How to cite this paper:
Norbert F. Tofall, "China, the US, and Europe: Who Will Lead after the Coronavirus Crisis?" *Austrian Institute Paper* No. 33-EN (2020).

Austrian Institute Paper No. 33-EN / 2020

Norbert F. Tofall

China, the US, and Europe: Who Will Lead after the Coronavirus Crisis?

Long before the Coronavirus crisis, it was often claimed that China could soon become the new dominant world power, that the US would fall behind China, and that Europe and the European Union would be completely cut off geopolitically. And the global Coronavirus crisis now appears to be accelerating those exact economic and political processes that are sparking changes in international relations and in the world economy, creating the danger of de-globalization and a new bipolarity.[1]

It is Impossible to Predict the Future

But will these accelerated economic and political processes necessarily bring about the predicted changes? Or to put it differently: Are the "predicted" economic and political developments inevitable and irreversible from today's perspective? For if Karl R. Popper assumes that *first*, the course of human history is strongly influenced by the growth of human knowledge, but *second*, that the future growth of our scientific and human knowledge cannot be predicted with rational scientific methods, then *third*, we cannot predict the future course of human history and economic development.[2]

Since economic processes specifically represent knowledge-utilizing processes, and since political processes decisively shape the conditions under which economic processes successfully, unsuccessfully, inadequately, or insufficiently utilize unpredictable, dispersed, and non-centralizable knowledge, then both the institutional design of the economic and political spheres, and the institutional relationship between these same spheres are decisive for economic development.

The Global Fragility of the Financial System, whether in the US, Europe, or China

There is great uncertainty surrounding the question of how the economy and political realm will be shaped in China, the US, and Europe in the future. No one can predict with certainty when the fundamental contradiction

[1] See Norbert F. Tofall, "De-Globalisierung und neue Bipolarität? Wohin führt die strategische Rivalität zwischen China und den USA?" *Studie zu Wirtschaft und Politik des Flossbach von Storch Research Institute* (December 6, 2019), available online at: https://www.flossbachvonstorch-researchinstitute.com/de/studien/de-globalisierung-und-neue-bipolaritaet/

[2] Cf. Karl Popper, *The Poverty of Historicism*, 3rd ed. (New York: Routledge & Kegan Paul, 1961), preface.

between economic freedom and the lack of political and social freedom will erode into a systemic crisis in China and break the totalitarian dictatorship of the Chinese Communist Party. There is no timetable for all of China that can be deduced from the conflict over power and independence in Hong Kong. But a "peace of the graveyard" in Hong Kong, which is now being sought through new security laws in Beijing, and which is likely to be implemented by force, does not mean that the fundamental contradiction between economic freedom, on the one hand, and a lack of political and social freedom, on the other, cannot be resolved throughout China sooner or later. Whatever happens in the presidential elections in November, no one can say for sure how long the US will stick to a protectionist policy. And no one can say for sure how long the European Union will hold on to its course of debt-financed postponement of its problems, which have been further intensified by the Coronavirus crisis.

What China, the US, and the European Union have in common is that since the financial crisis of 2007/2008 they have attempted to generate economic growth through low interest rates and debt-financed government rescue programs. Low interest rates and debt-financed government rescue programs were seen everywhere as a recipe for economic growth. Nevertheless, a sustained investment boom was nowhere in sight, because the necessary structural adjustments and creative destruction were not permitted. Instead, the zombification of banks and companies was allowed, and a Japanization of the world economy was advanced.[3] The economic and political spheres in China, as well as in the US and Europe, were designed in such a way that the interest rate, and thus the most important price of any economy, could no longer fulfill its knowledge-utilizing function. Today, to combat the economic consequences of the Coronavirus crisis, even more comprehensive bond purchase programs are now being launched by central banks. The Fed has cut interest rates drastically. And the debt-financed government rescue and economic stimulus programs are even larger than during the financial crisis: even if China is currently showing conspicuous restraint in economic stimulus programs, unlike after the financial crisis of 2008.

The Ultra-Loose Monetary Policy of Recent Years Has Not Led to a Solution, but a Worsening of the Debt Problem

Even before the Coronavirus crisis, the International Monetary Fund stated in its Global Financial Stability Report of October 16, 2019 that the loose monetary policy practiced worldwide supported economic growth in the short term and limited downward risks. At the same time, however, the loose monetary policy led to more "financial risk-taking" and to the further accumulation of financial vulnerabilities, which would endanger economic growth in the medium term.[4] In other words, the risks to financial stability had already increased again in the year before the Coronavirus crisis, and our financial system had

[3] See Norbert F. Tofall, "Wer gewinnt bei einer Japanisierung der Weltwirtschaft? Die Nullzinspolitik führt zur Zombifizierung," in: *Frankfurter Allgemeine Zeitung* (November 2, 2015), Nr. 254, S. 20 . And with a focus on Germany, see Alexander Horn, *Die Zombiewirtschaft. Warum die Politik Innovationen behindert und die Unternehmen in Deutschland zu Wohlstandsbremsen geworden sind,* with contributions from Michael von Prollius and Phil Mullan, NOVO Volume 129 (Frankfurt am Main: NOVO Argumente, 2020).

