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THE SATURDAY ESSAY

The Rescues Ruining Capitalism

Easy money and constant stimulus have undermined the basic dynamics of the free market. We've paid the price in low growth and productivity, falling entrepreneurship and rising inequality.

By Ruchir Sharma

July 24, 2020 11:15 am ET

Modern society looks increasingly to government for protection from major crises, whether recessions, public-health disasters or, as today, a painful combination of both. Such rescues have their place, and few would deny that the Covid-19 pandemic called for dramatic intervention. But there is a downside to this reflex to intervene, which has become more automatic over the past four decades. Our growing intolerance for economic risk and loss is undermining the natural resilience of capitalism and now threatens its very survival.

The world economy went into this pandemic vulnerable to another financial crisis precisely because it had already become so fragile, so heavily dependent on constant government help. Governments have offered increasingly easy credit and generous bailouts not only to soften the impact of every crisis since the 1980s but also to try to boost growth during the good times.

Now, amid the worst crisis since World War II, governments are riding to the rescue again. In the U.S., the Treasury is adding trillions in automatic crisis spending (such as benefits for the unemployed) and discretionary spending (like cash payments to single

jobholders making up to \$99,000). The Federal Reserve is doing its part by cutting rates, printing massive amounts of new money and directly buying the debt of troubled companies for the first time.

The governments of many other countries are, likewise, launching an array of stimulus measures that would have been unimaginable a few months ago. The mantra of government officials is that these efforts are not only necessary but also will carry no cost or consequences. They believe that they can easily borrow to pay for it all because the last four decades of easy money have brought interest rates to near or less than zero: Money is free.

The rising culture of government dependence is, in fact, a form of socialism—for the rich and powerful.

This is a dangerous form of denial. A growing body of research shows that constant government stimulus has been a major contributor to many of modern capitalism's most glaring ills. Easy money fuels the rise of giant firms and, along with crisis bailouts, keeps alive heavily indebted "zombie" firms at the expense of startups, which typically drive innovation. All of this leads to low productivity—the prime contributor to the slowdown in economic growth and a shrinking of the pie for everyone.

At the same time, easy money has juiced up the value of stocks, bonds and other financial assets, which benefits mainly the rich, inflaming social resentment over growing inequalities in income and wealth. It should not be surprising that millennials and Gen Z are growing disillusioned with this distorted form of capitalism and say that they prefer socialism. The irony is that the rising culture of government dependence is, in fact, a form of socialism—for the rich and powerful.

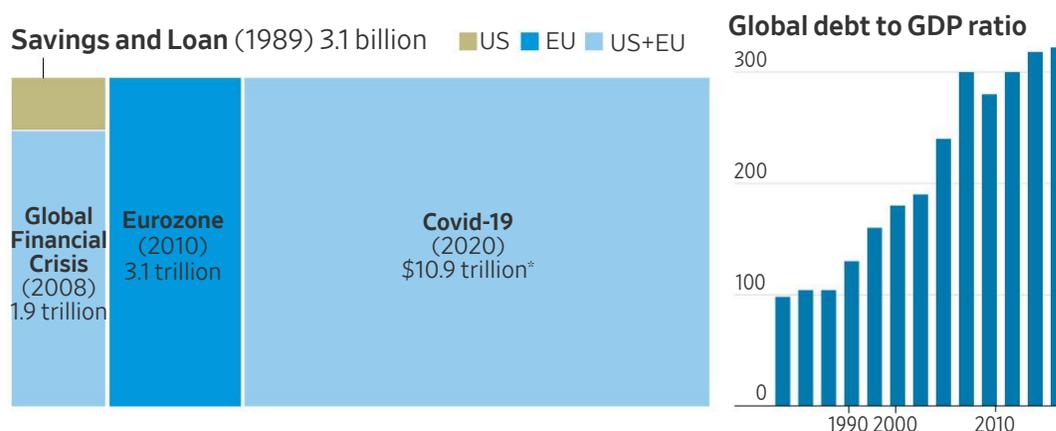
What capitalism urgently needs is a new, more focused approach to government intervention—one that will ease the pain of disasters but leave economies free to grow on their own after the crises pass.

