Opinion **EU economy**

How to think about the EU's rescue fund

We do not need another big lending programme; equity investments would get us out of the credit-versus-loans debate

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Christine Lagarde, president of the European Central Bank. Much of the complacency in and around Europe rests on the assumption that the ECB will in the end fix everything © Thomas Lohnes/Getty

Wolfgang Münchau APRIL 26, 2020

The deed is done. Italy's "coronabond" is history, and so is Spain's proposal of a perpetual bond as a fiscal stabiliser.

The leaders of the EU may not have reached final agreement. But they set the direction: there will be a temporary increase of the EU's budget, perhaps from 1.2 to 2 per cent of the EU's gross domestic product. This money will not be paid in cash, but will come in the form of guarantees.

A report suggests that the European Commission plans to raise maybe some €320bn on the financial markets over a period of two or three years. Part of that money will be spent in the form of grants. The rest is supposed to be leveraged for a fund that would lend for investments. Both grants and loans would be directed to the regions most affected by Covid-19.

This is a very rough sketch. The details will be worked out over the next few weeks — and those details will matter more than the headline numbers. Only the numerically illiterate ever add up grants, credits and lending capacity into a single number. What will determine the economic impact for the worst-affected member states is the redistributive portion of the grants — the bit they have not funded themselves as part of their share in the scheme.

I struggle to see the need for another big programme of loans. The European Central Bank and member states have taken big steps to protect companies and consumers from a credit crunch. I am also wondering whether the EU's old trick of leveraging a small amount into a large sum can be repeated again and again. Also, do we really believe that the private sector has enough resources and risk appetite to put up the lion's share of a €2tn fund at a time like this?

Jean-Claude Juncker's investment fund, launched in November 2014, used a small portion of the EU budget to mobilise €315bn in investments. The eurozone crisis had left huge gaps in investments, which the former commission president wanted to address. His motivation was honest but there was an element of artful deception in the proposal. The European Court of Auditors concluded that the Juncker fund did make the investments. But it questioned whether these investments would not have been funded by other means. At least back then, during the heydays of austerity, there was a case for such a programme. Today's crisis is characterised by a simultaneous supply and demand shock.

An alternative has been suggested by six economists who argue that the best way for the EU to support the economy is not to lend to companies, but to create a European pandemic equity fund that takes equity stakes in unquoted small and medium-sized companies. The fund trades an initial cash flow against a share in future earnings.

The big attraction of this plan is that it improves the strength of corporate balance sheets. Equity investments would also get us out of the heated credit-versus-grants debate, because equity is neither.

Unfortunately, equity is also alien to the EU and its institutions. They do credit. But equity is a more appropriate instrument to counter an incipient corporate debt crisis. If companies default on the guarantees from their governments or on EU loans, a string of corporate debt defaults could turn into a contagious sovereign debt crisis.

This is why I am not surprised to read that US investment banks are starting to withdraw from Europe. The uncertain outlook for the eurozone must surely be a contributing factor. According to the IMF Fiscal Monitor, the discretionary fiscal stimulus is lower in the eurozone than in both the US, the UK and Japan. The US Federal Reserve's asset purchases since the outbreak of Covid-19 have been of an order of magnitude higher than the ECB's.

Much of the complacency in and around Europe rests on the assumption that the ECB will in the end fix everything. I do not share that consensus view. The ECB will give unlimited support to member states during the crisis, and may continue to support national debt issuance in the future.

But it faces hard legal constraints. The hardest of all is the capital key that only allows it to buy assets in accordance with the member states' capital in the central bank. Germany's very probable reversion to fiscal surpluses after the crisis will impose a hard limit on the ECB's ability to solve Italy's solvency problem through debt monetisation.

So where does this leave the recovery fund? It will have only a minuscule fiscal impact. I doubt that EU companies need trillions of credits, and I am really struggling to see what a fund, so designed, would accomplish other than to serve as a cry for attention.

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Letter in response to this column:

A face-saving EU rescue plan already exists / From Caroline Bergaud, Bergaud & Partners, Brussels, Belgium