Don't feed the zombies: a key lesson from the European debt crisis

Zombie lending has prolonged the pain of Europe's sovereign debt crisis, especially in Italy, where economic woes continue. New research links an effort to save the euro in 2012 to more zombie lending — and points to what could be done differently.

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Seven years ago, as head of the European Central Bank, Mario Draghi famously promised to do "whatever it takes to preserve the euro."

That "whatever it takes" included unconventional monetary policy measures, which worked better in some areas than others, according to research by Viral V. Acharya, Tim Eisert, IESE's

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Christian Eufinger and Christian Hirsch. Digging into the data on banks and their loans following the European Central Bank's announcement of its Outright Monetary Transactions (OMT) program of 2012, the co-authors offer advice for doing it better next time around.

Zombie lending

For example, in the aftermath of Europe's sovereign debt crisis, an Italian publishing company — which had reported three consecutive years of losses — managed to secure millions of euros in fresh credit. What's more, its lenders (including two of Italy's largest banks) offered an interest rate below what most top-rated "AAA" companies were paying for their loans.

So, why would these banks give a troubled company a dubiously cheap loan?

The short answer to this riddle is that troubled banks might "gamble for their resurrection," as Eufinger puts it, or at least make their finances look better in the short term. This is zombie lending in a nutshell.

Really this phenomenon has a few forces behind it, research has found. In Europe, after the OMT program was announced in 2012, some troubled banks — especially those in Greece, Ireland, Italy, Portugal and Spain (aka GIIPS countries) — found themselves with more lending capacity, thanks to the propped-up value of their riskiest sovereign bonds. And then banks that realized significant gains from the OMT announcement started lending more, but those banks that were still weakly capitalized were especially likely to lend to pre-existing customers — including so-called zombie firms that might well default — in order to gamble for resurrection or just avoid realizing losses for bad loans on their books.

Arguably, these weakly capitalized banks were postponing the inevitable, staggering along, helping their zombie clients postpone the evitable, too, at lending rates below what the most creditworthy clients might receive. After all, zombie loans were usually used to service troubled borrowers' existing debts, as research has also found, so the new credit had to come cheap.

The consequences of this zombie lending have been dire for the GIIPS economies — especially Italy, and, to a lesser extent, Spain and Portugal — where zombie lending distorted the market, diverted money that could have helped a recovery, and tempered investment and job growth.

Specifically, the authors estimate that healthy firms in Europe invested about 12.6% of

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capital less after the OMT announcement and had around 5.6 percentage points lower employment growth rates. Yes, blame it on the zombies: In industries where zombies were more prevalent, such as construction and trade, this research implies non-zombie firms experienced an investment loss corresponding to 2.6 and 1.6 years of investment capital, respectively, and 10.8 and 7.8 percentage points lower employment growth. In three countries — Italy, Spain, and Portugal — affected industries experienced an investment loss corresponding to, on average, 1.5 years of investment capital and they experienced 7 percentage points lower employment growth, on average. (The other GIIPS, Greece and Ireland, were not included here due to incomplete data for the study's calculations.)

Exposing the undead

"To the best of our knowledge, our paper is the first to provide systematic evidence that, indeed, Europe's slow economic recovery can be at least partially explained by zombie lending of banks that regained some lending capacity after the OMT announcement but which still remained weakly capitalized post-OMT," Eufinger et al. summarize.

The co-authors' work has been cited in *The New York Times* and Bloomberg News, where they note that Draghi quite possibly saved the euro in a time of crisis, but that the European economy might have been better off with one or two added actions: (a) combining the OMT program with a "targeted recapitalization program" for banks and/or (b) "forced bank closures." Reviving the ailing and/or killing off the dead could help Europe avoid the plague of zombie lending, which has been blamed for Japan's lost decade and continuing woes.

For context, the researchers found that roughly 8% of loans extended to companies in their data sample were tell-tale zombie loans. And yet: "This shift in loan supply away from creditworthy productive firms toward distressed and less productive borrowers led to an inefficient credit allocation, which distorted market competition and caused detrimental effects on employment, investment, and growth," they write. Next time, bank regulators should treat the zombie problem head on.

Methodology, briefly

The authors obtained extensive data on European banks, their funding, and their lending activities from 2009 to 2014. Their empirical analysis consisted of three main parts. First, they calculated how much individual banks were affected by the OMT announcement of 2012. Here they found that the equity of banks in GIIPS countries increased by an average of 8%. Meanwhile, it increased by roughly 1% for non-GIIPS banks like Germany, France and the

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United Kingdom. Next, they tracked the post-OMT changes in lending behavior. Third, they evaluated the effects for European firms.

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