Zombies must live or die on merits, that’s capitalism

COMMENT

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The absence of risk-pricing enabled companies like Virgin to become highly-leveraged despite losing about $2 billion in less than a decade.

The polarised debate over whether or not the federal government should bail out Virgin Australia is a fragment of a larger debate about the nature of capitalism that started in 2008 and has been given even sharper focus by the response of governments and central banks to the coronavirus pandemic.

Before the global financial crisis, it was generally only major banks that, because of their central roles in financial systems, were deemed too big to be allowed to fail.

Even as global banking regulators significantly toughened capital and liquidity standards in the aftermath of the crisis, the key central banks have pursued policies that appear to have been designed to avoid broader corporate failures.

The enormous floods of liquidity with which the US Federal Reserve, the European Central Bank and Bank of Japan have swamped financial systems and markets since 2008 have kept afloat non-banks that should have sunk.

Now, in response to the coronavirus, they are again under pressure to bail out companies.

Bizarrely, a week and a half ago the Fed started investing, for the first time in its history, in exchange-traded funds that hold high-yield ‘‘junk’’ debt. There was a record inflow of cash to those ETFs. The Fed is also buying higher grade corporate bonds for the first time.

In 2007, before the crisis, only 5 per cent of listed companies were classified as ‘‘zombie’’ companies, or businesses whose earnings before interest and tax didn’t cover their interest costs. Ahead of the pandemic that had grown to about 12 per cent, with the proportion of zombies in the US estimated at closer to 16 per cent.

There’s been no update from the international agencies that track the zombies since the outbreak of the coronavirus but it seems certain that the proportion of companies in the category would have rocketed as economies were locked down.

It is a central tenet of market capitalism that companies should be allowed to fail.

Austrian economist Joseph Schumpeter coined the phrase ‘‘creative destruction’’ to highlight the central role corporate failures play in innovation and in weeding out the inefficient and anachronistic from the efficient and dynamic.

Yet, ostensibly to prevent recessions and financial instability, since 2008, central banks have gone to unprecedented lengths to – as a byproduct of their macroeconomic strategies – effectively help prevent corporate failures and create armies of zombie companies by driving the concept of pricing for risk out of financial markets.

The absence of risk-pricing has enabled companies to borrow more cheaply than at any time in history. It has enabled US companies to winnow out their capital bases through share buybacks and to leverage themselves without being disciplined by financial markets.

It has enabled companies like Virgin, operating in an industry renowned for its volatility and vulnerability to unexpected events (such as epidemics, terrorist attacks and volcanic eruptions), to become highly-leveraged even though it had lost about $2 billion over the best part of a decade. In the US, airlines will receive a $25 billion bailout despite buying back close to $US50 billion ($79 billion) of their shares in recent years.

Virgin has made a profit only once (during Qantas' fleet grounding) since 2010, when Brett Godfrey handed over a highly profitable business with a robust balance sheet to John Borghetti, despite having a third of one of the most profitable domestic aviation markets in the world.

Conventionally, Virgin's shareholders (90 per cent of its shares are owned by five foreign strategic investors) would have been wiped out some time ago and its lenders, particularly its unsecured lenders, would have taken a savage haircut.

Instead, having been kept afloat by cheap and easy credit ahead of the pandemic, it has been pleading for – and receiving a lot of external support for – a government bailout that would preserve something for its equity holders and protect lenders who deserve to be punished for their poor credit evaluation.

The pandemic and the lockdowns are being used as an excuse for government intervention to prop up weak entities that have options, albeit unpleasant ones, of their own. The government did close the borders (hence the arguments for a bailout) but there is little chance Qantas, Virgin or any other airline would be flying much given everyone is too afraid to travel.

There is a difference between liquidity and solvency issues. The primary role of central banks is to ensure that there is access to cash and credit for those companies that are viable; not to provide lifesupport for insolvent enterprises.

The coronavirus does complicate the creative destruction argument, given that lockdowns threaten the base of economies – the armies of smalland medium-sized enterprises that can't survive a prolonged shutdown – but there is a distinction between those entities that were viable before the virus and those that entered the lockdowns teetering on the brink.

If capitalism is to work, the structurally weak need to be allowed to survive or fail on their merits, with those that can be salvaged via restructuring (after their shareholders and lenders have been taught a painful lesson about risk) re-emerging with stronger financial profiles and better strategies. Virgin could (and should) be one of them.

Since 2008, markets and businesses have operated within a world without risk.

Central banks removed the risks and encouraged and rewarded ever-increasing risk taking by pouring cheap liquidity into their systems, pumping up the value of assets and companies that, in more conventional settings, would have been punished for having little real worth.

It has never been the mandate of central banks to avoid recessions at any cost, or prevent corporate failures at any cost. Their role is to limit the damage of the recessions that are a regular and disciplining feature of capitalism.

Their post-crisis interventions and ''whatever-it-takes'' approach to the pandemic are transforming capitalism into something quite different.

It's a ''heads you win, tails you win'' world for businesses and investors, with taxpayers underwriting their risks on the downside while they maintain unlimited upside. It's not capitalism.