[4] See International Monetary Fund, *Global Financial Stability Report October 2019: Lower for longer*, p. viii.

become even more fragile. As early as October 2018, the IMF stated that the medium-term risks to financial stability were still high, that the debt of the non-financial sector in countries with systemically relevant financial sectors had reached an all-time high of 250 percent of gross domestic product, and that debt was rising faster than economic growth.[5] And as early as October of 2017 the IMF wrote:

> Leverage in the nonfinancial sector has increased since 2006 in many G20 economies and easy financing conditions. While this has helped facilitate the recovery in aggregate demand, it has also made the nonfinancial sector more sensitive to changes in interest rates. Private sector debt service burdens have increased in several major economies as leverage has risen, despite declining borrowing costs. Debt servicing pressure could mount further if leverage continues to grow and could lead to greater credit risk in the financial system.[6]

Two years later, the IMF showed in its financial stability report that the "debt servicing pressure" had not decreased. The three main risks of the global financial system are *first*, rising corporate debt burdens, *second*, a growing amount of risky and more illiquid assets held by institutional investors, and *third*, emerging markets becoming more dependent on foreign borrowing.[7]

All these risks are now likely to have greatly increased once again as a result of the ultra-loose monetary policy in China, the US, and Europe: policy which has been expanded to deal with the Coronavirus crisis and the gigantic debt-financed government rescue programs. Debt levels are likely to reach new highs worldwide.

China: Eliminating Market Forces and a Policy of Repressing Information

In order to bear the new record-high debts to manage the Coronavirus crisis to some extent, interest rates must be kept low by the central bank and by the state for the foreseeable future, and *ceteris paribus*—i.e., if debt relief and currency reforms fail to materialize—even indefinitely. However, without an interest rate that can freely emerge in the market, the market economy will be increasingly undermined, even in the US and Europe. The financial repression of recent years will expand tremendously. For the sake of systemic debt management, the economic and political spheres in China, as well as in the US and Europe, will increasingly focus on maintaining structures and securing the status quo. In China, the US, and Europe, the market is allowed to do its work when the economy is on the upswing. However, the market is systematically eliminated when the economy is going downhill. The most important task of the market, i.e., to carry out economic adjustments, is impeded.

In China, for example, real estate prices are simply not allowed to collapse, because the debt-financed real estate financing for many millions of Chinese people is geared toward ever-rising real estate prices, and is likely to collapse when real estate prices fall. However, suppressing volatility, economic adjustments, and "creative destruction" only eliminate the visible signs of risks around the world and in China, but they do not reduce the risks as such. On the contrary, beneath the surface, hidden risks continue to accumulate and increase the fragility of the economic and financial system. Unlike in the US and Europe, however, the totalitarian one-party dictatorship of China has

[5] Cf. International Monetary Fund, *Global Financial Stability Report October 2018: A Decade after the Global Financial Crisis: Are we Safer?*, viii.

[6] *Global Financial Stability Report October* 2017, p. 32.

[7] See International Monetary Fund, *Global Financial Stability Report October 2019: Lower for longer,* ix.

far-reaching possibilities for "social control" to prohibit and suppress already potentially bad news or analysis that questions, for example, the real estate prices, so that a process of public and critical questioning of the relationship between supply and demand is torpedoed from the outset.

The Coronavirus Crisis—An Unintended Side Effect of Totalitarian Power

The fact that such suppression of bad news through state repression often has fatal economic consequences is evident today in the Coronavirus crisis. Doctors in China who had already pointed out the spread of a new lung disease and a possible new coronavirus in the fall were silenced by state repression and, if deemed necessary, removed. This systematic state repression of bad news in China ultimately triggered a global economic crisis. Only when the spread of the new coronavirus became undeniable did the Chinese leadership take a 180-degree turn.

