BRUSSELS INTERNATIONAL CENTER

COVID-19: WILL WE LEARN FROM OUR MISTAKES?

MANAGING GLOBAL RISKS EXACERBATED BY THE COVID-19 CRISIS BEFORE IT IS TOO LATE

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POLICY BRIEF
MAY 2020

RETHINKING SECURITY IN 2020 SERIES

INTRODUCTION

In the middle of a crisis, it is easy to overlook how easily seeds are laid for future instability, conflict, and division. Few predicted that a poorly-planned response to the 2008 economic crisis – which almost exclusively created a surge in incomes and asset values for the wealthy[i] – would trigger a wave of populism across the US and Europe by catalyzing a surge of inequality and social anxiety. Fewer predicted that these policies would help create rising food prices,[ii] unemployment spikes, and liquidity crunches across the MENA region, which exacerbated longstanding sociopolitical grievances and sparked years of instability that led to on-going conflict in Syria and the creation of ISIS.

With today's ground fertile for populist narratives, unprecedented resource competition, and autocratic power-grabs, the scale of the COVID-19 crisis should make it painfully obvious that we can't afford to make the same mistakes again. COVID-19 responses must address immediate health needs, while carefully considering the bigger picture, and the seeds being planted for the future.

While the crisis poses a threat to many aspects of our lives, there are three long-term risks that are uniquely exacerbated by the crisis. If left unaddressed, these risks will have dire consequences, and could potentially lead to the collapse of our global system.

KEY TAKEAWAYS

- We are at a crossroads between repairing our global system or watching it collapse. There are three key risks.
- The first risk is that COVID-19 will accelerate an exponential deflationary curve as more companies embrace technology, while governments simultaneously buckle down on quantitative easing.
- The second risk is an exacerbation of inequalities caused by debt-fueled growth, mirroring the aftermath of the 2008 crisis, dangerously widening the disconnect between growth, wages, and productivity.
- The third risk is that COVID-19 will reinforce structural obstacles to economic transformation in low-income countries, reversing progress towards regional integration, competitive advantages, and sustainable monetary, debt and fiscal policies.
- Combined, these risks can lead to a toxic mix of rising disenfranchisement, frustration, and inequality that will fuel future populism, division, and instability.

RISK 1: DEFLATION

It is no secret that the world is on a massive deflationary trend caused by exponential advancements in technology – we continually get more for less money.[iii] Technology is quickly removing the inefficiencies that drive up costs in every industry, increasing availability and naturally driving costs down. This phenomenon should be positive, but it poses an inherent contradiction to the foundation of our economic system, which is built around continual growth and inflation: we rely on continually rising prices, and we expect assets to accrue value over time.[iv]

The crucial shift is that while demand growth was once driven by wage growth, for the past 40 years it has been increasingly driven by debt.[v] Debt-fueled spending to create growth is not always negative, however due to years of exponential deflationary trends, more and more debt is needed to maintain this model and keep prices rising. It took $185 trillion of global debt to create $46 trillion in global growth between 2000 and 2018.[vi] Following the 2008 crisis, central banks still struggled to hit target inflation and growth rates with near rock-bottom interest rates, indicating a possible limit to this approach.[vii]

The risk at hand is that COVID-19 will accelerate the deflationary curve as more companies embrace technology to reduce inefficiencies,[viii] while governments simultaneously buckle down on quantitative easing. In the aftermath of emergency liquidity injections, attempts to fight deflationary trends with additional stimulus will fail as technology *doubles* in power every 18 months. Most jobs will be lost: the question is whether job losses are accompanied with rising prices and distressed debt in pursuit of artificial growth, or whether they are accompanied with a new economic model[ix] that deprioritizes limitless growth and embraces deflation to achieve social, financial and social sustainability.

RISK 2: INEQUALITY

The aftermath of the 2008 crisis exposed how debt-fueled growth is the backbone of modern inequality, mainly by widening the disconnect between growth, wages, and productivity. The losers in this model are always the average workers without assets. They are essentially on a treadmill moving faster and faster, as the value of their labor no longer increases at the rate of growth, leaving them unable to keep up with rising prices. The winners are the wealthy, whose asset values have been artificially boosted, and whose gains are largely exempt from any income or corporate tax. Ultimately, this phenomenon contributes to driving the rate of return to capital higher than the growth of the economy.[x]

After 2008, a decade of low-interest rates and quantitative easing allowed banks and financial institutions to speedily recover, driving up asset prices and creating a new credit bubble.[xi] These gains never 'trickled down'. Employment rates never returned to pre-2008 levels, and the bulk of income gains since 2008 accrued at the top end of the income distribution.[xii] Rising inequalities were accompanied by the inevitable reallocation of power to major corporations at the expense of communities, unions, and local businesses. Combined, these trends fueled social polarization, populist narratives, a loss of faith in government institutions, and the weakening of participatory democracy.[xiii]