In the early 1980s, central banks started to win the "war" on double-digit inflation. Containing consumer prices allowed them to start pushing interest rates downward, at a time when financial deregulation was easing lending conditions and corporate bailouts were becoming standard practice.

The Fed intervened in the markets to counter the crash of 1987 and in 1998 organized the rescue of a specific financial firm, Long Term Capital Management, for the first time. In 2008 the Treasury stepped in to save an entire sector—banks at the core of the mortgage crisis—with \$200 billion. Unable to do much more to cut rates, which were already close to zero, the Fed launched its first experiments in “quantitative easing,” buying up to tens of billions of dollars in assets each day, including mortgage-backed securities, to calm the credit markets.

Bigger Bailouts, Deeper Debt

The scale of government rescues in response to crises has ballooned, as has the global ratio of debt to economic output.



* As of April 27

Sources: Deutsche Bank (bailouts), Morgan Stanley (debt)

The rest of the world followed the Fed. As interest rates fell toward zero, the world’s debts—including households, governments and nonfinancial companies—more than tripled between 1980 and 2007 to more than three times the size of the global economy. It was taking more debt to fuel the same amount of growth, because more debt was going to unproductive borrowers. Capitalism was bogging down.

Worldwide, recessions were decreasing in frequency and severity. In the 2010s, as easy money continued to flow from central banks, the global economy staged a recovery that was unusual for its length but also for its frustratingly slow pace of growth and for how few nations were allowed to suffer a moment’s pain. In 2017—many years into its recovery—the U.S. pushed through a large tax cut to stimulate growth.

By 2019, only 7% of the nearly 200 economies tracked by the International Monetary Fund were in recession, and only 3% were expected to fall into recession in 2020—near a record low. As governments stepped in to do whatever it took to eliminate recessions, downturns

no longer purged the economy of inefficient companies, and recoveries have grown weaker and weaker, with lower productivity growth.

What has happened during the pandemic is the story of the last four decades, telescoped into a matter of weeks and magnified to previously unimaginable scale.

Four months after the market crashed amid warnings that lockdowns would trigger another Great Depression, governments have intervened as never before. Many rich countries have rolled out stimulus measures amounting to 10% of GDP or more. That means an even bigger role for government, which will have to be funded by more debt.



A trader on the New York Stock Exchange floor, on Oct. 1, 2008, in the early days of the global financial crisis.

PHOTO: RICHARD DREW/ASSOCIATED PRESS

After the global financial crisis of 2008, households and financial firms in many capitalist countries felt pressure to restrain their borrowing. Governments did not. The world's total debt burden plateaued at a historical high of 320% of global GDP by the end of 2019, but within that total, government debt rose most rapidly. Many economists swatted away concerns about higher government debt arguing that with interest rates so low the borrowing could be easily financed.

The problem is that growing government involvement in the economy typically leads to lower productivity and weaker growth. A 2011 European Central Bank working paper found a “significant negative effect” of bigger government on per capita GDP growth in a set of 108 countries over the previous four decades. A recent report from BCA Research found a similar link in 28 major developed economies, including the U.S., over the last two decades.

The idea of government as the balm for all crises is appealing in the short term, but it ignores the unintended consequences. Without entrepreneurial risk and creative destruction, capitalism doesn't work. Disruption and regeneration, the heart of the system, grind to a halt. The deadwood never falls from the tree. The green shoots are nipped in the bud.

With more debt to fuel the same amount of growth, capitalism bogs down.

Low interest rates are supposed to encourage investment in companies large and small, increasing productivity and boosting growth. Instead, as a recent paper from the National Bureau of Economic Research shows, low rates gave big companies a strategic incentive to grow even bigger, in large part because securing a dominant position in the market promises outsized financial rewards.

