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OP-ED

Zombie Firms in Pakistan

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The efficient allocation of capital plays a key role in development by nurturing innovation and increasing industrial productivity. However, the reallocation ofcapital towards less productive firms at the expense of more productive firmsharm the growth of the industries. Recently economists discuss the existence and the rise of the Zombie firms which slowed down the growth in several countries including neighboring India. Zombie firm – a loss-making firm thatlost the ability to generate enough profits to cover their interest payments. They survive only by repeatedly refinancing their loans. In the competitive market, Zombies have to either exit or restructure. If Zombies congestion rises, it potentially crowd-out growth opportunities for more productive firms.

The Zombie firms first time had been applied to Japanese firms during the period of the Lost Decade (1991-2000 – the period of economic stagnation in Japan). In that period, Japanese banks were kept injecting new loans to unprofitable firms to keep them alive. The Japanese economy did not begin to recover until this practice of misallocation of capital had ended. Recently literature revisits this connection and shows that misallocation of capital is emerging as a vital explanation of the fall in productivity in several OECD and Asian economies.

Rarely discussed, but the concentration of the Zombies is the real challenge for industrial growth in Pakistan as well. The misallocation of capital to these unprofitable firms indicates that credit reallocation is not always to the healthier, innovative, and more productive firms in Pakistan, this perhaps crowd-out the growth opportunities for the productive firms. Using balance sheets of the listed firms, we estimate the share of these unproductive firms in the marketplace. Our estimated value suggests that approximately 25 percent of firms show up as the Zombie firms in Pakistan. Our calculations show that roughly 47% of these nonviable firms exist in textile, 19% in chemical industries, 10%of them walkin the cement sector a Zombie firms in the marketplace in Pakistan. The concentration of these firms is not limit any particular sector. They exist both in the private and public sectors. Our estimates suggest, roughly $3 billion short term bank credit flows to these firms annually, the efficie allocation of this credit could improve the performance of industrial sector.

What are the potential sources of the prevalence of the Zombie firms in Pakistan? One driver is the tendency for banks to make evergreen loans to nonviable firms. This practice allows them to avoid show losses on their balance sheet, and if they show the losses, they have to create provisions to balance their sheets. Second, the meager interest rate is another potential factor that reduces the pressure on creditors to clean up their balance sheets,which encourage the banks to makeevergreen loans these firms. Third, public sector enterprises appear as Zombie firms as well, which again a big challenge to banks because the public sector (PSEs) firms have faced high levels of debt or overcapacity. These firms have created a debt cycle, as they are often forced to borrow from banks to repay the interest payments. Banks lend to them because they come under the government guarantee, banks keep lending even having nonperforming loans.

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The support to Zombie firms to stay alive impairs the market competition. In this situation, banks let these unprofitable firms to distort competition in the economy. They depress the market prices and increase congestion of the less productive firms in the market that results in less credit availability for healthy firms. The Zombie's distortion also impacts the overall productivity of the industry and the job creation that more productive firms could generate. The survival of the unproductive firms for an extended period may crowd out the investment opportunities, employment generation, and the overall productivity of the industry that more productive firms could generate.

This debate should not distract from the contribution of the banks in a hard time to support firms. However, the role of regulators is the key to break this ongoing debt cycle. Devising effective regulatory measures to capture the non-viable firms in the marketplace, regulators can generate larger space for the more productive and small-medium enterprises (SMEs) to access the credit. Priority in credit access to productive firms, as well as small-medium and innovative enterprises, would improve the health of financial markets and may reap the higher investment and employment generation in the country.

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