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The joy of exit

Why are downturns in India so long? One factor is the slow exit of firms

SNAKES & LADDERS

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In his column in *Business Standard* on Saturday, T N Ninan showed the gloomy environment of private businessmen facing difficulties. There are major difficulties in the Indian arrangements of the relation between the state and the market. But there is a silver lining: The exit of the weak boosts the profits of the survivors through higher output prices and lower input prices. This process of exit is accelerated by the bankruptcy reform. Greater leverage fosters less sentimental decisions. When exit is swift, business cycle downturns are shorter.

The heart of a business cycle downturn is private sector optimism and investment. Why has optimism declined in India? Every infrastructure company has stories about a government that does not pay on time, and a government system that does not flinch when violating contracts. Similarly, instability or perversity of regulation, taxation and agencies have hampered many a business. The daunting government interface, along with the lack of the rule of law, has fed into the lack of animal spirits and investment. Conversely, investment booms are born of reform teams that solve these problems.

Alongside this are the competitive battles within each relevant market, where creative destruction plays out and the death of firms reshapes the profitability of the survivors. We focus on that process here.

Business cycle conditions turned in 2011-12. About 40 per cent of the Indian corporate balance sheet had a lot of debt, coupled with sluggish revenues and profits. In most cases, the can was kicked forward by borrowing from Peter to pay Paul. This was supported by banks who were also keen to hide the bad news.

The bad news has increasingly crept out. The Insolvency and Bankruptcy Code (IBC) has helped. Banking regulation has improved a little. At first, debt growth shifted from banks to mutual funds and non-banking financial companies (NBFCs). After the IL&FS default in August 2018, that process is now taking place in a more cautious way, which is making debt rollover harder.

We economists have some good cheer to offer to every worried private practitioner: The very destruction of some private businesses, which we see around us, will help the survivors. We have an optimistic phrase, "creative destruction", for the death of firms.

The long Japanese stagnation led to the invention of a phrase "zombie firm". A zombie firm is a firm that ought to be dead, but is selling in the market through artificial life support. The presence of these firms harms the health and investment of the firms that they compete with.

The presence of one Air India, and the relatively modest injection of taxpayer money into Air India every year, impacts the health of the entire airline industry. When we prop up zombie firms, there is an amplification in translating modest fiscal expenditures into industry-wide impact.

Conversely, the exit of (say) Reliance Communications reduces competition in telecom, and gives a slight uptick in the profitability of the survivors. This process is playing out in every industry. The survivors breathe easier when a rival collapses.

The favourable impacts run deeper. If an Air India exits the industry, it frees up resources for the survivors. The price of pilots will be reduced when Air India's pilots seek jobs with private airlines. When Air India exits, it will free up credit lines and industry exposure limits, which will then be used by other airlines.

When Air India's real estate holdings all over the country are sold, the price of real estate is reduced for everyone. But to the extent that many of these locations suit the requirements of airlines, surviving airlines will get a bigger favourable impact. The sale of spectrum by Reliance Communications reduces input prices for all survivors.

The survivors thus benefit from exit on the product market (with slightly higher product prices) and on factor markets (with slightly lower prices for factors of production). Reduced prices of land, labour and capital are a key part of the process, through which profitability is re-established after a business cycle downturn.

By this reasoning, when exit takes place quickly, it is better for the economy. When zombies linger long after their lack of viability is established, the harm that they cause the economy is increased. It is better to make a clean break and move on. This is the logic of the bankruptcy code, and this is why we should have no policy bias in favour of liquidation versus resolution in the bankruptcy process.

In the Indian story of recent decades, we had an investment boom in the early 1990s, and then we had a long downturn from 1998 till 2002. We then got good times from 2003 till 2011 and a long downturn from 2011 onwards. There are long painful periods: From 1998 till 2002 and then from 2011 onwards. Why are downturns in India so long?

One factor is the slow exit of firms. Banking regulation and the government apparatus have traditionally worked together to favour zombie-fication. We have begun changing course with the IBC. By building modern banking regulation, and by building the bankruptcy process well, we will create a world of rapid exit of low-productivity firms. This will give shorter downturns. As I read T N Ninan's column, I thought how nice this was for the rivals of the firms who have collapsed.

We often revile firms that have borrowed a lot as greedy or over-optimistic. But from the viewpoint of the economy, it is a bit better to have leveraged firms.

Consider a low-productivity firm with all equity financing versus the same firm with a lot of debt. There is a danger that shareholders are sentimental, or illegally skimming cash, and thus keen to hang on to a company that produces poor returns on capital. Borrowing, the pressure to repay, and the bankruptcy process help close the door upon such sentimentalism. A leveraged strategy ups the ante, and forces the firm to perform or exit. An economy is more dynamic if there is more debt.

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