Between mid-March and mid-May, U.S. billionaires increased their wealth by $434 billion, as the pandemic rewards the largest tech-driven companies.[xiv] As this model continues to severely widen inequalities, the situation risks playing into the hands of autocratic leaders who aim to use the crisis to further weaken democratic institutions. Governments must bailout people, not just businesses, and leverage economic responses to target the root causes of inequality. This means restricting government support from companies registered in tax havens,[xv] and focusing on localized solutions, such as providing direct cash transfers and basic income,[xvi] instead of expecting money to trickle down through liquidity injections.

RISK 3: EMERGING ECONOMIES

Emerging economies, particularly those in the Middle East and Africa, are most susceptible to volatile reactions to the socioeconomic impacts of the crisis. Any bleak economic outlook must be put in context of regional history, which has seen smaller crises exploited by groups that weaponize frustration, economic stress, and inequalities. In addition to the immediate shocks, the long-term risk at hand is that COVID-19 will reinforce structural obstacles to economic transformation, which could permanently leave low-income countries in poverty, conflict and cycles of debt crises. Economic development is largely a factor of regional integration, development of competitive advantages, and sustainable monetary, debt and fiscal policies, all of which could face major setbacks due to COVID-19.

West Africa is a prime example where the crisis may indefinitely stall the introduction of the new Eco currency, which showed potential to foster the regional integration, trade and economic convergence that the CFA franc failed to catalyse.[xvii] Meaningful reforms required political determination from West African leaders to exploit their new autonomy at the BCEAO, principally by broadening the scope of flexibility in monetary policy. This level of multilateral cooperation appears increasingly unlikely in the midst of the COVID-19 crisis, and as economic forecasts plummet, the prerequisite convergence levels for implementation of the Eco drift further away.

Finally, as low-income countries face disproportionate and systemic risks due to weak health systems, large informal sectors, and unstable food supplies, it will be imperative for high-income countries to invest long-term support to address these vulnerabilities, while also preparing to accept higher numbers of refugees in the near future. Increased public sector spending must be accompanied by increased transparency to guarantee recovery programs impact those who need support the most, particularly in support to the private sector, to ensure that firm-specific credit risks are distinguished from systemic risks that arise from the pandemic.[xviii]

CONCLUSION

While COVID-19 crisis is unique in its cause, the pandemic is exposing and deepening preexisting flaws in our global economic system. Notably, economic principles that once generated significant prosperity are now the principal drivers behind rising inequality, underfunded health systems, and poor pandemic preparedness. Combined these risks create a toxic mix of rising disenfranchisement and anger, that continue to fuel populism and division.

Changing this trajectory will require thinking big and doing things differently. Instead of asking how to create more high-paying jobs, economists should ask how to create a system where these jobs aren't needed because everything costs less. Governments should consider how to structurally reduce inequalities, starting by bailing out people and not just corporations, and rethinking how economies value social equity, informal labor, and ecological sustainability. Emerging economies must ambitiously pursue sustainable debt and monetary policies, as well as the implementation of regional integration strategies such as the African Continental Free Trade Area (AfCFTA) to reduce dependencies on global supply chains.

In the aftermath of a tumultuous decade, it appears seldom pondered what steps could have been taken to avoid many of today's crises. The choice today is to continue along yesterday's trajectory, accelerating towards certain and complete collapse, or rewrite the rules completely for a better tomorrow.

There is no plan C.

BIC POLICY RECOMMENDATIONS

- Governments should consider de-growth strategies that embrace technology driven deflation, focusing on the recognizing the long-term value of social equity and ecological sustainability. In the short-term central banks should condition interest rate policy on real wage growth, taking into account nominal wage deflation.
- Governments should consider measures to structurally reduce inequalities, ensuring recovery funds are directed towards those who need support the most in the form of cash-based support, and leveraging assistance to fight illicit financial flows. In the long-term, governments should work towards establishing targeted universal basic incomes.
- Emerging economies must ambitiously pursue sustainable debt and monetary policies, urgently increase fiscal transparency, and move towards the implementation of regional integration strategies such as the AfCFTA to reduce dependencies on global supply chains. High-income countries should support critical investments in health system strengthening and prepare for large numbers of refugee flows.

The BIC is an independent, non-profit, think-and-do tank based in the capital of Europe that is committed to developing solutions to address the cyclical drivers of insecurity, economic fragility, and conflict the Middle East and North Africa. Our goal is to bring added value to the highest levels of political discourse by bringing systemic issues to the forefront of the conversation.