However, due to its totalitarian repressive apparatus, China's one-party totalitarian dictatorship is in a position to cloud even this connection and to pretend before the masses (and not just those in China) that China is more successful than the decadent West in fighting the new Coronavirus, and that the Chinese system is superior to the Western one. This may even be true for the actual fight against the Coronavirus because of the almost unlimited possibilities of a totalitarian repression apparatus. But for this very reason it cannot be said often enough: The systematic suppression of bad news through state repression in China has triggered a global economic crisis. It has not reduced the health risks, and consequently the economic risks, but has only suppressed their visibility and prevented them from being combated in time.

It seems that anyone who seriously claims that this cannot be repeated in other areas, such as the real estate market, has already become a victim of Chinese propaganda. The contradiction between economic freedom, on the one hand, and the lack of political and social freedom, on the other, has produced very real negative practical economic consequences the world over. The Chinese system has caused these global economic costs, although it can be conceded that this was unintentional. It is by no means claimed here that the Chinese leadership deliberately introduced the Coronavirus to economically cripple the West. The cause of the world economic crisis triggered by the suppression of bad news is primarily not an intentional problem but a systemic one. But precisely for this reason it is completely absurd to speak of the superiority of the Chinese system.

"Westlessness" and the New Protectionism: Has the West Lost Sight of Its Liberal Foundations?

This does not mean, however, that the United States and Europe are currently successfully defending their own economic and social systems, or that they have even come close to winning the "battle" with China. The Western societies even seem to have lost sight of the liberal foundations of their own economic and social order (keyword "Westlessness") and thus their compass and blueprint for joint solutions to their problems. Instead of the West responding to the Chinese challenge in a closed and thoughtful manner by building countervailing power, so that China is increasingly pushed into a position where it has to recognize the same rights for everyone in world trade and international relations, U.S. President Donald Trump believes that he can bring China to its knees all by himself, without Europe.

Trump's protective tariff furor is also directed against the EU. As a result, this policy leads to a disintegration of counter-power potential. Setting to a side the fact that Trump will not solve the economic problems of the US economy through protective tariffs, but will continue to delay them, the suspension of the TTIP negotiations between the US and Europe, and Trump's refusal to sign the Pacific Free Trade Agreement, has virtually cleared the way for China to gain increasing geopolitical space and weight. TTIP and TPP, however, would have been effective geopolitical measures to build countervailing power against China. Unfortunately, the transatlantic relations between the United States and Europe currently seem to be missing a political will to build a joint countervailing power for the West. However, without a common Western countervailing power, neither the Chinese issue nor other problems in international relations are likely to be solved. In a pandemic like the Coronavirus crisis, all US presidents since World War II would have immediately put themselves at the head of the West without hesitation, so that the Western societies under American leadership could jointly overcome the global challenges of this crisis to their mutual advantage. Not so for Donald Trump.

However, since not only Trump, but also large sections of the Democratic Party in the United States want to protect the American economy through protectionist measures, prevent the rise of China, and preserve US technological leadership over China, the option of a targeted economic disengagement with China could become entrenched in the US on a broad political front regardless of the outcome of the November 2020 elections. Even before the Coronavirus crisis, it was already clear that the technological basis of the US should be protected by more than just intensifying action against Chinese industrial espionage. In addition, Chinese investments in the US are being reviewed and increasingly restricted by the Committee on Foreign Investment, and the Foreign Investment Risk Review Modernization Act of 2018 has expanded such reviews to include, in particular, critical technologies. Moreover, measures are being taken to specifically slow down technological innovation in China, which means that economic transactions with Chinese companies will be specifically restricted and export controls tightened. The Export Control Reform Act put export restrictions into effect on newly developed and innovative technologies, restrictions that were not covered by previous controls. The transfer of knowledge by Chinese students and scientists working in sensitive research areas in the US is also reduced through restricting the granting of visas and refusing to grant visas to Chinese scientists with any relations to Chinese intelligence agencies.[8]

De-Globalization: The New Protectionism and the Possibility of Global Disentanglement

Even now, China is likely to have a great interest in further reducing its technological and economic dependencies simply because of the measures that the United States has already taken. China could also strive for and push for the economic disentanglement of its sphere of influence from that of the United States. The de-globalization of the world economy and the formation of two limited orders could be the result. Through such a development, the respective allies of the two poles would presumably be forced to abandon their economic interdependence with the other side and its allies.

[8] Cf. Peter Rudolf: "Der amerikanisch-chinesische Weltkonflikt," *Stiftung Wissenschaft und Politik*, *SWP-Studie* 23 (Berlin: October 2019), 30–1.

As the dispute over the nuclear agreement with Iran exemplifies, the United States knows how to use its existing export control system and sanctions laws to prevent European companies from trading with Iran. Should European companies be forced by these levers to choose either the US or the Chinese market, this would have serious consequences for European companies that are present in both markets, or have even organized their supply chains across both markets jointly. This danger alone is likely to be the reason why European companies are already cutting back their production capacities in and withdrawing from China.

