How to rebuild after the crisis

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27 March 2020

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. As with a disease that leaves patients dehydrated, providing liquidity to firms is the top priority to ensure their survival. While this helps, it does not guarantee their healing, and their ultimate survival and growth.

Today, most companies around the world have seen their revenues almost vanish and, therefore, find themselves in a severe liquidity crisis. Various proposals have recently been put forward to funnel liquidity to businesses before they are forced to lay off employees, cancel their supplies, and eventually close their doors. One of these proposals is to have the EIB provide a liquidity lifeline to European 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 ECB.

This is a step in the right direction, but is insufficient to meet the challenge: it keeps the patient alive a little longer on life-support, but does not enable her to 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 long in most of the Eurozone, especially in Italy, will slow down even further, if its businesses run out of **equity** capital after the crisis.

So where does the necessary equity capital injection come from? It can hardly come from households, which are also suffering a tremendous loss of wealth. In fiscally stressed countries it cannot come from the state either - high pre-crisis public debt levels, compounded by the current runup in deficits, will stand in the way. In striking contrast, recapitalization with government funding will instead 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 firms, and with even outright nationalizations in some industries.

Post-crisis, the likely scenario is that many undercapitalized firms from fiscally stressed countries will face competition from stronger foreign companies 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 fiscally stressed countries, 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 strength, owing mainly to the state aid from their national fiscal authorities, to compete more aggressively, or even take over weaker European companies, thus disrupting competition not only in the product market, but also in the capital market, all across Europe.

Is there an alternative to this dark scenario that portends the end of the European dream for all practical purposes? We see the only path forward is 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 companies, pension funds and sovereign wealth funds, as well as accompanied by the issuance of very long-term bonds.

Obviously, it is 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 had not already received state aid, because its purpose would be to rebalance capital injections between firms that are supported by its governments and firms that are not. **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 the pre-crisis levels for a period of time, say three years. **Fifth**, the fund would be governed by managers, independent of the national governments, and would not acquire controlling stakes in the companies in which it invests, so as not to become a source of competition 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 as during a pandemic is it clear how much the common good depends on the responsible behavior of all concerned: the costs that each country incurs in fighting the virus limit the 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.

First published on Bloomberg Opinion on 9 April 2020:
https://www.bloomberg.com/opinion/articles/2020-04-09/covid-19-germany-will-be-a-post-coronavirus-winner?srnd=premium-europe