Long-term consequences of the 2020 coronavirus pandemics: Historical global-macro context

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Abstract
The COVID-19 pandemics is likely to accelerate the trends of de-globalization and de-dollarization. Over the long term, the major financial consequence is likely to be the accelerated trend of rising inflation and long-term interest rates. More broadly, the post-pandemic environment will likely encompass difficult longer-term economic and geopolitical challenges. Alternatively, the COVID-19 pandemics also creates an opportunity for building a new trend of more sustainable globalization.

KEYWORDS
COVID-19, economy, long term consequences

1 | INTRODUCTION

In response to the outbreak of COVID-19 (novel coronavirus) in January 2020, the governments of the 210 affected countries implemented the various levels of social-distancing policies and stay-home orders to stop the spread of the virus—essentially shutting down the global economy. Additionally, the policymakers in large countries, led by the United States and the Europe, passed the extraordinary mix of fiscal and monetary measures to ensure that the period of “lockdown” is effectively bridged to minimize the effects of the sudden economic-stop on social stability and the financial markets until they return to normalcy.

As of early May, many countries had begun to gradually reopen their economies, as the social distancing measures were effective in slowing the spread of the virus—flattening of the curve. Similarly, the stock markets strongly rebounded from the lows reached at the “peak of the infection curve” in anticipation of a gradual return to normalcy, with the embedded prediction that the global economy would likely strongly rebound in the third quarter of 2020 (Q3), after the sharp and short recession in the first two quarters of 2020 (Q1 and Q2)—the V-shape recovery. More importantly, the key assumption seems to be that there would not be any major consequences of the COVID-19 pandemic over the longer term.

The “V-shape” recovery scenario, thus, assumes that: (a) the pandemic would be short-lived, 3 months; (b) the policy mix would effectively bridge the “lock-down” period and prevent the financial crisis, and (c) the global economy would return to normalcy (or the pre-pandemics state) after the pandemics are finished. The “U-shape” recovery case recognizes the potential that the pandemics could last longer and that additional stimulus would be required to bridge the crisis, but the economy would eventually return to normalcy as the virus eventually disappears.

The assumption that the COVID-19 virus would eventually disappear is reasonable, as the vaccine is likely to be eventually developed. Further, the assumption that the policy mix will effectively bridge the economic crisis period is also reasonable, given the Fed’s ability to implement an infinite money-printing press via quantitative easing (QE) in tandem with the fiscal debt monetarization. However, it is highly questionable and uncertain whether the global economy would return to the pre-virus state or “normalcy” after the virus disappears. The “L case” scenario predicts that the COVID-19 pandemics will have significant longer-term negative geopolitical and economic effects and rejects the return
to normalcy assumption after pandemics is finished—essentially the economy would not recover from the pandemics shock.

The purpose of this article to (a) explain the pre-pandemic geopolitical and economic state within the historical context, (b) critically discuss the longer-term consequences on the COVID-19 pandemics, or the likely post-pandemic geopolitical and economic state, and (c) discuss the implications with respect to the V-shaped, the U-shaped, or the L-shaped economic recovery.

2 | PRE-PANDEMICS ENVIRONMENT: HISTORICAL GLOBAL-MACRO CONTEXT

The discussion of the pre-pandemics environment, within the historical global-macro context, starts with the World War I period, which coincidently includes the last pandemics—the Spanish Flu of 1918. This article points to key historical events, which are necessary to understand the pre-pandemics state—or “the normalcy” that should be waiting at the end of the tunnel.

Before the World War I, the geopolitical scene was dominated by the Empires—the Ottoman Empire, the Russian pan-Slavic Empire, the Prussian Empire, and so forth. After the World War I, the pre-war Empires collapsed and the United States emerged as the dominant global power. Similarly, the US dollar emerged as a global reserve currency—backed by Gold. In the mid-1920s, other key European countries also joined the Gold standard. However, Germany experienced hyperinflation due to the extraordinary money printing-press to cover the war repatriation costs.

The post-World War I period, or the roaring 1920s, was the first wave of globalization, characterized with the post-war recovery and infrastructure spending in Europe, technological innovations, US economic and geopolitical dominance, but also toward the end of the decade with the financial speculation which eventually led to the stock market crash of 1929 and the great depression.

