

SAFE Finance Blog

Grants vs. loans? Equity is the need of the hour

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SAFE Pandemic Policy Team: The EU deal on the coronavirus recovery package fails to reanimate entrepreneurial spirits that are needed for a lasting economic upswing



After lengthy and intense discussions, European leaders have struck a major deal (<https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf>) on a 750 billion euros Coronavirus recovery package. Negotiations and media coverage have centered on the breakup of the package between grants and loans. In the event, the European Council members settled on 360 billion euros in loans and 390 billion euros in grants. However, focusing only on the split between grants and loans is narrow in perspective and misses the broader picture.

An important element of the EC proposal was the Solvency Support Instrument that was designed to provide equity capital to sound companies placed at risk by the COVID-19 crisis. In the end, the European leaders left this instrument out of the final deal and missed a great opportunity for a bottom-up recovery of

the heavily battered European economy. In fact, we see this type of instrument as an absolutely crucial element for the ultimate economic recovery.

Support for the backbone of Europe's economy

Current efforts fail to rejuvenate businesses by essentially providing only loans and guarantees. It only leaves firms over-indebted and unable to grow, accentuating their incentive problems. And this is particularly acute for small and medium sized enterprises, the backbone of the European economy. A real economic recovery demands entrepreneurship and a dynamic energy – a kindling of the animal spirits in businesses across Europe. For this to happen, firms need equity, i.e., risk-bearing funding that permits them not just to survive the hardship of the Corona crisis today, but motivates them to seize business opportunities in the world of tomorrow. As the European Commission proposal (https://ec.europa.eu/info/sites/info/files/about_the_european_commission/eu_budget/1_en_annexe_autre_acte_states), “...more and more companies that would otherwise be viable will face solvency problems and the liquidity support will not be sufficient. [...] loans [...] can further weaken corporate balance sheets as many companies witnessed a steady increase in leverage in recent years.”

The proposed Solvency Support was a step in the right direction. However, it was still a tentative one, and one that deserves an even more prominent role in Europe's recovery plan. To that end, we propose an ambitious European Pandemic Equity Fund (https://safe-frankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_Policy_Letter_84_final2.pdf) (EPEF) to provide equity to hitherto profitable businesses all across Europe. As an equity investor in businesses, the EPEF would not just hand out money but would expect reasonable returns in the future. Of course, there is risk, as there is with any investment.

The EPEF should be targeted where it can add real value at the core of the European economy: its small- and medium-sized enterprises. This true backbone of Europe accounts for much of the economic growth of the last decades. We are talking about private firms, mostly with less than 250 employees, covering up to 80 percent of employment in the member states.

Sharing risks and rewards

By designing a broad-based European equity-like participation scheme, the EPEF will not only help create a joint perception of shared responsibility and solidarity across Europe, but also, at least as important, a strong perception of shared success. It would offer a way out of the recent paralyzing North/South discussion with Southern member states accusing the North of a “bookkeeping mentality,” whereas the Northern states fear wasteful spending by the South, and being drawn into a transfer union. The equity structure allows for the sharing of risks *and* rewards.

In that sense, the EPEF fits perfectly into the narrative of an emerging European capital markets union and may indeed be one of its defining moments. In the words of Jean Monnet, one of the founding fathers of the EU: “Make men [and women] work together, show them that beyond their differences and geographical boundaries there lies a common interest.” Despite the recent setback, we encourage the European Parliament and the European Commission to do everything in their power to move to a European Pandemic Equity Fund.

The blog post is written by several international financial experts around the Leibniz Institute for Financial Research SAFE in Frankfurt: Arnoud Boot (<https://www.arnoudboot.nl/>) (University of Amsterdam), Elena Carletti (<http://mypage.unibocconi.eu/elenacarletti/>) (Bocconi University), Hans-Helmut Kotz (<https://safe-frankfurt.de/research/researchers/researchers-details/showauthor/209-kotz.html>) (Harvard Center for European Studies and SAFE), Jan Pieter Krahen (<https://safe-frankfurt.de/research/researchers/researchers-details/showauthor/14-krahen.html>) (SAFE), Loriana Pelizzon (<https://safe-frankfurt.de/research/researchers/researchers-details/showauthor/82-pelizzon.html>) (Goethe University Frankfurt and SAFE), and Marti Subrahmanyam (

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Contact

Leibniz Institute for Financial Research SAFE

Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Phone: +49 69 798 30080

Fax: +49 69 798 30077

Email: info@safe-frankfurt.de

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More information on the *European Pandemic Equity Fund proposal* (<https://safe-frankfurt.de/news-latest/all-news/news-view/a-pandemic-fund-how-to-support-companies-in-the-crisis-without-overwhelming-them-with-debt.html>)

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