Due to the current global economic interdependence and the structure of global markets, the European Union cannot disengage itself from the geopolitical conflict between China and the US, a conflict conducted by geo-economic means. In its current economic and political constitution, however, the European Union cannot decisively influence the American-Chinese conflict either.[9] And it is already foreseeable that with the New Silk Road project, China wants to make some of the southern EU countries dependent on itself and thus take China's side.

An Alternative Strategy for Europe: Salutary Debt Relief, a Consistent Market Economy, and Free Trade

On the other hand, the current geopolitical and geo-economic situation certainly provides the European Union with a strategic option that could allow it to survive in the geopolitical and geo-economic struggle of the world powers: Ending the economic and monetary policy problems of the last 10 years. Painful economic adjustment processes would be allowed. The euro would no longer be misused for monetary state financing. The EU would allow the logic of the market to work both within the EU and in its external relations, so that prosperity can once again be created for everyone. In short, the EU would act consistently at all levels according to the principles of market economy and free trade.[10]

However, this strategic option for the EU only has a chance of being taken up by EU governments if the Eurozone is first relieved of its debts. And only if the Eurozone is debt-relieved after the Coronavirus crisis will it be politically feasible for interest rates to emerge freely on the market in Europe. The zombification of banks and companies could be stopped, and new growth and investment opportunities could arise. However, without an interest rate that freely emerges in the market, the market economy will be undermined in more and more areas of the economy and degenerate into a politically controlled state economy. Property rights will be increasingly restricted and regulated by the state, so that there will be less and less talk of ownership of the means of production. The financial repression of recent years will be greatly expanded. The European Union will be crushed in the geopolitical struggle between China and the United States because of the economic weakness that will result from all this. Even in its current economic state, the EU cannot significantly influence the geopolitical conflict between China and the US. The debt relief of the Eurozone and the resulting economic recovery could change all this.

Since the gradual debt relief of the Eurozone, as aimed at by the rules of the European Fiscal

[9] See Norbert F. Tofall: "Zur ökonomischen und politischen Lage der Europäischen Union," in *Studie zu Wirtschaft und Politik des Flossbach von Storch Research Institute* (July 30, 2019), 3-4; available online at: https://www.flossbachvonstorch-researchinstitute.com/de/studien/zur-oekonomischen-und-politischen-lage-der-europaeischen-union/

[10] Ibid., 11.

Pact, had already failed before the Coronavirus crisis, only a debt relief of the Eurozone in a single step would be successful after the Coronavirus crisis. This one step should consist of three elements to be implemented simultaneously. Following the so-called Chicago Plan of 1933[11] the ECB should, *first*, take the national debt of the euro countries onto its balance sheet and, *second*, provide the citizens of the Eurozone with secure bank deposits fully backed with central bank money, as well as create a digital euro as a sovereign currency,[12] something made more difficult by the political manipulation of interest rates. *Third*, through the admission of competing private currencies[13] "market-based pressure to emigrate" is to be established and expanded, thus stabilizing the euro through the practical possibility of emigrating from it.[14]

A Concrete Strategy for Debt Relief and Thus for Strengthening the Eurozone

If one considers that the European Central Bank with its bond purchase programs has *de facto* been on the path to taking on the national debt of the euro countries for some time now, then the approach outlined above appears anything but utopian. The other elements of the outlined plan serve to ensure that the transition to a market-based monetary order is initiated, and that after the onetime step of reducing the Eurozone's debt, the previous game does not start again. By creating a secure bank deposit, banks, like all other companies in a market economy, can also go bankrupt, because the secure deposit backed by 100 percent central bank money does not disappear in the event of a bank going bankrupt. All the customer has to do is inform the settlement authority of the name of another bank to which the safe deposit will be transferred. The purpose of a digital sovereign euro is to expand the money supply by means of a rule laid down in an algorithm—for example, potential growth of the economy as defined by Milton Friedman—and not on the basis of political opportunity. And the admission of competing private currencies such as crypto-currencies allows for a flexible total money supply; on the other hand, as a market-economy debt brake, it also prevents the euro from being '*Lira*-cized' in a targeted way, because citizens could migrate away from the euro if that were to happen.

Debt relief for the Eurozone after the Coronavirus crisis would promote the economic

[11] See Irving Fisher: *100% Money and the Public Debt*, Economic Forum April-June 1936, pp. 406-420; see also Jaromir Benes and Michael Kumhof: "The Chicago Plan Revisited," *IMF-Working Paper*, WP/12/202 (August 2012). Among the proponents of a 100% reserve requirement for commercial banks were Irving Fisher and Milton Friedman: see Milton Friedman: *A Program for Monetary Stability, Vol. 3: The Millar Lectures* (New York: Fordham University Press, 1961).