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[i] *Thomas Palley. (2018). "Monetary policy and the punch bowl: The case for quantitative policy and wage growth targeting." European Journal of Economics and Economic Policies, 15(1), 32-32–46.*

[ii] The US Federal Reserve's policy of quantitative easing, which was mirrored by the European Central Bank, prompted investors to buy physical assets to hedge against rising inflation, such as agricultural goods and metals, a pattern that subsequently drives higher food and commodity prices.

[iii] *Jeff Booth (2020). "The Price of Tomorrow: Why Deflation is the Key to an Abundant Future." 2019.* In this book, Booth argues that technology will soon cause a structural change so great we can't see it coming. He likens our economic tweaks to halt deflation "like Blockbuster setting up candy aisles to solve its financial problems."

[iv] *Kate Raworth (2017) "Doughnut Economics, 7 Ways to Think Like a 21st Century Economist."* Raworth offers a provocative critique to neoclassical economic theory that focuses on the importance of capital accumulations and growth increases, urging to change the goal from ever-increasing GDP to a sustainable social and ecological balance.

[v] Palley (2018) succinctly writes, "*In the Keynesian economic regime, demand growth had been fueled by wage growth, which was tightly tied to productivity growth and supported by full employment. The neoliberal regime severed the link between wages and productivity, in part by abandoning the policy commitment to full employment. In place of wage growth, demand growth was now fueled by debt and asset price inflation."*

[vi] *Emre Tiftik & Khadija Mahmood (2019). "High and Rising Debt Levels: Should we worry?" Institute of International Finance.* Not surprisingly, this trend dramatically increased following the 2008 crisis. Interesting to note that higher debt levels have also led to significantly higher debt service costs for many emerging markets.

[vii] *Fiedler, Gern, Jannsen, & Wolters (2019). Growth prospects, the natural interest rate, and monetary policy. Economics, 13(35), 1-34.* Interestingly, despite a decade of near rock-bottom interest rates, potential growth forecasts for most developing countries remain in decline, mainly attributed to several factors that include aging populations. Paradoxically, these forecasts account for declines in growth productivity, which may point to our current inability to measure the returns of digitalization on productivity, and by extension the deflationary impact of technology on potential growth.

[viii] Inefficiencies include human liabilities, such as getting sick, or even the need to travel to work. Technology increasingly allows employees to work from home, while automation provides a hedge against human inefficiencies.

[ix] For more on various propsals, see Raworth's "Doughnut Economics" (2017).

[x] *Thomas Piketty (2013) "Capital in the 21st Century."* Piketty argues that inequality is hardwired into our current economic model simply because the return on assets is growing faster than the economy. This means the wealthy depend more on asset wealth than salaries, which cause old forms income redistribution (based on income tax and corporation tax) to no longer work.

[xi] It should be noted that this system represents the antithesis of a truly capitalist and free-market system. The scales were tipped towards the 'winners' with assets, those who lose big bets are not allowed to fail.

[xii] *Centre on Budget and Policy Priorities (2020). "A Guide to Statistics on Historical Trends in Income Inequality."* Note that real wages for US workers hardly increased since 1979, and the bulk of income gains since 2008 have accrued at the top end of the income distribution. Palley (2018) argues that one solution may be directly conditioning interest rate policy on real wage growth. Compared to standard rules that respond to price deflation, implementing a wage growth rule would also respond to nominal wage deflation.

[xiii] *Thomas Piketty (2019). "Capital and Ideology."* Piketty argues that the roots of inequality are not an economic inevitability, but rather ideological and political in nature, reflecting a set of ideas on how society should be structured. A defining driver of our 'hypercapitalism' is unlimited international capital mobility – including the ability to evade regulation and national taxation- with simultaneous concerted efforts to undermine the 'inefficiencies' of organized labour.

[xiv] Note that in the month following the global coronavirus outbreak, US billionaires saw an increase of $283 billion to their wealth, according to the Institute for Policy Studies. Since then, Americans for Tax Fairness released a subsequent report, noting an increase of $434 billion.

[xv] Restrictions should also restrict public support from those who engage in significant stock-buybacks or payouts of dividends. This should apply to all forms of support, including both loans and equity injections.

[xvi] *World Bank (2019). "The Changing Nature of Work."* It should be noted that universal basic income allows for both social protection and necessary elasticity in labor markets to cope with shocks and future trends in automation.

[xvii] *Brandon Locke (2019) "The CFA Franc: Stabilizing Force or Neocolonial Relic." BIC.* Note that despite its stabilising effect, the key consequence of the CFA franc was the facilitation of West and Central African states' vertical integration into European economies, distorting horizontal interdependencies that would normally foster regional integration.

[xviii] OECD (2020). "Government support and the COVID-19 pandemic."