address the analytical framework and relevant assumptions of Austrian economics.

1. *Economic Reality and Walrasian Equilibrium*

According to Austrian economists such as Hayek and Schumpeter[3], recessions are due to temporary imbalances in the economy after it has moved away from an originally neoclassical Walrasian equilibrium. Looking back on his own work in 1984, Hayek defended this neoclassical framework and specifically his own monetary over-investment theory against critics, in particular Keynes. In Hayek's view, Keynes had completely eliminated the decisive effect of the change in relative prices in his *General Theory* with the assumption that "unused resources of all kinds are available".[4] In Schumpeter's *Theory of Economic Development,* an innovator starting to use new combinations "must draw the necessary means of production from old combinations". Based on his Walrasian equilibrium framework, Schumpeter argued that "the carrying out of new combinations means, therefore, simply the different employment of the economic system`s existing supplies of productive means."[5]

In reality, however, in addition to the existence of innovative and highly productive companies that replace these zombies, full utilization of resources is also necessary. If this is not the case, for

[1] Starbatty and Stark (2016).
[2] See Schnabl (2018).
[3] Hayek (1931), Schumpeter (1931).
[4] Hayek (1984), p. 26.
[5] Schumpeter (1934), p. 67f.