[12] See Thomas Mayer, "Ein digitaler Euro zur Rettung der EWU," *Studie des Flossbach von Storch Research Institute* (October 24, 2019), available online at: https://www.flossbachvonstorch-researchinstitute.com/de/studien/ein-digitaler-euro-zur-rettung-der-ewu/

[13] See Friedrich A. von Hayek, *Denationalization of Money: An Analysis of the Theory and Practice of Concurrent Currencies*, Hobart Paper Special, 70 (London: The Institute of Economic Affairs, 1976).

[14] See above Frank Schäffler and Norbert F. Tofall: "Euro-Stabilität durch konkurrierende Privatwährungen," in: Dirk Meyer (Hg.): *Die Zukunft der Währungsunion. Chancen und Risiken des Euros,* mit Beiträgen von Helmut Schmidt, Václav Klaus, Arnulf Baring, Roland Vaubel, Wolf Schäfer, Hans-Olaf Henkel, Charles B. Blankart und anderen (Berlin: LIT, 2012), 275 – 288; see also Norbert F. Tofall: "Währungsverfassungsfragen sind Freiheitsfragen. Mit Kryptowährungen zu einer marktwirtschaftlichen Geldordnung?" *Studie zu Wirtschaft und Politik des Flossbach von Storch Research Institute* (January 15, 2018), available online at: https://www.flossbachvonstorch-researchinstitute.com/de/studien/waehrungsverfassungsfragen-sind-freiheitsfragen/

recovery of the Eurozone and the entire EU, so that the EU would become more formidable in transatlantic relations with the US. An alliance between the US and the EU to build countervailing power against China in order to force China to observe the same law as everyone else in world trade and international relations would then be attractive to the US. In addition, debt relief of the Eurozone after the Coronavirus crisis could trigger a salutary compulsion to imitate it in the US.

At this point at the latest, it would be questionable whether China would really become the new dominant world power, whether the US would fall behind China, or whether Europe and the EU would be completely defeated geopolitically. The defeat of "Westlessness," and the common defense of the liberal foundations of Western societies could still, however, be effectively promoted through debt relief after the Coronavirus crisis. The Western governments must, however, dare to destroy their self-inflicted debt traps. The prospect of regaining active and potential competitiveness through debt relief after the Coronavirus crisis should be incentive enough to do it. ■

This is a slightly revised version of a text originally published by the Flossbach von Storch Research Institute on May 26, 2020: https://www.flossbachvonstorch-researchinstitute.com/de/kommentare/china-usa-europa-wer-fuehrt-nach-der-corona-krise/.

Translation from German by Thomas and Kira Howes.

About the author:

Norbert Friedrich Tofall is Senior Research Analyst at the Flossbach von Storch Research Institute, where he has been since 2014. There he works in the area of macroeconomic analysis with a focus on "Economics, Politics and Philosophy." He has been working on the subject of private and cryptocurrencies for many years. Shortly after the financial crisis in June 2009, together with Thorsten Polleit, Michael von Prollius and Frank Schäffler, he brought Friedrich August von Hayek's private currency approach back into the public debate in the FAZ article "Overcoming the crisis with good money" („*Überwindung der Krise durch gutes Geld*").

Norbert F. Tofall was a research assistant to Frank Schäffler, member of the German Bundestag from 2008 to 2013. From 2004 to 2011 he was a lecturer for the course "Justice and Freedom in Europe" at the Europa Universität Viadrina Frankfurt/Oder in the Master's program in International Management. Norbert Tofall is also a member of the Federal Government's Expert Pool for International Peace Operations and has participated in various OSCE election observations as an international election observer. He has also studied business administration and philosophy at the Universities of Paderborn and Tübingen.

Norbert Tofall has been a member of the Friedrich A. von Hayek Society since 2002 and has served on the Board of the Friedrich August von Hayek Foundation since 2015. He is initiator and founding member of the Lord Acton Circle. From 2015 to 2017 he was Vice President of the Austrian Institute of Economics and Social Philosophy in Vienna.

How to cite this paper:

Norbert F. Tofall, "China, the US, and Europe: Who Will Lead after the Coronavirus Crisis?" *Austrian Institute Paper* No. 33-EN (2020).

Original version (online) and Download of the Working Paper:

https://austrian-institute.org/en/blog/china-the-us-and-europe-who-will-lead-after-the-coronavirus-crisis