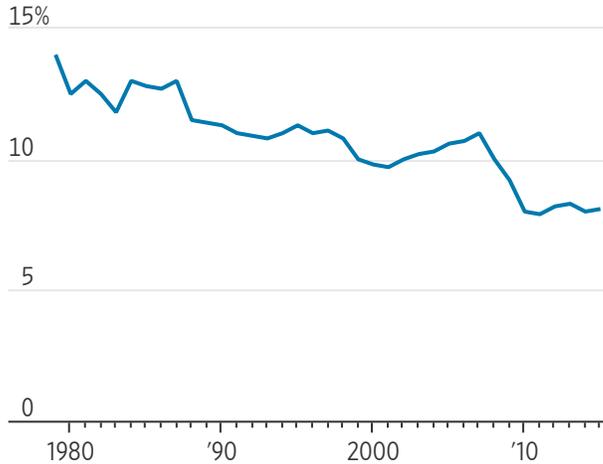
The big were growing bigger for many reasons, of course. The rise of the internet created a winner-take-all market, in which dominant giants could reach every consumer on the planet. Government regulations, which expanded at an accelerating rate over the past four decades, created a thicket of rules best navigated by big companies with armies of lobbyists and lawyers.

The big tech companies, in particular, came to sit on tens of billions in cash, much of which they used to buy back their own stock—hardly a productive investment in the future of the economy. As the large grew increasingly entrenched, they sucked up talent and resources, crowding out the little guys.

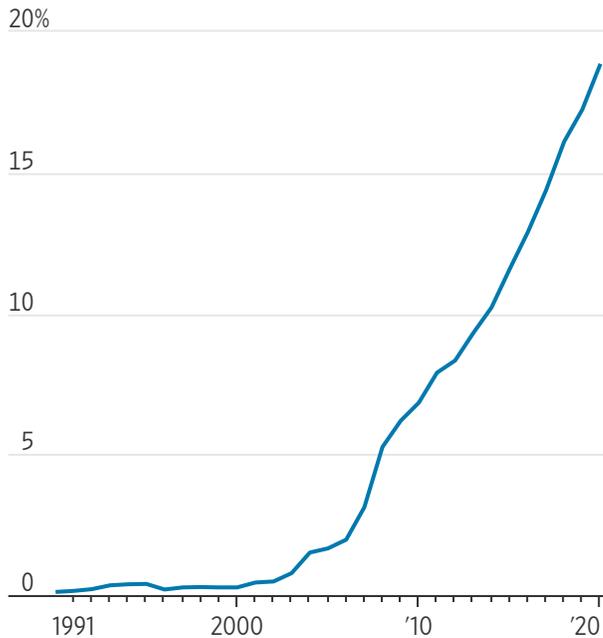
The 'Zombie' Economy

Ever fewer startups are launching in the U.S., while the number of publicly traded companies that can't even pay interest on their debt is growing.

Start-up rates for U.S. firms



Percentage of 'zombie' firms



Sources: Brookings Institution (startups), Deutsche Bank Research (zombies)

Startups represent a declining share of all companies in the U.S. and many other industrialized economies. Before the pandemic, the U.S. was generating startups—and shutting down established companies—at the slowest rates since at least the 1970s. The number of publicly traded U.S. companies had fallen by nearly half, to around 4,400, since

the peak in 1996. And many of them started running up massive debts, in part as a desperate effort to grow in the shadow of the giants.

Today an astonishing number of the survivors are, quite literally, creatures of credit. In the 1980s, only 2% of publicly traded companies in the U.S. were considered “zombies,” a term used by the Bank for International Settlements (BIS) for companies that, over the previous three years, had not earned enough profit to make even the interest payments on their debt. The zombie minority started to grow rapidly in the early 2000s, and by the eve of the pandemic, accounted for 19% of U.S.-listed companies. Zombies are also spreading in Europe, China and of course Japan, where this phenomenon first became apparent.

With every crisis, more of these creatures of debt survive. Since the 1980s, recent Deutsche Bank research shows, each new U.S. recession has been met with more bailouts and easy money, leading to a lower rate of corporate defaults. Over the last 20 years, the falling default rate has also closely mirrored the slowdown in U.S. productivity, which is not surprising.

Keeping profitless companies alive naturally retards productivity. A 2017 OECD study found, for example, that “zombie congestion” in any industry lowers the productivity of rival companies—and blocks the entry of new companies—by raising labor costs and making it difficult to attract capital. Now forecasters expect companies with junk debt ratings to default at a rate of around 10% during the pandemic—a rate lower than in recent recessions, despite the historic depth and speed of the current contraction.