As the great depression took hold of the US economy in the early 1930s, the Fed was initially unable to engage in the money-printing press or significant monetary stimulus, given that the value of the US dollar was pegged to Gold. Eventually, the US devalued the US dollar versus gold, which ended the gold standard, and implemented a significant monetary and fiscal stimulus. However, the US dollar devaluation also started the wave of global competitive currency devaluations, beggar-thy-neighbor policies, and general protectionism and populism, essentially ending the first wave of globalization. These combined policies eventually led to World War II.

After World-War II, the global community decisively engaged in creating the new World order, and the second wave of globalization, with the specific purpose to (a) prevent another Great Depression, and (b) prevent another global war. First, at the Breton-Woods conference, the US dollar regained the status of the global reserve currency, directly convertible to gold at fixed price $35/oz, while other currencies were pegged to US dollar—directly addressing the issue of competitive devaluations. Second, financial institutions such as World Bank, IMF were established to distribute US dollars globally via loans to support the global post-war recovery, ensuring a heavy global demand for US dollars. Third, the Coal and Steel Community planted the seeds of the European Union, which would ensure the geopolitical stability in Europe. However, the bi-polar World emerged as the Soviet-bloc embraced a different system based on the communist principles, which eventually led to the Cold War and several proxy wars between the West and the East, such as the Vietnam War that started in the mid-1960s.

The Vietnam War ended the post-World War II rebuilding recovery and economic boom. The United States was forced to abandon the US dollar-gold peg in the early 1970s as the Vietnam War demanded more military spending, in addition to the domestic social program spending needs. As a result, the United States experienced several inflationary recessions. The US dollar significantly depreciated, and it was losing the status of the reserve currency as other nations questioned the US ability to control inflation, and grasp the consequences of the US dollar as a fiat currency—not being backed by gold.

However, the United States and Saudi Arabia entered the oil-for-security agreement in the mid-1970s, by which Saudi Arabia (and OPEC) agreed to sell crude oil internationally exclusively in US dollars, while the US agreed to protect to ensure the security Saudi Arabia and in the region. This agreement essentially re-established the US dollar as the global reserve currency, as all nations had to have the US dollars to pay for oil and other commodities. As a result, the US regained the ability to print an unlimited amount of US dollars, which supported its’ military spending and eventually led to the Cold War victory, as the Soviet-bloc collapsed bankrupt in the late 1980s.

During the 1980s, the US policy of neoliberalism aimed to expand the reach of capitalism to Latin American, Asia, and later Eastern Europe. During this period, the process of outsourcing emerged, as the US companies started to move manufacturing to emerge markets, and expand the markets for US products globally. Thus, the US companies were able to increase international sales and lower the costs of production, resulting in higher profits and soaring stock market prices during the 1990s, also supported by technological innovations—a period similar to the 1920s.
However, the terrorist attacks on 9/11 (2001) caused to the first major obstacle to the US-led globalization. The US aimed to protect the globalization by engaging in “export-led” recovery, aiming to boost the economic growth in emerging markets, with significant engagement from China, which was admitted to the World Trade Organization in December 2001.

Additionally, the US started to experiment with the extraordinary monetary stimulus to boost the domestic economy, which eventually resulted in the housing bubble and the Great Financial Crisis of 2008.

Moreover, the United States also responded to the 2008 recession with the extreme monetary stimulus, which boosted the asset prices post-recession, but failed to increase the standard of living of the poor and the middle-class, which resulted in a significant wealth-gap and consequent the rise in populism globally.

As a result, the globalization trend which commenced post-World-War II started to reverse, first with the Brexit, and second, with the election of right-leaning US president Trump. Thus, the new trend of de-globalization has begun to unfold, promoting the America-first policies, questioning the stability of the European Union, and especially the role of China in the global economy.

Since joining the World Trade Organization in 2001, China has become the second-largest economy in the World, after the US, with a significant increase in geopolitical power. In fact, China has started to create its own economic and geopolitical bloc via the Belt and Road Program, with financial institutions parallel to the World Bank. The global COVID-19 crisis started in Wuhan, China in January 2020 (or earlier).

So, what is the pre-pandemics situation or the “normalcy” that the economy needs to return to fully recover?

• De-globalization: Taking the broad macro view, the global geopolitical situation has been resembling a Cold War II, with a clear division between the China-bloc affiliated countries such as North Korea, Iran, Venezuela, and Russia, and the US-bloc. The European Union has been facing internal issues with the rise of populism and nationalism, and the inability to fully develop into the political union. The US-China trade war seems to be only the fraction of a bigger issue with respect to the general rise in Chinese geopolitical and economical influence directly challenging the US dominance as the sole global super-power.

