An oversupply of Chinese products could cause disinflation in the EU

So-called “zombie credits,” subsidized loans or credits for companies that aren’t viable, are meant to stimulate economic growth. They may have the opposite effect.

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By Christian Eufinger

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Inflation is still high in much of the eurozone. Although it has decreased significantly from 10.6% in October 2022, inflation has been more or less stuck since October 2023, fluctuating between 2.4% and 2.9%.

But that could soon change thanks to an influx of Chinese products coming into Europe — a spillover effect of the Chinese government subsidizing Chinese firms, which allows them to produce more. These subsidies are often referred to as "zombie credit" because they're loans provided to companies that aren't financially viable, bringing them "back to life."

In my recent research paper published in *The Journal of Finance*, my co-authors and I found that zombie credit can reduce inflation because it creates an oversupply of goods and services in the market, which in turn puts pressure on prices to go down because there's more competition among firms. Our paper serves as a mechanism for understanding how this chain of events works — and why an oversupply of goods in China could lead to disinflationary effects all the way in Europe.

The rise of zombie firms

Our research focused on the phenomenon of zombie credit in Europe after the global financial crisis of 2008 and the resulting debt crisis — a period that was characterized by highly accommodative and lenient central bank policies. After looking at data from 12 European countries across 65 industries, we found that indeed the share of zombie firms increased from 4.5% in 2012 to 6.7% in 2016.

But why are companies kept afloat that are not economically viable in the long run? In part because banks were left weakly capitalized by the economic crisis, and they hoped to avoid regulatory penalties and "gamble for resurrection" by propping up these firms. So it's actually more of an unintended consequence of central bank policies than anything else: their intention was to stimulate growth and increase inflation, but they got zombie lending as an inadvertent side effect. These tactics kept inflation down, resulting in a period of economic stagnation that perplexed economists and policymakers alike — known as the "missing inflation puzzle."

Through our research, we found that providing credit to nonviable firms can distort economic activity, reduce productivity and limit growth potential. That's because zombie credit artificially inflates the number of active firms in the market and leads to excess supply, which creates artificially low prices and contributes to low inflation. It also leads to negative

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consequences for healthy firms by reducing their profitability and sales growth. We refer to this mechanism as the “zombie credit channel.”

Our findings show that in markets with a high prevalence of zombie firms, there is a notable decline in Consumer Price Index (CPI) growth. We estimate, then, that if weakly capitalized banks had been decisively recapitalized in 2009 — strengthening their capital base through a series of policy actions — it could have reduced their incentives to engage in zombie lending and the annual CPI growth in Europe could have been up to 0.21 percentage points higher post-2012. This underscores the significant role that zombie credit plays in dampening inflation, thereby partially explaining Europe’s missing inflation puzzle.

Surplus of Chinese goods

Our research is one of the first to show that supply-side factors matter for inflation. And although our data focused on Europe, our findings can also be applied to other parts of the world in order to better understand current global economic contexts.

Take China as an example. In recent years, the country’s GDP growth has slowed to 4.5% — half of what its average growth used to be. As a result, the Chinese government has shifted from a growing economy with heavy investments in real estate toward a strategy of generating economic growth by supporting corporations with cheap credit.

In other words, the Chinese government is supporting certain borrowers that are under distress — borrowers that would usually leave the market if it weren’t for zombie lending. This is similar to European central banks’ approach in the aftermath of the financial crisis. And much like in Europe, China is seeing an influx of firms in the market that’s leading to increased supply.

As a result, we’re seeing spillover effects in Europe, where the local market is currently flooded with goods produced by Chinese firms. China’s global trade surplus has more than doubled since the COVID-19 pandemic — approaching $1 trillion — and its prices are at their lowest levels since 2009. These products include electric vehicles, solar panels and wind turbines.

If we apply our findings — that zombie credit can lead to excessive supply, which brings prices down — then we can conclude that the influx of Chinese products could lower inflation in the eurozone. This could have a crucial impact on European central bank policy: If they expect disinflationary effects, they can begin to plan for further rate cuts.

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At the same time, China’s trade surplus could have negative consequences on European companies, putting them at risk of being priced out by the availability of cheaper goods. This, in turn, could add to geopolitical tensions between the EU and China, and keep alive the ever-present threat of tariffs.

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Christian Eufinger

Associate Professor in the Financial Management Department at IESE Business School, where he teaches banking, corporate finance and operational finance. His research interests include banking regulation and banks’ influence on the real economy.

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