Federal Reserve Chairman Jerome Powell during his briefing on Jan. 29, his first mentioning financial risks stemming from the coronavirus pandemic.

PHOTO: YURI GRIPAS/REUTERS

As lockdowns began in March, the Fed promised to start buying debt at a rate up to twice as fast as in 2008, including corporate bonds for the first time. Gradually, the Fed has loosened the definition of what it will buy. Even after the credit markets had settled down in June, the Fed ramped up purchases, and it now owns debt issued by, among others, Apple, Walmart, AT&T, Disney, Nike and Berkshire Hathaway.

The question is how much further capitalism will be deformed by government intervention on this scale. When the government is willing to buy just about anything, it distorts market prices, which normally guide people to buy into profitable, promising companies. Now investors are simply buying what the Fed buys. The process of competitive capital allocation, which is critical to raising productivity, has broken down.

Governments also rescue fellow governments as quickly as they bail out domestic companies. The amount of sovereign debt that is currently in default is close to a record low. The result is that even nations with checkered credit records can sell bonds offering improbably low returns. Cyprus, which was bailed out in 2013, recently issued new 20-year debt at a yield of just over 1%—suggesting investors are confident that if Cyprus falters again, other governments will step in to save it. Policy makers fear that with global debt levels already very high, even one default could set off a contagion and bring down this increasingly fragile house of cards.

When the pandemic passes, authorities need to shift out of rescue mode.

In a way, much of the world is following the path of Japan, which pioneered central bank purchases of corporate debt in response to the market crash of 1990, then kept those companies on debt support indefinitely. Japan's public debts have since quadrupled to 240% of gross domestic product, weighing on growth and even discouraging young people from having children in a debt-soaked and dysfunctional economy.

But Japan's mistakes also point the way forward. The issue is not rescue efforts during a crisis—the soundness of that strategy was demonstrated during the Great Depression and has been reaffirmed many times since. It is how that money is spent—productively or not—and whether rescues turn into endless easy money and constant stimulus, through good times and bad.

Germany is the rare model of a government that still saves during the good times. In response to the eurozone crisis of 2010, Germany increased public spending and debt, but as the crisis ebbed, it shut off the spigot. While public debt was still rising in the U.S. and Japan, it was shrinking in Germany from 80% of GDP to 60% on the eve of the pandemic.

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Germany had a government surplus and could afford one of the most generous stimulus packages in the world when the pandemic hit. Germany's public debt will rise again, but according to the IMF, to a level that will still be much lower than any other big industrialized economy. The government has also targeted billions in new stimulus spending for startups in artificial intelligence and other technologies that could lift slumping productivity, which is a global phenomena. Because central banks move as a pack, borrowing is cheap world-wide, and even Germany has a horde of unproductive zombie companies.

Governments need to recognize that constant intervention to prop up the economy and financial markets is not achieving its intended purpose. After 2008, the Fed and the Treasury were praised to the moon for "saving the world," but the Fed's "experimental" forays into quantitative easing continued long after the crisis was over. The widespread assumption that the recovery would have been even weaker without Fed support ignores the mounting evidence that its interventions are doing more to boost the stock market than the real economy.

The Fed insists it is fulfilling its mandate so long as easy money is not stoking consumer price inflation, and at least so far, it is not. But that mandate is too narrow, because easy money is instead inflating stock and bond prices, encouraging inefficient firms to take on more debt and seeding financial instability.

When the pandemic passes, authorities need to shift out of rescue mode and start weaning capitalism off easy money and bailouts. They have to recognize how heavy government intervention is distorting the price signals that make free markets efficient in allocating capital. Otherwise, they will continue creating more zombies and monopolies, widening inequality, undermining productivity and slowing growth. For all their good intentions, they will continue to feed the dysfunction that is alienating younger generations and deforming capitalism.

Mr. Sharma is chief global strategist at Morgan Stanley Investment Management and the author, most recently, of “The Ten Rules of Successful Nations.”

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Does government intervention in economic crises ultimately hurt more than it helps? What about bailouts of companies and industries? Join the conversation below.

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