• De-dollarization: The key lesson throughout the history is that a country has to be able to increase the money supply without hyperinflation. Thus, given that the US dollar has been the global reserve currency, the United States has been able to print infinite amounts of US dollars to support the military spending, and to backstop financial crisis via monetary stimulus. In addition, the United States has been using the US dollar based system to enforce the foreign policy by imposing sanctions on nations such as North Korea, Iran, Venezuela, and even Turkey. Thus, as the key part of the de-globalization efforts, the China-bloc has been aiming to reduce the reliance on US dollars in international trade using the Euro or even domestic currencies in international transactions. Even though the US dollar remains the most widely used currency in international transactions, the gradual trend of de-dollarization has been forming in recent years.

• Financial bubbles: The US economy rebounded post 9/11 and after the 2001–2002 recession by inflating the housing bubble due to the Fed’s policy of lowering the interest rates to 1%, which resulted in the Great Financial Crisis and the Great Recession of 2008. The US economy rebounded from the 2008 recession due to the several rounds of the Fed’s quantitative easing monetary stimulus, which included holding the interest rates at near 0% for extended time. These alternative monetary policy tools re-inflated the housing market, and also inflated the stock market. The global stock markets (in Europe and Emerging Markets) never reached the 2008 highs, however, the US stock market charged higher well above the 2008 highs, also supported by the Trump’s precyclical fiscal stimulus. At the height of the US stock market peak just before the pandemics in February 2020, the cyclically adjusted PE-10 ratio for S&P500 was around 33, which is well above the 1929 level of 30, and second only to the madness valuations during the dot-com bubble of 2000. The average PE ratio is around 16. Thus, the US stock market was arguably in the bubble right before the pandemics hit in February 2020, possibly 100% overvalued compared to the average market multiple.

3 | LONGER-TERM IMPACT OF THE COVID-19 PANDEMICS

What are the longer-term effects of the severe shock caused by the COVID-19, as related to the pre-pandemics environment? Specifically, what are the effects of the pandemics on the unfolding trends of de-globalization and de-dollarization?

As previously stated it’s important to place the current environment within the historical global macro context. Historically, we observe the pattern of War—Post War Recovery—Financial Crisis—New War. The pre-pandemic state can be classified as the Financial Crisis mode, similarly to the 1930s, whereby the mix of monetary and fiscal policies reflated the financial assets post-2008 Great
Financial Crisis, but failed to improve the real economy and thus, created a large wealth gap and consequently a wave of populism.

More broadly, the interest rate on a 10-year US Treasury Bond reflects the global economic model in recent history (Exhibit 1). First, it shows the inflationary crisis from the late 1960s to the early 1980s, reflected in the trend of rising interest rates. Second, it shows the trend of falling inflation and interest rates since the early 1980s, which effectively ended as the pandemics emerged in 2020 with the interest rate hitting the near 0% lower level bound.

The trend on falling interest rates reflected the wave of accelerating globalization that started in the early 1980s with neoliberalism, and the more inclusive model of global economic and political order. Specifically, the global economy operated in a system where emerging markets, led by China, were the low-cost manufacturing engine, while the United States was a primary consumer of globally produced goods. Geopolitically, the US dollar was anchored as a reserve currency, which ensured heavy global demand for US Treasury Bonds, as the global trade surpluses with the US were recycled directly into the US Treasury Bonds. The net result was falling inflation as well as falling real interest rates.

The downtrend in interest rates in more recent history also reflects the fact that the global manufacturing base, led by China, was increasingly able to produce over demand—the oversupply problem, as the capacity and productivity increased, casing the disinflationary effect, evident since 2012 with extra-low interest rates.

3.1 | De-globalization

The COVID-19 pandemics is likely to accelerate the trend of de-globalization. The virus originated in China, and based on current information, China was not as transparent about the virus in the early stages of contagion. Thus, it is likely that the global community will be more guarded in the future with respect to China, and it is possible that some countries could request some form of repatriation of costs associated with the virus.

Furthermore, the global supply chains will likely be redirected from China in an accelerated trend, for diversification and risk-management. Some industries such as medical equipment and accessories, pharmaceuticals, basic foods, and critical technologies will become the issue of national security, and nations will aim to become self-sufficient in these industries as much as possible, thus reducing the global trade. Essentially, the reversal of the global economic model based on outsourcing (as implemented in the early 1980s) will accelerate due to COVID-19 pandemics, which will be reflected in rising inflation and rising interest rates, as shown in Exhibit 1. China will accelerate the development of the new markets via the programs such as Belt and Road, which will accelerate the creation of the new bipolar world, and potentially accelerate the Cold War II, as previously described. This would be consistent with the historical pattern of War—Post War Recovery—Financial Crisis—New War.

