Finance

Germany Will Be a Post-Coronavirus Winner

Fiscally sound governments will be able to pump money into their companies unhindered by state aid rules. The EU needs an equity fund to level things up.

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We'll be back. *Photographer: Bloomberg/Bloomberg*

All great economic crises pose two equally important challenges: they drain the liquidity necessary for the functioning of businesses, large and small, and burn up their equity capital, or a substantial part of it. Of the two, the former is the immediate challenge amid the coronavirus-induced lockdowns. Providing liquidity to companies is the top priority to ensure their survival. Yet this doesn't guarantee their healing, or their ultimate durability and growth. Equity capital, the stuff that's needed to invest and thrive, is essential to the second stage of recovery.

Today, many businesses have seen their revenues almost vanish and, therefore, find themselves in a severe cash crunch. Various proposals have been put forward to funnel money to businesses before they're forced to lay off employees, cancel their supplies, and close their doors. One of these proposals is to have the European Investment Bank – the

European Union's lending arm – provide a liquidity lifeline to the continent's firms, in the form of immediate, massive funding at zero interest to enable companies to meet their expiring debt obligations, with backup funding provided by the European Central Bank.

This is a step in the right direction, but it's not enough by itself: It keeps the patient on life support, but doesn't let them recover. Indeed, as liquidity reaches companies through loans, it increases their leverage through greater debt and, therefore, their default risk, leaving them with little room to invest and grow. Growth, which has already been low for a long time in most of the euro zone, especially in Italy, will slow even further if its businesses run out of equity capital after the crisis because of the sharp rise in indebtedness.

So where does the necessary capital injection come from? It can hardly come from households, which are also suffering a tremendous loss of wealth. In fiscally stressed countries like Italy it cannot come from the state either; high pre-crisis public debt levels, compounded by the current run-up in deficits, will stand in the way.

In striking contrast, recapitalization with government funding will be substantial in fiscally strong European countries, especially in Germany. There, the state, with its accounts in good order, and with the newly acquired exemption from the EU ban on state aid, will go ahead with robust capital injections into domestic companies, and with outright nationalizations in some industries.

Post-crisis, the likely scenario is that many under-capitalized companies from fiscally stressed countries will face competition from stronger foreign rivals strengthened by massive state aid, so that markets will be very far from the "level-playing field" pursued for decades by the EU competition authorities. This will be a further cause of weakness for the indebted nations, and will make their growth rate diverge from the EU average.

In addition, European companies in fiscally strong countries will be able to use their newly acquired advantage, owing mainly to state aid, to compete more aggressively, or even to take over weaker European competitors, thus disrupting competition not only in Europe's product markets, but also in its capital markets.

Is there an alternative to this dark scenario, which portends the end of the European dream for all practical purposes? We see the only path forward as coordinated intervention at the European level, through the creation of a pan-European equity fund, financed by the EIB. This fund, which would underwrite the issue of new equity capital in companies across Europe, would also be open to participation from long-term investors such as global asset management firms, pension funds and sovereign wealth funds. It could be accompanied by the issuance of very long-term bonds.

It's crucial to establish strict rules to determine how this fund should choose which companies to invest in. First, it would have to finance businesses that were hitherto profitable and growing before being hit by the COVID-19 crisis, not those that were already financially stressed. Second, the fund would only have to finance companies that hadn't already received state aid, because its purpose would be to rebalance capital injections between firms supported by governments and firms that aren't. Third, the funded companies would be required not to distribute dividends or repurchase their own shares for some time, to prevent the injection of capital from benefiting existing shareholders rather than enabling new investment. Fourth, the compensation of the top management of these companies would be frozen at pre-crisis levels, say for three years. Fifth, the fund would be governed by managers, independent of the national governments, and wouldn't acquire controlling stakes in the companies in which it invests, so as not to become a source of disruption itself.

The economic rationale for creating such a fund is that it would allow European companies to invest and compete only based on their profitability, regardless of the fiscal capacity of their respective states.

The entity we propose would be the most ambitious and far-sighted mechanism for enforcing the risk-sharing that today – more than ever – appears to be the truest reason for being part of the European project. Never has it been clearer how much the common good depends on the responsible behavior of all concerned: the costs that each country incurs in fighting the virus limit its spread across borders and, therefore, also benefit other countries. In a similar manner, after the crisis, greater growth across all countries, not just in a few, will benefit all European citizens. This is the only way to keep the European dream alive.

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