3.2 | De-dollarization

The process of accelerated de-globalization is also likely to accelerate de-dollarization. China is likely to demand the increased use of the Chinese Yuan with its trading partners. The Euro is at the key crossroads. The COVID-19 will either break the EU or make it progress to a political union and strengthen the use of the Euro as a global reserve currency. If the EU countries show solidarity and issue Eurobonds (or the common debt) to help the EU countries most affected by the COVID-19, it is likely that the progression to the political union would accelerate, which would create a stronger Euro and a real challenge to the global reserve status of the US dollar. The key
aspect of de-dollarization will be the reduced ability of the US to increase the money supply without experiencing inflation, as many historical lessons show. The accelerated process of de-dollarization will, thus, contribute to the rising US inflation and interest rates (Exhibit 1), as the global demand for the US dollar decreases.

3.3  |  Monetary policy and financial bubbles

The COVID-19 crisis has also revealed three key observations about the Federal Reserve: (a) the Fed is essentially able to engage in an unlimited money-printing press, as shown in Exhibit 2; (b) the Fed is not really as independent as previously thought, and in time of crisis it's really just a tool of the Treasury Department; and (c) the Fed can buy assets such as high-yield junk bonds. Thus, the COVID-19 crisis blurred the lines between the Treasury Department and the Federal Reserve, and it is likely that in the future the line will remain blurred. Thus, the ideas related to Modern Monetary Policy, whereby the government can engage in a limited budget deficit (financed by the Fed) to reach and maintain the full employment and finance programs such as free healthcare and education, will only gain traction in the future. In addition, the financial markets will continue to experience the bubble-bust periods. Nevertheless, the evolved role of the Federal Reserve will also add to the expected longer-term rising inflationary trend (Exhibit 1), especially when combined with de-dollarization.

3.4  |  Practical implications

The V-shape economic recovery post the Great Lockdown due COVID-19 assumes the return to normalcy, or the pre-COVID-19 environment. However, the pre-COVID-19 environment encompassed the gradual trends of de-globalization and de-dollarization, masked by the US stock market bubble. Thus, it is not really desirable to return to such an environment. Unfortunately, the COVID-19 pandemic will only accelerate these trends. As a result, the new long-term trend of rising inflation and interest rates will likely commence and accelerate as the virus eventually disappears.

Over the short term, the COVID-19 is likely to expose the excesses in consumption based on credit, and many businesses will not be able to re-open, which will permanently increase the unemployment rate. The emerging markets with excess US dollar-denominated debt are likely to suffer major financial issues, which will only contribute to the trend of de-dollarization. The travel and leisure industries will not be able to return to the pre-pandemic state as long as the border remains closed, even if domestic restrictions are lifted. Oil-producing nations are likely to suffer a budgetary financial crisis as the demand for crude oil plummets due to restricted travel and reduced global trade. Finally, consumer confidence is likely to suffer and some consumption habits could permanently change (such as take-out dining, teleworking, and online-education) and overall savings rate could increase. Thus, even in the short term, until the effective vaccine is developed and the virus is completely eradicated, the economy will not be able to return to the pre-pandemic level. The longer the Great Lockdown lasts, even in less restricted mode, the more severe the long-term consequences.

Thus, over the short-term, it is unlikely that the economy would be able to accomplish the quick V-shape recovery, as embedded in the stock market prediction. Over the long term, the COVID-19 pandemic will accelerate the trends of de-globalization and de-dollarization, producing a highly uncertain geopolitical and economic future. Based on these observations, the L-shape economic recovery model is the most likely outcome, with the uncertain duration and depth of the “I” part of the “L.”

More broadly, within the global-macro historical context, we see the occurrence of the pattern: War—Post War Recovery—Financial Crisis—New War. The pre-pandemic state was still within the Financial Crisis mode, with the desperate mix of monetary and fiscal policies aiming to reflate the economy post-2008 recession, and even going back to the 2002 recession.

The question is whether this pattern will continue with the new war (other than Cold War II), as the part of the trend of accelerating de-globalization. Alternatively, the COVID-19 pandemic can be viewed as a war, and we could be entering a period of the post-COVID-19-war recovery, with the focus on sustainable infrastructure building and renewed global solidarity, which actually could create a completely new long-term trend of sustainable globalization. Let us hope for the latter.
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